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AUDITORS ROLE IN COMBATING BANK FRAUD: A CASE STUDY OF PUNJAB NATIONAL BANK SCAM

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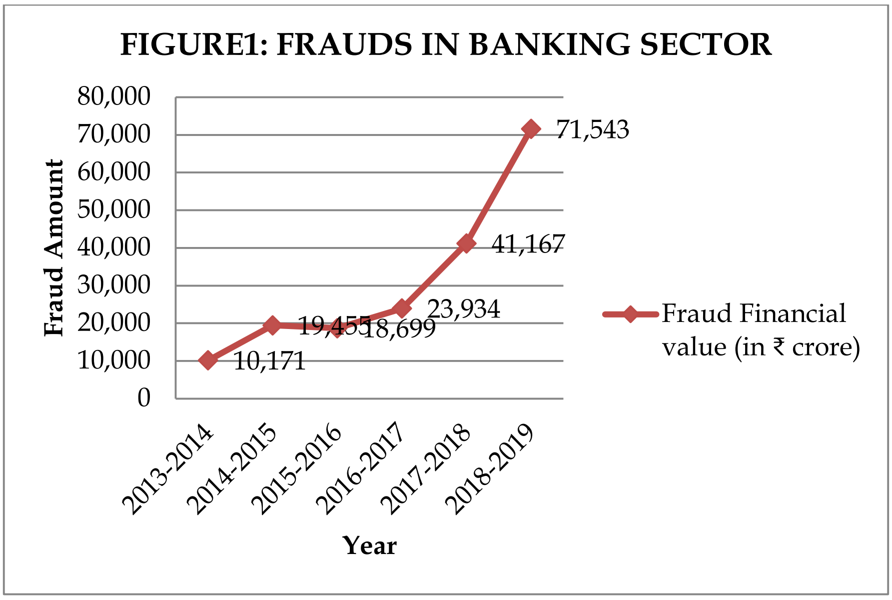
ABSTRACT

Indian economy is facing a major setback with rising numbers of cases of fraud in the banking sector. In the year 2017 Punjab National Bank (PNB) fraud disclosed that it was duped with whooping ₹14,356.84 crore (US$ 2.1 billion). The critical concerns relating to this fraud case was the quantum of fraud and associated modus operandi. This fraud case exposed the PNB's weak internal operations and control as the fraudsters succeeded to keep the matter under rags for more than 7 years. Auditors of Punjab National Bank are also under scanner because they failed to detect fraud of such huge magnitude which was being carried out for such a long period of time. A thoughtful analysis of the modus operandi of the Punjab National Bank (PNB) scam will help us identify the lacunae in the auditing process.

Keywords: Punjab National Bank (PNB), Audit, Bank Fraud

1. INTRODUCTION

According to ICAI's Standard on Auditing (SA 240) fraud is defined as, "an intentional act by one or more individuals among management, those charged with governance, employees and third parties, involving the use of deception to obtain an unjust and illegal advantage." Frauds are intentional activities undertaken by one or more individuals that are done in a dishonest and illegal manner and are designed to obtain an unjust or illegal advantage. Fraud in the banking sector is one of the most serious issues and cause of concern for all its stakeholders. Bank fraud is the exploitation of potentially illegal means to obtain funds and assets possessed by a financial institution, or to obtain funds from depositors by fraudulently posing as a bank or other financial institution. The magnitude of fraud detected and associated modus operandi poses a major challenge to the Indian banking sector.



Notes:

1 Refers to frauds of ₹ one lakh and above and above

2. The figures reported by banks and FIs are subject to change based on revisions filed by them

Source: RBI, REPORT ON TREND AND PROGRESS OF BANKING IN INDIA 2018-19

As per RBI report on banking sector (2017-18) the financial value of bank fraud soared to 72% in the year 2017-2018 from the previous year. As in the year, 2016-2017 amount of fraud was Rs. 23,934 crore and the year 2017-2018 was Rs. 41,167 crore and in year 2018-19 it reached Rs. 71,543 which was a leap of 74% even though there was no drastic change in incidences of fraud cases in both years. One of the reasons for such a significant rise in fraud financial value in 2017-18 was due to the unearthing of PNB fraud.

Table 1: FRAUDS IN BANKING SECTOR

Year	2013-2014	2014-2015	2015-2016	2016-2017	2017-2018	2018-2019
No. of fraud cases	4306	4639	4693	5076	5916	6801
Amount (in Cr.)	10,171	19,455	18,699	23,934	41,167	71,543

Notes:

1 Refers to frauds of ₹ one lakh and above and above and based on the date of reporting

2. The figures reported by banks and FIs are subject to change based on revisions filed by them

Source: RBI, REPORT ON TREND AND PROGRESS OF BANKING IN INDIA 2018-19

2. REVIEW OF LITERATURE

Bahl and Kaur (2018) did an empirical study to investigate the role of corporate governance in controlling the volume of frauds in the post-Punjab National fraud scenario. In their study, they found that the Internal Audit system to be one of the most important components of corporate governance to control raising the number of fraud cases in the corporate sector.

Gayathri and Mangaiyarkarasi (2018) in their study on PNB fraud laid unmonitored usage of SWIFT financial messaging responsible for the occurrence of fraud. They also pointed out that the bank's internal messaging system was weak and fragile.

Mangala and kumara (2017) studied the effectiveness of fraud detection and prevention methods used by the corporate sector. Their study suggests that expenditure on effective anti-fraud methods should not be viewed as an expense; instead, it must be considered as an investment as it saves from the potential losses due to fraud and damage to business stability, revenue and image.

Bhasin (2015) carried out empirical research on Indian Banking Industry in which he found out the fraud occurred due to poor employment practices and lack of effective employee training; usually over-burdened staff, weak internal control systems, and low compliance levels on the part of Bank Managers, Offices and Clerks.

Halbouni (2015) did an empirical study to investigate internal and external auditor perceptions regarding their responsibilities related to preventing, detecting, and reporting fraud. The results of empirical study demonstrated that the auditors perceived that it would have a negative effect on the users of accounting information if fraud has occurred.

Bhasin (2013) in their study on Satyam computer fraud advocated the implementation of ethics and corporate governance by corporate houses. Also suggested that forensic accounting procedure must be adopted by corporates to curtail the chances of fraud occurrence.

Sharma and Panigrahi (2012) in their paper advocated the application of data mining techniques for the detection of financial accounting fraud. They found out that data mining techniques like logistic models, neural networks, Bayesian belief network, and decision trees have been applied most extensively to detect and classify fraudulent data.

Mussa (2011) in his studied the modus operandi of the Central bank of Tanzania fraud case. This fraud case caused a national outcry and people at the highest position lost the trust of the public after the news of the fraud broke out.

3. AUDITING AND ASSURANCE SERVICE

The ICAI has defined Auditing as “Auditing is the independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon."

Auditors are appointed by the organisations to verify the legitimacy and reliability of the books of accounts recorded and the relevant documents preserved in order to support the transactions. After checking the books of accounts and relevant documents, the auditors are required to submit a report to the owners of the organisations. In this report, the auditors have to state as to whether the books of accounts maintained by the organisation give a true and fair picture of the financial activities of that organization, the auditors will report accordingly. The objective of an audit of financial statements is to enable an auditor to express an opinion on such financial statements. A financial audit has a basic objective of examining whether the accounts are true and fair. It has an incidental objective of detecting errors and frauds.

In the banking sector, there are four types of auditors namely Concurrent Auditor, Internal Auditor, Statutory Auditor and Auditors from the Reserve Bank of India. Also there is the Audit Committee, an integral part of the Firm's corporate governance.

FIGURE 2: TYPES OF AUDITOR

Concurrent Auditors- Concurrent Auditors are appointed to branches for a given business volume of branches. They are supposed to keep a check on a daily basis whether the branch authorities are following the guidelines issued by the Management.

Internal Auditors- Internal Auditors check whether there are any deviations from guidelines issued by the management classify them as Serious Irregularities, Irregularities/Deviations from Guidelines and Small procedural irregularities.

Statutory Auditors- Statutory Audit of banks is compulsory for Banks. Government of India, vide their letter No. F No. 1/14/2004-BOA dated 25/11/2014 issued by Ministry of Finance, Department of Financial Services, informed that the work of selection and appointment of Statutory Central Auditors (SCAs) and Statutory Branch Auditors (SBAs) is delegated to individual Banks and has granted managerial autonomy to Public Sector Banks (PSBs) in this matter. Statutory Auditors prepares and presents an auditor's report. In this the Auditor's opinion is stated regarding the company financial statement giving a true and fair representation of their financial position and affairs.

Auditors from the Reserve Bank of India- verify whether the bank/branches are following the guidelines given by the Reserve Bank of India from time to time. Auditors of the Reserve Bank of India visit bank branches to verify the records of branches of a bank at periodical intervals.

An audit committee is a committee constituted as per Section 177 of the Companies Act,2013 and Rule 6 and 7 of Companies (Meetings of Board and its Powers) Rules,2014 in which of bank's board of directors takes responsibility for oversight of the financial reporting process, selection of the independent auditor, and receipt of audit results both internal and external.

4. PUNJAB NATIONAL BANK'S (PNB) BRIEF PROFILE:

PNB is the second-largest state-owned bank in India. Punjab National Bank is an Indian multinational banking and financial services company. The bank was founded in 1894 having a brand image of 122 years of performance. As of 31 March 2019, the bank has over 110 million customers, 7001 branches and 10681 ATMs across 764 cities. PNB has a banking subsidiary in the UK (PNB International Bank, with seven branches in the UK), as well as branches in Hong Kong, Kowloon, Dubai, and Kabul. It has representative offices in Almaty (Kazakhstan), Dubai (United Arab Emirates), Shanghai (China), Oslo(Norway), and Sydney (Australia). In Bhutan, it owns 51% of Druk PNB Bank, which has five branches. In Nepal, PNB owns 20% of Everest Bank Limited, which has 50 branches. Lastly, PNB owns 84% of JSC (SB) PNB Bank in Kazakhstan, which has four branches.

Before unearthing of the fraud PNB financial performance was soaring with its share price hovering around Rs. 185 on January 2018 and was better than many of its peers also it was conferred second time with the prestigious "Corporate Vigilance Excellence award" from Institutes of public enterprise for two years in a row which was organized by Vigilance Officers conclave of vigilance professionals of Public sector enterprises on 13th March 2015, at Hyderabad considering the following remarkable achievements of the Bank in Vigilance Administration

5. MODUS OPERANDI

The Punjab National Bank Fraud Case gave a bad jolt to the nation. The Punjab national bank fraud is a shocking case of bank fraud as it was carried out by a handful of staff at a single branch of the bank by issuing fake bank guarantees over a period of several years. The branch-level officials who were supposed to have limited power repeated violation of rules and took advantage of weak internal operations and control to perpetrate the fraud. Higher authority claims to be unaware of the whole happening; this depicts poor managerial supervision and control. The fraud purportedly goes back to 2011. Between then and January 2017, officers of PNB bank Mumbai branch issued several fake letters of undertaking(LOU) worth ₹14,356.84 crore (US$ 2.1 billion) at its Brady House branch in Fort, Mumbai; making Punjab National Bank liable for the amount. The bank claims they then bypassed the PNB's internal messaging system in order to avoid detection and placed instructions via the SWIFT global payment system asking overseas branches of Indian banks to disburse the loans. Punjab National Bank (PNB) alleged three firms which are associates - Diamond R US, M/s Solar Exports and M/s Stellar Diamonds. On 16 January 2018, they came to bank with a request for LoUs to make payment to its overseas suppliers. Then the bank demanded at least a 100 percent cash margin for issuing LoUs. But they argued that in earlier similar transaction they were not required to maintain any cash margin. Branch records of facility granted to the firms were missing which set-on an alarm for fraud. On 29 January 2018, PNB filed a complaint with the CBI, wherein it was alleged that Nirav, Ami Modi, Nishal Modi, and Mehul Choksi, all partners of M/s Diamond R US, M/s Solar Exports and M/s Stellar Diamonds, in collusion with two bank officials committed the offense of cheating against PNB and caused a wrongful loss. Also PNB named two of its employees, Gokulnath Shetty, retired Deputy Manager of PNB and another bank official Manoj Kharat, for issuing fraudulent LoUs to Hongkong based creditors on behalf of three firms associated with Nirav Modi and the Gitanjali Group.

Punjab National Bank in an FIR filed with the Central Bureau of Investigation submitted that its in-house investigation had not found any role of chartered accountants, the statutory auditors and empanelled valuers in the alleged scam. Concern has been raised over the failure of Auditors in the detection of fraud at a massive level.

6. OBJECTIVE OF THE STUDY:

To understand the possible lapses due to which Punjab National Bank fraud remained undetected for such a long period of time.

To identify lacunae in the auditing process during the tenure PNB fraud

To understand the role and Liability of auditors in PNB fraud

7. RESEARCH METHODOLOGY

Bank fraud is a broad field of research the present focuses on the case study of Punjab National Bank Fraud.

7.1 Source of data

It is primarily based on secondary sources of data gathered from the related literature published in the journals, newspapers, books, statements and financial reports. Besides various statistical reports available on RBI website, moneycontrol and annual reports of Punjab National Bank were studied. Bank stock market data was taken from Sensex.

7.2 Period of study

The study has covered a period of 9 financial years. The news of the fraud broke out on 14th February 2018. According to an FIR filed in February 2018 the fraud was being carried out for the last seven years.

7.3 Research Gap:

Though there are studies in the literature that investigates happening fraud cases in the corporate sector and there are many studies that emphasize the role of auditors yet there are hardly any studies that stress the role and liabilities of an auditor in case of the unearthing of fraud in firms audited by them.

8. LACUNAE IN AUDITING PROCESS

There is specific detailed instruction of the Institute of Chartered Accountants of India to specifically entail auditors to check the SWIFT records autonomously and cross-check them against the bank's core banking solution(CBS) system accounts. Also there is specific detailed instruction of the Institute of Chartered Accountants of India to Auditors to check the Nostro accounts. This is mandated because many public sector banks' software i.e., CBS system and SWIFT system was not linked at that time. It was mandatory for the internal auditors of the bank, the concurrent auditors of the branch and the statutory auditors to check it each year during auditing process. If auditors checked Nostro account then they would have noticed the fact that Letters of Understanding were being issued but not logged in the main accounts.

The Punjab National Bank's Brady House branch Bank branches in south Mumbai where the scam took place was dealing with the foreign exchange. The level of audits and scrutiny prescribed for branches dealing with foreign exchange is comparatively much higher degree than others. The Board of Directors members in audit committee oversee a quarterly report particularly on the foreign exchange dealings of such branches.

Loans given to gems and jewellery segment are classified as risky asset hence; the auditors are required to keep a specific eye out for such segments. The audit committee are required to scrutinized loan given to risky category dealing with foreign exchange as well.

Auditors are required to check commission and fees separately so they could have spot the missing commission in bank's CBS against many letters of Understanding (LOU) which was passed through the SWIFT software.

Role of concurrent auditor- A senior executive from within the bank is designated as 'concurrent auditor', who tracks all the transactions of the branch and at the end of the day generates an audit report. This report goes to the head office after being verified by both the concurrent auditor and the manager. The concurrent auditor has a slim chance of catching any discrepancy as the transaction is not done using the bank's core banking system (CBS).

Role of Internal Auditor-Even if a SWIFT (Society for Worldwide Interbank Financial Telecommunication) system sits outside the CBS, it does leave a trail and eventually is linked with the CBS through the Nostro account overseas so it could have been detected. The auditors failed to do so as the number of treasury and foreign exchange specialists in Public Sector Banks is very small hence most of the time bank employees who join the audit department as Internal Auditor lack training and interest and they are good at accounts, but are not trained to track foreign exchange transactions. They get transferred to the audit department from other centers on deputation for around three years. Depending upon the size of the branch, an internal audit is conducted once or a couple of times a year.

Role of Statutory Auditor- These are external auditors who are highly trained and specialized. The bank accounts are audited by an independent auditor regularly. The auditors should have spotted the continuous foreign exchange outgo of over US$2 billion (S$2.65 billion) during that period, without receipt of export earnings. However, they do not necessarily visit branches but rely on internal audit reports to collate branch-based data.

Auditors of the Reserve Bank of India- Auditors job mainly lies in the head office. This auditing concentrates on risk-based supervision and not necessarily for the daily operations of a bank.

As per Punjab Nationals Annual report 2015-16 and 2016-17, the optimum combination of Independent Directors was not strictly adhered to in the composition of Board of Directors in terms of Regulation 17(1)(b) and Audit Committee in terms of Regulation 18(1)(b) of SEBI LODR Regulations 2015. The Punjab National Bank did not have an adequate number of independent board members on the audit committee. These independent members are individuals who do not have a material or pecuniary relationship with company or related persons.

9. ROLE AND RESPONSIBILITY OF AUDITORS IN DETECTING ERRORS AND FRAUDS

According to FIR filed by Punjab National Bank with the Central Bureau of Investigation (CBI) it submitted that its in-house investigation did not find any role of chartered accountants, the statutory auditors and empanelled valuers in the alleged scam. However, Auditors are facing questions over how the fraud at Punjab National Bank (PNB) went on for seven years and how they failed to detect it. Banks and Auditing houses were ineffective on due diligence, and there was a lack of professionalism on the board and other executive levels in companies. As it is the main responsibility of an auditor is to report to the members (stakeholders). The report must state whether, in the opinion of the auditor, the financial statements give a true and fair view of the state of the company's affairs and whether they have been prepared in accordance with relevant provisions of the Companies Acts and other relevant legislation and accounting standards.

Even though detection of fraud is considered as one of the most important duties of an auditor, nevertheless if an auditor fails to detect fraud in firms where the auditing process was carried on the auditor cannot be directly held responsible all the time. Audits by independent auditors are not designed to detect fraud, and most often they do not detect fraud that may be present. Instead, an audit is aimed at determining whether the financial statements are free from material misstatement (as per Statement of auditing 240 i.e. The Auditors' Responsibilities relating to Fraud in an Audit of Financial Statements, is an auditing standard issued by ICAI, India). That is, are the financial statements fairly presented, and do they give an accurate picture of the known financial condition of the company? The auditors test only a small number of transactions in this quest to audit the financial statements, and they will direct management to correct any material errors that are found during that testing. In no way are auditors required to look for fraud in a company. They are required to be aware of the potential for fraud, to discuss ways fraud could be committed, and to exercise professional skepticism when auditing the books and records. If they come across evidence that may suggest that fraud is occurring, the auditors have some responsibility to look into those matters and report their findings to management or the board of directors. This is a fairly low level of responsibility, so outside auditors cannot be relied on to find fraud in companies.

In recent years the nature of the frauds in banking sectors are very sophisticated and also these frauds are technology-driven. This complexity has made detection of fraud a very difficult task.

Detection of fraud becomes even more difficult when the fraudster colludes with people within the organization. These people conceal the facts in such a way that it becomes very difficult for the auditor to reveal such embezzlement.

10. CONCLUSION

Stakeholder started questioning the role of auditor especially after it was unable to detect the PNB fraud of such huge amount over a long period of time. The stakeholders of the bank and users of bank's audited financial statement have more expectation from the auditors to enhance the creditability of financial statement. Auditor's secondary objective is prevention and detection and fraud an error. Auditor's report gives a reasonable assurance and not absolute assurance on audited financial statement. Hence, we can see a gap between the stakeholders expectation and auditors role. In the auditing process the auditor depends on the work of the former so if there is any loophole in any stage it has a cascading effect.

Management has a key role to play in prevention and detection of fraud as the financial statement is prepared by the management which is audited at different levels. Management should hold the attitude of zero tolerance toward fraud and formulation and implementation of fraud control policies should be enforced. The paper suggests only analysing financial statements to detect fraud are insufficient and depending auditors on fraud prevention and detection is inordinate. Many other techniques like data mining, fraud risk assessment, forensic auditing, etc. must be applied.

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