

# **Forensics under Corporate Laws**

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# Basic Terms

- **“Forensic”**: means “suitable for use in the court of law”. Forensic audit can be conducted in order to prosecute a party for fraud, embezzlement or other financial claims;
- **Forensic Accounting**: study and interpretation of accounting evidence;
- **Forensic Investigation**: the examination of documents and the interviewing of people to extract evidence;
- **Fraud Auditing**: used to identify fraudulent transactions;
- **Red Flag**: sign or warning of any impending danger or inappropriate behavior
  - **financial performance red flag**: sudden increase in profits
  - **accounting system red flags**: single person responsible for receiving of cash and accounting of cash
  - **operational red flags**: major raw material supplies being obtained from Director’s firm rather than from open market;
  - **behavioral red flags**: CEO meeting with Govt. Officials on frequent basis

# Areas where services of forensic auditors can be used

- **Criminal Investigation** e.g. money laundering cases – Lalit Modi case in IPL
- **Professional Negligence Cases** e.g. contravention of accounting standards and auditing standards – PWC and Satyam Case
- **Arbitration service** e.g. Vodafone case for international taxation and company's offer for settlement with MoF
- **Fraud Investigation and Risk/ Control Reviews** e.g. PNB fraud case
- **Settlement of insurance claims** e.g. identification of fake claims
- **Dispute settlement** e.g. Jaypee Infratech issue for home buyers under Insolvency and Bankruptcy Code, 2016

## Power to call for information, inspect books and conduct inquiries [Section 206]

1. **Power of ROC (if he opines) to call** through written notice any **information**, explanation or documents;
2. **Duty of Company and its officers** including Past Officers;
3. Subject to reasons to be recorded in writing, **additional written notice may be given by the ROC**, if info. etc. is not submitted or is inadequate;
4. **ROC may call info for inquiry but subjected to written OBH** (for allegations) if (i) company's business purpose is fraudulent/ unlawful/ not compliant with this Act, (ii) investors' grievances not addressed
5. **CG/ RD may (under given circumstances) also direct ROC** or Inspector to conduct inquiry of Co.
6. **CG/ RD may also by general or special order authorise any other statutory authority** to conduct inspection of Books;
7. **Failure to furnish Information** = Fine on Co. as well OID (upto Rs. 1L plus Rs. 500 per day)

## Investigation into affairs of company [Section 210]

- **Investigation required if CG opines so:**
  1. On the basis of report u/s 208;
  2. On the basis of application made through SR passed by Co.;
  3. In public interest
- **Investigation shall be ordered by CG** if Court/ NCLT orders so and CG may appoint one or more Inspectors;
- CG may require the **applicant to deposit a security money** of upto Rs. 25,000 for carrying out investigation. Its refundable only if investigation results in prosecution [Sec. 214 and 210];
- **SFIO = Serious Fraud Investigation Office [Section 211 and Section 212].  
Website: [www.s fio.nic.in](http://www.s fio.nic.in)**

# Serious Fraud Investigation Office [SFIO]: Section 211 and 212

- SFIO to have Head Director and optimum combination of experts, to be appointed by CG;
- CG **may** assign investigation into affairs of Co. to SFIO on:
  1. ROC Inspection Report;
  2. Request of Members of Co. accompanied by their SR;
  3. Public Interest basis;
  4. Request from any deptt. of CG/ SG
- Other investigations under this Act shall not commence/ continue, during SFIO proceedings;
- **Offence under section 447 of this Act to be cognizable and accused person cannot be 'generally' released on bail or bond;**
- CG may direct SFIO to prosecute against Co. and its officers or employees or any other person on the basis of investigation report;
- SFIO shall share the info./ expln. to other Authorities (like DIT, Police, etc.) if its for use of these other Authorities;
- SFIO to submit its report on investigation into the affairs of a company to CG ~ Section 212(3)

- If any officer not below the rank of **Assistant Director of SFIO authorised in this behalf by the Central Government by general or special order**, has on the basis of material in his possession reason to believe (the reason for such belief to be recorded in writing) that any person has been guilty of any offence punishable under section 447, he may arrest such person and shall, as soon as may be, inform him of the grounds for such arrest ~ Section 212(8);
- Such officer u/s 212(8) shall immediately after arrest of such person, **forward a copy of the order**, along with the material in his possession, referred to in that sub-section, **to the SFIO in a sealed envelope** ~ Section 212(9)

# Disgorgement Order [Section 212(14A)]

- Where the **SFIO's investigation report** (interim or final) states that:
  - **fraud has taken place** in a company; and
  - due to such fraud
    - any **director**,
    - any **KMP**,
    - any **other officer** of the company, or
    - any **other person or entity**,has taken undue advantage or benefit, whether in the form of any asset, property or cash or in any other manner, the **Central Government may file an application before the Tribunal** for appropriate **orders with regard to disgorgement of such asset, property or cash** and also for holding such director, key managerial personnel, other officer or any other person liable personally **without any limitation of liability**.

**Investigation into Ownership of the Co. on CG  
opinion [Section 216]**

**IO appointed by CG to determine the true (i.e. actual)  
persons who are/ were**

**financially  
interested in  
success or  
failure of the  
Co.**

**able to  
control or  
materially  
influence the  
policy of the  
Co.**

**w.e.f.  
13.6.2018 -  
having  
beneficial  
interest in  
shares of  
a  
company**

**w.e.f.  
13.6.2018 -  
having  
beneficial  
owners or  
significant  
beneficial  
owner of a  
company**

**Power of inspector to conduct investigation into affairs of related companies, etc. [Section 219]**

**IO appointed u/s 210 or 212 also empowered to investigate any body corporate which is/ was**

- 1). Holding Co.;**
- 2). Subsidiary Co.;**
- 3). Subsidiary of Holding Co.**

**Managed by common MD/ Mgr.**

**Accustomed to act as per directions or instructions of the Co./ BOD**

# Inspection Report of the Inspector [Section 223]

- The inspector **may make an interim report**, if so directed and shall also make his final report to the CG and on the conclusion of the investigation, shall **submit a final report to the CG**;
- A copy of the interim report may be obtained by *members, creditors or any other person whose interest is likely to be affected* by making an application in this regard to the CG;
- The **report of any inspector shall be authenticated** in the prescribed manner;
- **Such report shall be admissible in any legal proceeding as evidence** in relation to any matter contained in the report.

# **Actions to be taken by CG in pursuance of inspector's report u/s 223 [Section 224]**

- **Situation 1: If any person guilty for criminal offence = CG may prosecute such person;**
- **Situation 2: If any Co./ Body Corporate liable to be wound up = CG may authorise any person to file before NCLT:**
  - (i). winding up petition; and/ or
  - (ii). application u/s 241
- **Situation 3: Where it appears that a fraud or misappropriation of property has been committed and the Co. is therefore, entitled to bring an action for damages for misconduct or for the recovery of any property, which has been misapplied or wrongfully retained, the CG may itself in public interest bring recovery proceedings for that purpose in the name of the Company before NCLT**

# Investigation of company's affairs in other cases [Section 213]

- If **on an application by prescribed number of applicants, it appears before NCLT** that:
  1. **the business of the Co. is being conducted for a fraudulent or unlawful purpose, or in an oppressive manner; or**
  2. **the Co. was formed for any fraudulent or unlawful purpose;**
  3. **persons concerned in the formation of Co. or the management of its affairs have in connection therewith been guilty of fraud, misfeasance or other misconduct towards the Co. or towards any of its members;**
  4. **the members of the Co. have not been given all the information with respect to its affairs which they might reasonably expect,** including information relating to the calculation of the commission payable to a managing or other director, or the manager, of the company

# Investigation of company's affairs in other cases [Section 213]

- **Then the NCLT may order**, after giving OBH to the parties concerned, **that the affairs of the company ought to be investigated by inspector(s) appointed by CG** and where such an order is passed, the CG shall appoint one or more competent persons as inspectors to investigate into the affairs of the company in respect of such matters and to report thereupon to it in such manner as the CG may direct;
- **If after investigation the cases referred to above are proved then every officer of the company who is in default and the person or persons concerned in the formation of the company or the management of its affairs shall be punishable for fraud in the manner as provided in section 447**

# Investigation of company's affairs in other cases [Section 213]

- **Prescribed Applicants:**

1. **If Company is having Share Capital:** Lower of the following:

- 100 members; or
- Members holding  $1/10^{\text{th}}$  of the total voting power

2. **If Company is not having Share Capital:** not less than  $1/5^{\text{th}}$  of the persons on the company's register of members

Application as above to be supported by evidence showing that the applicants have good reasons for seeking an order for conducting an investigation into the affairs of the company

**Note:** Application can also be made to it by any other person or otherwise and in such cases minimum number of applicants need not be there.

- **Non-disclosure of information in certain cases [Section 457 of Co. Act, 2013]:** Notwithstanding anything contained in any other law for the time being in force:
  - the ROC,
  - any officer of the Govt.; or
  - any other personshall not be compelled to disclose to any court, Tribunal or other authority, the source from where he got any information which:
  - (a) has led the CG to order an investigation u/s 210;  
or
  - (b) is or has been material or relevant in connection with such investigation

# Protection of Employees during Investigation

## [Section 218]

- Protection against **dismissal, discharge, removal, reduction in rank or otherwise, changing the terms of employment to his disadvantage**, of the employees;
- **Employees** = Employees of the Company under Investigation who make disclosure during the course of investigation;
- Section 218 requires company to **intimate NCLT prior of any such action** (i.e. dismissal etc.);
- If **NCLT objects (within 30 days)** any such action then it must send notice to employer;
- **NCLT not bound to hear** the employer (i.e. Co.) before issuing that notice [*Ashoka Marketing Ltd. case*];
- If **no notice within 30 days**, then **Company may proceed** to take action;
- If **Company dissatisfied** with NCLT objection = **Appeal to NCLAT within 30 days of receipt of notice**;
- **NCLAT decision** = final and binding on NCLT and Co.

# Legal advisers and bankers not to disclose certain information

- Legal advisers shall **not be bound to disclose any privileged communication** made to them except name and address of their client [Section 227];
- Bankers shall **not be bound to furnish information about the state of affairs** of any of their customers other than such body corporate, company or person [Section 227];

**Punishment for  
wrongful withholding of Company's Property  
[Section 452]**

# Penalty for wrongful withholding of Company's Property [Section 452]

- **Complainant:**
  1. Company;
  2. Member;
  3. Creditor;
  4. Contributory
- **Nature of Complaint:** An officer or employee:
  1. Wrongfully obtained possession of Company's Property (CP) including cash of the company;
  2. Being already in possession of any CP including cash of the company **but** wrongfully withholds it; or knowingly applies it for unauthorised purposes
- **Complaint to be made to Court;**
- CP may come in **company's possession either by rent/ lease/ other legal mode** [*Kannankadi Gopal Krishna Nair vs. Prakash Chander Juneja*]

# Penalty for wrongful withholding of Company's Property [Section 452]

- **Punishment:** Fine of atleast Rs. 1,00,000 but may extend to Rs. 5,00,000
- **Court may order** for delivery or refund of CP within specified time;
- Non-compliance with Court Orders may result in upto 2 years imprisonment;
- Both **existing as well as past** Officers or Employees covered u/s 452;
- Property obtained during employment but wrongfully withheld even after cessation of employment, complaint u/s 452 can be filed ***[Baldev Krishna Sahi vs. Shipping Corporation of India Limited]***
- Term 'officer or employee' of a company would by a deeming fiction include legal heirs and representatives of employee or officer concerned continuing in occupation of property of company after death of employee or officer ***[Smt. Abhilash Vinod Kumar Jain v. Cox & King's (India) Ltd.]***



**Common  
Red Flags**

# Entity and Operations

- Material changes to the business operations such as acquisition of a new division, sale of a division or a part of the undertaking, new investments in other entities, divestments , transfers of intangible assets of the CD;
- Large values of prior period items, transaction reversals, write-off of inventories or receivables, large provisions for obsolescence of inventory etc.;
- Sole selling arrangements, sole buying arrangements, pre-buy decisions, single sourcing strategies without competitive sourcing, high level of import-export and other related forex transactions etc.;
- Predominance of cash transactions;
- Registered Office of the CD not present at the address which is stated in the records of MCA;
- Presence of the CD/ Connected or related entities in foreign locations

## Directors and KMPs, etc.

- Affairs of the Company – financial as well as operations related matters were handled by a competent team;
- Directors of the CD may be disqualified u/s 164(2) of the Companies Act, 2013;
- Frequent changes in Directors and KMPs;
- Frequent changes of Auditors;
- Consider if the scale of the Audit firm engaged is commensurate with the size of the business operations and the credit exposures of CD

# Group and connected entities

- Presence of a large-number of related/ connected entities to the CD;
- Dormancy or status of such entities also needs to be reviewed;
- Special attention should be paid to all such entities (and transactions thereto) which are sharing common address/ common e-mail address (which is also registered with the MCA) with CD

## **Adverse Public Domain Information and Wilful Default Status**

- Undertake appropriate enquiries including public domain searches to identify any materially adverse information which may be a potential red flag;
- Obtain information whether the promoters / entities and connected entities have been marked as Wilful Defaulters by banks and financial institutions as per RBI directives as this would also be a decisive Red Flag indicator

# Forensic Auditors

<b>Functions of forensic auditors</b>	<b>Services rendered by Forensic Auditors</b>
Fraud Detection	Crafting (i.e. preparing) and responding questions to be asked to the offender
Computer Forensics	Identifying documents and individuals
Fraud Prevention	Conducting research relevant to facts
Providing Expert Testimony	Identifying and preserving key evidence
	Evaluating produced documentation and information for completeness
	Identifying alternative means to obtain key facts and information

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*Thank you*

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**Kamal Garg & Associates**