

STUDY ON FORENSIC ACCOUNTING AND FRAUD DETECTION



The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

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Foreword

Specialization in the areas of *Forensic Accounting and Fraud Detection* is more in demand in view of increased incidents of frauds and cyber-crimes. Forensic accountants with their core understanding of accounting, finance and laws with added knowledge of investigative techniques will be able to determine whether an activity is illegal or not. Forensic Accounting and Fraud Detection (FAFD) involves practice of utilizing accounting, auditing, CAATs/ Data Mining Tools and investigative skills to detect frauds/ mistakes. All Government bodies, PSUs, Insurance sector, Banks, Investigating agencies as well as many medium-sized and boutique firms also have specialist forensic accounting departments engaging Forensic Auditors. Forensic accountants usually investigate and analyze financial evidence, develop computerized applications to assist in the presentation and analysis of the evidence presented, communicate their findings in the form of various reports and assist in the legal proceedings in court as an expert witness.

In the wake of recent financial and cyber frauds and need for expertise in this newer area, the Committee on Information Technology (CIT) of the Institute of Chartered Accountants of India (ICAI) has identified Forensic Audit, Fraud Detection & Prevention as one of the niche area and has started conduct of Certificate Course on Forensic Accounting and Fraud Detection.

The Certificate Course on Forensic Accounting and Fraud Detection of ICAI aims to develop such investigative skills that are required to uncover corporate/ business frauds, measure resultant damage, provide litigation support/ outside counsel by applying accounting, auditing principles for the detection of frauds.

This background material of the Certificate Course contains various practical aspects, new technologies and case studies related to Forensic Accounting and Fraud Detection which together will make it a great learning guide and assist the members in understanding the nuances of this complex subject thoroughly. I appreciate the efforts put in by CA. Atul Kumar Gupta, Chairman, CA. Jay Chhaura, Vice-Chairman, other committee members, faculties and officials of CIT for bringing out this background material.

I am sure that it will be a useful learning material and will fulfill the objectives for which it has been developed.

Wishing you all the very best in this emerging professional opportunity.

Best wishes,

Place: New Delhi

Date: 21st September 2017

CA. Nilesh Shivji Vikamsey

President, ICAI

Preface

Recently, Forensic Accounting (FA) has come into limelight due to rapid increase in financial frauds and white-collar crimes. The integration of accounting, auditing and investigative skills creates the specialty, known as FA. 'Forensic' means "suitable for use in a court of law," and it is to that standard and potential outcome that forensic accountants generally have to work. FA uses accounting, auditing, and investigative skills to conduct investigations, and thefts and frauds cases. No doubt, FA is listed among the top-20 careers of the future. The job of forensic accountants is to catch the perpetrators of the financial theft and fraud occurring throughout the World every year. This includes tracing money laundering and identity theft activities, as well as, tax evasions.

Forensic accountants will be in high demand because of an increase in employee and management fraud, theft, embezzlement and other financial crimes. Growth is also fueled by high-visibility corporate scandals. The Bureau of Labor Statistics (BLS) USA has predicted 13% job growth for accountants and auditors by 2022. The growth of all forensic accounting jobs should correspond with this rate, if not exceed it, due to increasing financial regulations, with some estimates predicting a 20% growth in demand for investigative auditors.

This Course is a blend of theoretical and practical training and is intended to equip the participants with concepts in Forensic Accounting which aims at sensitizing Fraud Investigators, Auditors, Security Professionals, and IT executives about the risks and mitigation strategies for an effective business environment, update members on the developments taking place in the exciting world of forensic investigation related to finance and Information Technology sector. It provides an incisive analysis of how fraud occurs within an organization and explains the latest techniques for fighting it.

This background material is prepared so as to cover all major aspects applicable to Forensic Accounting and is intended to provide an understanding about the current state of Frauds, Technologies involved and their characteristics and give a well-knitted overview & assessment approach along with that of the prevailing cyber laws/ IT Act.

I would like to express my gratitude to CA. Nilesh Shivji Vikamsey, President ICAI and CA. Naveen N. D. Gupta, Vice President for their continuous support and

encouragement to the initiatives of the Committee. I must also thank my colleagues from the Council at the Committee on Information Technology for providing their invaluable guidance as also their dedication and support to various initiatives of the Committee.

I would also like to extend my sincere thanks and appreciation to CA Sailesh Cousik, CA Durgesh Pandey, CA Abhijit Sanzgiri, CA Yogesh Palekar, CA Shanobar Murali, CA Chetan Dalal, CA Mahesh Bhatki, CA Anand Jangid, CA M. S. Mehta, Mr. Alok Gupta, CA. Rajiv Gupta, Mr. Prashant Mali, CA. Ravi Suriyanarayanan, CA T.V.Balasubramaniam, and Dr. Triveni Singh, who contributed the technical material for this publication brought out by the Committee on Information Technology. I really appreciate their sincere efforts and dedication towards the work for the Committee.

I wish to express my thanks to Committee Secretariat in giving final shape to the publication.

I take pleasure in inviting you all to this Course on Forensic Accounting and Fraud Detection and I am sure that all the participants will immensely benefit from this Course.

CA Atul Kumar Gupta
Chairman
Committee on Information Technology

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Chapter 1

Introduction to Forensic Accounting

Forensic

The word forensic comes from the Latin word *forēnsis*, meaning "of or before the forum."

Means –

- Relating to, used in, or appropriate for courts of law or for public discussion or argumentation.
- Relating to the use of science or technology in the investigation and establishment of facts or evidence in a court of law

Forensic Accounting

The integration of accounting, auditing and investigative skills yields the specialty 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 Investigation

Also known as forensic audit is the examination of documents and the interviewing of people to extract evidence. Forensic Accounting examines individual or company financial records as an investigative measure that attempts to derive evidence suitable for use in litigation.

Forensic Accounting can sometimes be referred to as Forensic Auditing.

Purpose can be:

- A forensic audit can be conducted in order to prosecute a party for fraud, embezzlement or other financial claims
- In addition, an audit may be conducted to determine negligence

Fraud auditing

In a fraud audit one searches for the point where the numbers and/or financial statements do not mesh. It is a meticulous review of financial documents conducted when fraud is suspected. Some entities do them as a precaution to prevent fraud from happening and to catch it before the loss magnifies.

A Fraud Audit however is not an Investigation. *Fraud auditing is used to identify fraudulent transactions, not to figure out how they were created.* The auditor simply traces every

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transaction performed by the company, looking for the one that is fraudulent, if any. A regular auditor simply checks the numbers for accuracy.

Fraud auditors often go outside the books of accounts to find fraudulent transactions. This may include reviewing receipts, not only from the company, but from customers as well. Any inconsistencies in these numbers could help uncover an act of fraud. These auditors also interview employees, customers and sometimes clients to find out if a fraud has taken place.

How is a forensic accounting analysis different from an audit?

The general public believes that a financial auditor would detect a fraud if one were being perpetrated during the financial auditor's audit. The truth, however, is that the procedures for financial audits are designed to detect material misstatements, not immaterial frauds. While it is true that many of the financial statements and frauds could have, perhaps should have, been detected by financial auditors, the vast majority of frauds could not be detected with the use of financial audits. Reasons include the dependence of financial auditors on a sample and the auditors' reliance on examining the audit trail versus examining the events and activities behind the documents. The latter is simply resource prohibitive in terms of costs and time.

There are some basic differences today between the procedures of forensic auditors and those of financial auditors. In comparison, forensic accounting and audit differ in specific ways, as shown below:

Forensic Accounting

- In response to an event
- Financial investigation
- Findings used as evidence in court or to resolve disputes

Audit

- Mandatory
- Measures compliance with reporting standards
- Obtain reasonable assurance that financial statements are free of material misstatement

In practice, there are differences in mindset between forensic accounting and audit:

- "Investigative mentality" vs. "professional skepticism". A forensic accountant will often require more extensive corroboration.
- A forensic accountant may focus more on seemingly immaterial transactions.

A forensic accountant will often look for indications of fraud that are not subject to the scope of a financial statement audit.

Introduction to Forensic Accounting

Sr. No.	Particulars	Other Audits	Forensic Audit
1.	Objectives	Express an opinion as to 'True & Fair presentation	Whether fraud has taken place in books
2.	Techniques	Substantive & 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 & compliance with procedures.	Regulatory & propriety of these transactions / contracts are examined.
6.	Adverse findings if any	Negative opinion or qualified opinion expressed with/without quantification	Legal determination of fraud impact and identification of perpetrators depending on scope. .

What is Fraud?

Fraud is a type of criminal activity, defined as:

'abuse of position, or false representation, or prejudicing someone's rights for personal gain'.

Put simply, fraud is an act of deception intended for personal gain or to cause a loss to another party.

The general criminal offence of fraud can include:

- deception whereby someone knowingly makes false representation
- or they fail to disclose information
- or they abuse a position.

Apart from the general meaning let us study some notable definitions of Fraud as per various statutes and standards. Although definitions vary, most are based around the general theme mentioned above

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The **Companies Act, 2013** defines Fraud in relation to affairs of a company or anybody corporate, to include,

- (a) any act
- (b) omission,
- (c) concealment of any fact
- (d) abuse of position committed by any person or any other person with the connivance in any manner
 - ❖ with intent to deceive
 - ❖ to gain undue advantage from, or
 - ❖ to injure the interests of,
 - the company or
 - its shareholders
 - or its creditors or
 - any other person

Whether or not there is any wrongful gain or wrongful loss;

- “*wrongful gain*” means the gain by unlawful means of property to which the person gaining is not legally entitled
- “*wrongful loss*” means the loss by unlawful means of property to which the person losing is legally entitled

Fraud is also defined in **Para 11(a) of SA 240** issued by the Institute of Chartered Accountants of India –“Auditors Responsibilities relating to Fraud in Audit of Financial Statements” as

‘An intentional act by one or more individuals among

- Management
- those charged with governance
- employees or
- or third parties,

Involving use of deception to obtain an unjust or an illegal advantage.”

Similarly **Standards on Internal Audit** i.e. **SIA 11** – “Consideration of Fraud in an Internal Audit define Fraud as

“An intentional act by one or more individuals among management, those charged with governance or third parties involving the use of deception to obtains unjust or illegal

advantage. A Fraud could take form of misstatement of an information (Financial or otherwise) or mis-appropriation of assets of that entity”

Another notable definition of Fraud is the one of Indian Contract Act. According to **Section 17** of the **Indian Contract Act, 1872**

‘Fraud’ **means and includes** any of the following acts committed by

- a party to a contract or
- with his connivance,
- or by his agent,

With an intent to

- Deceive another party thereto or
 - His agent or
 - To induce him to enter into the contract
1. The suggestion, as a fact, of that which is not true, by one who does not believe it to be true
 2. The active concealment of a fact by one having knowledge or belief of the fact
 3. A promise made without any intention of performing it
 4. Any other act fitted to deceive
 5. Any such act or omission as the law specially declares to be fraudulent

Explanation:

Mere silence as to facts likely to affect the willingness of a person to enter into a contract is not fraud, unless the circumstances of the case are such that, regard being had to them, it is the duty of the person keeping silence to speak, or unless his silence, is in itself, equivalent to speech.

This can be illustrated by way of an example –A sells, by auction, to B, a horse which A knows to be unsound. A says nothing to B about the horse’s unsoundness. This is not fraud in A sells, by auction, to B, a horse which A knows to be unsound. A says nothing to B about the horse’s unsoundness. This is not fraud in A.”

Also Section 25 of IPC defines "Fraudulently" as: A person is said to do a thing fraudulently if he does that thing with intent to defraud but not otherwise.

The purpose of fraud may be monetary gain or other benefits.

Here is an insight on certain other statutes/standards/circulars/framework principles which have mentions of frauds and have given a framework with regards to their prevention, classification, detection and reporting