

# FINANCIAL FRAUDS – IMPACT ON GST



**Presented by  
CA Premnath D  
C Ramachandram & Co.,  
premnathd@gmail.com**

# Overview of the Session

- ❖ Economic Offences – Characteristics/Types
- ❖ Financial Statements - Disclosure Norms - Manipulations – Latest trends – Creative Accounting etc.,
- ❖ Financial Statement Manipulations
- ❖ System Failures – GSTN
- ❖ Case Study
- ❖ Leakages – How & Why
- ❖ Useful Red Flags and early Warning Signals for Prevention / Detection

# Defining Economic Offence

A Crime, the sole objective of which is to simply accumulate money, wealth or illicit profit at the cost of gullible

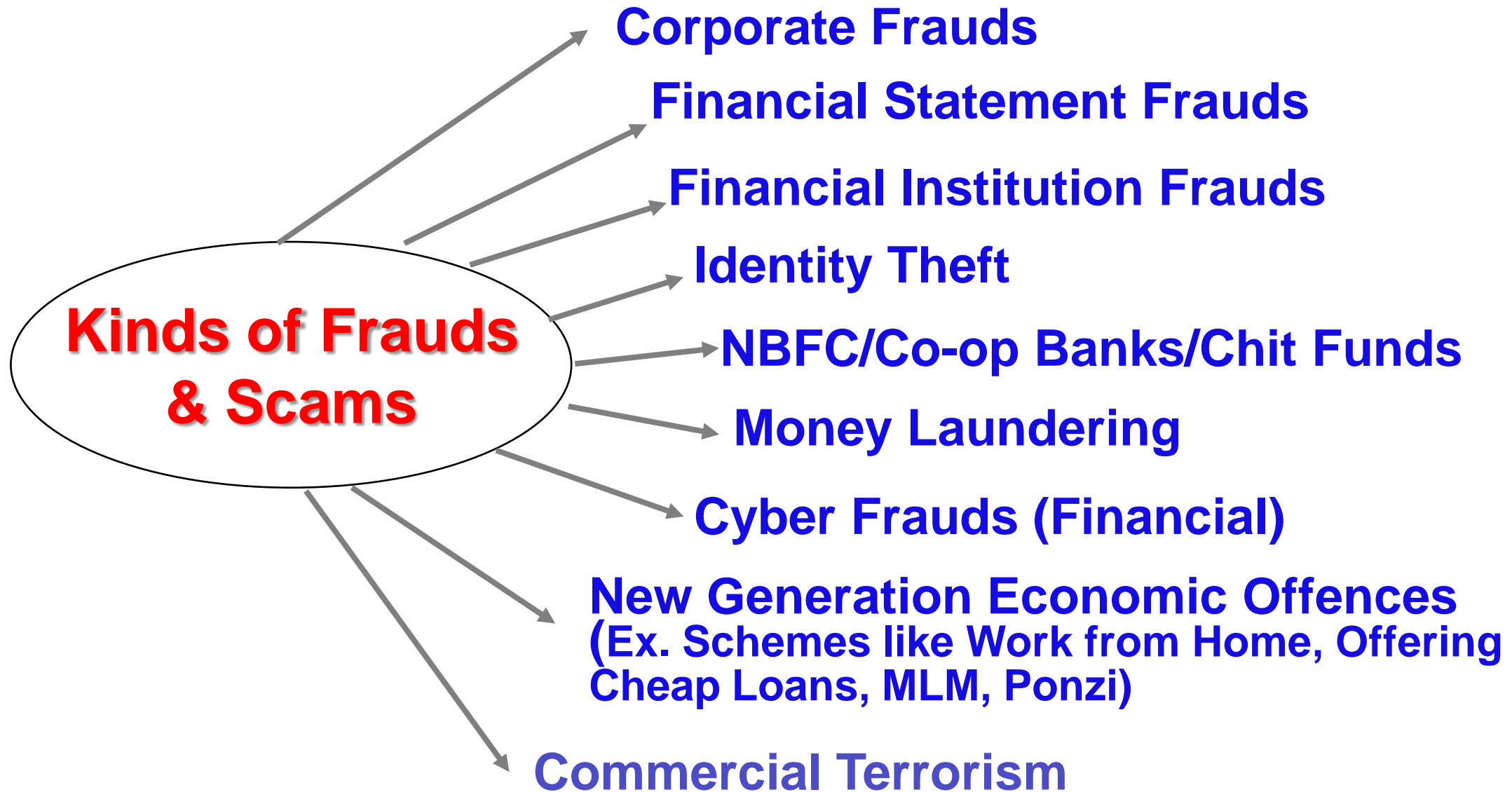
by exploiting the loopholes in the system;  
misusing the opportunities extended by the State to its citizens for their economic prosperity; and  
by violation of established regulations and fiscal laws

can be broadly categorized as Economic Crime.

# General Characteristics of Economic Offences / Commercial Frauds

- Perpetrators are educated, intelligent and often well placed in society;
- Know the system well;
- Mostly individual is not the victim, whole society is the victim;
- No social stigma attached;
- Technical, complex in nature;
- Not limited by geographical boundaries

# Types of Frauds / Economic Offences



# Typical Corporate Fraud Models

- Bank Loan Frauds & Tax Evasion Frauds
- Bogus Asset Creation
- Recycling / Evergreening
- Share Price manipulations by inflating Revenues
- Non Refund/Diversion of Public Deposits
- Financial Statement manipulations
- Hiding Liabilities
- Assets Stripping
- Creating Fictitious Liabilities before filing for Insolvency

# INDIAN CONTRACT ACT

- SECTION 17

- Fraud means and includes any of the following acts committed by a party to a contract or by his agent with his connivance, with intent to deceive or to induce a person to enter into a contract -
  1. The suggestion as fact of that which is not true by anyone who does not believe it to be true.
  2. The active concealment of a fact by one having knowledge or belief of the fact.
  3. A promise made without any intention of performing it.
  4. Any other act fitted to deceive.
  5. Any such act or omission as the law specifically declares to be fraudulent

# FRAUD

**Act or course of deception, an intentional concealment, omission, or perversion of truth, to**  
**(1) gain unlawful or unfair advantage,**  
**(2) induce another to part with some valuable item or surrender a legal right, or**  
**(3) inflict injury in some manner. Willful fraud is a criminal offense which calls for severe penalties, and its prosecution and punishment (like that of a murder) is not bound by the statute of limitations. However incompetence or negligence in managing a business or even a reckless waste of firm's assets (by speculating on the stockmarket, for example) does not normally constitute a fraud. In such cases, the aggrieved party(creditors or stockholders/shareholders) must prove that at some point they were intentionally deceived on a material  
fact.**



# Fraud

- Fraud is defined as an intentional act by one or more individuals among management, those charged with governance, or third parties, involving the use of deception to obtain unjust or illegal advantage. A fraud could take form of misstatement of an information (financial or otherwise) or misappropriation of the assets of the entity.

# Financial Statement Frauds

As most of these Frauds / Economic Offences involve / comprise Financial Statement Manipulations, these are extensively dealt with in the following slides

# Few Basics : Financial Statements

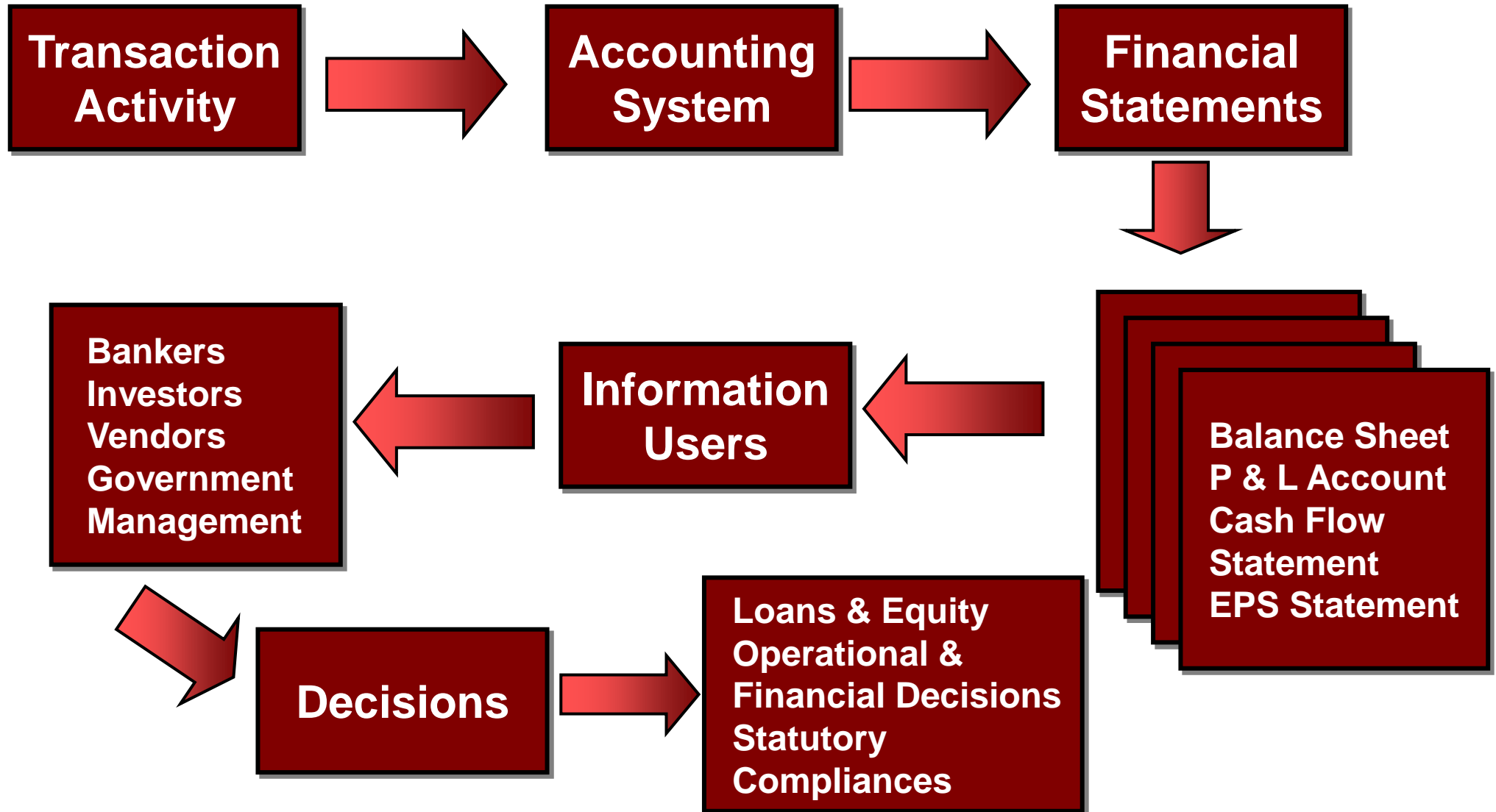
*Before understanding the Financial Statement Frauds, it is important to note few fundamental concepts, which are*

- ❖ **Balance Sheet**
- ❖ **Statement of Income or Profit and Loss Account**
- ❖ **Statement of Retained Earnings**
- ❖ **Statement of Cash Flows**
- ❖ **Statement of changes in Owner's Equity**
- ❖ **Notes to Accounts**
- ❖ **Income Tax Act mandated reports**

# Objectives of Financial Statements (FSs)

- ▶ Provide information about the financial position (*through Balance Sheet*), performance (*through Profit & Loss A/c*) and Cash Flows of an enterprise, which is useful to a wide range of users for making economic decisions and ensuring Statutory compliances.
- ▶ Financial Statements portray the effect of past events and transactions, captured in these two statements
- ▶ Accounting Policies & Methods adopted would influence the effect of depicting past events and transactions.
- ▶ As per applicable reporting laws, Financial Statements are to be prepared together with adequate disclosures, both in form and content

# Users of Financial Statements



# Disclosure Framework in Financial Statements

- Objectives of Financial Statements
- Statutory Requirements
- Accounting Policies
- Accounting Standards & Guidance Notes of ICAI
- Auditors' Report (*together with particulars mandated which are Country specific*)
- Other reporting norms under Income Tax Act, *which are specific to Tax filings*
- **Similar norms apply for VAT/GST & other Statutory Tax Returns**

# Accounting Errors, Irregularities & Fraud

- ❖ An “Error” refers to unintentional misstatements or omissions of amounts or disclosures on financial statements
  - *Mistakes in gathering or processing accounting data*
  - *Incorrect estimates due to misinterpretation of facts*
  - *Mistakes in the application of accounting principles*
  
- ❖ An “Irregularity” refers to intentional misstatements or omissions of amounts or disclosures on financial statements
  - *Falsification or alteration of accounting records or supporting documents*
  - *Misrepresentation or intentional omission of events or transactions*
  - *Intentional misapplication/non-application of accounting principles*
  
- ❖ **Fraud is always Intentional**

# Accounting – New Definitions !!

## ■ Fair Presentation

Using the flexibility within accounting norms to give true and fair picture of the accounts so that they serve the interests of Users

## ■ Creative Accounting

Using the flexibility within accounting norms to manage the measurement and presentation of the accounts so that they serve the interests of Preparers

## ■ Impression Management

Using the flexibility of the accounts (*especially narrative and graphs*) to convey a more favourable view than is warranted of a Company's results serving the interest of Preparers

## ■ Fraud

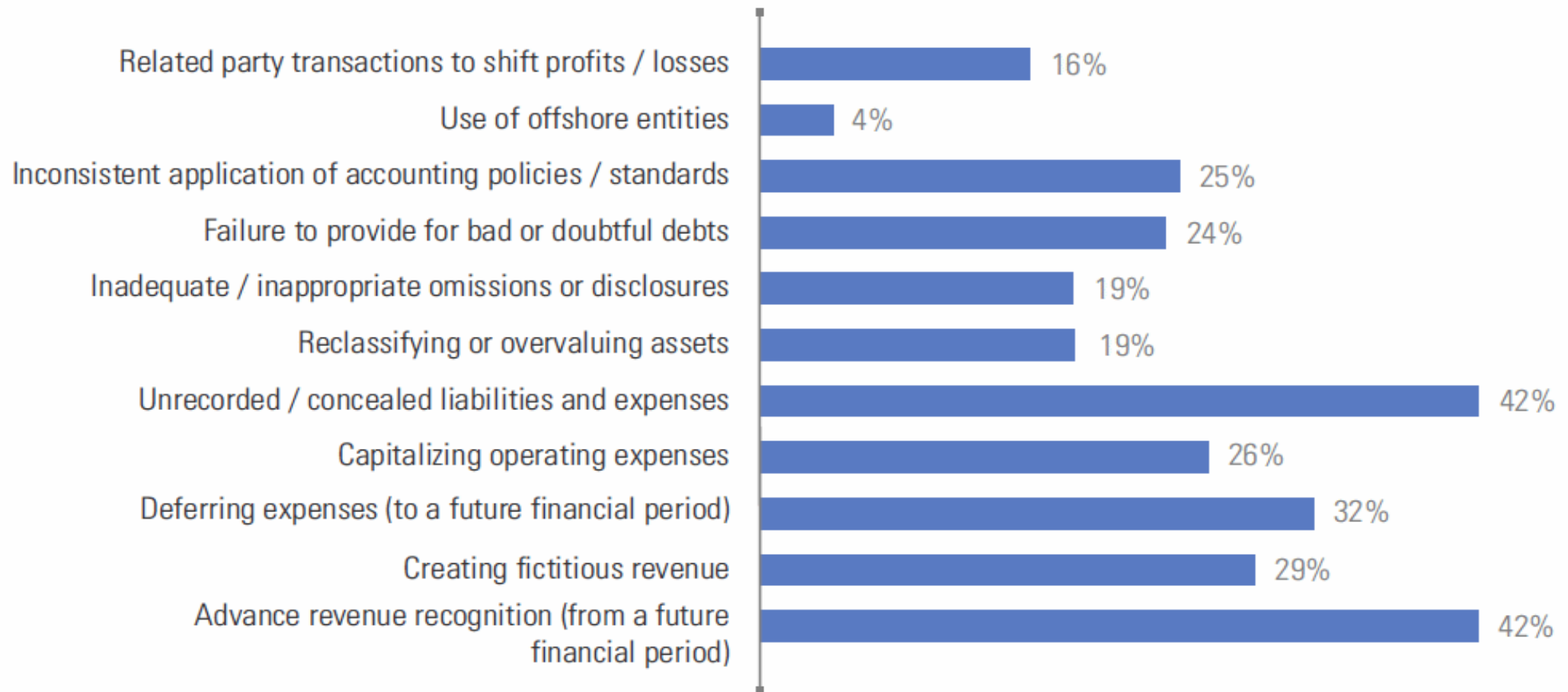
Stepping outside the Regulatory Framework deliberately to give a false picture of the accounts.



# How is Creative Accounting done??

- Using the flexibility, within the accounting process, to present a preferred picture of the Company at the desired point of time
- Can be done through:
  - **Accounting induced operational & financial decisions**
  - Choice of Accounting Policies
  - Manipulation of accounting estimates within purview of Accounting Standards
  - Fraudulent & bogus transactions
  - Booking revenue expenditure as Capital Expenditure or as Deferred Revenue expenditure
- Very thin demarcating line between **Fraud** and Creative Accounting

# Common Forms of Financial Statement Manipulations



# Common Methods of FS Manipulations

- **Window Dressing**

Manipulation of financial statements to camouflage the real position of a company to show a better position

- **Evergreeing**

Keeping the repayment schedules of loans/deposits in order by borrowing/ accepting additional loans/deposits

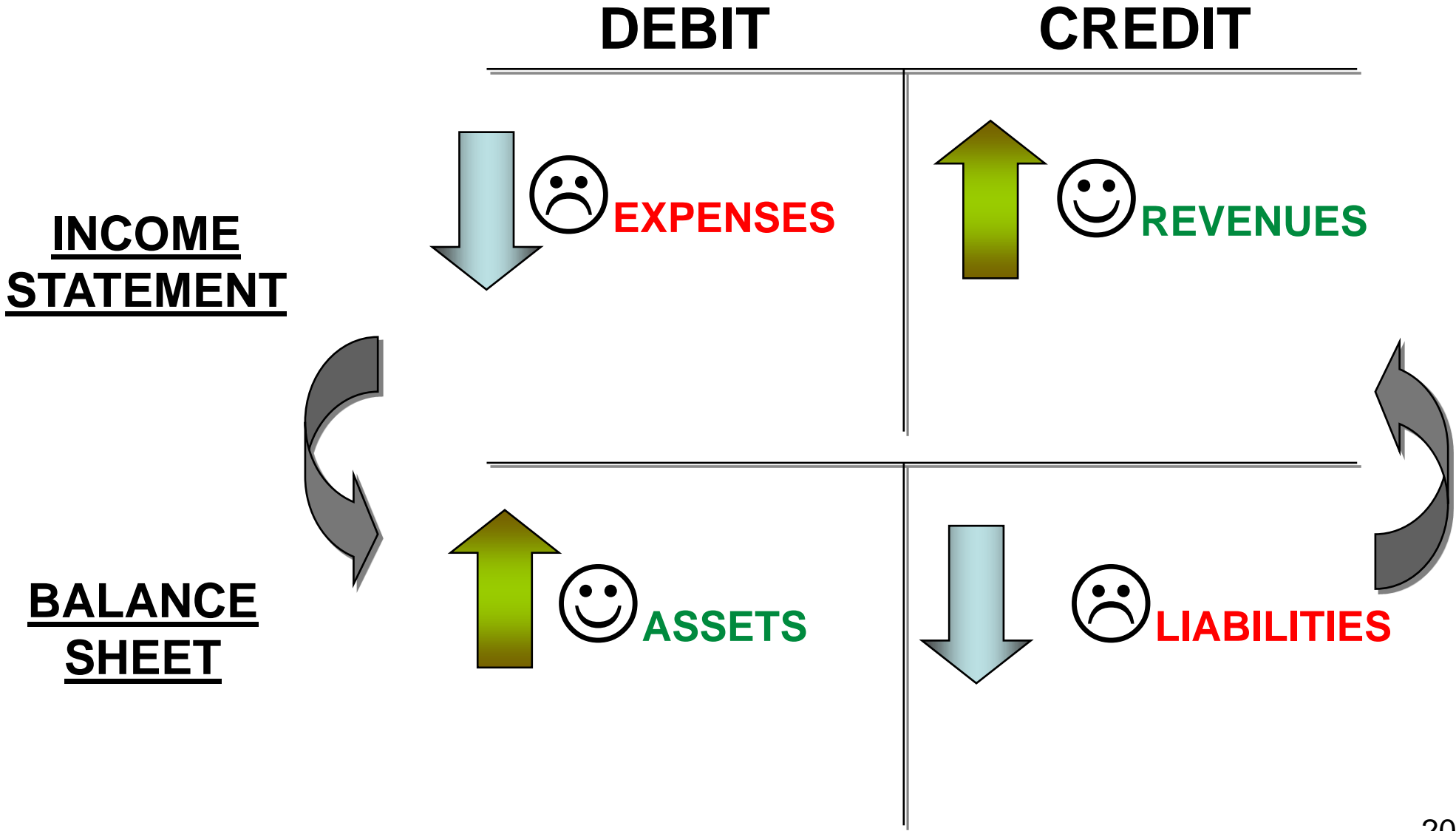
- **Recycling / Round Tripping of Funds**

Reusing the same money to create or show that much higher quantum of money has come in through different sources and many times

- **Bogus Asset Creation / Expenditure booking**

Normally used for diversion of funds or for Loan disbursal eligibility

# The Accounting Equation - A schematic explanation of how Errors and Manipulations arise



# Other FS Manipulations

<b>Methodology used</b>	<b>What do Companies Achieve?</b>	<b>How Done</b>
<b>Inflating or Bogus Expenses / Hiding Sales</b>	<b>Funds from issue of shares, public deposits/schemes/Bank loans are diverted for personal use</b> <b>Wrong claim of VAT input</b> <b>Show Promoters' Contribution</b>	<b>Booking Fictitious Expenses / Contracts, Ghost Employees/Staff, Consultancies, Huge Foreign Travel, VAT malpractices</b> <b>Money Laundering</b>
<b>Inflating Profits</b>	<b>Higher Bank Loan eligibility</b> <b>Enriching at the cost of investors</b>	<b>Window dressing accounts</b> <b>Reporting fake transactions through sister/group entities</b>
<b>Concealing Liabilities</b>	<b>Get better rating/loans</b> <b>Getting Higher credibility</b>	<b>Creating contingent liability for real liabilities</b> <b>Showing liabilities as Income</b> <b>Showing Unsecured Loans as CAPITAL</b>
<b>Off Balance Sheet items</b>	<b>Hide Real liabilities by showing them as 'Off Balance Sheet items'</b> <b>Significant where company applies for Bank Loans (D/E Ratio)</b>	<b>Guarantees given, LC's issued are not shown/disclosed</b> <b>Similarly, litigation cases impact not disclosed/shown</b>

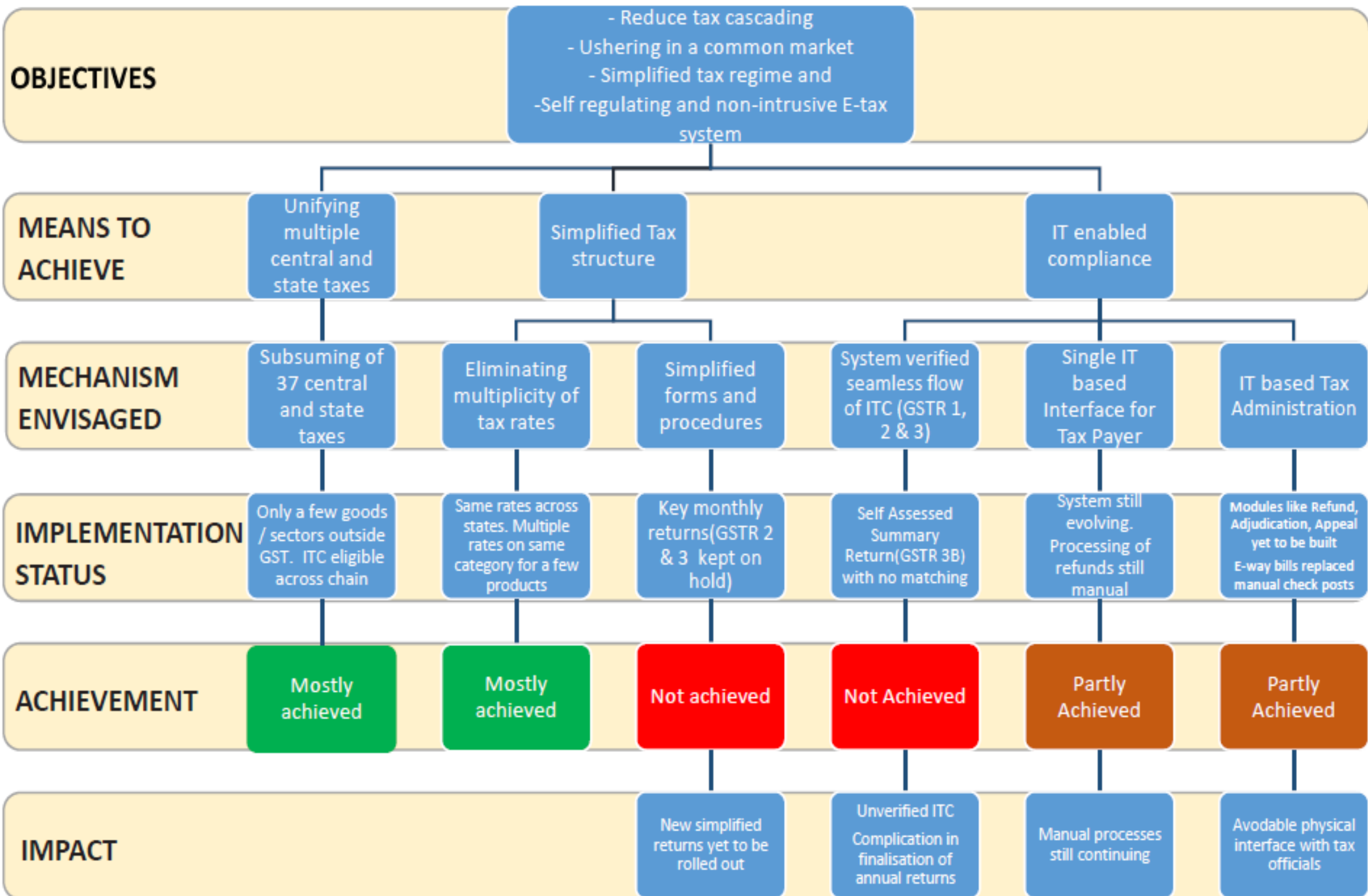
# **GSTN – System Lapses**

## The Systematic Lacunae

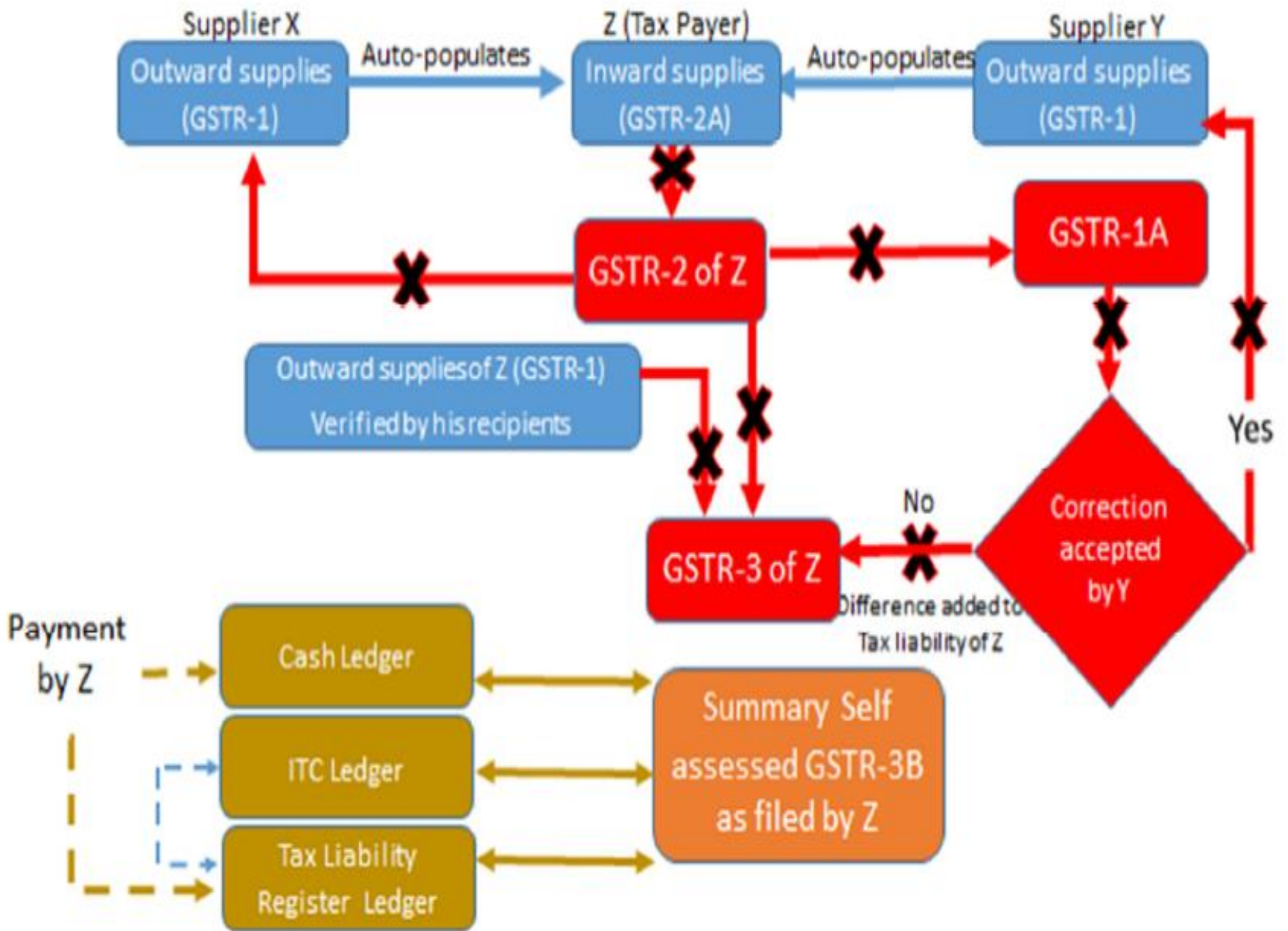
The CAG says system validated input tax credit (ITC) through invoice matching is not in place even after 3 years of the GST rollout. That is why a non-intrusive e-tax system remains elusive, it says.

"The complexity of the return mechanism and technical glitches resulted in rollback of invoice matching, rendering the system prone to ITC frauds. Thus, on the whole, the envisaged GST tax compliance system is non-functional," says the CAG report.

# Chart 1: Objectives of GST, extent of achievement and fall out









# Fraudulent GST Input Credit Frauds

- Post GST, this is one of the new trend of Fraudulent practices being adopted
- GST fraud was unearthed, where ineligible input tax credit of around Rs.450 crores was unearthed
- Modus operandi is that traders buy fake bills which enable them to claim input tax credit, on the supply which never happened
- Input tax is option in GST which allows taxpayer to claim credit for tax paid on purchase
- This is not first case; ever since new GST regime has come, there have been numerous such cases

# Fraudulent GST Input Credit Frauds

- In Feb 2018, Haryana GST wing detected Rs.50.34 Crores evasion
- In March 2018, Punjab Wing booked cases for fake invoice scam involving Rs.100 Crores
- In May 2018, Kolkata Intelligence detected tax evasion of more than Rs.40 Crores
- Same month, Mumbai Wing detected tax evasion worth Rs.127 Crores of similar type and Rajasthan GST Intelligence wing detected evasion of Rs.58 Crores

*Frauds here also evolving and there would be much more in the time to come*

# **The Leakages - Why and How**

## **Tax Leakages and Evasion**

As pointed out by the CAG, roll-back of invoice matching has made the system prone to ITC frauds and made the compliance system non-functional.

The finance ministry has estimated GST evasion of around Rs 45,000 crore in 2018/19; a big chunk is due to fake invoices. Finance Minister Nirmala Sitharaman informed the Lok Sabha on July 1 that GST officers had detected 535 cases of fake invoices involving fraudulent ITC claims of Rs 2,565 crore in the current financial year. In 2018/19, 1,620 cases, involving fake ITC claims of Rs 11,251 crore, were detected.

# **The Leakages - Why and How**

## **Tax Leakages and Evasion**

- Fake invoicing seems to be the most common GST fraud.
- It involves selling fake invoices for a commission of 1-2 per cent to businesses looking to claim ITC.
- For example, by selling fake invoices (of a good or service which attracts 18 per cent GST) of, say, Rs 500 crore, one can make Rs 5-10 crore.
- The buyer of these invoices can claim ITC of 18 per cent, or Rs 90 crore.

# **The Leakages - Why and How**

## **Tax Leakages and Evasion**

- Often those who buy goods in cash do not insist on pakka bills.
- These bills are then sold to entities in the business of exporting goods.
- Instead of exporting genuine goods, they export miniature or fake versions, thus claiming both input credit and duty drawback,

# The Leakages - Why and How

## Tax Leakages and Evasion

- Another method involves using layers of subsidiaries to evade GST.
- A business has six group companies.
- Each sells to the other company.
- The company with the highest sales closes down and vanishes.
- It files a winding up petition, which costs just Rs 12,000. If the tax department comes knocking at its doors, the promoter asks the department to file its claims with the liquidator. It is a good legal safeguard for Rs 12,000,"
- this is happening with the connivance of the tax authorities.

# **The Leakages - Why and How**

## **Tax Leakages and Evasion**

- Businesses are taking credits on certain goods and services on which credit is not available.
- For example, some take credit on gifts under the guise of sales promotion.
- The law does not allow ITC on items bought for gifting.
- There are 12 items for which input tax credit is not available.
- Also, family-owned businesses book personal expenses such as holidays, LCD/LED, AC as business expenses and then claim ITC on these.

# **The Leakages - Why and How**

## **Tax Leakages and Evasion**

- There are taxpayers who are consistently filing returns late
- Many are still showing different liability in GSTR-1 and GSTR-3B
- The gap between ITC claimed in GSTR-3B and that accruing from GSTR-2A still persists
- ITC claimed lower than ITC available. Indication of unaccounted sale
- In comparison with the count of Composition taxpayers (20 lakh), the cash paid by them is small
- Taxpayers have prepared E-way bill but have not filed GSTR-3B



# The Leakages - Why and How

## BOGUS BILL – WHY & HOW

### WHY

- Availment of ITC without receipt of goods/service
- To increase turnover for higher valuation for Share market
- For bank Overdraft facility/ overcome NPA status
- Financial Difficulties

### HOW

- A - B - C - D to E; *or*  
A - B - C - D to E (exporter) (bogus export and claim refund)
- A do not file return and does not pay GST and vanishes but B to E file returns.
- A pays tax, disclose in his return too but raises invoice without any supply. Mostly to increase the turnover or bank facilities
- A issue invoice to B who takes credit but goods are given to C without invoice
- Encasement of accumulated ITC
- Many such transactions done through middleman

# The Leakages - Why and How

## BOGUS BILL ISSUE – MANNER OF DETECTION - I

- A – B – C – D – E : A does not pay tax and do not file returns. But, B to E files return by availing credit.

### **DMD (Department's methodology for detection)**

- Analyze data of Non-fillers of GSTR I and GSTR 3B (A in this case)
- Analyze data of Non-fillers of GSTR 3B but who have filed GSTR I
- Mismatch between E Way bill and GSTR I transactions leading to inference that only Bills have been issued
- Analyze caeses where full tax payment is through ITC coupled with sensitive commodities.
  - Butter manufacturer taking credit on Ghee.
  - HDPE user taking credit on PVC.
  - Ground nut oil manufacturer taking credit on Castor seeds.

# The Leakages - Why and How

## BOGUS BILL ISSUE – MANNER OF DETECTION -2

- Analyze caeses where full tax payment is through ITC coupled with sensitive commodities.
  - Butter manufacturer taking credit on Ghee.
  - HDPE user taking credit on PVC.
  - Ground nut oil manufacturer taking credit on Castor seeds.
- Cases of substantial higher GST invoice value (on which IGST paid and claimed refund) as compared to FOB value declared in Shipping bill
- Compare ITC as per GSTR 3B and GSTR 2A – Cases where ITC as per 3B is much higher than 2A. It will highlight cases where ITC availed but supplier has not filed GSTR 1

# The Leakages - Why and How

## BOGUS BILL ISSUE – MANNER OF DETECTION -3

### Other Important aspects

- Encashment of accumulated ITC - Issue of fake invoices specifically for services
- Many Service transactions cases also detected
- Even many export refunds cases also detected mostly in case of export of service
- Recent circular No. 16/2019 – Cus dated 17th June, 2019 directing stoppage of export refund by Customs authorities. Even bank accounts attached.

# The Leakages - Why and How

Supply without Invoice - Clandestine Removal

## **DMD (Department's methodology for detection)**

- Compare import data (value and IGST) from Custom's with sales as per GSTR 1 and GSTR 3B – Cases where there is Import but no sale - Mostly Consumer goods cases
- Compare purchase data (value and IGST) as per GSTR 2A with sales as per GSTR 1 and GSTR 3B
- Returns are Filed but only part credit taken or part utilization of ITC leading to regular accumulation of ITC for traders (other than inverted duty structure) - Part goods are sold without invoices (Table Sl 8 (E) of GSTR 9) For import 8 J )
- Non-filers – GSTR 3B or GSTR 1 or both
- E-way bill details comparison with GSTR-1/GSTR 3B information may show cases of unaccounted sale – EWay bill but no GSTR 1
- Sale to URD ( B 2 C) by manufacturers/wholesalers (cash bills) – Indication of sale to actual user without invoice and bill raised to fake person

# The Leakages - Why and How

## Selection of Non filers Cases

- Substantial purchases as per GSTR 2A/ import data but no GSTR 3B filed
- Past tax payments – Trend Analysis to find out riskier cases
- Use of Section 150 : Check TDS deduction by customers of Non - filer entity – Use of Income Tax data  
(It means there is sale by Non-filer but not declared for GST purpose) – Can be very useful for default by Service providers like Contractors, Commission Agent, Security providers
- NPA cases as per Bank/RBI report – Airline's cases
- Analysis of E Way Bill : E way bill but no invoice



# The Leakages - Why and How

## Group Company/Intra-Company Transactions

Transfer of credit temporarily / permanently

- Issue of sales invoice and later on reversal of transaction by issue of Credit Note to transfer credit temporarily
- If **accumulated Credit** – Issue only invoices to transfer credit (mostly in Group company transactions)
- Identify cases of substantial accumulated credit and supply to related person

# The Leakages - Why and How

## Composition Dealers

- Composition scheme - As no ITC is available on purchases of goods, there is tendency to buy without GST paid invoice
- Analysis of quantum of non-GST paid purchases would indicate purchase against bogus invoices and diversion of tax paid invoices to other taxpayers. GSTR 4 Return [ 4(C ) ] captures purchase from URD.
- There could be cases of GST paid purchases as reflected in GSTR 2A but not shown in Composition dealer return. (Point already covered in earlier slide) [ Normally, officer would not examine GSTR 2A of Composition Dealer)
- Even all India study can be made for GST paid and without GST paid purchases by Composition dealers



# The Leakages - Why and How

## IMPORTANT REPORTS AVAILABLE TO TAX AUTHORITIES

- Non-filers – All returns, with periodicity & delayed period if any
- Tax payer paying substantial tax through utilization of ITC
- Risk profile of a taxpayer (ten risk parameters)
- Constitution wise tax payers (Individual/HUF/Firm, Company)
- Tax payers migrated to and from a jurisdiction
- Cash to credit ratio
- Top taxpayers making exempted sullivan

# GST Frauds - Refunds

- 1,200 untraceable exporters made refund claims worth Rs 350 crore
- nefarious elements among the customs broker community may be connected with these frauds, involving fictitious entities, existing only in virtual space through identity thefts with fake and morphed documents
- Custom brokers to collect KYC of exporters
- at least 50 customs brokers have been found to have dealt by and large with such exporter entities which are untraceable at their registered addresses
- Firm exporting ready made garments to SEZ claimed fraudulent refund of Rs 9.88 crore

# GST Frauds - Refunds

- GST authorities, using data analytics-based risk management, selected the taxpayer for physical scrutiny, who was then found non-existent at his declared address
- Using a web of fake invoicing of over Rs 847 crore, the firm created a fraudulent credit of Rs 195 crore and investigations led to discovering untraceable suppliers.
- The Revenue Department is carrying out risk evaluation of exporters with the help of predictive modelling
- 50 companies such as H.A. Creation, A.S. Fashion, Ritish Creations, R.D. Creation, Bamane Enterprises were floated to fraudulently avail benefits of IGST refunds,” revealed the official. “No one has actually paid the IGST on which ITC was availed by the exporter.”

# GST Frauds - Refunds

- These companies were created by using the PAN and Aadhar Cards of various un-suspecting persons through whom GST refunds were being claimed
- Bank accounts declared to the department at the time of obtaining GST registration certificate were allegedly different from the bank account declared to the Customs authorities for the purpose of IGST refund
- Most of the suppliers and CHAs are located at Delhi, the premises of dummy exporters are registered in Mumbai
- Documents such as purchase documents, export documents, cheque books, signed blank cheques, ATM debit cards and PIN of about 50 proprietorship firms were recovered from the office premises of the mastermind
- none of the suppliers down the line have generated mandatory E-way Bills for the purported supplies made to the exporters.

# Red Flags

**Sa 240 – ICAI – The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**

- Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting
- Risk Factors Arising from Misstatements Arising from Misappropriation of Assets
- Examples of Possible Audit Procedures to Address the Assessed Risks of Material Misstatement Due to Fraud
- Examples of Circumstances that Indicate the Possibility of Fraud

# Offences and Penalties – Sec 122

Nature of Offence	Prescribed Penalty
<ul style="list-style-type: none"><li>• Supplies any goods without invoice</li><li>• Issues invoice without supply of goods</li><li>• Collects tax amount but does not pay the same into the appropriate government treasury</li><li>• Collects tax in contravention of the Act</li><li>• Fails to deduct or collect tax and also fails to pay it to the appropriate governments</li><li>• Takes input tax credit without receipt of goods</li><li>• Obtains refund by fraud</li><li>• Manipulates financial records</li><li>• Fails to get registered</li><li>• Gives false information</li><li>• Transports taxable goods without documents</li><li>• Fails to maintain books of accounts.</li><li>• Fails to provide information and required documents.</li><li>• Takes or distributes credit in violation</li><li>• Obstructs or prevents a officer in discharge of duty</li><li>• Suppresses turnover</li><li>• Tampers or destroys evidence</li><li>• Disposes or tampers goods detailed or seized etc</li></ul>	<p><b><u>Higher of following:</u></b></p> <ol style="list-style-type: none"><li>1. Rs. 10,000/- <u>or</u></li><li>2. An amount equivalent to the amount of tax evaded/not deducted/collected or input tax credit availed or distributed or refund claimed in the matter</li></ol>

# The Leakages - Why and How

## ARREST PROVISIONS

- Section 69 empower arrest for serious offences like supply without invoice, issue of bogus invoices, availing ITC on such invoices and tax collected and not paid, as listed under Section 132 (1) (a to d)
- Where tax involved is more than 5 crore, arrest can be made as these are cognizable and non-bailable (Clause i)
- Where tax involved is 2 to 5 crore, arrest can be made as these are non-cognizable and bailable. In these cases bail needs to be granted by DC and AC, GST (clause ii)
- SC in Sapna Jain case ordered that HC's must follow Apex Court order where they upheld Arrest Power as decided by Telangana HC

# Prevention of Money Laundering Act – GST Frauds

- The Central Economic Intelligence Bureau (CEIB) says stringent PMLA could be considered to curb and deter ITC Fraud, claimed by companies generating fake invoices of GST.
- Money earned through these fake transactions is actually black money and laundered by entities creating web of shell companies.
- ITC Fraud thru fake GST invoices is contravention of Section 16 of the GST Act, a predicate offence ED or any other agency can book such entities under the PMLA and attach their properties and those of their associates.
- Revenue intelligence agencies to share real-time data and investigation updates on their cases to ensure that a coordinated action is taken against offenders and tax evaders.



# Preventive Measures – E-Invoicing

- “Today a business has to upload invoices, generate e-way bills when goods are transported and file returns as well. Effectively, it has to do these three processes separately.
- the time lag in generating the invoice and getting it verified longer time lag could slow down the process of prevention of fraud.
- An electronic invoice can do away with the need for both separate returns filed against sale of goods and e-way bills issued for transport of goods.
- Electronic invoicing, is a way to ensure that fake invoices are not generated and ITC against them are not claimed. The system works in a way that the invoice is generated on a portal, and is verified by the government. Once the invoice is verified, a UIN will be issued, which can be used by buyer.