

FORENSIC ACCOUNTING APPROACH



Presented By

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Overview of the Session

- ❖ **Forensic Accounting - Nature, Process & Usage**
- ❖ **Tools of Evidence using Forensic Accounting**
- ❖ **Useful Red Flags for Prevention / Detection of Frauds relevant while carrying out Forensic Accounting**
- ❖ **Live Case Studies**

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 Accounting application/usage



Latest Dimensions of Forensic Accounting

Presently, there is an increasing use of Forensic Accounting/Audit skills to prevent fraud by identifying and rectifying situations, which could lead to frauds being perpetrated (i.e. risks).

In this context, Forensic Accounting/Audit could be either 'Reactive' or 'Proactive'

Latest Dimensions of Forensic Accounting

PROACTIVE

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

REACTIVE

- Involves direct investigation into suspected fraud, so as to prove/disprove the suspicion
- If the suspicions are proven, to identify the processes, trail 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

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, using **specialized investigative skills**
- 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
- In doing so, the veil of corporate entity is pierced to establish the intentions of person(s) behind such transaction(s).

Process of Forensic Investigation

- Investigating and analyzing financial evidence
- Developing computerized applications to assist in the analysis and presentation of financial evidence
- Communicating their findings in the form of reports, exhibits and collections of documents
- Assisting in legal proceedings, including testifying in court as an Expert Witness and preparing data to support Court Trial evidence

Computer Forensics & Data Mining

- Computer forensics involves preservation, identification, extraction, documentation & interpretation of computer data.
- As in any discipline, computer forensic specialists follow clear, well-defined methodologies and procedures for Recovery, Assimilation and Analysis of Data
- Finding key pieces of evidence - *even if someone has tried to hide, discard, or destroy computer data* – same can be retrieved with appropriate tools, Ex. deleted E-mails & Other Data retrieved in Satyam Computers Case
- Data Mining is an extensively used technique in Forensic Audit & Investigation, which is a part of Computer Forensics
- Excel is one of the many simple and useful tools in Data Mining

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

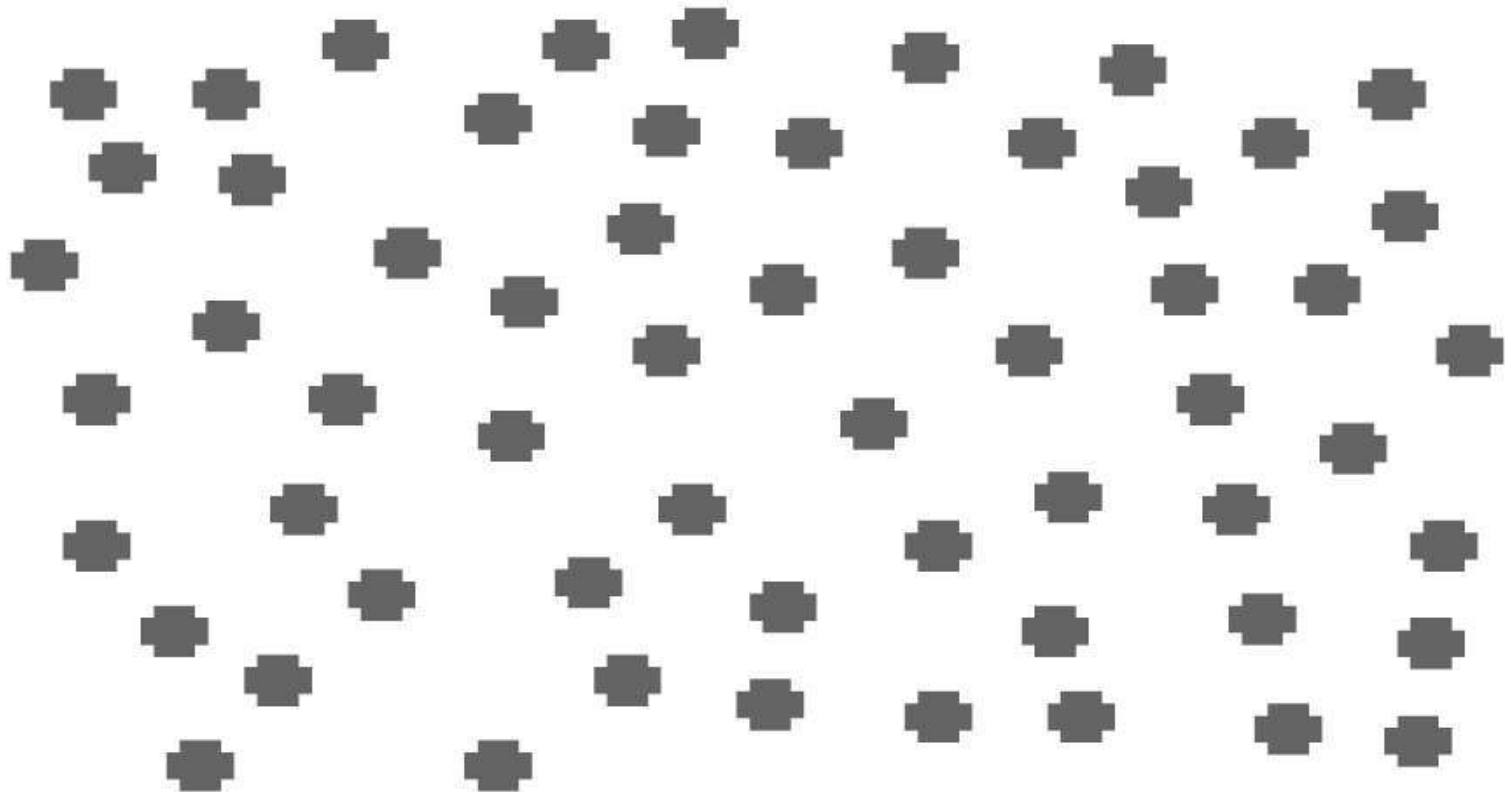
- Understanding facts of case
- Documenting the scope of assignment
- Conducting Field Survey to gain understanding of complexity
- Planning Assignment in terms of
 - Approach (Form Hypothesis)
 - Strategy
 - Methodology
 - Team Choosing
- Executing Assignment using appropriate Techniques including detailed 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

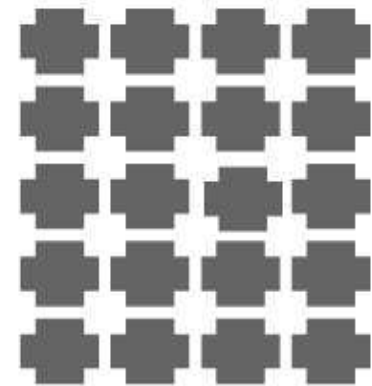
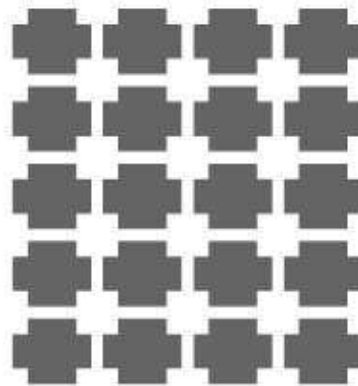
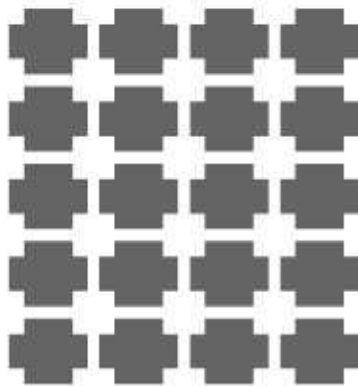
Data Analytics – Why is it required ?

How Many Crosses Do You See ?



Data Analytics – Impact

Now, How Many Crosses Do You See ?



Applying Data Mining & Quantitative Analysis Techniques can **“connect the dots”** and reinforce your findings in a clear Formatted Report.

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 Advisors 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

Data to be seized for Investigation

Books, Records and Other Documents to be seized at the time of Searches (*Immediately on taking up the case*)

- **Books of Accounts - Cash Book, Bank Book, Ledgers and other misc. books of accounts**
- **Computer Hard Disk, Floppy Disks & CDs**
- **Computer should not be operated under any circumstances**
- **Minutes Books**
- **Loan Documents**
- **Confidential Correspondence files**
- **Bank Pass Books and Statements of Accounts**
- **Records filed with Statutory Authorities, viz.,**
 - **Income Tax, Sales Tax, Central Excise, ROC, etc.**

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

Important Forensic Audit Tools

TOOLS	DESCRIPTION
General Audit Techniques	<ul style="list-style-type: none">• This is more generic or standardized method which is used all these years, more as a part of regular Audit function;• Involves testing various Controls in place• Mostly used for preventing the occurrence of Frauds
Statistical/Mathematical Techniques	<ul style="list-style-type: none">• Trend Analysis (for ascertaining the pattern),• Ratio Analysis (provides required ratios spread across several periods/companies/peers etc)
Digital Forensics	<ul style="list-style-type: none">• Hard Disk Imaging• E Mail Analysis• Searching for Deleted/erased files (mostly for detection)• Analyse USE and possible MISUSE• Computer Software to analyse data

Important Forensic Audit Tools

TOOLS	DESCRIPTION
Computer Assisted Audit Technique (CAAT) Tools	<ul style="list-style-type: none">• Specialized softwares which are highly customized and require pre-training. These may integrate with regular accounting/ other system and provide data. Examples include ACL, IDEA etc.,• Generalized Softwares (like Excel/RDBMS) which have excellent inbuilt capabilities for detection. These are extremely easy to use• These are the most popular and widely acceptable• Examples of capabilities include tracing missing cheques, duplicate cheques, repetitive odd numbers, classification, isolated outliers etc.
Data Mining	<ul style="list-style-type: none">• Mostly used for big data, for finding and analysing the patterns; includes discovery, predictive modelling & deviation/link analysis

Forensic Auditor's Role

Assisting and Advising on

- ◆ Perusal of Records seized
- ◆ Decide upon Check Period
- ◆ Analysis of the Seized Data
- ◆ Disproportionate Assets
- ◆ Examining Questionable Claims of Accused Official (AO)
- ◆ Forensic Methodologies for tracing back and forth the funds flow including establishing Benami Investments.

The emphasis of FA is to go and look beyond the physical seized evidences and assets to establish link to various hidden Assets and transactions

Tools of Evidence

- Tools of evidence while carrying out Forensic Audit or such other investigation, while primarily are the same, varies depending on who is carrying out and also on whose behalf FA 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

Detailed breaking down of allegation into actionable points

- Analyzing 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 filings, 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 present environment of Core Banking Solutions or ERP systems in place, the data, predominantly, is in digital form
- Here, Digital Forensics come to usage most importantly, 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
- But, selection and applying of 'relevant' tool 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

Detailed Forensic Audit Analytics

- Mere perusal of the Books of Account and other records might not help in establishing the case
- The entries in these records have to be looked into, understood and assimilated in the required fashion to unearth the complexities involved
- There is something called Data Analytics, which will prove to be a major help in this regard
- These Data Analytics help in assimilating the data in a structured way, which could then be used for probing further
- Many a time, the unscrupulous promoters divert monies to sister concerns or relatives in a camouflaged way. The analysis of transactions and data seized will enable us to locate and seize such properties

Challenges in Forensic Audit

- **Establishing clearly the Fraud with evidence is the key and is a very complex and difficult task particularly in case of involvement of higher officials**
- **Establishing the Funds trail is very difficult and a herculean task, considering the present usage of technology for fund transfer**
- **Investigation may spread to several towns/cities/districts/states, involving many banks or may even include several States also**
- **Cases usually would be complex in nature (even in terms of understanding the modus operandi) and document based which is extremely difficult to collect 'in the admissible form'**
- **Modern Technology would certainly provide enhanced anonymity to fraudsters and Investigating team would be well equipped with latest trends to meet this challenge**
- **Offenders are mostly rich/influential people, who would use best of technology, people, legal brains to safeguard their interests**

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

Scope for Exercise

End-use of Funds

Identifying the actual end use of funds disbursed by the Lenders and assets created.

Analysis of equity/unsecured loans infused by promoter and verifying that they were not sub-sequentially withdrawn.

Establishing money trail of all major transactions of procurement of equipment, investments made, unsecured loans given and major collections from sales and debtors etc.

To examine the diversion / siphoning of lenders funds/ companies' assets charged to the lenders as Primary/ Collateral security and to quantify such amount.

Commenting on adherence to Escrow/ Trust and Retention Account (TRA) arrangements (if any) made with various banks. Details of all transactions with banks outside the consortium / other than nominated account.

Revenue & Receivables

Verification of Revenue from Operations including Sale Orders, Invoices and Controls in the Billing Process obtaining confirmation where-ever necessary and verifying the genuineness. Reconciliation with Tax Returns (VAT Returns/Service Tax Return/TDS Returns etc.)

Review of sales and debtors including review of sale transactions/customer ledger and customer confirmations, as may be found required. Analysis of vendor/customer relationships by analyzing sale transactions and verifications of genuineness of underlying documents.

Review of receivables including age-wise analysis of debtors, identifications of major debtors, recoverability of the debtors and commenting on the genuineness.

Scope for Exercise

Purchases & Payables

Verification of the purchases for operations including purchase order, invoices and controls in the billing process obtaining confirmation wherever necessary and verifying the genuineness. Reconciliation with Tax Returns (VAT Returns /Service Tax Returns/TDS Returns etc.)

Review of payables including age-wise analysis of creditors, identifications of major creditors and commenting on the genuineness.

Analysis of Expenses

Analysis and verification of all major expenses and commenting on their genuineness

Unsecured Loans and Advances Given and Taken

Movement of Loans & Advances and their documentations, approvals under companies act, confirmations and commenting on genuineness of these loans. The end use of loans should be verified and commented upon.

Investments

Analysis of various investments made and their approvals. The documentation of investments is to be verified and commented upon.

The commercial expediency and prudence of investments needs to be verified and commented upon

Related Party Transactions

All related Party transactions are documented year wise and commented upon as a separate section in the report Group Transactions/ inter-company transactions/ related party transactions are to be examined with respect to commercial prudence, genuineness, documentation and various approvals under the Laws. Non-compliances have to be brought out clearly. Diversion of funds is to be brought out clearly.

Scope for Exercise

Related Party Transactions should cover all transactions including but not limited to purchase, sales, expenses, loans given and taken, investments made in subsidiary, joint ventures and associates etc.

Accounting and Falsification of accounts

To examine whether accounting standards have been observed and whether there has been falsification of accounts where there are fraudulent transactions which are mere book entry and not backed by any genuine documents.

Wherever frauds, if any are observed, the modus operandi, the motive of the suspect and opportunity to commit fraud are to be commented. Whether there is any collusion and also mention the physical and documentary evidences to substantiate it, whether there was any attempt to destroy the evidence, etc.

Commenting on Drawing Power

To examine the stock statement/ debtor statement and the drawing power statement submitted by the borrower to the banks for availing of facilities and verify the same with the books of accounts.

Where Fraud Transaction or ingenuine transactions or where there is over-statement of stock auditors and understatement of creditors, to re-work the drawing power and clearly bring out the excess borrowing availed by the borrower.

To conclude diversion/fraud as per the RBI guideline

Please note that the above scope is indicative and the same can be modified post discussion.

Any Questions / Clarifications ??

Thank You