Basic Concept of Forensic Accounting & Fraud Detection

Forensic Accounting

- Forensic accounting is a particular field of accounting that explores fraud and examines historical data which can be used in legal proceedings.
- Forensic accounting is a sensible blend of accounting, auditing and investigative abilities to conduct financial fraud inquiries.
- It is useful for court action and analytical accounting.

Forensic Accounting Covers

- Litigation Support Services
- Investigative / Fact-Finding Services

1. Litigation support services

A forensic accounting expert measures the damages experienced by the parties implicated in legal disputes and can aid in settling conflicts, even before it reaches the courtroom. In the event that a conflict reaches the courtroom, the forensic accounting professional could give evidence as an expert witness.

2. Investigative/fact-finding services

A forensic accountant must determine whether illegal matters such as employee felony, securities embezzlement (including tampering and distortion of financial accounts), identity theft and insurance racket have taken place.

The scope of forensic accounting is to:

1. Look for evidence of unusual development in the accounting and financial systems.
2. Design accounting processes for verifying important premises and data. A forensic accounting orientation also calls for skills in identifying possible fraud.
3. Perform audit type processes on a routine schedule in order to reduce transaction processing risks.
4. Cover a broad range of businesses and locations that require customary or continuous surveillance of all transaction processing systems.

Types of Forensic Accounting:

There are various types of forensic accounting that can take place and they are typically combined by the types of legal proceedings that they fall under. Below are some of the most common examples:

- **Financial theft (customers, employees, or outsiders)**
- **Securities fraud**
- **Bankruptcy**
- **Defaulting on debt**
- **Economic damages (various types of lawsuits to recover damages)**
- **M&A related lawsuits**
- **Tax evasion or fraud**
- **Corporate valuation disputes**
- **Professional negligence claims**
- **Money laundering**
- **Privacy information**
- **Divorce proceedings**

Forensic Accountants: Scope of work

- **Although the focus is fundamentally on accounting concerns, the function of a forensic accountant may also cover a more generic investigation including collection of evidence.**
- **Almost every accounting firm in the country today has forensic accounting sections. Within these sections, there may be sub-differentiations; for instance, some forensic accounting experts may specialise in insurance applications, personal injury declarations, fraudulence, construction or royalty audits.**
- **Forensic accountants may also offer their services in retrieving profits from crime and in relation to appropriation proceedings relevant to definite or assumed proceeds of crime or dubious transfer of funds.**
- **Unique only to India, there is a specific species of forensic accountants known as Certified Forensic Accounting Professionals.**

Forensic Accounting in India

Given the nature and types of fraud in India, the Reserve Bank of India (RBI) has compulsorily made forensic accounting audit mandatory for all banks within the country. The establishment of Serious Fraud Investigation Office (SFIO) in India has become the turning point for forensic accountants in the country.

The indications of the growing demand for the field are:

- **The growing list of online criminal offences.**
- **Breakdown of regulators to trace and detect cyber-security frauds.**
- **The long chain of co-operative banks going bust.**

How is a forensic accounting analysis different from an audit?

The difference between the public's expectation of the purposes and objectives of an audit and the CA's responsibilities under Generally Accepted Auditing Standards has been referred to as the "expectation gap". Forensic accounting can help to bridge the expectation gap.

In comparison, forensic accounting and audit differ in specific ways, as shown below:

S. No.	Particulars	Audit	Forensic Accounting
1	Objective	Express opinion as to "true & fair" presentation.	Whether any fraud has actually taken place in books.
2	Techniques	'Substantive' and 'Compliance' procedure. Sample based.	Investigative, substantive or in depth checking.
3	Period	Normally for a particular accounting period.	No such limitations.

S. No.	Particulars	Audit	Forensic Accounting
4	Verification of stock, estimation of realizable value of current assets, provisions/liability estimation, etc	Relies on the management certificate/Management representation.	Independent verification of suspected /selected items.
5	Off balance-sheet items (like contracts etc.)	Used to vouch the arithmetic accuracy & compliance with procedures.	Regularity and propriety of these transactions / contracts are examined.
6	Adversed findings, if any.	Negative opinion or qualified opinion expressed, with/without quantification.	Legal determination of fraud and naming persons behind such frauds.

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.

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

(a) any act

(b) omission,

(c) concealment of any fact

(d) abuse of position committed by any person or any other person with the connivance in any manner with intent to deceive to gain undue advantage from, or to injure the interests of,

- **the company or**
- **its shareholders**
- **or its creditors or**
- **any other person**

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

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

Fraud is also defined in Para 11(a) of SA 240 issued by the Institute of Chartered Accountants of India –"Auditors Responsibilities relating to Fraud in Audit of Financial Statements" as 'An intentional act by one or more individuals among

- **Management**
- **those charged with governance**
- **employees or**
- **or third parties, Involving use of deception to obtain an unjust or an illegal advantage**

Types of Frauds

1. Trojan Horse Frauds:

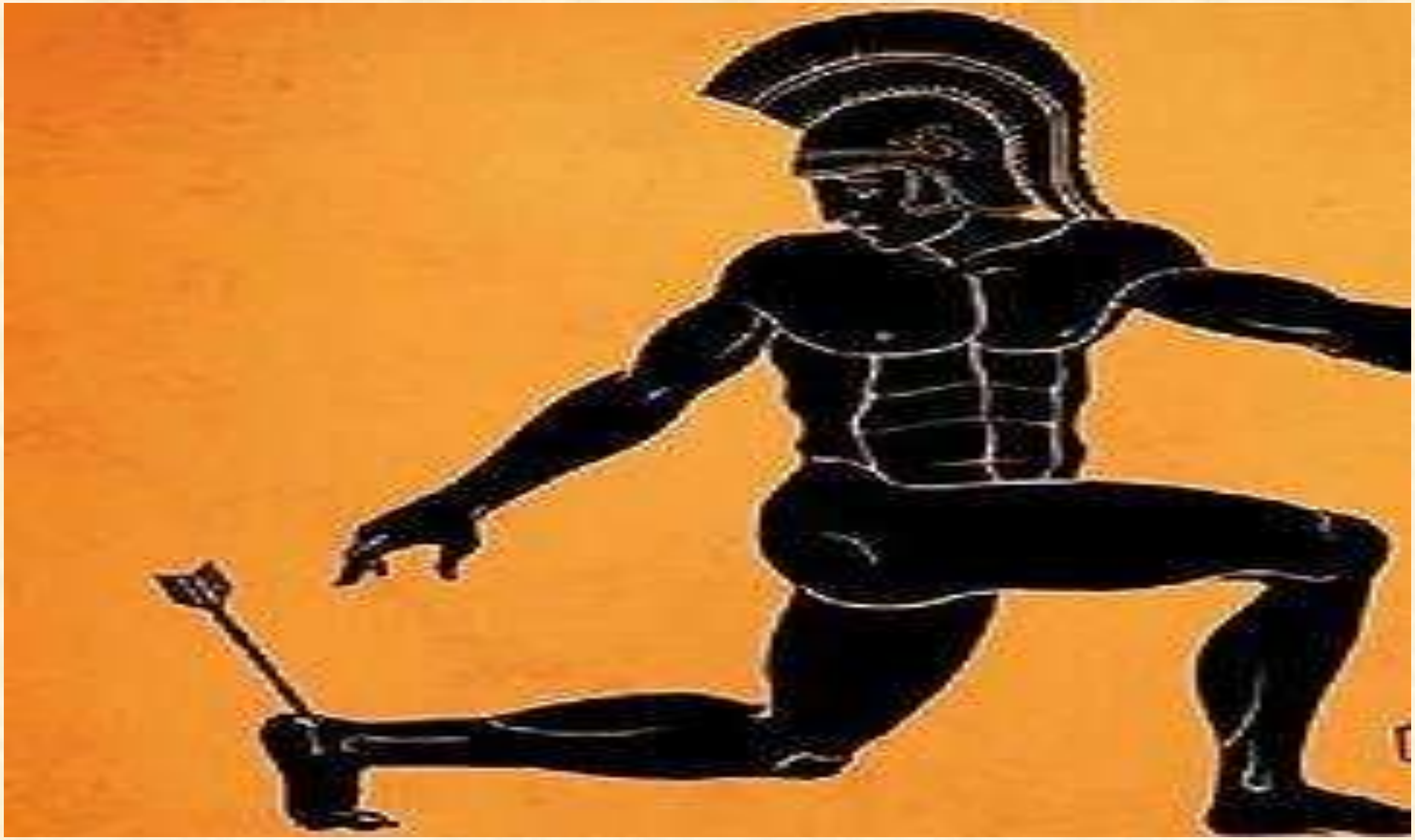
Eg: Cash Available for Purchase of Scrap/Garbage

2. Disaster Frauds:

Eg: Fire in the Stock Room – Theft of stocks or data.

3. Achilles Heel Frauds:

Eg: Cheque Date & Receipt Date



4. Corporate Espionage:

Eg: Lower Working-Class Employee purchased a big house.

5. Technical Frauds:

These are fakes which can happen directly before the eyes of the administration and it may not realize that it has been swindled.

Eg: Plastic made up of crude oil – 90% Material & 10% Scrap.

6. Bank Frauds:

This area has the highest potential of fraud.

The raw material is money itself.

Frauds can be perpetrated within a bank itself or by outsiders.

Insiders may manipulate funds, loans, and apply teeming and lading between favoured accounts.

Outsiders could defraud a bank by furnishing fabricated, duplicated or altered demand drafts, cheques, bills of exchange and other negotiable instruments.

Apart from these borrowers also often cheat banks in hypothecation agreements by inflating inventories or even providing substandard or spurious stocks with little or no value.

7. Digital Frauds:

- Business E-Mail Compromise (BEC)
- Data Breach.
- Denial of Service (DOS).
- E-Mail Account Compromise (EAC).
- Malware/Scareware.
- Phishing/Spoofing.
- Ransomware.

Red Flags

- **A red flag is a warning or indicator, suggesting that there is a potential problem or threat with a company's stock, financial statements, or news reports.**
- **General Eg: Based on the Patient's Symptoms, doctor diagnose the illness.**

Red Flags:

1. Absence of revolution of obligations or delayed presentation in a similar zone. Eg: No arrangement of Revolution of suppliers or merchants.
2. Close nexus with merchants, customers or outside gatherings.
3. Sudden Losses.
4. TGTBT condition (Green Flags) (Too Good To Be True).

Red Flags:

5. Generation of 'vagrant' reserves. Eg: Assets Gathered by Trusts.
6. Disaster circumstances.
7. Missing Documentation.
8. Chaotic conditions. Eg: Delay in finalization of accounts.
9. Irrational conduct.

Concept of Green Flags or the unrealistic' (TGTBT) disorder:

Few Instances are:

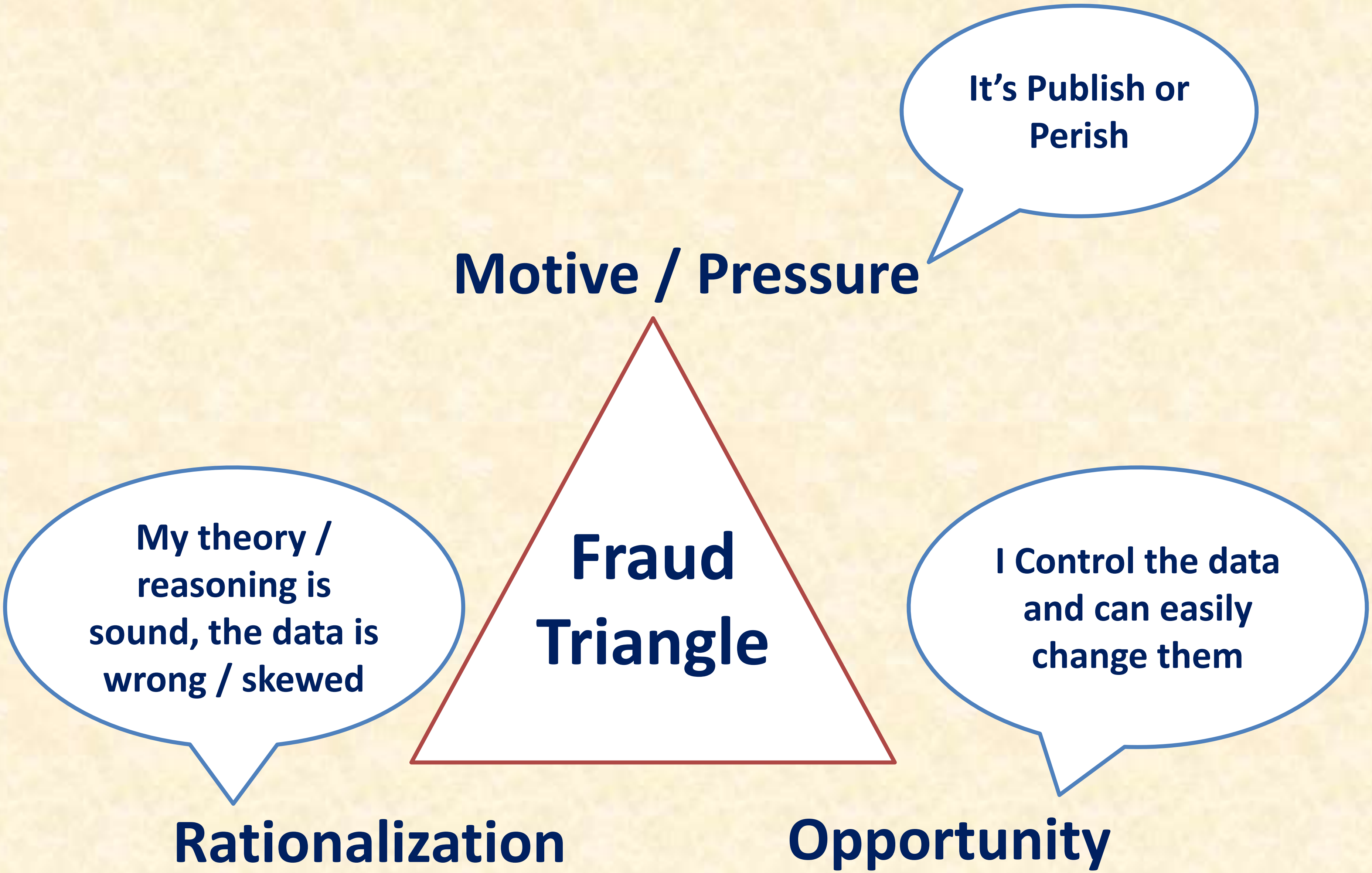
1. **Oneway Mistakes. For Example, circumstances where clerks or vendor who show overabundance stocks, however never any deficiencies. In fact there are no stocks.**
2. **Messy bookkeepers. For example, a long-standing, past due compromise of receivables or payables, which proves to be fruitful.**
3. **A bookkeeper/worker deliberately pays from his own pocket to compensate for a slip by.**

Concept of Green Flags or the unrealistic' (TGTBT) disorder:

4. Worker doesn't take progresses/money skim when he goes on outstation visits for organization purposes. He spends from his own assets and presents travel bills for repayment months or even two or after three years.
5. Outrageous conduct of being neighbourly or devoted or agreeable or brutal should be taken a gander at with doubt. For Eg: Quality Control (QC) supervisor in dismissing food rolls fabricated by a subcontractor.
6. An expansion of point 5 above, pirating great material in the pretense of dismissal.

Future Opportunities in Forensic Field:

1. Conventional Investigation tasks as a continuation of reviews.
2. Investigations by Statutory specialists.
3. Bank Fakes.
4. Business hazard assessment. Eg: Loans to New Ventures.
5. Insurance case fakes.
6. Compliance confirmations. For Eg: Assets given to the Trust are properly utilized for the intended purpose.


It's Publish or Perish
Motive / Pressure
Fraud Triangle
My theory / reasoning is sound, the data is wrong / skewed
Rationalization
I Control the data and can easily change them
Opportunity

Fraud Triangle - Opportunity:

Opportunity refers to circumstances that allow fraud to occur. In the fraud triangle, it is the only component that a company exercises complete control over.

Examples that provide opportunities for committing fraud include:

1. Weak internal controls.
2. Poor tone at the top.
3. Inadequate accounting policies.

Fraud Triangle – Incentive(Pressure):

Incentive, alternatively called pressure, refers to an employee's mindset towards committing fraud.

Examples of things that provide incentives for committing fraud include:

1. **Bonuses based on a financial metric.**
2. **Investor and analyst expectations.**
3. **Personal incentives. May include wanting to earn more money, the need to pay personal bills, a gambling addiction etc.**

Fraud Triangle – Rationalization:

Rationalization refers to an individual's justification for committing fraud.

Examples of common rationalizations that fraud committers use include:

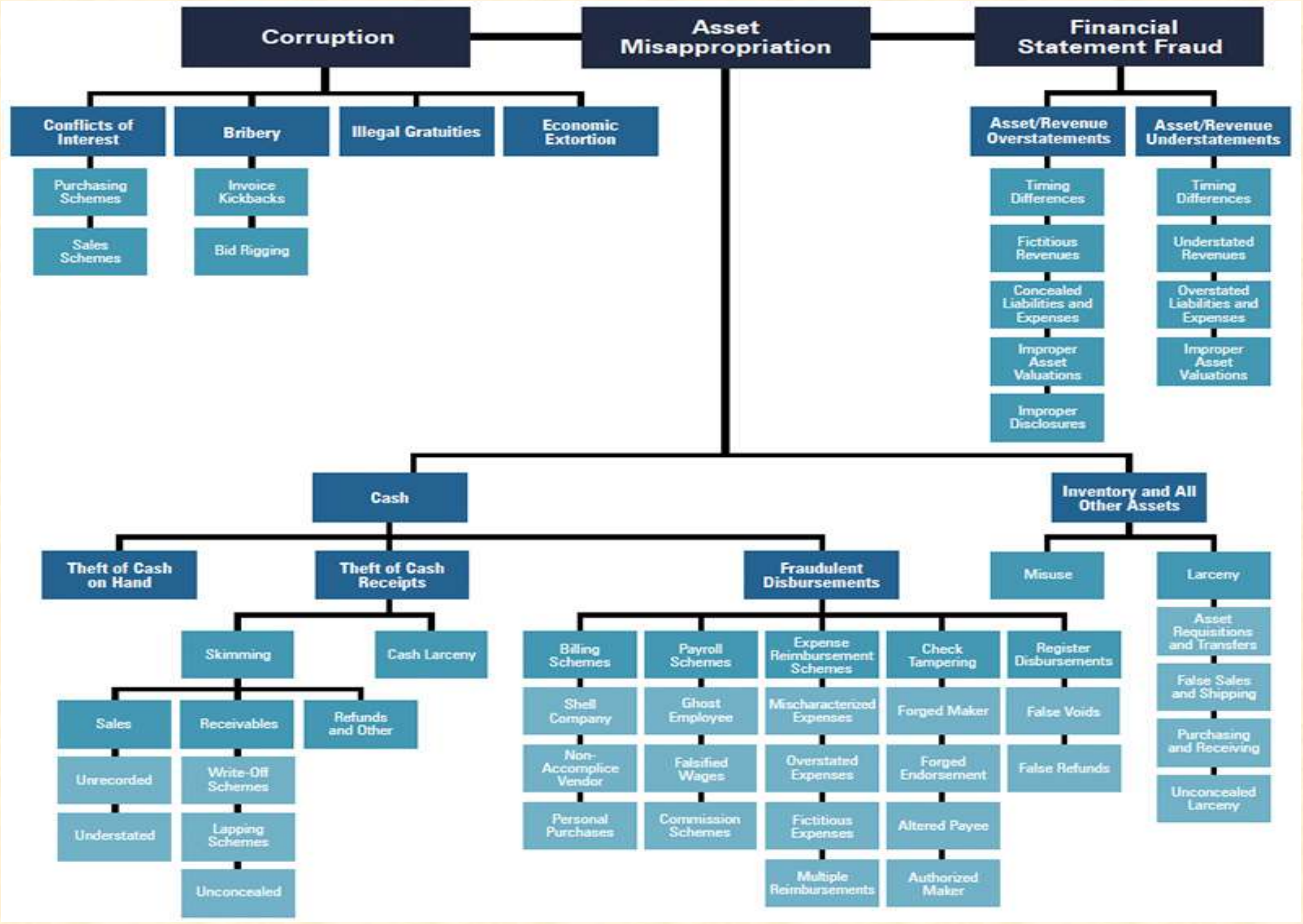
1. "They treated me wrong".
2. "Upper management is doing it as well".
3. "There is no other solution" - An individual may believe that they might lose everything (for example, losing a job) unless they commit fraud.


Incentive
Opportunity
The Fraud Diamond
Rationalization
Capability

As per the forensic accountant David T. Wolfe and Professor Dana R. Hermanson, the Capability Factors Include:

1. Having the right organizational position or function to take advantage of fraud opportunities.
2. Having the appropriate expertise to take advantage of fraud opportunities.
3. Having the confidence or ego to take advantage of fraud opportunities.
4. Being able to coerce others to participate in fraudulent activities.
5. Being able to deal with the stress associated with committing fraud.
6. Being a good liar.

The Fraud Tree



1. Corruption:

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

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

2. Asset misappropriation:

By far the most common frauds are those involving asset misappropriations and there are many different types of fraud which fall into this category. The common feature is the theft of cash or other assets from the company, for example:

• Cash theft – the stealing of physical cash, for example petty cash from the premises of a company.

• Fraudulent disbursements – company funds being used to make fraudulent payments. Common examples include billing frauds, where payments are made to a fictitious supplier and payroll frauds, where payments are made to fictitious employees (often known as 'ghost employees').

• Inventory frauds – the theft of inventory from the company.

• Misuse of assets – employees using company assets for their own personal interest.

3. Financial statement fraud:

This is also known as fraudulent financial reporting and is a type of fraud that causes a material misstatement in the financial statements.

It can include deliberate falsification of accounting records; omission of transactions, balances or disclosures from the financial statements; or the misapplication of financial reporting standards.

This is often carried out with the intention of presenting the financial statements with a particular bias, for example concealing liabilities in order to improve any analysis of liquidity and gearing.

Techniques involved in Forensic Accounting to examine the frauds are:

I. Benford's Law.
II. Theory of Relative size factor (RSF).
III. Computer Assisted Auditing Tools (CAATs).
IV. Data Mining Techniques.
V. Ratio Analysis.

Thank You