

# Basic Concepts of Forensic Audit

## Lesson 10

### KEY CONCEPTS

■ Audit ■ Forensic Audit ■ Fraud ■ Fraud Triangle

### Learning Objectives

#### To understand:

- Meaning and Significance of Forensic Audit & the areas cover under Forensic Audit
- What is Audit and its process?
- What are the key advantages of Forensic Audit?
- The need and objectives of Forensic Audit
- The common areas where Forensic Audit can be used
- What are the fundamentals of Forensic Audit?
- The stages of Forensic Audit
- What is Fraud?
- What are the elements of Fraud and Fraud related concept?
- Kinds of Frauds
- Forensic Audit *vis-a-vis* Audit
- Modern Day Scenario

### Lesson Outline

- Introduction
- Forensic Audit: Meaning and Significance
- Need and Objectives of Forensic Audit
- Fundamentals of Forensic Audit
- What is Fraud
- Kinds of Frauds
- Forensic Audit *vis-a-vis* Audit
- Modern Day Scenario
- Case Study
- Lesson Round-Up
- Test Yourself
- List of Further Readings

## INTRODUCTION

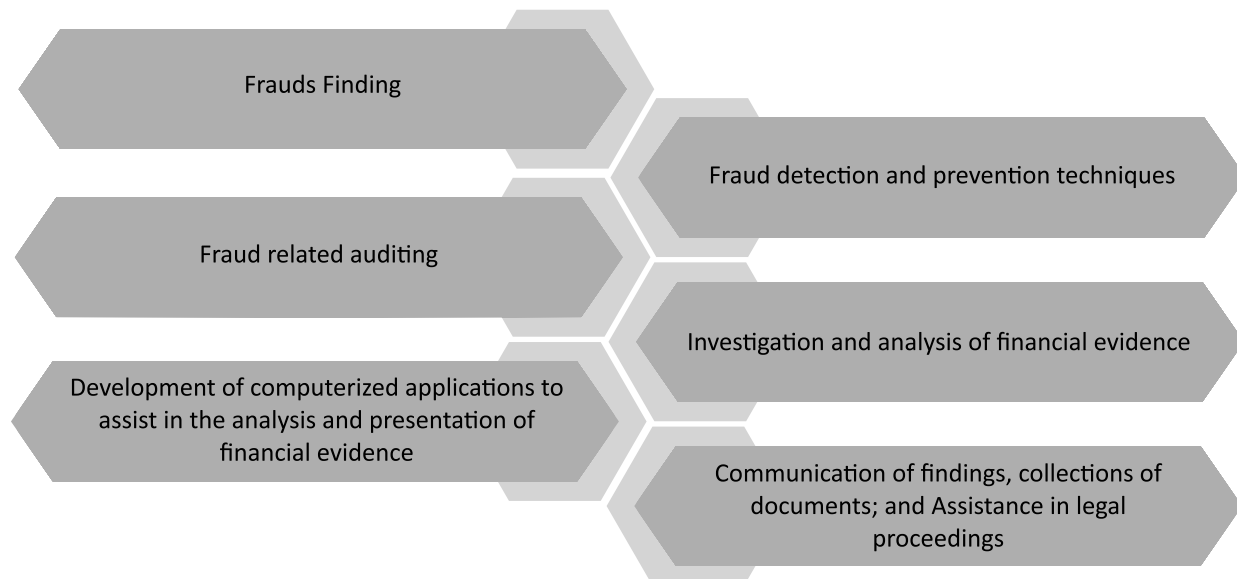
When it comes to auditing, many of organizations consider it is as simply a statutory requirement for getting the financials examined by a certified accountant to ensure compliance. However, this type of audit (financial audit) is just one of many other types of audits that any organization would undergo. Forensic audit is one among such audits which involves an examination of past financial records of an entity to detect any illegal action, manipulation in the books of accounts, siphoning of funds, etc. The forensic audit begins with the suspicion and doubts and ends with the performance of investigation procedures either to confirm the case or dispel the suspicion.

Unlike financial audits which are focused more on statutory compliance, the forensic audits are designed to investigate the financial records of an entity to derive evidences in support of fraud that can be used in court of law or legal proceedings.

In general, Forensic Audit represents an area of finance that combines detective skills and financial acuity. The forensic audit professionals dig deep into financial reports, locate financial transactions and figure out what really happened at various companies and who is the real culprit behind any fraud which has taken place in the company.

**Forensic Auditing** – It is an independent, comprehensive and scientific approach of reviewing an entity's financial statements in order to determine its accuracy, free from material misstatements and importantly, to derive evidences that can be used in a court of law or legal proceedings.

Forensic Audit cover areas such as:



Further, Forensic Auditing is used in a number of ways and for a number of purposes and not just for criminal activity detection. Firms that do “turn-arounds” or takeovers of businesses, for example, need to have an in-depth understanding of their target’s finances. In that scenario, Forensic Audit provides a clear understanding of the financial position along with the connection of the communications related to that.

## FORENSIC AUDIT: MEANING AND SIGNIFICANCE

In order to catch the glimpse of Forensic Audit in totality, it also become significant to know and understand the meaning of Audit itself.

**Meaning of Audit**

Audit, in general, refers to the examination or inspection of various books of accounts by an auditor followed by physical checking of inventory to make sure that all departments are following documented system of recording transactions. It is done to ascertain the accuracy of financial statements provided by the organization.

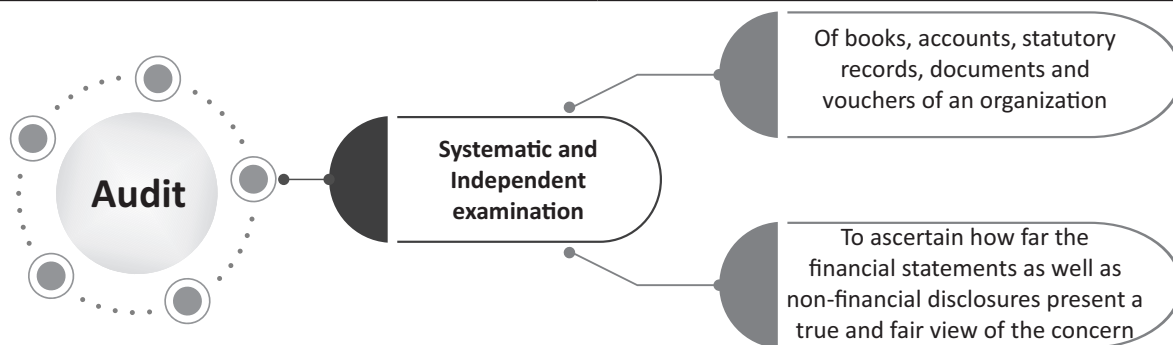
Audit can be done internally by employees or heads of a particular department and externally by an outside firm or an independent auditor. The idea is to check and verify the accounts by an independent authority to ensure that all books of accounts are made in a fair manner and there is no misrepresentation or fraud that is being conducted.

All the public listed firms have to get their accounts audited by an independent auditor before they declare their results for any quarter.

As per *English Oxford Dictionary*, “Audit” means an official inspection of an organization’s accounts, typically by an independent body. It also states a word of caution that many a times, audits are not expected to detect every fraud.

*Cambridge Dictionary* refers that Audit is a systematic process to make an official examination of the accounts of a business and produce a report.

English Oxford Dictionary	Cambridge Dictionary
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With an analysis of these definitions, it is apt to state that an audit is a systematic and independent examination of books, accounts, statutory records, documents and vouchers of an organization to ascertain how far the financial statements as well as non-financial disclosures present a true and fair view of the concern.

It also attempts to ensure that the books of accounts are properly maintained by the concern, as required by law.

When we talk about Audit, one should not forget the role of Indian Accounting Standard (abbreviated as Ind-AS). Ind\_AS is the Accounting standard adopted by companies in India and issued under the supervision of Accounting Standards Board (ASB) which consists of representatives from government department, academicians, other professional bodies, representatives from ASSOCHAM, CII, FICCI, etc.

The Ind AS are named and numbered in the same way as the International Financial Reporting Standards (IFRS). National Advisory Committee on Accounting Standards (NACAS) recommend these standards to the Ministry of Corporate Affairs (MCA). MCA has to spell out the accounting standards applicable for companies in India. As on date MCA has notified 41 Ind AS. This shall be applied to the companies of financial year 2015-16 voluntarily and from 2016-17 on a mandatory basis.

Based on the international consensus, the regulators will separately notify the date of implementation of Ind-AS for the banks, insurance companies etc.

### Audit: An Adhering Significance

The word audit is derived from a Latin word “audire” which means “to hear”. During the medieval times when manual book-keeping was prevalent, auditors in Britain used to hear the accounts read out for them and checked that the organization’s personnel were not negligent or fraudulent.

Any subject matter may be audited. Auditing is a safeguard measure not only in medieval times, rather it is in existence since ancient times.

Audit provides third party assurance to various stakeholders that the subject matter is free from material misstatement. The term is most frequently applied to audits of the financial information relating to a legal person. Other areas which are commonly audited include, secretarial & compliance audit, internal controls, quality management, project management, water management, and energy conservation.

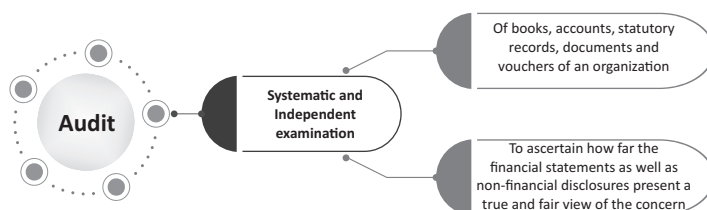
In view of Audits’ imperative value for detecting the fraud and ensuing financial health of the corporate, auditing has become such a ubiquitous phenomenon in the corporate and the public sector that professionals started to specialize the process of auditing, wherein forensic audit is also one specialized branch of audit having specific objectives in operation.

During the Audit, the auditor perceives and recognizes the propositions before them for examination, obtains evidence, evaluates the same and formulates an opinion on the basis of his judgment which is communicated through their audit report.

As a result of an audit, stakeholders may effectively evaluate and improve the effectiveness of risk management, control, and the governance process over the subject matter.

### Stages of Audit

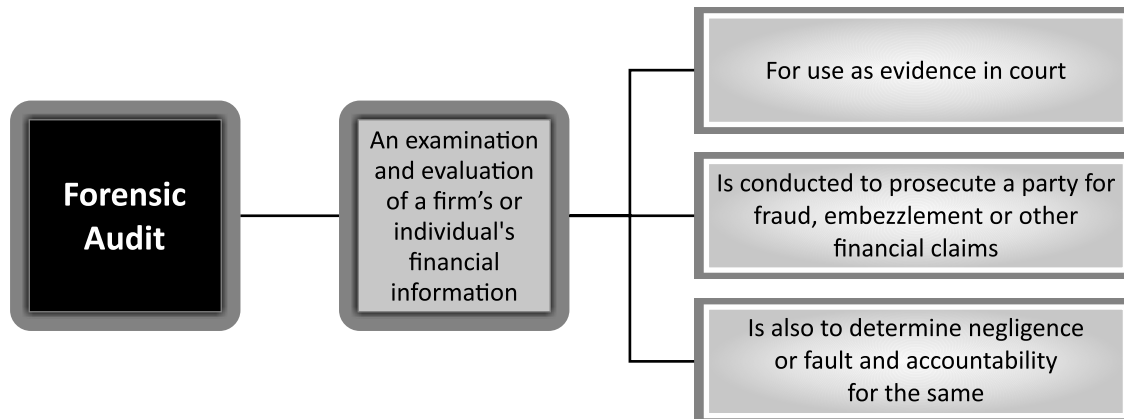
Some Typical Stages in the Audit Process are as below:



### Meaning of Forensic Audit

Forensic audit is, in general, referred to as an examination of evidence regarding an assertion to determine its correspondence to established criteria carried out in a manner suitable to the court.

As per the definition given in Investopedia, Forensic Audit is an examination and evaluation of a firm's or individual's financial information for use as evidence in court. A Forensic Audit can be conducted in order to prosecute a party for fraud, embezzlement or other financial claims. In addition, an audit may be conducted to determine negligence or even to determine how much spousal or child support an individual will have to pay.



Jack Bologna and Robert defined Forensic Audit as the application of financial skills and an investigative mentality to unresolved issues, conducted within the context of the rules of evidence. As a discipline, it encompasses financial expertise, fraud knowledge, and a strong knowledge and understanding of business reality and the working of the legal system.

Collin Greenland defines that forensic accounting (or auditing) is the integration of accounting, auditing and investigative skills in order to provide an accounting analysis suitable for the resolution of disputes (usually but not exclusively) in the courts.

Business Dictionary defines Forensic Audit as the application of accounting methods to the tracking and collection of forensic evidence, usually for investigation and prosecution of criminal acts such as embezzlement or fraud. It further states that forensic audit is also called forensic accounting.

### Significance of Forensic Audit

Forensic auditing has taken an important role in both private and public organizations since the dawn of the 21<sup>st</sup> century especially in the advance economies. The catastrophe of some formerly prominent public companies such as Enron and WorldCom (MCI Inc.) in the late 1990s, coupled with the terrorist attacks of September 11, 2001 and the recent incidence of frauds taken place in the corporates including the one in the leading public bank of Indian economy, have fueled the prominence of forensic auditing/ accounting, creating a new, important and lucrative specialty. Forensic auditing procedures target mostly financial and operational fraud, discovery of hidden assets, and adherence to federal regulations.

Cressy (2012) in his paper explained that 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. Evidence may also be gathered to support other issues which would be relevant in the event of a court case.

Further, with the increase in the financial frauds popularly known as white collar crimes, forensic auditing and

accounting have risen to prominence for ensuring the directed growth of the corporates and inclusive growth of economy.

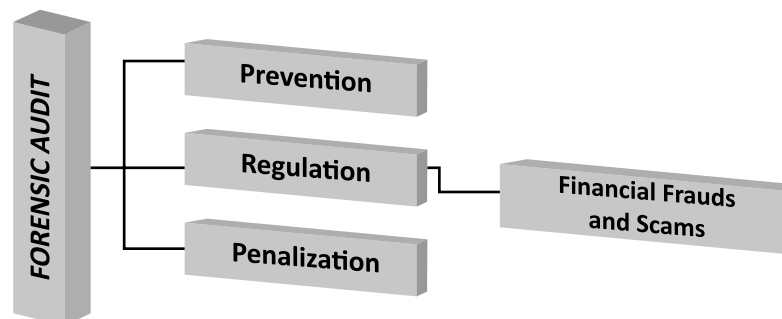
Forensic audit is becoming increasingly frequent for top leadership searches as stringent corporate governance norms and increasing stakes are prompting Indian and multinational companies to make sure that the people they take on board have no blotches on their track record. This realizes the significance of Forensic Audit in the contemporary time for the corporates to rationalize premier principles of Good Governance.

A Ready Reference to the Significance of Forensic Audit could be rationalized as below:

- In general, forensic auditing, which is described as a specialized field of accountancy investigates fraud and analyses financial information to be used in legal proceedings.
- In Forensic Audit, a systematic and independent examination of books, accounts, statutory records, documents and vouchers of an organization is held to ascertain fraud or probability of fraud.
- Much beyond the official documents of the company, the Forensic audit involves lot of field work, trying to talk to multiple stake holders to gather information and then look for evidence to corroborate it and alike.
- It also attempts to identify or to corroborate the culprit behind the fraud.
- It arranges and collects the evidences of the fraud and the person accused of fraud.
- The collected evidences and reviewed facts are used in the legal proceedings which assist the court in granting punishment to the real accused of the fraud.
- Forensic auditing uses accounting, auditing, and investigative skills to conduct investigations into theft and fraud. It encompasses both Litigation Support and Investigative Accounting.

This makes forensic audit an apt tool in the contemporary times, ensuring financial health of the companies through aiding in the **Prevention, Regulation and Penalization** of financial frauds and scams.

As we have discussed clearly that Forensic Audit is an examination of a company's financial records to derive evidence which can be used in a court of law or legal proceeding. In the contemporary times, when the Government is looking forward for a robust economy and nation building at par, financial stability is a must in the corporates. Henceforth, Forensic audit submits various recompenses in ensuring commercial health of the companies through aiding in the **Prevention, Regulation and Penalization** of financial frauds and scams.



**For example,** A Company, on the recommendation of its Chief Financial Officer (CFO), entered into a contract with ABC Inc for the supply of carts. At the time, ABC Inc was not authorized to conduct business, as its license was suspended due to certain irregularities in taxes paid. The CFO had knowledge of this fact, but still recommended the company to enter into a contract with ABC Inc because he was secretly receiving compensation from ABC Inc for doing so. A forensic audit cannot reveal such cases of fraud, but could also create bunch of evidences

for the production the court of Law. This way forensic audit ensures the healthy conduct of the organization and stability and growth to the economy as a whole.

### Key Advantages of Forensic Audit

In this context, few key benefits of Forensic Audit are listed below:

**1. Detection and Responsibility of Corruption:** In a Forensic Audit, while investigating fraud, an auditor would look out for:

- **Conflicts of interest** – When fraudster uses his/her influence for personal gains detrimental to the company. For example, if a manager allows and approves inaccurate expenses of an employee with whom he has personal relations. Even though the manager is not directly financially benefitted from this approval, he is deemed likely to receive personal benefits after making such inappropriate approvals.
- **Bribery** – As the name suggests, offering money to get things done or influence a situation in one's favor is bribery. For example, ABC bribing an employee of B2C company to provide certain data to aid ABC in preparing a tender offer to B2C.
- **Extortion** – If B2C demands money in order to award a contract to ABC, then that would amount to extortion.

In this process, Forensic Audit aids in detecting the corruption in the corporates and also determine responsibility of the person liable for the corruption and its practices.

- 2. Detection of Asset Misappropriation:** This is the most common and prevalent form of fraud. Misappropriation of cash, raising fake invoices, payments made to non-existing suppliers or employees, misuse of assets, or theft of Inventory are a few examples of such asset misappropriation.
- 3. Detection of Financial Statement Fraud:** Companies get into this type of fraud to try to show the company's financial performance as better than what it actually is. The goal of presenting fraudulent numbers may be to improve liquidity, ensure top management continue receiving bonuses, or to deal with pressure for market performance. Some examples of the form that financial statement fraud takes are the intentional forgery of accounting records, omitting transactions – either revenue or expenses, non-disclosure of relevant details from the financial statements, or not applying the requisite financial reporting standards.
- 4. Fraud Identification and Prevention:** Fraud is quite common in big organizations where the number of daily financial transactions is huge. In such an environment, an employee can easily undertake fraudulent activities without being caught. Forensic accounting helps in analyzing whether the company's accounting policies are followed or not, and whether all the transactions are clearly stated in the books of accounts. Any deviation observed in the books of accounts can help in identifying fraud, and necessary measures can be taken to prevent it in the future.
- 5. Making Sound Investment Decisions:** As forensic accounting helps in analyzing the financial standing and weaknesses of a business, it provides a path for investors to make thoughtful investment decisions. A company engaged in fraud is definitely not a good option for investment. Therefore, the reports of forensic accountants act as a guide for potential investors of a company. Many organizations also apply for loans from various financial institutions. By performing an analysis, such institutions can come to a decision on whether they would like to fund a company or not.
- 6. Formulation of Economic Policies:** Various cases of fraud that becomes evident after forensic analysis act as a reference for the government to formulate improved economic policies that would be able to curb such fraudulent activities in the future. By doing so, the government can strengthen the economy and prevent such illegal activities in the country.

- 7. Rewarding Career Opportunity:** As a career, forensic auditing is extremely rewarding, as it not only involves regular auditing and accounting activities, but also involves identification, analysis, and reporting of the findings during an audit. The acceptance of reports generated by a forensic auditors by the court of law, gives them an upper hand as compared to other accountants. Good forensic auditors are in high demand and can easily draw a striking starting salaries around the globe.

### Other Advantages

- **Objectivity and Credibility** – An external party as a forensic auditor would be far more independent and objective than an internal auditor or company accountant who ultimately reports to management on his findings. An established firm of forensic auditors and its team would also have credibility stemming from the firm's reputation, network and track record.
- **Accounting Expertise and Industry Knowledge** – An external forensic auditor would add to the organization's investigation team with breadth and depth of experience and deep industry expertise in handling frauds of the nature encountered by the organization.
- **Provision of Valuable Manpower Resources** – An organization in the midst of reorganization and restructuring following a major fraud would hardly have the full-time resources to handle a broad-based exhaustive investigation. The forensic audit and his team of assistants would provide the much needed experienced resources, thereby freeing the organization's staff for other more immediate management demands. This is all the more critical when the nature of the fraud calls for management to move quickly to contain the problem and when resources cannot be mobilized in time.
- **Enhanced Effectiveness and Efficiency** – This arises from the additional dimension and depth which experienced individuals in fraud investigation bring with them to focus on the issues at hand. Such individuals are specialists in rooting out fraud and would recognize transactions normally passed over by the organization's accountants or auditors.

The above discussed advantages of Forensic Audit confirms that Forensic Audit is a strategical approach in detecting the financial frauds in the organizations along with enhancing their financial stability at par.

### NEED AND OBJECTIVES: FORENSIC AUDIT

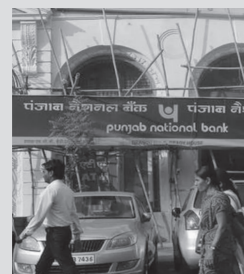
#### The Punjab National Bank has lost the most to frauds in the last five financial years among all the banks in India

##### Amount lost to frauds (FY13 to FY17)

Punjab National Bank	₹8,999 cr.
State Bank of India	₹6,228 cr.
Bank of Baroda	₹4,412 cr.
Central Bank of India	₹3,944 cr.
Indian Overseas Bank	₹3,339 cr.

##### Number of frauds (FY13 to FY17)

State Bank of India	2,786
ICICI Bank Ltd.	2,584
HDFC Bank Ltd.	1,146
Bank of Baroda	1,100
Axis Bank Ltd.	1,020



The Kala Ghoda branch of PNB in Mumbai, where the fraud was Reported  
■ Emmanuel Yogini

Time and again, it has been established that corporate frauds are one of the major hindrances to the inclusive growth of the economy. In any economy the rise in corporate frauds is directly proportionate to the fall of economy. Corporate fraud schemes go beyond the scope of an employee's stated position, and are marked by their complexity and economic impact on the business, other employees and outside parties.

Goldman Sachs on the Impact of PNB Scam on Indian Economy stated that *"To global investors, India's economy may seem a bit like a raw mango these days—enticing from a distance but bitter to taste; good for pickles, and not much more. Indeed, in the days following the revelation that billionaire jewellers, Nirav Modi and Mehul Choksi, duped India's second-largest government bank, the PNB stock has lost more than a quarter of its market value. Other public sector bank scrips have tumbled, too."*

In the previous years too, India has witnessed financial frauds which affected the golden growth of India's economy. The Investigations and risk consulting firm Kroll unearthed in their survey that 69% of companies studied were affected by fraud in Financial Year of 2013, up from 68% in the previous year. The value of fraud, the study found, rose, to 71% from 67%. Insider fraud was particularly rife in India, with 89% of respondents indicating the perpetrator was an insider of some sort — a junior, middle management or senior employee, or an agent. That's the reason forensic audit practices have evolved significantly over the last 10-15 years. He added that *"earlier the investigations were restricted to books and records but now there is a significant element of intelligence gathering. The technology, analytics and professional expertise have a greater play in every aspect of forensic auditing"*.

Indeed, the recent upswing in the financial frauds in India, compelling more management to conduct forensic audits in the interest of our growing economy. Experts on white-collar crimes say forensic auditing is not just gaining prominence, the methods are changing fast.

From all the past incidences, it has been found that Crimes are of all hues, seven in particular — (i) Theft of physical assets, (ii) Theft of information, (iii) Corruption and Bribery, (iv) Internal financial fraud, (v) Vendor fraud, (vi) Management conflict of interest and (v) Regulatory breach, are high in their perspectives of corporate fraud.

As of now, the forensic auditing has emerged as a specialized field in the industry that requires a specific skill set to detect the fraud, leaving no scope for overlap. But, to determine when an organization needs forensic auditing is significant to deal with the early warning signals of fraud. Thus, there are few instances on the occurrence of which an entity should direct for forensic audit like

- i. Theft of business information or where business systems have been hacked,
- ii. Issues identified by Whistle Blowers,
- iii. Reconciliations resulted in unidentified material differences,
- iv. Suspicious of fraud or illegal activity,
- v. Turnover has occurred and balances are showing negative results.

Forensic Audit is assuming greater importance in India and also globally in the wake of numerous financial frauds, unethical business practices and high incidence of cybercrime. In almost every sector and in verticals, there has been some financial frauds and white-collar crimes, which has paved the way for introducing and adopting the Forensic Audit.

### Purpose of Forensic Audit

<i>Lenders / Banks</i>	<i>Resolution Professional</i>	<i>SFIO</i>	<i>SEBI</i>	<i>CBI</i>
Misutilization of Funds	Transaction related to Fraudulent trading	Monitory misappropriation	Manipulation of the books of accounts	Misutilization of Funds
Financial Statement Manipulation	Sale/Transfer of assets	Transaction related to Fraudulent trading	False public notices	Financial Statement Manipulation
Sale/Transfer of Assets	Excess payments to related parties	Sale/Transfer of assets & Excess payments to related parties	Insider trading, Price Rigging & Misappropriation of assets	Availing facility through false documentation, False public notices
Availing facility through false documentation via non fund based facilities like LC	Transactions with respect to section 43, 45, 46, 49, 50 and section 66 of IBC	Transactions with respect to section 43, 45, 46, 49, 50 and section 66 of IBC	Cash flow movement, Transaction with group concerns	Excess payments to Management/ Promoters, Siphoning of funds

### Common Areas where Forensic Audit is used

With the increase in financial fraud popularly known as white-collar crime, the forensic accounting and auditing has emerged as prominence to ensure the financial growth for businesses and economy as well. Some of the common areas that are to be detected in forensic audit are:-

- **Asset Misappropriation:** Asset misappropriation is the most prevalent form of fraud. Activities such as creating fake invoices to either existing or non-existing suppliers, payments, misappropriation of cash or theft come under the purview of asset misappropriation.
- **Bribery:** Bribery involves offering money to influence a situation or get things done in one's favor.
- **Extortion:** The wrongful use of actual or threatened violence, intimidation or force to gain property or money from an entity or individual. If a fraudster demands the same forcefully then that would amount to extortion.
- **Financial Statement fraud:** Financial statement fraud is the deliberate misrepresentation, misstatement or omission of financial statement data for the purpose of misleading the reader and creating a false impression of an organization's financial strength. The most common practice here is deferring revenues or expense in a different time period to give the appearance of consistent earnings or growth.
- **Conflict of interest:** When a fraudster uses influence for personal gains that prove to be detrimental for the company.

### FUNDAMENTALS OF FORENSIC AUDIT

Forensic Auditing in general is referred as a discipline of detecting frauds in the organizations and gathering and presenting financial information in a form of evidences that will be accepted by a court of jurisprudence against perpetrators of economic crimes.

The integration of accounting, auditing, and investigative skills and evidences yields the specialty known as Forensic Auditing which focuses very closely on detecting or preventing financial fraud.

- “Forensic”, according to the Webster’s Dictionary means, “Belonging to, used in or suitable to courts of judicature or to public discussion and debate.”
- The word “Auditing” is defined as the examination or inspection of various books of accounts by an auditor followed by physical checking of inventory to make sure that all departments are following documented system of recording transactions. It is done to ascertain the accuracy of financial statements provided by the organization.

With India being ranked as the 81<sup>st</sup> in the Global Corruption Perception Index, the needs for forensic audit become all the more profound to strengthen the corporate culture with the vibes of good governance in the country.

The term forensic auditing’ refers to financial fraud investigation which includes the analysis of various books of accounts to prove or disprove financial fraud and serving as an expert witness in Court to prove or disprove the same. Thus, basically, the forensic auditing is the use of accounting or secretarial skills for legal purposes.



Major Fundamentals of Forensic Audit involves:

1. An audit
  2. An investigation
  3. An agreed-upon procedures engagement
  4. A proactive search for fraud
1. **Forensic Audit:** - An examination of evidence regarding an assertion to determine its correspondence to establish 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.

2. **Forensic Investigation:** - The utilization of specialized investigative skills in carrying out an inquiry conducted in such a manner that the outcome will have application to a court of law. A Forensic Investigation may be grounded in accounting, medicine, engineering or some other discipline.
3. **Agreed Upon Procedural Engagement:** As the purpose of the forensic audit is ensure that there is no financial deception in the organizations and it collects evidences after the examination of accounts and its records, therefore, it is required that forensic audit is done under the agreed procedures of Audit and Evidences. For instance for Company Audit, the auditor is required to prepare the audit report in accordance with the Company Auditor's Report Order (CARO) 2016. CARO requires an auditor to report on various aspects of the company, such as fixed assets, inventories, internal audit standards, internal controls, statutory dues, among others.
4. **Predicting the Unpredictable – A Proactive Search:** A Proactive search for fraud comprises a Forensic Audit Thinking. Forensic Audit Thinking involves –
  - The critical assessment throughout the audit of all evidential matter; and
  - Maintaining a higher degree of professional skepticism;
  - That fraud may have occurred, is occurring, or will occur in the future.

It further involves to decipher pattern, evaluating reports with figures to study their number patterns and comparing them with standards established looking for prima facies area of suspicion.

In this scenario, Forensic auditing aids in detecting, investigating and preventing the frauds. Whether it is stock market fraud or bank fraud or cyber fraud; forensic auditing seems to be an essential tool for investigation and defining accountability of perpetrators.

### Stages of Forensic Audit

#### 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.

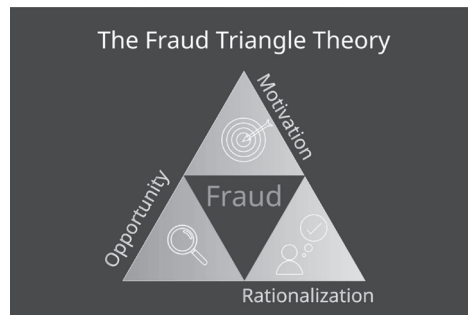
### Fraud Triangle and Fraud Risk

Dr. Donald Ray Cressey a brightest student of Edward Sutherland was intrigued by why a good person suddenly becomes embezzler whom he called trust violators. While working on his Ph.D in criminology he decided to focus on embezzlers and to serve a basis for his research, Cressey interviewed about 133 people. The records of these people revealed that they had in one way or another misused a position of trust and were jailed after having caught for embezzling money. He excluded from his research those employees who took their job for the purpose of stealing (habitual offenders).

After completion of his interviews, his research was published in **Other People's Money: A Study in the Social Psychology of Embezzlement**.

Donald Cressey's final hypothesis was:

Trusted persons become trust violators when they conceive of themselves as having a financial problem that is non-shareable, are aware this problem can be secretly resolved by violation of the position of financial trust, and are able to apply to their own conduct in that situation verbalizations which enable them to adjust their conceptions of themselves as trusted persons with their conceptions of themselves as users of the entrusted funds or property.



Over the years, Cressey's hypothesis has become more well known as the fraud triangle.

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/organisation has to 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/organisation. The planning involves the formulation of techniques and procedures that align with the fraud risk and fraud risk management.

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 behaviour.

### 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.

## WHAT IS FRAUD

Fraud is a type of criminal activity, defined as: ‘abuse of position, or false representation, or prejudicing someone’s rights for personal gain’. Put simply, fraud is an act of deception intended for personal gain or to cause a loss to another party.

The general criminal offence of fraud can include:

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

However, incompetence or negligence in managing a business or even a reckless waste of firm’s assets (by speculating on the stock-market, for example) does not constitute an act of fraud, but yes, invites legal liabilities.

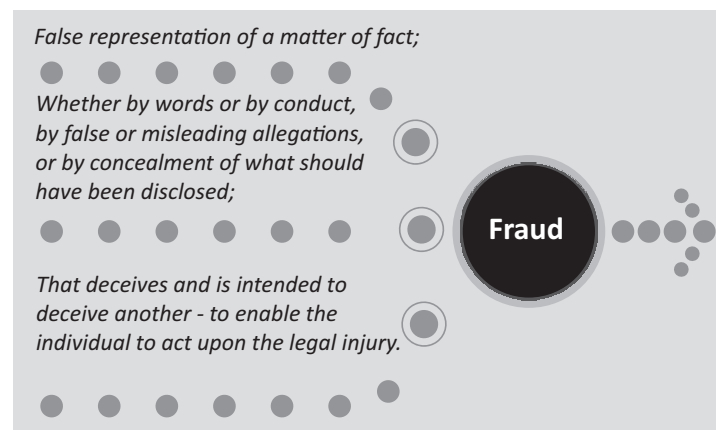
In such cases, if the act of causing financial loss to the business or manipulating the stock market is attempted with the clear intention of deceit, this would tantamount to financial frauds.

In law, fraud is a deliberate deception to secure unfair or unlawful gain, or to deprive a victim of a legal right.

Fraud can also be a civil wrong (*i.e.*, a fraud victim may sue the fraud perpetrator to avoid the fraud or recover monetary compensation), a criminal wrong (*i.e.*, a fraud perpetrator may be prosecuted and imprisoned by governmental authorities) or it may cause no loss of money, property or legal right but still be an element of another civil or criminal wrong.

The ultimate object of practicing fraud may be some monetary gain or other benefit, such as, obtaining a passport or travel document, driver's license or qualifying for a mortgage by way of false statements.

As per Black Law Dictionary, 'Fraud' refers to 'All multifarious means which human ingenuity can devise, and which are resorted to by one individual to get an advantage over another by false suggestions or suppression of the truth. It includes all surprises, tricks, cunning or dissembling, and any unfair way which another is cheated.



With the clear analysis of the above definitions, it could be asserted that Fraud is a –

- False representation of a matter of fact;
- Whether by words or by conduct, by false or misleading allegations, or by concealment of what should have been disclosed;
- That deceives and is intended to deceive another;
- So that the individual will act upon it to her or his legal injury.

'Fraud' is commonly understood as dishonesty calculated for advantage. A person who is dishonest may be called a fraudster. In almost all the legal systems, fraud is a specific offence with certain unique features.

'Fraud' is most commonly practiced in the acts of buying or selling of property, including real estate, personal property, and intangible property, such as, stocks, bonds, and copyrights. Indian law under various statutes criminalizes fraud, but not all cases graduate to the level of criminality. Prosecutors also have discretion in determining which case to pursue and which not. Victims may also seek redress in civil court, provided that the fraud conducted does not affect the society at large. For example, if a fraud is carried out in a company and has adversely affected the profit generation in that company without in any way affecting any counter of the economy, the victims might seek relief under the civil remedy. On the other hand, if the fraud conducted in the company affects the entire economy altogether then the only way to punish the accused is through criminal prosecution against the accused under different criminal law statutes, including the Indian Penal Code, 1860

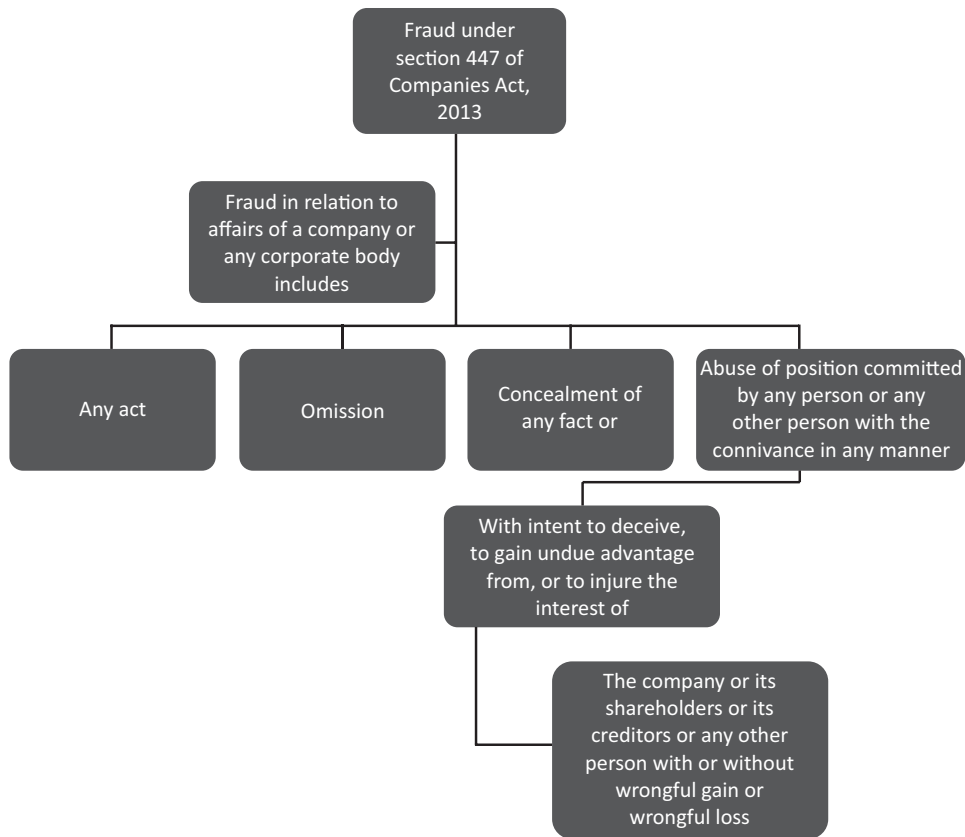
along with the recovery of amount earned through fraudulent transactions. For instance, in the recent ill-fated Punjab National Bank Scam, CBI added the charges of Criminal Breach of Trust under section 409 of IPC along with charges of Fraud under section 420 IPC, 1860.

As it is clear that fraud is recognized as an act of deceit which is subject to criminal as well as civil legal action in almost all the jurisdictions, including India, hence, it would be apt to discuss the definition and meaning of Fraud under specific laws like Companies Act, 2013, Bharatiya Nagarik Suraksha Sanhita, 2023 (Criminal Procedure Code, 1973) and (Bharatiya Nyaya Sanhita, 2023 (Indian Penal Code, 1860).

**Meaning and Definition under Companies Act, 2013**

Explanation of Section 447 of Companies Act 2013 defines Fraud and related terms as below:

- (i) 'Fraud' in relation to affairs of a company or anybody corporate, includes any act, omission, concealment of any fact or abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss;
- (ii) 'Wrongful gain' means the gain by unlawful means of property to which the person gaining is not legally entitled;
- (iii) 'Wrongful loss' means the loss by unlawful means of property to which the person losing is legally entitled.



In the context of this definition, it could be said that Corporate Fraud is a Fraud in relation to affairs of a company or any corporate body as defined in the explanations of Section 447 of Companies Act 2013, which includes

- a. Any act,
- b. Omission,
- c. Concealment of any fact, or
- d. Abuse of position committed by any person or any other person with the connivance in any manner, -
  - i. with intent to deceive,
  - ii. to gain undue advantage from, or
  - iii. to injure the interests of,
    - a) the company or
    - b) its shareholders or
    - c) its creditors or any other person

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

### **Meaning and Definition under Bharatiya Nagarik Suraksha Sanhita 2023 (BNSS) (Cr.PC, 1973)**

The Bharatiya Nagarik Suraksha Sanhita, 2023 is the procedural law providing the machinery for punishment of offenders under substantive criminal law which has replaced the Criminal Procedure Code, 1973. The Sanhita contains elaborate details / provisions regarding the procedure to be followed in every investigation, inquiry and trial, for every offence under the Bharatiya Nyaya Sanhita 2023 (BNS) or any other criminal law. In general, the BNSS does not provide for the definition of various terms rather it only describes certain limited terms like Complaint, Cognizable Offence, Warrant Case and alike, which helps in the interpretation of BNS.

For rest of the terms, section 2(2) of BNSS says that “words and expressions used herein and not defined but defined in the Information Technology Act, 2000 and the Bharatiya Nyaya Sanhita, 2023 shall have the meanings respectively assigned to them in that Act and Sanhita.” Therefore, to understand the meaning of ‘Fraud’ in the sphere of criminal law, one has to take recourse to the Bharatiya Nyaya Sanhita, 2023.

### **Meaning and Definition under Bharatiya Nyaya Sanhita, 2023 (BNS) (IPC, 1860)**

The term ‘Fraud’ is not defined in the Bharatiya Nyaya Sanhita per se, but Section 2(8) defines as to what would amount to ‘fraudulently’. As per the definition, fraudulently refers – “A person is said to do a thing fraudulently if he does that thing with intent to defraud but not otherwise.”

This shows that fraud as a crime is nowhere defined in the Bharatiya Nyaya Sanhita, but implication of this term is made at various places in the BNS.

*In general, fraud is an act of deliberate deception with the design of securing something by taking unfair advantage of another. It is a deception in order to gain by another's loss.*

Whenever the term fraud or defraud appears in the context of criminal law, two things are automatically to be assumed.

- First is deceit or deceiving someone; and
- Second is, injury to someone because of such deceit.

Implications of fraud is found in the following sections of BNS namely, 318, 319, 320 and 321.

- Fraudulent removal or concealment of property to prevent distribution among creditors.
- Fraudulently preventing debt being available for creditors.
- Fraudulent execution of deed of transfer containing false statement of consideration.
- Fraudulent removal or concealment of property.

Though Fraud is not clearly defined in BNSS and BNS, yet Indian Contract Act, 1872 defines the term Fraud quite clearly. In the context of Corporate Fraud, there is no harm in exploring the definition of Fraud as per the other related statutes.

### Meaning and Definition under Indian Contract Act, 1872

Section 17 of the Act defines Fraud as –

“Fraud” means and includes any of the following acts committed by a party to a contract, or with his connivance, or by his agents, with intent to deceive another party thereto his agent, or to induce him to enter into the contract.

**Section 17 (1)** – the suggestion as to a fact of that which is not by one who does not believe it to be true – is known as *SUGGESTIO FALSI* or suggestion of falsehood.

**Section 17 (2)** – the active concealment of a fact by one having the knowledge or belief of the fact – is known as *SUPPRESSIO VERI* or suppression of a fact.

**Section 17 (3)** – a promise made without any intention of performing it. It means a promise made falsely with the intention of inducing the other party to make a reciprocal promise and thereby enter into a contract.

**Section 17 (4)** – any other Act fitted or designed to deceive.

**Section 17 (5)** – any such act or omission as the law specially declares to be fraudulent

#### Explanation to Section 17

This explanation states a very important proposition of law. According to Explanation to Section 17 – the mere silence as to a fact likely to affect the willingness of a person to enter into a contract is not fraud. However, such silence is to be held as fraud, if the circumstances of the case that –

- It is the duty of the person keeping silence – to speak
- That his silence in itself is equivalent to speech

### Definition of Fraud: The Judicial View

The Supreme Court of India in *Dr. S. Dutt v. State of Uttar Pradesh*, while dilating upon the words “with intent to deceive” has observed that it does not indicate a bare intent to deceive, but an intent to cause a person to act, or omit to act, on account of deception practiced upon him, to his advantage. The words ‘but not otherwise’ after the words ‘with intent to deceive’ in the definition of ‘fraudulently’, it has been observed, clearly show, “..... that the words intent to defraud are not synonymous with intent to deceive and requires some action resulting in some disadvantage which but for the deception, the person deceived would have avoided”.

So, under the Indian law a penal offence of fraud, demands for successful prosecution, the twin elements of ‘intent to defraud’ of the offender *i.e.*—

- An intent to deceive another; and
- An intent to cause, by that deception, injury to some person.

Now to clearly understand the term ‘fraud’ in reference of penalizing, preventing and regulating this act, one should be well-versed with the elements of fraud.

As, it has been thoroughly laid down in the previous discussion that fraud is a termite to growth, development and prosperity, in general, and to the progression of the corporates and economy, in specific. And therefore,

the Government is quite dynamic in regulating and preventing the practices of fraud as well as any likelihood of fraud from Indian economy.

In addition, with various laws constituting civil as well as criminal liability for the accused, it is important that fraud should be detected at the first instance and further accused should be penalized with the appropriate punishment in order to introduce the element of deterrence for the anticipated fraudsters, while preventing them from playing any fraud in future.



This all requires a diligent set of skills and tools for detecting the fraud through transactions outside the system reflecting fraud, through analysing the financial statements and other circumstantial evidences making the difference in identifying fraudulent disclosure and finding the real culprit behind the fraud and related loss, providing the evidences in the court and in toto helping the governance of the company with regulation and prevention of frauds in the company. *This consolidated tool is known as Forensic Audit.*

### Elements of Fraud

Few Essential Elements of Fraud are listed as below:

- 1. False and Wilful representation or Assertion:** To constitute fraud there must be some representation or assertion, which is untrue. In the absence of representation or assertion except in the following two cases, there can be no fraud.
  - Where silence may itself amount to fraud, and
  - Where there is active concealment of facts.

The person making the representation should not believe it to be true, otherwise he/she will not be guilty of fraud. Moreover, to constitute fraud, the false representation must have been made wilfully or intentionally.

For example, X, intending to deceive Y, informs him that his estate is free from encumbrance. Y thereupon buys the estate. The estate is, however, subject to mortgage. The contract is induced by fraud.

2. **Perpetrator of Representation:** The false representation or misstatement must have been made by a party to the contract or by anyone with its connivance, or by its agent. If a stranger makes the misstatement to the contract, it cannot result in fraud. For instance, A suggests B to buy C's car, which according to A runs 15 kms per litre. Later on, B finds that the car runs only 8 kms per litre. A was, however, acting neither at the instance of C nor was his agent; he was a stranger. The contract that took place between B and C cannot be stated to be induced by fraud.
3. **Intention to deceive:** Intention to deceive the other party is the essence of fraud. In order to commit a fraud, one person asserts or misstates the fact with the intention that it should be acted upon. As a matter of fact, misrepresentation elevates to the level of fraud when it is prefixed by the element of intention to deceive the other party. For example, A, intending to deceive B, falsely represents that 1,000 tons of sugar is produced annually at his factory, although A is fully aware that only 600 tons of sugar can be produced annually. B thereby agrees to buy the factory. A has resorted to fraud to obtain the consent of B.
4. **Representation must relate to a fact:** The representation made by the party must relate to a fact, which is material to the formation of the contract. A mere statement of opinion, belief, or commendation cannot be treated as fraud. For instance, A states that the detergent produced at his factory washes whiter than whitest. The statement made by A is merely a commendation of the product and not a fact. But if A describes the ingredients, which the detergent contains, it becomes a statement of fact. And if that is found incorrect, it amounts to fraud provided A knows it to be a false statement.
5. **Active concealment of facts:** 'Active concealment' must be distinguished from 'passive concealment'. Passive concealment implies mere silence as to material facts, which barring a few cases, does not amount to fraud. Whereas, active concealment implies 'when the party takes positive or deliberate steps to prevent information from reaching the other party and this is treated as fraud.' For example, A sells a horse to B in an auction despite knowing that the horse is unsound. A says nothing to B about the horse's soundness. This is a case of passive concealment of fact and cannot tantamount to fraud.
6. **Promise made without intention of performing it:** If a person while entering into a contract has no intention to perform his/her promise, there is a fraud on his/her part, for the intention to deceive the other party is there from the very beginning. For example, an English merchant appointed an Indian woman as his personal secretary and promised that he would marry her. Later she came to know that he was already married and had made the promise without any intention to perform it. It was held that she could avoid the contract on the ground of fraud.

On similar count, a purchase of goods without any intention of paying the price is a fraud and the contract can be avoided on this ground.

7. **Representation must have actually deceived the other party:** The representation made with the intention to deceive must actually deceive. The party, induced by fraudulent statement, must have relied on it to accord its consent.

Thus, an attempt to deceive does not amount to fraud until the other party is deceived thereby. A case in point is the following example. A had a defective cannon. With a view to conceal the defect, he put a metal plug on it. B without examining it bought it. The cannon burst when used by B. B refused to pay the price and accused A of fraud. It was held that B was bound to pay because he was not actually deceived, as he would have bought the cannon even if the deceptive plug had not been inserted.

8. **Any other act fitted to deceive:** The expression 'any other act fitted to deceive' obviously means any act, which is done with the intention of committing fraud. This category includes all tricks, dissembling, and

other unfair ways, which are used by cunning and clever people to cheat others. For example, a husband persuaded his illiterate wife to sign certain documents telling her that by the papers he was going to mortgage her two plots of land to secure his indebtedness. But, in fact, he mortgaged four plots of land belonging to her. This was held as an act done with the intention of deceiving the wife.

**9. Any such Act or omission that the law specially declares as void:** This category includes the act or omission that the law specially declares to be fraudulent. For example, the Insolvency Act and the Companies Act declare certain kinds of transfers to be fraudulent. Similarly, under the Transfer of Property Act, the transferor of real estate is bound to disclose to the transferee the following details:

- Material defects, if any, in the property such as, cracks in the wall or in beams, and/or
- Any defect or dispute as regards transferor's title, such as property is subject to encumbrance, i.e., mortgaged or is subject to some dispute pending in a court of law. An omission to make such disclosure on the part of transferor amounts to fraud.

**10. Wrongful Loss and Wrongful Gain is Immaterial.** For the purposes of "Fraud" under the Companies Act, 2013, it is immaterial whether there has been some wrongful loss to one and/or wrong gain to another. The only important thing is intention to deceive and the act or omission actually deceiving the victim. Common corporate frauds for example are, if the CMD husband benefits from a loan transaction sanctioned by her it is a fraud. If a CEO take bribe to approve a contract that is a fraud.

On the same principle, Bharatiya Nyaya Sanhita, 2023 (IPC,1860) too works, as for BNS to constitute an offence, two elements are required which are Mens Rea – Intention to Commit Offence and Actus Reus – The Wrongful Act.

### Examples – Corporate Fraud

There are a number of ways in which a corporation can commit fraud. Corporate fraud can encompass the loss of assets by a corporation, or acts perpetrated by the corporation to take funds from others. Here are several examples:

- **Personal purchases.** An employee can divert funds to buy goods or services on his own behalf. This is usually done by approving his own expense reports or supplier invoices. The person must hold a sufficiently senior position to be able to browbeat other employees into participating in this diversion of assets. Usually, the potential amount of funds diverted increases with the seniority of the job title of the individual committing the fraud.
- **Ghost employees.** The payroll staff can create fake employees and then pay these "ghost employees," directing the funds into their own bank accounts. Weak controls over the payment of employees makes this type of fraud more likely.
- **Skimming.** Incoming funds are intercepted before they can be recorded in a company's accounting records. This is usually caused when a person is allowed to both open the mail and record accounting transactions.
- **Tax avoidance.** A company can alter its tax returns to reveal less taxable corporate income than is really the case, resulting in lower tax remittances. This can only be done with the connivance of senior management, which typically signs off on the tax returns.
- **Asset theft.** Any employee can steal from an organization by making off with assets, such as cash or fixed assets. Weak controls can encourage employees to engage in this activity.
- **Unauthorized use.** An employee may use company assets in an unauthorized manner, such as driving a company car for personal use, or using a company condominium for personal use. Though the asset is not stolen, it is being consumed, so its value lessens over time.

- **Financial statement falsification.** An organization can falsify its financial statements to reveal excellent financial results. These documents can then be used as the basis for obtaining bank loans or selling stock to investors. Such falsification can be conducted entirely within the accounting department, or be forced upon it by management. Examples of such falsification are:
  - Extending the depreciation period to delay depreciation recognition
  - Shifting debt to special purpose entities
  - Accelerate the recognition of revenues and delay the recognition of expenses
  - Capitalize expenses
  - Counting nonexistent inventory, which reduces the cost of goods sold.

Corporate fraud can be extremely difficult to contain, and is essentially impossible to stop if senior management is willing to engage in it. In such cases, even the most robust control systems can be breached. This contemplates the significance of Forensic Audit, wherein a check and vigil mechanism could be establishing in finding out the probability of fraud as well as real culprit behind corporate frauds.

### Fraud and Forensic Audit: An Introspect

Forensic auditing covers a broad spectrum of activities, with terminology not strictly defined in regulatory guidance. Generally, the term ‘forensic auditing’ is used to describe the wide range of investigative work which the professionals in practice could be asked to perform. The work would normally involve an investigation into the financial affairs of an entity and is often associated with investigations into alleged fraudulent activity.

- Forensic Auditing refers to the whole process of investigating a financial matter, including potentially acting as an expert witness if the fraud comes to trial.
- The process of forensic accounting includes the ‘forensic investigation’ itself, which refers to the practical steps that the forensic auditor takes in order to gather evidence relevant to the alleged fraudulent activity.
- The investigation is likely to be similar in many ways to an audit of financial information, in that it will include a planning stage, a period when evidence is gathered, a review process, and a report to the client.
- The purpose of the investigation, in the case of an alleged fraud, would be to discover-
  - a. If a fraud had actually taken place,
  - b. To identify those involved,
  - c. To quantify the monetary amount of the fraud (i.e. the financial loss suffered by the client), and
  - d. To ultimately present findings to the client and potentially to court.
- Finally, ‘forensic auditing’ refers to the specific procedures carried out in order to produce evidence.
- Audit techniques are used to identify and to gather evidence to prove, **for example**, “how long the fraud has been carried out, and how it was conducted and concealed by the perpetrators.”
- Evidence may also be gathered to support other issues which would be relevant in the event of a court case. Such issues could include:
  - a. The suspect’s motive and opportunity to commit fraud
  - b. Whether the fraud involved collusion between several suspects

- c. Any physical evidence at the scene of the crime or contained in documents
- d. Comments made by the suspect during interviews and/or at the time of arrest
- e. Attempts to destroy evidence.

### Fraud Related Concept

Fraud is an independent civil as well as a criminal offence, but it also appears in different contexts as the means used to gain legal advantage or accomplish a specific crime. For example, it is fraud for a person to make a false statement on a license application in order to engage in the regulated activity. A person who did so would not be convicted of fraud. Rather, fraud would simply describe the method used to break the law or regulation requiring the license.

Fraud must be proved by showing that the defendant's actions involved five separate elements:

- (1) A false statement of a material fact,
- (2) Knowledge on the part of the defendant that the statement is untrue,
- (3) Intent on the part of the defendant to deceive the alleged victim,
- (4) Justifiable reliance by the alleged victim on the statement, and
- (5) Injury to the alleged victim as a result.

*These elements contain nuances that are not all easily proved. And that is the reason the tool of forensic audit is effective in identifying the fraud, proving the fraud, determining accountability of the malefactors of fraud and assisting the court of law in penalizing the wrongdoers.*

In order to understand the fraud in clarity, one must go through the frauds related concepts which are described as below:

- **First**, not all false statements are fraudulent. To be fraudulent, a false statement must relate to a material fact. It should also substantially affect a person's decision to enter into a contract or pursue a certain course of action. A false statement of fact that does not bear on the disputed transaction will not be considered fraudulent.
- **Second**, the defendant must know that the statement is untrue. A statement of fact that is simply mistaken is not fraudulent. To be fraudulent, a false statement must be made with intent to deceive the victim. This is perhaps the easiest element to prove, once falsity and materiality are proved, because most material false statements are designed to mislead.
- **Third**, the false statement must be made with the intent to deprive the victim of some legal right.
- **Fourth**, the victim's reliance on the false statement must be reasonable. Reliance on a patently absurd false statement generally will not give rise to fraud; however, people who are especially gullible, superstitious, or ignorant or who are illiterate may recover damages for fraud if the defendant knew and took advantage of their condition.
- **Finally**, the false statement must cause the victim some injury that leaves her or him in a worse position than she or he was in before the fraud. A statement of belief is not a statement of fact and thus is not fraudulent. Puffing, or the expression of a glowing opinion by a seller, is likewise not fraudulent. For example, a car dealer may represent that a particular vehicle is "the finest in the lot." Although the statement may not be true, it is not a statement of fact, and a reasonable buyer would not be justified in relying on it.

- **Further, the relationship between parties can make a difference in determining whether a statement is fraudulent.** A misleading statement is more likely to be fraudulent when one party has superior knowledge in a transaction, and knows that the other is relying on that knowledge, than when the two parties possess equal knowledge.

For example, if the seller of a car with a bad engine tells the buyer, the car is in excellent running condition, a court is more likely to find fraud if the seller is an auto mechanic as opposed to a sales trainee. Misleading statements are most likely to be fraudulent where one party exploits a position of trust and confidence, or a fiduciary relationship. Fiduciary relationships include those between attorneys and clients, physicians and patients, stockbrokers and clients, and the officers and partners of a corporation and its stockholders.

- **A statement need not be affirmative to be fraudulent.** When a person has a duty to speak, silence may be treated as a false statement. This can arise if a party who has knowledge of a fact fails to disclose it to another party who is justified in assuming its non-existence.

For example, if a real estate agent fails to disclose that a home is built on a toxic waste dump, the omission may be regarded as a fraudulent statement. Even if the agent does not know of the dump, the omission may be considered fraudulent. This is constructive fraud, and it is usually inferred when a party is a fiduciary and has a duty to know of, and disclose, particular facts.

- Fraud resembles theft in that both involve some form of illegal taking, but the two should not be confused. Fraud requires an additional element of False Pretenses created to induce a victim to turn over property, services, or money. Theft, by contrast, requires only the unauthorized taking of another's property with the intent to permanently deprive the other of the property. Because fraud involves more planning than does theft, it is punished more severely.

The above discussion clarifies, that the menace of fraud is not easy to detect and it may be mean different acts, omissions and offences under different circumstances and further it requires vibrant evidences to prove the conduct as fraud. In these circumstances, forensic audit aids for detection and gathering evidence of frauds, embezzlement, or any other such white-collar crime. It is the application of accounting skills to legal questions. And with this skills of ensuring financial stability in both public and private organizations, especially in advanced economies, forensic audit is the need of the hour.

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## KINDS OF FRAUDS

Fraud in general could be categorized in two category in legal parlance, which includes

1. Fraud as a Civil Wrong and
  2. Fraud as a Criminal Offence.
1. **Fraud as a Civil Wrong**, is a tort. While the precise definitions and requirements of proof vary among jurisdictions, the requisite elements of fraud as a tort generally are the intentional misrepresentation or concealment of an important fact upon which the victim is meant to rely, and in fact does rely, to the

harm of the victim. Proving fraud in a court of law is often said to be difficult. That difficulty is found, for instance, in that each and every one of the elements of fraud must be proven, that the elements include proving the states of mind of the perpetrator and the victim, and that some jurisdictions require the victim to prove fraud by clear and convincing evidence.

The remedies for fraud may include rescission (i.e., reversal) of a fraudulently obtained agreement or transaction, the recovery of a monetary award to compensate for the harm caused, punitive damages to punish or deter the misconduct, and possibly others.

In cases of a fraudulently induced contract, fraud may serve as a defense in a civil action for breach of contract or specific performance of contract. Fraud may serve as a basis for a court to invoke its equitable jurisdiction.

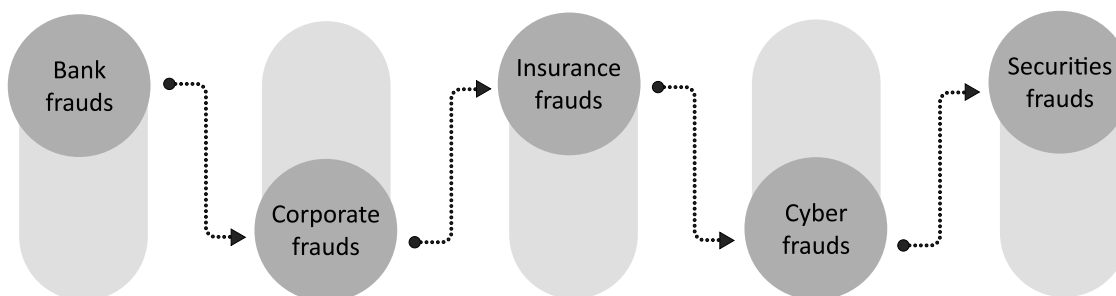
2. **Fraud as a Criminal offence**, takes many different forms, some general (e.g., theft by false pretense) and some specific to particular categories of victims or misconduct (e.g., bank fraud, insurance fraud, forgery). The elements of fraud as a crime similarly vary. The requisite elements of perhaps the most general form of criminal fraud, theft by false pretense, are the intentional deception of a victim by false representation or pretense with the intent of persuading the victim to part with property and with the victim parting with property in reliance on the representation or pretense and with the perpetrator intending to keep the property from the victim. In Indian Law, Implications of fraud is found in these following sections of BNS namely, 318, 319, 320 and 321.

- Fraudulent removal or concealment of property to prevent distribution among creditors
- Fraudulently preventing debt being available for creditors.
- Fraudulent execution of deed of transfer containing false statement of consideration.
- Fraudulent removal or concealment of property.

### Kinds of Fraud in specific to Economy and Financial Transactions

In specific to the impact on economy and financial transactions, frauds could be categorized as below:

- 1) Bank frauds
- 2) Corporate frauds
- 3) Insurance frauds
- 4) Cyber frauds
- 5) Securities frauds



- 1) **Bank Frauds:** Bank fraud is a big business in today's world. The number of bank frauds in India is substantial. It is increasing with the passage of time in all the major operational areas in banking. There is a different area in Bank Deposits, loan, inter branch, accounting, transaction etc.
- 2) **Corporate Frauds:** In India, Corporate Frauds from leading Indian business are shaking the economy time and again. From Satyam Computers stunned the national financial world in 2009, when Satyam's Founder B. Ramalingan Raju declared he had inflated profit and jacked up the company's Balance Sheet by more than one billion dollars to the recent incident of PNB Fraud in year 2017, Frauds are apparent in the corporates. This needs to be checked strictly to ensure financial stability and emerging economy.
- 3) **Insurance Frauds:** There is a different type of frauds in insurance sectors. E.g. health insurance, claims fraud, false claims, insurance speculations, application frauds etc.
- 4) **Cyber Frauds:** Cyber Frauds are the frauds done with the help of the internet targeting the unauthorized use of digital instruments like credit card, ATM card, cyber equipment's at home etc.
- 5) **Securities Frauds:** Apart from Corporate Frauds, Frauds in the Securities and Securities Market are also affecting many people time and again. From the perspective of frauds in securities, investor community could not forget the under truncate Rs. 4000 crore of Harshad Metha scam and over Rs. 1,000 Crore of Ketan Parekh scams which duped the shareholder with the loss of their wealth in the big markets. In addition to this, the instances of Insider trading are also considered securities fraud in many circumstances.

### Corporate Frauds: An Insight

Fraud against a company can be committed either internally by employees, managers, officers, or owners of the company, or externally by customers, vendors, and other parties. Other schemes defraud individuals, rather than organizations.

**Internal Fraud:** Internal fraud, also called occupational fraud, can be defined as: "the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the organization's resources or assets." Simply stated, this type of fraud occurs when an employee, manager, or executive commits fraud against his or her employer.

**External Fraud:** External fraud against a company covers a broad range of schemes. Dishonest vendors might engage in bid-rigging schemes, bill the company for goods or services not provided, or demand bribes from employees. Likewise, dishonest customers might submit bad checks or falsified account information for payment, or might attempt to return stolen or knock-off products for a refund. In addition, organizations also face threats of security breaches and thefts of intellectual property perpetrated by unknown third parties.

As reported time and again with various incidents like that of Nirav Modi in the early month of 2018, of Vijay Mallya, of Sahara Subrato Rao, of Satyam Computers, of 2G and alike, Corporate Scams are affecting the economic health of the companies time and again. With nearly over 250 scams in India since 1947, an approximate of 20.23 Trillion US Dollar loss has been reported in Corporate Scams in India.

Deccan Chronicle in its latest article reported that India has seen a significant rise in incidence of fraud, cyber and security related incidents, which according to a private survey is higher than the global average. Around 89 per cent of the respondents in India who participated in the Kroll global fraud survey report said that they had experienced a fraud incident in the past one year. Respondents in India reported one of the world's highest incidences of theft of physical assets or stock, with two-fifths saying they had experienced this type of fraud, second only to those in Canada. Theft of intellectual property and market collusion are also high on the list of incidents of fraud in India. What is more interesting is that a higher proportion of respondents (45 per cent) in India cited joint venture partners as the main reason for increased exposure to fraud while 43 per cent attributed the role of junior employees for the likely occurrence of frauds.

According to the survey, India figures among the top three countries globally for every category measuring fraud vulnerability except for vendor, supplier, or procurement fraud. Nearly nine in 10 respondents (87 per cent) cited information theft, loss, or attack as their greatest concern, 30 percentage points higher than the global average of 57 per cent.

Internal financial fraud, IP theft, piracy, and counterfeiting were also significantly higher than the global averages. However, the survey noted that Indian corporates are becoming more aware of the risks and are implementing preventive measures such as financial controls and physical security systems. Coming to cyber related frauds, 84 per cent of the respondents said they experienced a cyber-attack in the last one year. Nearly half of these respondents experienced email-based phishing attacks. Virus/worm attacks were the second most common type of incident reported. The most common targets for cyber-attacks in India were employee records, trade secrets or intellectual property and customer records. Henceforth, there seems an urgent need to implement the tool of forensic audit, which would be a great check on these frauds and in turn would boost the economy of the nation.

### Live Cases

#### 1. FORENSIC AUDIT ON PNB SCAM

Punjab National Bank appointed a BDO to conduct a forensic audit of jeweler Nirav Modi's companies, according to people directly briefed on the matter.

The bank issued a formal appointment letter to the Belgium-headquartered audit firm on February 27, 2018 to conduct a forensic audit in the scam wherein Modi, his uncle Mehul Choksi and their companies have been accused of defrauding the bank of as much as Rs 12,700 crore.

In the starting of January, 2018, PNB informed the BSE (Bombay Stock Exchange) that it has detected some "fraudulent and unauthorized transactions" in one of its branches in Mumbai to the tune of \$ 1771.69 million (approx.). Following the announcement, the share price of the state-owned bank plunged 10%.

Meanwhile, the Central Bureau of Investigation (CBI) received two complaints from PNB against billionaire diamantaire Nirav Modi and Jewelry Company alleging fraudulent transactions worth about Rs. 11, 400 crores, the Press Trust of India reported. This is in addition to the Rs. 280 crore fraud case that he is already under investigation for, again filed by PNB.

Nirav Modi, the billionaire in the middle of this controversy, is a luxury diamond jewelry designer who was ranked #85 in the Forbes list of India's billionaire in 2017.

#### The Modus Operandi

- In a statement issued to stock exchanges, PNB said it has detected some "fraudulent and unauthorized transactions (messages)".
- A stock statement is a business statement that provides information on the value and quantity of stock related transactions. It details opening and closing balances for transacted items as well.

According to the complaint filed by PNB with the CBI on January 28, the fraudulent issuance of Letters of Undertakings (LOU) was detected at the Mid Corporate branch, Brady House in Mumbai.

#### 2. FORENSIC AUDIT ON DENA BANK

The Finance Ministry has ordered a forensic audit of Dena Bank and Oriental Bank of Commerce after some of their Mumbai-based branches allegedly misappropriated funds worth Rs. 437 crore, mobilised through fixed deposits. Professional services firm KPMG in India has been given the mandate to undertake forensic investigations. In the case of Dena Bank, the misappropriation was to the tune of Rs. 257 crore and related

to funds mobilised from seven corporate. In Oriental Bank's case, it related to misappropriation of funds amounting to Rs. 180 crore, reportedly belonging to the Jawaharlal Nehru Port Trust. The Central Bureau of Investigation is already looking into the alleged fraud. The developments are disparate ones and took place at different times. But a common feature could be that they centered on mobilising deposits: fixed deposits/bulk deposits. The incidents have again brought to the fore the weak risk management systems in public sector banks. "The persons responsible have been taken to task; some disciplinary action is being taken. There are also some suspensions, some transfers..."

### Directors' Responsibilities

The ubiquitous issue of corruption and the high risk of internal fraud raise serious concerns about the liability of corporate directors. India has learned a lot in recent years, and its laws have gradually evolved in this context.

Director liability in India can be divided into two principal areas:

- (1) liability under the Companies Act 2013 (the 2013 Act); and
- (2) Liability under other Indian statutes.

There has been a seminal shift in the Indian corporate legal regime with the enactment of the 2013 Act and more recent amendments.

For instance:

- Penalties under the erstwhile Companies Act 1956 that were seen as ineffective have been significantly amplified under the Companies Act, 2013.
- The Companies Act, 2013 also provides statutory recognition to the duties of a director, such as exercise of due and reasonable care, skill, diligence, and independent judgment.
- One of the key concepts of the Companies Act is the meaning of the term "officer who is in default." Under the act, liability for default by a company has been imposed on an officer who is in default.
- By virtue of their positions in the company, the managing director, the whole-time director, and the company secretary directly fall within the scope of this term.
- Under the erstwhile Companies Act, 1956 certain key employees such as the chief executive officer and chief financial officer did not directly come within the ambit of the term, which raised serious concerns because these personnel were viewed as key officials in any company.
- The Companies Act, 2013 corrects this anomaly and significantly expands the scope of the expression "officer in default." The term also includes the following:
  - i. any individual who, under the superintendence, control, and direction of the board of directors, exercises the management of the whole, or substantially the whole, of the affairs of a company;
  - ii. any person on whose advice, directions, or instructions the board of directors is accustomed to act, other than persons giving advice in a professional capacity; and
  - iii. Every director aware of wrongdoing by virtue of knowledge of or participation in proceedings of the board without objection.

This way, under Companies Act, 2013, the scope of Director Responsibility has been expended to stop the tendencies of fraud in the Corporates. Directors can be held liable both jointly and collectively, for any and every act, commission or omission which is prejudicial to the interests of the company and violates any of the duties to be discharged by them.

A ready reference of Directors Responsibility could be chalked as under:

### Director's Personal Liability

As a general rule, since the company and its Director are separate entities, the Director has no personal liability on behalf of the company. However, under certain circumstances, a Director may be held liable on behalf of the company. These circumstances are:

- Liability for Tax
- Debts of the Company
- Liability for company's Contracts
- Refund of Share application Money
- Liability to pay for qualification shares
- Mis-statement in the Prospectus

**Fraudulent Conduct of Business:** A Director may be held personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company if he or she was knowingly party to the fraudulent carrying on of business.

**Unlimited Liability:** The liability of any or all of the Directors of a limited company can be unlimited if so provided by the Memorandum, or can be so done if approved by a special resolution as authorized by the Articles.

### FORENSIC AUDIT VIS-À-VIS AUDIT

Major difference between Audit and Forensic Audit is discussed as below:

- Objective of financial auditing is to express opinion as to 'true & fair' presentation. Forensic Audit determines correctness of the accounts or whether any fraud has actually taken place.
- Techniques used in the financial auditing are more of 'Substantive' and 'compliance' procedures. The techniques used in the forensic auditing are analysis of past trend and substantive or 'in depth' checking of selected transactions.
- Normally all transactions for the particular accounting period are covered under the financial audits. Forensic audits don't face any such limitations. Forensic auditors may be appointed to examine the accounts from the beginning.
- For ascertaining the accuracy of the current assets and the liabilities financial auditor relies on the management certificate or representation of management. Forensic auditors are required to carry out the independent verification of suspected or selected items.
- Whenever the financial auditor has adverse findings, then the auditor expresses the qualified opinion, with/without quantification. In case of the adverse findings, the forensic auditors are required to quantify the damages to the clients and is also supposed to point the culprit. Many a times, Legal action will be sought.

### MODERN DAY SCENARIO

It is always said that to ensure the availability of best means of livelihood and to provide citizens with virtues of 'Justice' and 'Welfare', which also results in the inclusive growth of nation as a whole, the prerequisite is that there must be a relationship of trust and faith *inter se* the Citizens and the Government. The activity of the

Government has to be such that the citizens repose faith in the Government and its activities. It is important to realize that this trust and faith cannot be demanded rather it has to be earned by the Government. The government has to be the harshest critic of scourge like corruption, waste and fraud in almost every sphere of life and human activity.

Capturing the spirit of serving the citizens with welfare, justice and growth, and to maintain parity while working towards achieving them, and to ensure that the means of inclusive progress and growth of India, at par, the Government of India has objectives of coming together towards building an Inclusive India, which is free from scourge of corruption, terrorism, poverty, communalism, casteism and filth. In order to take forward this pledge of creating a new India which is not only strong and prosperous but also all-encompassing, the Government of India has also launched “Sankalp se Siddhi” (Attainment through Resolve) Scheme, which aims at Good Governance.

In the present contemporary era, the New India Movement Scheme envisages an India which is free from poverty, corruption, terrorism, communalism, casteism and uncleanness and aims to unite the entire nation by adopting the policy of Good Governance and most importantly employing technology with the focus objective of serving growth in all sectors of the nation, be it economic, political, social, technological, legal or environmental.

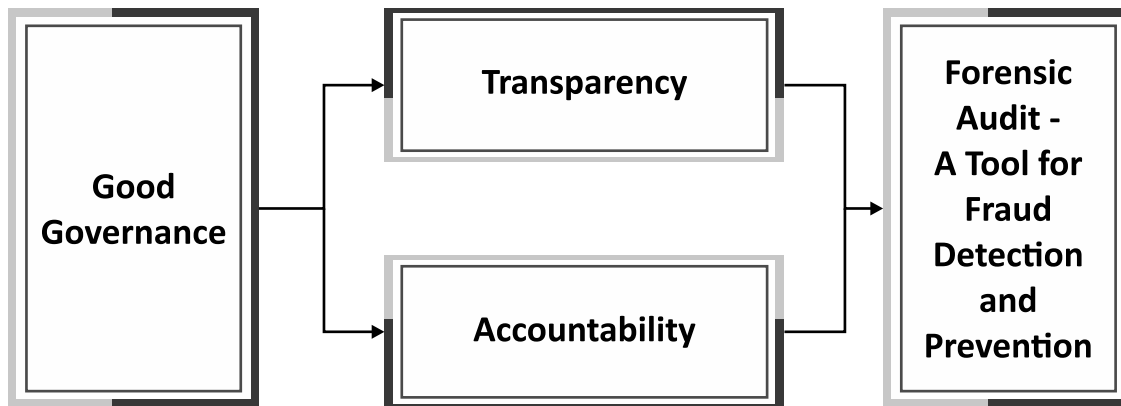
In addition to it, one should also have an insight into the Preamble of the Constitution of India, which envisages to establish a nation that provides Justice – Social, Economic and Political, along with Liberty, Equality and Fraternity to the people of India. Aligning the spirit of the Preamble of our Constitution along with the functional objectives and vision, one can say that the transformation envisaged should take place in all the spheres *i.e.* Social, Economic and Political spheres of Indian society while at the same time upholding the principles of Liberty of thought, expression, belief, faith and worship; Equality of status and of opportunity; and to promote among them all fraternity assuring the dignity of the individual and the unity and integrity of the Nation.

In this context, different measures adopted by the Government of India in the form of the reform measures like *Jan Dhan Yojna, National Scholarship Portal, Pradhan Mantri Kaushal Vikas Yojana, National Young Leaders Program, Khelo India – Boost the Sports* and many others are being brought in with the single-minded focus of transforming and reforming the nation and take it on the path of success and development. In order to transform the compassing pillars of Indian economy to enhance its performance with excellence, we are witnessing a plethora of Government initiatives including *Ease of Doing Business, Start-Up India, Stand Up India, Digital India* along with reformative regulating regime with the implementation of *Goods and Services Tax, Insolvency and Bankruptcy Code, Real Estate – Regulation and Development, Companies Amendment Act, Forensic Audit, Class Action Suit, Valuation et al.*

A consolidated and holistic review of these reforms confirms the fact that the Government aims to establish the best practices of Good Governance wherein the virtues of Transparency and Accountability should rule the inclusive growth of our Economy as well as of Corporates in consonance. In order to serve all compassing views of growth and development of the Indian economy while making us as one of the fastest moving and emergent economies in the World, the Government of India is not only looking forward to encourage the perspectives of development, it is also introducing some strong measures by regulating the improper practices and non-compliances which hinder the way forward for the inclusive corporate culture of emergent Indian economy.

### **Forensic Audit: Leading way to Emergent Economy**

This confirms that the Government of India is adopting a highly collaborative approach and addressing various challenges like fraud, deceit, financial misplacement and alike, which are a big hindrances in the path of inclusive growth of corporates in India.



Among other things, 'fraud' is one of the most critical ailments which not only holdups the corporate organizations where it is conducted, rather it shakes the economy of entire country which has both short term as well as long term impact.

The recent incident of financial deception faced by one of the leading Public Sector Bank of India, has not only dazed the Government, the Regulator, the Stakeholders, the Corporate community, and also the Public at large, rather it has also rung the alarm bells for all of us, specially regulators and governance professionals to critically examine the gaps responsible for making us to a witness to this kind of financial catastrophe. In fact, after making this discovery and unearthing this massive fraud which took place at PNB, the second biggest staterun lender of India, the Financial Services Secretary was constrained to direct and instruct that 'All Bad Loan Cases above INR 50 Crores at Public Sector Banks will be examined for fraud.' Further the respective MDs were directed to detect bank frauds and consequential wilful default in time and refer all such cases to the CBI.

Globally, the regulators are in the best position and are the best masters to give signals of a financial cataclysm, but it seems that seldom do players heed to their conscience and follow the voice of wisdom. Keeping this vigil in mind, Forensic Audit is a dynamic approach adopted which aims to have timely detection of all frauds and also to take the requisite financial information in determining and identifying the real culprit behind the deceit.

In this whole process of timely detection of frauds and reference of such case for due investigation, Forensic Audit has an imperative role in assisting the corporates to maintain efficiency as well as merit at par. In the larger perspective, Forensic Audit is known as a tool which aims to improve the efficiency, compliance, governance and merit parameters of financial and other regulatory aspects.

Aligning the augmenting need and significance of Forensic Auditing for making sure that a company's finances are being kept safe and in order has become a growing concern in today's business environment along with the rise in money laundering and wilful default cases, the Reserve Bank of India has recently made forensic audit mandatory for large advances and restructuring of accounts.

Reserve Bank of India has recently made forensic audit mandatory for large advances and restructuring of accounts.

The Enforcement Directorate and the Serious Fraud Investigation Office have also emphasized the need for forensic audit following the rise in money laundering and Wilful default cases that are plaguing the banking system.

Regulatory Reforms for enhancing the financial stability of the country also increases the importance of Forensic Audit in the country's fight against financial offenders.

Along with Reserve Bank of India making forensic audit mandatory for large advances and re-structuring of accounts, the Enforcement Directorate and the Serious Fraud Investigation Office have also emphasized the need for forensic audit following the rise in money laundering and wilful default cases that are plaguing the banking system. They referred to the example that as the enactment of The Prohibition of Benami Property Transactions Act, 1988 increases the importance of Forensic Audit in the country's fight against financial offenders, there are other levels too, where forensic audit would prove to be a boon in settling down the principles of transparency and integrity in addition to settling down the accountability of real culprit.

The above discussion confirms that in order to assist in the paramount growth of Indian economy on the global platform under the realm of good governance, transparency, accountability and uprightness, Forensic Audit has become a need of the hour. With its key benefits in the form of Objectivity, Credibility, Expert Accounting, Enhanced effectiveness and Efficiency, Forensic Audit assures the growth of the corporates and development of the Indian Economy, which in turn leads to the inclusive growth of the emerging India. Therefore, it becomes imperative that the professionals should be well versed with basic concepts of Forensic Audit in order to effectively implementation the means and techniques of Forensic Audit towards mitigating the corporate frauds and strengthening an efficient corporate culture in India.

Further, in an era of supporting a robust economy of India, which is becoming one of the fastest emerging economies of the world, it is significant to encounter all the challenges affecting the directed growth of the economy. In such the efforts encountering the challenges, the menace of fraud, deception and scam has to be encountered at the first instance in order to promote a viable growth to corporates and economy as a whole. Considering the urgent need to check financial frauds on one side and characteristics of Forensic Audit on other side, which helps in an examination and evaluation of a firm's or individual's financial information for use as evidence in court along with a fact finding process to prosecute a party for fraud, embezzlement or other financial claims, forensic audit is leading the check in the modern day scenario.

With the contemporary phase of making a New India as free from corruption on the lines of good governance, Forensic auditing is a

- Rapidly growing area as a specialized branch of accounting and investigations; and
- Is concerned with the detection and prevention of financial fraud and white-collar criminal activities.

In this context, this book serves as a ready reference to the principles, facets and the concept of Forensic Audit, providing a basic understanding to the meaning and significance of Forensic Audit, tools and techniques of conducting it, audit and investigations as well as the laws applicable to Forensic Audit and investigations in India.

#### CASE STUDY

**1. Inventory manipulations are some of the most common areas of fraud incidence but the auditor should look beyond a typical stock audit process.**

XYZ & Co. is engaged in mining and sale of manganese ore and had availed of working capital limits from the Banks to undertake its business. The excavated ore and processed manganese were provided as collateral for the same. The company had successful business years and increased its growth plans and the corresponding working capital limits. A regulatory order banning mining activities came in to force leading to stoppage of business and a subsequent default of the lending limits. The Bank engaged forensic auditors as per the guidelines of the RBI.

**Audit Approach:**

- Evaluate if the business failure was genuine due to the change in regulatory regime
- Validate the business growth in the past and the justification for increased working capital limits
- Investigate the inventory control mechanisms as that forms the major collateral in this case
- Quantity and Price assumptions in arriving at inventory value as the product is a mining output with value add at various stages.

**Audit Findings:**

1. Poor record keeping
2. Records maintained in MS Excel
3. No proper disclosure of inventory
4. Inability to verify inventory records
5. Weak management systems.

**2. Auditors should research on all group companies and related business activities of the borrower to identify potential sources of diversion of funds through purchases.**

ABC & Co. is engaged in manufacturing of alloy steel with operations located in East India. The company has availed of loans for expansion of capacity in order to meet the growth plans of the company. The project cost was revised during the implementation and an additional loan was provided by the lenders. The account turned NPA before the new facility could get operational and was subject to a forensic audit as mandated by the RBI Guidelines.

**Audit Approach:**

- Study the techno-economic feasibility study of the project
- Identify the major procurement needs and sourcing plans as per the detailed project report (DPR)
- Understand the procurement process as defined in the management systems of the company
- Review the procurement decision related documentation – call for quotations, review mechanism, price comparisons, negotiations before awarding the contract for supply of materials and services
- Verify the documents for genuineness of the quotes received
- Contact vendors of high value items to establish if the procurement process was implemented in spirit o Identify related parties in the vendors, if any
- Review all procurement related documentation – Purchase Order, Delivery Challans, Weigh Bridge slips, taxes paid and goods received notes maintained at the company.
- Validate the veracity of the purchase documents with a special focus on duties and levies paid on the goods purchased, the transportation receipts and weigh bridge noting, etc. for any mismatch and inconsistencies
- Cross verify the transportation documents from public sources like RTO

- Check for duplicate purchase orders for the same materials and services
- Compare the landed cost of the materials and services with the current market trends and past price data for commodity items that are tracked independently
- Research and review details of other business interests of the promoters and close family members
- Verify the sources of funds for the other business interests of the promoters.

**Audit Findings:**

1. Errors in the purchasing process. Further company had infused funds in another project with an unrelated business interest, several transactions with related parties as suppliers of goods and services.
2. Layer of purchase transactions instead of direct purchases.
3. False quotations, duplicate purchase orders, fake transportation bills,
4. Inflated of the project cost.

**LESSON ROUND-UP**

- In general, Forensic Audit represents an area of finance that combines detective skills and financial acuity. Further, Forensic Auditing is used in a number of ways and for a number of purposes and not just for criminal activity detection.
- In order to catch the glimpse of Forensic Audit in totality, it also become significant to know and understand the meaning of Audit itself. As per English Oxford Dictionary, “Audit” means an official inspection of an organization’s accounts, typically by an independent body. It also states a word of caution that many a times, audits are not expected to detect every fraud.
- Forensic audit is, in general, referred to as an examination of evidence regarding an assertion to determine its correspondence to established criteria carried out in a manner suitable to the court.
- As per the definition given in Investopedia, Forensic Audit is an examination and evaluation of a firm’s or individual’s financial information for use as evidence in court.
- Forensic audit is becoming increasingly frequent for top leadership searches as stringent corporate governance norms and increasing stakes are prompting Indian and multinational companies to make sure that the people they take on board have no blotches on their track record. In order to assist in the paramount growth of Indian economy on the global platform under the realm of good governance, transparency, accountability and uprightness, Forensic Audit has become a need of the hour.
- Forensic Auditing in general is referred as a discipline of detecting frauds in the organizations and gathering and presenting financial information in a form of evidences that will be accepted by a court of jurisprudence against perpetrators of economic crimes.
- **Forensic Audit cover areas such as:**
  - i. Frauds Finding
  - ii. Fraud detection and prevention techniques
  - iii. Fraud related auditing

- iv. Investigation and analysis of financial evidence
- v. Development of computerized applications to assist in the analysis and presentation of financial evidence
- vi. Communication of findings, collections of documents; and Assistance in legal proceedings.

- **Key Advantages of Forensic Audit**

- i. Detection and Responsibility of Corruption
- ii. Detection of Asset Misappropriation
- iii. Detection of Financial Statement Fraud
- iv. Fraud Identification and Prevention
- v. Making Sound Investment Decisions
- vi. Formulation of Economic Policies
- vii. Rewarding Career Opportunity.

- **Few instances on the occurrence of which an entity should direct for Forensic Audit:**

- i. Theft of business information or where business systems have been hacked,
- ii. Issues identified by Whistle Blowers,
- iii. Reconciliations resulted in unidentified material differences,
- iv. Suspicious of fraud or illegal activity,
- v. Turnover has occurred and balances are showing negative results.

- **Fundamentals of Forensic Audit involves:**

- i. An audit
- ii. An investigation
- iii. An agreed-upon procedures engagement
- iv. A proactive search for fraud.

- **Stages of Forensic Audit**

Step 1 – Accepting the Investigation

Step 2 – Planning the Investigation

Step 3 – Gathering Evidence

Step 4 – Reporting

Step 5 – Court Proceedings.

- **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/organisation has to 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/organisation. The planning involves the formulation of techniques and procedures that align with the fraud risk and fraud risk management.

- **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,

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

- **'Fraud'**, in general, refers to a wrongful or criminal deception practiced which is intended to result in financial or personal gain to oneself and a financial or personal loss to the other.

- Explanation of Section 447 of Companies Act 2013 defines Fraud and related terms as below:

- i. 'Fraud' in relation to affairs of a company or anybody corporate, includes any act, omission, concealment of any fact or abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss;
- ii. 'Wrongful gain' means the gain by unlawful means of property to which the person gaining is not legally entitled;
- iii. 'Wrongful loss' means the loss by unlawful means of property to which the person losing is legally entitled.

- In general, fraud is an act of deliberate deception with the design of securing something by taking unfair advantage of another. It is a deception in order to gain by another's loss.

- **Elements of Fraud**

- i. False and Wilful representation or Assertion
- ii. Perpetrator of Representation
- iii. Intention to deceive
- iv. Representation must relate to a fact
- v. Active concealment of facts
- vi. Promise made without intention of performing it
- vii. Representation must have actually deceived the other party
- viii. Any other act fitted to deceive
- ix. Any such Act or omission that the law specially declares as void
- x. Wrongful Loss and Wrongful Gain is Immaterial.

**TEST YOURSELF**

*(These are meant for re-capitulation only. Answers to these questions are not to be submitted for evaluation)*

1. What do you mean by Forensic Audit? Discuss its need and significance in detail.
2. Write down the similarities and differences between Audit and Forensic Audit.
3. What are the areas covered under Forensic Audit?
4. What are the sign to conduct Forensic Audit?
5. What are the Stages of Forensic Audit? Describe each stages in details along with example.
6. What is Fraud?
7. What are the elements of Fraud?
8. What is Fraud Triangle?
9. What are the techniques to gather evidences while conducting Forensic Audit?
10. All False Statements are not fraudulent? Narrate the statement with examples.
11. Statement need not be affirmative to be considered as Fraudulent. Illustrate with examples.

**LIST OF FURTHER READINGS**

- **Forensic Audit Decoded**

*Author: G.C. Pipara*

*Publishers: Taxmann*

- **Forensic Audit**

*Author: CA Kamal Garg*

*Publishers: Bharat's*

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