

# INDIAN JOURNAL OF PUBLIC AUDIT AND ACCOUNTABILITY



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## **The Institute of Public Auditors of India (IPAI)**

The Institute of Public Auditors of India (IPAI) was established in 1996 with the main objective of promoting sound accounting, auditing and financial management practices. The Institute has established itself as a leading Institute in the country in the areas of management consultancy, audit and investigative examination, evaluation of programmes, system appraisals and setting up systems for efficient functioning of the organisations/ departments of the central and state governments and local bodies. IPAI has a presence across the country through its eighteen Regional Chapters located at Ahmedabad, Allahabad, Bengaluru, Bhopal, Bhubaneswar, Chandigarh, Chennai, Guwahati, Hyderabad, Jaipur, Kolkata, Lucknow, Mumbai, Patna, Ranchi, Shimla, Srinagar and Thiruvanthapuram.

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## **FROM THE PRESIDENT'S DESK**

This is the 24<sup>th</sup> issue in the chain of publications of the Journal of Public Audit and Accountability since its inception in 2005. We have been covering in the Journal wide range of issues relating to Audit, Accounts, Accountability, Governance, Management etc. We have been approaching people in all spheres of activity related to accountability so that the Journal brings to its audience the diverse views on a complex and hotly debated issue.

After bringing out an issue of the Journal on Goods and Service Tax in March 2018, we thought to make this issue assorted so that we cover a wide range of topics .We approached officers in service in audit and executive, retired bankers and officers of Audit, so that we get different perspectives on the issues of audit, finance and accountability.

The present issue has well researched articles on issues of current relevance. We have articles on the role and the work being done in General Accounting Standards Advisory Board, audit of arbitration cases, responsibility of auditors for prevention and detection of fraud, importance of internal control systems in an organisation and about non-performing assets in public sector banks. We have also an article on reminiscences of the consultancy assignment in Afghanistan.

I hope the readers will find the articles interesting reading. We will be happy to have the reactions of the readers so that we continue our efforts to make the Journal better each time.

**AJIT PATNAIK**

## EDITORIAL

Of late the whole country is reverberating about the talk on institutional autonomy in the wake of the spat between the Government of India and the Reserve Bank of India. The Government has threatened to invoke the Section 7 of the RBI Act which states that the government can give directions to the Reserve Bank in public interest. This has arisen as the government wants the RBI to give to government part of its reserves, to relax the norms of Prompt Corrective Action to enable the Banks to finance the power sector etc. Reserve Bank is taking the stand that any relaxation in PCA will undo the progress which has been achieved in cleaning up the banks stressed assets which has saddled the country with the twin balance sheet problem. One section of opinion is arguing that government of the day having a political mandate should have the final say. They refer to the letter of Mr Nehru, the first Prime Minister of India, to B Rama Rau, the first Governor of RBI in post-independence India, asserting the primacy of the government. The other section argues that the independence and autonomy of the Central Bank is sacrosanct and same is required to act as a brake or 'seat-belt' to act as a check on the actions of the government which has far-reaching implications on the economy. One columnist took the stand that while the government and the RBI is engaged in tug-of-war, the requirements of the economy should not starve like Burridan's ass.

Be that as it may be, it raises the serious question of respecting and building up institutions which the Constitution and the Parliament have created. Institutions have been ordained with the objective of making the Constitution work in practice. The institutions provide a framework of stable policy environment in the highly volatile policy fluctuations in a democratic polity. The institutions have to work following certain principles e.g the principle of separation of powers and the check and balance. In the financial sphere as in other spheres, the institutions like C&AG and Reserve Bank have to be given the status as envisaged by the Constitution and the Parliament.

The C&AG of India has been widely applauded for his path-breaking audit reports since independence. However, academic

discussion to introduce reforms as working in closer interaction with Parliament in view of inaction and partial action by the executive on audit reports which has plagued Audit, may be the need of the day. A question often has been raised whether C&AG should be made an officer of the Parliament in the pattern of the C&AG of UK. The NAO Act of 1983 states that the person can be appointed as C&AG by Her Majesty only after the permission is jointly approved by the Prime Minister and Chairman of the Public Accounts Committee and ratified by the House of Commons. The CAG is also an officer of the House of Commons and has also got the authority to attend the sessions of the Parliament to explain his audit reports. Also, should the constitutional auditor be given the audit of Reserve Bank of India and Public Sector Banks? It is established beyond doubt that the statutory audit and audit by RBI have not been able to provide the necessary therapeutics as is evidenced in crumbling bottomline of the PSBs and their window-dressed balance sheets. This had been highlighted by Shri R. Venkataraman, Ex-President of India, at the inauguration of the Institute of Public Auditors of India, in April 1998.

Efforts have been made through GASAB to facilitate the process of introduction of accrual accounting by formulating the Indian Government Accounting Standards and Indian Government Financial Reporting Standards. The authors at present working in GASAB have given us a picture of significant standards formulating work that is being done in GASAB. GASAB is the research laboratory in Accounts. One author has from his experience in banking sector has highlighted the problem of non-performing assets in the public sector banks and he hopes banks will emerge stronger from this crisis. Audit of Arbitration is an area which needs focussed attention in audit so as to highlight the deficient management of contracts by the management. One author with case studies has highlighted the responsibility of management to have a proper system of internal control to prevent fraud in an organisation and another author has delved into the techniques and evaluation of the same. Auditors write accounts journals but seldom they write a journal about the country of their posting reminiscing about the Damocles' sword (substitute gun) while

teaching about the fine points of audit in an audit environment. It is like 'ab goli kha' after eating pizza! The author has given hair-raising account of his stay in Kabul, no less thrilling than adventures of early settlers in US.

We have also added in the two significant acts enacted in 2018 by the Parliament of India - The Prevention of Corruption (Amendment) Act, 2018 and the Fugitive Economic Offenders Act, 2018- for ready reference.

**AJIT PATNAIK**  
**Editor-in-Chief**



# **GASAB AND ITS RELEVANCE: A PERSPECTIVE IN GOVERNMENT ACCOUNTS**

**MS. ANITA PATTANAYAK AND MS. ASHA R. RUNGTA\***

## **Background**

Government accounting is the process of recording, classifying, compiling, consolidating, reporting and interpreting financial information about cash transactions in general and other economic events. The financial records are maintained for budgetary control, internal control, reporting to stakeholders and the requirement of auditors. Accounts are maintained for a wide range of administrative entities *i.e.* ministries, departments, state Government, autonomous bodies and local bodies which are spread throughout the country.

Not only the Finance Commissions but the Administrative Reforms Commission also strongly indicated an inevitable shift towards accrual accounting in government, to the extent that the 12th Finance Commission (2005-10) directly linked it to the much required reforms in Government accounting. The report conveyed a sense of urgency to this transition and emphatically summed up in paragraph 14.16 of the Report that “the system of accrual accounting, thus, *inter alia*, allows better cost price calculations, records capital use properly, distinguishes between current and capital expenditures, presents a complete picture of debt and other liabilities and focuses policy attention on financial position, as shown in the whole balance sheet not just cash flows or debts. It gives a complete measure of cost of various services, takes care of

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disinvestment receipts and provides adequate information of both fiscal balance and net worth and their changes over time.”

Further, the 13th Finance Commission, in its Report, advocated a ‘bubble up’ approach for adoption of accrual accounting in para 13.9 of the Report. This is stated while supporting the Second Administrative Reforms Commission in its recommendation that a task force be set up to examine the costs and benefits to the system as well as its applicability in the case of appropriation accounts and finance accounts. The report also underlines the need for training and capacity building; ensuring alignment of the plan, budget and accounts; as well as putting in place a viable financial system of accounts. To further reiterate this paradigm shift, the government set up an Apex Committee with Secretary. Finance as its chair in 2011 to commission pilot studies and oversee pilot implementation for transition to accrual base accounting in government.

However, the Ministry of Finance, in its presentation to the Finance Commission<sup>1</sup>, urged that the changeover to accrual accounting be managed with care and circumspection, given that the process is resource and time intensive, and that its benefits have not been unambiguously proven by international experience.

### **The International Scenario**

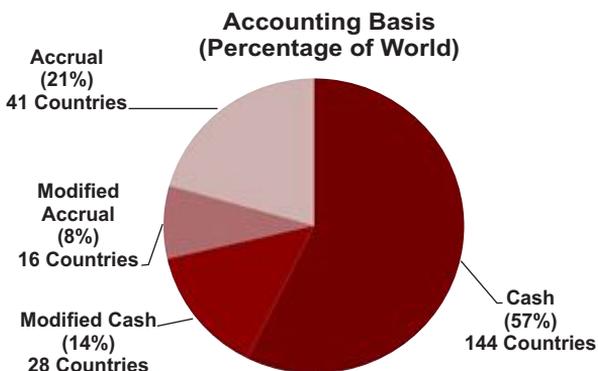
International Public Sector Accounting Standards Board (IPSASB), International Accounting Standards Board (IASB), International Monetary Fund (IMF), International Financial Reporting Standards (IFRS), The International Federation of Accountants (IFAC), World Bank and other international bodies feel that it is now imperative that Government , across countries now adopt robust accounting systems which present and reflect the utilization of the taxpayer’s money in addition to disclosing the complete and comparative economic impact of government’s decisions. A better accounting inevitably ensures an optimum use of public resources. “High-quality financial reporting is essential to ensure that Government make fiscal decisions based on up-to-date

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<sup>1</sup> Para 13.9 of the Thirteenth Finance Commission Report

information and an accurate understanding of their financial position,” said Fayez Choudhury, IFAC CEO. “They provide a mechanism through which legislatures, auditors, and the public at large can hold Government accountable for their financial performance.”

While there is undoubtedly a very strong case for switching to accrual accounts, there are other ramifications to this transition. The international experience so far has been quite mixed. According to an IMF report<sup>2</sup>, the current accounting practices show the following trend:



Source : IMF Staff Estimates based on various public sources including OECD survey

Further, Nearly three-quarters of OECD countries have adopted accrual accounting for their year-end financial reports and more than a quarter now prepare their annual budgets on an accrual basis, according to the landmark study *Accrual Practices and Reform Experiences in OECD Countries* by the IFAC and the Organisation for Economic Co-operation and Development (OECD). The study also points out that while the direct adoption of international accounting standards, such as IPSAS or IFRS, by national Government remains very low, many standard setters use

<sup>2</sup><https://www.slideshare.net/OECD-GOV/implementing-accrual-accounting-in-the-public-sector-suzanne-flynn-imf>

IPSAS or IFRS as primary or explicit references for developing their national standards.

To take the example of UK, one of the pioneers in accrual accounting in Government, this was done under Resource Accounting and Budgeting. First accrual accounts, parallel to the cash accounts were prepared in UK in 2001. Despite more than 15 years into the process, the Government continues to face significant challenges. For example, the Ministry of Defence raises the issue of stock-taking 1.5 million lines of inventory in over hundred locations, some dating from the first world war, the issue of assigning values to these assets/inventory and whether the majority are then, to be treated as assets or spare parts or obsolete items, is still ambiguous. Further, depreciation model is based on the assumption of useful life of assets which may be, in effect, far from ground reality.

### **Points of issues- International**

The challenges faced by those in the process of transition commence with the:

- a) basic approach on whether it is “top down” including elements that are pre-determined with fixed timelines and are mandatory or “bottom up” where principles are still to be firmed up depending on the success of the subordinate units;
- b) current accounting policy and system of the entity, the IT and MIS systems and the completeness, transparency and accuracy of existing system along with other logistics;
- c) methodology of accounting used in the preparation of budget, especially because there is an increasing demand that Government should be accountable to the community for the resources entrusted;
- d) level of commitment by the Government to the adoption of accrual accounting; and

capacity, knowhow and skills of the target people and organizations responsible for implementing the changes.

## **The Current Indian Scenario**

Choosing the right accounting method does make a difference between an accurate reading of the financial status and health of an organization and a mere formal compilation of figures. However, the transition to accrual accounting entails professional accounting and technological skills, identification and valuation of assets, development of accounting policies, rules, systems, procedures etc as well as validation of assumptions by neutral and skilled agents/ evaluators and auditors, all involving high cost of transition and a long transition period. Further, it is largely designed to measure profit which is corporate performance yardstick whereas for Government the main motive is good governance and in connection therewith, administrating and gearing up the entities and departments to render best possible service to the citizens in a primarily non-reciprocal way.

Sound and transparent public accounting is a necessary component for effective public resource management for better reporting and decision-making, enhanced accountability and finally to better use of public resources. The Government of India also realized the constraints in transition to and implementation of the accrual accounts in Government, especially given the scale of operations and the size of the Indian economy and the fact that this was a time consuming process. The 12<sup>th</sup> Finance Commission recommended that as an interim measure, subsidies, salaries, pensions, committed liabilities, salary and non-salary portions, liabilities on outstanding debts should be appended to the present system of cash accounting (Para 14.16) to enable a more informed decision making. This not only lends greater credence due to enhanced transparency but ensures faith of international stakeholders in the strength of Indian economy and its future prospects. The Government accepted the recommendation in principle and set up Government Accounting Standards Advisory Board (GASAB) which framed the roadmap for gradual transition from cash to accrual accounting system.

In India, the accounting policies followed by all Government entities following cash based system of accounting are embedded in the General Financial Rules (GFR) and the Government

Accounting Rules (GAR). These lay down the rules to be followed by the government entities in their accounting for any receipt or expense. Hence, it was also decided that GASAB would commence work on the shift from a rule based to a standard based accounting and develop the framework and formulate cash based Accounting Standards as well as Accrual based Standards, the basic objective being providing of relevant information to the stakeholders in standardized reporting structure.

The existing problems and the need to introduce the concepts of accrual accounting into cash accounting by appending information as disclosures, thereby, leading to a hybrid accounting was considered the way forward, without entailing the long, tedious and expensive process of actually switching to accrual.

### **Core challenges in India**

The Indian government accounting system continues to be cash based with intermittent proforma accounts in some entities parallel drawing their accounts on accrual basis. The issues and challenges remain:

- timeliness, reliability, completeness and accuracy of information;
- non-standardisation in recognising and recording transactions and other processes across government entities;
- the government has conducted pilot studies in 4 states through GASAB, reports from some departments within these 4 states have been received and forwarded to the Apex committee, these reports depict differing states of readiness of entities within the Government;
- there is presently an attempt to prescribe a standard format for disclosure on physical assets, however, detailed information on assets and liabilities across Government entities is not available;
- accounting policies and a revised chart of accounts will need to be developed;
- consolidation of business processes;

- mapping will also be required for new processes under accrual accounting;
- capacity building and skill enhancement for the accounting and finance personnel;
- software modules and other IT requirements to support accrual accounting;
- creation of database on assets and liabilities;
- amalgamation of the budgetary processes with the contemplated accrual accounting , shall also then, need to be planned, to cover the entire continuum from resource allocation to asset creation or rendering of service;
- The Department of Railways has prepared proforma accounts on accrual basis for the year 2015-16 wherein the South East Central Railway (SECR) has also identified several areas of accrual impact which are hitherto not captured as current assets and current liabilities. Some areas which have been identified are as under: 1. Work/measurement done but bill not received 2. Bill received but payment not made 3. Revenue received but service not provided 4. Employees liabilities viz. Pension 5. Demands payable, Salary payable 6. Advances to employees 7. Demands Recoverable 8. Inventory closing stock;
- The Department of Posts is also preparing proforma accounts of two Head Post Offices (HPOs) in accrual system.

### **Government Accounting Standards Accounting Board (GASAB)**

GASAB was constituted by the Comptroller & Auditor General of India on August 12, 2002 for the Union and States under Article 150 of the Constitution of India to formulate Indian Government Accounting Standards (IGAS) for government cash accounting entities and Indian Government Financial Reporting Standards (IGFRS) for facilitating pilot studies on accrual

accounting in government in addition to other pronouncements and Guidance Notes. These accounting standards will be formulated in conformity with the provisions of the Constitution, our laws and international norms, promoting best practices on the basis of Generally Accepted Accounting Principles (GAAP). GASAB was entrusted with the following responsibilities:

- i. To establish and improve standards of governmental accounting and financial reporting in order to enhance accountability mechanisms;
- ii. To formulate and propose standards that improve the usefulness of financial reports based on the needs of the financial report users;
- iii. To keep the standards current and reflect changes in the governmental environment;
- iv. To provide guidance on implementation of standards;
- v. To consider significant areas of accounting and financial reporting that can be improved through the standard setting process; and
- vi. To improve the common understanding of the nature and purpose of information contained in financial reports.

GASAB endeavors and is contributing to a fuller understanding of resource allocation decisions both at the Centre and State levels, disclose debt and other liabilities of entities in the public domain fully and transparently. It attempts to a) address the direct correlation of accounts with financial management, b) improve the understanding of the accurate financial position of a Government, c) synthesize the cash based accounting system and accrual based accounting system, d) cover both Union and States, e) promote best practices on the basis of generally accepted principles of Government Accounting and f) steer a gradual course in reforming our accounting system. It is in the process of addressing three major gaps in the current system of government accounts, viz., understating liabilities, overstating assets and unconsolidated financial statements in Government accounts.

The idea is also to ensure better information on liabilities such as employee entitlements, claims, obligations, expected losses which are not typically recognized in a cash accounting environment. The financial decision is then an informed one apart from a useful evaluation of government's performance in terms of its accomplishments, service costs and efficiency. The government entities fail to keep full records of their fixed assets, sometimes even its current assets and fail also to account for all financial resources available to meet their obligations. Government that follow pure cash accounting typically account only for their cash holding on the assets side and debt on the liability side.

The process is also on to address the issue of current non-recording of assets and liabilities, in balance sheets including financial assets (equity) and physical assets (land and buildings etc), and liabilities other than debts and bonds (e.g. payment arrears and pension obligations). A complete listing of assets available with all government entities was the absolute need of the hour. This shall, then, to a large extent, lead to:

- i. credibility of the accounting data
- ii. transparency in disclosing the correct data

which are the underlying principle of a sound accounting system. Cost accounting, fixed assets management, performance management and long-term planning and forecasting are all key accounting areas. Improving these shall contribute to enhanced service performance and long-term sustainability of public finances.

### **The pronouncements of GASAB on IGASs and IGFRSs**

- IGAS: The standard based on cash based accounting system are termed as Indian Government Accounting Standards (IGASs) and become mandatory for application by the Union, States and the Union territories with legislature from the date as notified by the Government.
- IGFRS: The standards based on accrual based accounting system are termed as Indian Government Financial Reporting Standards (IGFRSs) and have become

recommendatory for pilot studies from the date approved by GASAB.

- Both the pronouncements, however, are developed in consultation with stakeholders and are forwarded to Ministry of Finance for consideration and notification in accordance with provisions of the Constitution.

### **Status on pronouncements by GASAB**

The IGASs duly notified include:

- Guarantees given by the Government : Disclosure Requirements (IGAS1)
- Accounting and Classification of Grants-in-aid (IGAS2)
- Loans and Advances made by Government (IGAS3)

The notified IGAS 2 and IGAS 3 are also undergoing modification not only to keep them updated but also to make them more relevant for both the grantor and the loaner entities by proposing to include additional information by way of Annexures. The modified IGAS2 proposes to include a disclosure by both the grantor and the grantee on duplication of grants for the same purposes by the grantor, if any, utilization of grants for the specified purpose, the extent to which the grants have been provided for capital formation, the extent to which the grants have remained unspent with the grantee before release of subsequent grant by the grantor, whether submission of ‘Achievement-cum-performance Report’ has been done and the details and utilization of grants-in-aid in kind, especially land. The modified IGAS3 proposes to include information on duplication of loans, if any, given for the same purposes by the government, extent and type of loan given to individual entities, their utilisation and the interest charged, arrears pertaining to different entities and information in cases where fresh loans have been given despite arrears alongwith reasons therefor, loans in perpetuity, if any, loans given where terms and conditions are yet to be decided and quantum of subsidy, if any, given to meet the interest burden.

Further, there are IGASs approved by GASAB, but under consideration by the President of India for notification. In the 31<sup>st</sup> meeting of Board of GASAB, it was decided that since documents awaiting notification are already dated, they may be deliberated in the TBG again and modified to make them current with the changing financial milieu, viz., General Purpose Financial Statements of Government, Foreign Currency and Loss/ Gain by Exchange Rate Variations, Public Debt and Other liabilities.

Further, due to the fact that the present system of cash basis of accounting does not recognize fixed assets as such, but recognizes them merely as capital expenditure, Capital Works-in-Progress (CWIP) is subsumed in the capital expenditure booked and both the accounts and the existing Asset Registers do not separately depict Capital Works-in-Progress. Similarly, it is seen that complete details of fixed assets owned/under construction/constructed/purchased/acquired by a Government entity are not available in the Finance Accounts. Further, fixed assets like computers, furniture etc., booked under revenue object heads viz., Office Expenses and Other Administrative Expenses are currently not captured as capital expenditure. In addition, heritage, intangible and leased assets are not recognized and therefore not included in the Asset Registers. Further, no de-recognition of asset takes place even after the asset is no longer in use. GASAB, in its 32<sup>nd</sup> meeting has recently approved a Guidance Note on Accounting of Fixed Assets to enable comprehensive and transparent financial reporting with regard to capital expenditure and provide information about entity's fixed assets including changes therein. The document is awaiting notification by Ministry of Finance.

Pronouncements under development include a Standard on Accounting of Reserve Funds. Currently, proliferation of reserve funds/ developmental funds leads to lack of legislative control over the expenditure, as expenditure from the Public Accounts is not subject to vote of Parliament/ Legislature. Further, excessive transfer of funds from the Consolidated Fund to Public Account, especially at the close of the Financial Year in order to avoid lapsing of budget allocation, undermines the basic principles of operation of reserve funds/ developmental funds.

There are other IGAS approved by the Board of GASAB and are yet to be notified by MoF, viz., General Purpose Financial Statements of Government, Foreign Currency and Loss/ Gain by Exchange Rate Variations, Public Debt and Other liabilities. A decision has been taken to further update these approved documents as these documents are now dated.

IGFRSs approved but pending notification include:

- IGFRS 1: Framework for financial reporting under accrual basis accounting
- IGFRS 2 : Property, Plant and Equipment
- IGFRS 3: Revenue from exchange transactions
- IGFRS 4: Inventories
- IGFRS 5: Provision, contingent liabilities and contingent assets

Just like the approved IGASs, the approved IGFRSs are also proposed to be modified as a decision was taken by the Government Accounting Standards Advisory (Board) to keep all the pronouncements current as the Government accounts must gradually make a transition from a rule based accounting to a standard and principle based accounting. GASAB's role is also vital in bringing pragmatism to the structure of accounts, accounting heads and the related rules and principles, thereby adhering to a compliance of GAAP and the best international accounting practices, not to mention the adherence to a uniformity and standardization in presentation. This is inevitable as there is also an increasing demand that government should be accountable to the stakeholders for the resources entrusted.

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# **PUBLIC SECTOR BANKS AND THE CHALLENGES OF NPAs**

**Y.S.S. KAPDI\***

## **Introduction**

The public sector banks (PSBs) in India are going through an unprecedented crisis created by the non performing assets (NPAs). As per the recent report of Trans-Cibil Union presented to RBI<sup>1</sup>, as at the end of FY 2017-18, the stressed asset percentage of banks in India is 19.19% and the position is likely to be further aggravated by an undisclosed layer of around Rs.3.1 lakh crores. This layer forms that part of loans under multiple banking arrangements, where only one bank has declared the borrower as NPA. RBI norms now make it mandatory for all banks to declare a unit as NPA under cross-default clause. Thus, the September 2018 position of NPAs of banking sector in India may be frighteningly high. The larger part of the damage on account of NPAs is in the public sector banks.

## **Bank Nationalization for National Development**

There is a need to analyse this critical situation in historical perspective. The banking industry in India has weathered several upheavals during the past century. The sudden nationalization of 20 bigger banks in 1969 and 1980, bringing in the erstwhile private banks under state ownership, gave them not only a new master but also a new business orientation. Overnight these banks acquired a national character, which, till then was enjoyed only by State Bank

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\*The Author, retired from State Bank of India, is a former Managing Director and CEO of SBI DFHI Ltd and Clearing Corporation of India Ltd.

<sup>1</sup> TOI dated 06-08-2018

of India (SBI). These public sector banks were transformed to drive a national agenda of mass banking and poverty alleviation. As such, the PSBs, including the SBI group, were steadfastly driven to implement all state governed schemes for financing the priority sector, the small and marginal farmers, small scale industries and small business finance, with low interest rates and low or nil security cover. This business reorientation in the new government-owned banks, created a thinking that banking in India was for national development and not for profits.

### **Globalization and Bank Transformation from 1990s.**

The next transformational turn the public sector banks had to take was that of globalization and the resultant technological leap, when the banking platform itself underwent a change from ancient ‘ledger age’ to ‘computer age’. This change was gradual and, though internally painful for PSBs, was completed with far greater success. Whereas nationalization of banks was a political decision, computerization was a business decision compelled by pressures of globalization.

A compelling fall-out of globalization was the need for alignment with IFRS<sup>2</sup>/GAAP<sup>3</sup> standards and to streamline the provisioning and income recognition norms in the balance sheets of banks. RBI initiated the process in 1990 in a phased manner where the basic Income Recognition and Asset Classification (IRAC) norms were modified from ‘accrual’ basis to ‘actual’ basis. The loan assets were also classified on the basis of their interest paying capacity and security cover, into ‘Standard’ and ‘Non Performing’ assets (NPAs). While the standard assets are those where interest was actually received within the specified time period, (presently 90 days), the NPA account was one where interest or instalment was ‘past due’ i.e. not received within the specified time. The NPAs had a sub-classification of ‘Sub-standard’, ‘Doubtful’ and ‘Loss’ assets, depending upon the period of impairment of the NPA. This categorisation also determined the percentage of provisioning requirement by the banks. The IRAC

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<sup>2</sup> International Financial Reporting Standards

<sup>3</sup> Generally Accepted Accounting Principles (US)

norms were made gradually stiffer by RBI, from three quarters in 1990 to one quarter as at present. The quality of the asset was determined essentially on its ability to generate income for the bank.

### **Income as a Criterion of NPA Classification**

While the RBI enunciated new norms on income recognition in 1990, ironically, income, per se, was never a primary concern with the PSBs after nationalization. The focus of banking activities for PSBs was assumed to be assisting the ‘nation-building’ process, as working capital providers. In that mission the PSBs not only excelled their brief, but, in the absence of well-equipped term lending institutions, they even took over the role of term lenders for large corporate projects. SBI, traditionally the pioneers in every commercial banking activity in India, naturally took up the leadership in building large consortia for multi-crore projects with long gestation periods. The delays in implementation of many of these large projects, due to several reasons, made these projects NPAs, much before they could even commence production. The world financial crisis of 2008-10 added its bit to the woes of large and small projects. Consequently, as at end-March 2018, except two banks, none of the PSBs has declared any profits. Moreover, 11 of the 21 nationalized banks are under Prompt Corrective Action (PCA)<sup>4</sup> by the RBI, which imposes severe restrictions on their normal banking activities. Five more could be added soon, as per ICRA report. The situation would take a long time to recover.

### **Challenges before Public Sector Banks**

The NPA crisis has thrown some critical challenges before the PSBs in India, as discussed below. But why only PSBs? Answers are obvious. The private sector banks, although have a common industry regulator, have different masters. As such, they have independence in decision making and in dealing with external pressures. Their core market segments are also different with predominance on retail loans and fee based services. Their technological innovations and youthful appearance provide a

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<sup>4</sup> RBI Notification 2016-17/276 dated April 13, 2017

different customer base, and above all, due to their “private” ownership, they have the freedom and the discretion, within the regulatory framework, to resolve the recovery issues without public scrutiny. Resultantly, the percentage of gross stressed assets of private sector banks over the past few years has been far less than that of the PSBs, which is evident from the following figures<sup>5</sup>:

**Statement of Gross NPAs to Total Advances as at 31<sup>st</sup> March:**

		<b>(Rupees in Millions)</b>		
		<b>2015</b>	<b>2016</b>	<b>2017</b>
<b><u>SBI &amp; 5 Assoc</u></b>				
1	Total Advances	17191685	19107755	19519311
2	Gross NPAs:	735084	1219686	1778106
3	Percentage	4.28	6.38	9.11
<b><u>Public Sector Banks (21)</u></b>				
1	Total Advances	38975490	39111756	39144423
2	Gross NPAs	2049595	4179878	5069217
3	Percentage	5.26	6.38	12.95
<b><u>Private Sector Banks</u></b>				
1	Total Advance	16073394	19726588	22667207
2	Gross NPAs	336904	558531	919146
3	Percentage	2.10	2.83	4.05
Corresponding ASCB <sup>6</sup> %		4.27	7.48	9.32

Some of the major challenges faced by the PSBs on account of the above problems are as under:-

**1. The Challenge of Capitalisation:**

Maintaining not only the regulatory but also a desirable capital to risk adequacy ratio (CRAR) on a sustained basis is the primary challenge for every bank. The CRAR norms are stringent and regulated with great concern by RBI. Banks are advised by RBI to maintain a minimum CRAR of 9% on an ongoing basis<sup>7</sup> under Basel III capitalization norms. The direct effect of NPAs in the balance sheet of a bank is the erosion of the assets, arising out

<sup>5</sup> Statistical Tables – RBI , Table 18

<sup>6</sup> All Scheduled Commercial Banks

<sup>7</sup> RBI Master Circular Basel III Capital Regulation -RBI 2015-16/58 , dated July 01, 2015

of regulatory norms of classification of stressed assets and the mandatory provisioning thereon. As per the RBI prudential guidelines, banks have to provide from 15% (Sub-Standard) to 100% (Loss) provision on the assets depending upon the period of impairment and the available security cover on the impaired assets. Between March 2014 to June 2017, PSBs have made provisions to the extent of Rs 3,79,000 crores. Resultantly, PSBs have suffered a major hit on their profits. Of the 21 state owned banks only 2 banks posted profits of barely Rs.1986.01 crores in FY 2017-18. The aggregate net loss booked during 2017-18 was to the extent of Rs 85370 crores, as against a meager profit of Rs 473.72 crores booked in the previous year 2016-17.

This has certainly depleted the lending capacity of the PSBs in the years when the economy has started to show signs of revival. Unless the rate of deposit accretion is significantly accelerated, any increase in the lending capacity appears an uphill task for PSBs. Unfortunately the percentage share of deposits with 21 nationalized banks, other than SBI group, has fallen from 54.64% in 2015 to 47.80% in 2017. Moreover, more than half of these banks are already under RBI's PCA control of restricted lending.

Under the above circumstances, the PSBs are left with the only option of pleading for fresh capital from the government. The centre has already infused over Rs 89000 crores for recapitalization during the period 2012 to 2017. But this additional capital has predominantly gone only to support the losses, since the credit growth rate for all PSBs in 2015-16 and 2016-17 has been less than 2%. Going further, although the Centre has announced a re-capitalisation plan of nearly Rs 2.10 lakh crores for the PSBs, through various instruments, the actual materialization is a long term process. Particularly coinciding with the election year, a quick action in this matter is a remote possibility.

Evidently, government has reportedly<sup>8</sup> approached RBI to reduce the CRAR requirements for PSBs only upto the Basel III

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<sup>8</sup> ET dated 07-08-2018

requirements<sup>9</sup>, which are lower than the RBI stipulations, considering their dominant sovereign ownership. This would reduce the Government liability to recapitalize the PSBs to the extent of Rs 60,000 crores and release Rs 6,00,000 crores of PSB funds for lending. This could, even if accepted by RBI, only be a short term respite. In the circumstances, the PSBs would have to continue with their stretched position on capital for a long and indefinite time. The challenge is so imminent that several PSBs have initiated the process of liquidating their non-core assets, like prime real estate and holdings in associates, to boost their lending capacity.

## **2. The Challenge of Leadership and maintaining the employee morale:**

Another unfortunate fall-out of the NPA crisis for PSBs has been the atmosphere of culpability that has been built around the bank officers who have recommended, sanctioned or monitored the impaired accounts. This approach of investigative adventurism or judicial activism of public agencies has led to the prosecution of several bank officials, many of whom being retirees, for procedural lapses while taking bona-fide decisions. The perverse implications drawn by the state investigating agencies that the NPAs are necessarily created in fraudulent collusion with the bank staff has also led to a fear psychosis among the PSB bankers which would dissuade them from any decision making. No doubt, the recent fraud<sup>10</sup> in the Punjab National Bank (PNB) has raised questions about the systems and processes as well as the management supervision and internal audit controls in that bank, but to adopt an omnibus approach of ‘catch the banker, if you can’t catch the borrower’, appears to be out of desperation of the investigating agencies. *“The government is under political pressure, after a spate of bank frauds and loans that turned non-performing, to be seen to act tough.”*<sup>11</sup>

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<sup>9</sup> Only 4.5% of risk weighted assets as against RBI stipulation of minimum 5.5% common equity Tier 1 capital

<sup>10</sup> Nirav Modi and Gitanjali Gems case

<sup>11</sup> Editorial, ET 08/08/2018

The systems of credit appraisal and sanctioning decisions in banks are highly regulated and always collective in nature. Sanctioning of a loan is a business call of taking a calculated risk by assessing the alternatives in a trained and professional manner. It is equally a decision based on the trust reposed in the borrower and his commitments. Holding an official, whose signature appears last, as a criminal responsible for the NPA, would be highly unjust. Many of the retired senior bankers prosecuted for such alleged criminal conspiracy with fraudulent borrowers had to apply for anticipatory bail, since, not being ‘public servants’ in service, the protection available to serving officers under sec 19 of the POC Act<sup>12</sup>, of obtaining prior sanction of the competent authority before any action, is not available to them. The IBA<sup>13</sup> has approached the government to rectify the situation. Although, the government fortunately has made necessary pronouncements in support of upright bankers and has taken steps for amendment of the POC Act, the damage appears to have been done. No wonder if the decision making in the PSBs gets atrophied in future.

PSBs will have to enthrone their officers to continue to trust an industrial promoter, to maintain records of every deliberation, formal as well as informal, and above all, to look at the glass as half full rather than as half empty. Simultaneously PSBs will also have to reinforce their internal audit and vigilance mechanisms to review the systems and processes from the angle of employee integrity, by ensuring that the firewalls are not compromised and the ‘four-eyes principle’ is always kept sacrosanct.

### **3. The Challenge of Cultural amalgamation**

The NPA crisis has thrown up an apprehension of a “weak” bank, going by the public perception of a bank brought under the PCA. A potential depositor may in future make a due diligence on the bank to assess its creditworthiness and look for a KYB (Know Your Banker) document. Although this apparently looks far-fetched and almost ridiculous at present, in a business like banking, which largely runs on the reputation of the financial institution, the

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<sup>12</sup> Prevention of Corruption Act , 1988

<sup>13</sup> Indian Banks Association

present leadership of the PSBs, particularly those with very high levels of asset impairment and accumulated losses, would certainly have to think in that direction. The government, on its own, may act to ring-fence the weak ones by merging them with a stronger one, thereby creating multiple D-SIBs (domestic systemically important banks). Creation of one or more 'Too big to fail' banks out of multiple smaller weak banking organisms, would throw another challenge of cultural assimilation. In India, where every nationalized bank can trace its origin as a community bank with pronounced regional bias, making up a juggernaut of multiple banks, having diverse cultural orientations, would present a formidable cultural challenge.

#### **4. The Challenge of Business Innovation**

The conventional image of a bank, being one which accepts deposits and lends money, has long changed in India. Post globalization, in keeping with the international trend, Indian PSBs converted themselves into one-stop-financial-shops. But the unhealthy growth trend in NPAs of PSBs would compel the management to innovate alternate stress-proof avenues for generating revenue. Although cautious lending would always be preferred, the boost given to alternate modes of working capital funds like CPs, CDs, and corporate bonds would certainly limit the prime lending opportunities. To top it all, the recent SEBI proposal<sup>14</sup> to corporates with credit outstandings of Rs 100.00 crores and above, to tie their one fourth of working capital requirements from corporate bond market, beginning March 2019, is further limiting the market for credit dispensation for the banks.

#### **5. The Challenge of trust in banker - borrower relationship**

Trust is the basic element of banker-borrower relationship. This is invariably an outcome of transparency in dealings and commitments shown by the borrower. Many of the credit decisions of the bankers are often based on this inherent trust in the borrower. The difficulties experienced by bankers in the recovery of NPAs and the various instances of frauds, criminal conspiracies,

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<sup>14</sup> Livemint , Dated 06-08-2018 , Tamal Bandopadhyay

false counterclaims etc. that the bankers have faced from unscrupulous borrowers to delay the recovery, have affected this basic trust in the relationship. The reputation of an industrial promoter, whom the public sector banker once perceived as a ‘nation-builder’, having legitimate rights to public funds, has been severely dented.

The government, on its part, has also sent a message by abolition of BIFR and SICA Act that the rehabilitation of a sick account is not a primary concern of the banker. The legislative changes effected from the commencement of DRT regime in 1993 till the enactment of IBC- 2016, where recovery could start on a single ‘default’, also reinforces this understanding. Today, the time value of public money is paramount and needs to be protected by the banker. Reorienting to this new relationship with suspected confidence level towards the borrower may be difficult for a traditional public sector banker.

## **6. The challenge of improvement in the legal process of recovery:**

Legal protection of banker’s recovery rights has been an important concern of successive Banking Reforms Committees (Narasimhan Committees I and II) (1991 and 1998). This gave rise to the creation of exclusive judicial set-up under Debt Recovery Tribunals (DRT) with special DRT Act (RDDBFI Act, 1993)<sup>15</sup>. The inadequacies of the DRT regime were soon evident and SARFAESI Act<sup>16</sup> was enacted in 2002, where direct possession of the secured assets of an NPA was made possible for the secured banker, without the intervention of courts. However, the legislative force of the SARFAESI Act could not withstand the procedural / administrative delays and the various machinations of the wilful defaulters and the Act was not effective enough to enforce the security rights of the banker quickly and in full measure. The entire process could not succeed in cutting the delays in recovery, particularly in the absence of a legal framework laying down a

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<sup>15</sup> Recovery of Debt Due to Banks and Financial Institutions Act, 1993

<sup>16</sup> Securitization And Reconstruction of Financial Assets and Enforcement of Security Interest Act , 2002

clear insolvency and bankruptcy regime in the country. The enactment of the Insolvency and Bankruptcy Code, 2016, under NCLT<sup>17</sup> is intended to facilitate release of impaired assets within a stipulated time of maximum 270 days.

The legislative journey of nearly two and half decades viz. from the DRT regime to the NCLT regime, has not completely protected the recovery rights of the lender. Recovery of stressed assets is still a daunting task for the banker as several loop holes remain to be plugged. Legislative changes to provide attachment of benami properties, liquidation of assets transferred in the names of core relatives, nullifying transfers of assets to third parties without actual receipt of market value, prior approval of bankers for foreign travel of promoters, mandatory personal guarantees of key promoters as collaterals etc. are some of the legislative changes that bankers will have to demand if the recovery of NPAs is to be smooth, quick and complete. This is a daunting task. In spite of the successive legislative innovations, full and fast recovery of NPAs continues to be a mirage for the banker in India.

## **Conclusion**

The PSBs in India are almost going through a fire of self-purification and will emerge much stronger and healthier, if they succeed in overcoming the above challenges. PSBs have been successful in dealing with all the previous challenges and have stood up as a strong and dependable financial force in our country, thanks to the people's faith in their state ownership and also due to the internal strength of their systems and practices. The NPA crisis has presented the PSBs with some new challenges which they are expected to overcome. They would hopefully resurrect from this crisis with a renewed vigour and also perhaps with different identities.

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<sup>17</sup> National Company Law Tribunal

# AUDIT OF ARBITRATION CASES

S. VASUDEVAN\*

Evolution of Arbitration and Conciliation process as a speedy settlement system for commercial disputes:

<sup>18</sup>Law guarantees a redressal system for all disputes. The normal forum is that of civil courts. With the **evolution** of **arbitration**, an option is available to parties to have their disputes resolved outside the civil court system. A resolve to arbitrate upon disputes is usually found in commercial contracts. <sup>19</sup>In India, there is a long history of **arbitration**. It is a mode of settlement of disputes evolved by the society for adjudication and settlement of the disputes and the differences between the parties apart from the courts of law. **Arbitration** has a tradition; it has a purpose. **Arbitration**, that is a reference of any particular dispute by consent of the parties to one or more persons chosen by the parties with or without an umpire and an award enforceable by the sovereign power were generally unknown to ancient India. Hindus recognised decisions of Panchayats or bodies consisting of wealthy, influential and elderly men of the Community and entrusted them with the power of management of their religions and social functions. The sanction against disobedience to their decision was excommunication, or ostracism and exclusion from all religions and social functions of the community. An agreement to abide by the decision of a Panchayat and its decision with regard to the line of boundary was held not to be conclusive, since a reference to **arbitration** and award did not exist. Arbitration and

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<sup>18</sup> Mohan Lal Harbanslal Bhayana vs Larsen And Toubro Ltd. on 27 April, 2007

<sup>19</sup> Obiter of SC in Food Corporation Of India vs Joginderpal Mohinderpal on 3 March, 1989

Conciliation Act 1996 is based on UNCITRAL Model Law on International Commercial Arbitration (1985). Major objective is to pave way for significant contribution to the establishment of a unified legal framework for the fair and efficient settlement of disputes arising in international commercial relations; Any dispute can be referred to Arbitration only if there exists arbitration agreement. “Arbitration agreement” means an agreement by the parties to submit to arbitration all or certain disputes which have arisen or which may arise between them in respect of a defined legal relationship, whether contractual or not. An arbitration agreement shall be in writing and may be in the form of an arbitration clause in a contract or in the form of a separate agreement.

2. While there may be genuine need for Arbitration, generally reference to Arbitration is used by some of the management for the following reasons:

<sup>20</sup> The money in the coffers of the exchequer is the main source to meet the expenditure required to be incurred on the litigation by and against the public sector undertakings. It is nothing but wastage of precious exchequer's funds collected through the hard-earned money of the public, utilised merely for the whims and fancies of certain over-enthusiastic Departments of the Government and certain public sector undertakings to keep on litigating for frivolous reasons such as a matter of prestige etc. This also heavily congests the dockets of the court and its graph of arrears rises upward.

### 2.1 Management failures referred to Arbitration:

The major failures of the management which are sought to be referred to Arbitration and clothed with “sub-judice” are as under:

- a. Camouflaging the delay in recovery of the amounts legally due from the contractors by including the same as part of counter claim in order to escape prosecution or detection of fraud / corrupt practices;

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<sup>20</sup> Government and Public Sector Undertaking Litigation Policy AND Strategies 1988

- b. Allowing excess payments during the contract period and thereafter claiming the same as during arbitration proceedings;
- c. Issue materials / Plant and machinery as returnable materials, terminate the contract or levy liquidated damages just before submission of final bills such that the contractor would seek arbitration and thereby directly and tacitly benefit the contractor at the cost of the company;
- d. Pay ineligible claims and when detected, place the same before Arbitration Tribunal as part of counter claim;
- e. Employers' variations and contractors variations carried out without prior approval and claim made along with final or pre-final bill. Rate analysis not supported by documentary evidence;
- f. Awarding part of the works to another contractor (to favor that other contractor) in the garb of Risk & Cost;
- g. or the original contractor could have quoted least price for some major items to grab the contract but later on with or without connivance of the employer, refused to do the work and same being awarded to another contractor at "Risk and Cost" but without following the laid down procedure.

Pointing to Kerala's bitter experience in arbitrations, Justice Ramasubramanian said the state suffered while handling World Bank funds for its Kallada Irrigation Project from June 1982 to March 1989. Though the agreement had clauses providing for settlement of disputes through arbitration in a just and equitable manner, arbitrations went haywire.

Justice Ramasubramanian quoted<sup>21</sup> as follows.

"The state was asked to nav "unconscionable amounts". completely contrav to the provisions of the agreement. Officials of the government acted in collusion with contractors, who, in turn, colluded with arbitrators also. When the total loss suffered by the government far exceeded the original project cost itself, the state legislature nassed the Kerala Revocation of Arbitration Clauses and Reopening of Awards Act, 1998 and obtained presidential assent,"

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<sup>21</sup> As reported in Times of India "dt. 30 March 2014 under caption Arbitration to settle disputes bleeding PSUs: Judge

### 3. Case Studies

For the reasons of confidentiality of the contract conditions and since some of the awards might have been challenged in the High Court / Supreme Courts, the names of the parties in some case studies have been kept anonymous.

In the forthcoming paragraphs the term

- *Employer means the entity awarding the contract*
- *Engineer means the staff of Employer in charge of execution.*
- *Contractor means the entity which got the contract.*

Only gist of the management lapses leading to unfavorable awards have been brought out here:

#### **3.1 Non tendered (NT) or extra or variation items:**

Normally high value contracts provide for variations in quantities of BoQ items beyond certain level and extra (also known as Non tendered – NT or Non BOQ items). Variations may be made by the Engineer or the contractor. In either case, it should be with prior approval of the Employer. Further, contractor's variation shall preferably ought to be on account of value engineering. The contract conditions also stipulate that in case rate analysis is based on Govt. published Schedule of Rates (PWD SR), then price variation shall be payable. If the rate analysis is based on market quotes, no price variation shall be paid. The following issues were referred to Arbitration by the contractor and the Award went in favor the contractor:

##### **3.1.1: Modification in BoQ item was treated as NT due to lack of timely communication:**

The contractor was asked to use particular material as per BoQ. During execution, the Engineer asked the contractor to use a substitute material without analyzing financial implications. The contractor had, by invoking the conditions of the contract, claimed this to be NT. However the Engineer did not respond and towards the end, the Engineer took a stand that it was only modified BoQ item and hence recommended payment at BOQ rate. On

completion of the contract, the claim of the contractor for extra payment was disallowed. The contractor preferred Arbitration and the Arbitration Tribunal awarded in favor of the contractor *not on merits but on technicalities* i.e. the Engineer should have, before instructing the contractor to use substitute material, communicated that this would not be treated as variation.

### **3.1.2: Price variation on NT:**

Where the rate analysis is based on PWD SR, price variation is payable provided the execution of NT item requires more than 12 months for completion. In case the rate analysis is based on existing BoQ rate, the contract conditions apply. Where the rate analysis is based on market rates, no price variation is applicable. In another case, a BOQ item was modified to add finer finishing and glossy look. Additional cost was based on the market rates. The contractor claimed price variation treating additional cost also as eligible for price variation as the basic rate was derived from BOQ rate. Arbitration Tribunal awarded in favor the contractor. However the fact that additional cost was derived based on the market rate for similar item was not brought to the notice of the Arbitration Tribunal (AT) for reasons best known to the Engineer.

### **3.2 Lack of clarity on responsibility for the taxes and duties:**

In one of the contracts, the conditions provided that Employer would reimburse all taxes and duties for execution of the works contract. During negotiations, the contractor agreed for the same and he stated that “Customs duty, if applicable” would also require to be reimbursed. While issuing Letter of Acceptance (LOA) and entering into the contract agreement, it was stated that “all taxes and duties, as applicable for execution of the works contract, will be reimbursed at actual. The contractor raised a dispute for reimbursement of customs duties on imported plant and machinery. Employer declined. The Arbitration Tribunal partly (by considering life of the asset) awarded the claim on the grounds that the machinery formed part of inputs required to execute the works contract. Though the intention of the Employer was not to reimburse any taxes on plant & machinery, same was not clearly brought out in the LOA or contract agreement.

### **3.3. Providing facilities to the Engineer by the Contractor:**

Some of the civil contracts incorporate a requirement under General or Miscellaneous items a lump sum amount for providing facilities like office building, furniture, computer, printer, office assistant, telephone, car / van for commuting by the Engineer or other staff, etc. This is quoted as lump sum price by the contractor. The quoted price is only for duration of the contract. Any extension in the contract period would entail additional expenditure. In one of the cases, the contract duration was 30 months for which the contractor quoted lump sum price of Rs 60 lakhs. Due to various reasons, the contract was extended from time to time without levy of penalty or damages. The contractor also continued to extend the facilities provided to the Engineer and indicated the cost thereof. However the Engineer did not bring this fact to the notice of the sanctioning authority. Finally the contractor claimed about Rs 5 crore towards additional cost of providing the facilities. While the contractor had been cautiously building his case, the Engineer on the other hand enjoyed the facilities but did not refute or bring to the notice of sanctioning authority. The claim went to Arbitration Tribunal which decided in favor of the contractor and awarded Rs 5 crore with interest thereon from the last date of his claim.

In such cases, Audit may examine the issue on merits to:

- a. Fix responsibility for such lapses
- b. Evaluate value for money as to need for the contractor to provide such facilities (i.e. audit may insist deletion of such clauses in the tender itself and ask the Employer to provide facilities by itself)
- c. Examine whether such assets (like building, computer, printer, etc) have been transferred by the Contractor to the Employer on completion of the work.

### **3.4 Substitution of materials without value engineering:**

A contract was awarded for manufacture and supply of a particular item using higher quality of raw material. After award of the contract, the contractor approached the Employer to permit him to manufacture the item by using lower cost raw material. The

Employer gave approval for the same without evaluating the financial implication (favorable to the Employer, as there seemed to be deliberate collusion between the employees and the contractor in this case). After completion of supply and based on report of internal audit, the Employer asked the contractor to pay the difference and failing which it was referred to AT. However, since the Employer gave consent without any conditionality as to reduction in price, the AT held Employer could not agitate the same before it at a later date. Thus the Employer lost the case thought it was a case of fraud.

### **3.5 Compensation awarded due to premature award of contract:**

High Value contract for about Rs 200 crore was awarded for electrical works with completion time of about 208 weeks (about 4 years) to a contractor with identified milestones and key dates. This contract was dependent on various other activities like land acquisition, civil construction, etc. But this contract was awarded even before:

- a. the land was acquired
- b. dependent civil construction was not even tendered at the time of award of electrical works
- c. required statutory clearances

The contractor was able to demonstrate above fallacies and claimed compensation for idling of his resources, mainly project personnel, machineries and office rent. AT awarded the compensation amounting to Rs 28 crore in this case. Thus the mismanagement in contract planning and awarding would now be clothed with AT award in reply to Audit para.

### **3.6 Risk & Cost:**

It is a common practice that some contractors quote lower rates for significant volume of works in order to grab the contract and later on abandon execution of that part of contract on some or other pretexts like material not available, or technological change, etc. In some of such cases, the Engineer with the connivance of the

contractor, entrust such works to another party, apparently on Risk & Cost basis. The Risk & Cost basis exists only in internal noting but the procedure as laid down in the contractual conditions not duly complied with. After completion of the main contract, the Employer issues notice for recovery of additional cost for the Risk & Cost works. Contractor goes into Arbitration. The Arbitration Tribunal has, invariably held that where contractual conditions, which require, at least 21 days prior notice before entrusting that part of work at Risk & Cost of the contractor, is not complied with, the Risk & Cost term could not be invoked by the Employer. There are umpteen cases where the Risk & Cost clause has not been complied with by the Employer and AT goes into more of technicalities than merits of the case; thereby putting the Employer (mainly PSU) into double whammy – one not getting the work done at quoted price and another paying higher price for getting the work done by another agency. In most of these cases, connivance of Engineer with the contractors cannot be ruled out.

#### **4. Conclusion:**

There is a growing tendency to refer all claims / disputes to Arbitration and some cases may be intended to use Arbitration / Dispute settlement as a tool to hide corruption /lapses/ inefficiencies of the management and thereby escape accountability. While conducting audit, SAI may focus on litigation cases and also go into detail to determine whether the action of the management is for bonafide interests of the organization or not. Further, Audit may also ask the management to formulate appropriate policies /procedures for:

- i. Distinguishing claims from disputes
- ii. Inserting suitable clause in the contract for Early warning of claims /disputes
- iii. Go for less costlier mechanism like Dispute Settlement Board, etc or conciliation

- iv. Suitable mechanism for deciding on filing appeal against Arbitral Awards based on the facts and also to identify and fix responsibility for lapses, if any.
- v. Arrange for dissemination of knowledge amongst its staff on “dos & dont’s” to minimize cost of litigation.

# RESPONSIBILITIES OF MANAGEMENT AND AUDITORS FOR PREVENTION AND DETECTION OF FRAUDS: FOCUS ON PUBLIC SECTOR

**K.V.S.S.SITARAMARAO \***

## **1. Introduction**

Fraud and corruption have been the twin cancers increasingly ailing the Indian society in general and the Indian public sector in particular, for quite a few years. When it comes to investigation and detection of the two evils, corruption by its very nature often not being evident on documents, can best be handled by the law enforcing agencies like the Police. Frauds on the other hand, particularly, accounting frauds are more often relatable to books of accounts and connected documents. Whatever be the organisation, public or private, the players have their own ingenious and insidious methods of flouting the organisational rules, to make illegal personal gains quietly without attracting the attention of the stakeholders, who range from the general public to shareholders/investors/lenders etc.as the case may be.

Prevention is better than cure, as the saying goes. So is the management, which handles the daily affairs of an organisation, primarily responsible to prevent any financial mismanagement in it; the auditors come only next, to assess, within their remit, whether everything is in place to prevent any damage and if any damage was actually done, to analyse the causes for the damage. Naturally, the spontaneous reaction of a common man on hearing about any fraud, is to point an accusing finger against its auditors too, besides the management, either for their inefficiency or complicity. When a major fraud takes place in a public sector

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organisation, the ire of public at large is also directed against the government in power, at times, with wide-ranging political repercussions. In this article it is proposed to discuss broadly the statutory role and responsibilities of the management and auditors for preventing and detecting frauds in public sector and how far they are able to fulfil these responsibilities.

## **2. Types of organisations**

Public sector broadly refers to all entities which are either government or quasi- government bodies, which are fully or partly funded by or under the authority of governments or otherwise subject to the administrative control of governments. Union and State government departments, local bodies, government companies incorporated under Companies' Act, statutory corporations and autonomous bodies etc. set up by governments fall in this category.

## **3. Audit arrangements**

### **3.1 Types of audit**

The audit conducted in any entity, in general, can be either a statutory audit or internal audit. Statutory audit is the audit prescribed in the law (statute), governing the functioning of the entity. Internal audit is an internal exercise undertaken by the management as part of their internal controls, to ensure that all rules and procedures are being complied with.

From the point of view of auditors, they are either External Auditors or Internal Auditors, depending on whether they are employees of the entity or engaged from outside. Statutory audit is always conducted by External Auditors, while internal audit could be conducted by either Internal Auditors or External Auditors. It has become a practice though, to refer to Statutory Auditors as External Auditors and those conducting Internal Audit as Internal Auditors, though they are not employees of the entity.

### **3.2 Appointment of auditors**

- a)** In respect of Union and State governments departments, the Comptroller and Auditor General of India (CAG) appointed by the

President as per the Constitution of India, is the primary and Statutory Auditor. In exercise of the powers conferred on him by CAG's (Duties, Powers and Conditions of Services) Act, 1971 he has issued detailed guidelines in his Auditing Standards, Audit and Accounts regulations, and various Standing orders/manuals etc. for conducting audit of these organisations. As for other government bodies, necessary provision for appointment of auditors is made in their respective legislations, subject to CAG's jurisdiction as provided therein and the CAG's Act.

**b)** With regard to companies (whether government, public or private), the Companies Act 2013 lays down detailed provisions relating to Audit and Auditors in Sections 139 to 148. According to section 141(1), only a qualified Chartered Accountant (CA) or a firm of CAs can be appointed as auditors and as per Section 139 and the appointment of the auditor should be approved at the annual general meeting of the company. Further, as per section 143(9), the audit has to be carried out in terms of the Standards of Auditing (SAs) and other procedures laid down by Government of India/Institute of Chartered Accountants of India (ICAI) set up under Chartered Accountants Act, 1949.

It is also pertinent to note, that the above statutes do not contain the expression "statutory audit" but refer only to "audit". "Statutory audit" should, therefore, be understood as an informal expression for "audit" prescribed mandatorily under a statute.

## **4. Fraud and its scope**

### **4.1 Concept of fraud**

#### **4.1.1 Definition**

The term 'fraud' connotes a criminal concept. But, it is not exactly defined in the Indian Penal Code, which, however, explains the word 'fraudulently' in Section 25, by laying down that "a person is said to do a thing fraudulently, if he does that thing with intent to defraud". Without going into detailed legal aspects, 'fraud' can be generally understood from the identical explanations given in the Standards of Auditing (SAs) issued by ICAI (SA 240) and the Standing Order (SO) dated 6 September 2006 (para 3.2) issued

by CAG ([www.saiindia.gov.in](http://www.saiindia.gov.in)>Home>Resources) on “role of audit in relation to cases of fraud and corruption” as an “intentional act by one or more individuals among management, those charged with governance, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage”.

#### **4.1.2. Frauds within the scope of audit**

Fraud is a broad concept, which includes both accounting and non-accounting frauds; the latter category cases are totally outside the purview of books of account. For example, if a company illegally takes possession of government land by creating fake documents of purchase, this is a fraud which is not reflected in the books of account of the company. There is nothing the auditor could do about it.

The duties of Auditor are enumerated in SA 200 *et seq*, starting with audit of financial statements. The relevance of frauds to the auditor is explained in S A 240, (para3) by stating that the auditor is concerned only with two types of frauds, resulting from i) fraudulent financial reporting and ii) misappropriation of assets, Para A 5 of the same SA further concedes, that of these two types of frauds, misappropriation of assets is often accompanied by false or misleading records and is disguised or concealed in ways that are difficult to detect. Exactly, similar views are also expressed in Para 8 .1 of the CAG’s S O of September 2006.

To take simple examples, if an employee intentionally writes a cheque for an amount in excess of that authorised in a voucher and the financial statements are prepared on that basis, it is a case of fraudulent financial reporting and normally capable of being detected in audit scrutiny. On the other hand, a contractor or supplier submits invoices for goods that have not been delivered or do not properly represent the quality and quantity of goods and services supplied or work done as per contracted specifications, and the invoice is admitted for payment by the management, it is a fraud related to assets. (This case is referred to in the Appendix- A to the CAG’s Standing Order of September, 2006).

### **4.1.3 Instances of frauds**

An example of accounting fraud happened not long ago is the one relating to Satyam computers in which the management of the company falsified the accounts and projected a rosy picture of the finances of the company, suppressing the actual state of affairs. Naturally, the auditors of the company, who should have detected this in their audit were found guilty by Courts of law. Another case of very recent origin is that of Punjab National bank, where its employees issued letters of undertaking (similar to bank guarantees) to other banks abroad, to enable them to extend credit to a customer of the former bank, bypassing the procedures for issuance and recording of such undertakings in the system of core banking solutions. Ultimately, due to non-settlement of the credit by the beneficiary, the bank had to be responsible for the liabilities. The law enforcing agencies are rightly looking askance at the auditors of the banks too, for not highlighting the accounting lapses by the bank management. The investigations are actively under way.

## **5. Management's responsibility**

### **5.1. Internal controls**

(a) The responsibility for prevention and detection of frauds being cast primarily on the management/governments concerned, it is implied that they are also responsible to ensure that appropriate systems are put in place to prevent and detect such frauds. The first and foremost among them is a sound system of internal controls including, internal audit. Internal controls can be broadly defined as policies and procedures adopted by the management of an organisation to ensure orderly and efficient conduct of its activities. They cover the entire ambit of an organisation, which include manufacture, trading, service, administration and accounts etc.

(b) While every organisation has to frame its own internal controls suitable for its activities and operations, a few basic principles common for all organisations in framing a system of internal controls are as follows:

- i. administrative and financial powers relating to any work should be divided among different personnel,
- ii. a single person should not have independent control over any important activity,
- iii. all actions of one person should come under the review of another,
- iv. duties of staff should be changed from time to time without notice,
- v. persons having physical custody of assets should not have access to accounting records ,
- vi. physical verification of assets should be periodically conducted with reference to accounts control registers of assets etc.

## **5.2. Internal audit**

Internal audit is a part of the internal controls and is an independent appraisal of the activities within an organisation, and generally cover all the operations of the entity and physical examination and verification of assets etc. The need for conducting internal audit was legally recognised and mandated in Sn.138 of Companies Act, 2013 read with the Companies (Accounts) rules 2014. (Rule 13), which specifically mandates a) all listed companies and b) all unlisted companies satisfying the financial parameters specified therein (with regard to paid up share capital, annual turnover etc.) to appoint Internal Auditors. An effective internal audit should cover the accounting systems, related internal controls, scrutiny of financial and operating information to enable the management to take considered decisions. The exact scope of the internal audit, however, can be decided by the management keeping in view, the nature of activities and the practical needs of the entity. The Internal Auditors are responsible to the management within the scope of audit entrusted to them.

As regards government departments, no such statutory mandate seems to exist. However, many government departments in their best judgement have put in place internal audit systems,

apparently depending on the size of financial implications. In the Union Government all the Civil Ministries have well established systems of internal audit, with guidance and support from The Controller General of Accounts, whereas in the State governments no uniform procedures exist. Besides, there is a tendency on the part of government departments to wink at this aspect, perhaps, with an impression that the cost of resources deployed on internal audit would be disproportionately larger than the benefits achieved and, that in any case, there would be the statutory auditor, CAG, conducting the audit. This view is not correct. As discussed in the succeeding paragraph, the statutory auditor has his own limitations and it cannot be an exhaustive and comprehensive audit, whereas, in internal audit the scope and sampling of audit could be as extensive as the management desires. A combined system of internal and external audits to an organisation is, what policing is to a society. An efficient police force may be a reason for absence of crime in a society, but the latter cannot be a reason to do away with the police force itself. Similarly, both the audits are an indispensable necessity of an organisation, whether or not frauds take place and together, their very existence acts as a deterrent on fraud perpetrators. So irrespective of the legal mandate, it is advisable to have an internal audit system, which would be a value addition to the financial health of an entity.

## **6. Statutory auditors' responsibility**

**6.1** In the case of entities audited by CAs, the responsibilities of the auditors for detection of fraud are laid down in their respective mandates viz., the SAs issued by the ICAI. In SA 240 (para 4), firstly, it is stated that the primary responsibility for prevention and detection of fraud rests with those charged with governance of the entity and management. Secondly, the type of frauds that an auditor is concerned with were already discussed in para 4.1.2 above. Thirdly, in para 5, it is clarified that the auditor is “responsible to obtain *reasonable assurance* that the financial statements taken as a whole are free from material misstatement caused by fraud or error”. Again, SA 200 (para A 45) concedes that the auditor is not expected to and can not obtain absolute assurance, as most of the audit evidence on which the auditor

draws conclusions are persuasive rather than conclusive. Again, in A52 *ibid*, it is reiterated that because of the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs. Further, in SA 315 detailed guidelines are given to the auditors to identify and assess the risks of material misstatements due to fraud or error through understanding the entity and its environment, including the entity's internal controls. The overall inference is that the auditor is absolved of his responsibility, if the audit is conducted in accordance with the guidelines in the SAs.

**6.2** In the case of public sector including government departments and other government entities, the S O (September, 2006) of CAG contains exactly similar views.

In terms of this order (paras 7.1 to 7.3) the “responsibility for prevention and detection of fraud and error rests with the management of the audited entity, through the implementation and continued operation of accounting and control systems designed to check fraud. Audit must, however, evaluate and report on the adequacy of the systems in place and competence with which the management has discharged its responsibility....”. Again in the Financial Attest Audit Manual (Para 2.28), the CAG also observes that “the audit opinion provides *reasonable assurance* that the financial statements are free from material misstatement and irregularity. An understanding of the term *reasonable assurance* is central to the understanding of the audit and audit opinion”. Regarding inability of the auditor to obtain absolute assurance, views similar to those in SA 200 (A52) were expressed in para 8.4 of the S O too.

## **7. Status of internal controls and internal audit in public sector**

A study of the recent Audit Reports of CAG (for the years 2015-16 and 2016-17) containing comments on some of the government companies and departments audited by him across different states throw some light on the position obtaining in these

entities on these issues. By and large, the comments go to show that proper internal controls and internal audit either do not exist or where they exist, are not effective enough. Significant comments made by CAG, in the reports of the companies and departments of various governments are grouped below separately. This list, however, is only illustrative and not exhaustive.

## **7.1 Government Companies**

### **a) Government of Assam-Report no.5 of 2016 for 2015-16 Assam Petro Chemicals Ltd.**

Para2.17:The company conducted internal audit through a CA for the period 2011-16. The internal audit reports were silent on several vital areas of operation such as efficacy of systems and controls, particularly in the manufacturing units, operational efficiency of plants , adherence to plans policies and procedures etc.

### **b) Government of Bihar –Report no.3 of 2017 for 2015-16**

#### **i) Bihar State Hydro Electric Corporation Ltd.**

Para 2.1.29: The company failed to devise a proper and efficient review procedure to analyse its financial, operational and generational activities and take corrective measures on deficiencies noticed. The company failed to reconcile its bank balances with balances as per cash book since 2011-12. As on 31 March 2016, unreconciled difference was Rs.13.37 cr.

The company failed to maintain proper records showing full particulars, including quantitative details and situation of fixed assets. Besides, a system of physical verification of company's assets was also not being practised in the company.

The company did not have its own internal audit wing. A firm of CAs, appointed for the internal audit of the company was merely certifying the compilation of annual accounts and did not undertake any technical/proprietary audit of the company.

#### **ii) Bihar State Electronics Development Corporation Ltd.**

Para2.2 38: The company did not have its own internal audit wing. Firms of CAs were engaged for the work of internal audit and also

for the work of compilation of accounts, reconciliation of bank accounts etc. There was no mechanism whereby the reports of internal audit were reviewed and complied with .Hence the internal audit system was ineffective.

**c) Government of Haryana-report no.6 of 2016 for 2015-16  
Uttar Haryana Bijli Vitran Nigam Ltd.**

Para2.9: The internal audit reports contained observations, having financial implications of Rs. 46.70 cr. relating to the period 2007-08 to 2013-14. They were neither charged nor settled as of March 2016.The internal audit wing has not commented on the system deficiencies like, delay in filing adjustment claims, release of connections in wrong category, short-recovery of meter rents, delay in issue of first bills, unauthorised extension of load etc. which all have a bearing on the revenues of the company.

**d) Government of Jharkhand-report no.2 of 2017 for 2015-16  
Tenughat Vidyut Nigam Ltd.**

Para2.1.15.1:Physical verification of stores was not carried out by the company during 2011-12 to 2014-15. The physical verification conducted during 2015-16 revealed shortage of coal valued Rs. 33.23 cr. The company has not prepared fixed assets register containing details of assets procured, cost of the assets, date of commissioning and location of the assets etc. Physical verification of the assets was also not conducted by the company.

Para 2.1.15.5:The company has not prepared any internal audit manual .The internal audit function was outsourced to CAs , whose scope of work included preparation of accounts, verification of cash book, stores transactions and other accounting work. However, core activities of the company relating to operation and maintenance of plant, sale of power, purchase of fuel, equipment and other stores were not covered in the scope of work for internal audit. No internal audit reports were submitted by the internal auditors from 2011-12 to 2015-16.

e) **Government of Maharashtra-report no.2 of 2017 for 2015-16 Maharashtra Tourism Development Corporation Ltd.**

Para 2.26: The company had not prepared accounts manuals or functional manuals for their operations. The Assets register was not updated since 2013-14. Physical verification of stores was not conducted. The scope of internal audit carried out by a firm of CAs did not cover transactions relating to purchase of land, leasing of resort and restaurants, execution of various projects and expenditure relating to advertisement. Internal audit reports were not submitted to MD/or Board of Directors (BoD) for scrutiny and remedial action. The company should streamline and strengthen their internal control mechanism.

f) **Government of Punjab-Report no.3 of 2016 for 2015-16 Punjab Water Resources Management Development Corporation Ltd.**

Para 2.1.13.1: The company did not frame internal audit manual. The internal audit was in arrears from 2012-13 onwards. Though the reports up to 2011-12 pointed out irregularities of high risk categories like non-maintenance of control registers, wrong classifications, negative balances, non-compliance with provisions of Income Tax Act and Companies Act, the reports were not placed before the BoD.

g) **Government of Tamilnadu-Report no.7 of 2016 for 2015-16 Tamilnadu Industrial Investment Corporation Ltd.**

Para 2.1.35: The company had not prepared internal audit manual. The internal audit did not cover the planning and resources management sectors of the corporate office. The internal control system was inadequate to periodically review the system for efficient performance, and to help the management take informed decisions.

## **7.2 Government departments**

In Government departments, internal auditors were engaged mostly in revenue earning departments. A few cases where CAG made some interesting comments are indicated below:

**a) Government of Assam-Commercial Taxes Department (Para2.2 of Report no.3 of 2017 for 2015-16)**

No staff were working in the Internal Audit wing.

**b) Government of Chattisgarh - Commercial Taxes Dept.(Para4.2 of Report no.4 of 2016 for 2015-16)**

Four CAs were functioning as Internal Auditors in Head Office. The Department did not intimate the number of cases checked and the observations made by the Internal Auditors along with action taken by the department.

**c) Government of Punjab-Finance Department (Para 1.9 of report no.4 of 2016 for 2015-16)**

As against 1751 units planned for audit, only 472 units were actually audited.

**d) Government of Rajasthan-Commercial Taxes Dept.( Report7 of 2016 for 2015-16)**

Paras 2.2,3,2,4.2and 5.2 : All the major revenue earning departments like, Sales Tax, Motor vehicles Tax, Stamps and registration, and Land revenue have internal audit systems in place. There were shortfalls in conducting internal audit in Sales Tax as also Stamps and Registration departments, ranging from 14 to 72% and 50 to 97% respectively, during 2011-12 to 2015-16.

**e) Government of Telangana-Animal Husbandry and Fisheries Department**

(Para2.1.14.1 of Report no.3 of 2016 for 2014-15)

The Department has an Internal Audit wing headed by a Senior Accounts Officer. Out of 56 field offices in the State, the Internal Audit wing audited only 8 units in 2012-13 and did not audit any offices thereafter .

**7.3** The bottom line is that, with this kind of laxity in internal controls and internal audit, there is an increasing risk for frauds and errors to happen. These issues need to be addressed by the

managements urgently, to ensure better financial health of public sector.

## **8. Specific case studies**

Against the background of absence or deficiency of internal controls and internal audit, a couple of cases of fraud reported in the press recently, make an interesting study.

### **8.1 Hyderabad Metropolitan Development Authority, Government of Telangana**

HMDA engaged a private security agency for providing security services for their organisation and used to issue cheques towards payment for their services. An employee of the agency opened an unauthorised account in the name of the agency with a bank, with fabricated documents. He would tamper the cheques for larger amounts, credit them to the unauthorised account, pocket the excess amount and finally transfer the balance amount to the legitimate bank account of the agency. Thus, the management of the agency was also in dark about the fraud. The Accounts officer of HMDA detected the fraud but colluded with the employee of the agency for monetary gains. A total amount of Rs.5.87 cr was swindled over a period of 8 years from 2008 to 2016, when it was noticed by other officials in HMDA. Though the fraud was detected by HMDA itself, the fact remains that severe damage was already done by the time it was detected after more than 8 years. This is a clear case of failure of internal controls in HMDA on the following counts.

i) Any organisation maintaining bank accounts and making payments by cheques, has to prepare a Bank Reconciliation Statement at the end of every month, reconciling the differences between the bank balance as per their cash book and that as per the bank statement (Pass book), by comparing each receipt and payment entry between the cash book and bank statement. This process invariably brings to light any discrepancy between the cheque amount as per cash book and as per the bank statement. There is scope for this process to fail, if only one person is writing the cheques as well as cash book, and does the bank reconciliation also or if there is no proper second check over the cash book

entries and preparation of bank reconciliation statements. This position holds good even if the accounts are computerised.

ii) Secondly, at the time of preparation of Annual Financial statements like Income and Expenditure and Balance sheet, the balance with each bank should also be got certified and kept on record. If the fraud was not detected at this stage also, it could be due to the same person handling cash book etc., prepared the annual accounts also getting an opportunity, to fudge all the connected accounts records like cash book, bank reconciliation statements and annual accounts etc. at every stage.

iii) Thirdly, while manually writing up cheques, a basic precaution to be taken is that no gap should be left while writing the amount in figures after the letters 'Rs. ' in the box provided for the purpose. Similarly, no gap should be left while writing the amount in words also, on the line provided for this purpose, so that no interpolations could be made later. However, as the fraudster was able to tamper the amount in the cheque, gaps must have been left by HMDA staff either intentionally or inadvertently, facilitating interpolations both in figures and words. The fact that such tampering was done for years together with impunity, evidently shows that this precaution was thrown to winds.

## **8.2 Agriculture Department, Medak Dist. Government of Telangana**

In a somewhat analogous case, a computer operator has stolen some blank cheque leaves from the office and forged the signature of the Drawing officer concerned and misappropriated a total sum of Rs.3.13 cr, which was noticed in January 2016. Though full details are not forthcoming, the non-observance of internal controls as in the case of HMDA is applicable in this case also.

## **9. Conclusions and recommendations**

Every organisation in the public sector, should frame policies and procedures for internal controls in all its departments and prepare an internal audit manual. The internal controls should be meticulously followed, however, innocuous or intricate they may

seem to be. The cost of ignoring or neglecting even simple controls will be known only after the damage is done.

Governments should arrange for internal audit systems in all departments at periodical intervals and ensure follow up action on the observations made therein. The expenses on internal audit system will be more than recovered by way of preventing losses on account of fraud and error etc. The desirability of adopting the system obtaining in the Union Government on an organised basis in all departments also deserves consideration.

# GUNPOWDER AND PIZZA- A KABUL JOURNAL

**PRANAB MUKHOPADHYAY\***

When I was offered to do a project in Kabul, it looked a familiar ground having worked in several war-torn countries for UN. A capacity building project by another agency meant that the security ring fence as in a UN office would not seclude me from outside world in Kabul. I readily agreed. As it looks, working in Kabul (2014-2017) was more than an auditor's drab life.

This is an incomplete story of a humbling experience; learning the value of patience and being sensitive to build trust. Whenever I slipped from these standards, I made mistakes that left deep scars. Officialise and formalities stifle project operation. Being light footed and alert to signals made the difference in managing this project especially in Afghanistan.

My decision to work in Kabul had the expected raising of eye brows (are *you mad?*). After the initial blues were settled, my first challenge was to get visa for working in Afghanistan. Afghan visa rules were changing Ministry of External Affairs (MEA) needed to authenticate my degree certificate issued several decades ago. The embassy staff told that too many '*expert and consultants*' went to Afghanistan with fake degrees and hence this precaution! I got a visitor visa for one month after many trips to the Afghan embassy.

My comrade-in-arms in this project Mr B B Pandit reviewed the draft of this paper and gave valuable inputs to me. We spent many exciting hours together in Kabul. My other colleague, from India (a Canadian citizen) also gave me great support. I am grateful for their help in a project that was fraught with so many imponderables and risks.

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\*Shri Pranab Mukhopadhyay was Director General in the office of the C&AG of India and Chief Resident Auditor OIOS U.N.

## **Flight down the Hindukush**

I landed in Kabul on a cloudy day of March. The flight was full of Afghan citizens who were returning from India after treatment, business trip or vacation. The snow-clad Hindukush mountains greet you as you approach Kabul airport after two hours in the air. The airport was well built, but the unlicensed porters were jostling to carry your luggage and the immigration desk meant a lone person asking you to fill a form before stamping the passport. After four years as I was leaving, the Kabul airport has a streamlined immigration, security and check-in system with well trained staff at par with any international airport.

On my way to hotel, I passed through a developed urban centre with walled compounds of government buildings, asphalted roads, well-built roundabouts, high rises, shopping malls and soldiers standing in alert at each street corner. This was a pleasant surprise. I was expecting a rundown city for Kabul in the face of the continuing war.

It snowed in the evening. The hotel that was booked for me had skimpy security, the room leaked and all night the rats were scurrying over the frayed carpet. Heating was low and I shivered and had to put on my overcoat while going to bed. I left that hotel next day and went to another hotel about two kilometres away. A year later I thanked my stars that I took a providential decision that day.

## **A building dominates the landscape**

My first day's travel to the office took me through dense traffic across the city's main thoroughfare and as we hit a large four lane road separated with gardens, the topography changed. Dark blue mountains with snow tops now marked the skyline. Supreme Audit Institution (SAI) office building appeared after a long drive. It is a modern well-built 4 story building, with fashionable brick and glass façade. It stood tall with the mountains in the background, in a sparsely built area of the city and dominated the landscape. The high compound wall with barbed wire fencing on the top and iron gate with layers of security staff

remind you of the grim security scenario. Inside, there was impressive landscaped gardens.

### **Know the client**

The stamp of Auditor General's leadership and personality was evident in the SAI office. I met the Auditor General in his office in the fourth floor and his room offered a grand view of the skyline of the mountains. Being a Phd. in Physics, widely travelled, politically well-connected, an educationist (he teaches Physics in the Kabul university), he strikes you as a warm, well-organised modern person. He was an active participant in the civil war on the side of the Northern Alliance that significantly contributed to the ouster of the Taliban. For me it was a rare opportunity to work with a former top brass of the Northern Alliance. Auditor General is an Indophile and I had many hours of interesting and stimulating insights from him.

Auditor General is the most critical point in the success of SAI. He piloted the metamorphosis of SAI from being an arm of the Ministry of Finance to a functionally independent pillar of accountability. He was supported with a national audit law in this transformation. In his quest for a quick transformation, he organised international cooperation for developing the SAI, obtained funding for projects, year-long training classes in using computer and English language, many foreign trips and training programmes abroad for his staff and instilled a culture of discipline. The office that I saw was tightly controlled, confident, aspirational and internationally exposed institution.

The enormity of this transformation is significant in the context of the anarchy and dismantling of formal education in the Taliban period that cast its lingering shadow long after they left.

He was hands-on on the project operation. His focus was training and he spent unbounded energy in supervising all aspects of training. This is an area where I was to interact with him frequently. He would meet the project Team leader every week to get report personally on important matters. This gave an opportunity to me to know his concerns and interesting inside views on the power struggle in the government.

## Smell of gunpowder

Afghanistan is engaged in an unending two decades old ruthless civil war in the current history. When I joined my work in Kabul, Afghanistan was ranked the most dangerous country in the world.

Living in a state of apprehension of terrorist violence was the new normal. I had my baptism by fire quickly. I spent barely a week in SAI office in Kabul when Taliban attacked the neighbouring office of the Attorney General and killed several staff to scare the judges and the investigating officers. From the third floor of the SAI office, I saw smoke swirling up from a walled compound in the next lane and heard the *tat tat tat* of machine gun. I huddled in a secure room with other Indian advisors who were working in that office. Seeing the increased threats, Auditor General advised that we should get out of Afghanistan quickly and come back when the situation gets calm.

Shortly after the first anniversary of the project, security issue suddenly took an ugly turn. A resident terrorist attacked the same hotel that I left an year ago, killing 17 people over four hours in an evening while armed police waited outside trying to figure out how to get in the hotel. The list of dead included several Indians and some colleagues in another project. We were awake whole night as it was known that the hotel that was under attack hosted many of our colleagues and friends. I was called next morning by the embassy to identify a colleague with bullet hole between his eyebrows, lying in body bag. Most of the international staff working in his team left Kabul.

Shortly before this great tragedy, a former cricket player and UN staffer, joined our team as an expert. As the news of killing in the other hotel burst on us, he was quick to get a ticket to USA, his present home, never to return again.

Given these realities, I and the project expert faced the tough question if we should stay along or leave. Assessing all factors, we stayed on. In the next two years the experts took personal risks every day as they moved through the city's roads to go to the Ministry offices. Each work day we travelled 20 kilometres up and

down from our hotel to the office in an unarmed vehicle and watch the flow of life on the way. We also visited many places in Kabul city.

As the project was in the closing months, one morning, a thunderous and blood curdling sound for several seconds shook me. I was getting ready to go to office. There was commotion outside my hotel room and I saw white smoke from one corner and splintered glass on the corridor and cries of the reception lady was renting the air. I ran to my colleague's room in the same corridor. He was getting ready. His wife (yes, she was there too!) was taking bath. I asked him to run to the safe room. Down there the entire hotel staff was in the basement safe room, it looked that our hotel was attacked.

After some time, news came that the German embassy was attacked with huge explosive material carried in a swage truck. This was barely a kilometre and half away from our hotel. The blast shook Kabul and nearly 200 people were killed. We returned to our rooms shaken as my colleague was to go in the same area where the blast happened. He could be very near the blast if he was already on the way! It was sheer luck that he was still in hotel and his going was delayed.

### **Suits, pizzas and Bollywood**

The smartly dressed staff in the office could not escape a newcomer's notice. I felt that on average, the SAI staff was better turned out than what I have seen in other offices. Male staff are dressed in suit or in jacket and trousers. Female staff use modern dress and had their hair covered with hizab around their face.

Auditor General shared the interesting story of his sartorial intervention in the new office. When he assumed office shortly after the ouster of Taliban, the staff were sporting long beards and followed the Taliban dress code with traditional Pushtun dress and turbans. He got funds to help them getting formal suits and ensured that they shave their beards and come to work in their new dress. An officer recalled that when he went to India a few years ago for training, their Indian hosts were surprised at their suit-and-tie-clad

appearance; perhaps they expected the traditional dress with long tunic, beard and the turban!

The officers have graduate degrees (and some have post graduate degrees) in law, economics, education, literature or psychology. Some are pursuing MBA courses in the evening. Many of the young staff are fluent in speaking English and net savvy. In general, office staff are warm and courteous and had an innate liking for Indians. I often felt that I was at home and wished that I could speak Dari.

As government job offers modest salary, young collage educated staff aspire to get scholarship to pursue higher studies abroad that is a ticket for well-paid job and ultimately migration to a western country. Every day we saw very long queues of applicants for passport as we passed the Foreign ministry office.

The young SAI staff are savvy with mobile telephony that reflects the general trend - everyone loves Facebook and the small screen to read the jokes and stories and download movies! Pizza, KFC (*Afghan Fried Chicken!*) and fast food are very popular even while *Kebab* and *pilau* were the staple!

Many of the SAI staff visited India for education, treatment and vacation and loved Bollywood films. They often surprised me with their knowledge of Indian heroes and heroines, Hindi lyrics and local marriage rituals thanks to the Bollywood films. Their visit strengthened the ties between the two cultures.

### **Zig zags in the project operations**

The project was part of the donor funded public finance management reform (PFMR) programme across the government and World Bank (WB) was overseeing it. We had to serve two clients- SAI and World Bank who had sometimes different perspectives. When I met the WB boss in his heavily secured office, he shifted the project goal post and compressed the main outputs of the project for two years in the first year itself to meet donor-imposed benchmark. So, even before we could do the groundwork we were in the field! We met the benchmark of WB that brought much kudos and relief to SAI.

SAI top brass championed the project for modernisation and capacity building in compliance audit that was its core operation across most of the units. The broad-base of the project meant that we were interacting with many units in the office. That presented new challenge as it was unclear how the entity will adopt new professional practices across the board.

The first year was trying time in the project. The project agreement was not translated in Dari till late in the day and a communication gap was evident. A few months in the project, requests of SAI exceeded the scope of the contract. SAI had an advisor from the World Bank to interlocate and monitor the project. Even this did not help.

In Kabul you cannot ignore the tribal realities- Taziks, Pushtuns and Hazaras were the dominant claimants of the fruits of power in the post-Taliban settlement. Knowing important signals of this reality was crucial for survival and wherever I missed a cue, I faced great adversity.

But these hitches notwithstanding, appreciation of our work in the first year blew the dark clouds and the project proceeded on a cordial note. Work done by Indian Advisors created great goodwill and positive impact in SAI office and our project was seen as a continuum in that mode. Genuine warmth and friendship with staff and officers of SAI marked our journey.

### **Translation is key to project success**

The project recruited well trained translators but in the initial months, we had some surprises. Our training materials, templates and guidance notes met cold reception from the staff. It came out that our translators had modest familiarity with technical words and terms of audit and so they often used Dari version from google search! SAI has a laconic writing style for audit reports. Our experts fleshed out complex matters with analytical and discursive sentences. There was no resident skill in SAI to translate such words and concepts. Our translators had no external resource to fall back on.

To meet such challenges, I started speaking to the translators and explain the concepts, clarify audit points and even the logic of the writing style of reports. The texts were edited to simplify the narration. These efforts paid. The quality of translation improved as we progressed with the project.

## **Training stories**

SAI built up an impressive training apparatus. The training halls located in the top floor, are well equipped and well furnished. The training unit had hand-picked staff and led by an ever-smiling Training Director. Our training sessions for class room training had batches of 20 to 40 in one class. But we had an unique situations to deal with in the classes.

Some of the trainees would be restless as we discussed new audit concepts. They were in their late fifties, had schooling during Taliban period and made their discomfort known loudly. Our training manager, an ambitious young person stepped in to help- he would explain them the concepts in his own way though he has never audited himself! The experts got time to focus on the young and keen learners.

A big surprise was waiting in the first year. Come November, nearly 200 odd field staff are grounded for three months in the winter and they had to be trained. The basement hall was used as makeshift training classroom. Many of the trainees were about to retire while many others had just joined. Each session resembled a townhall meeting. It stretched our resources. Our training manager, translators, office manager and the office assistant joined hands to meet the challenge of preparing large quantity of training material at short notice. With their help, translated material was printed in time and copies carried to the class. The translators were on hand to go with the expert at the right time to the class. If the chain broke at any point the training would be in doldrums.

## **Livewires of the project**

Our project staff were our eyes and ears in a foreign country. The interns, translators, training managers, office manager, office

assistant and drivers were the livewires that kept the project light burning bright. These were young Afghan boys and girls, educated, articulate, highly motivated and ready to learn and improve.

The young boys and girls who joined as interns would learn auditing and be the go between the experts and SAI staff and ministry staff. Many of them are now employed in Kabul having worked in our project while pursuing professional courses in locally operating foreign universities.

Training managers assisted us in organising trainings, support experts in the class and coordinate with SAI counterparts. One of them was an expert in her area and took classes herself. These training managers are now pursuing higher studies abroad.

The Office manager was the fulcrum and a great resource for the project. Smiling and smart, he knew how to go around with his wide contacts and helped in our visa and other matters. His easy manners and flexible approach got us great leeway with the SAI at all levels.

Translators were innovative in translating difficult texts and training materials. Without their help the project would not move an inch. I have spoken about their stellar role earlier.

The office assistant was a versatile young man and could produce miracles with a smiling face. He was always at hand to solve difficult problems and infuse new energy. Our drivers were our guide and security in the many forays in the city.

# INTERNAL CONTROL TECHNIQUES AND EVALUATION

**P.N. KOUL** \*

## **Introduction**

Internal control system is a combination of objectives and techniques. Objectives are the organizational goals to be achieved and are identified to each activity in the organisation. The techniques are the processes through which the control activities are achieved and include policies, procedures, organizational plans and fiscal arrangements. The techniques require sound practices and procedures, delegated powers and authorisations.

Internal control is a management tool to provide reasonable assurance that the management's objectives are being achieved. The responsibility for the adequacy and implementation of internal control structure rests with management. Head of each organisation must ensure that a proper internal control structure is instituted and updated to keep it effective. International Standards of Supreme Audit Institutions (ISSAI) 1003 issued by International Organisation of Supreme Audit Institutions (INTOSAI) define the internal audit function as examining, evaluating and monitoring the adequacy and effectiveness of internal control ([www.issai.org](http://www.issai.org)).

Management personnel and various other functionaries in an organisation refer to variety of internal controls such as Administrative controls, Program controls, Budgetary, Accounting and Financial Reporting controls. These are actually the sub-sets of overall internal control system in an organisation. Internal controls provide reasonable but not absolute assurance that waste, fraud and abuse can be eliminated. Even the best system cannot prevent acts

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of dishonesty. The possibility of errors arising from mistakes, carelessness or collusion of some employees in the organisation circumventing controls cannot be ruled out. The system has to be combination of control techniques which will prevent impropriety and errors and ensure timely detection of errors.

## **Definitions**

Committee of Sponsoring Organisation of the Treadway Commission (COSO) developed (1992) model defines internal control as a process effected by an entity's board of directors, management and other personnel designed to provide reasonable assurance on the achievement of objectives in the:

- Effectiveness and efficacy of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations

In an effective internal control system the following five components have been listed by COSO to work to support the achievement of an entity's mission, strategies and related business objectives:

- Control Environment,
- Risk Assessment,
- Control Activities,
- Information and Communication, and
- Monitoring

Whether these elements are present and functioning determines if a particular internal control system is effective. In November 2010 COSO had a project to include technology as a component.

Internal Control-Integrated Framework (Framework) developed by COSO (updated in 2013) facilitates objective and process of designing, implementing and conducting internal controls and assessing its effectiveness. ([www.coso.org/info.knowledgeleader.com/bid/](http://www.coso.org/info.knowledgeleader.com/bid/))

General Accounting Office (GAO) standards (1983) for internal control define the internal control as organisational plan and procedures adopted by management to ensure that:

- i. the use of resources is consistent with laws, regulations and policies,
- ii. the resources are safeguarded against waste, loss and misuse, and
- iii. reliable data are obtained, maintained and fairly disclosed in reports.

### **Responsibility mandated by Regulations**

In India, Audit and Accounts Regulations 2007 issued by the Comptroller and Auditor General (CAG) under the powers vested in him under the CAG's Duties, Powers and Conditions of Service (DPC) Act, 1971 establish the responsibility of instituting and evaluating internal control in the audited organisation to minimize the risk of errors and irregularities. The Regulations extend the scope of audit to the assessment of internal control in the auditable entity. The Regulations mandate Government to establish an adequate system of internal control to minimise the risk of errors and irregularities. Evaluation of internal control will be the prime concern of Auditors who need to report deficiencies in internal control that they consider significant.

Strengthening of internal audit system in India was officially articulated in (2009) in 14<sup>th</sup> report of the 2<sup>nd</sup> administrative Reforms Commission. The report recognises internal audit first line of defence against inefficiency and bureaucratic inertia in government system. India has a well established internal audit system in government departments. It is, however, handicapped by resources and capacity constraints. The system would need to be renewed to make it effective and meaningful as an instrument of internal management control.

In the US the Federal Managers Financial Integrity Act of 1982 (FMFIA) requires an annual report to be prepared by the head of each executive agency on the agencies compliance with the internal control standards of the Comptroller General.

## **Internal controls are necessary**

A reliable system of internal controls properly executed is essential for conduct of government programs efficiently. Strong internal controls it is a common realization, reduce waste, restrict fraud and abuse. Conceptually the internal control system in an organisation encompasses entire functioning including policies and procedures in managing its affairs. Internal controls are vital to Financial Management. These ensure that resources are used in accordance with rules, regulations and policies of the organisation, the resources are safeguarded against waste, fraud and misuse and reliable data are maintained and disclosed in reports. Through these tools an organisation governs its activities to achieve its objectives.

Internal controls have relatively received little attention. For some time past, numerous incidents of waste, fraud and abuse have brought the lack of internal controls over governmental operations to the public attention. Incidences of poor controls have led to avoidable waste of resources, losses, misuse and frauds. Governments have been embarrassed for their failure to implement efficient and effective financial management system. A good system of internal controls reassures effective implementation of organizational objectives and accountability of resources. These provide checks and balances in the efficient implementation of programs and achieving program goals.

## **Control techniques**

The internal control techniques require;

- Sound practices and procedures, delegation of powers and authorizations, qualified and experienced personnel, standards of quality and performance and effective internal audit.
- Lines of responsibility and delegated authority clearly defined and understood by all.
- Different manuals containing rules and regulations, financial powers and levels of authorisation available to all employees.

- Disbursement procedures and authorisation limits for individual transactions documented and available for review. The documentation should be available as a up-to-date procedure manual.

The Advisory Group on Fiscal Transparency had, however, observed (2001) that most of the staff in the offices of Chief Controller of Accounts (CCAs) employed on the work of internal audit and internal control functions did not have the requisite background, training or experience in the area of finance or accounts. The group had observed that the system of internal audit and internal control needed to be made more effective and meaningful as an instrument of internal management control.

### **Internal Accounting Controls**

Sound accounting system is an essential internal control technique. Unsound system may promote irregularities. Accounting manual and a set of written instructions supporting various transactions and events, manner of their recording/classification as per chart of accounts in the books of accounts for reporting purposes is an important control mechanism to prevent mistakes. This shall list the various elements of accounting system, documents and records to be maintained to support events, the manner of recording these in the accounts and reporting through various financial statements. Protective access to an accounting system is encouraged to keep unauthorised users out of the system and deter attempts at fraudulent access. Budget, receipts, expenditure, assets, liabilities, financial reporting are various areas that are put to internal accounting control procedures to test whether the internal control systems are adequately functioning in accordance with the prescribed procedures. Auditors focus on internal accounting controls rather than on administrative controls. In the financial administration process the budget, the accounts and the financial reports are inseparable. Informative budget documents could be helpful to the Internal Audit to determine whether the budgetary process was performed in accordance with the prescribed procedure. Internal control relative to financial reporting enhance the reliability of the financial statements by reducing risk of material errors and misstatement. Financial reporting control

provide reasonable assurance that the statements have been prepared in accordance with generally accepted accounting principles.

Internal controls for cash management and processing of cash receipts ensure effective utilization of cash and aid in accounting for and controlling cash and essentially ensure good financial system, budgeting and accounting. The Financial Regulations specify Empowered Committee to take investment decisions both short term and long term of idle cash.

### **Control activities**

Control environment expects management and employees in an organisation maintain and demonstrate positive and supportive attitude towards internal controls at all times. Employees' lenient attitude towards controls and procedures weakens effectiveness of controls. Violating the procedures, they will be punished, they need to know. It is likely that controls will be adhered to. Competent and honest employees need to be trusted and retained. An evidence of the supportive attitude should ensure appropriate resolution of audit findings and prompt action on audit recommendations for corrective action.

Systems and procedures for effecting, recording and reporting individual events and transactions should be documented and available to the employees. Key duties and responsibilities of employees in processing, authorising, recording, reviewing transactions shall be separated *e.g*: cheque preparation and cheque signing functions, ordering, recording and authorising payments for procurement of goods and services, staff processing claims to be different from the staff authorising payments, both to be independent of administration. Access to records and financial data need to be limited to authorised persons. The size of staff in an organization may obstruct separation of duties. This would require implementation of compensating controls to ensure that organizational objectives are achieved.

## **Evaluation**

For the purpose of facilitating evaluation of internal controls, organisation may be divided into functional units or activity cycles such as administrative unit, cash receipting unit, payments unit, accounts unit, assets management, budgetary processing unit. Activities in each unit will be documented from the start to the end. Illustratively, for payments the beginning will be availability of funds to meet the charge, availability of bills that meet the requirements, processing of bills for payment, verification of invoiced amounts with reference to purchase orders, stock certificates authorisation of payment, issue of cheque. Document activities in each unit from beginning to end, as illustrated here above. Each unit shall be evaluated to assess its susceptibility to errors and irregularities and also the inherent potential for errors and irregularities.

## **Conclusion**

Strong system of internal controls established together with a strong organisational environment in an organisation is an effective tool to prevent fraud. Governments have an obligation to institute adequate controls in order to prevent abuse, fraud and waste of public money and should fairly disclose reliable data in the financial reports. Each organisation is encouraged to review and evaluate the results if these are operating effectively. In case the controls are found to be inadequate the weaknesses like violation of regulatory requirements and the relative associated risks on the organisation like waste of resources, loss, misappropriation of funds and assets should be determined and reported to the management. Internal control weaknesses which may be material to the financial statements noticed during examination of these statements should be disclosed with recommendations for corrective action.

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The following Act of Parliament received the assent of the President on the 26th July, 2018, and is hereby published for general information:—

**THE PREVENTION OF CORRUPTION (AMENDMENT)  
ACT, 2018**

**NO. 16 OF 2018**

**[26th July, 2018.]**

An Act further to amend the Prevention of Corruption Act, 1988.

BE it enacted by Parliament in the Sixty-ninth Year of the Republic of India as follows:—

1.(1) This Act may be called the Prevention of Corruption (Amendment) Act, 2018.

(2) It shall come into force on such date as the Central Government may, by notification in the Official Gazette, appoint.

2. In the Prevention of Corruption Act, 1988 (hereinafter referred to as the principal Act), in section 2,—

(i) after clause (a), the following clause shall be inserted, namely:—

“(aa) “prescribed” means prescribed by rules made under this Act and the expression “prescribe” shall be construed accordingly;”;

(ii) after clause (c), the following clause shall be inserted, namely:—

‘(d) “undue advantage” means any gratification whatever, other than legal remuneration.

*Explanation.*— For the purposes of this clause,—

(a) the word “gratification” is not limited to pecuniary gratifications or to gratifications estimable in money;

(b) the expression “legal remuneration” is not restricted to remuneration paid to a public servant, but includes all remuneration which he is permitted by the Government or the organisation, which he serves, to receive.’.

3. In section 4 of the principal Act, for sub-section (4), the following sub-section shall be substituted, namely:—

(4) Notwithstanding anything contained in the Code of Criminal Procedure, 1973, the trial of an offence shall be held, as far as practicable, on day-to-day basis and an endeavour shall be made to ensure that the said trial is concluded within a period of two years:

Provided that where the trial is not concluded within the said period, the special Judge shall record the reasons for not having done so:

Provided further that the said period may be extended by such further period, for reasons to be recorded in writing but not exceeding six months at a time; so, however, that the said period together with such extended period shall not exceed ordinarily four years in aggregate.’.

4. For sections 7, 8, 9 and 10 of the principal Act, the following sections shall be substituted, namely:—

“7. Any public servant who,—

(a) obtains or accepts or attempts to obtain from any person, an undue advantage, with the intention to perform or cause performance of public duty improperly or dishonestly or to forbear or cause forbearance to perform such duty either by himself or by another public servant; or

- (b) obtains or accepts or attempts to obtain, an undue advantage from any person as a reward for the improper or dishonest performance of a public duty or for forbearing to perform such duty either by himself or another public servant; or
- (c) performs or induces another public servant to perform improperly or dishonestly a public duty or to forbear performance of such duty in anticipation of or in consequence of accepting an undue advantage from any person,

shall be punishable with imprisonment for a term which shall not be less than three years but which may extend to seven years and shall also be liable to fine.

*Explanation 1.*—For the purpose of this section, the obtaining, accepting, or the attempting to obtain an undue advantage shall itself constitute an offence even if the performance of a public duty by public servant, is not or has not been improper.

*Illustration.*—A public servant, ‘S’ asks a person, ‘P’ to give him an amount of five thousand rupees to process his routine ration card application on time. ‘S’ is guilty of an offence under this section.

*Explanation 2.*—For the purpose of this section,—

- (i) the expressions “obtains” or “accepts” or “attempts to obtain” shall cover cases where a person being a public servant, obtains or “accepts” or attempts to obtain, any undue advantage for himself or for another person, by abusing his position as a public servant or by using his personal influence over another public servant; or by any other corrupt or illegal means;
- (ii) it shall be immaterial whether such person being a public servant obtains or accepts, or attempts to obtain the undue advantage directly or through a third party.

“7A. Whoever accepts or obtains or attempts to obtain from another person for himself or for any other person any undue

advantage as a motive or reward to induce a public servant, by corrupt or illegal means or by exercise of his personal influence to public servant, by corrupt or illegal means or by exercise of his personal influence to or to cause to forbear such public duty by such public servant or by another public servant, shall be punishable with imprisonment for a term which shall not be less than three years but which may extend to seven years and shall also be liable to fine.

8. (1) Any person who gives or promises to give an undue advantage to another person or persons, with intention—

(i) to induce a public servant to perform improperly a public duty; or

(ii) to reward such public servant for the improper performance of public duty;

shall be punishable with imprisonment for a term which may extend to seven years or with fine or with both:

Provided that the provisions of this section shall not apply where a person is compelled to give such undue advantage:

Provided further that the person so compelled shall report the matter to the law enforcement authority or investigating agency within a period of seven days from the date of giving such undue advantage:

Provided also that when the offence under this section has been committed by commercial organisation, such commercial organisation shall be punishable with fine.

*Illustration.*—A person, ‘P’ gives a public servant, ‘S’ an amount of ten thousand rupees to ensure that he is granted a license, over all the other bidders. ‘P’ is guilty of an offence under this sub-section.

*Explanation.*—It shall be immaterial whether the person to whom an undue advantage is given or promised to be given is the same person as the person who is to perform, or has performed, the public duty concerned, and, it shall also be immaterial whether

such undue advantage is given or promised to be given by the person directly or through a third party.

(2) Nothing in sub-section (1) shall apply to a person, if that person, after informing a law enforcement authority or investigating agency, gives or promises to give any undue advantage to another person in order to assist such law enforcement authority or investigating agency in its investigation of the offence alleged against the later.

9. (1) Where an offence under this Act has been committed by a commercial organisation, such organisation shall be punishable with fine, if any person associated with such commercial organisation gives or promises to give any undue advantage to a public servant intending—

- (a) to obtain or retain business for such commercial organisation; or
- (b) to obtain or retain an advantage in the conduct of business for such commercial organisation:

Provided that it shall be a defence for the commercial organisation to prove that it had in place adequate procedures in compliance of such guidelines as may be prescribed to prevent persons associated with it from undertaking such conduct.

(2) For the purposes of this section, a person is said to give or promise to give any undue advantage to a public servant, if he is alleged to have committed the offence under section 8, whether or not such person has been prosecuted for such offence.

(3) For the purposes of section 8 and this section,—

- (a) “commercial organisation” means—
  - (i) a body which is incorporated in India and which carries on a business, whether in India or outside India;
  - (ii) any other body which is incorporated outside India and which carries on a business, or part of a business, in any part of India;

- (iii) a partnership firm or any association of persons formed in India and which carries on a business whether in India or outside India; or
  - (iv) any other partnership or association of persons which is formed outside India and which carries on a business, or part of a business, in any part of India;
- (b) “business” includes a trade or profession or providing service;
- (c) a person is said to be associated with the commercial organisation, if such person performs services for or on behalf of the commercial organisation irrespective of any promise to give or giving of any undue advantage which constitutes an offence under sub-section (1).

*Explanation 1.*—The capacity in which the person performs services for or on behalf of the commercial organisation shall not matter irrespective of whether such person is employee or agent or subsidiary of such commercial organisation.

*Explanation 2.*—Whether or not the person is a person who performs services for or on behalf of the commercial organisation is to be determined by reference to all the relevant circumstances and not merely by reference to the nature of the relationship between such person and the commercial organisation.

*Explanation 3.*—If the person is an employee of the commercial organisation, it shall be presumed unless the contrary is proved that such person is a person who has performed services for or on behalf of the commercial organisation.

(4) Notwithstanding anything contained in the Code of Criminal Procedure, 1973, the offence under sections 7A, 8 and this section shall be cognizable.

(5) The Central Government shall, in consultation with the concerned stakeholders including departments and with a view to preventing persons associated with commercial organisations from bribing any person, being a public servant, prescribe such

guidelines as may be considered necessary which can be put in place for compliance by such organisations.

10. Where an offence under section 9 is committed by a commercial organisation, and such offence is proved in the court to have been committed with the consent or connivance of any director, manager, secretary or other officer shall be of the commercial organisation, such director, manager, secretary or other officer shall be guilty of the offence and shall be liable to be proceeded against and shall be punishable with imprisonment for a term which shall not be less than three years but which may extend to seven years and shall also be liable to fine.

*Explanation.*—For the purposes of this section, “director”, in relation to a firm means a partner in the firm.”.

5. In section 11 of the principal Act,—

(i) in the marginal heading, for the words “valuable thing”, the words “undue advantage” shall be substituted;

(ii) the words “or agrees to accept” shall be omitted;

(iii) for the words “valuable thing”, the words “undue advantage” shall be substituted;

(iv) for the words “official functions”, the words “official functions or public duty” shall be substituted.

6. For section 12 of the principal Act, the following section shall be substituted,

“12. Whoever abets any offence punishable under this Act, whether or not that offence is committed in consequence of that abetment, shall be punishable with imprisonment for a term which shall be not less than three years, but which may extend to seven years and shall also be liable to fine.”.

7. In section 13 of the principal Act, for sub-section (I), the following shall be substituted, namely:—

“(I) A public servant is said to commit the offence of criminal misconduct,—

- (a) if he dishonestly or fraudulently misappropriates or otherwise converts for his own use any property entrusted to him or any property under his control as a public servant or allows any other person so to do; or
- (b) if he intentionally enriches himself illicitly during the period of his office.

*Explanation 1.*—A person shall be presumed to have intentionally enriched himself illicitly if he or any person on his behalf, is in possession of or has, at any time during the period of his office, been in possession of pecuniary resources or property disproportionate to his known sources of income which the public servant cannot satisfactorily account for.

*Explanation 2.*—The expression “known sources of income” means income received from any lawful sources.”.

**8.** For section 14 of the principal Act, the following section shall be substituted, namely:—

“14. Whoever convicted of an offence under this Act subsequently commits an offence punishable under this Act, shall be punishable with imprisonment for a term which shall be not less than five years but which may extend to ten years and shall also be liable to fine.”.

**9.** In section 15 of the principal Act, for the words, brackets and letters “clause (c) or clause (d)”, the word, brackets, and letter “clause (a)” shall be substituted.

**10.** In section 16 of the principal Act,—

(a) for the words, brackets and figures, “sub-section (2) of section 13 or section 14”, the words, figures and brackets “section 7 or section 8 or section 9 or section 10 or section 11 or sub-section (2) of section 13 or section 14 or section 15” shall be substituted;

(b) for the word, brackets and letter “clause (e)”, the word, brackets and letter “clause (b)” shall be substituted.

**11.** In section 17 of the principal Act, in the second proviso, for the words, brackets, letter and figure “clause (e) of sub-section

(1)”, the words, brackets, letter and figure “clause (b) of subsection (1)” shall be substituted.

12. After section 17 of the principal Act, the following section shall be inserted, namely:—

“17A. (1) No police officer shall conduct any enquiry or inquiry or investigation into any offence alleged to have been committed by a public servant under this Act, where the alleged offence is relatable to any recommendation made or decision taken by such public servant in discharge of his official functions or duties, without the previous approval—

(a) in the case of a person who is or was employed, at the time when the offence was alleged to have been committed, in connection with the affairs of the Union, of that Government;

(b) in the case of a person who is or was employed, at the time when the offence was alleged to have been committed, in connection with the affairs of a State, of that Government;

(c) in the case of any other person, of the authority competent to remove him from his office, at the time when the offence was alleged to have been committed:

Provided that no such approval shall be necessary for cases involving arrest of a person on the spot on the charge of accepting or attempting to accept any undue advantage for himself or for any other person:

Provided further that the concerned authority shall convey its decision under this section within a period of three months, which may, for reasons to be recorded in writing by such authority, be extended by a further period of one month.”.

13. After Chapter IV of the principal Act, the following Chapter shall be inserted, namely:—

## ‘CHAPTER IV A

### ATTACHMENT AND FORFEITURE OF PROPERTY

18A. (1) Save as otherwise provided under the Prevention of Money Laundering Act, 2002, the provisions of the Criminal Law

Amendment Ordinance, 1944 shall, as far as may be, apply to the attachment, administration of attached property and execution of order of attachment or confiscation of money or property procured by means of an offence under this Act.

(2) For the purposes of this Act, the provisions of the Criminal Law Amendment Ordinance, 1944 shall have effect, subject to the modification that the references to “District Judge” shall be construed as references to “Special Judge”.

14. In section 19 of the principal Act, in sub-section (1),—

(i) for the words and figures “sections 7, 10, 11, 13 and 15”, the words and figures “sections 7, 11, 13 and 15” shall be substituted;

(ii) in clause (a), for the words “who is employed”, the words “who is employed, or as the case may be, was at the time of commission of the alleged offence employed” shall be substituted;

(iii) in clause (b), for the words “who is employed”, the words “who is employed, or as the case may be, was at the time of commission of the alleged offence employed” shall be substituted;

(iv) after clause (c), the following shall be inserted, namely:—

“Provided that no request can be made, by a person other than a police officer or an officer of an investigation agency or other law enforcement authority, to the appropriate Government or competent authority, as the case may be, for the previous sanction of such Government or authority for taking cognizance by the court of any of the offences specified in this sub-section, unless—

(i) such person has filed a complaint in a competent court about the alleged offences for which the public servant is sought to be prosecuted; and

(ii) the court has not dismissed the complaint under section 203 of the Code of Criminal Procedure, 1973 and directed the complainant to obtain the sanction for prosecution against the public servant for further proceeding:

Provided further that in the case of request from the person other than a police officer or an officer of an investigation agency or other law enforcement authority, the appropriate Government or

competent authority shall not accord sanction to prosecute a public servant without providing an opportunity of being heard to the concerned public servant:

Provided also that the appropriate Government or any competent authority shall, after the receipt of the proposal requiring sanction for prosecution of a public servant under this sub-section, endeavour to convey the decision on such proposal within a period of three months from the date of its receipt:

Provided also that in case where, for the purpose of grant of sanction for prosecution, legal consultation is required, such period may, for the reasons to be recorded in writing, be extended by a further period of one month:

Provided also that the Central Government may, for the purpose of sanction for prosecution of a public servant, prescribe such guidelines as it considers necessary.

*Explanation.*—For the purposes of sub-section (1), the expression "public servant" includes such person—

- (a) who has ceased to hold the office during which the offence is alleged to have been committed; or
- (b) who has ceased to hold the office during which the offence is alleged to have been committed and is holding an office other than the office during which the offence is alleged to have been committed."

**15.** For section 20 of the principal Act, the following section shall be substituted, namely:—

“20. Where, in any trial of an offence punishable under section 7 or under section 11, it is proved that a public servant accused of an offence has accepted or obtained or attempted to obtain for himself, or for any other person, any undue advantage from any person, it shall be presumed, unless the contrary is proved, that he accepted or obtained or attempted to obtain that undue advantage, as a motive or reward under section 7 for performing or to cause performance of a public duty improperly or dishonestly either by himself or by another public servant or, as the

case may be, any undue advantage without consideration or for a consideration which he knows to be inadequate under section 11."

**16.** In section 23 of the principal Act,—

(a) in the marginal heading, for the word, figures, brackets and letter "section 13 (1) (c)", the word, figures, brackets and letter "section 13 (1) (A)" shall be substituted;

(b) for the word, brackets and letter "clause (c)", the word, brackets and letter "clause (a)" shall be substituted.

**17.** Section 24 of the principal Act shall be omitted.

**18.** After section 29 of the principal Act, the following section shall be inserted, namely:—

"29A. (1) The Central Government may, by notification in the Official Gazette, make rules for carrying out the provisions of this Act.

(2) In particular, and without prejudice to the generality of the foregoing power, such rules may provide for all or any of the following matters, namely:—

(a) guidelines which can be put in place by commercial organisation under section 9;"

(b) guidelines for sanction of prosecution under sub-section (1) of section 19;"

(c) any other matter which is required to be, or may be, prescribed.

(3) Every rule made under this Act, shall be laid, as soon as may be after it is made, before each House of Parliament, while it is in session, for a total period of thirty days which may be comprised in one session or in two or more successive sessions, and if, before the expiry of the session immediately following the session or the successive sessions aforesaid, both Houses agree in making any modification in the rule, or both Houses agree that the rule should not be made, the rule shall thereafter have effect only in such modified form or be of no effect, as the case may be; so, however,

that any such modification or annulment shall be without prejudice to the validity of anything previously done under that rule.”.

19. In the Prevention of Money Laundering Act, 2002, in Part A of the Schedule, for Paragraph 8, the following Paragraph shall be substituted, namely:—

**“PARAGRAPH 8**

**OFFENCES UNDER THE PREVENTION OF  
CORRUPTION ACT, 1988**

**(49 OF 1988)**

Section Description of offence.

7. Offence relating to public servant being bribed.
- 7A. Taking undue advantage to influence public servant by corrupt or illegal means or by exercise of personal influence.
8. Offence relating to bribing a public servant.
9. Offence relating to bribing a public servant by a commercial organisation.
10. Person in charge of commercial organisation to be guilty of offence.
11. Public servant obtaining undue advantage, without consideration from person concerned in proceeding or business transacted by such public servant.
12. Punishment for abetment of offences.
13. Criminal misconduct by a public servant.
14. Punishment for habitual offender.”.

# THE FUGITIVE ECONOMIC OFFENDERS ACT, 2018

## ACT NO. 17 OF 2018

[31<sup>st</sup> July 2018]

*Ac Act to provide for measures to deter fugitive economic offenders from evading the process of law in India by staying outside the jurisdiction of Indian courts, to preserve the sanctity of the rule of law in India and for matters connected therewith or incidental thereto.*

BE it enacted by Parliament in the Sixty-ninth Year of the Republic of India as follows:—

### CHAPTER I

#### PRELIMINARY

**1. Short title, extent and commencement** - (1) This Act may be called the Fugitive Economic Offenders Act, 2018.

(2) It extends to the whole of India.

(3) It shall be deemed to have come into force on the 21<sup>st</sup> Day of April, 2018.

**2. Definitions** - (1) In this Act, unless the context otherwise requires,—

(a) “Administrator” means an Administrator appointed under sub-section (1) of section 15;

(b) “benami property” and “benami transaction” shall have the same meanings as assigned to them under clauses (8) and (9) respectively of section 2 of the Prohibition of Benami Property Transactions Act, 1988;

(c) “contracting State” means any country or place outside India in respect of which arrangements have been made by the Central Government with the Government of such country through a treaty or otherwise;

(d) “Deputy Director” means the Deputy Director appointed under sub-section (1) of section 49 of the Prevention of Money-laundering Act, 2002;

(e) “Director” means the Director appointed under sub-section (1) of section 49 of the Prevention of Money-laundering Act, 2002;

(f) “fugitive economic offender” means any individual against whom a warrant for arrest in relation to a Scheduled Offence has been issued by any Court in India, who—

(i) has left India so as to avoid criminal prosecution; or

(ii) being abroad, refuses to return to India to face criminal prosecution;

(g) “key managerial personnel” shall have the same meaning as assigned to it in clause (51) of section 2 of the Companies Act, 2013;

(h) “notification” means a notification published in the Official Gazette and the expression “notify” shall be construed accordingly;

(i) “person” includes—

(i) an individual;

(ii) a Hindu Undivided Family;

(iii) a company;

(iv) a trust;

(v) a partnership;

(vi) a limited liability partnership;

(vii) an association of persons or a body of individuals, whether incorporated or not;

(viii) every artificial juridical person not falling within any of the preceding sub-clauses; and

(ix) any agency, office or branch owned or controlled by any of the above persons mentioned in the preceding sub-clauses;

(j) “prescribed” means prescribed by rules made under this Act;

(k) “proceeds of crime” means any property derived or obtained, directly or indirectly, by any person as a result of criminal activity relating to a Scheduled Offence, or the value of any such property,

or where such property is taken or held outside the country, then the property equivalent in value held within the country or abroad;

- (l) “Schedule” means the Schedule appended to this Act;
- (m) “Scheduled Offence” means an offence specified in the Schedule, if the total value involved in such offence or offences is one hundred crore rupees or more;
- (n) “Special Court” means a Court of Session designated as a Special Court under sub-section (1) of section 43 of the Prevention of Money-laundering Act, 2002.

(2) The words and expressions used and not defined in this Act but defined in the Prevention of Money-laundering Act, 2002 shall have the meanings respectively assigned to them in that Act.

**3. Application of Act** - The provisions of this Act shall apply to any individual who is, or becomes, a fugitive economic offender on or after the date of coming into force of this Act.

## **CHAPTER II**

### **DECLARATION OF FUGITIVE ECONOMIC OFFENDERS AND CONFISCATION OF PROPERTY**

**4. Application for declaration of fugitive economic offender and procedure therefor** - (1) Where the Director or any other officer not below the rank of Deputy Director authorised by the Director for the purposes of this section, has reason to believe (the reasons for such belief to be recorded in writing), on the basis of material in his possession, that any individual is a fugitive economic offender, he may file an application in such form and manner as may be prescribed in the Special Court that such individual may be declared as a fugitive economic offender.

- (2) The application referred to in sub-section (2) shall contain—
- (a) reasons for the belief that an individual is a fugitive economic offender;
  - (b) any information available as to the whereabouts of the fugitive economic offender;

- (c) a list of properties or the value of such properties believed to be the proceeds of crime, including any such property outside India for which confiscation is sought;
  - (d) a list of properties or benami property owned by the individual in India or abroad for which confiscation is sought; and
  - (e) a list of persons who may have an interest in any of the properties listed under clauses (c) and (d).
- (3) The Authorities appointed for the purposes of the Prevention of Money-laundering Act, 2002 shall be the Authorities for the purposes of this Act.

**5. Attachment of property** - (1) The Director or any other officer authorised by the Director, not below the rank of Deputy Director, may, with the permission of the Special Court, attach any property mentioned in the application under section 4 by an order in writing in such manner as may be prescribed.

(2) Notwithstanding anything contained in sub-section (1) or section 4 the Director or any other officer, not below the rank of Deputy Director, authorised by the Director, may, by an order in writing, at any time prior to the filing of the application under section 4, attach any property—

- (a) for which there is a reason to believe that the property is proceeds of crime, or is a property owned by an individual who is a fugitive economic offender; and
- (b) which is being or is likely to be dealt with in a manner which may result in the property being unavailable for confiscation:

Provided that the Director or any other officer who provisionally attaches any property under this sub-section shall, within a period of thirty days from the date of such attachment, file an application under section 4 before the Special Court.

(3) The attachment of any property under this section shall continue for a period of one hundred and eighty days from the date of order of attachment or such other period as may be extended by the Special Court before the expiry of such period.

(4) Nothing in this section shall prevent the person interested in the enjoyment of the immovable property attached under sub-section (1) from such enjoyment.

*Explanation.*— For the purposes of this sub-section, the expression “person interested”, in relation to any immovable property includes all persons claiming or entitled to claim any interest in the property.

**6. Powers of Director and other officers** - The Director or any other officer shall, for the purposes of section 4, have the same powers as are vested in a civil court under the Code of Civil Procedure, 1908 while trying a suit in respect of the following matters, namely:—

- (a) discovery and inspection;
- (b) enforcing the attendance of any person, including any officer of a reporting entity and examining him on oath;
- (c) compelling the production of records;
- (d) receiving evidence on affidavits;
- (e) issuing commissions for examination of witnesses and documents; and
- (f) any other matter which may be prescribed.

**7. Power of survey** - (1) Notwithstanding anything contained in any other provisions of this Act, where a Director or any other officer authorised by the Director, on the basis of material in his possession, has reason to believe (the reasons for such belief to be recorded in writing), that an individual may be a fugitive economic offender, he may enter any place—

- (i) within the limits of the area assigned to him; or
- (ii) in respect of which he is authorised for the purposes of this section, by such other authority, who is assigned the area within which such place is situated.

(2) Where the Director or any other officer authorised by him, on the basis of material in his possession, has reason to believe (the reasons for such belief to be recorded in writing) that an individual

may be a fugitive economic offender and it is necessary to enter any place as mentioned in sub-section (1), he may request any proprietor, employee or any other person who may be present at that time, to—

- (a) afford him the necessary facility to inspect such records as he may require and which may be available at such place;
  - (b) afford him the necessary facility to check or verify the proceeds of crime or any transaction related to proceeds of crime which may be found therein; and
  - (c) furnish such information as he may require as to any matter which may be useful for, or relevant to any proceedings under this Act.
- (3) The Director, or any other officer acting under this section may—
- (i) place marks of identification on the records inspected by him and make or cause to be made extracts or copies therefrom;
  - (ii) make an inventory of any property checked or verified by him; and
  - (iii) record the statement of any person present at the property which may be useful for, or relevant to, any proceeding under this Act.

**8. Search and seizure - (1)** Notwithstanding anything contained in any other law for the time being in force, where the Director or any other officer not below the rank of Deputy Director authorised by him for the purposes of this section, on the basis of information in his possession, has reason to believe (the reason for such belief to be recorded in writing) that any person—

- (i) may be declared as a fugitive economic offender;
- (ii) is in possession of any proceeds of crime;
- (iii) is in possession of any records which may relate to proceeds of crime; or

(iv) is in possession of any property related to proceeds of crime,

then, subject to any rules made in this behalf, he may authorise any officer sub-ordinate to him to—

(a) enter and search any building, place, vessel, vehicle or aircraft where he has reason to suspect that such records or proceeds of crime are kept;

(b) break open the lock of any door, box, locker, safe, almirah or other receptacle for exercising the powers conferred by clause (a) where the keys thereof are not available;

(c) seize any record or property found as a result of such search;

(d) place marks of identification on such record or property, if required or make or cause to be made extracts or copies therefrom;

(e) make a note or an inventory of such record or property; and

(f) examine on oath any person, who is found to be in possession or control of any record or property, in respect of all matters relevant for the purposes of any investigation under this Act.

(2) Where an authority, upon information obtained during survey under section 7, is satisfied that any evidence shall be or is likely to be concealed or tampered with, he may, for reasons to be recorded in writing, enter and search the building or place where such evidence is located and seize that evidence.

**9. Search of persons** - Notwithstanding anything contained in any other law for the time being in force—

(a) if an authority, authorised in this behalf by the Central Government by general or special order, has reason to believe (the reason for such belief to be recorded in writing) that any person has secreted about his person or anything under his possession, ownership or control, any record or proceeds of crime which may be useful for or relevant to any proceedings under this Act, he may search that person and seize such record or property which may be useful for or relevant to any proceedings under this Act;

(b) where an authority is about to search any person, he shall, if such person so requires, take such person within twenty-four hours to the nearest Gazetted Officer, superior in rank to him, or a Magistrate:

Provided that the period of twenty-four hours shall exclude the time necessary for the journey undertaken to take such person to the nearest Gazetted Officer, superior in rank to him, or the Magistrate's Court;

(c) if the requisition under clause (b) is made, the authority shall not detain the person for more than twenty-four hours prior to taking him before the Gazetted Officer, superior in rank to him, or the Magistrate referred to in that sub-section:

Provided that the period of twenty-four hours shall exclude the time necessary for the journey from the place of detention to the office of the Gazetted Officer, superior in rank to him, or the Magistrate's Court;

(d) the Gazetted Officer or the Magistrate before whom any such person is brought shall, if he sees no reasonable ground for search, forthwith discharge such person but otherwise shall direct that search be made;

(e) before making the search under clause (a) or clause (d), the authority shall call upon two or more persons to attend and witness the search and the search shall be made in the presence of such persons;

(f) the authority shall prepare a list of record or property seized in the course of the search and obtain the signatures of the witnesses on the list;

(g) no female shall be searched by anyone except a female; and

(h) the authority shall record the statement of the person searched under clause (a) or clause (e) in respect of the records or proceeds of crime found or seized in the course of the search.

**10. Notice - (1)** Where an application under section 4 has been duly filed, the Special Court shall issue a notice to an individual who is alleged to be a fugitive economic offender.

(2) The notice referred to in sub-section (1), shall also be issued to any other person who has any interest in the property mentioned in the application under sub-section (2) of section 4.

(3) A notice under sub-section (1) shall—

(a) require the individual to appear at a specified place and time not less than six weeks from the date of issue of such notice; and

(b) state that failure to appear on the specified place and time shall result in a declaration of the individual as a fugitive economic offender and confiscation of property under this Act.

(4) A notice under sub-section (1) shall be forwarded to such authority, as the Central Government may notify, for effecting service in a contracting State.

(5) The authority referred to in sub-section (4) shall make efforts to serve the notice within a period of two weeks in such manner as may be prescribed.

(6) A notice under sub-section (1) may also be served to the individual alleged to be a fugitive economic offender by electronic means to—

(a) his electronic mail address submitted in connection with an application for allotment of Permanent Account Number under section 139A of the Income-tax Act, 1961;

(b) his electronic mail address submitted in connection with an application for enrolment under section 3 of the Aadhaar (Targeted Delivery of Financial and Other Subsidies, Benefits and Services) Act, 2016;

(c) any other electronic account as may be prescribed, belonging to the individual which is accessed by him over the internet, subject to the satisfaction of the Special Court that such account has been recently accessed by the individual and constitutes a reasonable method for communication of the notice to the individual.

**11. Procedure for hearing application - (1)** Where any individual to whom notice has been issued under sub-section (1) of section 10 appears in person at the place and time specified in the notice, the Special Court may terminate the proceedings under this Act.

(2) Where any individual to whom notice has been issued under sub-section (1) of section 10 fails to appear at the place and time specified in the notice, but enters appearance through counsel, the Special Court may in its discretion give a period of one week to file a reply to the application under section 4.

(3) Where any individual to whom notice has been issued under sub-section (1) of section 10 fails to enter appearance either in person or through counsel, and the Special Court is satisfied—

(a) that service of notice has been effected on such party; or

(b) that notice could not be served in spite of best efforts because such individual has evaded service of notice,

it may, after recording reasons in writing, proceed to hear the application.

(4) The Special Court may also give any person to whom notice has been issued under sub-section (2) of section 10 a period of one week to file a reply to the application under section 4.

**12. Declaration of fugitive economic offender - (1)** After hearing the application under section 4, if the Special Court is satisfied that an individual is a fugitive economic offender, it may, by an order, declare the individual as a fugitive economic offender for reasons to be recorded in writing.

(2) On a declaration under sub-section (1), the Special Court may order that any of the following properties stand confiscated to the Central Government—

(a) the proceeds of crime in India or abroad, whether or not such property is owned by the fugitive economic offender; and

(b) any other property or benami property in India or abroad, owned by the fugitive economic offender.

(3) The confiscation order of the Special Court shall, to the extent possible, identify the properties in India or abroad that constitute proceeds of crime which are to be confiscated and in case such properties cannot be identified, quantify the value of the proceeds of crime.

(4) The confiscation order of the Special Court shall separately list any other property owned by the fugitive economic offender in India which is to be confiscated.

(5) Where the Special Court has made an order for confiscation of any property under sub-section (2), and such property is in a contracting State, the Special Court may issue a letter of request to a Court or authority in the contracting State for execution of such order.

(6) Every letter of request to be transmitted to a contracting State under sub-section (5) shall be transmitted in such form and manner as the Central Government may, by notification, specify in this behalf.

(7) The Special Court may, while making the confiscation order, exempt from confiscation any property which is a proceed of crime in which any other person, other than the fugitive economic offender, has an interest if it is satisfied that such interest was acquired *bonafide* and without knowledge of the fact that the property was proceeds of crime.

(8) All the rights and title in the confiscated property shall, from the date of the confiscation order, vest in the Central Government, free from all encumbrances.

(9) Where on the conclusion of the proceedings, the Special Court finds that the individual is not a fugitive economic offender, the Special Court shall order release of property or record attached or seized under this Act to the person entitled to receive it.

(10) Where an order releasing the property has been made by the Special Court under sub-section (9), the Director or any other officer authorised by him in this behalf may withhold the release of any such property or record for a period of ninety days from the

date of receipt of such order, if he is of the opinion that such property is relevant for the appeal proceedings under this Act.

**13. Supplementary application - (1)** Where at any time after the institution of the application under section 4, any other property is discovered or identified which constitutes proceeds of crime or is property owned by the fugitive economic offender liable to be confiscated under this Act, the Director or any other officer not below the rank of Deputy Director authorised by the Director for the purposes of this section, may file a supplementary application in the Special Court seeking confiscation of such properties.

(2) The provisions of sections 4 to 12 shall, as far as may be, apply in relation to such application as they apply in relation to an application under section 4.

**14. Power to disallow civil claims -** Notwithstanding anything contained in any other law for the time being in force,—

(a) on a declaration of an individual as a fugitive economic offender, any Court or tribunal in India, in any civil proceeding before it, may, disallow such individual from putting forward or defending any civil claim; and

(b) any Court or tribunal in India in any civil proceeding before it, may, disallow any company or limited liability partnership from putting forward or defending any civil claim, if an individual filing the claim on behalf of the company or the limited liability partnership, or any promoter or key managerial personnel or majority shareholder of the company or an individual having a controlling interest in the limited liability partnership has been declared as a fugitive economic offender.

*Explanation.*—For the purposes of this section, the expressions—

(a) “company” means anybody corporate and includes a firm, or other association of persons; and

(b) “limited liability partnership” shall have the same meaning as assigned to it in clause (n) of sub-section (1) of section 2 of the Limited Liability Partnership Act, 2008.

### **15. Management of properties confiscated under this Act - (1)**

The Central Government may, by order published in the Official Gazette, appoint as many of its officers (not below the rank of a Joint Secretary to the Government of India) as it thinks fit, to perform the functions of an Administrator.

(2) The Administrator appointed under sub-section (1) shall receive and manage the property in relation to which an order has been made under sub-section (2) of section 12 in such manner and subject to such conditions as may be prescribed.

(3) The Administrator shall also take such measures, as the Central Government may direct, to dispose of the property which is vested in the Central Government under section 12:

Provided that the Central Government or the Administrator shall not dispose of any property for a period of ninety days from the date of the order under sub-section (2) of section 12.

## **CHAPTER III**

### **MISCELLANEOUS**

**16. Rules of evidence - (1)** The burden of proof for establishing—

(a) that an individual is a fugitive economic offender; or

(b) that a property is the proceeds of crime or any other property in which the individual alleged to be a fugitive economic offender has an interest,

shall be on the Director or the person authorised by the Director to file the application under section 4.

(2) Notwithstanding anything contained in any other law for the time being in force, where any person referred to in sub-section (2) of section 10 claims that any interest in any property was acquired *bonafide* and without knowledge of the fact that, such property constitutes proceeds of crime, the burden of proving such fact shall lie upon him.

(3) The standard of proof applicable to the determination of facts by the Special Court under this Act shall be preponderance of probabilities.

**17. Appeal -** (1) An appeal shall lie from any judgment or order, not being an interlocutory order, of a Special Court to the High Court both on facts and on law.

(2) Every appeal under this section shall be preferred within a period of thirty days from the date of the judgment or order appealed from:

Provided that the High Court may entertain an appeal after the expiry of the said period of thirty days, if it is satisfied that the appellant had sufficient cause for not preferring the appeal within the period of thirty days:

Provided further that no appeal shall be entertained after the expiry of period of ninety days.

**18. Bar of jurisdiction -**No civil court shall have jurisdiction to entertain any suit or proceeding in respect of any matter which the Special Court is empowered by or under this Act to determine and no injunction shall be granted by any court or other authority in respect of any action taken or to be taken in pursuance of any power conferred by or under this Act.

**19. Protection of action taken in good faith -** No suit, prosecution or other legal proceeding shall lie against the Central Government or Presiding Officer of the Special Court or Director or Deputy Director or any other officer authorised by the Director for anything which is in good faith done or intended to be done under this Act or any rule made thereunder.

**20. Power of Central Government to amend Schedule -** (1)

The Central Government may, having regard to the objects of this Act, and if it considers necessary or expedient so to do, by notification add to, or as the case may be, omit from the First Schedule any offences specified therein.

(2) Every such notification shall, as soon as after it is issued, be laid before each House of Parliament.

**21. Overriding effect** - The provisions of this Act shall have effect, notwithstanding anything inconsistent therewith contained in any other law for the time being in force.

**22. Application of other laws not barred** - The provisions of this Act shall be in addition to and not in derogation of any other law for the time being in force.

**23. Power to make rules** - (1) The Central Government may, by notification in the Official Gazette, make rules for carrying out the provisions of this Act.

(2) In particular, and without prejudice to generality of the foregoing power, such rules may provide for all or any of the following matters, namely:—

- (a) the form and manner of filing application under sub-section (1) of section 4;
- (b) the manner of attachment of property under sub-section (1) of section 5;
- (c) other matters under clause (f) of section 6;
- (d) the manner in which the notice shall be served under sub-section (5) of section 10;
- (e) any other electronic account under clause (c) of sub-section (6) of section 10;
- (f) the manner and conditions subject to which the Administrator shall receive and manage the property confiscated under sub-section (2) of section 15; and
- (g) any other matter which is required to be, or may be, prescribed or in respect of which provision is to be made by rules.

**24. Laying of rules before Parliament** - Every rule made under this Act shall be laid, as soon as may be after it is made, before each House of Parliament, while it is in session, for a total period of thirty days which may be comprised in one session or in two or more successive sessions, and if, before the expiry of the session immediately following the session or the successive sessions

aforesaid, both Houses agree in making any modification in the rule or both Houses agree that the rule should not be made, the rule shall thereafter have effect only in such modified form or be of no effect, as the case may be; so, however, that any such modification or annulment shall be without prejudice to the validity of anything previously done under that rule.

**25. Power to remove difficulties** - (1) If any difficulty arises in giving effect to the provisions of this Act, the Central Government may, by order, published in the Official Gazette, make such provisions not inconsistent with the provisions of this Act as may appear to be necessary for removing the difficulty:

Provided that no order shall be made under this section after the expiry of five years from the date of commencement of this Act.

(2) Every order made under this section shall be laid, as soon as may be after it is made, before each House of Parliament.

**26. Repeal and saving** – (1) The Fugitive Economic Offenders Ordinance, 2018 (Ord. 1 of 2018), is hereby repealed.

(2) Notwithstanding such repeal, anything done or any action taken under the said Ordinance, shall be deemed to have been done or taken under this Act.

THE SCHEDULE  
[See section 2(l) and (m)]

Section	Description of offence
<b>I. Offences under the Indian Penal Code, 1860 (45 of 1860)</b>	
120B read with any offence in his Schedule	Punishment of criminal conspiracy
255	Counterfeiting Government stamp.
257	Making or selling instrument for counterfeiting Government stamp.
258	Sale of counterfeit Government stamp.
259	Having possession of counterfeit Government stamp.
260	Using as genuine a Government stamp known to be counterfeit.
417	Punishment for cheating.
418	Cheating with knowledge that wrongful loss may ensue to person whose interest offender is bound to protect.
420	Cheating and dishonestly inducing delivery of property.
421	Dishonest or fraudulent removal or concealment of property to prevent distribution among creditors.
422	Dishonestly or fraudulently preventing debt being available for creditors.
423	Dishonest or fraudulent execution of deed of transfer containing false statement of consideration.
424	Dishonest or fraudulent removal or concealment of property.
467	Forgery of valuable security, will, etc.
471	Using as genuine a forged [document or electronic record].
472	Making or possessing counterfeit seal, etc., with

<b>Section</b>	<b>Description of offence</b>
	intent to commit forgery punishable under section 467.
473	Making or possessing counterfeit seal, etc., intent to commit forgery punishable otherwise.
475	Counterfeiting device or mark used for authenticating documents described in section 467, or possessing counterfeit marked material.
476	Counterfeiting device or mark used for authenticating documents other than those described in section 467, or possessing counterfeit marked material.
481	Using a false property mark.
482	Punishment for using a false property mark.
483	Counterfeiting a property mark used by another.
484	Counterfeiting a mark used by a public servant.
485	Making or possession of any instrument for counterfeiting a property mark.
486	Selling goods marked with a counterfeit property mark.
487	Making a false mark upon any receptacle containing goods.
488	Punishment for making use of any such false mark.
489A	Counterfeiting currency notes or bank notes.
489B	Using as genuine, forged or counterfeit currency notes or bank notes.
<b>II. Offence under the Negotiable Instruments Act, 1881 (26 of 1881)</b>	
138	Dishonour of cheque for insufficiency, etc., of funds in the account
<b>III. Offence under the Reserve Bank of India Act, 1934 (2 of 1934)</b>	
58B	Penalties.

Section	Description of offence
<b>IV. Central Excise Act, 1944 (1 of 1944)</b>	
Section 9	Offences and Penalties.
<b>V. Offences under the Customs Act, 1962 (52 of 1962)</b>	
135	Evasion of duty or prohibitions.
<b>VI. Offences under the Prohibition of Benami Property Transactions Act, 1988 (45 of 1988)</b>	
3	Prohibition of benami transactions.
<b>VII. Offences under the Prevention of Corruption Act, 1988 (49 of 1988)</b>	
7	Public servant taking gratification other than legal remuneration in respect of an official act.
8	Taking gratification in order, by corrupt or illegal means, to influence public servant.
9	Taking gratification for exercise of personal influence with public servant.
10	Punishment for abetment by public servant of offences defined in section 8 or section 9 of the Prevention of Corruption Act, 1988.
13	Criminal misconduct by a public servant.
<b>VIII. Offences under the Securities and Exchange Board of India Act, 1992 (15 of 1992)</b>	
12A read with section 24	Prohibition of manipulative and deceptive devices, insider trading and substantial acquisition of securities or control.
24	Offences for contravention of the provisions of the Act.
<b>IX. Offence under the Prevention of Money Laundering Act, 2002 (15 of 2003)</b>	
3	Offence of money-laundering.
4	Punishment for money-laundering.
<b>X. Offences under the Limited Liability Partnership Act, 2008 (6 of</b>	

Section	Description of offence
<b>2009)</b>	
Sub-section (2) of section 30	Carrying on business with intent or purpose to defraud creditors of the Limited Liability Partnership or any other person or for any other fraudulent purpose.
<b>XI. Foreign Contribution (Regulation) Act, 2010</b>	
34	Penalty for article or currency or security obtained in contravention of Section 10.
35	Punishment for contravention of any provision of the Act.
<b>XII. Offences under the Companies Act, 2013 (18 of 2013)</b>	
Sub-section (4) of section 42 of the Companies Act, 2013 read with section 24 of the Securities and Exchange Board of India Act, 1992 (15 of 1992)	Offer or invitation for subscription of securities on private placement.
74	Repayment of deposits, etc., accepted before commencement of the Companies Act, 2013.
76A	Punishment for contravention of section 73 or section 76 of the Companies Act, 2013.
Second proviso to subsection (4) of section 206	Carrying on business of a company for a fraudulent or unlawful purpose.
Clause (b) of section 213	Conducting the business of a company with intent to defraud its creditors, members or any other persons or otherwise for a fraudulent or unlawful purpose, or in a manner oppressive to any of its members or that the company was formed for any fraudulent or unlawful purpose.

Section	Description of offence
447	Punishment for fraud.
452	Punishment for wrongful withholding of property.
<b>XIII. Offence under the Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015 (22 of 2015)</b>	
51	Punishment for wilful attempt to evade tax.
<b>XIV. Offence under the Insolvency and Bankruptcy Code, 2016 (31 of 2016)</b>	
69	Punishment for transactions defrauding creditors.
<b>XV. Offence under the Central Goods and Services Tax Act, 2017 (12 of 2017)</b>	
Sub-section (5) of section 132	Punishment for certain offences.