

## “Forensic Accounting and Auditing with Special Reference of National Spot Exchange Ltd.”

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### Abstract

#### Fraud Vis-a-Vis Forensic Audit

We know very well that a parasite can kill or destroy a beautiful green tree, in the same way corporate frauds in an economy can lead to devastation of the whole economy of the country. We have many examples of such corporate frauds which lead to economic downfall of the nation like Commonwealth Games Scam, Satyam Scam, 2G Spectrum Scam, Bihar Fodder Scam, Harshad Mehta and Ketan Parekh Stock Market Scam, Hawala Scandal etc.

Now a days Forensic audit is proving a specialized tool to identify these financial frauds & Scams at very early stage by applying techniques & methods of forensic audit. It is used for fraud examination which covers fraud allegations from inception to disposition, including obtaining evidence, interviewing, writing reports and testifying.

#### Introduction:

Considering the above views, it seems that forensic accounting plays a significant role in preventing and detecting possibilities of fraudulent financial reporting. It can be seen as an attainable effort to improve quality financial reporting through education and provide other alternative research in accounting.



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One of such corporate fraud is National Spot Exchange Limited Scam which came under public domain in year 2013 in the month of July. In the NSEL case, there have been claims of 13,000 trading clients who have faced monetary losses of around 5400 crores. However, the authenticity or genuineness of these so-called investors is under scrutiny.

**National Spot Exchange Limited** is the national level, institutionalized, electronic, transparent spot trading platform for commodities. It is a structured market place, setup to transform the commodity market by way of reducing the cost of intermediation and thereby improving marketing efficiency. Its state of the art technology facilitates risk free and Hassel free purchase and sale of various commodities. NSEL provides customized solution to farmers, traders, processors, exporters ,importers, arbitrageurs investors and other stake holders pertaining to commodity procurement, storage, marketing, warehouse receipt financing, etc.

NSEL commenced operations providing an electronic trading platform in October 2008 and simultaneously, as many six state governments issued licenses under the Model Agricultural Produce Market Committees (APMC) Act to NSEL. In August 2011, the Forward Market Commission (FMC) was appointed as the 'designated agency' to regulate these spot exchanges.

Three spot exchanges, NSEL, NSPOT and National APMC were exempted by the government under Section 27 of FCRA to conduct forward trading in one day contracts. This was done to boost volumes so that their economic viability improved. While Financial Technologies (India) promoted NSEL, it was granted general exemption on June 5, 2007, whereas, NSPOT and National APMC received exemptions under the same provisions on July 23, 2008 and August 11, 2010 respectively.

**Objectives of the research & Problems to be investigated:**

In general Forensic audit intends to perform with resolve some specific objectives like searches for evidence of criminal conduct or assists in the determination of, or rebuttal of, claimed damages and inconsistencies, fraud, embezzlement, money laundering, the concealment of debt, the concealment of assets or other fraudulent activities, or even financial crimes an during this special audit, auditor uses its skill, Competence, professional expertise and do apply various techniques to identify whether actually fraud has been happened and if yes then potential reason of the same.

In this fast growing world and in the era of globalization, whole system is getting integrated and thus for such an evolutionary change in the system we need to have some systematic tools to deal with such change. Forensic audit and accounting is one such tool which can be used by organizations to cope up with this change and hence can make the procedure more efficient and effective. These days large organizations have a team of forensic accountants and forensic auditors to manage their working and to have a check on the system being run by the organization.

NSEL case relates to a payment default at the National Spot Exchange Limited that occurred in 2013 involving Financial Technologies India Ltd, when a payment default took place after a commodities market regulator, the Forward Markets Commission (FMC), directed NSEL to stop launching contracts. This led to the closure of the Exchange in July 2013.

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There were certain problems which lead to such a huge scam and if we do apply techniques of Forensic audit in context of such scam at some early stage then we find out major problems, their causes and procedures adopted to implement these frauds in NSEL through conducting some forensic audit measures over the available data and information.

#### **Details of the Research done & significant findings**

Though very difficult part of the research was to identify the actual scope of working and then to collect the data and evidences to come out with the replies of the queries and objectives of the research. During the course of research we have done our working through various documents & information's made available to us through various websites, Balance Sheets of NSEL, News agencies & news papers , various books and through some other sources. In our research we have also combined and worked with statements of Police officials and various government departments like SEBI, Enforcement Directorate, Forward market commission, Ministry of Consumer affairs and other Government Agencies. We have also taken cognizance of various statements of Auditors of the Spot exchange for the time being at different different periods.

It was our believe that investigation should be made regarding authenticity of the scandals and manipulations reported in the working of National Sport Exchange Ltd. And during the course of research through conducting some forensic audit measures over the available date and information we came to know about various significant findings.

**The Main object of the research was to find out the necessity of Forensic Audit in this case by examining the various documents and information's available during the course of research and to establish whether there were sufficient circumstances and evidences which lead to conduct the forensic audit of activities of National Spot Exchange Limited.**

**Some of the critical findings** can be summarized here below-

- While applying the techniques of forensic audit in National Spot Exchange Limited case it came to our notice that FMC found that the exchange allowed trading on its platform without verifying whether the seller had stocks, in effect allowing short sales by members. This discrepancy could have been identified if forensic accounting has been done at early stage. At the end of July, 2013, the investigations by the FMC found that the contracts traded on the exchange for which the settlement period exceeded 11 days were non-transferable specific delivery contracts, which were violating the provisions of Forward Contract Regulation Act, 1952. This problem escalated further when The amount involved in unsettled payouts as on July 29, stood at around Rs 5400 crore. This lead to suspended trading and suspended launch of new contracts indefinitely.
- The major problem caused such a huge scam was the issuing of false warehouse receipts by the brokers to the investors. Brokers of National Spot Exchange Limited sold warehouse receipts to investor against which there was no appropriate stock were maintained in the warehouses and there was no system to check whether such stock was maintained in the warehouses or

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not. On the basis of these false warehouse receipts transaction limits of the brokers have been performed.

- Also there were lack of documentation in National Spot Exchange Limited as there was no proper record of investors and brokers were maintained who were involved in the regular transactions of the exchange. This deficiency lead to problem of identifying who were the actual investors. No proper KYC was being done as a result it was difficult for authorities to identify who were the actual investors and accordingly the fraud performed.
- There were also some problems with the email servers. There were allegations on EOW of tampering with NSEL-FTIL email servers. Later it was confirmed that the email server of NSEL/FTIL has crashed and was to be investigated.
- Also there were several violations of the provisions of Prevention of Money Laundering Act (PMLA).The other major problems includes several irregularities/violations such as false assurances to investors, wrong and misleading statements, arbitrage products sold with assured returns and as risk-free products, funding of clients and client code modification for those trading on NSEL.
- Also brokers have also been accused of indulging in massive manipulation of client KYCs, large-scale modification of client codes for doing multiple deals and infusion of unaccounted money through their NBFCs, SEBI has asked them as to why they should not be declared not "fit and proper" since they were found to have violated securities regulations. In the notice, SEBI has conveyed to these errant brokers that 'it is alleged that your continuance as a market intermediary in the securities market is detrimental to the interest of this market.
- SEBI has issued show-cause notices to the top five brokers namely Anand Rathi Commodities, India Infoline Commodities (IIFL), Geofin Comtrade, Motilal Oswal Commodities, and Phillip Commodities, on charges of mis-selling NSEL contracts by promising assured returns without ensuring delivery.
- It also alleged that these brokers had manipulated client code modifications. They engaged in trades without the permission of clients. They also allowed clients to execute trades despite debit balances in their accounts. The regulator said they had also not segregated funds between client accounts and their own, thus violating rules.
- FIU (under Finance Ministry) held that NSEL came under the purview of Forward Contracts (Regulation) Act (FCRA) and therefore guilty of failing in several of these obligations under the law. The black money watchdog has slapped a penalty of Rs 1.66 crore for several counts of violating the provisions of Prevention of Money Laundering Act (PMLA) on NSEL. The watch dog further held that failures is deliberate and willful and hence, invite penalties. NSEL is fined Rs.1 lac for each failure and the collective fine was Rs.1.66 crores.
- Who made money and how- The Exchange Revenues through charging a transaction cost as a percentage of turnover. The more the turnover, the higher the earning. The Broker Brokerage

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fees of 2-3% on the gross amount invested. A typical AUM of Rs 100 crore nets the broker Rs 1-3 crore per annum.

- The Investor Earned 1-1.5% a month buy short-term contracts at lower price and selling long-dated contracts at higher price and pocketed the difference.
- The Trader Bought long-dated contracts at higher price and sold short-date contract at a lower price and a paid a net difference of 1-1.5%. In the process received easy funding at a very low cost.
- From the Scrutiny of Balance Sheet and Profit and loss account of NSEL for the year ending 2010-11 and 2011-12 we can observe that there are some items which recorded change with a large amount without any justified reasons and indicates probable window dressings and potential frauds, which are illustrated as below:
  - The balance of Reserve and Surplus in Financial Year 2011 is negative i.e. (9,58,79,523) but in F.Y. 2012 it has risen by Rs. 25,63,68,654 (approx 2.67 times) and this rise is due to rapid increase in profit of the NSEL in F.Y. 2011-12.
  - In the Profit and Loss Account of F.Y. 2010-11 there was profit of only Rs. 2,60,73,499 but it increased to Rs.25,63,68,654 i.e. in one year profit increased by Rs.23,02,95,155 (approx 8.83 times). Such a rise in profit is difficult to achieve just in one year span specially at the time when total revenue of the exchange goes down.
  - From the Balance Sheet it reflects that the balance of Short Term Loans and Advances was Rs. 52,40,50,865 in F.Y. 2010-11 but it increased to Rs.2,01,27,30,939 in the F.Y. 2011-12.
  - From the notes to account for the F.Y. 2011-12 it is observed that around Rs 55,00,00,000 was given as advance to related parties while in the previous year it was just Rs. 2,08,297 , this was supposed to be checked that whether such advances were actually given or not to the related parties, also to check the pattern of recovery of such advances and the purpose for which advances were given etc.
  - Also in the Notes to Account it is analysed that during the F.Y. 2011-12 unsecured advances increased by Rs.98,44,10,292 which is also a huge amount which should have been checked whether such advances were given or not and what was the purpose of the same. List of Parties to whom such advances were given should have been checked and also their credit rating should have been checked in order to find the amount of provision which can be made on such advances.

Such transactions involving huge amount of money should have been checked as these are the major reasons which lead to window dressing of financial statements of the National Spot Exchange Limited and in our opinion If FMC has taken these actions or has recognized these discrepancies at a earlier stage with the help of forensic audit methods then such a situation would never had occurred.

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**Limitations**

While conducting the research we got data from various primary and secondary sources in form of statements, information, records, books of accounts, newspaper publications, study reports etc. Also whatever articles which were published by various publications and financial experts were also used in order to complete the research on NSEL scam. These articles were of great use and it enabled to understand the whole situation which arose due to NSEL scam in a better way.

We have also used the financial statements of National Spot Exchange Limited of various years which were available on secondary platforms. All these really helped in the whole research and provided us with information which were relevant for the process.

we hereby want to mention that we have also tried to get the official statements of management of NSEL and to get some additional documents from the management side to further investigate the scam but they have not entertained to provide the documents and statements. So this research study and thesis is subjected to the same and based on the available primary and secondary data.

**Further Scope of Study**

This whole research on National Spot Exchange Limited scam is majorly based upon the deficiency on the part of the management of the National Spot Exchange Limited and the proceedings are majorly done on the management by the investigating agencies. But from the research, it was analysed that it was not only the managers who were involved in this fraud rather it was the brokers who were also responsible, also the top personnel of the National Spot Exchange Limited were involved in this conspiracy.

In this research we already discussed how the brokers were involved in the wrongful issue of warehouse receipts and also there were no proper documentation which was being done on the part of brokers. So we can get further positive results if Forensic audit is also conducted for the transactions done by the brokers and Personal Companies of Promoters Jignesh Shah and others.

So the research does have further scope of study by way of analysis of accounts of brokers and promoters.

**Conclusion**

Apart from the important findings and analysis mentioned herein above, there are also various other transactions in the financial statements which could have been checked earlier by the auditors in order to find out whether any wrongful act was being done by the exchange in order to gain undue advantage over the investors of the exchange who invested their money in the exchange.

Like this the whole conspiracy lead to a huge corporate fraud which damaged the economy and also played with the trust of investors who invested in the exchange thinking of getting good returns. In India stock trading is still in its development phase due to conventional approach of people towards the corporate. This conventional approach of people proves to be right when such huge corporate frauds take place in the country. SEBI and other authorities should take proper care of such transactions and interest of the investors otherwise this would lead to complete collapse of stock

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marketing culture in the economy.

So such dark patch of corporate fraud on economy gives a clear picture of irregularities with which the whole system is infected and again it could be summarized that there were sufficient evidences and indicators which could be worked as whistle blower of frauds at National spot exchange limited and if forensic audit could be applied to NSEL Scam at some early stage then the frauds could not be lead to that huge size of more than 5400 crore and total recovery of the same which is presently around 7% of the total scam amount could be reached up to a satisfactory level with a safeguard to the Interest of the Investors.

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