Role of Forensic Accounting

in the

Investigation of Financial Frauds

Fraud is defined as an act or course of deception, an intentional concealment, omission, or perversion of truth, to

- ☞ Gain unlawful or unfair advantage,
- ☞ Induce another to part with some valuable item or surrender a legal right, or
- ☞ Inflict injury in some manner. Wilful 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.

- ‘ Abuse of position, or false representation, or prejudicing someone’s rights for personal gain’.
- Fraud is a global phenomenon affecting all sectors of the economy. Fraud encompasses a wide-range of illicit practices and illegal acts, consisting of intentional deception or misrepresentation. Fraud is highly rampant these days and is increasing exponentially in the current scenario.

Who Commits Frauds ?

- Generally, there are three groups of business people, who commit financial statement frauds.

They range from

(a) Senior Management

(b) Middle and Lower level management

(c) Organization of criminals

What is Financial Statement?

☞ Financial Statement means “set of reports which quantitatively describes the financial health of a Company”. These include Balance Sheet, Profit and Loss Statement (Profit & Loss Account), Cash Flow/Funds Flow Statement.

What is Financial Statement Fraud?

☞ Financial statement frauds usually involve activities such as **manipulation of Financial Statements with intent to defraud the readers thereof.**

☞ Financial Statement Fraud means deliberate misrepresentation of the financial condition of an enterprise accomplished through the intentional misstatement or omission or amounts or disclosures in the financial statements to mislead financial statement users.

Causes of Financial Statement Fraud

☞ This is mainly due to greed for money and work pressure, is the most common factors compelling management to commit financial frauds and deceive investors and creditors.

Some examples are cited below:

What is Scheme?

- ☞ Make plans, especially in a devious way or with **intent to do something illegal or wrong**. Financial statement fraud consists of a wide variety of schemes, ranging from overstatements of revenues and assets to omission of material financial information. Accounting Frauds like Enron, WorldCom., Satyam, etc., have surprised the whole world.
- ☞ Enron(American energy, commodities and services co.) executives used fraudulent accounting practices to inflate the company's revenues and hide debt in its subsidiaries. According to investigations, Enron was disguising losses and concealing its debts. The U.S. Securities and Exchange Commission (SEC), credit rating agencies, and investment banks were also accused of negligence—and, in some cases, outright deception—that enabled the fraud.
- ☞ WorldCom was an American telecom company. At its height, WorldCom was one of the largest long-distance providers in the United States. WorldCom

Fictitious revenues

Timing differences

Improper asset valuations

Types of Financial Statement fraud scheme

Concealed liabilities and expenses

Improper disclosures

Methodology	Results
• Showing bogus export turnover. • Current Liabilities shown as sales • Advances received shown as Income • Booking of Fictitious Expenses & Asset purchase • Inflation of Assets & Bogus Purchase • Unsecured Loans shown as Capital • Stating expenditure as Advance given	• Obtain fraudulent exemptions • Understatement of Liability and overstating of profits • Understatement of Liability and overstating of profits • Diversion of Funds for personal use/sister concerns • Increase in Capital & Assets, claim wrong subsidies • Increase in Net Worth & understatement of Liabilities • Overstatement of profits and enhancing current asset

- Domination of management by a single person or small group without compensating controls.
- Overly optimistic press releases or annual report messages.
- Recurring negative cash flows.
- Recurring attempts to justify marginal or inappropriate accounting on the basis of materiality.
- Restrictions on auditors that limit access to people or information.
- Rapid growth of revenues or unusual profitability.
- Unusual complex transactions.
- Accounting anomalies, such as growing revenues without a corresponding growth in cash flows.

- Consistent sales growth while established competitors are experiencing periods of weak performance.
- A rapid and unexplainable rise in the number of day's sales in receivables in addition to growing inventories.
- The company maintains consistent gross profit margins while its industry is facing pricing pressure.
- A large buildup of fixed assets. An unexpected accumulation of fixed assets can flag the usage of operating expense capitalization, rather than expense recognition.
- Depreciation methods and estimates of assets' useful life that do not correspond to the overall industry.
- Outsized frequency of complex related-party or third-party transactions, many of which do not add tangible value
- The auditor was replaced, resulting in a missed accounting period.
- Significant related party transactions.

Other Examples of Financial Fraud:

- ☞ Cookie Jar Reserves : This involves overestimating liabilities during "good" periods and storing away funds for future use against declining revenues and profitability.
- ☞ Lapping: It generally involves converting one customer's payment and then using a subsequent payment, usually from another customer, to cover the payment converted from the previous customer's account.
- ☞ Skimming and Larceny of cash **:** A form of white-collar crime, skimming is taking cash "off the top" of the daily receipts of a business (or from any cash transaction involving a third interested party) and officially reporting a lower total. The formal legal term is defalcation. This is actually misappropriation of cash.

The word "forensic" comes from the Latin word "forensis" meaning “ of or before the forum relating to debate or discussion before a group or body constituted to resolve a dispute or an issue or matter:"

1. Relating to or to be used in, or for appropriate for courts of law or public discussion or argumentation.
2. Relating to the application of scientific principles and technology in the investigation and establishment of facts or evidence in a court of law.

- The **integration of accounting, auditing and investigative skills yields the speciality known as Forensic Accounting.**
- It is the study and interpretation of accounting evidence.
- It is the application of accounting methods to the tracking and collection of forensic evidence usually for **investigation and prosecution of criminal acts** such as embezzlement or fraud.
- Forensic accounting can sometimes be referred to as Forensic Auditing.
- A forensic audit can be conducted to gather the evidence to establish any fraud or wrongdoing and prosecute a party for fraud, embezzlement, or other financial claims.
- It may be conducted to determine negligence.

Forensic Audit is generally taken to refer to a comprehensive view of fraud investigation, including:

1. Business Methodology
2. Forensic Accounting - The audit of accounting records and systems to prove or disprove fraud.
3. Digital Forensics
4. Investigation
5. Litigation Support

Business Fraud :

- ☞ Asset misappropriation
- ☞ Corruption
- ☞ Financial statement fraud

Techniques for prevention of Business fraud

- ☞ Know the Employees
- ☞ Make Employees Aware/Set Up Reporting System
- ☞ Implement Internal Controls
- ☞ Monitor Vacation Balances
- ☞ Hire Experts
- ☞ Live the Corporate Culture

Payroll Fraud

- Falsified wages
- Ghost employees
- Benefit schemes

Techniques for prevention of Payroll fraud

- Set the tone at the top
- Require mandatory vacations
- Regularly review payroll reports after payroll is processed
- Monitor overtime payments
- Review PTO accruals(Paid time off)
- Require supervisor approval for timesheets
- Cross train and rotate the job duties of employees who handle payroll processing

- ☞ Implement direct deposit for payroll and bonuses
- ☞ Review bank statements and cancelled cheque images each month to spot anomalies
- ☞ Prosecute fraudsters

e-Commerce Fraud

Techniques for prevention of e-Commerce fraud

- ☞ Geolocation
- ☞ Proxy Piercing
- ☞ Device Fingerprinting
- ☞ Address Verification
- ☞ Fraud Scoring
- ☞ Rescreening
- ☞ Blacklists & Whitelists

- Velocity Checking
- Machine Learning
- Biometrics

Embezzlement

Techniques for prevention of Embezzlement

- Effective Internal Controls
- Background Check
- Fraud Awareness Education and Training
- Fraud Hotline

Employee Theft and Fraud

- Larcency (outright theft)
- Skimming (diverting business funds)
- Fraudulent disbursements (billing schemes, inflated expense reports, cheque tampering)
- Embezzlement of raw materials or inventory
- Stealing business opportunities (misappropriation of customer lists or other trade secrets).

Techniques for prevention of Employee Theft and Fraud

- Know your employees
- Supervise employees closely
- Use purchase orders
- Control cash receipts

- ☞ Use informal audits
- ☞ Install computer security measures
- ☞ Track your business checks
- ☞ Manage inventory and use security systems
- ☞ Beware of accounts receivable
- ☞ Provide a way for employees to report theft or fraud by co-workers

Procurement Fraud

- ☞ Kickbacks and Bribery
- ☞ Conflict of Interest
- ☞ Phantom Vendors and/or False Invoices

Techniques for prevention of Procurement Fraud

- ☞ Verify Vendors
- ☞ Review Financial Reports
- ☞ Require Back-Up

Banking Frauds

- ☞ Types of bank frauds which exist and how these types of activities can be prevented

Credit Card Fraud

Prevention of Credit Card Fraud

- ☞ Keep the Credit Cards Safe
- ☞ Shred Anything with the Credit Card Number on It
- ☞ Don't Sign Blank Credit Card Receipts

- ☞ Avoid Giving out the Credit Card Information
- ☞ Be Safe with the Credit Card Online
- ☞ Report Lost or Stolen Credit Cards Immediately
- ☞ Review the Billing Statements Each Month
- ☞ Make Strong Passwords and Keep Them Safe
- ☞ Check Gas Stations and ATMs for Credit Card Skimmers

Cheque Fraud

- ☞ depositing a cheque into an account without the proper authorization
- ☞ altering a cheque by changing bank information such as account numbers
- ☞ using a cheque to make a payment knowing that there are insufficient funds in the account
- ☞ altering the payment amount on a cheque
- ☞ using cheques for false invoices

Forensic Accounting:

1. Is done in response to an event.
2. It is a financial Investigation.
3. Findings used as evidence in court or to resolve disputes.
4. It will often look for indications of fraud that is not subject to financial audit.

Financial Audit:

1. Is mandatory.
2. It measures compliance with reporting standards.
3. It obtains reasonable assurance that financial statements are free of material misstatement.

DIFFERENCE BETWEEN FINANCIAL AUDIT AND FORENSIC AUDIT			
S.No	**Particulars**	**Financial Audit**	**Forensic Audit**
1	Objectives	Express an opinion as true & fair presentation	Whether fraud has taken place
2	Technique	Substantive and Compliance Sample based	Investigative, Substantive or in-depth checking
3	Period	Normally for a particular accounting period	No such limitations
4	Verification of stock , estimation, realizable value of assets, provisions , liability etc.	Relies on the Management certificate/ Management Representation	Independent verification of suspected/ selected items where misappropriation is suspected.
5	Off Balance Sheet items (like contracts etc.)	Used to vouch the arithmetic accuracy\ and compliance with procedures	Regulatory and propriety of these transactions/ contracts are examined
6	Adverse findings if, any	Negative opinion or qualified opinion expressed with or without qualification	Legal determination of fraud impact and identification of perpetrators depending on scope

Corruption or Fraud:

In a forensic audit, an Accountant/auditor would be on the lookout for findings of:

Conflicts of Interest—when a fraudster uses their influence for personal gains to the company's detriment.

Bribery-offering money to get things done or to influence a situation in one's favour.

Extortion—the wrongful use of actual or threatened force, violence, or intimidation to gain money or property from an individual or entity.

Asset Misappropriation:

Asset misappropriation is the most prevalent form of fraud. Examples include misappropriating cash, submitting falsified invoices, making payments to non-existent suppliers or employees, misusing assets (like company equipment), and stealing company inventory.

Financial Statement Fraud:

- A company can get into this type of fraud to try to show that its financial performance is better than it is. The goal of presenting fraudulent numbers may be to **improve liquidity**, ensure that C-level **executives** continue to receive bonuses, or cope with the pressure to perform.
- Financial statement fraud is the deliberate misrepresentation of a company's financial statements, whether through omission or exaggeration, to create a more positive impression of the company's financial position, performance and cash flow.
- Example : Satyam Case Scam

Forensic Accounting is an art of investigation over accounting records, financial statements, and other related financial records. The result of the investigation is mostly used for legal support and resolving conflict.

- This job requires **technical skills in accounting, investigation, and legal.**
- Skills to **analyze** financial statement and supporting documents
- Technical skills to **check documents** with computer assistance.
- Skill to **undertake investigative interview.**
- Have expertise in **accounting standards, and legal implication.**
- Must have **knowledge and experience** in accounting and investigation skills.

A forensic audit comprises the following steps:

1. **Planning the Investigation:** The forensic auditor and the team will plan their investigation in order to meet their objectives.
2. **Collecting Evidence:** The evidence gathered should be sufficient to prove in court the identity of the fraudster(s), reveal the **details of the fraud scheme** and **document the financial loss suffered** and the parties affected by the fraud.
3. **Reporting:** A forensic audit will need a written report on the crime to be given to the client, so that if they desire, they can **continue to file a legal case**.
4. **Court Proceedings***:* During court proceedings, the forensic investigator must be present to clarify the evidence collected and how the suspect(s) were found by the team.

- ☞ By virtue of becoming an expert in the field, the Forensic Auditor could be the **witness used by the court.**
- ☞ A most forensic accountant is hired by a lawyer or court to investigate the subject matter and produce the report.
- ☞ They can witness areas like **profit and loss, fraud, patent and copyright, breach of contract, and many others.**
- ☞ They could also be witnessed over **the accounting records** related to the dispute between shareholders.
- ☞ A Forensic Accountant could also be the expert witness testimony on **how** the fraud is committed, **who** committed fraud, and the **amount of loss**. Such a witness will be part of the court’s decision-making.

TOP 10 BANK FRAUDS IN INDIA IN THE LAST DECADE:

1. Vijay Mallya Fraud Case (2016)
2. Punjab National Bank Scam (2018)
3. Winsome Diamond Scam (2016)
4. ABG Shipyard Fraud Case (2022)
5. Kanishk Gold Bank Fraud (2017)
6. Andhra Bank Fraud (2017)
7. Rotomac Pen Scam (2015)
8. Videocon Case (2019)
9. R.P. Info Systems Bank Scam (2018)
10. IDBI Bank Fraud (2018)

CONCLUSION

Forensic Accounting / Audit is a very specialist type of engagement which requires highly skilled team members who have experience not only of accounting and auditing techniques but also of the relevant legal framework.

Forensic investigation is likely to ultimately lead to legal proceedings against one or several suspects.

It is only through the practice of preventive rather than reactive auditing that forensic auditing will become visibly effective and make auditing credible once more.

Awareness of human element , organization’s behaviour , knowledge of the system, the technology in use and expected to be used , knowledge of fraud , evidence are so red flags and the key issues .

THANK YOU

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