

KEY CONCEPTS

- Forensic Audit Thinking ■ Forensic Audit Procedures ■ Forensic Data Analysis ■ Professional Negligence
- Investigation Mechanism ■ Fraud Triangle ■ Red Flags ■ Green Flags

Learning Objectives

To understand:

- The tools for handling Forensic Audit
- The forensic data analysis, its benefits and tools for forensic data analysis
- The role of Company Secretaries in the areas of Forensic Audit
- The procedure / steps to be followed in Investigation
- What is Fraud Triangle? How it is used as a tool for conducting forensic audit.
- What are the techniques for Gathering Evidence while conducting forensic audit.
- The steps involved in Investigation
- What is Red Flags? What are the Sign of Red Flags?
- What is Green Flags? What are the Sign of Green Flags?
- Financial Statement Analysis

Lesson Outline

- Tools for handling Forensic Audit
- Role of Company Secretary as Forensic Auditor
- Investigation Mechanism
- Types of Investigation
- Methods of Investigations
- Red Flags
- Green Flags
- Case Study
- Financial Statement Analysis
- Lesson Round-Up
- Test Yourself
- List of Further Readings

TOOLS FOR HANDLING FORENSIC AUDIT

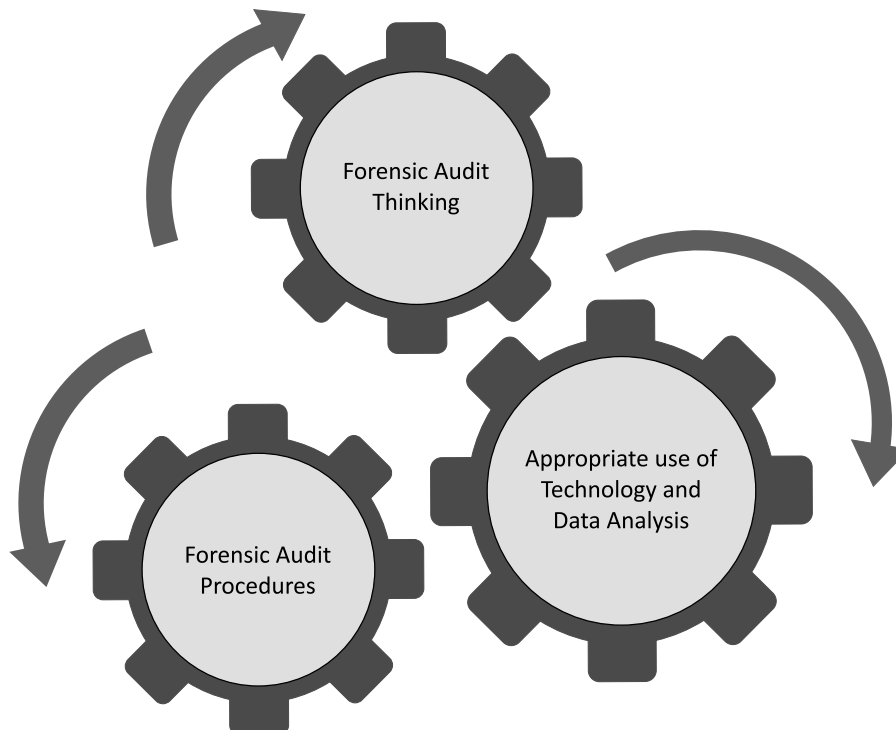
In recent years, there have been considerable changes in the business landscape. The increasing globalization, free movement of people, easy communication, technological advancements, and the shrinking of the world have helped change the business environment. These factors have led to the rapid growth of established businesses and the sprouting of new ones. However, this growth of companies has also increased in **financial crimes and frauds**.

Many businesses keep a separate department of in-house accountants who keep an eye on all the business activities and strive to minimize any irregularities in the businesses recordings. However, there are still cases of new and innovative fraudulent activities that can only be uncovered after an in-depth analysis of all the records and books of the business.

This situation has led to the growth of a niche field known as **Forensic Audit**, which can be explained as the integration of accounting and investigative skills.

Forensic procedures involve the systematic gathering of evidentiary data through the use of recognized investigative techniques that can be presented in a court of law. A forensic specialist, though not specifically defined, is an individual having expertise and/or training and experience in one or more disciplines that could be used in a forensic environment. Disciplines commonly applicable to forensic environments include accounting, auditing, fraud examination, law, computer and other technologies. Forensic accounting services generally involve the application of special skills in accounting, auditing, finance, quantitative methods, certain areas of the law and research, and investigative skills to collect, analyze, and evaluate evidential matter and to interpret and communicate findings, and may involve either an attest or consulting engagement.

Forensic Auditing is a new concept that comprises three key ingredients:



Forensic Audit Thinking (Thinking Forensically)

Involves the critical assessment throughout the audit of all evidential matter and maintaining a higher degree of professional skepticism that for example fraud or financial irregularity may have occurred, is occurring, or will

occur in the future. Furthermore, Forensic thinking is a mind shift where the auditor believes that the possibility of fraud or financial irregularity may exist and the controls may be overridden to accomplish that possibility. Forensic thinking is used throughout the audit work i.e. from start to finish.

Forensic Audit Procedures

Forensic audit procedures are more specific and geared toward detecting the possible material misstatements in financial statements resulting from fraudulent activities or error.

Audit procedures should align with Fraud Risks and Fraud Risk Assessments.

According to Donald R. Cressy, in his proposition Fraud Triangle. He highlighted that there are three interrelated elements that enable someone to commit fraud:

- (a) The **Motive** that drives a person to want to commit the fraud,
- (b) The **Opportunity** that enables him to commit the fraud, and
- (c) The ability to **Rationalize** the fraudulent behavior.

The vulnerability that an organization has to those capable of overcoming all three elements of the fraud triangle is **fraud risk**. Fraud risk can come from sources both internal and external to the organization.

Fraud Risk Assessment: A fraud risk assessment is a powerful proactive tool in the fight against fraud for any organization. According to Association of Certified Fraud Examiners, Fraud Risk assessment is a process aimed at proactively identifying and addressing an organization's vulnerabilities to internal and external fraud. It is important to think about a fraud risk assessment as an ongoing, continuous process, rather than just an activity. A fraud risk assessment starts with an identification and prioritization of fraud risks that exist in the organization.

Performing Forensic Procedures: Those performing forensic procedures (either the auditor or other forensic specialists like certified fraud examiners, certified financial forensics) may consider having:

- To have an investigative mindset which should be more than skeptical.
- An understanding of fraud schemes termed as occupational fraud (Corruption, Asset Misappropriation and Financial statement fraud).
- Experience in dealing with fraud issues.
- Knowledge of certain investigative, analytical, and technology-based techniques (Digital or computer forensics, e.g. how to gather, analyze and interpret data).
- Knowledge of legal processes.

Appropriate Use of Technology

Forensic Data Analysis can be used to Prevent, detect and control fraud along with other irregularities.

Forensic Data Analysis

Forensic data analysis is the process of gathering, summarizing, comparing, and aggregating existing different sets of data that organizations routinely collect in the normal course of business with the goal of detecting anomalies that are traditionally indicative of fraud or other misconduct (Donald, 2007).

Benefits of using Forensic Data Analysis

- Analyzes 100% of data sets rather than using statistical sampling—such as Risk Based Sampling.
- Can help identify potential control environment weaknesses.

- Can assist with the assessment of the effectiveness of existing anti-fraud and fraud risk management programs and practices.
- Can help to identify potential policy and process violations—vendor acceptance/approval process, Bidding tailoring, etc.
- Can assist with interviews in investigations.

Data Analysis Tools

1. Forensic Data Analysis Process
 - (i) Acquire Data and Normalize
 - (ii) Brainstorming and Real-Time Data Analysis
 - (iii) Output and Anomalies
2. Digital and Frequency Testing – Benford Analysis
3. Analytical Testing – Income Statement Items
4. Related Party Transaction Analysis – e-Discovery.

ROLE OF COMPANY SECRETARY AS FORENSIC AUDITOR

It is reiterated time and again that Good Governance is paramount for the inclusive growth of the country while promoting the community confidence, their participation, transparency, accountability, lead for better decisions embarking the welfare of the masses and supporting the ethical decision making, which all in consolidation call for the emergent and bright future of the nation at global platform. In the similar context, India has opted to Reform, Perform, Transform under vision New India, adhering to the best practices of good governance. In this direction, we are witnessing various legal reforms like GST, RERA, IBC, and initiation of amendments in Prevention of Money-laundering Act, 2002 and alike.

The objects of all these reforms and initiatives is to support and ensure inclusive growth and development of the nation in the all the sphere while encountering the challenging hindering the growth of those spheres.

When talking all encompassing growth, economic growth is one of the significant spheres to be adhered with the premium practices of good governance and henceforth the glitches bugging the emerging growth of economy are tackled by the government at priority. In this context among other things, Corporate Frauds are considered as one of the major challenges which is obstructing the growth of corporates as well as of economy as a whole.

Right from initiating the amendments in the Prevention of Money-laundering Act, 2002 (PMLA) to enhancing the scope of preventing and punishing the frauds with the assistance of Serious Fraud Investigation Office, Government is working at length and breadth to enhance governance in the corporates and to ensure corporate compliances at par.

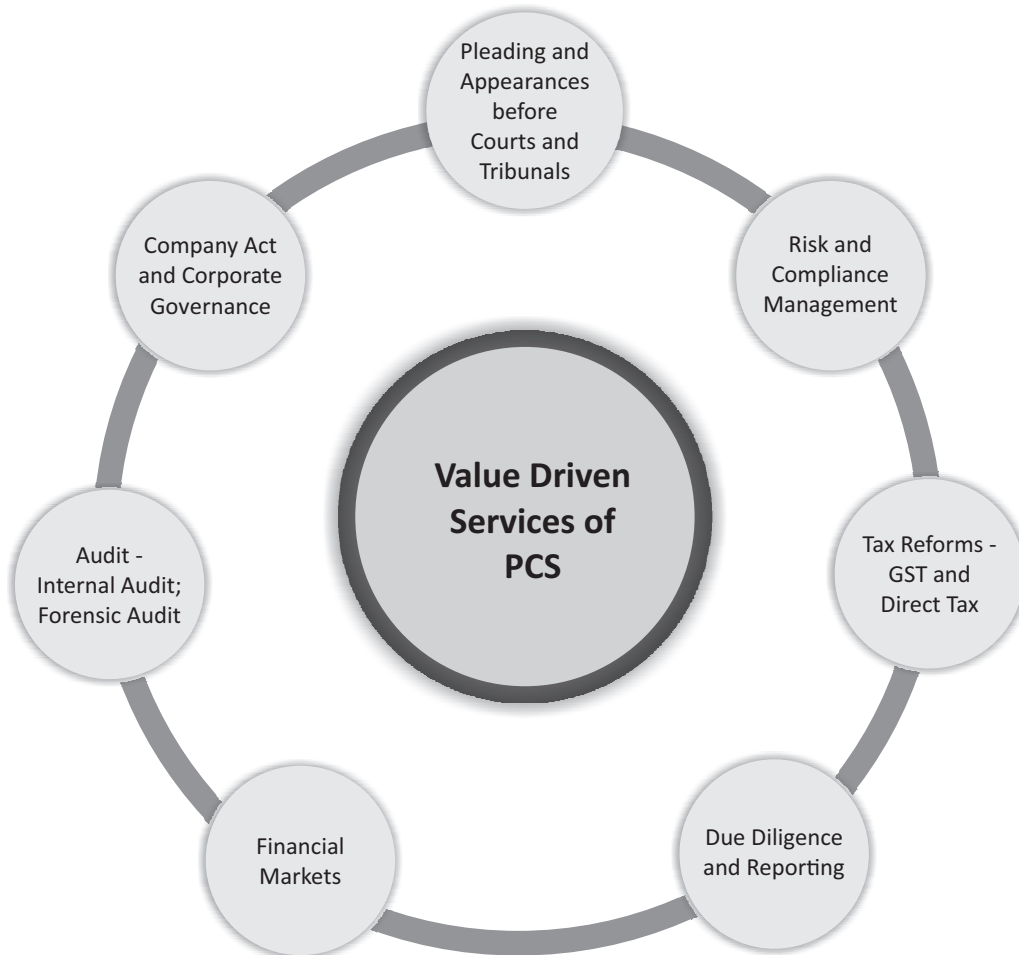
SFIO is a multi-disciplinary organization under Ministry of Corporate Affairs, consisting of experts in the field of accountancy, forensic auditing, law, information technology, investigation, company law, capital market and taxation for detecting and prosecuting or recommending for prosecution white-collar crimes/frauds. SFIO has head office in New Delhi and regional offices in Maharashtra, Andhra Pradesh, Tamil Nadu and West Bengal.

It should be comprehended that corporate compliance lies not in the adequacy of legislature, but in its implementation. Here comes the effective role of Company Secretaries to implement the enactments of various laws enough to eradicate fraud completely. Implementation of the law should be given more importance, to reduce the occurrence of fraud. Indeed, a directed implementation of the provisions promoting the parameters of the governance is similar to what is blood for the veins.

Under this context, one must not forget that in the last five decades, the institute of Company Secretaries of India along with its expert professional commune has immensely contributed in turning each and every stone positively sighting the successful implementation from governance to good governance and from good to now sustainable governance in our country.

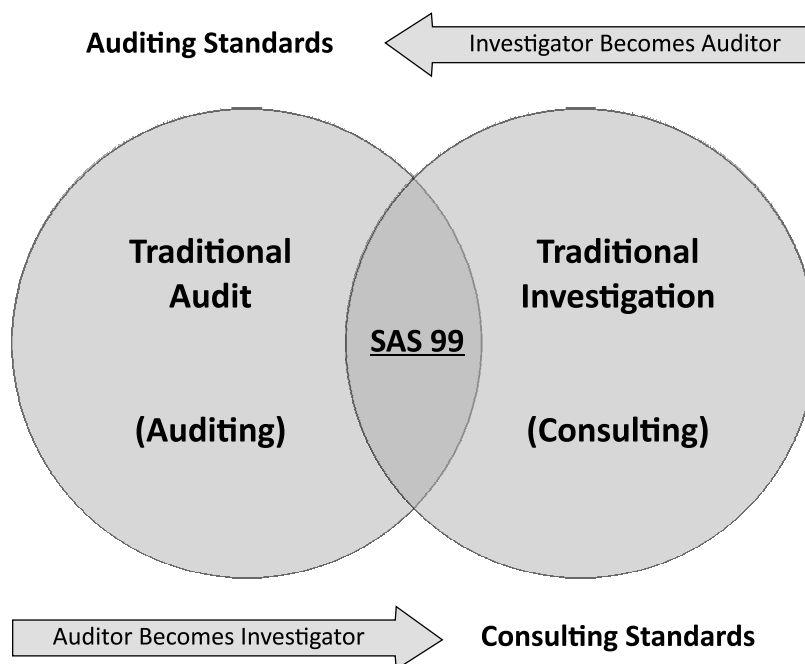
In the paraphrase of reforms, good governance, interpretation leading the world in the direction of transformation, the performance and role of Company Secretaries tends vital. In a system of reformed rules, practices, processed by which the new era of good governance is directed and subsumed, it is the Company Secretary who balances the interest of various stakeholders and ensure well complied mechanism of these reforms.

Company Secretaries decides the Corporate Culture of India and ensures in all the ways that the companies in India follow the laws and regulations, do not mishandle the accounts, and are honest in their work.”



In the environment where government is directing on establishing the premium practices of governance in general and of corporate governance in specific, Company Secretaries both in practice and employment are providing their value driven professional expertise in the varied face of contemporary transformation including Financial Markets, Capital Market, Secretarial Audit, Forensic Audit, Due Diligence and Reporting, IBC, Valuation, RERA, GST, Direct Tax, Internal Audit, Risk and Compliance Management, Insolvency Professionals before NCLT and NCLAT, and many alike.

Among all, the role of company secretaries is expanding in the era of forensic audit wherein they are crucially assisting in preventing, regulating and penalizing the instance of corporate frauds.



Source: Durkin Forensic Incorporated

Right from conducting forensic audit to examining the evidences, from finding the culprit behind the fraud to appearing in the court for submitted the testimony, a Company Secretary is apt in serving his professional excellence as a forensic auditor.

To summarize, where forensic audit is a detailed engagement which requires the expertise of not only accounting and auditing procedures but also expert knowledge regarding the legal framework, and a forensic auditor is required to have an understanding of various frauds that can be carried out and of how evidence needs to be collected.

In this context, Company Secretary is a Catalyst in Upholding Good Governance via Forensic Audit. His role in Specific to Forensic audit is discussed as below:

A Forensic Auditor is often retained to analyze, interpret, summarize and present complex financial and business-related issues in a manner that is both understandable and properly supported. Forensic Auditors can be engaged in Public Practice or employed by Insurance companies, banks, police forces, government agencies and other organizations. The Role of Company Secretary as a Forensic Auditor may be understood as follow:

1. Criminal Investigations

A Company Secretary would use his/her investigative accounting skills to examine the documentary and other available evidence to give his/her expert opinion on the matter. Their services could also be required by Government departments, the Revenue Commissioners, the Fire Brigade, etc. for investigative purposes. Practicing forensic accountants could be called upon by the police to assist them in criminal investigations which could either relate to individuals or corporate bodies.

2. Personal Injury Claims

Where losses arise as a result of personal injury, insurance companies sometimes seek expert opinion from a forensic auditors before deciding whether the claim is valid and how much to pay.

3. Fraud Investigations

A Company Secretary might be called upon to assist in business investigations which could involve funds tracing, asset identification and recovery, forensic intelligence gathering and due diligence review. In cases involving fraud perpetrated by an employee, the forensic auditors will be required to give his/her expert opinion about the nature and extent of fraud and the likely individual or group of individuals who have committed the crime. The forensic expert undertakes a detailed review of the available documentary evidence and forms his/ her opinion based on the information gleaned during the course of that review.

4. Investigation and Inspection

Company Secretary may help the Police, ACB and other investigating authorities in collecting evidences and other investigation purposes. For example, section 157 Cr.P.C, 1973; sections 17 and, 18 of the Prevention of Corruption Act, 1988; Section 6 of The Bankers Books Evidence Act, 1891; Section 78 of Information Technology Act, 2000; Section 447 of the Companies Act, 2013 wherein the Court or Police may require the skills of Forensic auditors while inspecting any books in so far as related to the accounts of an accused.

5. Expert Opinion

Company Secretaries see and carefully examine the accounts and balance sheets and use his skills to find out whether there is any fraud committed or any anomaly associated with it by giving his expert opinion. This finds place in for example section 45, section 118 of Indian Evidence Act, 1872; section 293 of Cr.P.C, 1973.

6. Professional Negligence

The forensic auditor might be approached in a professional negligence matter to investigate whether professional negligence has taken place and to quantify the loss which has resulted from the negligence. A matter such as this could arise between any professional and their client. The professional might be an accountant, a lawyer, company secretary etc. The forensic expert uses his/her investigative skills to provide the services required for this assignment.

7. Expert Witness Cases

Company Secretary as Forensic Auditor often attend court to testify in civil and criminal court hearings, as expert witnesses. In such cases, they attend to present investigative evidence to the court so as to assist the presiding judge in deciding the outcome of the case.

8. Mediation and Arbitration

Some forensic auditors because of their specialist training they would have received in legal mediation and arbitration, have extended their forensic auditing practices to include providing Alternative Dispute Resolution (ADR) services, in absence of which a matter could be expensive and time consuming for individuals or businesses involved in commercial disputes with a third party.

9. Litigation Consultancy

Company Secretaries are eligible to be engaged in litigation and assisting with evidence, strategy and case preparation. Computer Forensics: Assisting in electronic data recovery and enforcement of IP rights etc.

10. Computer Forensics

A Company Secretary is trained in assist in electronic data recovery and enforcement of IP rights etc.

Power and Duties of Auditors and Accounting Standards

Section – 143 of Companies Act, 2013 talks about the power and duties of auditors and auditing standards. It reads: “Every auditor of a company shall have a right of access at all times to the books of account and vouchers of the company, whether kept at the registered office of the company or at any other place and shall be entitled to require from the officers of the company such information and explanation as he may consider necessary for the performance of his duties as auditor and amongst other matters inquire into the following matters, namely: –

- a. whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;
- b. whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;
- c. where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;
- d. whether loans and advances made by the company have been shown as deposits;
- e. whether personal expenses have been charged to revenue account;
- f. where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading;

Provided that the auditor of a company which is a holding company shall also have the right of access to the records of all its subsidiaries and associate companies in so far as it relates to the consolidation of its financial statements with that of its subsidiaries and associate companies.

2. The auditor shall make a report to the members of the company on the accounts examined by him and on every financial statements which are required by or under this Act to be laid before the company in general meeting and the report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of this Act or any rules made there under or under any order made under sub-section (11) and to the best of his information and knowledge, the said accounts, financial statements give a true and fair view of the state of the company’s affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed.
3. The auditor’s report shall also state –
 - a. whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;
 - b. whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;
 - c. whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company’s auditor has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;

- d. whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;
 - e. whether, in his opinion, the financial statements comply with the accounting standards;
 - f. the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;
 - g. whether any director is disqualified from being appointed as a director under sub-section (2) of section 164;
 - h. any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;
 - i. whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls;
 - j. such other matters as may be prescribed.
4. Where any of the matters required to be included in the audit report under this section is answered in the negative or with a qualification, the report shall state the reasons therefor.
 5. In the case of a Government company, the Comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.
 6. The Comptroller and Auditor-General of India shall within sixty days from the date of receipt of the audit report under sub-section (5) have a right to, –
 - a. conduct a supplementary audit of the financial statement of the company by such person or persons as he may authorize in this behalf; and for the purposes of such audit, require information or additional information to be furnished to any person or persons, so authorized, on such matters, by such person or persons, and in such form, as the Comptroller and Auditor-General of India may direct; and
 - b. comment upon or supplement such audit report:

Provided that any comments given by the Comptroller and Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub section (1) of section 136 and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.
 7. Without prejudice to the provisions of this Chapter, the Comptroller and Auditor-General of India may, in case of any company covered under sub-section (5) or sub-section (7) of section 139, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company and the provisions of section 19A of the Comptroller and Auditor-General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.
 8. Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country

and the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed:

Provided that the branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.

9. Every auditor shall comply with the auditing standards.
10. The Central Government may prescribe the standards of auditing or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority:

Provided that until any auditing standards are notified, any standard or standards of auditing specified by the Institute of Chartered Accountants of India shall be deemed to be the auditing standards.

11. The Central Government may, in consultation with the National Financial Reporting Authority, by general or special order, direct, in respect of such class or description of companies, as may be specified in the order, that the auditor's report shall also include a statement on such matters as may be specified therein.
12. Notwithstanding anything contained in this section, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within such time and in such manner as may be prescribed.

Provided that in case of a fraud involving lesser than the specified amount, the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as may be prescribed:

Provided further that the companies, whose auditors have reported frauds under this sub-section to the audit committee or the Board but not reported to the Central Government, shall disclose the details about such frauds in the Board's report in such manner as may be prescribed.

13. No duty to which an auditor of a company may be subject to shall be regarded as having been contravened by reason of his reporting the matter referred to in sub-section (12) if it is done in good faith.
14. The provisions of this section shall mutatis mutandis apply to –
 - a. The cost accountant in practice conducting cost audit under section 148; or
 - b. The company secretary in practice conducting secretarial audit under section 204.
15. If any auditor, cost accountant or company secretary in practice do not comply with the provisions of sub-section (12), he shall
 - (a) in case of a listed company, be liable to a penalty of five lakh rupees; and
 - (b) in case of any other company, be liable to a penalty of one lakh rupees.

Henceforth in accordance with Section 143 the Power and Duties of a Company Secretary could be as below:

Powers of Auditor

1. **Right to access:** Every auditor of a company shall have right to access at all time to book of accounts and vouchers of the company. The Auditor shall be entitled to require from officers of the company such information and explanation as he may consider necessary for performance of his duties. There is an inclusive list of matter for which auditor shall seek information and explanation. The list includes issues

related to: (a) Proper security for Loan and advances, (b) Transaction by book entries, (c) Sale of assets in securities in loss, (d) Loan and advances made shown as deposits, (e) Personal expenses charged to revenue account, (f) Case received for share allotted for cash. The auditor of holding company also has same rights.

2. **Auditor to sign audit reports:** The auditor of the company shall sign the auditor's report or sign or certify any other document of the company and financial transactions or matters, which have any adverse effect on the functioning of the company mentioned in the auditor's report shall be read before the company in general meeting and shall be open to inspection by any member of the company.
3. **Auditor in General Meeting:** It is a prime requirement under section 146, that the company must send all notices and communication to the auditor, relating to any general meeting, and he shall attend the meeting either through himself or through his representative, who shall also be an auditor. Such auditor must be given reasonable opportunity to speak at the meeting on any part of the business which concerns him as the auditor.
4. **Right to remuneration:** The remuneration of the auditor of a company shall be fixed in its general meeting or in such manner as may be determined therein. It must include the expenses, if any, incurred by the auditor in connection with the audit of the company and any facility extended to him but does not include any remuneration paid to him for any other service rendered by him at the request of the company.
5. **Consent of auditor:** As per Section 26, the company must mention in their prospectus the name, address and consent of the auditors of the company.

Duties of Auditors

1. **Fraud Reporting:** Among others, fraud reporting is one of the major duties of a Company Secretary in the context of forensic audit. If an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within such time and in such manner as may be prescribed. During the Performance of his duties against Corporate Frauds, a Company Secretary should keep a pace with the following-

A. Offence of Fraud Non-Compoundable

As the punishment for Fraud is both imprisonment and fine, it is considered a non-compoundable offence. It shows that, the commission of Fraud has become a serious offence in the eyes of law. The Act has provided punishment for fraud under Section 447 and around 20 sections of the Act talk about fraud committed by the directors, key managerial personnel, auditors and/or officers of company. Thus, the new Act goes beyond professional liability for fraud and extends to personal liability, if a company contravenes such provisions. Here, the contravention of the provisions of the Act with an intention to deceive are also considered as fraud, to name a few acts amounting to fraud-

- Furnishing of false information at the time of incorporation of company by promoters, first directors or any other person – Section 7(5)&(6)
- Managing the affairs of the non-profit company fraudulently – Section 8(11)
- Misrepresenting any material information in prospectus – Section 34
- Inducing any person fraudulently to invest money – Section 36
- Making of applications for acquisition of any securities in fictitious names – Section 38(1)
- Issue of duplicate shares of company with intent to defraud or deceive – Section 46(5)

- Transfer of any shares by depository or depository participant with an intent to defraud, deceive any person – Section 56(7)
- Concealment of name or misrepresenting the amount of claim knowingly of any creditor – Section 66(10)
- Failure to repay deposit with intent to defraud depositor -Section 75(1)
- Furnishing of false statement, mutilation, destruction of secretarial documents – Section 229
- Conducting business to defraud its creditors, members or any other person – Section 213 (proviso)

B. Punishment for Fraud (section 447)

Section 447 reads that 'Without prejudice to any liability including repayment of any debt under this Act or any other law for the time being in force, any person who is found to be guilty of fraud, shall be punishable with imprisonment for a term which shall not be less than six months but which may extend to ten years and shall also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to three times the amount involved in the fraud:

Provided that where the fraud in question involves public interest, the term of imprisonment shall not be less than three years.'

C. Punishment for False Statement (Section 448)

If in any return, report, certificate, financial statement, prospectus, statement or other document required by, or for, the purposes of any of the provisions of this Act or the rules made thereunder, any person makes a statement, –

- which is false in any material particulars, knowing it to be false; or
- which omits any material fact, knowing it to be material.

He shall be liable under section 447.

D. Punishment for False Evidence (Section 449)

If any person intentionally gives false evidence –

- upon any examination on oath or solemn affirmation; or
- in any affidavit, deposition or solemn affirmation in or about winding up of any company under this Act, or otherwise in or about any matter arising under this Act.

He shall be punishable with imprisonment for a term which shall not be less than three (03) years but which may extend to seven years (07) and with fine which may extend to ten lakh rupees (Rs. 10 Lacs).

E. Punishment where no specific penalty or punishment is provided (Section 450)

If a company or any officer of a company or any other person contravenes any of the provisions of this Act or the rules made thereunder and for which no penalty or punishment is provided elsewhere in the Act, they shall be punishable with fine which may extend to ten thousand rupees (Rs. 10,000) and where the contravention is continuing one, with a further fine which may extend to one thousand rupees (Rs. 1,000) for every day after the first during which the contravention continues.

F. Punishment in case of Repeated Default (Section 451)

If a company or an officer of a company commits an offence punishable either with fine or with imprisonment and where the same offence is committed for the second or subsequent occasions within a period of three (03) years, then, that company and every officer thereof who is in default shall be

punishable with twice the amount of fine for such offence in addition to any imprisonment provided for that offence. This section is not applicable to the offence repeated after a period of three (03) years from the commitment of first offence.

Fraud Reporting Procedure

Rule 13 of Companies (Audit and Auditors) Rules, 2014 contains the operational procedure for reporting of Fraud prescribed in Section 143(12) of the Act. If the statutory auditor detects any Fraud, it is his duty to inform the same to the Audit Committee or the Board of Directors, seeking their reply within forty-five (45) days. After receiving the aforesaid reply, he has to forward his report to the Central Government within fifteen (15) days of receipt of such reply or observations. Even in the case of no reply from the Audit Committee or the Board of Directors he has to forward his report along with his comments to the Central Government within stipulated time frame. Similar provisions of Fraud Reporting are applicable to the cost auditor and the secretarial auditor.

- 2. Make report:** The auditor shall make a report to the members of the company on accounts examined by him on every financial statement and shall state:(a) Whether he has sought and obtained all the necessary information and explanations, (b) Whether proper books of account have been kept, (c) Whether company's balance sheet and profit and loss account are in agreement with books of accounts and returns.
- 3. Audit report of Government Company:** The auditor of the government company will be appointed by the Comptroller and Auditor-General of India and such auditor shall act according to the directions given by them. He must submit a report to them which should include the action taken by him and impact on accounts and financial statement of the company. The Comptroller and Audit – General of India shall within 60 days of receipt of the report have right to (a) conduct a supplementary audit and (b) comment upon or supplement such audit report. The Comptroller and Audit – General of India may cause test audit to be conducted of the accounts of such company.
- 4. Liable to pay damages:** As per section 245, the depository and members of the company have right to file an application before the tribunal if they are of the opinion that the management or conduct of the affairs of the company are being conducted in a manner prejudicial to the interests of the company. They also have right to claim damages or compensation from the auditor for any improper or misleading statement made in his audit report or for any fraudulent or unlawful conduct.
- 5. Branch Audit:** Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company, or by any other person qualified for appointment as an auditor of the company. The branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.
- 6. Auditing Standards:** Every auditor shall comply with the auditing standards. The Central Government shall notify these standards in consultation with National Financial reporting Authority. The government may also notify that auditors' report shall include a statement on such matters as notified.
- 7. Winding up:** As per section 305, at the time of voluntary winding up of a company it is a mandatory requirement that auditor should attach the copy of the audits of the company prepared by him.

INVESTIGATION MECHANISM

A forensic auditor is required to have special training in forensic audit techniques and in the legalities of accounting issues. A forensic audit has additional steps that need to be performed in addition to regular audit procedures.

Forensic Audit could be done with the adoption of the procedure detailed as below



Step 1 – Accepting the Investigation

A forensic audit is always assigned to an independent firm/group of investigators in order to conduct an unbiased and truthful audit and investigation. Thus, when such a firm receives an invitation to conduct an audit, their first step is to determine whether or not they have the necessary tools, skills and expertise to go forward with such an investigation. They need to do an assessment of their own training and knowledge of fraud detection and legal framework. Only when they are satisfied with such considerations, can they go ahead and accept the investigation.

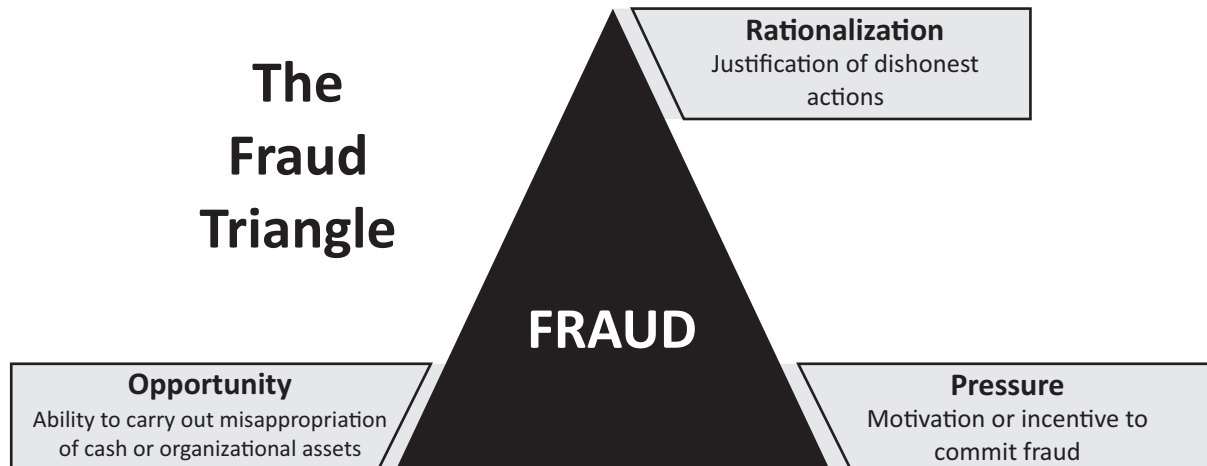
Step 2 – Planning the Investigation

Planning the investigation is the key step in a forensic audit. The auditor(s) must carefully ascertain the goal of the audit so being conducted, and to carefully determine the procedure to achieve it, through the use of effective tools and techniques. Before planning the investigation, they should be clear on the final categories of the report, which are as follows,

- Identifying the type of fraud that has been operating, how long it has been operating for, and how the fraud has been concealed.
- Identifying the fraudster(s) involved.
- Quantifying the financial loss suffered by the client.
- Gathering evidence to be used in court proceedings.
- Providing advice to prevent the recurrence of the fraud.

Fraud Triangle and Fraud Risk

A fraud triangle is a tool used in forensic auditing that explains three interrelated elements that assist the commission of fraud- Pressure (motive), opportunity (ability to carry out the fraud) and rationalization (justification of dishonest intentions). Fraud risk is the vulnerability, a company/organization has towards those who are capable of overcoming the three elements in the fraud triangle. Fraud risk assessment is the identification of fraud risks that exist in the company/organization. The planning involves the formulation of techniques and procedures that align with the fraud risk and fraud risk management.



ACFE Fraud Triangle

Planning also includes the identification of the best way/mode to gather evidence. Thus, it is necessary that ample research is done regarding certain investigative, analytical, and technology-based techniques, and also related legal process, with regard to the outcome of such investigation.

Step 3 – Gathering Evidence

In forensic auditing specific procedures are carried out in order to produce evidence. Audit techniques and procedures are used to identify and to gather evidence to prove, for example, how long have fraudulent activities existed and carried out in the organization, and how it was conducted and concealed by the perpetrators. In order to continue, it is pertinent that the planning stage has been thoroughly understood by the investigating team, who are skilled in collecting the necessary evidence.

The investigators can use the following techniques to gather evidence,

- Testing controls to gather evidence which identifies the weaknesses, which allowed the fraud to be perpetrated
- Using analytical procedures to compare trends over time or to provide comparatives between different segments of the business
- Applying computer-assisted audit techniques, for example, to identify the timing and location of relevant details being altered in the computer system
- Discussions and interviews with employees
- Substantive techniques such as reconciliations, cash counts and reviews of documentation.

Forensic Data Analysis (FDA)

FDA is the technology used to conduct fraud investigations; the process by which evidence is gathered, summarized and compared with existing different sets of data. The aim here is to detect any anomalies in the data and identify the pattern of such anomalies to indicate fraudulent activity. Such an analysis requires three kinds of expertise,

- Data analyst to perform the technical steps and write the queries
- Team member with extensive experience of the processes and internal controls in the relevant area of the investigated company
- A forensic scientist who is familiar with patterns of fraudulent behavior.

Step 4 – Reporting

The reporting stage is the most obvious element in a forensic audit. After investigating and gathering evidence, the investigating team is expected to give a report of the findings of the investigation, and also the summary of the evidence and conclusion about the loss suffered due to the fraud. It should also include the plan of the fraud itself, and how it unfolded, basically the whole trail of events, and suggestions to prevent such fraud in the future.

Step 5 – Court Proceedings

The last stage expands over those audits that lead to legal proceedings. Here the auditors will give litigation support as mentioned above. The auditors are called to Court, and also included in the advocacy process. The understanding here is that they are called in because of their skill and expertise in commercial issues and their legal process. It is important that they lay down the facts and findings in an understandable and objective manner for everyone to comprehend so that the desired action can be taken up. They need to simplify the complex accounting processes and issues for others to understand the evidence and its implications.

TYPES OF INVESTIGATIONS

A fraud investigation tries to determine whether fraud has taken place and tries to detect evidence of fraud has occurred. Fraud is considered to involve misrepresentation with intent to deceive. If a company makes specific promises about a product, for example, in order to sell that product, they may be guilty of fraud if they are aware that the product does not work as advertised. Fraud is a very real and costly problem in today's world, and it causes not only loss of money but also loss of life and serious injuries. Most fraud investigations begin with a meeting between the investigator and the client. The person launching the investigation explains to their investigators why they suspect fraud has taken place and hand over any evidence they have to the investigator. A good fraud investigator will use this initial information to find more evidence and more facts. A fraud investigator may use surveillance, asset searches, background checks, employee investigations, business investigations, and other types of methods to get to the bottom of a case. In most cases, fraud investigations are investigations of white collar crime, which involves surveillance and careful consideration of complicated financial records.

The forensic auditor could be asked to investigate many different types of fraud. It is useful to categorize these investigations into following groups to provide an overview of the wide range of investigations that could be carried out. The three categories of frauds are corruption, asset misappropriation and financial statement fraud.

1. Corruption

There are three types of corruption fraud: conflicts of interest, bribery, and extortion. Research shows that corruption is involved in around one third of all frauds.

- In a conflict of interest fraud, the fraudster exerts their influence to achieve a personal gain which detrimentally affects the company. The fraudster may not benefit financially, but rather receives an undisclosed personal benefit as a result of the situation. For example, a manager may approve the expenses of an employee who is also a personal friend in order to maintain that friendship, even if the expenses are inaccurate.
- Bribery is when money (or something else of value) is offered in order to influence a situation.
- Extortion is the opposite of bribery, and happens when money is demanded (rather than offered) in order to secure a particular outcome.

2. Asset Misappropriation

By far the most common frauds are those involving asset misappropriation, and there are many different

types of fraud which fall into this category. The common feature is the theft of cash or other assets from the company, for example:

- Cash theft – the stealing of physical cash, for example petty cash, from the premises of a company.
- Fraudulent disbursements – company funds being used to make fraudulent payments. Common examples include billing schemes, where payments are made to a fictitious supplier, and payroll schemes, where payments are made to fictitious employees (often known as ‘ghost employees’).
- Inventory frauds – the theft of inventory from the company.
- Misuse of assets – employees using company assets for their own personal interest.

3. Financial Statement Fraud

This is also known as fraudulent financial reporting, and is a type of fraud that causes a material misstatement in the financial statements. It can include deliberate falsification of accounting records; omission of transactions, balances or disclosures from the financial statements; or the misapplication of financial reporting standards. This is often carried out with the intention of presenting the financial statements with a particular bias, for example concealing liabilities in order to improve any analysis of liquidity and gearing.

METHODS OF INVESTIGATIONS

As appears from the previous discussions that a forensic investigation 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.

In the forensic audit, the auditor need to **plan the investigation**, and with this he is required to understand what the focus of the audit is. For example, the organization might be suspicious about possible fraud in terms of quality of raw material supplied. The forensic auditor will plan their investigation to achieve objectives such as:

- Identify what fraud, if any, is being carried out
- Determine the time period during which the fraud has occurred
- Discover how the fraud was concealed
- Identify the perpetrators of the fraud
- Quantify the loss suffered due to the fraud
- Gather relevant evidence that is admissible in the court
- Suggest measures that can prevent such frauds in the company in future.

Further after understanding the possible type of fraud that has been carried out and how it has been committed, **the auditor is required to support the evidence collected with adequacy, enough to prove the identity of the fraudster(s) in court**, reveal the details of the fraud scheme, and document the amount of financial loss suffered and the parties affected by the fraud.

With this, Forensic auditors are required to take precautions to ensure that documents and other evidence collected are not damaged or altered by anyone. Henceforth the forensic audit need be done with specialized method of investigation so that the audit could rear the objective results.

Forensic Audit Investigation Methodology

Forensic investigation is 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. Forensic Investigators are be grounded in accounting, medicine, engineering or some other discipline. Forensic investigation is the examination of

evidence regarding an assertion to determine its correspondence to established criteria carried out in a manner suitable to the court. An example would be a Forensic Audit of sales records to determine the quantum of rent owing under a lease agreement, which is the subject of litigation.

Umeraziz (2014) while discussing the methodology to be followed by fraud/forensic auditors/investigators opines that the examination could be approached from both the angles of whether the fraud could have occurred and whether it could not have occurred. The methodology which he believes that is straight forward as follows:

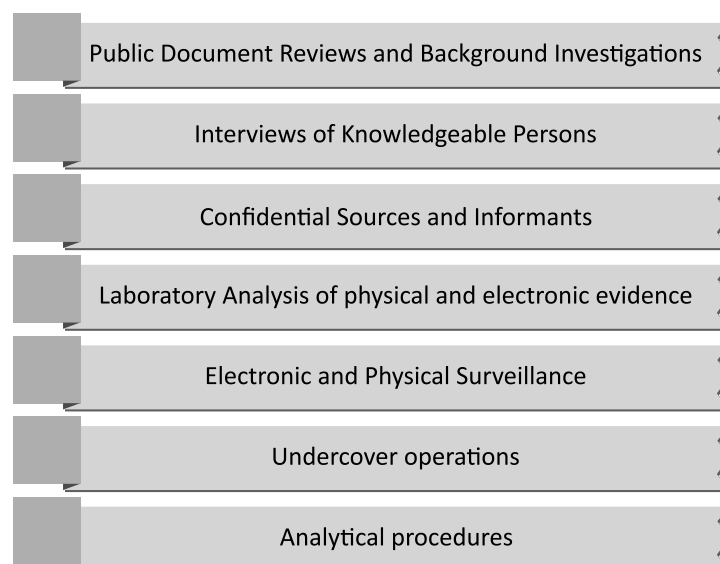
1. Analyzing data which is available
2. Creating a hypothesis based on such data
3. Testing the hypothesis
4. Refining and altering the hypothesis

Common techniques used for collecting evidence in a forensic audit include the following:

1. **Substantive Techniques** – For example, doing a reconciliation, review of documents, etc.
2. **Analytical Procedures** – Used to compare trends over a certain time period or to get comparative data from different segments
3. **Computer-Assisted Audit Techniques** – Computer software programs that can be used to identify fraud
4. **Understanding Internal Controls and Testing** them so as to understand the loopholes which allowed the fraud to be perpetrated.
5. **Interviewing and Interrogation**- Interview and Interrogation are two major techniques in investigation. That are used to elicit responses from the suspect or accused. It should however be noted that the investigator (interviewer or interrogator) cannot usurp the power of the court of competent jurisdiction by pronouncing the suspect or accused guilty. His/her role is to gather evidence that can be used to prove or disprove the act in issue (Fred, John, Joseph, Brian, 2004, Oyedokun, 2014).

Seven Investigative Tools

Further, on forensic audit procedures, there are seven recognized investigative tools and techniques used by forensic specialist / fraud examiners. (Richard 2013)



1. Public Document Reviews and Background Investigations

At the onset of an investigation, the forensic specialist may conduct or engage another specialist to conduct a background investigation of the business; its owners, employees, related parties, competitors; and any potential targets of the investigation. The process continues as new information or new individuals are identified that warrant further investigation.

A background investigation may identify current, historical, and other relevant information that may be helpful to the forensic specialist. Such information may include real and personal property records, corporate and partnership records, civil and criminal records, and stock trading activities on the part of management or board members. Through a review of publicly available records, a forensic specialist may be able to determine or understand possible motives (incentives and pressures) for perpetrating fraud. For instance, a forensic specialist may identify insider trading activities, related party transactions, or businesses owned or controlled by individuals under investigation, which could indicate a conflict of interest.

2. Interviews of Knowledgeable Persons (the witness and the accused)

The primary purpose of an interview is to gather evidence through facts and other information supplied by witnesses. Interviewing is performed throughout an investigation. With each successive interview, the forensic specialist should obtain background information about the witness, the subject matter of the investigation, and the target(s) of the investigation. As a result of the dynamic nature of the investigative process, evidence obtained from all of the investigative techniques employed can provide additional leads and areas to explore in interviews. With each successive interview, new records and additional witnesses may be identified. This progressive approach to the investigation allows peripheral witnesses to be interviewed with the purpose of having the target or targets of the investigation interviewed last.

Forensic specialists who perform attest or litigation services engagements normally do not interrogate individuals in order to obtain admissions of guilt. The primary reason forensic specialists do not normally get involved in interrogations is that legal counsel normally engages forensic specialists and controls the investigation. If a forensic specialist is working under the direction of counsel, one can argue that the target of an investigation may need to have his or her own counsel present. In addition, various legal issues may arise during the course of an interrogation that could complicate the investigation. Last, forensic specialists are fact-finders who may appear to lose their objectivity if they assume the role of interrogator seeking a confession. Although a confession may be elicited based on the evidence produced by the forensic specialist, interrogation is normally reserved for specialists such as polygraph examiners or law enforcement officers.

3. Confidential Sources and Informants

In nearly every organization, there are people who are willing to share information if they can remain anonymous. In a number of cases, confidential sources provide information through employee hotlines and anonymous letters. Additionally, former employees may provide valuable information through letters of resignation and exit interviews.

A confidential source of information may have a hidden motive for providing information. Former spouses, business partners, employees, neighbors, and friends may know specific details, but their reasons for cooperating may be suspect. The confidential source may be providing information that is intended to discredit or embarrass the target. A forensic specialist should weigh the benefit of relying on the evidence against the risk of potential damage to the case if the information is later determined to be false. A prudent forensic specialist, in the interest of exercising professional skepticism, will always attempt to corroborate the information provided by an informant or confidential source.

- 4. Laboratory Analysis of physical and electronic evidence (Physical Forensic Analysis** which includes Handwriting analysis, fingerprint analysis, document dating, ink sampling , simulated forgery of signatures analysis, **Computer Forensics** which includes hard disk imaging, E-mail analysis, search for erased files, analyze use & possible misuse of office computers for personal use, ensure chain of custody for electronic evidence.)

These specialists have the ability to recover previously erased electronic files and documents, and search electronic mail for evidence of fraud. Furthermore, forensic specialists have expertise in using computer technology to analyze numerous transactions, extract statistical samples, format data to apply specific investigative routines, and examine journal entries looking for signs of attempted defalcation or misrepresentation of financial statement balances.

- 5. Electronic and Physical Surveillance**

Law enforcement agencies routinely conduct physical and electronic surveillance. Private investigators and other specialists also perform these techniques under limited circumstances. A forensic specialist may recommend physical or electronic surveillance and, if appropriate, that counsel consider using one or both of the above techniques. Surveillance is primarily used to monitor people; however, the forensic specialist may turn to similar techniques for observing places or objects, such as a loading dock after business hours to determine whether inventory or equipment is being removed without authorization. The forensic specialist may also recommend that a client install surveillance cameras to protect vulnerable areas of the company, such as inventory loading and storage areas and cashier's areas.

- 6. Undercover operations**

Law enforcement agencies may use agents or officers to conduct undercover operations. Additionally, private investigators may use this technique in limited circumstances. By putting agents or private investigators in direct contact with alleged perpetrators, this technique can be an effective way to obtain first-hand knowledge of the details surrounding a fraud scheme. In most instances, forensic specialists would not participate in an undercover operation, but may recommend to the client that they consider employing this technique. Nevertheless, there have been instances in which specialists, positioned inside organizations, were able to uncover sufficient evidence of fraudulent behavior by first gaining the trust of perpetrators.

- 7. Analytical procedures (Using of Ratio analysis, Trend or time series analysis, Horizontal and vertical analysis and use of work-back ratios techniques to analyze financial statement)**

The forensic specialist's knowledge of fraud schemes and indicia of fraud is invaluable in performing analytical procedures. Forensic specialists can use a variety of analytical procedures in conducting a fraud investigation. Examples include analyzing manual journal entries for improprieties, calculating comparative ratios to analyze trends in the business, or reviewing individual or group-related transactions to check for improprieties. Also, fictitious vendors and employees can be identified, indicating that improper payments were made. Finally, investigations of sales returns and allowances can indicate the padding of sales figures.

Reporting – A report is required so that it can be presented to a client about the fraud. The report should include the findings of the investigation, a summary of evidence, an explanation of how the fraud was perpetrated, and suggestions on how internal controls can be improved to prevent such frauds in future. The report needs to be presented to a client so that they can proceed to file a legal case if they so desire.

Finding Facts and Conducting Investigations: A Process Exemplified

International Anti-Corruption Resource Center, a Non-Profit Organization, headquartered in Washington DC has provided for some basic steps of a complex fraud and corruption investigation, that one can follow for finding facts in the case of fraud and alike.

The Basic Steps of a Complex Fraud and Corruption Investigation

The steps as provided below are generally applied to administrative investigations by international development agencies that lack law enforcement powers to compel evidence from third parties by subpoena or otherwise. Development organizations including corporates, can, however, expand their access to evidence by referring cases to law enforcement agencies for assistance, as discussed below.

(A) Preliminary Matters

Use the “Case Theory” approach to investigations

It is essential that every investigator or prosecutor develop and follow a “theory of the case” when investigating complex corruption and fraud offenses. The Case Theory approach to complex investigations is second nature to most investigators, at least the successful ones, but is misunderstood or neglected by others, with disastrous results. It is similar to the scientific method of experimentation, and involves the following steps:

- Analyze the available data to create an hypothesis;
- Test it against the available facts;
- Refine and amend it until reasonably certain conclusions can be drawn.

Expressed somewhat differently, the approach begins with an informed assumption or guess, based on the available evidence, of what the investigator thinks may have happened, which is then used to generate an investigative plan to test – prove or disprove – the assumption. It is best illustrated by example:

Example of the Case Theory Approach

Investigator One receives anonymous allegations of corruption in the award of government contracts. He pursues the case with no case theory or investigative plan. He asks a dozen witnesses if they have any knowledge of payoffs; none do (this is not unusual). He subpoenas the contract files and whatever else he can think of but sees no smoking gun as he flips through them (this is even less unusual). He confronts the suspect, who denies any wrongdoing. The investigator does not know what else to do. He has assembled a thick file and an impressive command of the contracts, but can prove nothing. Investigator Two pursues the same case, using the Case Theory approach:

- He analyzes the available data – the details of the allegations;
- Creates a simple, initial hypothesis or theory, e.g., company A is paying kickbacks to government official B for government work;
- Makes assumptions which can be used to test the theory – e.g., if the allegations are true, official B would be expected to:
 - Favor Company A in buying decisions
 - Bend or break the rules to award contract to Company A
 - Display sudden new wealth or have unexplained income.

Investigator Two uses his hypothesis to organize the investigation, i.e., looks for evidence to confirm or rebut the theory (initially, this evidence is often the “red flags” of the suspected offense.)

The Case Theory approach generates the investigative plan (see if a, b or c occurred) and if the theory is correct, evidence of guilt. If not, the investigator may amend his theory, e.g., company C is paying official A, and try again. This approach also enables one to prove, to a certain extent that a suspected act did not occur. Investigator One, after inter-viewing a dozen witnesses, did not know if bribes had been paid or not, only that he could not prove it. Investigator Two, however, can have some assurance that the alleged acts did not take place, if no evidence appears in support of his test assumptions. Remember, the Case Theory approach is simply an investigative tool to generate a hypothesis that can organize and direct an investigation, based on the information available at the time. It should not be treated as evidence itself. Do not be too committed to any particular theory and be ready to amend or abandon it as necessary.

Learn the elements of proof for the suspected offenses

Memorize the elements of proof for each of the suspected offenses, based on your theory of the case, and use them to organize the investigation and test the sufficiency of the evidence. An investigator should know at every stage of the case what evidence he needs to obtain to prove an offense. Again, many investigators neglect this fundamental rule, with the result that too little (or too much irrelevant) evidence is collected.

Carefully organize and maintain the evidence

Use charts and graphs, spreadsheets and summaries as necessary to organize and analyze complex data, but be careful not to overdo this exercise at the expense of having time to pursue leads and pursue your theory of the case. Make sure that all evidence is properly logged in, secured and accounted for, including electronic evidence, and that the source of the evidence is recorded.

Prepare the case chronology

Preparing a Chronology of Events – putting the important facts in the order they occurred – is always helpful, particularly to prove knowledge and intent and to see how a case unfolds. Concisely record the date, the event or document, and the source of information in separate columns. Include important meetings, telephone calls, email communications, travel, key documents and other potentially important events. Keep the chronology simple and focused on potentially relevant evidence – too much extraneous information will reduce its utility – and review and update it regularly. Add new information as the investigation proceeds and remove what is shown to be irrelevant.

(B) The Basic Steps of a Complex Investigation

The information below illustrates basic steps in a typical complex procurement fraud case. Most significant fraud and corruption cases occur in procurement. Ofcourse the steps are general suggestions that can be adjusted to one’s situation. Some cases will require fewer steps, others perhaps more or different, such as requesting legal assistance, which is not addressed here.

The **TEN Steps** that are generally required for finding facts in a case of frauds and corruption are listed as below:

STEP ONE: Begin the case (respond to complaint, etc.)
STEP TWO: Evaluate the allegations or suspicions
STEP THREE: Conduct due diligence background checks
STEP FOUR: Complete the internal stage of the investigation
STEP FIVE: Check for predication and get organized
STEP SIX: Begin the external investigation

STEP SEVEN: Prove Illicit Payments
STEP EIGHT: Obtain the cooperation of an inside witness
STEP NINE: Interview the primary subject
STEP TEN: Prepare the final report

STEP ONE: Begin the case (respond to complaint, etc.)

If the case starts with a complaint or report, fully debrief the complainant, getting as much detail as possible. If the case starts with the discovery of a red flag, match the red flag to the potential scheme and then look for other red flags of the suspected schemes. An automated, “proactive” search for fraud indicators might be effective if the necessary data is available.

STEP TWO: Evaluate the allegations or suspicions

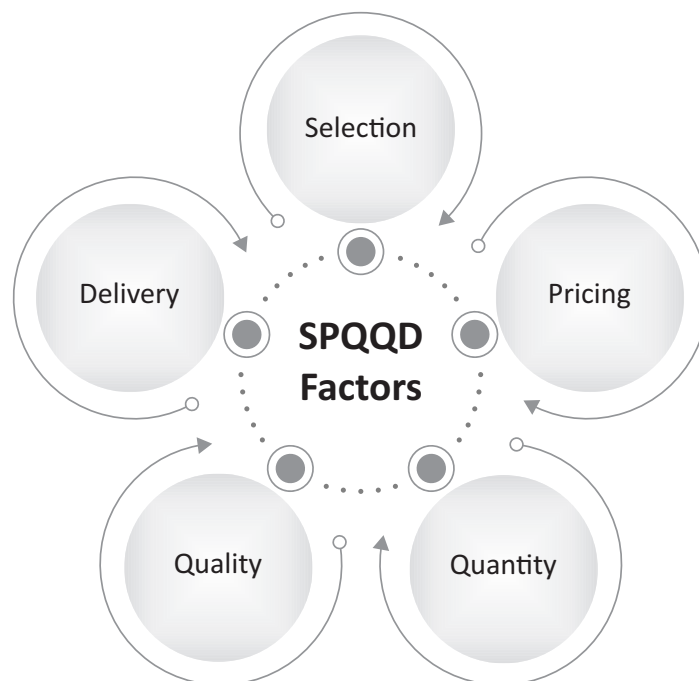
Determine whether the allegations or suspicions – the “Red Flags” – are specific and serious enough to justify an investigation, which can be time consuming, disruptive and costly.

If you determine that a complaint or report warrants further investigation, try to make a quick, preliminary assessment of the accuracy of the complaint. For example, if the complainant alleges that he or she was unfairly disqualified from a tender, examine the relevant project files to attempt to determine if this may have occurred. Use this information to prepare for the follow up interview of the complainant.

STEP THREE: Conduct due diligence background checks

Check on-line and other records on the suspect firms and individuals to evaluate the allegations and to look for other evidence of fraud or corruption, such as the presence of shell companies as subcontractors, prior debarments of a contractor or evidence that a project official is living beyond his means.

STEP FOUR: Complete the internal stage of the investigation



Complete the collection of documents, data and interviews within the investigating organization, For example:

- Look in the bidding documents for evidence of corrupt influence through the manipulation of the “SPQQD” factors – Selection, Pricing, Quantity, Quality and Delivery;
- Carefully examine bids and proposals, CVs and other documents submitted by a suspect firm for possible fraudulent representations;
- Access, with the proper authority, the relevant e-mail and computer hard drive information;
- Determine if an early interview of the subject is warranted.

STEP FIVE: Check for predication and get organized

Review the results of the investigation to date to determine if there is adequate “predication” – a sufficient factual basis – to proceed. Decide or refine the initial “Case Theory” and organize the evidence according to the elements of proof of the potential claims. If law enforcement assistance is needed (e.g., to subpoena documents, exercise search warrants or to request legal assistance) take steps to ensure that there is sufficient “probable cause” to obtain such cooperation.

STEP SIX: Begin the external investigation

Conduct interviews of witnesses outside the investigating organization, proceeding from the disinterested, cooperative witnesses to “facilitators” to co-conspirators to the subjects. Request or compel documents from third parties and the suspect contractors through negotiated agreements, the exercise of contract audit rights or, if available with law enforcement assistance, subpoenas or search warrants.

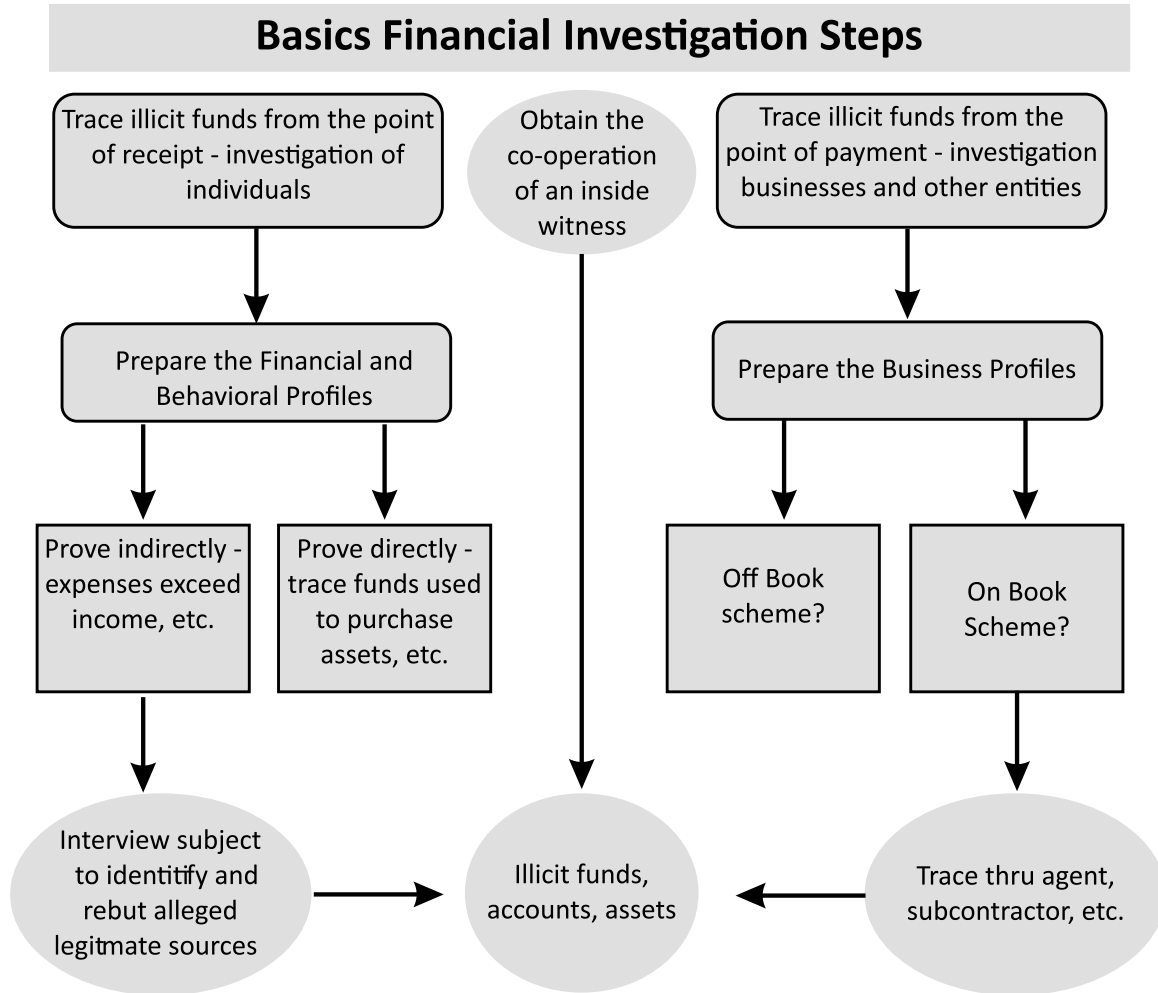
STEP SEVEN: Prove Illicit Payments

Determine the best strategy to prove illicit payments: out from the point of payment (by examining the contractor’s records), or back from the point of receipt (from the suspect employee’s records) and begin the tracing process. If it is not possible to prove the corrupt payments directly, try to prove them circumstantially by showing the subject displayed unexplained sudden wealth or expenditures.

The three primary ways to prove corrupt payments and fraudulent transfers are:

1. Out from the suspected point of payment, i.e., from an examination of the books, records and accounts of the entity suspected of paying bribes or making fraudulent transfers;
2. Back from the suspected point of receipt, i.e., from the accounts and financial records of the person suspected of receiving the illicit funds, or by;
3. Obtaining the cooperation of an inside witness, such as a co-conspirator, middleman or the bribe payer. This approach may be necessary to find well-hidden or laundered payments.

The three approaches are also illustrated in the chart below:



Source: International Anti-Corruption Resource Center (IACRC)

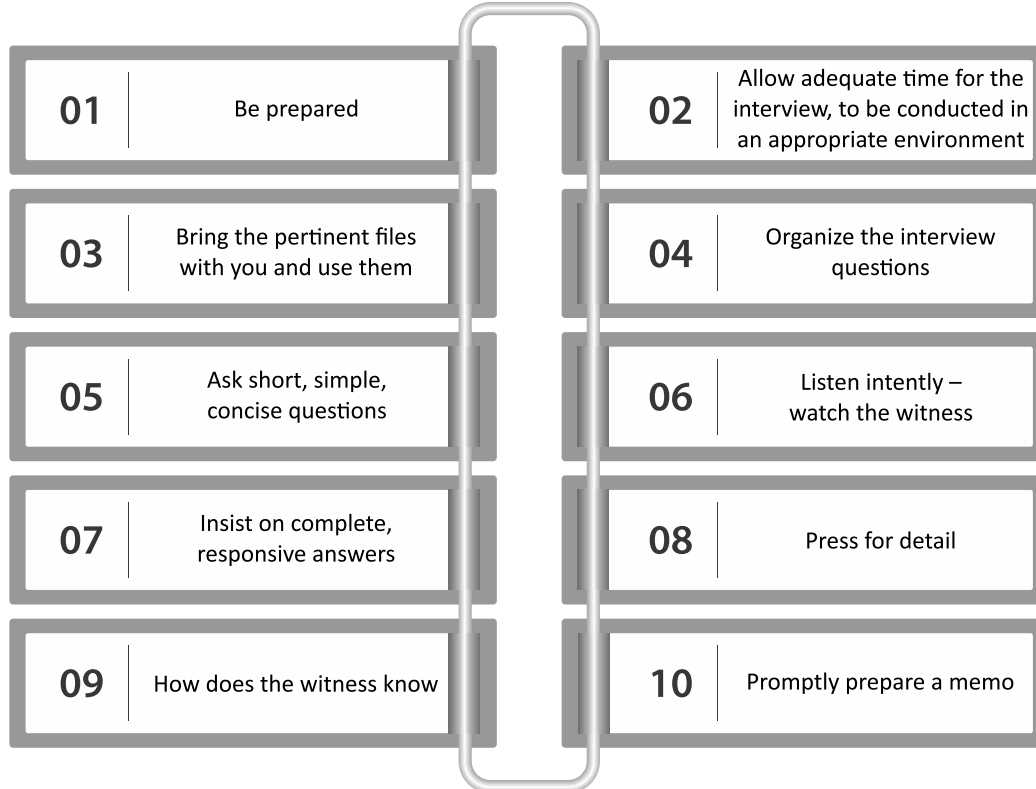
STEP EIGHT: Obtain the cooperation of an inside witness

A Cooperative Witness could be an honest inside observer or a lesser participant in the offense, such as a middleman or the smaller of several bribe payers. Decide the best strategy to obtain his or her cooperation.

Process of Interviewing a Cooperative Witness

The seemingly routine interviews in the early stages of a case are much more important, and not as easy, as they may seem. Therefore, one must organize or structure the way to interview the cooperative witness. A structured and result oriented interview would be one of the biggest strength of the Auditor in realizing rationalizing and proving the things with authentic evidences.

The Ten Most Important Points in Interviewing are listed as below:



1. Be prepared

Master the known facts of the case – review the case files and prior interviews – and decide what you need from the witness to prove the offense or fill gaps. Do not rush into an interview until you are fully prepared. Prepare an outline of the points you want to cover, but do not write out the questions. That will distract you from carefully listening to the witness’s answers and generating useful follow up questions. As the interview progresses, the answers will suggest the next questions.

2. Allow adequate time for the interview, to be conducted in an appropriate environment

Be honest with the witness about how long the interview will take. Most interviews in complex cases take much longer than the witness anticipates. Conduct the interview in a professional environment; do not attempt to interview an important witness at lunch or in another social setting.

3. Bring the pertinent files with you and use them

If the relevant files are voluminous, do the interview where the files are located. As appropriate, show the witness the relevant documents and let him or her review them before answering. Otherwise very important points will be missed or forgotten.

4. Organize the interview questions

Go through the transactions in chronological order – as they occurred – or according to the documents, or in some other logical order, rather than just firing questions at random as they occur to you. If you are not organized there will be gaps in the questioning and you will inevitably forget to ask something important.

5. Ask short, simple, concise questions

Avoid the long, unfocused, repetitive stream of consciousness questions that are typical of an inexperienced

or unprepared investigator. Train yourself to fully cover a particular topic by asking a series of short, simple questions. This is quite important but not easy to do. Short, clear questions make it easier for the witness to understand the question and for you to understand and evaluate the answer. And if the answers are not truthful, it will be easier to impeach the witness and rebut his or her claim that he misunderstood the question.

6. Listen intently – watch the witness

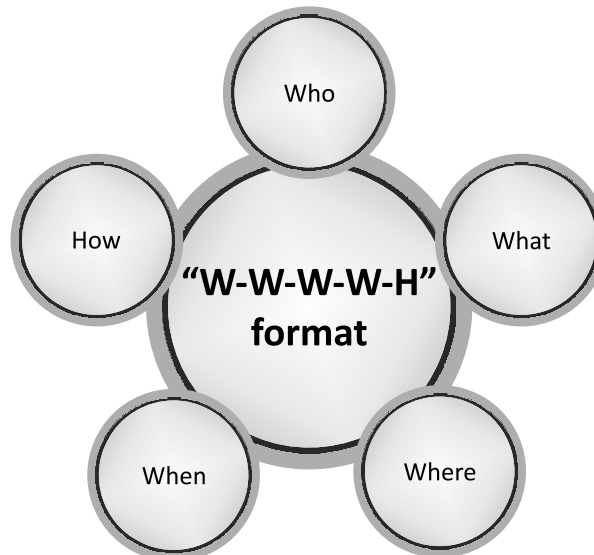
Good interviewers rely more on their eyes and ears than their mouth in interviews. If feasible, have a second investigator attend and take notes so you can concentrate on the witness. Look at the witness (not down at your notes) as he or she answers and think about the answer – is it responsive, complete, plausible? – before asking the next question. There is no need to rush. And don't interrupt the witnesses' answer unless he or she plainly does not understand the question.

7. Insist on complete, responsive answers

As noted above, listen carefully and think about the answer before asking the next question – did the witness really answer the question? Often even well-intentioned witnesses do not – keep asking until you get a proper answer.

8. Press for detail

Follow the journalistic “W-W-W-W-H” format (Who, What, Where, When and How.)



Always get the dates of key events, all the persons present at important meetings, what was actually said (as best the witness can recall, rather than just a summary of the statements) by whom, whether any record of the meetings, exist, and so on. Do not be afraid to ask the big or sensitive questions directly – ask politely, but do not beat around the bush for fear of embarrassing or upsetting the witness.

9. How does the witness know

Ask, politely, how the witness became aware of the information he or she is relating. This will reveal possible unreliable hearsay – uncorroborated information from a third party – and otherwise allow you to evaluate the reliability of the information.

Hearsay information is useful and acceptable during an investigation to generate leads and can lead to important evidence and witnesses. Eventually, however, investigators should try to obtain information from witnesses with direct knowledge of the facts. Direct knowledge means that the witness participated in the event, or observed it directly, or heard about it from the subject. The latter is known as an “admission,” is not hearsay, and often is the best evidence of knowledge and intent.

10. Promptly prepare a memo

Have the witness review and correct the memo if necessary, and to sign it if circumstances suggest he or she might later recant. Delays in preparing the memo can be used to impeach its credibility. Be consistent in your practice of keeping or discarding notes. If your memos do not include everything in your notes, keep them.

The above may not be necessary if the interview is recorded, although a summary memo of the most pertinent points will be useful if the interview is a lengthy one.

Most importantly, remember that even honest, disinterested witnesses can be concerned about retaliation and the personal and business consequences of cooperation. Their decision whether to cooperate, and if so, to what extent, often depends on their assessment of the professionalism, experience and trustworthiness of the interviewer. Present yourself accordingly, in appearance, preparation, poise and interest in what the witness is relating.

STEP NINE: Interview the primary subject

In a corruption case, conduct a thorough interview of the primary subject, usually the suspected bribe recipient. Ask about his role in the suspect contract award and relevant financial issues, such as his sources of income and expenditures. Decide if there is sufficient evidence to obtain a confession; if not, try to get helpful admissions and identify possible defenses (different objectives require different tactics.) Record the interview, if possible, and request all relevant financial and other records. In a fraud case, interview the person most knowledgeable and responsible for the suspected false statement or fraudulent document. Again, decide if there is sufficient evidence to obtain a confession and, if not, try to get helpful admissions and identify possible defenses. These typically include that any false statement was an honest mistake, or that another person was responsible for a fraudulent document. Record the interview if possible.

STEP TEN: Prepare the final report

Decide what action to recommend based on the results of the investigation – an administrative sanction or criminal referral, for example – and prepare a concise final report, organized according to the elements of proof for the relevant offenses.

Note: The steps discussed above assume that the case begins with a complaint about the procurement process, without any specific information about possible illegal payments or fraud. If so, the investigation would typically begin by examining the procurement process to identify leads and eventually evidence of bribery, collusion or other wrongdoing. This is the way most such cases begin and are organized.

In other cases the investigation may begin with reports that a public official is displaying unexplained wealth or living beyond means, suggesting possible corruption, without reference to any particular procurement abuses. In that case, the forensic auditor must reverse the investigation process by first identifying the illicit financial transactions and then tracing them back to the underlying procurement transactions, if necessary.

RED FLAGS

Red flags are nothing but symptoms or indicator of situation of fraud. A red flag is a set of circumstances that are unusual in nature or vary from the normal activity. It is a signal that something is out of the ordinary and may need to be investigated further.

Definition of Red Flag for Forensic Audit

Red flags are nothing but symptoms or indicator of situation of fraud.

1. A red flag is a set of circumstances that are unusual in nature or vary from the normal activity.

2. It is a signal that something is out of the ordinary and may need to be investigated further.

Significance of Red Flags

Red Flags aids the Auditor's Responsibility to Consider Fraud & Error

1. Effective for all audits relating to accounting periods commencing on or after 1st April 2009.
2. When planning and performing audit procedures and evaluating and reporting the results thereof, the auditor should consider the risk of material misstatements in the financial statements resulting from fraud or error.
3. Two types of misstatements are relevant to the auditor's consideration of fraud:
 - Misstatements arising from misappropriation of assets.
 - Misstatements arising from fraudulent financial reporting.
4. Studies of fraud cases consistently show that red flags were present, but were either not recognized or were recognized but not acted upon by anyone.
5. Sometimes an error is just an error.

Common Types of Red flags

The most common types of Red Flags and fraudulent activity can be categorized as:

1. Employee Red Flags
2. Management Red Flags.

Employee Red Flags are like:

- Employee lifestyle changes: expensive cars, jewelry, homes, clothes
- Significant personal debt and credit problems
- Behavioral changes: these may be an indication of drugs, alcohol, gambling, or just fear of losing the job
- High employee turnover, especially in those areas which are more vulnerable to fraud
- Refusal to take vacation or sick leave
- Lack of segregation of duties in the vulnerable area

Management Red Flags are like

- Reluctance to provide information to auditors
- Managers engage in frequent disputes with auditors
- Management decisions are dominated by an individual or small group
- Managers display significant disrespect for regulatory bodies
- There is a weak internal control environment
- Accounting personnel are lax or inexperienced in their duties
- Decentralization without adequate monitoring

- Excessive number of checking accounts
- Significant downsizing in a healthy market
- Continuous rollover of loans
- Excessive number of year end transactions
- High employee turnover rate
- Unexpected overdrafts or declines in cash balances
- Refusal by company or division to use serial numbered documents (receipts)
- Compensation program that is out of proportion
- Any financial transaction that doesn't make sense - either common or business
- Service Contracts result in no product
- Photocopied or missing documents
- Frequent changes in banking accounts
- Frequent changes in external auditors
- Company assets sold under market value.

GREEN FLAGS

Above discussion on Red Flags says that red flags are symptoms or indicators of fraud, white collar crime or something detrimental to the interest of the organization. To the contrary there are other signals which could also imply the existence of fraud but do not activate alarm bells. Rather they may even lead to a greater sense of assurance and comfort in a scenario which may be potentially infused with fraud. These signals are referred as 'green flags'.

The instance of Green Flags could be helpful in identifying are unusual signs or inconsistencies, but apparently harmless or perhaps even helpful.

During the fraud detection in any organization, the auditors generally look for the red flags for indication and reduction of risk arising due the fraud for the white-collar crimes. These indicators could be shortages in stock, close nexus with third parties, missing documents, shortages in collections etc. On the contrary there could be other symptoms which leads to greater sense of assurance and comfort in a particular situation but which may potentially infuse with fraud. These signals could be termed as GREEN FLAGS. Green flags are in many ways converse to the red flags. They can also be termed as "Too Good to be True" syndrome. Few of the examples for the Green Flags could be:

- Maintenance of excess cash without any shortage
- Unexpected windfall income in certain months
- Unusually high return provided by an investment
- Company performing very well when the overall industry is in slump.

Indicators of Green Flags

1. **Excess cash reported by the cashier:** In one of the unique cases, the cashier always showed excess cash on the cash counts, but never reported any shortage of cash.
2. **Up dation of the records:** Sales and service station jobs statistically moved together in the service station and the sales outlet of a manufacturing entity.

3. **Excessive loyalty of employee:** An accountant / employee paid from his personal balances to make up for a double payment which was inadvertently approved and also paid by him.
4. **High rejection by the Quality Manager:** Rejections were made by the Quality Manager which was as high as the twice the production by the sub-contractor. The sub-contractor was penalized for the rejection of the raw material. The sub-contractor almost lost quarter of his profits for rejection.
5. **Unexpected increase of income in certain situation:** A branded educational institution received unidentified cheques for conducting specialized and popular training workshops and seminars. The cheques were received which did not contain any covering letter mentioning the purpose for which the cheques were sent.
6. **Employee making out of pocket expenses:** Employee went to outstation tour for the company purpose. As per the policy of the company, the employee did not take any advance but made expenses from his personal account. The bills for the expenses incurred were sent to the company almost after two years for reimbursement.

While conducting the audit of financial statement and fraud investigation it is imperative for the auditor to focus his attention not only for the RED Flags but also to draw his attention towards the green flags in the financial statements and the operations in the organization. Ignoring the green flags in the organization and the financial statements may be detrimental and sometimes it is possible that the green flags in the present scenario may result in converting to potential red flags.

PRACTICE MCQ

1. Management Red Flags is/are-
 - a. Management decisions are dominated by an individual or small group
 - b. Managers engage in frequent disputes with auditors
 - c. Reluctance to provide information to auditors
 - d. **All of the above**
2. Payment to vendors who aren't on an approved vendor list, a -
 - a. Management Red flag
 - b. **Red flag in purchasing**
 - c. Red flag in payroll
 - d. Red flag in account receivable
3. The Red Flag Rules apply to anyone who deals with-
 - a. Financing and credit
 - b. Retail merchants
 - c. University healthcare practices
 - d. **All of above**
4. Employees with duplicate social security numbers, names and addresses, a-
 - a. Management Red flag
 - b. Red flag in purchasing

- c. Red flag in payroll**
 - d. Red flag in cash/ account receivable
- 5. Which of the following is/are red flags for embezzlement:
 - a. Carrying usually large sum of money**
 - b. Continuous rollover of loans
 - c. Significant downsizing in a healthy market
 - d. Photocopied or missing documents
- 6. _____ are those cheque tempering schemes in which an employee intercepts a company cheque intended for a third party and converts the cheque by signing the third party's name on the endorsement line of cheque.
 - a. Intercepted cheques
 - b. Altered payee schemes
 - c. Authorized maker scheme
 - d. Forged endorsement scheme**
- 7. All of the following are indicators of financial statement fraud except:
 - a. Unusually rapid growth of profitability
 - b. Dependence on one or two products
 - c. Large amounts of available cash**
 - d. Threat of a hostile takeover.
- 8. Which among the following will not be an example of Green flag-
 - a. Auditee nice behavior with auditor during audit (eg. Offering drinks during lunch)
 - b. Auditee is too much friendly with staff and vendors
 - c. Regular receipt of material of same qty
 - d. Employee with few or no payroll deductions**
- 9. Jackson is a receiving clerk at a warehouse. His job is to count the number of units in incoming shipments, record the figures in receiving reports, and forward copies of the reports to the accounts payable department. One day, Jackson received a box of 20 laptop computers at the warehouse. His wife's computer just broke, so he stole one of the com
 - a. An asset transfer scheme
 - b. A purchasing and receiving scheme**
 - c. A non-cash larceny scheme
 - d. None of the above

CASE STUDY**CASE STUDY 1**

Jupiter Hospitals Ltd., (JHL) is a renowned corporate house owning a famous hospital called “Jupiter Hospitals”. Two family groups (L and M) controlled the majority of the shareholdings in the company. The hospital is operated in Coimbatore, a non-metro city, where electronic and cheque transactions were not much high and patients mostly were making payments in cash.

The management of the company facing problems because of some disturbing events taken place during the financial year 2023-24. All these events are summarized as under:

(i) Robbery in Pharmacy :

A robbery took place in the pharmacy in the night of 29-3-2024 and cash of around Rs. 20 lakh was lost in the robbery. The robbers had entered through a window pane during 2 a.m. to 3 a.m. when none was present in the pharmacy. They decamped with all the cash in the cash chest, leaving nothing behind. No traces were found to have left behind by the robbers. Fingerprints were seen on the chest as they had not been wiped off. However, none belonged to an outsider (other than employees). The CC TV camera had turned defective a day earlier being 27-3-2024 and had been given for repairing and accordingly no help was available through CC TV recording.

Two key personnel in the pharmacy, the manager and the cashier, were supposedly doing a good job, showing remarkable growth in the night sales of the pharmacy. It is further to be noted that in nights high priced medicines were sold in huge quantities. The sales in comparison during day time was found to be less. The increase in sales was also having issues and complaints from the patients that the bills issued by the pharmacy for the goods purchased by them and cash received when asked to be verified for onward transmission for making claims, were not authenticated by saying that the same were not issued by the pharmacy. It transpired to the management that the employees involved are being in the habit of issuing the duplicate bills.

It was further reported by the internal stock auditor that there is collection of the expired goods in the pharmacy and why the same has not been got replaced or exchanged from the companies as per policy.

The police who came for investigation hence concluded that the act of robbery might have been done by a North Indian gang who were committing similar crimes in the locality and area and thus closed the case file. Insurance policy for loss of cash in safe had expired on 20-3-2024 and was not been renewed, since it was felt that no robbery would take place in a hospital which is always having movement of patients. The management entrusted the work to a forensic auditor to investigate the issue.

(ii) Related Party Transactions:

There were complaints put in the suggestion box by the various persons that some directors were making money from the purchase contracts which the hospital was entering into with the concerns in which these persons were interested. Till 15th March, 2024, the hospital had made purchases of around 22 crore from such related parties. However, on comparison with the earlier year, this was marginally higher by 5% and was thus not taken care by the management of hospital.

The allegations were that the prices paid were higher than the market prices and that some of the concerns were not reputed and have been earmarked by the drug authorities also.

There was a Purchase Committee which monitored the purchases and so the allegations were initially ignored. However, when they started pouring in, the Audit committee decided to investigate the matter and entrusted the job of ascertaining the correctness of the allegations to the forensic auditor.

(iii) Drop in Hospital Revenues:

There is an arrangement between the two groups of the shareholders that each group will administer the hospital for three years on a rotational basis. Group L's tenure had ended on 31-3-2023 and during the current year, group M had taken over the administration. Despite the number of surgeries and of other patients had not been dropped, there was a sharp fall in the revenues of hospital in the year 2023-24, except from the pharmacy. The cashier desk was managed by a director or his relative for having control over the cash. Group 'L' desires a forensic audit of the affairs to be conducted and entrusts the same to an outside forensic auditor.

In this backdrop you are being appointed as an 'Outside Forensic Auditor' to investigate all the three issues and required to give your report on the matters indicating:

- (a) That it was not a robbery, but defalcation of goods camouflaged as cash sales and subsequent given shape of robbery. You are required to build up all such points from the details given on which you could have come to such conclusion. Make reasonable assumptions in this regard as being found necessary to draw up the report in the matter of robbery as reported.
- (b) In respect of the related party transactions, suggest a suitable strategy to be applied to carry out the forensic audit in an effective manner.
- (c) How the forensic auditor should plan his course of action to investigate and find out the cause of drop in revenue of hospital?
- (d) What are the consequences under the Companies Act, 2013 and Income-tax Act, 1961 when the cause of drop in revenue is being proved?

Solution:

- a) Robbery in the Hospital:** Various points are being build up by the forensic auditor to prove that it was not a robbery. Those points are discussed as below:
- i. The first suspicion is that no clue had been left behind by the robbers, which indicated that there is some collusion because there's nothing like a perfect robbery.
 - ii. The Hospital area is reasonably guarded area. Therefore it seems that it is difficult for outsiders to enter the premises and commit a robbery by breaking in some window open for making the entry.
 - iii. When a small cash chest is opened by fraudster using a duplicate key, it would have left some points or telltale evidence. In this perspective, it is inconceivable that there were none being found.
 - iv. Remarkable increase in night sales is hard to believe because in a hospital more sales take place during the day time.
 - v. The system login details to be seen to find out that the manager and the cashier had logged in during the night hours on the days of purported high night sales, to invoice fictitious sales.

- vi. The date of robbery is few days prior to 31-3-2024, when stock taking would have been done and defalcation of stock would have been detected. To escape this, the manager and the cashier had punched in fictitious sales invoices and generate heavy cash available in the cash chest.
- vii. It is worth to be noted that fraudsters had concentrated on high priced medicines, being sold in the nights –
 - For making their defalcation exercise easier; and
 - For generating cash balance, purported to be shown as being robbed, whereas the same was defalcated.
- viii. In the cash chest, there were no fingerprints of an outsider, because no outsider was involved. A smart robber inside the organization would have wiped off all the fingerprints easily, but not an outsider. This is a case of purported employee collusion where they knew the loopholes in the internal control system which the fraudsters used to their advantage. (Internal Control System Effectiveness needs to be reviewed.)
- ix. In addition to this process, the following factors needs to be looked into by the auditor for corroborating his or her investigation in the matter:
 - For Manager and Cashier, it has to be checked whether a background verification done on them when they were recruited. Auditors to check that.
 - How many years of service, the Manager and Cashier has rendered to the hospital.
 - Were there any previous records against them?
 - They also need to be interviewed to get some details about them and their personal life.
 - A market intelligence team could be deployed to check on their lifestyles to see if there is a sudden change.
- x. The CCTV had not turned defective by its own. This was done by the two fraudsters deliberately and not got repaired immediately, so that there is no evidence through the CCTV available for this act. Further, all the CCTV cameras needs to be checked to see if there was any trace of people entering the premises at the time of robbery.

It is further to be seen by the auditor regarding the compliant of the customers as to the issue of duplicate bills. This indicates that the low price sale had been complying in high value sales by having duplicate bills. The modus operandi in this respect needs to be looked into under the light of following perspectives:

- On what basis duplicate bills were issued.
- How many duplicate bills were issued during the month?
- Was it issued only during night sales?

The increase in the items of the dead and expired goods in the pharmacy may attract the attention of the auditors to find out the reasons. It is also possible that the employees involved had purchased such goods from the market and piled up in pharmacy so that stock inventory gets tallied on 31-03-2024.

b) Related Party Transactions: The Forensic Auditor to investigate such transactions may adopt the following strategy:

- i. The register of contracts (form MBP-4) maintained under section 189 of the Companies Act, 2013 should be seen first. There is a specific query as to whether the transactions are at arm's length. The reply for the same is to be seen carefully.
- ii. The Minutes of the various Board meetings in which the said Register was placed for the approval of the Board must be looked into, in order to find out the number of directors who had voted against the transactions or directors remaining neutral. The Auditor should have conducted interviews with them to ascertain their views. The reasons for voting against or remaining neutral could be crucial to the issue on hand. The remarks column, if found filled up in MBP-4, then merits special attention of the Forensic Auditor.
- iii. The manner of working of the Purchases Committee must be looked into. The minutes of meetings of Purchase committee to be referred to ascertain the procedure for selection of vendors. The criteria based on which the Committee had short listed the related party concerns must be seen. Whether aspects such as qualifications, experience, etc. were met with, are to be seen. Whether competitive quotations were obtained should be seen, including the aspect of whether bids were received from other reputed companies or not. Vendor comparison sheet should be reviewed.
- iv. In respect of the quotes found higher, it is essential to ascertain as to who such parties were provided with higher quote. Whether there was collusive bidding to deliberately present a higher price, so as to make the prices of related party concerns lower, should be seen. In order to find out collusive bidding, one under to undertake the following activities:
 - Analyze the purchase contracts entered into in the last 5 years to comprehend since when contracts started getting awarded to related concerns.
 - A disk imaging of the procurement/ committee head and his team members should be performed. The emails and other communications needs to be reviewed to identify any red flags.
 - Identify vendors who have been blacklisted or discontinued in the last 5 years and contact them to understand the reason for blacklisting or discontinuation.
 - Is there any conflict of interest angle needs to be checked, i.e. any relationship exists between purchase committee members and the UBOs of the companies to whom contracts were awarded?
- v. Since the value of contracts with related parties exceeds Rs. 20 crores, the domestic transfer pricing provisions of the Income-tax Act, 1961 will apply and be examined in this perspective. However, for the current year, domestic transfer pricing report of an auditor may not be available; the report of the earlier years will be useful.
- vi. It should be seen how the Company had treated the related party transactions in the return of income. If the company had determined the arm's length price (ALP) at lower prices and thereby voluntarily agreed for primary adjustments. This will be very good evidence to intricate collusion and loss.
- vii. If any Income Tax Assessment of any earlier year in which domestic transfer pricing was involved has been concluded, the income-tax assessment order, including all assessment correspondences must be seen. Forensic auditor will get valuable information from the same.

c) Drop in Hospital Revenues

- i. Major avenues from which Jupiter Hospital derives income need to be examined such as from surgery and room rent, from laboratory and Scan & X-Ray Unit and from OPD Patients.
- ii. Hospital rate charts for last 3 years needs to reviewed and compared with current year to see if there is any major negative variance.
- iii. The register of patients maintained at the three wings being surgical ward laboratory, scan and X – Ray and OPD must be verified. The same should be compared with the earlier year to compare the number of patients.
- iv. Bank account in which payments get credited from patients' needs to be reviewed.
- v. Bank and revenue account needs to be reconciled to see payment received has been completely accounted.
- vi. Invoices/Bills to be reviewed to see if there are any red flags.
- vii. Given that there is an increase in the number of patients opting for surgery, visiting the laboratory and using the scan facilities has not diminished, it is unlikely that there will be a reduction in the surgery fees charged (It is most likely that there will be a hike).
- viii. In this scenario, the only obvious thing is that the receipts are under invoiced/ billed. Given that a director or his relative sits at the cash counter, this could easily happen.
- ix. Reason for appointing a director or relative as Cashier needs to be checked.
- x. Auditor should interview some patients who had recently undergone surgery, visited the lab, etc., to ascertain how much they have actually paid and what amount was stated in the receipt issued to them. Further, the auditor can interview employees or former employees so as to get some insider information.
- xi. The Auditor may found that for surgeries, a mere acknowledgement was issued to patients which merely stated that they had paid the amount. There was no issue of proper receipt. Later on the receipts were prepared for lower amounts by Group M, so as to lower down the revenue and deflection of cash.
- xii. For the lab, receipts issued are to be looked into as no test took place prior to the issue of the receipts.
- xiii. Can arrange for some known persons to use the hospital facilities and gather live evidence as to payments and receipts issued and the modus operandi employed by the cashier.

The cumulative effect of the above leads to the inescapable conclusion, to be taken by the Forensic Auditor in his report that Group M had been suppressing the receipts of the hospital and same being drawn by them through the cashier's desk which was managed by their relative and to falsify, the drop in the revenue.

d) Consequences of the Detection of Fraud**Under the Companies Act, 2013**

Considering the consequence of corporate frauds on the growth of Corporates and Economy, the Companies Act, 2013 lists down frauds and prescribe penalties and punishments for violations.

Suppressing the sales is clearly an act of fraud committed on the company. Section 447 of the Companies Act, 2013 deals with provisions relating to punishment for fraud.

The Section reads that ‘Without prejudice to any liability including repayment of any debt under this Act or any other law for the time being in force, any person who is found to be guilty of fraud, shall be punishable with imprisonment for a term which shall not be less than six months but which may extend to ten years and shall also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to three times the amount involved in the fraud Provided that where the fraud in question involves public interest, the term of imprisonment shall not be less than three years.

The Companies Act, 2013 has provided punishment for fraud as provided under Section 447 in around 20 sections of the Act e.g. u/s 7(5), 7(6), 8(11), 34, 36, 38(1), 46(5), 56(7), 66(10), 75, 140(5), 206(4), 213, 229, 251(1), 266(1), 339(3), 448 etc. for directors, key managerial personnel, auditors and/or officers of company.

Under the Income - Tax Act, 1961

- Suppression of revenues will result in concealment of income by way of under reporting and negative reporting of the income.
- Concealment will lead to levy of penalty u/s 270 of the Income Tax, 1961, which may be of 300% of the tax on such income.
- Prosecution may also be launched on all the officers involved.

CASE STUDY 2

Thrivikram Dazzlers (TD) is a reputed diamond jewellery merchants in existence for the past two decades. Their jewellery store was located at Chennai and the branch was also operated at Mumbai.

TD had been regularly dealing with a client at Delhi named Sunil Raina & Co., (SR). SR generally electronically transfers funds to TD for purchases. An employee “EM” of them then would visit TD and take delivery of the jewellery ordered. EM had become familiar to TD, having been visiting the shop for the last three years regularly. On 24-3-2024, there was an electronic transfer of funds from SR for a sum of Rs. 16 lakhs. EM produced a letter in the company’s letter head which stated that the articles purchased were gifts for special clients for certain services rendered and hence requested that invoice be made out in the name of EM for 3 necklaces and that the delivery be effected to EM.

TD mailed to SR and asked for a confirmation regarding supply of goods in the name of EM. A mail was received in reply confirming the same. TD hence complied with the same after receipt of mail from SR.

(a) On 30-3-2024, TD received a phone call from SR asking them why the goods had not yet been delivered despite the payment being made on 24-3-2024. Only then it transpired that EM had defrauded SR and TD.

Both TD and SR approach you, a leading forensic auditor, to conduct a joint forensic audit and submit a report. Both are willing to cooperate with you in providing details and information and records.

- (a) Outline the aspects to be considered of the transaction by the Forensic Auditor for taking course of action in detecting the truth of the employee EM.
- (b) What would have been the course of action, taken by the Forensic Auditor, in case TD is a dealer in consumer products like costly refrigerators, TV sets, etc., and the goods delivered to EM were six costly TV sets?

Solution:**a) Defalcation by employee of customer Sunil Raina & Co., Delhi**

Following aspects are to be looked into by the forensic auditor for taking his course of action in detecting the truth.

- i. TD and SR should be asked to lodge a complaint with police about the incident taken place of taking delivery of goods by EM from TD by having invoice being made in his name.
- ii. The employment records of EM available with SR should be seen and must be looked into by whom he was referred for employment.
- iii. EM's immediate reporting manager needs to be interviewed to understand EM's general conducts during his employment and if there were any issues against him. In order to understand his general conduct, following concerns must be looked into:
 - Did EM keep his Manager in loop when conducting company related transactions?
 - EM's residence needs to be visited to interview few people staying in that area if they know him and his family and their social image.
- iv. His previous employment certificate should also be verified so as to analyze his conduct.
- v. Enquiries should be made to ascertain the service records with the earlier employees of EM in a secret way. It is possible that the earlier employer certificate given by EM to SR is a fake document.
- vi. If the employer really existed, then it should be investigated whether EM had any history of proved or unproved allegations against him during his employment and why he had left the job.
- vii. If the previous employer had not given a clean chit to the auditor then find as how the Human Resource Department of SR had hired him. There could be a collusion here with the HR.
- viii. The authorization letter in SR's letter head should be deeply looked into to find out that whether it is in legitimate company stationery or not? If yes, then a deeper scrutiny of the trial to find out as how EM could get hold of the same, should be investigated. Who signed the same must be seen and authenticity of signature of the person to be verified. If someone other than EM (forged), then here is an accomplice, which should be brought out of records.
- ix. TD sent a mail to SR asking for confirmation of delivery of goods to EM. This shows that a reasonable precaution was taken by TD prior to supply. Forensic Auditor should find out whether TD send such mail to the official email id of SR or to some other email id mentioned in the "authorization letter" produced by EM. If it is an official email id, then TD is not at fault. If it was be the latter, then it could be a case of sheer negligence on the part of TD, or there could be an accomplice for EM in TD shop. These aspects merit attention and deeper scrutiny.
- x. If TD had sent the mail to SR to the official mail id and got back a confirmation mail, who sent it must be investigated. This person is clearly an accomplice of EM. In case of common id, IP address of device from where it is sent to be identified.
- xi. If this employee gave confirmation based on a superior's order, then it is SR which is at fault. In such cases, any act done by any of its employee (EM) will be construed to be act done by an agent, which is binding on the principal SR. TD cannot be held liable in such a situation.

- xii. Checking mobile call logs to ascertain whether he has contacted any other employee in either of the companies.

The Forensic Auditor by applying the aforesaid course of action can find out the truth of the case for making out a report for TD and SR.

b) Where the goods delivered were costly TV sets instead of Jewelry

In such case, apart from the course of action as stated above, the forensic auditor should also look into the following aspects:

- i. How the delivery of goods were taken of?
- ii. Was it in TD's vehicle or was it arranged by EM?
- iii. If TD's vehicle, place of delivery is easy to track, if latter, the vehicle owner should be found out and place of delivery be ascertained the said place can be visited to find out if there is a nearby market for such goods.
- iv. E-way Bills are required under GST law for transportation, since the value of the products exceed Rs 50,000. The e-way bills should also be studied for clues, if any.

CASE STUDY 3

PQR & company are the manufacturers of sophisticated consumer products. They have a system of getting certain work done by Job Workers. The costly raw material will be sent to the Job Worker through the company's transport and delivery challan will be prepared by the Stock Manager and acknowledgement obtained from the Job-workers on delivery. Job Worker will process the material as per the company's instruction and specification and the same will be inspected by the Quality Controller of the company at the premises of the Job Worker; entire quantity of material sent earlier now in semi-finished form will be returned to the company for which the company itself provides their own transport. A reasonable percentage for shortage and wastage and rejections of a maximum of 2% was allowed by the company to the Job Worker. This engagement was established for some years and was found to be working well. Processing charges are paid to the Job Workers on receipt of the processed material along with his challan. However, some complaints have come recently from some sources that some processed materials was selling in the market.

Management is desirous of conducting a Forensic Audit. In the background of aforesaid facts, you are required to:

- (a) Indicate your line of Investigation.
- (b) Do the facts fall to be considered as fraud as per section 447 of the Companies Act, 2013? Discuss.

Solution:

- (a) On going through the case, certain points arise viz. materials sent to job worker are costly and the company itself sends through its transport and brings back by their own transport and returned materials are accounted after deduction at 2% for wastages. It is said that it is their practice.

As an auditor, we planned to have a casual discussion with the Stock Manager on the arrangement that is going on. He explained raw material being costly, it is transported to job worker considering the safety and that after approving the process, the same is brought back by the company itself by certain authorised transporters for safety purpose. On the challan prepared by Job worker while sending back the stock, he clarified that since other document prepared by the Quality controller after allowing 2% for wastage will be accounted as usual and challan of job worker will not be considered. Regarding the wastage, he said that much importance is not given to small things.

We have decided to visit the place where the Job Work process is carried out to know the operation. He is doing the job for PQR Company only. On wastage and rejection, he said that earlier job was carried manually and some wastage or rejection had arisen but now the job is done by latest technology and very rarely wastage or rejection occurs. Now it is clear that there is no wastage and that the entire quantity was going back and therefore a deduction of 2% was unwarranted. To tackle the situation, we have taken the address of the transporters who bring back the materials.

Questioning them and investigating further, the driver of the vehicle admitted that on instruction of stock manager, every time some quantity of the processed material was under dispatch from the Job worker to the factory, a part of it would be unloaded in the premises of the stock manager and the balance alone will be delivered in the office.

With the facts ascertained, the Stock Manager was cornered who accepted that unknown to the management, he was selling the processed material and pocketing money.

The Forensic Auditor has finally unearthed the fraud for management to take action.

(b) Fraud as per Section 447 of the Companies Act, 2013 is defined as below:

- i. In relation to affairs of a company or a body corporate, includes any act, any omission, concealment of any fact or abuse of position.
- ii. Committed by a 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.
- iii. Whether or not there is any wrongful gain, or any wrongful loss.

On the strength of the facts found in this case, fraud u/s 447 of the Companies Act, 2013 is established.

CASE STUDY 4

Raj & Company has been dealing with reputed company's TVs. They are the agents of many company's TVs. They offer instalment systems payments which attracts customers and their turnover has been improving. They have a spacious office where TVs are displayed which naturally tempts the customers to visit and buy. Adjacent to their office they have taken a warehouse to keep stock of TVs received from companies and would draw stocks from the warehouse as and when required. They maintain necessary records like goods received report, sales register and stock statement on daily basis. They have the system of maintaining parallel stock ledger at the office also. There was an outbreak of fire in the warehouse and stocks and records have been completely destroyed. Raj & Company preferred their claim with the underwriters for Rs. 15 lakh being the cost of 50 TVs, which seems to be very high according to Insurance Company. Insurance Company is of the view that the claim requires to be probed before accepting.

They doubt that there is a possibility of manipulation in the claim. If you are appointed as Forensic Auditor What investigation would you follow to detect the genuineness of the claim?

Solution:

The Insurance Company has handed over to us to audit the claim preferred by Raj & Co. All records are completely destroyed along with TVs. The only material available was the parallel stock ledger at the office. After ascertaining the details of their business, we started gathering the information of quantity purchased during the past six months and the sales effected.

On going through the records of parallel register, it is observed that average sale of TVs during the past six months was 20 numbers and the purchases also an average of 20 to 25 numbers. The credit period allowed by the supplier was 30 days and customers are paying through installment and it is also seen cash sales. Raj & Co. says there is a sales drive to earn incentive and sometime they purchase increased quantity and stock in the warehouse so that they do not enter into a stock out situation and therefore, they stock in the warehouse more than 50 TVs.

On going through purchase details and sales pattern, bulk purchase of 40 or 50 numbers had not taken place but still their contention is that they had 50 TVs in the warehouse on the day of the outbreak of fire. Not being satisfied with their explanation, we have decided to inspect the warehouse. It is a small warehouse and considering the size of TV boxes, stacking norm permitted is only three boxes in a column and vacant space needed for human movement. Taking into consideration the storage volume for each model and the space required, they can store the warehouse only 8 columns and the number of TVs cannot exceed at best 24 numbers. When these queries were put up, they were shocked and accepted to reduce the claim unconditionally. It is now left to accept the claim or not since claim was inflated.

CASE STUDY 5

A bank suspects that the stock statements furnished for the 12 months during the FY 2023-24 by Ravana Handlooms, one of its borrowers, do not reflect the true position and that they have been systematically furnishing statements showing higher quantities of various items of stock as compared to the actual quantity present in their godowns, and also that the values have been overstated. The borrower is a registered supplier under the GST law. Their turnover for the year ended 31st March, 2024 is Rs. 3.4 crores and they have filed their return of income on 12th October, 2024.

As a forensic auditor appointed by the bank, how will you go about gathering evidence and what are the documents, statements, returns, etc., you will go through to check the veracity of the stock statements furnished by the borrower?

Solution:

Gathering of Audit Evidence

In forensic auditing specific procedures are carried out in order to produce evidence. Audit techniques and procedures are used to identify and to gather evidence to prove, for example, how long have fraudulent activities existed and carried out in the organization, and how it was conducted and concealed by the perpetrators. In order to continue, it is pertinent that the planning stage has been thoroughly understood by the investigating team, who are skilled in collecting the necessary evidence.

The investigators can use the following techniques to gather evidence:

- Testing controls to gather evidence which identifies the weaknesses, which allowed the fraud to be perpetrated.
- Using analytical procedures to compare trends over time or to provide comparatives between different segments of the business.
- Applying computer-assisted audit techniques, for example, to identify the timing and location of relevant details being altered in the computer system.
- Discussions and interviews with employees.

- Substantive technique such as reconciliations, cash counts and review of documentation.

Documents / Papers etc., to be seen by Forensic Auditor

The Forensic Auditor should verify the following statements/papers/ documents:

1. Analyse the stock held on various dates during the FY 2023-24 and FY 2022-23. The stock statements submitted to the bank themselves may be seen in this regard.
2. Trend analysis of the two years may be carried out from above.
3. The borrower has filed the Income tax return for the AY 2024-25. Since its turnover exceeds Rs. 2 crores, it will be subject to tax audit. Form 3CD should be verified to see the comments of the auditor about valuation of stock. In case, there is any adverse comment or qualification, this will be helpful for further probe.
4. Form 3CD also furnishes quantitative details of stock, which are to be verified by the forensic auditor.
5. Forensic auditor should check whether the quantity as well as value as furnished to the banker tally with those disclosed in the Income-tax return. In case the difference is material, the same justifies strong further action.
6. GST returns filed for each month may be verified. Thus will give an idea of the selling prices of the borrower for various items. By deducting rough Gross Profit margin, the cost of goods sold can be ascertained. The Forensic Auditor can compare the said rates with the rates adopted by the borrower in the Stock statements of various months.
7. Forensic Auditor could conduct a surprise visit of the godown where the stocks are held and undertake a stock verification.

CASE STUDY 6

Vishnu Mobiles Ltd., is a domestic company dealing in mobiles of famous international brands. During August, 2023, the company suspects that its sales volume has come down, thanks to the red flag raised by the Sales Manager. Two persons L and M are handling sales of two famous brands viz., Orange (Costly mobiles) and Bamfung (economy model mobiles). Anonymous letters have come to the company about sudden spurt in the lifestyles of L and M. The company, suspecting acts of collusion and corruption, entrusts the job to you as forensic auditor. What are the types of corruption you will look for?

What will be your course of action as forensic auditor to unearth the misdeeds, if any, committed against the company?

Solution:

Forensic Audit of Corruption Fraud

There are three types of Corruption Fraud: Conflicts of Interest, Bribery, and Extortion. Research shows that corruption is involved in around one third of all frauds.

- In a conflict of interest fraud, the fraudster exerts the influence to achieve a personal gain which detrimentally affects the company. The fraudster may not benefit financially, but rather receives an undisclosed personal benefit as a result of the situation. For example, a manager may approve the expenses of an employee who is also a personal friend in order to maintain that friendship, even if the expenses are inaccurate.

- Bribery is when money (or something else of value) is offered in order to influence a situation.
- Extortion is the opposite of bribery, and happens when money is demanded (rather than offered) in order to secure a particular outcome.

Methodology to be adopted

The following methodology may be adopted by the Forensic Auditor, singly or in combination:

- i. Conducting interviews with the employees of the company, especially in the sales division.
- ii. Encourage the employees to post their views about L and M, in suggestion boxes anonymously kept in this regard.
- iii. Where the company policy permits, check the email history of L and M for the past one year.
- iv. Buyers of the two mobile products are to be interviewed to ascertain whether there is any collusion between any of them and L (or M).
- v. Forensic auditor may obtain SOP for sake for these two mobiles and check whether they have been adhered to by L and M.
- vi. It is possible that L and M have colluded with each other, along with some buyer. Costly products of Orange might have been billed as the other product.
- vii. Confirmation of balances should be obtained from various buyers and cross checked with company records.
- viii. GST returns for the month should be scrupulously checked and any fraud pattern visible therein must be looked into.
- ix. Look for red flags. Were L and M too sincere in their work, without even taking sick leave or going for vacation, even though they were entitled to?
- x. Market Intelligence techniques can be adopted wherein cover agent will visit the suspected person's residence area to get an understanding his lifestyle, discreetly enquire about him with the few people in the area adjoining etc.

CASE STUDY 7

Department of Foreign Trade (DFT) have received complaints from several quarters about one exporter who is alleged to have indulged in book exports (actual exports have not taken place, only the books show as if exports have taken place), against one Duryodhana Jewellers, Surat (DJS).

DFT appointed a forensic auditor (FA) to probe into the matter. The FA came out with a report proving that the complaints received were true. Discuss how the FA would have gone about in the course of his audit to prove the misdeeds of DJS.

Solution:

Forensic Audit of alleged book exports fraud

The Forensic Auditor (FA) will go about examining various aspects connected with the alleged exports of Duryodhana Jewellers, Surat (DJS). Various aspects the Forensic Auditor would have looked into, the documents and records which the Forensic Auditor would have verified and related aspects involved are as under:

- a) Compare the track record of DJS for the past 5 years to see whether there is any alarming increase in the quantum of exports during the current year, as compared to the earlier / previous years.

- b) Verify the details of the alleged buyers for the exported product, to see whether such buyers are located in notified jurisdictional areas for Income tax purposes. In case there are notified jurisdictional areas buyers, deeper scrutiny is required.
- c) Bank records are to be thoroughly scrutinised to see whether there are actual remittances in foreign exchange from the alleged buyers.
- d) Investigate the origin and the manner of utilisation of the alleged remittances received from abroad for the exports. This will help to see whether the same are funnelled out of India for remittances again into India.
- e) Compare the rates shown in the various export invoices with the rates of sellers of similar products who also export.
- f) Production /stock records of DJS to be seen to examine the flow of production. Sales is possible only if stock is held and stock can arise only if they are produced or purchased.
- g) In case the inflow of stock is due to purchases, all the purchase invoices are to be verified.
- h) Related party transactions, if any, should be looked into and in case of any, deeper scrutiny is required.
- i) Form 3CD to be verified to look into transactions with related parties or with persons specified in section 40A (2) of the Income-tax Act, 1961.
- j) GST returns to be checked thoroughly to see how DJS has claimed the refund for GST paid on exports.

FINANCIAL STATEMENT ANALYSIS

Financial statement analysis (or financial analysis) is the process of reviewing and analyzing a company's financial statements to make better economic decisions to earn income in future. These statements include the income statement, balance sheet, statement of cash flows, notes to accounts and a statement of changes in equity (if applicable). Financial statement analysis is a method or process involving specific techniques for evaluating risks, performance, financial health, and future prospects of an organization.

It is used by a variety of stakeholders, such as credit and equity investors, the government, the public, and decision-makers within the organization. These stakeholders have different interests and apply a variety of different techniques to meet their needs. For example, equity investors are interested in the long-term earnings power of the organization and perhaps the sustainability and growth of dividend payments. Creditors want to ensure the interest and principal is paid on the organizations debt securities (e.g., bonds) when due.

There are three major financial statements: the balance sheet, profit-and-loss statement and cash-flow statement. The balance sheet tells you about the assets and liabilities of a company. The profit-and-loss statement tells you about a company's profitability and the cash-flow statement is about the flow of cash into and out of a company.

Balance sheet: The balance sheet shows the assets that a business owns, the liabilities that it owes and the funds contributed by its shareholders.

Assets = Liabilities + Owners' equity.

Assets include land, equipment, inventory, goodwill, patents, brand value, etc. Liabilities include debt (long-term and short-term) and any other payables that a business has. Shareholder funds are in the form of equity and reserves.

A weak balance sheet is one that is saddled with debt. When a business has a strong balance sheet, it has more assets and equity than liabilities. In order to know the balance-sheet strength, can look at the debt-equity ratio.

Profit and loss Statement: As its name suggests, the P&L statement tells about the profitability of a company. The simple formula to calculate profits is Profit (loss) = Revenue - Expenses.

The head 'revenue' generally has two entries: revenue from sales and other income. Other income is the revenue from sources other than the core area of the company's operations. For instance, it could be income from investments, dividends, royalties, etc.

The head 'expenses' constitutes the categories of expenditure such as cost of raw materials, employee costs, etc. On subtracting the total costs from the total revenues, we get the 'operating profit', which is nothing but a company's profit from its core operations.

In order to arrive at the final profit figure, any miscellaneous income or loss is to be added to or subtracted from the operating profit. Finally, net profit is obtained after deducting the tax applicable.

Cash-flow statement

The cash-flow statement shows the movement of cash in a business. While businesses can misstate their profits through accounting jugglery, they can't fudge the movement of cash. Hence, a cash-flow statement provides a true picture of a company's financial health. However, for banks and finance companies, the cash-flow statement is of limited use as they follow a different business model than other types of businesses.

The cash-flow statement has three components: cash flows from operating activities, from financing activities and from investing activities. The statement also mentions the current cash holding of the business.

What need to check in the data is whether flows from operating activities are positive or not. If they are positive, it means that the company is able to generate cash from its operations. If they are negative, it means that the company is losing money. While it may show profits in its P&L statement, negative flows from operations should ring an alarm.

Cash flows from financing activities show the money raised for the company's operations or the money paid towards debt repayment. The former will be a positive number on the statement, while the latter will be a negative number.

Cash flows from investing activities capture the cash used in investments. For instance, a business that has generated surplus cash may park it in a bank fixed deposit. Next year it may withdraw cash from that FD. The former will be a negative number on the statement, while the latter will be a positive number.

The balance sheet, profit-and-loss statement, as well as the cash-flow statement contain the data necessary to guide investors looking to invest in a company. Ratios used in analysing stocks also require figures and data contained in these statements, without which a thorough analysis is impossible. All these statements may be found in the annual reports of companies.

Common methods of financial statement analysis include fundamental analysis, DuPont analysis, and the use of financial ratios. Historical information combined with a series of assumptions and adjustments to the financial information may be used to project future performance.

Analysis of Auditors Report and Opinion

The objective of the reporting phase of a financial audit is to present an informed opinion about a business's financial statements, including whether they conform to generally accepted accounting principles. Even though the report contains only three sections, the impact it can have on the future of a business makes being able to read and understand its contents crucial.

A financial audit report is the final step of an external financial audit. After planning the audit and gathering necessary information, an auditor then must interpret results. Although the information an auditor collects through inquiry, observation, inspection, calculations, comparisons and analysis is “fact,” the report itself expresses the opinion of the auditor.

The introductory section identifies the responsibilities of the company director and the independent auditor. Regardless of how large the company or financial accounting department, the auditor holds the company director responsible for accounting policies, the preparation of financial documents, internal business controls designed to ensure the financial documents are honest and correct and the presentation of financial statements to the auditor. The auditor takes responsibility for expressing an opinion based only on the facts and for complying with ethical and legal auditing guidelines during the planning and information-gathering stages of the financial audit.

Scope of the audit -- the area it covers -- is the second and shortest section. It provides a description of what the auditor has done and includes a blanket statement -- a statement common to and for the most part identical in every audit report -- that specifically states the auditor has examined the financial statements of the business in accordance with generally accepted auditing standards and has performed appropriate tests to make a reasonable assessment of the business's financial processes, internal controls and documents.

Auditor's Opinion

The auditor's opinion is the most important section of the audit report. Here the auditor sums up findings by expressing one of three generally accepted opinions or includes a disclaimer, which means the auditor refuses to give an opinion, most often because the business either can't or won't produce the appropriate documents or information. The most favorable opinion is an unqualified opinion, meaning the company director provided all the necessary financial documents and everything was in order and met all auditing requirements. A qualified opinion means that while the majority of documents were in order, the auditor did find one or two exceptions. An adverse opinion is an opinion no business wants; this negative opinion says the business financial records are inaccurate, incomplete or not in compliance with generally accepted accounting principles.

Analysis of Management Judgement

Management Personal judgement plays a vital role in the preparation of financial records and financial statements. The management may use their judgement in choosing the method of valuation of closing inventory, in calculating the provision for bad debts and in choosing the method of charging the depreciation of fixed assets. Likewise, the application of various accounting concepts and conventions depends upon the personal judgement of the management. Therefore, different meaning and results can be obtained from the financial statements of the same company. Based on the different results, different recommendations may be provided for the growth and development of a business concern.

Problems in Financial Statement Analysis

Lack of an Underlying Theory The basic problem in financial statement analysis is that there is no theory that tells us which numbers to look at and how to interpret them. In the absence of an underlying theory financial statement analysis appears to be ad hoc, informal, and subjective. As Horrigan put it: “From a negative viewpoint, the most striking aspect of ratio analysis is the absence of an explicit theoretical structure. As a result the subject of ratio analysis is replete with untested assertions about which ratios should be used and what their proper levels should be.”

Conglomerate Firms Many firms, particularly the large ones, have operations spanning a wide range of industries. Given the diversity of their product lines, it is difficult to find suitable benchmarks for evaluating their financial performance and condition. Hence, it appears that meaningful benchmarks may be available only for firms which have a well-defined industry classification.

Window Dressing Firms may resort to window dressing to project a favourable financial picture. For example, a firm may prepare its balance sheet at a point when its inventory level is very low. As a result, it may appear that the firm has a very comfortable liquidity position and a high turnover of inventories. When window dressing of this kind is suspected, the financial analyst should look at the average level of inventory over a period of time and not the level of inventory at just one point of time.

Price Level Changes Financial accounting, as it is currently practised in India and most other countries, does not take into account price level changes. As a result, balance sheet figures are distorted and profits misreported. Hence, financial statement analysis can be vitiated.

Variations in Accounting Policies Business firms have some latitude in the accounting treatment of items like depreciation, valuation of stocks, research and development expenses, foreign exchange transactions, installment sales, preliminary and pre-operative expenses, provision of reserves, and revaluation of assets. Due to diversity of accounting policies found in practice, comparative financial statement analysis may be vitiated.

Interpretation of Results Though industry averages and other yardsticks are commonly used in financial ratios, it is somewhat difficult to judge whether a certain ratio is 'good' or 'bad'. A high current ratio, for example, may indicate a strong liquidity position (something good) or excessive inventories (something bad). Likewise, a high turnover of fixed assets may mean efficient utilisation of plant and machinery or continued flogging of more or less fully depreciated, worn out, and inefficient plant and machinery.

Another problem in interpretation arises when a firm has some favourable ratios and some unfavourable ratios and this is rather common. In such a situation, it may be somewhat difficult to form an overall judgment about its financial strength or weakness. Multiple discriminant analysis, a statistical tool, may be employed to sort out the net effect of several ratios pointing in different directions.

Correlation among Ratios Notwithstanding the previous observation, financial ratios of a firm often show a high degree of correlation. Why? This is because several ratios have some common element (sales, for example, is used in various turnover ratios) and several items tend to move in harmony because of some common underlying factor. In view of ratio correlations, it is redundant and often confusing to employ a large number of ratios in financial statement analysis. Hence it is necessary to choose a small group of ratios from a large set of ratios. Such a selection requires a good understanding of the meaning and limitations of various ratios and an insight into the economics of the business.

Guidelines for Financial Statement Analysis

From the foregoing discussion, it is clear that financial statement analysis cannot be treated as a simple, structured exercise. The following point to be taken into consideration while analyse financial statements.

1. **Use ratios to get clues to ask the right questions:** By themselves ratios rarely provide answers, but they definitely help to raise the right questions.
2. **Be selective in the choice of ratios:** Compute scores of different ratios and easily drown into confusion. For most purposes a small set of ratios-three to seven-would suffice. Few ratios, aptly chosen, would capture most of the information that can derive from financial statements.
3. **Employ proper benchmarks:** It is a common practice to compare the ratios (calculated from a set of financial statements) against some benchmarks. These bench marks may be the average ratios of the industry or the ratios of the industry leaders or the historic ratios of the firm itself.
4. **Know the tricks used by accountants:** Since firms tend to manipulate the reported income, should learn about the devices employed by them.

5. **Read the footnotes: Footnotes sometimes contain valuable information.** They may reveal things that management may try to hide. The more difficult it is to read a footnote, the more information-laden it may be.
6. **Remember that financial statement analysis is an odd mixture of art and science:** Financial statement analysis cannot be regarded as a simple, structured exercise. It is a process requiring care, thought, common sense, and business judgment—a process for which there are no mechanical substitutes.

Going Beyond the Numbers

The tools of analysis discussed in this chapter are helpful in making business decisions, evaluating performance, and forecasting future developments. Comprehensive business analysis, however, calls for going beyond the conventional financial measures to consider qualitative factors relevant for evaluating the performance and prospects of a company. The American Association of Individual Investors (AAII) has summarised these factors as follows:

1. *Are the company's revenues tied to one key customer?* If so, the company's performance may decline dramatically if the customer goes elsewhere. On the other hand, if the relationship is firmly entrenched, this might actually stabilise sales.
2. *To what extent are the company's revenues tied to one key product?* Companies that rely on a single product may be more efficient and focused, but a lack of diversification increases risk. If revenues come from several different products, the overall bottom line will be less affected by a drop in the demand for any one product.
3. *To what extent does the company rely on a single supplier?* Depending on a single supplier may lead to unanticipated shortages, which investors and potential creditors should consider.
4. *What percentage of the company's business is generated overseas?* Companies with a large percentage of overseas business are often able to realise higher growth and larger profit margins. However, firms with large overseas operations find that the value of their operations depends in large part on the value of the local currency. Thus, fluctuations in currency markets create additional risks for firms with large overseas operations. Also, the potential stability of the region is important.
5. *Competition.* Generally, increased competition lowers prices and profit margins. In forecasting future performance, it is important to assess both the likely actions of the current competition and the likelihood of new competitors in the future.
6. *Future prospects.* Does the company invest heavily in research and development? If so, its future prospects may depend critically on the success of new products in the pipe line. For example, the market's assessment of a computer company depends on how next year's products are shaping up. Likewise, investors in pharmaceutical companies are interested in knowing whether the company has developed any potential blockbuster drugs that are doing well in the required tests.
7. *Legal and regulatory environment.* Changes in laws and regulations have important implications for many industries. For example, when forecasting the future of tobacco companies, it is crucial to factor in the effects of proposed regulations and pending or likely lawsuits. Likewise, when assessing banks, telecommunications firms, and electric utilities, analysts need to forecast both the extent to which these industries will be regulated in the years ahead, and the ability of individual firms to respond to changes in regulation.

LESSON ROUND-UP

- Forensic Auditing is a new concept that comprises three key ingredients:
 1. Forensic Audit Thinking—in other words thinking forensically
 2. Forensic Audit Procedures—both proactive and reactive
 3. Appropriate use of technology and Data analysis.
- Forensic Data Analysis can be used to Prevent, detect and control fraud along with other irregularities.
- Forensic data analysis is the process of gathering, summarizing, comparing, and aggregating existing different sets of data that organizations routinely collect in the normal course of business with the goal of detecting anomalies that are traditionally indicative of fraud or other misconduct.
- Rightly quoted by honorable Prime Minister during the inauguration of Institute's Golden Jubilee on October 4, 2017 that "Company Secretaries decides the Corporate Culture of India and he felt utmost contented of the fact that Company Secretaries ensures in all the ways that the companies in India follow the laws and regulations, do not mishandle the accounts, and are honest in their work.
- Among all, the role of company secretaries is expending in the era of forensic audit wherein they are crucially assisting in preventing, regulating and penalizing the instance of corporate frauds.
- Right from conducting forensic audit to examining the evidences, from finding the culprit behind the fraud to appearing in the court for submitted the testimony, a Company Secretary is apt in serving his professional excellence as a forensic auditor.
- To summarize, where forensic audit is a detailed engagement which requires the expertise of not only accounting and auditing procedures but also expert knowledge regarding the legal framework, and a forensic auditor is required to have an understanding of various frauds that can be carried out and of how evidence needs to be collected.
- In this context, Company Secretary is a Catalyst in Upholding Good Governance via Forensic Audit.
- Section 143 of Companies Act, 2013 talks about the power and duties of auditors and auditing standards.
- A forensic auditor is required to have special training in forensic audit techniques and in the legalities of accounting issues. A forensic audit has additional steps that need to be performed in addition to regular audit procedures.
- A fraud triangle is a tool used in forensic auditing that explains three interrelated elements that assist the commission of fraud- Pressure (motive), opportunity (ability to carry out the fraud) and rationalization (justification of dishonest intentions). Fraud risk is the vulnerability, a company/organization has towards those who are capable of overcoming the three elements in the fraud triangle. Fraud risk assessment is the identification of fraud risks that exist in the company/organization. The planning involves the formulation of techniques and procedures that align with the fraud risk and fraud risk management.
- Red flags are nothing but symptoms or indicator of situation of fraud. A red flag is a set of circumstances that are unusual in nature or vary from the normal activity. It is a signal that something is out of the ordinary and may need to be investigated further.
- The instance of Green Flags could be helpful in identifying are unusual signs or inconsistencies, but apparently harmless or perhaps even helpful.

