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A SPECIAL REPORT ON FINANCIAL FRAUD IN NEPAL

FINANCIAL FRAUDS – MITIGATING RISKS

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Financial fraud is an intentional act of deception involving financial transactions for personal gain. Fraud is a crime, and is also a civil law violation. Many fraud cases involve complicated financial transactions conducted by 'white collar criminals' such as business professionals with specialized knowledge and criminal intent.[1]

1. ONSET OF FINANCIAL FRAUD

The globalization of the financial services industry, increased sophistication and complexity of financial institutions and their services, and the ongoing advancement of technology continue to introduce new risks and opportunities for fraud. The pace and complexity of these advances have vastly accelerated beyond the risk associated with traditional credit and market risk activities. One of these emerging risks in financial institutions is fraud risk, which needs to be effectively controlled through effective governance and sound operational risk management processes.

Local Context

The banking sector in Nepal experienced a boom following economic liberalization in the 1980s. There has been a tremendous growth in the Nepali financial system, in terms of the number of financial institutions as well as products and services being introduced into the market. This growth along with rapid developments in information and communication technology has fostered increased competition as well as significant increases in complexities, risks and challenges in the industry, therefore making the supervisory role of Nepal Rastra Bank (NRB) more demanding.[2]

As Nepal emerged from its decade long conflict in 2006, the political development led to a favorable business environment which was well received by all the major sectors, with a significant acceleration in commercial banking and lending. The Real Estate sector was one of the key sectors which saw significant investments, due to the absence of investment opportunities in other productive sectors which later led to unnecessary speculation and quick gains.

However, with tightening of liquidity in the banking system in 2009, aided by slower deposit growth, negative balance of payments position and possible capital flight, the Banking and Financial Institutions (BFIs) were no longer in a position to extend further credit towards the real estate sector, in addition to being restricted by the new directive of the Central Bank.

> Research indicates that the problems have not arisen due to systematic risk, but from individual risk and fraudulent actions undertaken by the management, promoters or Board of Directors (BOD) of these BFIs

Thus began the downward trend in 2009. With the stagnation of the real estate sector and banks being highly leveraged in real estate lending, bank borrowers started to default which further worsened the situation.

BFIs with inadequate risk management system and poor corporate governance practices started to land in trouble, which led to some of the first cases of banking frauds emerging in the Nepali market. Despite there being a few cases of banking frauds in the past, the intensity and number of fraud cases experienced after the severe liquidity crisis indicate that the frauds were planned.

2. CASES OF FRAUDS DETECTED IN NEPAL

The Nepal Rastra Bank (NRB) has declared nine banks as problematic after these banks were asked to undertake Prompt Corrective Action (PCA). These banks are General Finance, World Merchant Banking and Finance, Capital Merchant Banking and Finance, Himalaya Finance, Kuber Merchant Banking and Finance, Crystal Finance, Nepal Share Market and Finance, United Development Bank, and Gurkha Development Bank, whereas People's Finance has been put under the PCA category. Problematic banks are required to improve within a stipulated time, and are barred from various activities including taking any deposits and extending new credits, with lack of improvement within the stipulated time frame resulting in liquidation.

A significant number of these BFIs have been declared problematic due to cases of bank fraud identified in these institutions. Further research indicates that the problems have not arisen due to systematic risk, but from individual risk and fraudulent actions undertaken by the management, promoters or Board of Directors (BOD) of these BFIs. Despite being a small market, there have been an increasing number of fraud cases. Fraud cases especially in a highly regulated sector such as the banking sector are extremely alarming. There are currently two BFIs facing the liquidation process – Samjhana Finance and Nepal Development Bank. Some of the recent fraudulent cases witnessed by the Nepali banking sector are discussed below.

General Finance

The General Manager at General Finance was found to be involved in financial fraud through misappropriation of assets, and insider lending. A total of NPR 78.25 million (USD 0.9 million), was found to be misappropriated from the finance. The manager was arrested in July 2012 and handed over to the court for judicial proceedings. Police investigation indicates that good for payment cheques worth NPR 13 million (USD 0.15 million) were issued by the manager, under the name of a person on different occasions despite the company having no liabilities to the same. The manager has also been accused of providing loans worth NPR 52.93 million (USD 0.6 million) to 11 individuals, despite these individuals having weak or no collateral.[3]

H and B Development Bank

14 people were found to be involved in a banking fraud worth NPR 1.09 billion (USD 12.4 million) in H&B Development bank. The Branch Manager at Kuleshwor branch was found to have issued fake good-for-payment cheques worth NPR 870 million (USD 9.9 million), in collusion with some internal bank staff and some businessmen. The fraud came to light when the bank head office detected a considerable

shortfall in its vault. The bank faced losses worth NPR 220 million (USD 2.5 billion) wherein deposits to be made into bank accounts were not actually made, but shown as deposited in the book of accounts. As per the Central Investigation Bureau (CIB), the branch manager has been charged with NPR 1.05 billion (USD 11.9 million), whereas eight employees under him have been charged with half the amount. Similarly NPR 473.3 million (USD 5.3 million) and NPR 172.9 million (USD 1.9 million) have been demanded respectively from bank customers who were found to be involved in the fraud.[4]

Nepal Sri-Lanka Merchant Bank and Finance

Three former directors of the now-defunct Nepal Sri Lanka Merchant Bank (NSMBL) and Finance (merged with Nepal Bangladesh Bank), and promoted by NB Group caused a huge loss to the company by flouting banking norms and disbursing loans at a time when the finance company was about to merge with Nepal Bangladesh Bank. It was found that loans worth NPR 20.08 million (USD 0.22 million) were provided to various persons, who had also defaulted on huge loans in other BFIs, without any collateral except personal guarantee in the final week of the merger. The institution bore losses worth NPR 353.1 million (USD 4.02 million).

With NSMBL and Nepal Bangladesh (NB) Bank being promoted by NB

Table 1: Frauds in Figures in order of scale

S.N.	BFIs Name	Amount*	Reason
1	General Finance (2012)	NPR 78.25 million (USD 0.89 million)	Lack of Internal Control System and Corporate Governance Misappropriation by Manager and Directors
2	Capital Merchant Banking and Finance (2012)	NPR 2.5 billion (USD 28.5 million)	Misappropriation by the former Managing Director, took out loans against weak or without collateral
3	Himalaya Finance (2013)	NPR 58.1 million (USD 0.66 million)	Fund embezzlement by the Branch Manager, Chairman and General Manager
4	Crystal Finance (2012)	NPR 446 million (USD 5 million)	Lack of Internal Control System and Corporate Governance Misappropriation by the Directors
5	Nepal Share Market Bank and Finance (2011)	NPR 2.66 billion (USD 30.3 million)	Misappropriation by Chairman, General Manager and Director
6	United Development Bank (2011)	NPR 462.2 million (USD 5.2 million)	Misappropriation by Chairman and Directors, bad Corporate Governance and Misuse of Funds
7	Gurkha Development Bank (2011)	NPR500 million (USD 5.7 million)	Misuse of Funds, Corruption, and Bad Corporate Governance
8	H&B Development Bank (2012)	NPR 1.09 billion (USD 12.4 million)	Misappropriation by Manager and fake good for payment cheques
9	Nepal Sri Lanka Merchant Bank and Finance (2012)	NPR 353.1 million (USD 4.02 million)	Misappropriation by Directors
10	Himalayan Bank (2005)	NPR 45.2 million (USD 0.5 million)	Misappropriation by Employee
	(2012)	NPR 56.7 million (USD 0.65 million)	Embezzlement through MasterCard and Visa by Employee
11	Nabil Bank (2011)	NPR 4 million (USD 0.45 million)	Theft of PIN numbers by Employee

*These are tentative figures based on various national dailies. The accuracy of these figures may therefore vary as per difference sources.

Table 2: Types of Financial Frauds

Financial Statement Frauds	Misappropriation of Assets	Corruption
Financial Statement Fraud is the least common type of fraud occurring least frequently and in only 10% of all fraud cases worldwide. However it is the most expensive as it leads to huge losses within firms.[10] This type of fraud involves: • Manipulation, falsification, alteration of financial statements and accounting records. • Misrepresentation or intentional omission of numbers. • Misapplication of accounting principles. • Intentionally false, misleading or omitted disclosures.	Misappropriation of assets is the most common type of fraud, and occurs most frequently. Recent statistics show that asset misappropriation happens in over 91% of fraud schemes worldwide. However it is also the least expensive fraud on a per-fraud basis. This type of fraud involves: • Theft of tangible assets such as money, inventory and services, by internal or external parties. • Sale of proprietary information. • Improper payments made to clients such as check forgery.	Corruption is one of the most frequently occurring types of fraud and constitutes 30% if all fraud that has been uncovered worldwide.[11] This type of fraud involves: • Bribery and corruption schemes such as kickbacks (negotiated bribery), and shell company schemes. • Making or receiving improper payments. • Offering bribes to public or private officials. • Aiding and abetting fraud by others.

Group, it was also found that two key promoters from NB group had taken out loans worth NPR 350 million (USD 4 million) despite being blacklisted by the Central Investigation Bureau (CIB) for defaulting on loans worth NPR 150 million (USD 1.7 million) taken from Nabil Bank under their promoted companies, and for issuing cheques that could not be processed because of insufficient balances in the accounts. Nepal Bangladesh Bank (NBB) is yet to recover an estimated NPR 1.5 billion (USD 17.1 million) in loans from NB Group, which was provided against rules and under pressure by a key promoter.[5]

Nepal Share Market and Finance (NSMF)

In one of the country's largest financial scams, a misappropriation of clients' deposits worth NPR 2.66 billion (USD 30.3 million) by the former Executive Chairman of NSMF was identified. A total of NPR 1.57 billion (USD 18 million) was found to be loaned out to 88 people without the provision of supporting documents, or collateral. A total of NPR 880 million (USD 10 million) worth of deposits from various large institutional depositors including NPR 165 million (USD 1.9 million) of Citizen Investment Trust and NPR 200 million (USD 2.3 million) of Rastriya Beema Sansthan (RBS) was also mismanaged, whereas over NPR 200 million (USD 2.2 million) of deposits were found to be distributed to family members.[6]

Gurkha Development Bank

Gurkha Development Bank was declared a crisis ridden bank by Nepal Rastra Bank (NRB) due to issues of corporate governance within the institution. The former Executive Chairman of the company was found to have taken loans worth NPR 250 million (USD 2.85 million), despite the Bank and Financial Institution Act (BAFIA) barring promoters and directors from taking loans from their own banks. Similarly the former General Manager and Director were found to have received money worth NPR 140 million (USD 1.6 million) and NPR 30 million (USD 0.34 million) respectively through third parties. In addition the Executive Chairman and the Chief of the Credit Department were involved in diverting loans worth NPR 130 million (USD 1.48 million) from the bank to one of their clients from the actual loanee's account.[7]

United Development Bank

Former Executive Chairman and one of the Directors of United Development Bank were involved in misappropriation of NPR 276.21 million (USD 3.15 million) and NPR 67.5 million (USD 0.76 million) of the banks funds from the bank's call in advance account without maintaining the transaction in the book of accounts, along with converting non-existent amounts into the share capital through the decision of the Board. They were also found to have withdrawn NPR 14 million (USD 0.15 million) in advance without disclosing any purpose, loaned out NPR 58.28 million (USD 0.66 million) by creating fake loanees to adjust misappropriated amounts, and rescheduled loans worth NPR46.21 million (USD 0.52 million) that went to banks Directors despite being against the central bank's directive.[8]

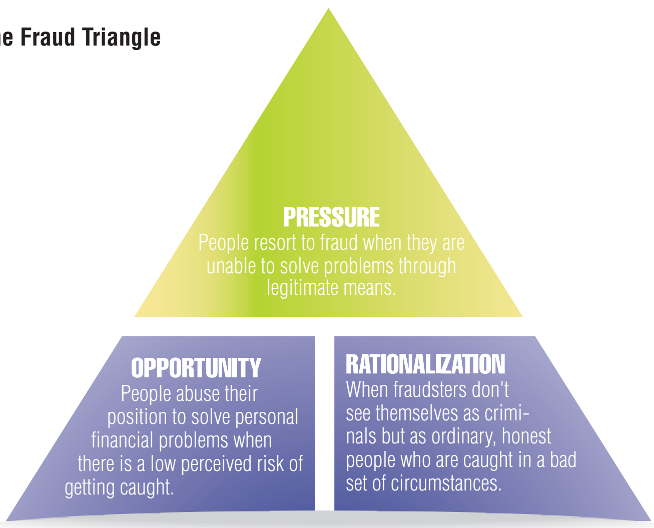
3. REASONS BEHIND FRAUD IN NEPAL

Financial Frauds are a feature of every organized culture in the world, and affect many organizations and individuals, regardless of size, location, or industry. Increased dependence on technology and automation of most processes has upped the possibility of financial fraud. According to the Federal Trade Commission's (FTC) Consumer Sentinel Network Data Book, there has been a 62% increase in financial and other fraud claims in just three years, with over 1.5 million individual claims in 2011.

As per the prosecutions and cases filed in the courts of Nepal; financial frauds occurring within BFIs regulated by the Nepal Rastra Bank (NRB), have cost the Nepalese economy an estimated total of NPR 5 billion (USD 57 million) within a period of 7 years, equivalent to NPR 23.5 million (USD 0.27 million) per BFI.[9] Based on analysis of fraudulent cases in the country, some of the common categories under which fraud takes place are listed in Table 2, whereas the most common reasons behind these frauds are provided in the Fraud Triangle (see Figure 1).

While the senior management and the Board are ultimately responsible for fraud management programs, the internal audit of a company can play a strong role in addressing fraud. Based on the cases of frauds detected in Nepal, there is a high change of fraudulent occurrence across the hierarchy, from the Board of Directors (BOD) to the operational management. The major reasons behind the occurrence of frauds in Nepal are loopholes and lapses within the internal control system, weak regulatory supervision, people taking advantage of positions held, changing lifestyles and availability of easy money. However there are also some individuals that enter the financial sector with the pure intention of conducting fraud and taking advantage of regulatory loopholes.

Figure 1: The Fraud Triangle



Source: The Fraud Triangle, Donald Cressey[12]

Table 3: Global Financial Fraud Acts and Legislations

Sarbanes-Oxley Act (SOX), 2002	Fraud Enforcement and Recovery Act (FERA) 2009	Indian Acts and Legislations
SOX is a United States (US) federal law that set enhanced standards for all US public company boards, management and public accounting firms. This Act was enacted as a reaction to a number of major corporate and accounting scandals including those affecting Enron, Tyco International, Adelphia, Peregrine Systems and WorldCom. These scandals, cost investors billions of dollars when the share prices of affected companies collapsed, shaking public confidence in the nation's securities markets. As per the SOX Act, top management has to individually certify the accuracy of financial information, and inaccuracies are severely penalized. The act covers corporate board responsibilities, criminal penalties, auditor independence, corporate governance, internal control assessment, and enhanced financial disclosures. Under the act a quasi-public agency, the Public Company Accounting Oversight Board (PCAOB), was created to oversee, regulate, inspect and discipline accounting firms in their roles as auditors of public companies. The SOX Act has also helped increase the independence of outside auditors, who review the accuracy of corporate financial statements, and increased the oversight role of the boards of directors. In response to global corporate scandals, SOX-type laws have subsequently been enacted in Japan, Germany, France, Italy, Australia, Israel, India, South Africa, and Turkey.[13]	FERA is a public law in the United States (US) which enhanced criminal enforcement of federal fraud laws, especially regarding financial institutions, mortgage frauds, and securities or commodities frauds. The Act changes the definition of a financial institution for the purpose of federal criminal law to include mortgage lending businesses, which are defined as: "Organizations which finance or re-finance any debt secured by an interest in real estate, including private mortgage companies and any subsidiaries of such organizations, and whose activities affect interstate or foreign commerce." In addition to including mortgage lending businesses in the range, the amendment also includes any other person "that makes in whole or in part a federally related mortgage loan", and makes it a federal offense to falsify loan documents submitted to a broad range of financial institutions. The Act also defines proceeds in the money laundering statute as "any property derived from or obtained or retained, directly or indirectly, through some form of unlawful activity, including the gross receipts of such activity".[14]	Financial crimes and fraudulent activities in India have been defined and enacted diversely by various laws and legislations. Some of the acts, legislations and regulations through which individuals as well as entities are booked or prosecuted are through the following.[15] i. Indian Contract Act 1872 ii. Indian Penal Code, 1860 iii. Prevention of Corrupt Act iv. Prevention of Money Laundering Act v. The Companies Act 1956 vi. Clause 49 of Listing Agreement vii. Companies Auditor's Report Order (CARO), 2003

4. POLICIES TO CURB FRAUDS

Banking Offence and Punishment Act (BOPA), 2007

The BOPA was established in 2007 to promote trust towards the banking and financial system and mitigate the consequences and risks. The Act outlines banking offences and demands fines or imprisonment as punishment depending on the degree of the offense. The Act covers unauthorized issuance of cheques, cheque-books or bank statements, unauthorized withdrawals or payments, unauthorized provision of loans, misuse of credit and banking resources and assets, baking resources and assets, window dressing of accounts and misappropriation of assets amongst others.

Similarly if any person/s create obstacles or hindrances during the

Table 4: Major Frauds Enacted Globally

Enron Scandal, 2001	Lehman Brothers	Satyam Computers
The Enron Scandal revealed in October 2001 led to the largest corporate bankruptcy in the United States with USD 63.4 billion (NPR 5.5 trillion)in assets, of Enron Corporation, an American energy company based in Houston, Texas, and the de facto dissolution of Arthur Anderson, one of the five largest audit and accountancy partnerships in the world. The Senior Management at Enron used accounting loopholes, special purpose entities and poor financial reporting to reduce tax payments inflate income, profits, stock price and credit rating, hide billions of dollars in debt and losses from failed deals and projects, and to funnel money to themselves, friends and family. The Enron Board of Directors and the audit committee were misled on high risk accounting practices, and the audit firm Arthur Anderson was pressured to ignore the issues. Shareholders of Enron lost an estimated USD 11 billion (NPR 964 billion) when the stock prices fell after the scandal was revealed. This scandal led to new regulations and legislations being enacted to expand the accuracy of financial reporting by public companies, such as the Sarbanes-Oxley Act. [16]	Lehman Brothers, a global financial services firm, and the fourth largest investment bank in the United States (US), filed for bankruptcy in 2008 following the massive exodus of most of its clients, drastic losses in its stock and devaluation of its assets by credit rating agencies. The company filed bankruptcy after citing a bank debt of USD 613 billion (NPR 53 trillion), USD 155 billion (NPR 13.5 trillion) in bond debts, and assets worth USD 639 billion (NPR 56 trillion). The collapse of the investment bank occurred due to Malfeasance; wherein executives constantly portrayed the finances of the company were good using various accounting gimmicks at the end of each quarter. Other major reasons for the downfall were engagement in subprime mortgage where loans and finances were made to people who may have had difficulty maintaining their repayment schedules and the naked short selling practice wherein they practiced short-selling of a tradable asset without first borrowing the security or ensuring that the security could be borrowed.[17]	Satyam Computer Services established in the mid-1980s was the fourth largest Indian Information Technologies (IT) company listed in India and the United States (US). The company had over 53,000 employees and were operating in 66 countries globally with annual revenues amounting to more than USD 2 billion (NPR 175 billion).In 2009, the Chairman-Ramalinga Raju along with two other executives were found to be involved fraud through falsification of accounts of the company, such as tampering the account books, overstating assets of the company by USD 90.23 million (NPR 7.9 billion), understating liabilities by USD 237.56 million (NPR 20.8 billion), making fake cash balances of over USD 920.81 million (NPR 80 billion) in the balance sheet and the interest earnings component of the company by USD 69.17 million (NPR 6.06 billion). Due to these issues investors lost a staggering USD 18.41 billion (NPR 1.61trillion) in market capitalization making it the biggest corporate scandal in India.[18]

investigation process, they are punishable with either up to six months imprisonment or a fine of NPR 5000 (USD 57), or both depending on the degree of offense.

Some major highlights of the BOPA in regard to the proceeding and Disposal of cases are provided below:

Time and Limitation for the Lodgement of the First Information Report (FIR) –

a. An FIR may be lodged within one year from the date the offense comes into knowledge, with the case having to be lodged within 6 months from the date of the FIR and a notice published in a Nepal Gazette.

b. A case can be initiated at anytime against any employee or office bearer of a BFI who has been involved in misappropriation or loss of assets of the BFI during his/her assumption of service, with there being no obstruction in initiating a case even after the office bearer or employee retires from service.

Proceedings can be initiated by detaining into custody:

a. The offender may be put into custody by issuing a detention order as per the prevailing laws, if there is an adequate ground to believe that the person, against whom proceedings have been initiated, may destroy any evidence, create hindrances or obstacles, or adversely influence investigation and inquiry. If the investigation process is not completed within 24 hours and further detaining is required, additional approval must be obtained from the adjudicating officer.

> The Act covers unauthorized issuance of cheques cheque-books or bank statements, unauthorized withdrawals or payments, unauthorized provision of loans, misuse of credit, baking resources and assets, window dressing of accounts, misappropriation of assets

Issuance of order for creating encumbrances over the assets of a foreign individual

a. If any foreign individual does not appear for an investigation after the provision of a notice, the investigating officer may issue an order to block international travel and create encumbrances over property, entitlements, interests or concerns held by the foreign individual in Nepal. Non compliance is also punished with fines up to NPR 100,000 (USD 1141).

OUTLOOK

Window dressing has a high likelihood for occurrence in Nepal as internal and external audits are not conducted in an exhaustive manner and the monitoring and verification by concerned regulatory bodies are not stringent enough to counter these frauds.

5.1. MORE FRAUDS YET TO COME

With the country's poor technological infrastructure, limited knowledge and monitoring mechanisms, the Nepali financial system is fraught with immense possibilities in regard to the occurrence of financial scams and frauds. Given below is a list of frauds that have a high likelihood of occurrence and could pose as a significant risk to the financial sector of the country.

Window Dressing

Window dressing has a high likelihood for occurrence in Nepal as internal and external audits are not conducted in an exhaustive manner and the monitoring and verification by concerned regulatory bodies are not stringent enough to counter these frauds. Window dressing involves making improvements to the appearance of a company's financial statements, using accounting tricks to make the company's balance sheet and income statement appear better than they actually are, usually at the end of the accounting period.

Cooperatives Bubble

The number of cooperatives in Nepal has been growing at a compounded annual growth rate (CAGR) of more than 18% over the past seven years. The total cooperatives registered have crossed over 26,000, out of which 45% constitute of savings and credit cooperatives. Kathmandu alone has over 4,044 Savings and Credit Cooperatives, 558 Multi-Purpose Cooperatives and constitutes 29% of total financial cooperatives in Nepal. Deposits within these cooperatives are over NPR 200 billion (USD 2.2 billion) and are much higher than that of the combined deposits in development banks and finance companies.

With the size of business being conducted and in the absence of a strong regulator such as NRB which regulates BFIs, a few financial cooperatives have been conducting activities that go against their basic cooperative principles. There have been various cases where these financial cooperatives have been engaged in providing favorable loans to promoters without pledging collateral, mobilizing more than 50% of loans in unproductive sectors such as the housing sector, maintaining inadequate loan loss provisions, capitalizing interest earned as principal amount and mobilizing deposits higher than the required amounts amongst others. The recent fraud cases witnessed in some of the large financial cooperatives operating in Kathmandu Valley clearly signals high probability of misappropriation of assets in the loosely regulated sector especially in Kathmandu Valley which may have negative impact to the overall financial system in the near future.

New Payment Gateways
With technological breakthroughs and the introduction of new methods of banking there is a high risk of fraudulent occurrences due to the absence of systematic safety protocols. The system is therefore vulnerable to various attacks such as Phishing (illegal acquisition of usernames, passwords, and credit card details), Pharming (redirection to a bogus website), spyware and man-in-the-middle attacks (request for client's passwords or personal details). With the introduction of branchless banking and mobile payment financial services through Fonepay and Hello Paisa in the Nepali market, there are high chances of fraud occurrences as cyber laws are not stringent enough to detect the same. For instance over the past three months, Nepali BFIs such as Nabil Bank, Nepal Investment Bank and Bank of Asia Nepal, have already been victimized though phishing and pharming. A total of 1.35 million (USD 15,400) has been pilfered from these banks. It is therefore essential that banks install stronger safeguards meanwhile also increasing public awareness. The Central Bank of Nepal has therefore introduced IT guidelines for BFI's that advises a board-approved IT related strategy, deputation of a senior officer as information security officer, regular risk analysis, board-approved information security policy that addresses all electronic delivery channels and payment systems, and maintenance of a workforce that is well aware about information risks.

Inadequate system of banks
BFIs are increasing rapidly in number and without the requisite investment in control systems, huge gaps are created in security. In addition, internal control mechanisms of BFIs are haphazardly managed, due to which there are huge concerns in regard to inter-branch reconciliations, where proper checks and control systems are lacking. Plastic money fraud is also becoming a huge concern for the banking sector with the involvement of internal staff in forgery and duplication of debit and credit cards.

Capital Market
The continued uncertainty and volatility of the financial markets could be used as a spearhead to commit and conduct various types of securities frauds. Some examples are:

i. *Insider Trading* where information received through internal sources of the concerned company is used to trade shares in the secondary market.

Plastic money fraud is also becoming a huge concern for the banking sector with the involvement of internal staff in forgery and duplication of debit and credit cards.

ii. *Accountant Fraud* wherein negligence of public accounting firms leads to failure in identifying and preventing the publication of falsified financial reports, therefore providing a misleading impression of the companies' financial status.

iii. *Demat Account Fraud* where several fictitious demat accounts[19] is opened by a single person to capitalize on IPOs, market manipulation, investment frauds, and miscellaneous matters such as broker embezzlement.

Commodity Market Frauds
Commodities market in Nepal has the highest risk in terms of safety of investment as the entire market is unregulated. There are a total of nine commodity exchanges registered with the Company Registrar Office (CRO), the de facto licensing authority since there are no regulators to issue licences. Investors

Table 5: Preventive Measures within the Organization

Board of Directors and Audit Committee	Internal Auditor	Senior Management	Internal Policies and Procedures
1. Maintenance of a sufficient number of independent board members that need to be knowledgeable about internal control. 2. BOD needs to be capable of questioning senior management to prevent and detect fraud. 3. Questioning the auditors without the presence of senior management if the auditors are aware of any indications of fraud and what procedures they employed during the audit to detect fraud. 4. Setting a strong ethical tone at the top and communicating it throughout the organization.	1. Independent of the President, CEO, or COO and knowledgeable about internal control. 2. Reports directly to the Board of Directors. 3. Able to ask hard questions to senior executives about how they prevent and detect fraud. 4. Periodically questions bookkeepers, data entry personnel, and IT staff if they have been asked to make unusual entries especially at year end, or know about theft of assets. 5. Interview the network administration and obtain a list of users who have access rights to make changes to accounting journals and review it with business managers for appropriateness. 6. Enable appropriate audit logging, establish the integrity and continuity of the logs, and review regularly.	1. Setting a strong ethical tone at the top and communicating it throughout the organization. 2. Conduct brainstorming sessions with employees at different levels of the organization and in different functional areas about the possible ways fraud can occur and how it can be prevented.	1. Non-standard and non-recurring entries 2. Accounting error correction 3. Changes to posted records and closed periods 4. Authorization of transactions 5. Documentation 6. Segregation of incompatible duties 7. Safeguarding of assets and records 8. Reviews and reconciliations 9. Audit logging 10. Audit trails and control of electronic records and transactions such as e-commerce, Electronic Funds Transfer (EFT), and electronic bank statements 11. Prevention and detection of fictitious entries and unauthorized changes to accounting journals and ledgers 12. Integrity of the process used to generate reports used by the external auditors 13. Corporate code of conduct

have limited or no knowledge of the international market and completely rely on the information provided by the local commodity exchanges and brokers. In addition investments are made based on pure speculation, rather than to hedge potential future risks. Therefore, in the absence of vigilant regulation there is a chance of anomalies occurring in the market, which can have an overall impact on the financial system.

Ponzi Schemes / Pyramiding / Network Marketing

Despite Ponzi schemes[20] being acknowledged as a fraud, with the lack of knowledge regarding the same in the Nepali market, individuals are easily lured with short-term returns that are either abnormally high or unusually consistent. In Nepal's context Unity Life International has already duped more than NPR 6 billion (USD 68 million) from over 0.6 million individuals, whereas Herbo International has duped over 0.2 million members by misappropriating over NPR 1.5 billion (USD 17 million).

5.2. PREVENTIVE MEASURES

Given the high risk in the Nepali Financial sector towards fraudulent activities, subsequent steps must be taken to prevent financial frauds. Frauds can be prevented through the adoption of internal and external control systems. Table 5 provides procedures that can be adopted internally to avoid the occurrence of frauds. External control systems include maintaining transaction monitoring and tie ups and linkages with concerned regulatory bodies such as the NRB, Securities Board of Nepal (SEBON), and CIB.

5.3. GAPS IN THE SYSTEM

Regulators capacity

Despite the presence of strong regulatory mechanisms, supervision and monitoring by regulatory bodies has been minimal. The capacity of the regulators to conduct thorough supervisions is curtailed by lack of professionalism and inadequate human resources. In addition a thorough 'Fit and Proper Test' is not conducted while issuing licenses. Policies drafted lack clarifications on the responsibilities and operation modalities of the A, B and C class financial institutions. It is therefore essential that capacity building of the regulators be undertaken.

Penalty

As per the Banking Offense and Punishment Act – 2007, if anyone is found to have committed fraudulent activities, the culprit faces a maximum imprisonment of five years, a maximum fine of NPR 10,000 (USD 115), or a fine equivalent to the value of collateral security or claimed amount. The imprisonment tenures and fines imposed in Nepal are very minimal and not stringent as compared to the penalties stipulated by policies worldwide.

Audit Scope and Independence

Internal and external audits conducted do not provide adequate independent analysis of finances and related issues. These kinds of lapses have been witnessed in both the private sector and the public sector. Regulators should therefore clearly articulate their requirements of the audit process and the information that they seek from prospective auditors; as such information is a necessary prerequisite to the achievement of consistent audit outcomes.

Bureau Capacity

With constantly changing technologies it is essential that the team at the Central Investigation Bureau and other various investigating agencies remain constantly updated on the same.

Investment in banking system is very low

With 214 licensed banking institutions and over 2,300 branches catering to Nepali consumers, there is a pressing need for BFIs to keep abreast with technological advances. The Nepali banking industry has not invested enough in ensuring better internal control systems. Investments therefore need to be made to maintain a proper check and balance environment.

Inappropriate juridical relevancy

There is no systematic and clear judicial system when dealing with financial frauds. For instance the ongoing cases of good for payment cheques should have actually been dealt under the "Negotiable Instrument Act"; rather than "The Banking Offense and Punishment Act", which it is currently being investigated under. Also, when cases are filed in court, all the people involved in the case, irrespective of their involvement, are treated by the court in the same manner. When a person has been blacklisted for any default, any person who is associated with the blacklisted person's ventures, even though he may be unrelated to the fraud, is also blacklisted.

6. CONCLUSION

With the recent rise in cases of fraudulent activities coupled with limited infrastructure to curtail these activities; the key stakeholders, CIB and other relevant agencies need to be well equipped and vigilant in minimizing such practices. The BOD should be willing to invest in developing and strengthening internal control systems which are the root cause of problems. The board should also be resilient on overseeing activities and ensuring better internal capacity controls of the management. Moreover, the regulators and the investigating agencies should further work on their own capacity building for more proficiency towards their duties. However, laws can only discourage the occurrences of such processes, eventually the board and the management will need to take responsibilities on restraining such illegitimate actions. Eventually, policies focusing on issues of financial frauds should be updated and be made more stringent to deal with the changing financial environment.

Laws can only discourage the occurrences of such processes, eventually the board and the management will need to take responsibilities on restraining such illegitimate actions.

This nefsearch is based on the research and analysis carried out by the nefsearch team. The exchange rate used in this nefsearch is NPR 87.67

ENDNOTES

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