Role of Forensic Accounting in the Investigation of Financial Frauds

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Forensic Accounting

- **"Forensic Accounting/Investigation/Audit"** ***(these terms are being practically used interchangeably)*** **provides an accounting analysis & conclusive proof that is admissible to the Court which will form the basis for examination and ultimately successful conduct of trial.**

- **The utilization of specialized investigative skills in carrying out an inquiry conducted in such a manner that the outcome will have application to a Court of Law. A Forensic Investigation may be grounded in accounting, financial transactions etc., like in any other discipline.**

- **Forensic Accounting involves looking beyond numbers by going to the background behind the facts & grasping the substance of situations.**

Forensic Investigation Involves

- **Using techniques of Forensic, Accounting, Auditing and related principles to establish the trail of Financial transactions back and forth and to link transactions conclusively**
- **Providing Accounting Analysis & conclusive proof that is admissible to the Court of Law, Disciplinary or Arbitration Authority, which forms the basis for examination & for the successful conduct of trial or Disciplinary Proceedings**
- **Utilization of specialized investigative skills in carrying out their task in a manner, the outcome of which will have admissibility & application in a Court of Law or any proceedings**
- **In doing so, the veil of corporate entity is pierced to establish the intentions of person(s) behind such transaction(s).**

Latest Dimensions of Forensic Accounting

Presently, there is an increasing use of Forensic Accounting skills to prevent fraud by identifying and rectifying situations, which could lead to frauds being perpetrated (i.e. risks). In this context, it might be useful, to discuss Forensic Accounting as being either ’Reactive’ or ‘Proactive'.

Proactive & Reactive Forensic Accounting

PROACTIVE

- Statutory Audit
- Regulatory Compliance
- Diagnostic Tools for System Weaknesses
- Red Flag Studies

REACTIVE

- As discussed earlier, this is directly into investigation of cases of suspected fraud so as to prove or disprove the suspicions;
- If the suspicions are proven, to identify the processes, trial of money and persons involved, support the findings by evidence and to present the evidence in an acceptable format in any subsequent disciplinary or criminal proceedings.

Reactive Forensic Accounting involves

- Working closely with the Investigating / Vigilance and prosecuting agencies
- Due authorization and process of the Forensic Accounting Investigation
- Documentation of relevant information and safeguarding all prime records pertaining to the case
- Rules of evidence governing admissibility / authentication of records
- Confidentiality
- Evaluation of the evidence to assess its sustainability
- Legal advice where appropriate
- Reporting the findings in a manner that meets legal requirements

Useful in Detecting & Dealing with

- **Financial Frauds & Economic Offences**
- **Tracking diversion of moneys where Banks / Financial institutions are hoodwinked**
- **Tracing Illegal funding through NGO's / Commercial Organizations**
- **Money Laundering Cases**
- **Vigilance & Tax Evasion Cases**
- **Anti Corruption Cases**
- **Business Frauds**
- **Partnership / Corporate Disputes etc.,**

Steps involved in Forensic Investigation

- **Planning and Information Gathering**
- **Analysis and Evaluation**
- **Preparation of Provisional/Draft and Final Reports**
- **Presentation of Reports, Evidence and Opinions**

Planning & Information Gathering

- Understanding facts of case
- Documenting the scope of assignment
- Conducting Field Survey to gain understanding of complexity
- Planning Assignment in terms of
  - Approach
  - Strategy
  - Methodology
  - Team Choosing
- Executing Assignment using appropriate Techniques including detailed examination of all relevant Documents & Records
- Documenting the findings
- Checking evidences for Completeness & Accuracy

Analysis & Evaluation

- **Sorting information into structured formats to facilitate the analysis, using special techniques like Data Mining, Data Tabulation, Summary & Comparison, Ratio Analysis etc.,**
- **Developing Chronology of relevant / dependent transactions, events & preparing Cause & Effect Flowchart focusing on issues to aid in the understanding of complex factual situation**
- **Assessing, Interpreting & Evaluating the results**

Preparation of Provisional / Draft and Final Reports

- Preparing Draft Report containing details of
  - Fraud Committed
  - Fraud Detection Methodology
  - Findings for the intended usage
  - Findings from the expert evidence angle for Court / Tribunals, etc.
- Discussion of Draft Report with Clients / Legal Advisers to verify / validate provisional findings and conclusions
- Carrying out amendment of Draft Report, where required, based on substantial reasons for doing the same
- Issue the Final Report with Full Supporting Data

Presentation of Reports, Evidence & Opinion

- **Presentation of Report at Meetings / Courts / Tribunals / Disciplinary Authorities**
- **Justifying or defending conclusions wherever required**
- **Responding to Questions, Cross-Examination and Explanations**

Creativity is the key in Forensic Audit

- The most important quality a successful Forensic Auditor should have is ‘creativity’ or ‘ability to think differently’ and many a time, common sense or keen observation around us would help in coming out with instant solutions
- In a recent case handled on behalf of Central Investigation Agency where there was allegation of dummy sales, the application of common knowledge about high premium for fancy numbers of Vehicles helped in cracking the case, as there were many bogus Delivery Challans showing these fancy numbers as used for goods transportation; when checked with RTA site, it revealed the fact that the vehicle in question was not Lorry but instead a BMW vehicle
- **Looking beyond financial data**, generally fancy numbers for vehicles (like 9999, 111, 1234, 555 etc.) carry heavy premium and generally these are taken by costly/high end cars etc. but not Lorries/Autos
- Thinking beyond the normal and application of knowledge – structured/ unstructured observation is the key for success in these arena

Company AGM Notice – A Live Case

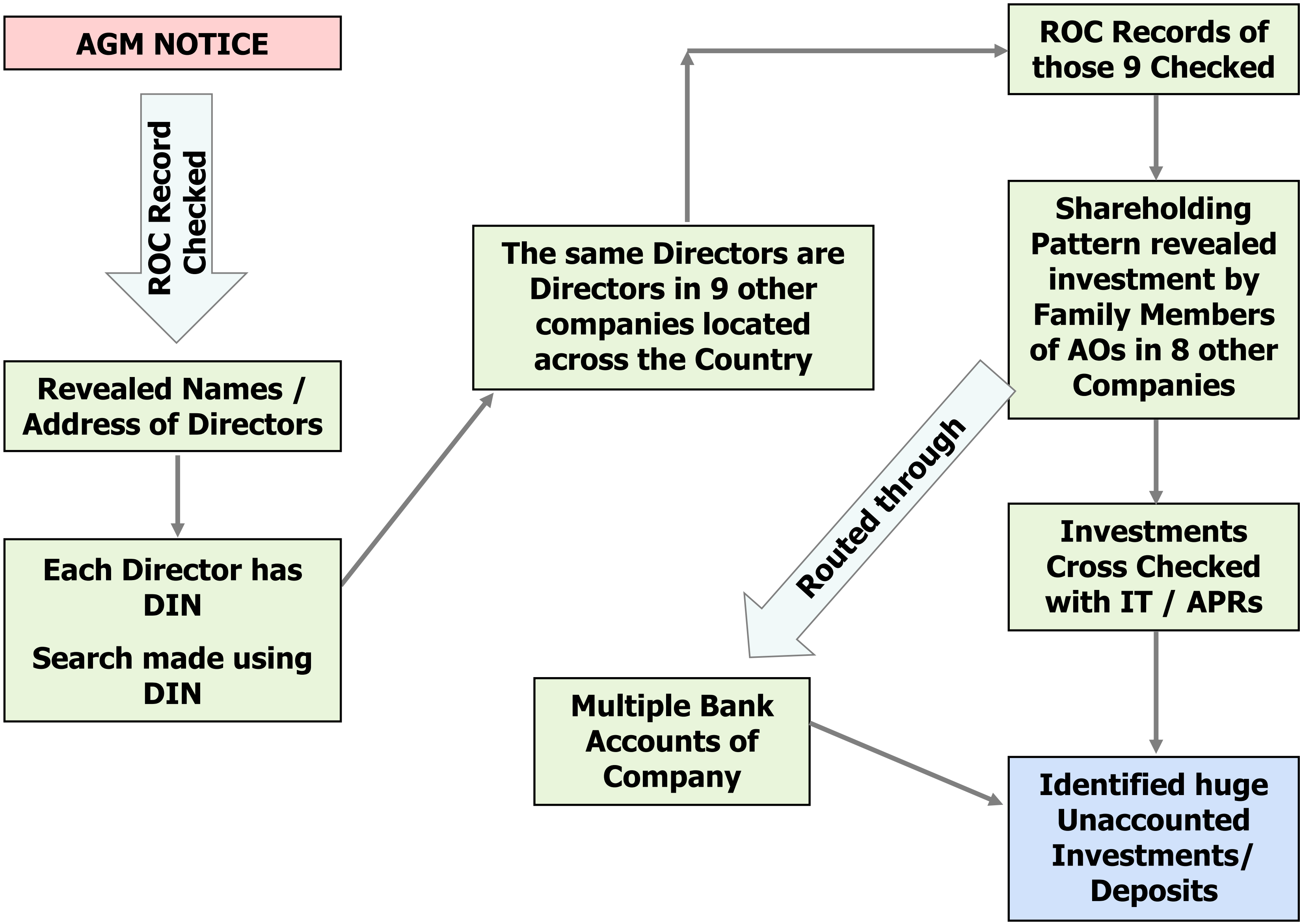
During searches by the Anti Corruption Wing of Investigation Agency in a dis-proportionate assets case, nothing material could be found at the residence of Senior AIS Officer. However, an old AGM notice of a Company was found. Further probe using Forensic Audit techniques resulted in following findings

- Checking of ROC records of the Company revealed the names of Directors, who are the family members of the Accused Officers
- Each Director will have a unique DIN (Director Identification Number);
- These DIN were identified and further searches were made using this DIN, to ascertain the details of any other companies, where the same persons are Directors
- This checking revealed the fact that same persons were directors of 9 other companies, which are located in several other States
- Then it was decided to ascertain as to who “owns” these Companies, which is possible by checking the shareholding pattern
- A detailed verification was made from the ROC site, downloading the financials of these companies and checking the shareholding and these Companies’ Bank details

Company AGM Notice… (Contd..)

- **When this exercise was carried out, it was revealed that the family of Accused Officials invested in about 8 companies and these investments were made from Banking channels**
- **Bank account details of these 8 companies were obtained and scrutinized as to the inflows from Accused Officers' family bank accounts**
- **It was found that these Bank accounts were instrumental in routing the ill-gotten money through individual accounts of the family members through staggered deposit of cash**
- **The accused very cleverly closed these accounts; however, these were linked from companies' accounts and although closed, the relevant bank statements were obtained, directly from individual Banks**
- **These investments were cross checked with their Income Tax Returns and Property Returns filed with Department for unearthing ill gotten money**
- ***Thus, the FA Trial led from AGM Notice tracking to ROC to Directors to DIN No. to other Directorships to Share holding pattern to Bank Accounts of Company to Bank Accounts used for investment to the illegal deposits amounting to Rs. 15 Crores.***
- **All these were conclusively proved beyond any doubt, paving way for successful prosecution.**

Economic Offences Investigation
(Diagrammatic Representation)



Tools of Evidence

- Tools of evidence while carrying out Forensic Audit or any other investigation, while primarily are the same, varies depending on who is carrying out the same and also on whose behalf this is being carried out
- It generally involves forensic audit of Accounts, Documents, examination of Bank Statements, various connected records and statements filed with different Government agencies by the company under scanner
- Where a criminality also has to be proved for prosecution, forensic audit may also involve sending the documents to relevant Govt. labs for getting the signatures/handwritings confirmed through proper channels
- Where it is a bank/PSU, depending on the allegations and seriousness, gathering of evidence may be restricted to that particular level; however, if it point towards fraud/criminality, then further evidences should be gathered for a full proof case.

Tools of Evidence

Tools of Evidence may include

- **Detailed breaking down of allegation into actionable points**
- **Analysing the trends/Red Flags *(which are discussed in detailed later)***
- **Identifying relevant documents in support of the same and collecting the same *'directly from the source'***
- **Examination of these documents and cross checking them with the objective of Investigation to either prove/disprove the notions**
- **This exercise may also involve gathering information for third party or diverse sources such as Capital Market reportings, other Govt. Agencies, Bank accounts of this company/person with other related party concerns of promoters/directors**
- **An excellent source for gathering information or intelligence is disgruntled employees and trading partners**
- **Many a time, it was proved that a low level employee or worker gives more authentic information and intelligence inputs**

Tools of Evidence

- **After gathering the data, detailed analysis has to be done to prove or disprove the fact**

- **With current environment of Core Banking Solutions or ERP systems in place, the data, predominantly, is in digital form**

- **It is here that Digital Forensics come to usage, for identifying the method by which fraud was perpetrated and necessary evidences to be gathered for proving beyond doubt**

- **Several tools are available while carrying out these functions; however, selection and applying of relevant tools is key to success. As there is no “standardized form of economic offence” for application of “exact tool”, the experience and expertise of the Forensic Accountant comes handy in these matters**

What are RED FLAGS ?

- **A Red Flag / Warning Signal is a set of circumstances/ facts that are unusual in nature or vary from the normal activity or presentation**
- **It is a warning or sense that something is not ‘Right’ or ‘Normal’. Such sense can lead you to take a closer look at the transaction / situation**
- **What is ‘unusual’ depends upon the activity or situation in a particular context.**
- **Some Red Flags are easily discerned, while others may be more subdued and/or concealed.**

CAUTION !

RED FLAGS & WARNING SIGNALS

ARE INDICATORS OF APPARENT INCONSISTENCIES / SIGNALS THAT MAY POINT TOWARDS FRAUD / MISCHIEFS / MISTAKES / LAPSES

BUT NOT FINAL PROOF OF THEM

Financial Statement Red Flags

- Trend of past declining revenues coupled with sudden spurt in current period particularly in the year end
- Making sudden losses, after very good performance
- Higher cost per unit of production, than the past trend
- Higher amount of losses / wastage in books VS peer entities
- Lot of non-operating or one-time items in the Financial Statements, on a year-to-year basis, significantly contributing to either Revenue or Expenditure
- Inability to generate Cash Flows from operations while reporting earnings & its growth (indicating Book entries only)
- Unusual accounting policies, particularly for Revenue recognition
- High amount of year end transactions than normally warranted
- **Significant amount of Directors' remuneration is 'Performance Dependent' – be it incentives / stock options / Bonus**

Financial Statement Red Flags

- Increase in Capacities without any increase in Capital Expenditure coupled with higher turnover and Profits
- Sizeable amount of Intangible Assets - exceeding > 25% of Total Assets
- High Investment in Group Companies / Subsidiary Companies
- Providing temporary advances to sister concerns frequently
- Consistently maintaining huge inventories than general industry norm
- Debtors having huge Old Debtors (inability to collect receivables)
- Increase in the amount of write-offs in Debtors / Investments
- Raising Capital particularly Foreign Capital from suspect sources and locations coupled with investments / procurements through suspect / unconnected locations
- Non Payment of Statutory Liabilities even while showing High Profits
- Continuously overdrawing credit facilities
- Too much debt, in the light of good performance
- Raising Profit, Raising Inventory coupled with Raising Debt

Useful Red Flags for Corporate Fraud Identification

MACRO LEVEL

- Extraordinary Higher Margins when compared with Peers
- Aggressive Growth – Total Assets/Revenue doubling within 3 years
- Consistently close or exact match between Actual Results and planned results
- Complex business/group structure where Income/Assets around 30% are through JVs/Associate entities
- High Customer Concentration – For example, more than 30% revenue comes from Top 3-4 customers
- Frequent changes in Auditors and Senior Management
- Overly optimistic news releases or shareholder communications
- Results TOO GOOD TO BE TRUE without substantive differences in operations when compared to Competitors
- Delay in announcement of results or where there are Auditor Qualifications
- History of effecting changes in Accounting Policies

Moving Further.....

- Keep yourself abreast of Current Trends in Economic Offences
- Sensitize your Subordinate Officers about current trends in Economic Offences on a regular basis
- Go through classified advertisements in local newspapers, promising ‘tempting’ offers
- Disseminate information to public, cautioning about ‘easy money schemes’ and the pitfalls associated through media
- Train your staff to smell questionable offers and to keep an eye on them

Can Economic Offences & Frauds ever be stopped ?

- Probably not
- Part of human nature
- Performance pressure ,market expectations & Bank Loan eligibility concerns
- Best we can do is set up a sound conceptual framework & sound standards
- Promote good ethical conduct
- Inter Agency & Professional co-ordination
- **Be Aware by continuous learning**
- **Learn to work with other Agencies/Professionals**
- **Help them & take help from them**

Any Questions / Clarifications?

Thank You

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