Unmasking India’s NPA issues – can the banking sector overcome this phase?
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Introduction

The banking and financial services sector has weathered many storms since the global slowdown. Business sentiments turned cautiously optimistic as the economy slowly steered toward the road to recovery. But recent news around the rising “Non-Performing Assets” (NPA) and instances of bribery and corruption has brought to the fore the risks faced by the sector in India. In certain cases, promoter integrity issues have come to the fore which has led to banks bearing the brunt of the resultant financial losses.

Whilst the Reserve Bank of India (RBI) has taken steps to initiate recoveries of these loans by introducing regulation which avoids postponing the problem, increasing the credibility of sales to asset reconstruction companies and early resolution of potential NPAs, the issues around fraudulent promoters requires a higher degree of attention. Whilst all resolutions now mandate a forensic audit, the very essence of promoter integrity needs more focus given the size of the problem.

The 7 May 2015 RBI circular on “Framework for dealing with loan frauds” is expected to bring a significant transformation, which will impact public and private banks. With this, all banks will now have to ensure strict vigilance during pre- and post-sanction due diligence processes. They will have to fortify their internal processes to ensure the funds are monitored effectively as well.

While the regulator and bankers are leaving no stone unturned to deal with these apprehensions, the need of the hour is to detect, report and mitigate such risks. With this background, EY’s Fraud Investigation & Dispute Services practice conducted a comprehensive survey to decode the reasons and challenges around rising NPAs in corporate loans.

We would like to thank all the bankers for their views and insights. Our survey would not have been successful without their contribution. We hope you find it helpful in driving meaningful discussions within your organizations, board and other stakeholders.
India is seeing a regulatory upheaval in the way the Government is addressing the NPA “crisis”. The road to recovery is long and winding. But bankers are cautiously optimistic that the NPA situation will improve albeit at a slow pace.
Is the NPA “crisis” just the tip of the iceberg?

The risk landscape for banks in India has undergone a major change over the last few years. Mounting bad loans in the banking sector have been the focus of media headlines, which directly reflects the financial health of the institutions. According to data released by RBI (as depicted in the below graph), there has been a sharp rise in the quantum of NPAs reported by banks. This is not only affecting their balance sheets (higher provisions), but perhaps impacting the economy as well.

The rise of stressed assets

Bankers say,

“The stressed accounts that have been hidden till now would keep the NPA levels rising at least for the next 2-3 years.”

“The short term borrowings made by corporate entities (mostly to meet the working capital/routine expenditure/current debt servicing obligations) will fall due within next year, exerting severe liquidity pressures. Moreover, on account of the stress built-up in their portfolios and improved surveillance of RBI on ever-greening efforts, banks/Financial Institutions/Non Banking Financial Companies may not consider rollover of such facilities leading to eventual failure of the corporates.”

RBI financial stability report shows that five sectors — mining, iron & steel, textiles, infrastructure and aviation — that together constitute 24.8 percent of the total advances of commercial banks, have a share of 51.1 percent in the total stressed advances.1

Media reports state the NPAs of the banks stood at US$ 47.3 billion as on December 2014. The top 30 defaulters alone account for US$ 14.9 billion, which is more than one-third of the entire NPAs of public sector banks. The reported numbers are quite high, and there are fresh additions every quarter, leading to further deterioration in asset quality. The portfolio of restructured accounts is adding to the problem at hand, thereby resulting in a “crisis”.

The regulator has been actively involved in tackling this situation through various ways such as instructing reviews of banks to identify the loopholes in the due diligence process, or mandating forensic audits for large corporates to identify the intent of key decision-makers, or enhancing the scope of regulations around “wilful defaulters”. More recently, it is allowing banks to take equity control for companies that fail to repay (strategic debt restructuring).

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1“RBI financial stability report: An infra-bomb is ticking in state-run banks’ books,” Firstpost, 26 June 2015, via Dow Jones Factiva, © 2014 Firstpost

Around 72% of the EY survey respondents stated that the NPA crisis in India is set to worsen.

While 15% seem optimistic and think that the issues around bad loans will be arrested due to regulatory changes and increased supervision from RBI.
Triggers leading to the NPA predicament

Stressed asset percentages have consistently been a cause of concern over the last few years. As on March 2015, gross NPAs stood at 4.6% as compared to 4.1% in previous year. Further, gross NPAs for public sector banks stood at 5.17% of advances as of March 2015 while the stressed assets (NPAs and restructured loans) were 13.2%. While corporate borrowers have repeatedly blamed the economic slowdown as the primary factor behind it, periodic independent audits on borrowers have revealed diversion of funds or wilful default leading to stress situations. Analyzing the gravity of the current situation, pre-sanction due diligence and sanctioning process have also been under the scanner of the regulator to gauge the control mechanism at banks.

High value loans have gone bad, in spite of large banks either being part of the multiple lending arrangements or under a consortium. So the question remains, is the rise in NPAs due to internal lapses in due diligence at banks or are complexities of business making it difficult to detect issues/any wrong doing by the borrowers at an early stage?

The survey respondents have stated that these are a result of both internal and external factors.

87% 64%

Around 87% of the respondents believe that the rise in NPA/stressed asset numbers is due to the diversion of funds to unrelated business or fraud

While 64% of the respondents believed that a major reason for every stressed asset/NPA is lapses in the initial borrower due diligence (pre-sanction)

54%

Around 54% attributed this to the inefficiencies in the post-disbursement monitoring process.

It has been observed that in most large proposals, the due diligence or credit appraisal done by the consortium leader is accepted as such by the member banks. This is applicable in multiple bank lending relationships, where the lenders with low exposure rely on checks done by the lenders with more exposure.

Bankers say, 

“Wrong borrower selection, herd mentality of the bankers and lure of high real estate returns have driven the borrowers to fund illiquid/long gestation acquisitions through short term bank funds, leading to collapse of the system.”

“Not obtaining adequate tangible collateral security at the time of enhancements in credit exposure has been a challenge.“

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2“Indian Banking Sector: Emerging Challenges and Way Forward,” 5 May 2015, via Dow Jones Factiva, © Reserve Bank of India
Case study

A consortium of banks sanctioned fund and non-fund based facility to a company which was later declared as an NPA. The company stated that this was due to the sluggish movement of the sector globally and requested for additional credit. An independent stock audit initiated by one of the banks indicated adverse findings, which were denied by the borrower at a consortium meeting.

The consortium subsequently conducted an independent investigative audit to confirm the findings of the stock audit. The audit included an onsite as well as offsite review of records and documents, factory visits and detailed background checks of the parties involved.

The audit indicated that the majority of the sales and purchases were done with related parties of the borrower. The sales made to related parties were done at a lower margin as compared to a higher margin with other entities. Adjustment entries were passed at the year-end to settle the accounts. Majority of the devolved Letters of Credit (LCs) were issued in favor of related parties. An attempt was made by the borrower to “stage-manage” the factory visits, and complete records and documents of the inventory were not made available.

Potential red flags and indicators of diversion of funds to related parties were highlighted to the bank which resulted in the rejection of further disbursement to the borrower.
Unmasking India’s NPA issues

As per media reports, around 40% of the loans restructured between 2011 and 2014 turned bad, raising alarms over the cases being put up for the restructuring process. The CDR cell was set up to provide debt ridden companies with flexible repayment terms and an option to turnaround to protect borrowers facing genuine financial difficulty due to factors beyond their control. However, the pace and quantum at which restructuring of loans were being undertaken, implied that restructuring of accounts was being resorted to avoid classification of accounts as NPA and thereby enable lower provisioning in the bank books.

According to the recent amendment made by RBI, all restructured assets would be treated and provisioned at par with the NPA accounts. While this may have a negative impact on the bottom line of the banks, it would also help in curbing the misuse of restructuring and CDR mechanism, if any.

Restructuring applications - need for cautious evaluation

Banks have been reeling under pressure due to the rising number of defaults affecting their bottom line. As a result, there is a substantial increase in corporates looking at Corporate Debt Restructuring (CDR) mechanism to streamline their loans.

Data available from CDR India shows a steep increase, 187% in number of cases referred to CDR (from 225 to 647), whereas in terms of amount it is more than 370% during the period 2008-09 to 2014-15. Given the unusual increase in cases, the CDR cell notified banks in early 2014 to carry out forensic audits before putting up the corporate case to the CDR for approval. This move was a proactive measure to check the quality and genuineness of companies requiring additional funds for survival.

Analysis of corporates approaching CDR

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An important aspect to consider before approving restructuring is the viability of the business/project and funds being contributed by the promoters. Project appraisals need to be more diligent and should account for facts and uncertainties surrounding the project. Restructuring proposals often include optimistic industry scenario, unrealistic cash flow analysis, aggressive repayment schedule and date of completion of project. Banks need to consider “window dressed” proposals cautiously and evaluate the corporate operations with a nip of skepticism to identify the real intent of the borrower.

About 91% of the bankers stated that forensic audits should be made mandatory prior to restructuring of loans.

Further, 54% of the respondents believed that forensic audit would help in weeding out “wilful defaulters” from genuine borrowers and thereby reduce recovery costs/efforts.

Additionally, 46% said that forensic audits would assist in rational decision-making for restructuring (early identification of diversion of funds/fraud).

According to the recent circular on “Framework for dealing with loan frauds,” RBI has asked banks to undertake investigations before taking a final view on a corporate loan account classified as “Red Flagged Account” based on the existence of early warning signals.

It has been observed that independent investigations have assisted banks in identifying the intent of the borrower and willingness to pay their obligations.

Banks however, need to ensure that the scope of investigations are well defined and have a comprehensive coverage. Success would also depend on the access to books and records of the borrower.

**EY Viewpoint**

EY’s experience in conducting various reviews and forensic audits has revealed potential gaps in the said process. Some insights are listed below:

1. Gaps in adequate screening of promoters/company on negative lists impacting reputation or early identification of red flags - appraisal documents are generally filled with positive company outlook and futuristic projections
2. Inadequate review of financial statements, especially sections such as notes to accounts
3. Overdependence on certifications provided by third parties such as technical agents, valuers, etc. For example: photo copies are accepted instead of originals.
4. Lack of adequate due diligence on the auditors to rule out nexus with borrower company - in many cases, relationships are identified later in forensic audits
5. Lack of in-person verification/site visits of key debtors/creditors - in many cases, fictitious customers/suppliers were identified later in forensic audits
6. Leaving the decision to appoint or refer verification/valuation agency to the borrower, thereby influencing the outcome
7. Borrowers, with an intention to de-fraud the bankers, often “stage-manage” the verification visits. For example: fictitious movement of goods backed by forged documentation for a sample of transactions are provided for review.
8. Trust-based lending, especially in case of multi-lending (consortium advances) - due diligence conducted by other lenders is relied upon within the consortium
9. Irregularities around collaterals which includes improper charge creation, unclear title deeds, etc.

Bankers say,

“When an independent body is doing the audit, the real fact shall surface and the decision shall be more correct.”

As high as 72% of the respondents surveyed stated that borrowers are misusing the restructuring norms; while 19% were indecisive about it.

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Third party agencies such as surveyors, engineers, financial analysts, and other verification agencies, etc. play a critical role in assuring financial information, proposals, work completion status, application of funds, etc. Lenders rely significantly on the inputs issued by such third parties.

Reports are made as a routine, with little scrutiny. In some situations, the reports may be drafted under the influence of unscrupulous borrowers. It is therefore important that the selection of such third parties is independent, done in a transparent manner and based on their capability and credentials.

“In the wake of various scams in the country, the Enforcement Directorate (ED) is preparing a consolidated list of unscrupulous chartered accountants who supposedly helped the companies launder money. There is a very small section which is at fault but that allows people to cast aspersions on the professionals”

“ED lists dishonest CAs in Ponzi scams,” Times of India, 13 July 2015, via Dow Jones Factiva, © 2014 Bennett, Coleman & Co. Ltd.

According to the survey, two out of three respondents considered third party reports (valuation, field verification etc.) could be manipulated to favor the borrower. While a minority negated it (5%), 29% were uncertain about it.
Inadequacy of existing mechanisms to identify NPAs

Rise in customer base, multiple product offerings and regulatory pressures led to the implementation of Core Banking Solutions (CBS). However, NPA tracking and flagging continued to be part of manual compilation, which in effect was prone to errors and manipulation. With the advancement of technology-based solutions, banks moved to system-based identification of NPAs with limited manual intervention. However, this led to a sudden spurt in the NPA reporting for some of the large banks, which has raised concerns over the system used for tracking. The key considerations that banks can question are:

- Are these systems robust or can they aid hiding NPAs?
- Are the scenarios/conditions for NPA recognition properly configured?
- Is the bank over-dependent on outsourced vendors managing such systems?
- Can the controls be manually overridden from back-end or at branch level?
- Are there adequate trails for the changes made?
- Is there adequate monitoring and oversight of the above?

According to the respondents, the following areas required substantial focus to enhance controls around NPA identification and reporting:

- Periodic reviews of the automated mechanism to check for errors on a proactive basis
- A centralized monitoring team to review exceptions identified around changes in NPA status
- Enhanced internal skills to reduce dependency on outsourced vendors for managing NPA identification system

Bankers say,

“Borrowers are insisting branches of financial institutions to window dress their position. It is not unusual for them to ask for corrupt alliances at the branch levels.”

EY viewpoint

The monitoring and reporting of NPAs is an underestimated issue, which has not seen much prominence. RBI’s initiative to conduct independent review of the NPA monitoring system proved a step in this direction. Realistically, banks need to be vigilant on some of the following issues as they have a major impact on the NPA numbers:

- Scenarios for identification/classification of NPAs (Income Recognition Asset Classification norms) not being configured correctly in the system
- Gaps in integration of NPA provisioning system and CBS system, leading to the incorrect provision of bad loans in the books of the bank
- Manual entries such as repayment or transfer from another loan account (ever-greening)
- Non-financial (dummy) codes being used to pass entries
- Modifications made to NPA classification and absence of adequate audit trails/logs
- Frequent changes done to the repayment schedule of an account
RBI has defined “wilful defaulter” as a borrower who intentionally defaults on its repayment obligation, despite adequate cash flows, or has diverted/siphoned off funds, or not utilized the funds for the purpose for which it was taken. Recently, RBI widened the scope of “wilful defaulters” by covering “guarantors” under its purview. While these changes are a welcome step, there are many reasons which curb bankers from declaring NPA borrowers as “wilful defaulters.” As per the guidelines, higher provision is required to be made for fraud accounts compared to NPA accounts.

According to RBI, banks tend to report an account as fraud only when they exhaust the chances of further recovery. At times, reluctance for undertaking an investigation on borrowers may be due to their long-standing relationship.

The new guidelines by RBI have now provided an incentive to banks for prompt reporting. They can spread the provision over four quarters, provided there is no delay in reporting of fraud.

Declaring NPA borrowers as “wilful defaulter” or “fraud”

Case study
A bank sanctioned fund and non-fund based facility to a company. The company was declared as NPA by the bank within two years from the date of sanction. The bank decided to conduct a detailed fact finding exercise.

The exercise indicated potential siphoning off funds through related/linked parties. Majority of LCs that devolved, were issued in favor of a third party that was related to the borrower. Detailed background checks revealed that no business activity was carried out by the related party. The exercise also indicated huge sum of money invested in properties and diverted to other business ventures. Irregularities were also noted in the financial statements and periodic stock/debtors’ statement submitted to the bank.

Post the fact-finding exercise, the borrower was declared as a “wilful defaulter.”

Bankers say,
“It is more or less certain that if we declare a borrower a “wilful defaulter,” he will approach the court. Then it becomes our responsibility to justify our action with supporting evidence. It is not always possible to establish that the borrower has siphoned off the money or used it for a purpose other than the one for which the loan was taken. Hence, we need to be extremely cautious before we declare someone a “wilful defaulter.” Otherwise, we will not only lose the case, but we will also let the defaulter off the hook.”

Other key reasons stated by the respondents were:

- Not being aware of the intent of borrower in case of default: 36%
- Impacts on future recovery from the borrower: 32%
- Not being aware of the intent of borrower in case of default: 44%

According to RBI, banks tend to report an account as fraud only when they exhaust the chances of further recovery. At times, reluctance for undertaking an investigation on borrowers may be due to their long-standing relationship.
A slow but steady future outlook

RBI and the Ministry of Finance are taking steps to mitigate the risks around the NPA bubble. The emphasis is more on proactively managing the account and identifying the early warning signals before it turns bad. Survey respondents highlighted the following key areas where investments would be made in the next year as part of their proactive strategies around managing NPAs:

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<th>56%</th>
<th>Technology and data analytics</th>
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<td></td>
<td>The launch of new banking products and increase in customer coverage calls for technology upgradation for comprehensive monitoring. Data analytics is a valuable component to effectively conduct periodic reviews and audit. Analytics provides insight into process anomalies, trends and risk indicators through the extraction and analysis of transactional data.</td>
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<th>56%</th>
<th>Independent borrower background checks</th>
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<td>One of the key reasons for stressed assets could be traced back to the lapses in the initial customer due diligence and inefficiencies in the sanctioning process. Past history - earlier defaults, excise/ income tax raids and/or negative information about the borrower should be adequately disclosed to the sanctioning committee of banks. Apart from discussion with the borrower, surprise site visits should be undertaken especially in case of high value loans.</td>
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<th>68%</th>
<th>Enhancing internal skill sets on credit assessment/evaluation</th>
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<td>Keeping the business dynamics and complex business structures into account, banks are required to enhance the skill sets of the credit teams. For instance, credit team/analysts need to undergo periodic training to upgrade their skills; scoring models, industry benchmarks and credit evaluation sheets should be updated regularly.</td>
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<th>47%</th>
<th>Formulating separate team for monitoring of accounts</th>
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<td>Some banks have a separate dedicated team for monitoring the performance of key accounts. The accounts are selected based on the amount disbursed, vulnerability of the business model/industry, indication of diversion or siphoning off bank funds, etc. A separate dedicated team for account monitoring would assist in early identification of irregularities, if any, and focus on immediate remedial measures.</td>
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<th>25%</th>
<th>Market intelligence</th>
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<td>Public domain searches and market intelligence can assist banks to gather additional information around the borrower and its business operations, where indicators for suspicious activities exist. The new RBI guidelines have also emphasized on collecting independent information through market intelligence/public domain/ Registrar of Companies/defaulter list as a part of the pre-sanction process. Tracking of “market information“ and monitoring databases during the annual review have also been stipulated by the regulator.</td>
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Case study

A bank had the indication of manipulation of inventory records by a borrower. A site visit was conducted for obtaining intelligence at the factory of the borrower and gather information around the quantum of inventory. It was understood that there was a collusion between the employees of verification agency and the borrower to consider the sister concern’s inventory as borrower’s inventory.

Accordingly the report submitted to the bank for working capital was inflated.
India is seeing a regulatory upheaval in the way the Government is addressing the NPA “crisis”. The efforts are visible, but the results may be achieved only on a medium- to long-term basis. According to the survey respondents, stricter penal measures for fraudulent borrowers, e.g., restricting access to additional bank borrowing and restructuring, prompt reporting of cases to law enforcement agencies etc., would act as deterrents and help prevent larger exposures of bad accounts in the banks’ books. Widening of the scope of “wilful defaulter” ably supported by Securities and Exchange Board of India (SEBI) would assist in restricting defaulting borrowers from accessing the equity and debt markets. The creation of the Central Fraud Registry would benefit banks in obtaining access to critical details of frauds reported by other banks and thereby avoid lending to tainted borrowers.

The boards of the banks will conduct a detailed scrutiny of the quarterly and annual financial results, review NPA management and reported NPA and provisioning integrity.

The new RBI circular on “Framework for dealing with loan frauds” demonstrates its commitment to addressing concerns pertaining to detection, reporting, mitigating and accountability with regards to loan frauds.

Significant expansion in the role of “Fraud Monitoring Group” (FMG) within the banks is expected based on the circular. Further, importance has also been laid on implementing a strong whistle-blower policy to encourage employees to report concerns.

Also, the recent circular around “Strategic Debt Restructuring Scheme” is a firm step by RBI giving strong clutches to the bankers to take-over management control of the defaulters. This would be where they feel the incapability of the borrower company to come out of stress due to operational/ managerial inefficiencies.

The following initiatives by the regulator were perceived to be the most relevant in improving the NPA crisis situation:

- Strengthening the procedure of appointment of top executives of public sector banks
- Empowering lead bankers to conduct project appraisals for all the lenders in the consortium set up for sanctioning corporate loans above INR500 crores
- Tightening the provisioning norms for restructured loans
- Expanding the coverage of “wilful defaulters”
Conclusion

RBI, Government and other authorities have initiated various steps in the direction of governance, accountability and responsibility. It is anticipated that the Government’s reforms in the core sectors such as infrastructure, power, telecom, metals and mining would help reducing the stress in the banking sector.

Analysis of the current situation indicate that banks need to become more proactive in framing policies or guidelines and implementing it right from the grass-root level, with constant supervision by the top management. The new RBI guidelines have laid a firm pathway for improving overall robustness to manage loan frauds. Banks would need to adopt and implement the measures in true spirit and substance and not just ‘form’. The key to proactive identification of red flags would be to integrate and analyze transactional data (bank statements) with documents available (audit report, sanction documents etc.) and information from the public domain including market information to find anomalies. Specific roles for designated persons, who will constitute the FMG/ensure compliance with the circular guidelines, would be necessary to ensure accountability of decisions taken.

The road to recovery is long and winding. But bankers are cautiously optimistic that the NPA situation will improve albeit at a slow pace.
EY’s Fraud Investigation & Dispute Services team conducted this survey, during the period November 2014 to March 2015. More than 110 respondents participated in this survey.

The survey was released through an online questionnaire, which was hosted on EY’s website in India. Many responses were also collected through face-to-face interviews.

The principal respondents were banking professionals from public, private, foreign and co-operative banks. The respondents belonged to business functions such as Vigilance, Credit/Operations, Legal/Compliance, Asset Recovery and Audit/Finance. The survey comprises qualitative comments and views by these bankers, which have been included in verbatim under the ‘Bankers say’ sections across the report.

In addition to the survey results, the report includes our viewpoint based on experience over a period of time.

Note: Some of the percentages in the charts total to more than 100%, since the respondents were allowed to make multiple selections. Therefore, all the percentage figures are derived from the total number of respondents who answered a particular question and not on the total number of overall respondents.

Nature of business

- A public sector unit: 68%
- A private sector unit: 21%
- A foreign bank: 10%
- A co-operative bank: 1%

Business functions of respondents

- Credit/Operations: 44%
- Legal/Compliance: 10%
- Asset Recovery: 3%
- Audit/Finance: 10%
- Vigilance: 11%
- Others: 22%

Corporate loans (INR in crores) held by respondents’ bank

- 0 - 30,000: 16%
- 30,000 - 100,000: 34%
- 100,000 and above: 50%
Dealing with complex issues of fraud, regulatory compliance and business disputes can detract from your efforts to achieve your company’s potential. Enhanced management of fraud risk and compliance is a critical business priority — whatever the industry sector. With our more than 3,300 fraud investigation and dispute professionals around the world, we will assemble the right multi-disciplinary and culturally aligned team to work with you and your legal advisors. In addition, we will provide you the benefit of our broad sector experience, our deep subject matter knowledge and the latest insights from our global activities.

FIDS India

- **Deep competencies:** Our FIDS team has specific domain knowledge along with wide industry experience.
- **Forensic technology:** We use sophisticated tools and established forensic techniques to provide requisite services to address individual client challenges.
- **Global exposure:** Our team members have been trained on international engagements and have had global exposure to fraud scenarios.
- **Market intelligence:** We have dedicated field professionals, who are specifically experienced and trained in corporate intelligence, and are capable of conducting extensive market intelligence and background studies on various subjects, industries, companies and people.
- **Thought leadership:** We serve a variety of leading clients, which gives us deep insight into a wide range of issues affecting our clients and business globally.
- **Qualified professionals:** We have a qualified and experienced mix of Chartered Accountants, Certified Fraud Examiners, Lawyers, CIAs, CIsAs, engineers, MBAs and Forensic Computer Professionals.
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