

Introduction to Forensic Accounting and Fraud Investigation

Session 1 - Forensic Workshop - WIRC

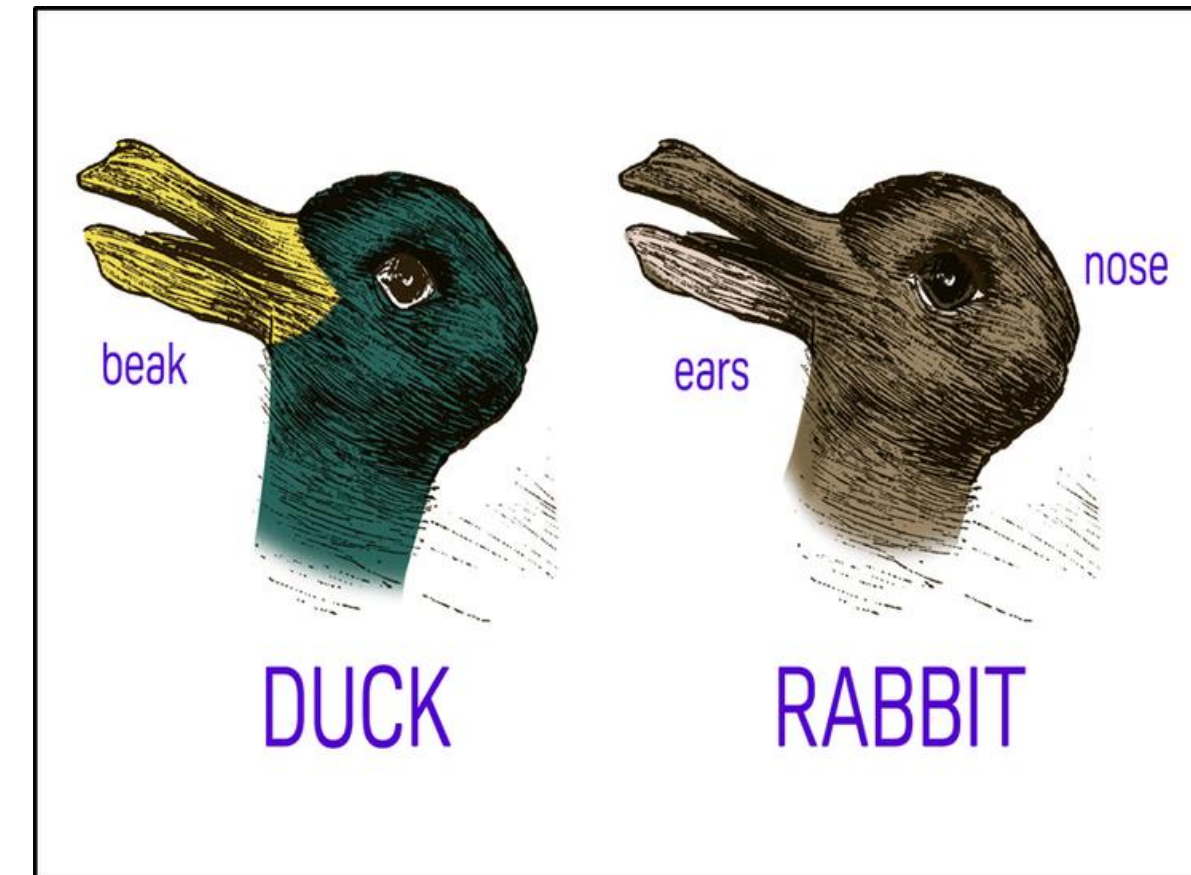
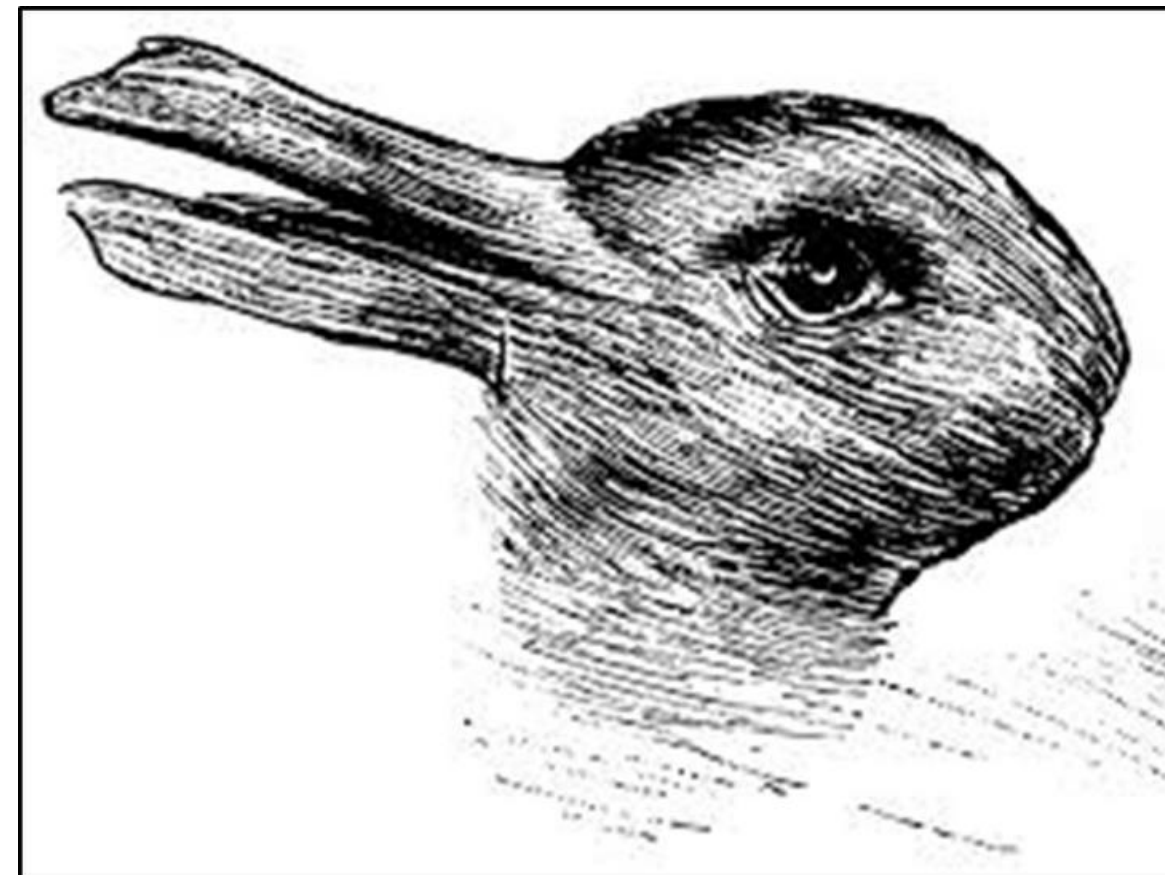
**WIRC
Forensic Workshop**

**Session Chairman
CA Harish Dua**

**Session Speaker
CA Jyot Baxi**

**25 October 2021
Monday**

Perspective



Understanding



Topic | Theme



Context | Scenario



New era - FAIS

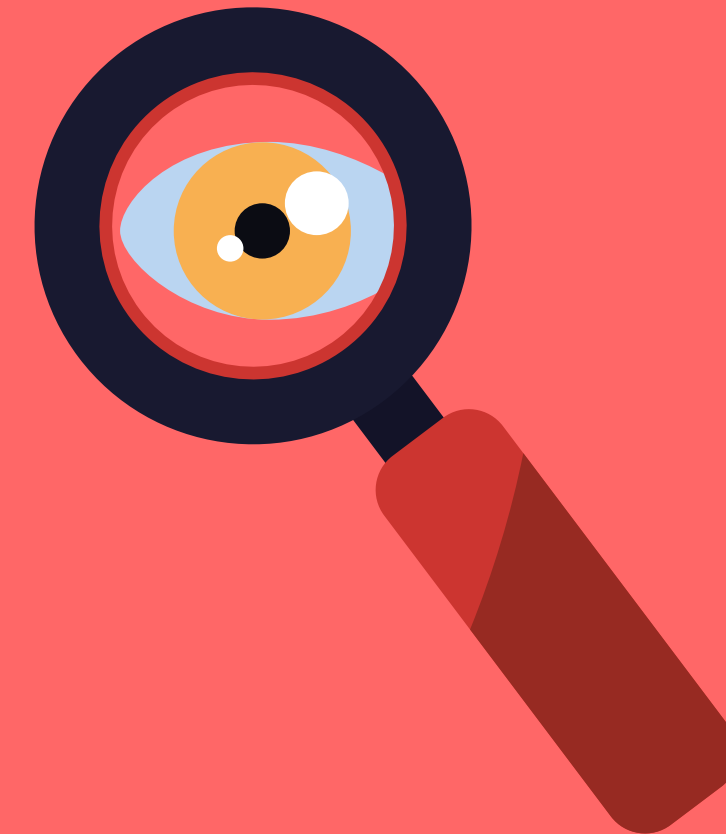


Difference between the two terms



FORENSIC ACCOUNTING

to apply forensic skills to collect evidence and present in the court of law or provide expert testimony,



INVESTIGATION

collect evidence to help establish possible fraudulent intent or identify potential perpetrators of fraud.

The number of frauds reported during **2020-21 decreased by 15 per cent** in terms of number and 25 per cent in terms of value, vis-à-vis 2019-20

Financial statements fraud occurs in **10 % of schemes**

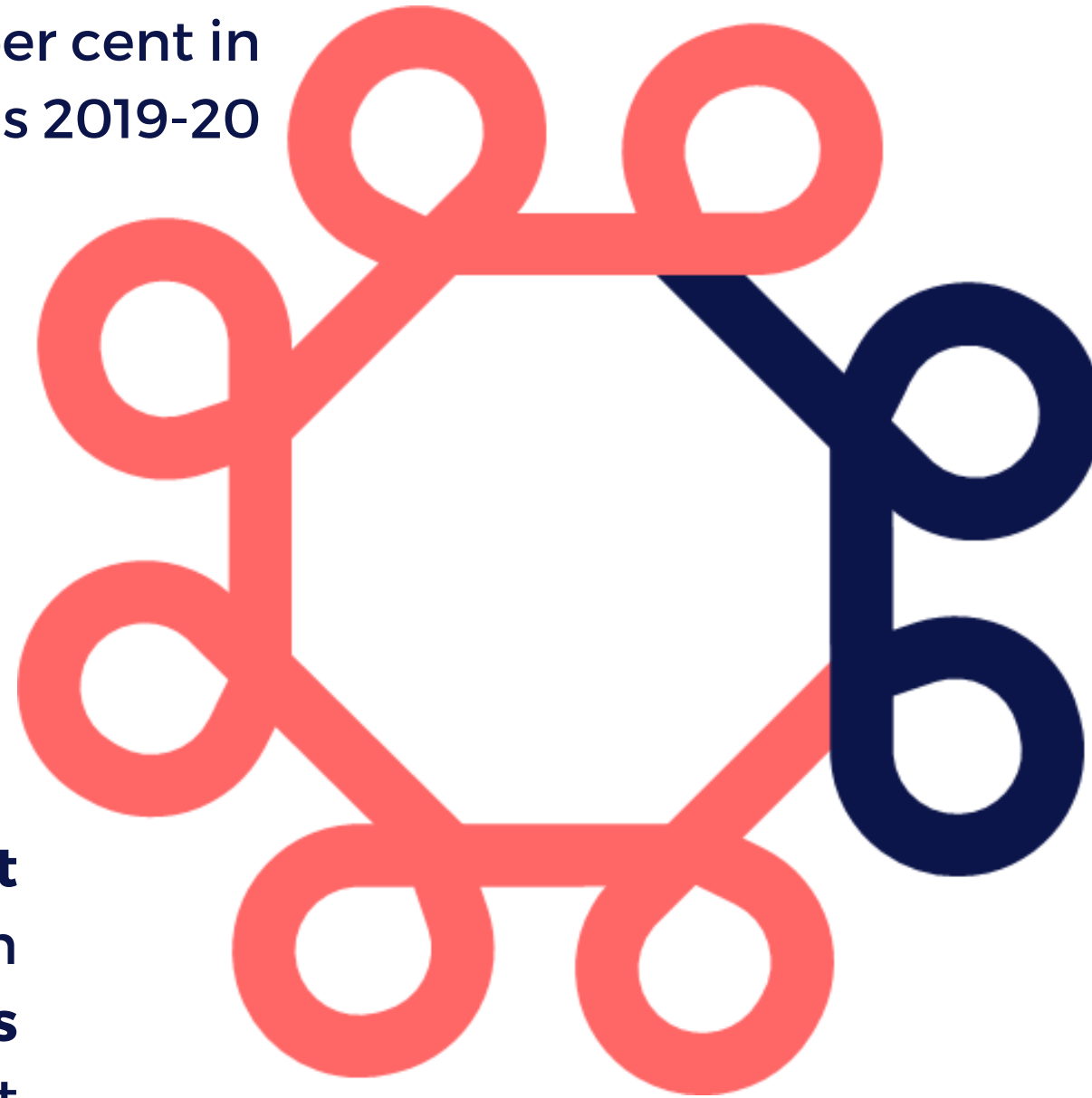
Organizations lose 5 % of the revenues to frauds each year, with an average loss of \$1.5 million per case

The most **common source** for fraud detection is a **tip**

The median **duration (from beginning to the detection) of occupational fraud is 14 months.** Meanwhile, financial statements fraud tends to last for 24 months before being detected

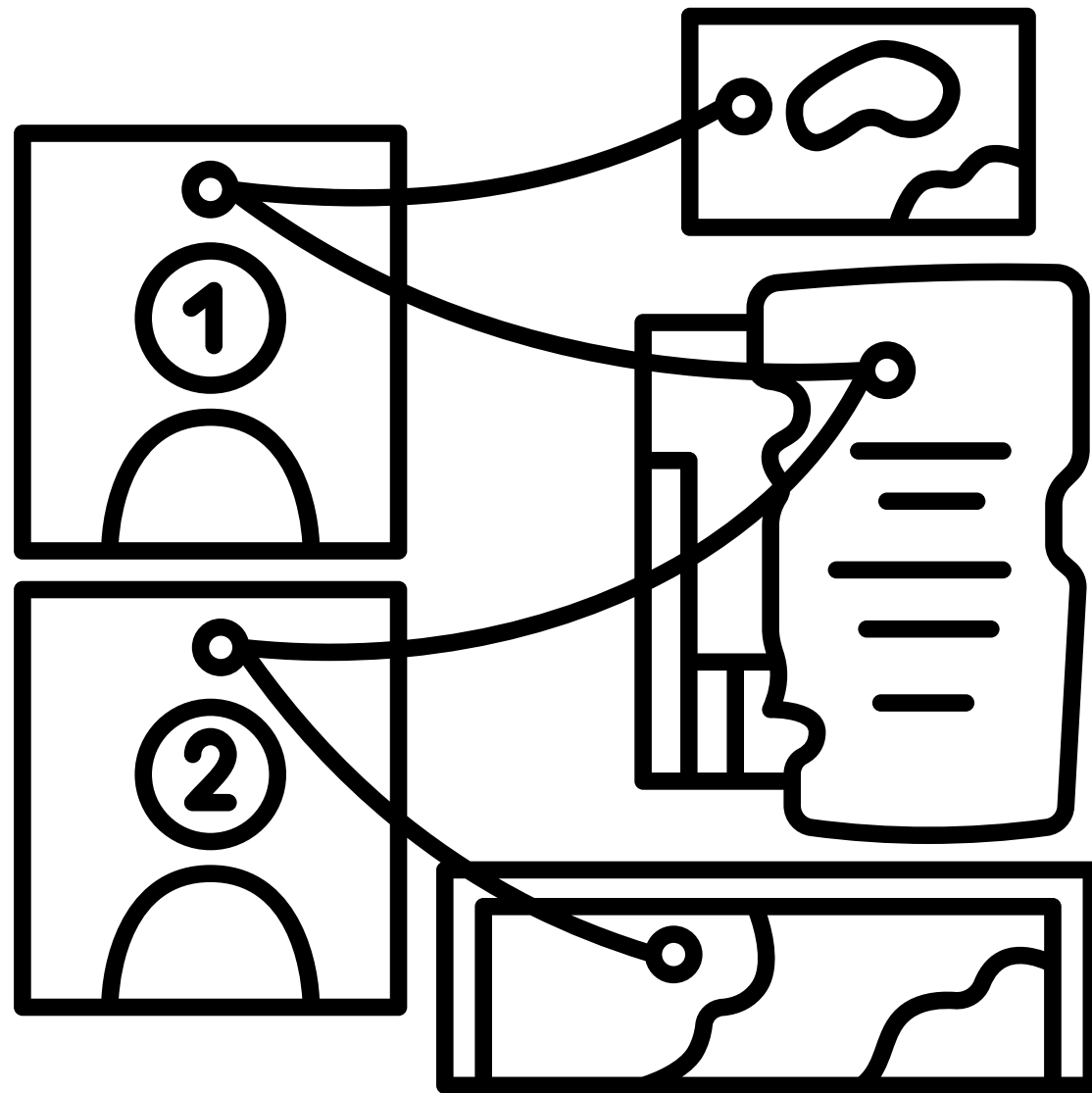
From 2016-2020, highest cases of fraud has been observed in **sales** department

Lack of internal controls and override of existing internal controls are two significant weaknesses that contribute to occupational fraud. (more than 20 %)



CONTEXT

Round Up



- Disclosure requirement by SEBI on Forensic Audit – **08 October 2020**
- SEBI forms a new department to keep a check on promoters' fraud- **13 December 2020**
- FCRA entrusting responsibilities vide notice dated **05 February 2021** – “Charter for Chartered Accountants”
- MCA and IBBI to announce forensic standards- as per public domain news of **17 March 2021**
- Accounting software required to maintain audit trail - **24 March 2021**

New Era with Forensic Accounting and Investigation Standards

- Standards on Key Concepts
 - Standards on Engagement Management
 - Standards on Executing Assignments
 - Standards on Specialised Areas
 - Standards on Reporting
 - Standards on Quality Control
- FAIS 140 - Applying Hypotheses
 - FAIS 320 - Evidence and Documentation

Unconventional Practical Techniques

Distrusting
the obvious



Birbal
Techniques



Time and Space
Dimensions



01

02

Inverse
Logic



03

Tiger
Team Tests

04



05

Distrusting the obvious

signals which could also imply the existence of fraud but such signals do not activate alarm bells. On the contrary they may even lead to a greater sense of assurance and comfort in a scenario which may be potentially infused with fraud. These signals could be called as 'green flags'.

ACCOUNTING RECORDS

Bank Statements
Access to accounting software / ERP
MIS / Existing reports

DOCUMENTATION

Invoices
Agreements - Authority vis-a-vis Board Ratification

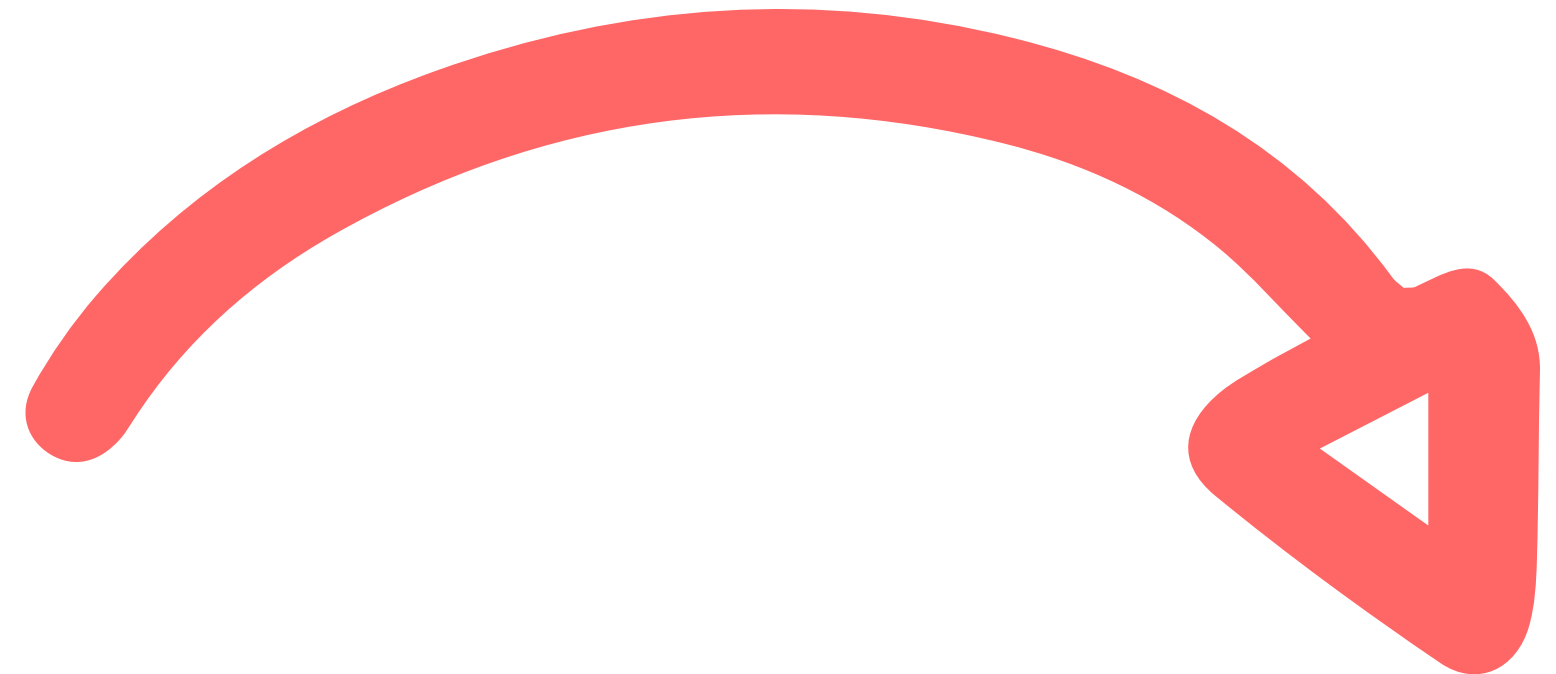
TRANSACTION SPECIFIC

Dividend
Profit in the Financial Statements

Inverse Logic

The principle of Inverse logic is that if one cannot find out what the truth is, one tries to find out what cannot be the truth.

- Stocks can not be physically greater than the volumetric capacity of the storage place.
- Fuel for diesel cars can not be supported by petrol bills and vice versa.
- Production can not be possible in the period of the strike.
- **T**wo or more employees' arrival and departure time can't be exact the same over a long period.



THE BIRBAL STRAW TEST

Guilt always surfaces when the environment around the fraudster is electrified with fear and that is the crux of the Birbal straw test.

THE BIRBAL BEHAVIOURAL TRAPS

These traps are based on the premise that every person has natural traits which are unique and usually innate.

THE BIRBAL LITMUS TEST

A suspect's inherent traits of honesty or dishonesty can be identified in an investigation by observing his reactions and general behaviour.

Birbal Techniques

Such techniques can be applied only in situations where symptoms of fraud appear to exist and the investigator believes that there is likely to be a material impact on the financial statements.

Tiger Team Test

TTTs are walk-through trials and tests of internal controls. Objective of this method is to test internal controls with intention to breach, whether they can be breached and if so, in how many ways they can be penetrated.

Examples:
Inventory Verification
Procurement

Time and Space Dimension Tests

Two dimensions of 'space' and 'time' offer infinite ways of examining the financial data for corroboration and further analytical purposes.

Examples:
Time of recording accounting transactions
Dispatch quantity vis-a-vis
Mode of transport

CAAT

Related Analytical Procedures



Benford's Law

WHAT

This law defies the normal law of probability which would state that every digit has an equal chance of appearing.

HOW

Benford's law has been used as a method for spotting fraudulent accounting data by looking at the first significant digit of each data entry and comparing the actual frequency of occurrence with the predicted frequency.

WHEN

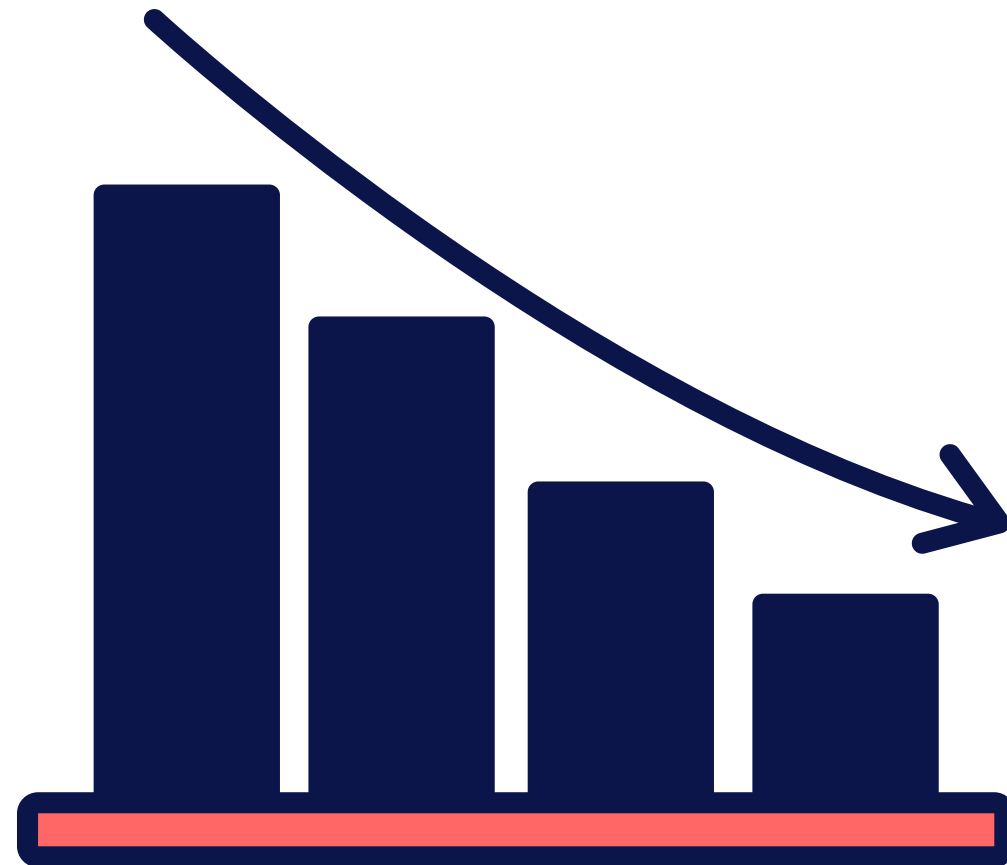
Benford's Law is increasingly used in the accounts payable area to detect broken payments of just under the limits approvals.

Examples:

Accounts payable transactions
Inventory prices
Journal entries
Purchase orders

SSS Tests

RSF Theory



This test identifies records that contain fields of information that are exact duplicates of other records. Application of this test will assist in detecting duplicate expenses claimed, occurrences of the same payment to vendors, multiple warranty claims or duplicated service fees paid by private or government health plans.

The purpose of the Relative Size Factor test (RSF) is to identify anomalies where the largest amount for subsets in a given key is outside the norm for those subsets. This test compares the top two amounts for each subset and calculates the RSF for each. It is a powerful test for detecting errors and potentially fraudulent activities.

Examples on where CAAT can be applied



PAYABLES

Payments made to unauthorized suppliers, Unauthorized premiums given to suppliers, Invoices are paid late, Payments are made in a way that these are not identified by audits.



INVENTORY

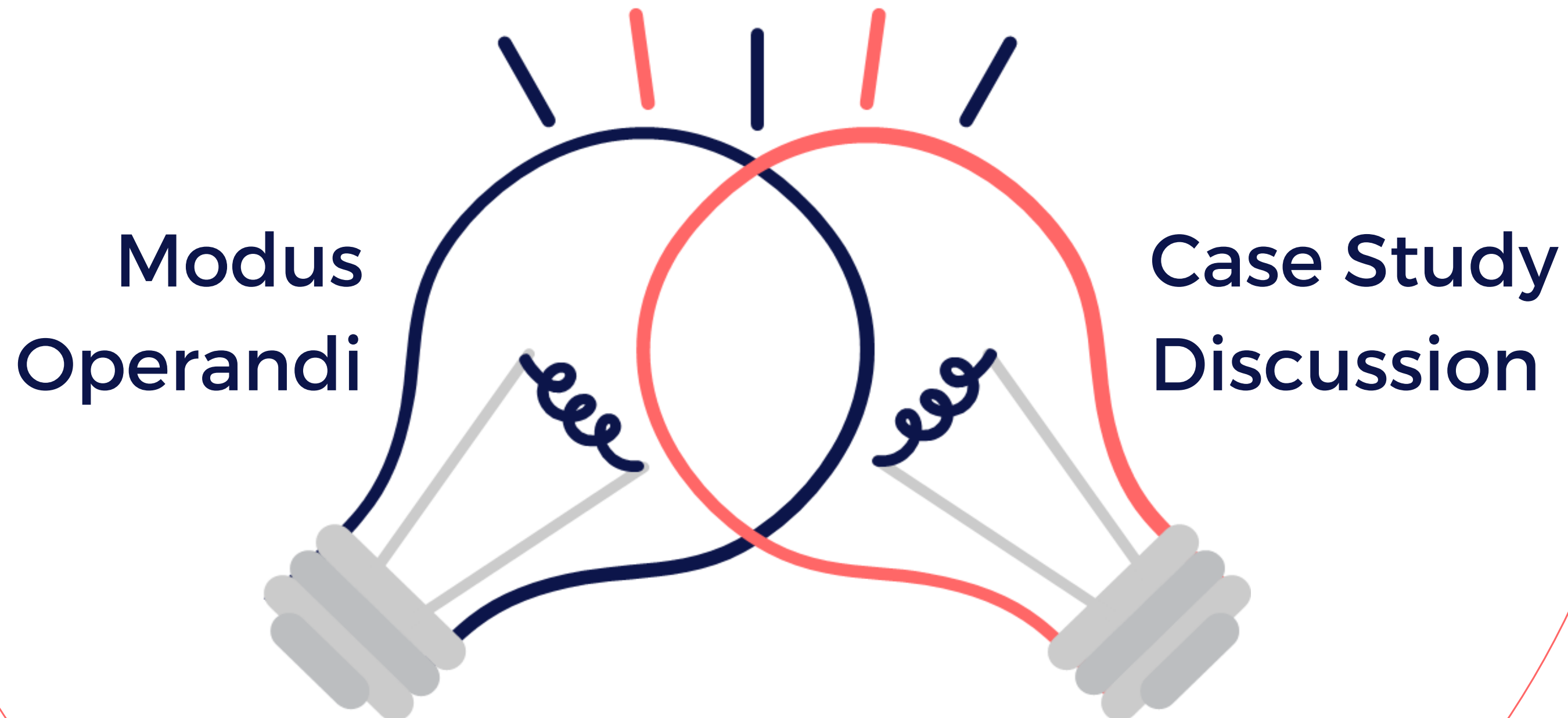
Inventory not correctly recorded, Obsolete inventory items are not identified, Items are not recorded in the correct period, Gaps in sequentially numbered documents are not accounted for.



PAYROLL

Payments of Location Allowances to Employees who are not entitled to them, Payment of both Asset Maintenance Expenses and Asset Maintenance Fixed Allowance, Employees having the same Bank Account Number.

Practice and Perspective



Case Study - 01



YEAR 1 - HIGH PROFITS

Exceptionally high profit due to good performance in a booming market!

Assume INR 100 crs was the profit, but created secret reserve and reported only INR 30 crs



YEAR 2 - BELOW PAR

Underperformance / Malpractice

Assume INR 10 crs was the profit, but used secret reserve and reported INR 25 crs (INR 10 crs actual + INR 15 crs from reserve)



PROVISION / LIABILITY

Can be added to the liability on account of an insurance claim or provision for doubtful receivables etc.



REVERSAL OF LIABILITY

Reversal of the liability / provision will eventually increase the profit.

Case Study - 02



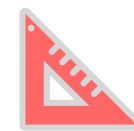
LISTED ENTITY - INCREASING REVENUE

Healthcare Company - performing well through many years, two types of income operating and non-operating income.



WHEN THERE IS A DECINE IN BUSINESS

Non-operating income classified as Operating income.



NO DISCLOSURES MADE

Eventually, non-profit generating business was made to show as operating revenue without any disclosures.



ALSO INFLATED PROFIT

Had to inflate the profit since actually