

Overview & Approach to Forensic Audit

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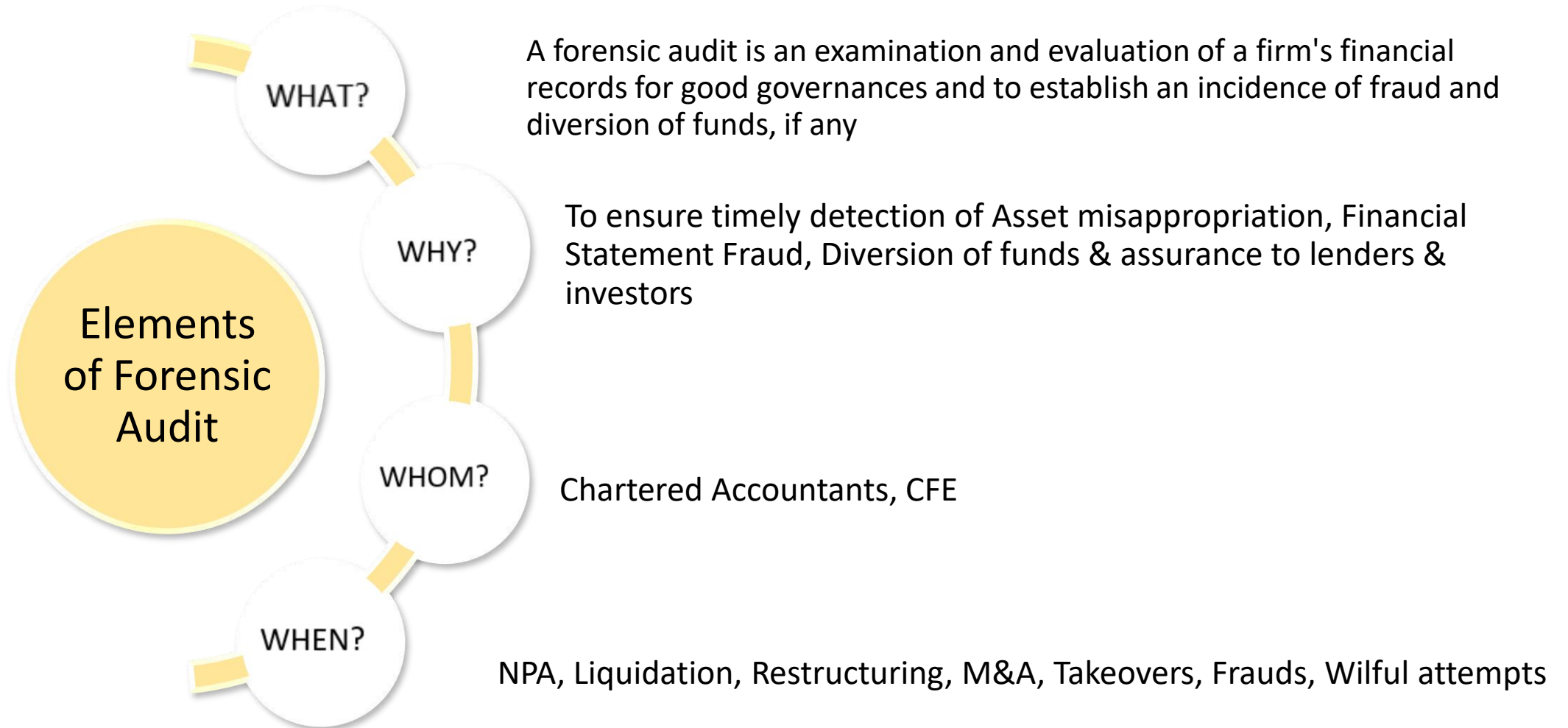
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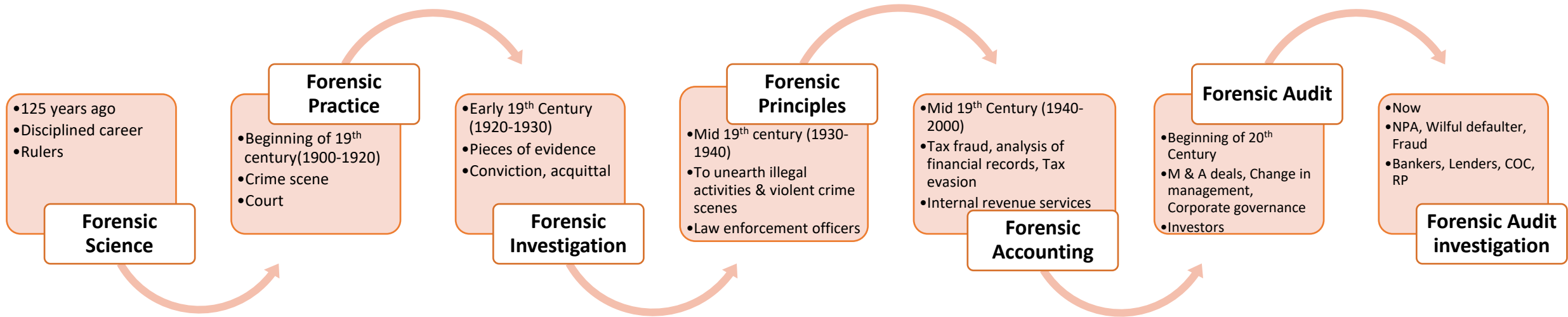
ICAI WIRC
Refresher course on Forensic Audit

Forensic Opportunities



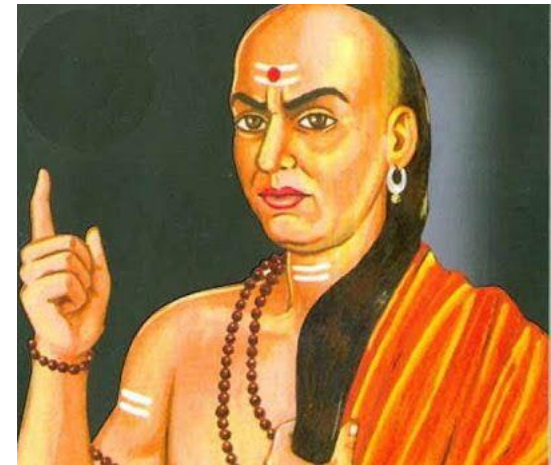


History & Background of Forensic Audit

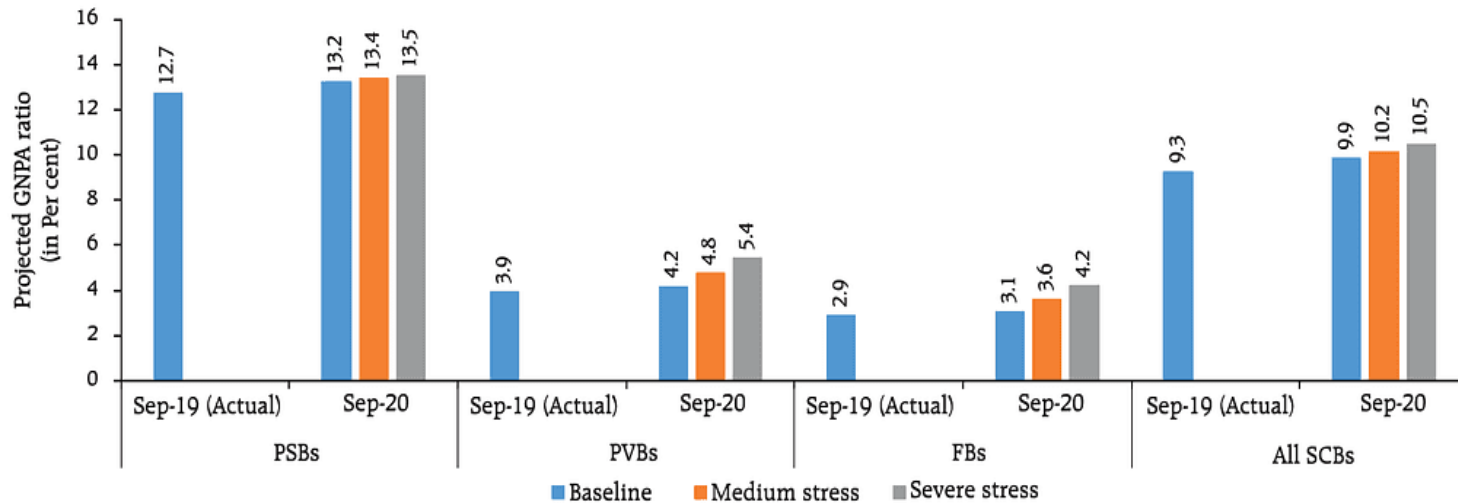


Kautilya's Arthashastra existed in ancient India in 4th century BC. The accounting principles and standards used in the present century are similar to those that existed in the 4th century BC.

In the Arthashastra, stress has been given both on fraud prevention as well as fraud detection. Kautilya had listed several ways of misappropriating public funds by way of fraud against which auditors at the royal treasury had to always be on their guard.



Projection Of Gross NPA Ratios For Banks



Source: RBI Financial Stability Report, December 2019

Bloomberg | Quint

- 1) Increasing NPA accounts with lenders
- 2) Indian banking sector being under stress
- 3) Change in guidelines by RBI
- 4) Strict governance and regulatory framework for businesses

Purpose of Forensic Audit



Lender/Banks

- Misutilization of Funds
- Financial Statement Manipulation
- Sale/Transfer of Assets
- Availing facility through false documentation via non fund based facilities like :
 - LC
 - LOU
 - BOE
 - BG
 - PC



Resolution Professional

- Transaction related to Fraudulent trading
- Sale/Transfer of assets
- Excess payments to related parties
- Transactions with respect to section 43, 45, 46, 49, 50 and section 66 of IBC



SFIO

- Monetary misappropriation
- Transaction related to Fraudulent trading
- Sale/Transfer of assets
- Excess payments to related parties
- Transactions with respect to section 43, 45, 46, 49, 50 and section 66 of IBC



SEBI

- Manipulation of the books of accounts
- False public notices
- Insider trading
- Price Rigging
- Misappropriation of assets
- Cash flow movement
- Transaction with group concerns



CBI/EOW

- Misutilization of Funds
- Financial Statement Manipulation
- Sale/Transfer of Assets
- Availing facility through false documentation
- False public notices
- Excess payments to Management/Promoters
- Siphoning of funds

Benefits of Forensic Audit



Limitations of Forensic Audit

- ❑ Forensic Audit as practiced by Chartered Accountants is limited to analysis of financial and operational working of the target verification of signs/signatures, stamps etc.
- ❑ Limited time for working/analysis
- ❑ Unavailability of data/ non-cooperation from the Company under audit
- ❑ High responsibility post submission of report
- ❑ Replacement of old staff with newer staff restricts/ breaks the chain of audit cycle
- ❑ Limited and inconsistent sharing of data by the Banks and Company management



“I don’t know how long we can keep telling auditors you’re away from your desk.”

Forensic Audit vs Statutory Audit

Sr.No.	Basis	Statutory Audit	Forensic Audit
1	Objective	To express opinion as to 'true & fair' presentation.	To determine correctness of the accounts or whether any fraud has actually taken place
2	Techniques	'Substantive' and 'compliance' procedures.	Analysis of past trend and substantive or 'in depth' checking of selected transactions are done.
3	Period	Normally all transactions for the particular accounting period are considered.	There is no such limitations while conducting forensic audit and accounts may be examined in detail from the beginning.
4	Management Representation	Auditor relies on the management certificate/representation of management.	Independent verification of suspected/selected items carried out/
5	Off balance-sheet items (like contracts etc.):	Off balance-sheet items are used to vouch the arithmetic accuracy & compliance with procedures	Regularity and propriety of these transactions/contracts are examined
6	Adverse findings, if any	If there are any adverse findings, negative opinion or qualified opinion is expressed, with/without quantification.	The auditor aims at legal determination of fraud and also naming persons behind such frauds.

Forensic Audit vs Financial Audit

Sr.No.	Financial Audit	Forensic Audit
1	Examine financial statement as per the accounting standards	It details with fraudulent financial reporting and misappropriation of assets
2	Financial statements is taken as a whole	Highlights the awareness of specific irregularities
3	Serves public interest	Serves the interest of the parties who hire them
4	Auditor's work stands on its own	Forensic auditors supports the work of the legal counsel or the board
5	Auditor express opinion	Forensic auditor highlights discrepancies
6	More concerned with errors and irregularities	Concerned with distinction between errors of judgement & deliberate misrepresentation
7	Auditor presumes the validity of documentation and information	Forensic auditor ensures the validity of documents and information
8	Auditor determines the nature, scope and extent of audit	Client determines the scope of forensic audit
9	Financial audit is not disruptive. Audits are rule based	Forensic audit tends to be disruptive. Forensic audit is principle based.

Lack of corporate governance

- No written policies and/or procedures
- Lack of internal controls
- Frequent or unusual related party transactions

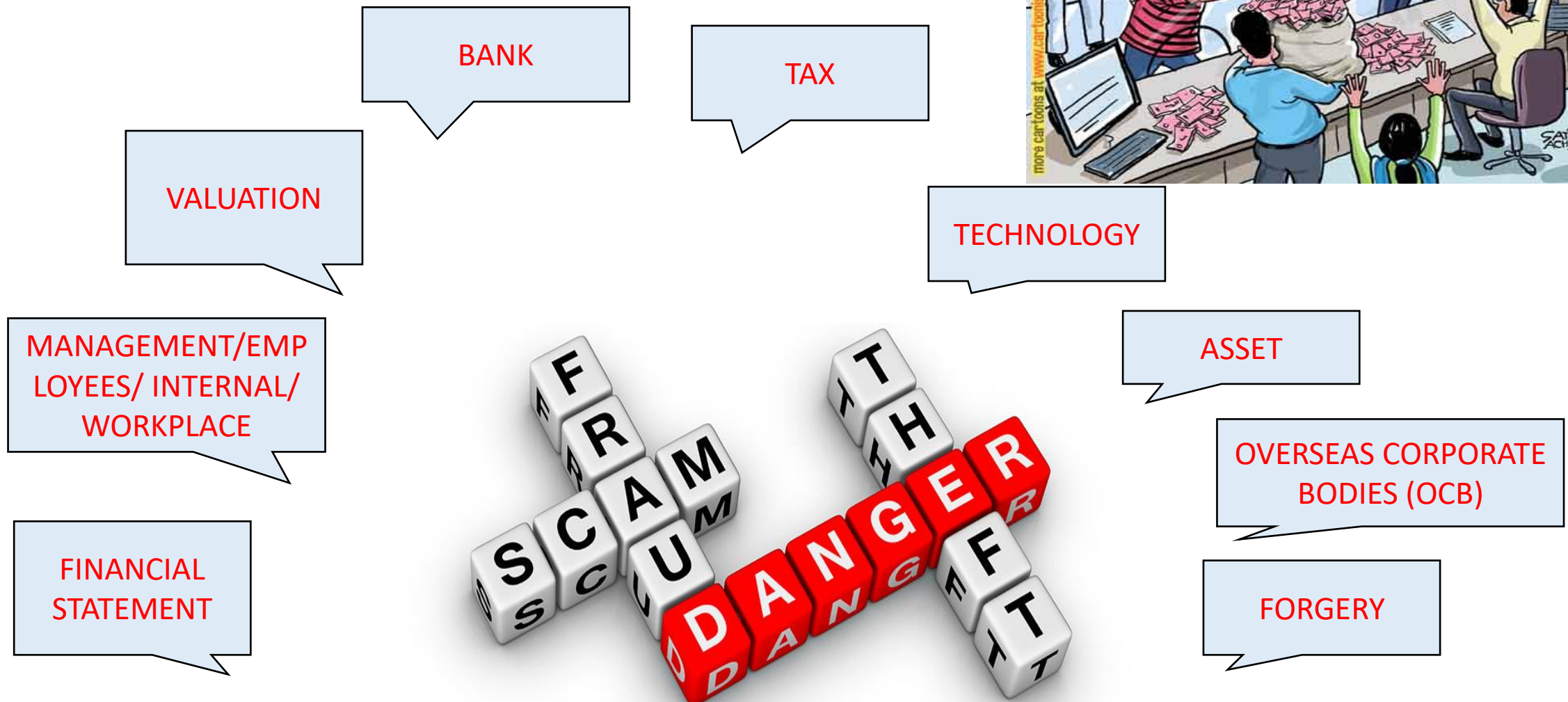
Questionable accounting activities

- Management override of internal controls
- Unreconciled subsidiary & general ledger accounts
- Continuous adjustments of books to physical inventories
- Topside journal entries
- Excessive number of manual checks

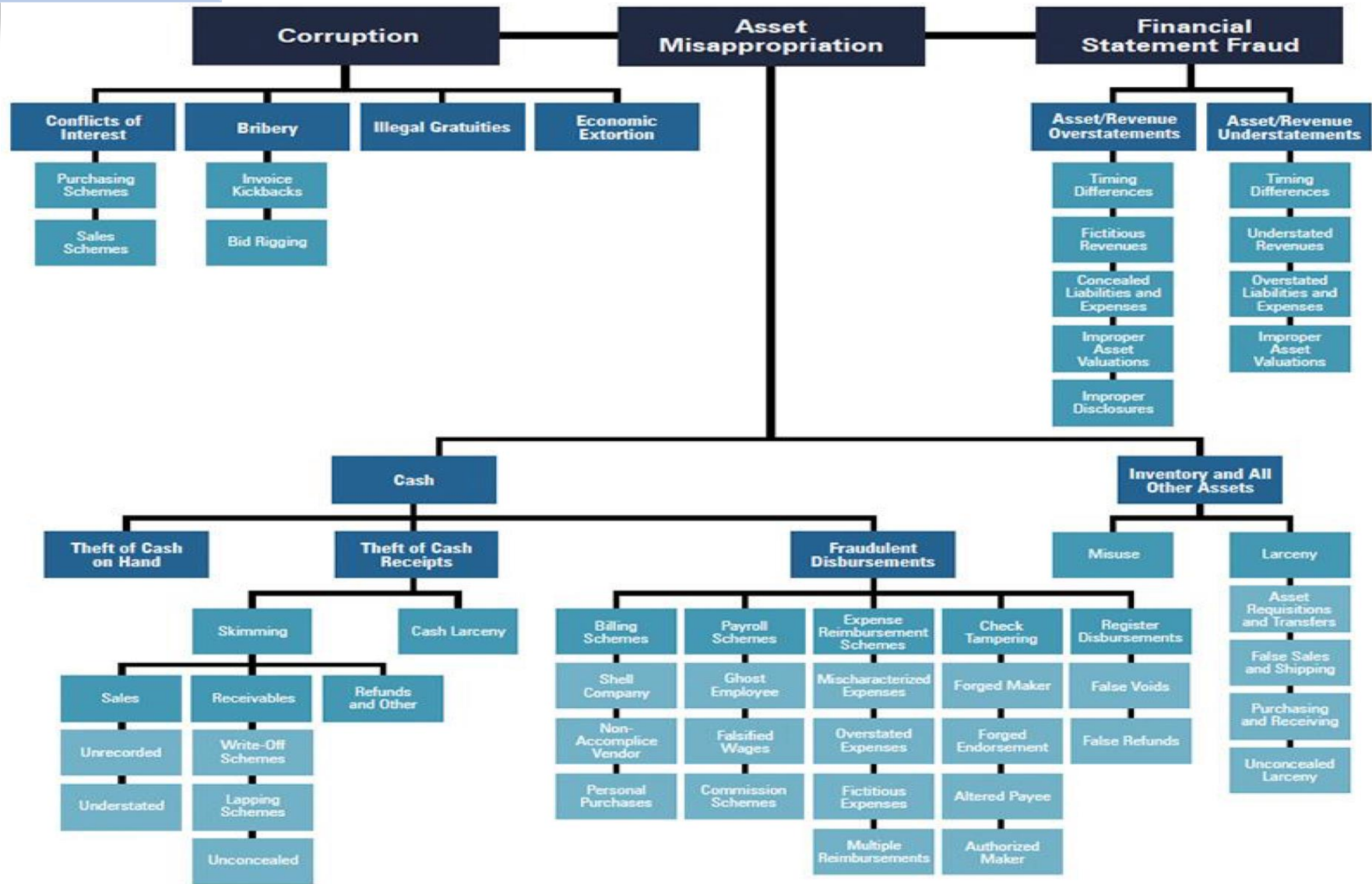
Behavioral Issues

- Failure to take vacations
- Living beyond one's means
- Insider trading
- Early arrival – late departure

Types of Fraud



Fraud Category



Fraud incidences

Sales schemes

Purchasing schemes

Payroll

Overstated values

Suspense Accounting

Improper disclosures

Ghost employee

Skimming of Receipts

False Sales

Asset transfer

Shell Company



PREVENTION STEPS

BANK

- Multi factor authentication

INSURANCE

- Algorithms to detect anomalies & patterns
- False claims
- Conduction of Forensic audit

PUBLIC/PRIVATE SECTOR

- Fraud prevention software
- KYE(Know your employee)
- Lay down of strong laws

HEALTH CARE

- Advance analytics
- Payment integrity

OTHERS

- Segregating accounting duties
- Departmental rotation of employees
- Setting up reporting system
- Guidance from forensic experts

Audit Approach

- 1 • Data collection with respect to correct sources and validation of the data & documents
- 2 • Record keeping in the form of hard as well as soft copies in the encrypted format
- 3 • Identifying fraudulent transactions & potential fraud
- 4 • Assess the quantum of fraud
- 5 • Differentiate between genuine business failure and fraud
- 6 • Evaluate the likely recourse available to the bank
- 7 • Need for further investigation/ action by the bank

Approach for Methodology

STAGE 1

Information available on Public domain

- Legal cases by or against the company, fraud history, Promoters background etc.

STAGE 2

Information Provided by Bank

- Bank statements, Loan documentations, Stock statements, CoC minutes etc.

STAGE 3

Information Provided by Company's Management

- Financial data, accounting software, operational procedures etc.

STAGE 4

Information review during plant visit

- Working of plant, inventory, invoices, employee/worker's records etc.

STAGE 5

Information absorbed while interaction with suppliers & other stakeholders

Approach for Data

APPROACH

News & Media

Compliance database

Regulatory Database

Credit History

Legal Database

Internet

MCA

CIBIL REPORT

WATCHOUT

INVESTORS

Customers

Vendors

Employees

Other principals

Business Associates

Competitors

Online Public Domain

Stakeholders

Public Domain Searches

On-ground intelligence collection

Interview with stakeholders

APPROACH

Approach to Data Collection

- 1) Documents to be collected with a view to submitting it as an evidence in the court of law
- 2) Maintaining several records
- 3) Originality and authenticity of the documents should be retained
- 4) Use of evidence as annexures
- 5) Source of information drives the quality of evidence/ documents

Non-cooperation

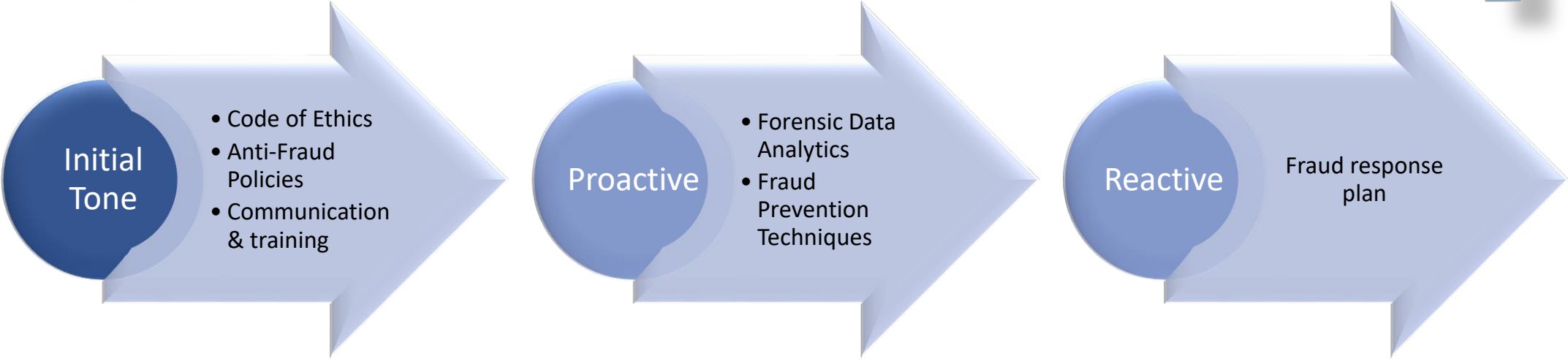
Incomplete Data

Delay in providing data

Assessment Approach

ASSESS

IMPROVE



MONITOR

COMMUNICATE

Scheduled Work Plan

Project Review & Reporting for Core Team to review all audits individually and as a service line														
	Month		Month				Month			Month				
	Week 1	Week 2	Week 3	Week 4	Week 5	Week 6	Week 7	Week 8	Week 9	Week 10	Week 11	Week 12	Week 13	Week 14
Planning Phase														
Scope Analysis & Internal Discussions	█													
Kick off Meetings (Bank & Company)	█													
Initial Data Request	█													
Initial Analysis & Hypothesis		█												
Design														
Report Outline			█											
Background Research (secondary)			█											
Information Availability (Bank)			█											
Information Required (Company)			█											
Execution														
Information & Data Review/ Collection				█		█								
Data Review & Analysis				█		█								
Report Writing (Initiate)				█		█								
List of Information not provided				█		█								
Review														
Internal Review							█							
Discussions with Bank							█							
Revision & Finalisation														
Fine Tune											█			
Finalise													█	

- 1) Public document reviews and background investigations
 - Public Databases
 - Increasing number of vendors
 - Reliability of data
 - What type of data is available?
 - Regulatory Websites
 - Can vary by industry and state of operations
 - Real Estate records; business registrations
 - Corporate Records
 - Stock Transfer records; Accounting data; vendors; competitors; customers
 - Internet
 - Search Engines
 - News Sources/Newspapers
 - Telephone Numbers and Addresses
 - Maps
 - Legal Resources
 - Government Sites

2) Interviews of knowledgeable persons

- Interview vs. Interrogation
- Continuous process throughout an investigation
- Gain additional information with each interview
- Evidence from witnesses provides additional leads
- May identify additional witnesses
- Interview the target only after completing the interviews of the peripheral witnesses

3) Confidential sources

- Hotlines
- E-mail
- Letters
- Current Employees
- Former Employees
- Vendors & former vendors
- Customers & former customers

4) Analysis of Physical and Electronic evidences

- Protection/Validation of Evidence
- Chain of Custody
- Altered & Fictitious Documents
- physical examination
- forgeries
- document dating

5) Analysis of financial transactions

- Horizontal/vertical analysis
- Authorization of new vendors & employees
- Comparison of employee & vendor addresses
- Analysis of sales returns & allowance account
- Management override of controls
- Different reviews based on known industry fraud schemes

Guidelines by Authorities

1) RBI Master Circular on Frauds – Classification and Reporting – 1 July 2015

[Declaring company as fraud with reference to circular: Criteria/ under which class is specified]

2) RBI Master Circular on Wilful Defaulter – 1 July 2015

[Declaring company as wilful defaulter with reference to circular: Criteria/ under which class is specified]

3) RBI Circular on Framework for dealing with loan frauds (Early Warning Signs) – 7 May 2015

[Classifying the transaction resulting into fraud]

4) RBI Circular on Non-Cooperative Borrowers – 22 December 2014

[Classifying the account due to non -cooperation]

5) IBA Circular on Forensic Audit Report – 11 June 2019

[Concluding the report pertaining to Fraud/ No Fraud]

Responsibilities & Liabilities of Forensic Auditor

- 1) Preparing financial evidence and analysis and presenting in court against criminal activity
- 2) Help formulate recovery of funds misused and deriving the end beneficiary of diversion
- 3) Forensic auditor must also be familiar with legal concepts and procedures, including the ability to differentiate between substance and form when grappling with any issue
- 4) Reviewing the factual situation and providing suggestions on alternative course of action
- 5) Assisting in securing documentation necessary to support or rebut a claim

Do's and Don'ts



- Reverifying all the data disclosed in the Audit reports, Stock Statements etc.
- Developing a theory of the case
- Limitations and disclaimers to be disclosed with respect to the scope of work
- Necessary email/ written communication with client and borrower/target
- Match verbal indicators with physical behaviors
- Findings to be backed with supporting's and evidences
- Hint to be provided for further investigation in situation of limited evidence
- Regular follow-up for data via emails
- Maintaining records of data collected from target and client



- No direct dependence on other work/report of professionals
- Don't make assumptions
- Should not be judgmental
- Incomplete/partial disclosures of limitations, clause and disclaimers
- Using of target's computers to work
- Direct working on the original data
- Collecting data illegally or without authorization
- Relying on data/information from unknown sources
- Submitting report without annexures
- Delay in submitting reports
- Not maintaining confidentiality of the audit

Practice opportunity

Forensic Audit
New field to explore

Growing number of Crimes, Scams etc.

Need of expert in analysis of financial evidences

Govt. Bodies, Banks, PSU's, Insurance Sector, Investigating Agencies need FA

Tightening economic conditions, higher scrutiny of governance on companies increases sensitivity to fraud



भारतीय प्रतिभूति और विनियम बोर्ड
Securities and Exchange Board of India



SFIO
Serious Fraud Investigation Office



IBA
Indian Banks' Association



WORLD BANK



Sample Case Study - I

Case Study:

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:

- o Study the techno-economic feasibility study of the project
- o Identify the major procurement needs and sourcing plans as per the detailed project report (DPR)
- o Understand the procurement process as defined in the management systems of the company
- o Review the procurement decision related documentation – call for quotations, review mechanism, price comparisons, negotiations before awarding the contract for supply of materials and services
- o Verify the documents for genuineness of the quotes received
- o 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
- o Review all procurement related documentation – Purchase Order, Delivery Challans, Weigh Bridge slips, taxes paid and goods received notes maintained at the company.
- o 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
- o Cross verify the transportation documents from public sources like RTO
- o Check for duplicate purchase orders for the same materials and services
- o 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
- o Research and review details of other business interests of the promoters and close family members
- o Verify the sources of funds for the other business interests of the promoters

Audit Findings:

1) We could find errors in the purchasing process, 2) Further company had infused funds in another project with an unrelated business interest, several transactions with related parties as suppliers of goods and services. 3) Layer of purchase transactions instead of direct purchases, 4) False quotations, duplicate purchase orders, fake transportation bills, 5) Inflated of the project cost.

Sample Case Study - II

Case Study:

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

Sample Case Study – Observations

Sample case study - I

Indicative Observations:

The company had manipulated the purchasing process to divert the loan funds to another project with an unrelated business interest by propping up related parties as suppliers of goods and services. Commodity items were purchased through a layer of transactions instead of direct purchases in order to inflate the prices and pass on the margins to other business interests of the promoters. The purchase documentation and process was rigged to benefit its promoters, including false quotations, duplicate purchase orders and fake transportation bills that did not match with the taxes paid for the goods procured. The artificial inflation of the project cost made it economically non-feasible leading to a default. ***The company was declared fraud on account of siphoning of funds.***

Sample case study - II

Indicative Observations:

The company had poor record keeping making it difficult to value the inventory at any given point in time. Records were maintained in MS Excel making it vulnerable for manipulations to suit the Drawing Power (DP) calculations. However, the business stress was valid and the weak management systems and aberrations could not be considered as acts of wilful intent as the account was regularly serviced to the satisfaction of the lenders till the event of regulatory change.

The management also liquidated non-business assets to repay the lenders before turning NPA and was hence declared as a case of mis-management not amounting to a fraud.

THANK YOU



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