

All about Frauds, Corruption and Forensic Audit



Public expectation from auditors is so great that normal world believes that auditors should have focused their energies in detecting and publishing frauds. Probably, this expectation is true so long as the fraud was detectable, and fraud or corruption could have been identified in the normal audit process. But if it was concealed, detection of fraud is hard to come by and it is difficult to pin the auditors on account of the very limitation of the audit scope. This then calls for special audits in the form of investigation by specialists in the chosen field. There is a tremendous scope for chartered accountants in dealing with fraud and corruption as part of forensic audit. Not only is it a potential area, but it also provides opportunities for checking and correcting unethical practices. The public perception and expectation, irrespective of the limitations of audit, is that auditors are well placed to detect and expose frauds. When this expectation is not met, it leaves a wide vacuum and, therefore, it is important that the auditing fraternity is able to fill this gap in one form or the other. The Institute is also making efforts to build up the profession's image in the public and, therefore, as members of the Institute, it is our duty to come up to this expectation. This article has been written keeping this expectation gap in mind.



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Expectation Gap

There has been a phenomenal increase in the social and commercial transactions across the world. These transactions are not merely complex but they take place at such velocity and speed that it is hard to fathom the undue benefits to some at the cost of others. Normal audits may not detect and deter the specially devised and planned frauds and corruption and the need for devising

new tools and wares to confront them have become the order of the day. The audit methodology presently in vogue for expressing an overall opinion on the general purpose financial statements, may not serve to meet the expectations of this specific need. It is expecting too much from such auditors, as the design and the objective of such audits are entirely different within the given time-frame for conducting the audit.

However, public expectation from auditors is so great that normal world believes that auditors should have focused their energies in detecting and publishing frauds. Probably, this expectation is true so long as the fraud was detectable, and fraud or corruption could have been identified in the normal audit process. But if it was concealed, detection of fraud is hard to come by and it is difficult to pin the auditors and haul them over the burning coal on account of the very limitation of its scope. This then calls for special audits in the form of investigation by specialists in the chosen field. Management of companies and businesses have to take the responsibility of instituting such special assignments by engaging experts. After all, it is the responsibility of the management to safeguard the assets and to ensure that they are put to best use in the interest of the shareholders.

Need of the Hour

There is a subterranean economy that is always making attempts to surface and mix with the economy in public gaze. The money-laundering business which probably runs into trillions of dollars runs parallel to the economy of the governments across the world. Not just the auditors but it is the duty of every ethical human being to expose the sinister designs of the black economy. But on account of very obvious reasons the same remains out of normal range and requires the investigators to be nimble footed. Such acts may not easily offer themselves to the diligence of normal audits. Public expectation and public grouse against normal audits have to change dramatically just as everything else has changed in our normal lives. The audit fraternity also needs to sharpen its skills, without which it may lose its significance and shine by offering its exclusive forte and domain

When frauds occur, the forensic audit adopts a scientific and systematic approach relating to such frauds by examining objects or substances involved in the crime. Hence, it has to necessarily do with legal systems, engaging the expert to deal with the subject matter, the law and the perpetrator of fraud. A series of steps are taken to deal with the issue, and evidences are established to prove the occurrence of fraud, the gravity and intensity of the act, with indications of who could have been involved in the act. Since we are talking of accounting and audit, chartered accountants are best suited for this profession as they basically are trained to understand normal accounting principles and processes. ☺

expertise to all others in the public.

There are many reasons as to why even the obvious frauds go undetected. This may be primarily due to lack of audit independence; the audit processes are so structured that they do not look for frauds; people do not normally comment on audit failures and also, colluded and concealed frauds are hard to detect unless investigation is taken up. Whatever may be the reason, public are not willing to buy explanations and they expect auditors to detect and report on frauds. Auditors, therefore, focus all their energies and efforts in looking at controls. If the controls are weak, the audit process becomes substantive and pervasive. But how far controls are effective and what if one tries to circumvent controls has to be again dissected to ensure effectiveness of controls

against frauds. Not all controls are fraud resistant and there can be no absolute assurance that they can work against frauds. Also if the motivation is strong, the perpetrator will find his way in circumventing the controls by identifying weak links.

Forensic Audit and Chartered Accountants

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Since we are talking of accounting and audit, chartered accountants are best suited for this profession as they basically are trained to understand normal accounting principles and processes. When it comes to books of accounts or business financial transactions, public perception is focused on accountants. While it has a positive side to it, we are all aware that when something goes wrong it brings negative publicity to the accountants even if there is a remote chance of their involvement. The accountants' findings regarding the quality of accounts presentation, the valuation of assets and liabilities, the correctness of estimates made, etc., have substantial and sustainable values in the court of law when matters of fraud are being litigated for a decision.

Essentials of Forensic Audit

What are the essential requirements of conducting a forensic audit?

The basic requirement is to ask questions, ask questions even if the person is tom, dick or harry. One does not know from which corner the untied loose thread reveals itself. The implications of not asking questions both in normal audit and forensic audit have far reaching consequences. The fallout from an organised crime is a harsh reality and that needs to be exploited to the core. Very diligent questions often have the impact of persuading frustrated employees, or disgruntled partners in the crime, to reveal certain matters that will open itself to the threshold of crime. It is obvious that planned crimes and frauds are concealed and are hard to detect. But they often leave enough clues or loose ends that can be cracked by asking proper questions rather than relying on the premise that verification of books will reveal them.

It's often observed that auditors hesitate to ask questions as they feel



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directly or that there is a lower confidence level in his answers. There may also be resistances that are self revealing and a sensitive observer can distinguish this from normal behaviour. All this has to come to the forensic auditor through training and practice. Forensic audit requires being proactive in fulfilling its objective. Skilful enquiry regardless of the person's position in the organisation and being obsessed with it, with all other methods of verification, will go a long way in establishing strong and intimidating processes for the auditor.

that it may hurt the other. This feeling creeps in because the auditor may be having less confidence in himself. He may have a periphery feeling that something is wrong, but does not have the courage to question it either because it embarrasses another person or that it may land him into legal trouble. One must understand that not questioning, which ultimately leads to a scandal, may be more disastrous than the gravity of asking a question.

Misstatements in financial statements that could have been obviously detected are part of auditor's risk and, therefore, the mind has to be trained to be sceptical, like the forensic auditor. No occasion must be turned down when there is an opportunity to ask questions. When appropriate questions are put to the perpetrator, it often happens that he is willing to confess. One can also observe that a partner in crime does not answer questions directly or that there is a lower confidence level in his answers. There may also be resistances that are self revealing and a sensitive observer can distinguish this from normal behaviour. All this has to come to the forensic auditor through training and practice.

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What are the types of fraud that one can envisage in a corporate environment? Of course these can extend to activities in the government and non-governmental entities as well. It can be in the form of kickbacks, payoffs, greasing the palm, bribery, embezzlements, inflating expenditure bills, collusive bidding, passing on insider's

information and so on and so forth. Poor governance procedures and lack of transparency often aid frauds to happen in organisations. When habits go unchecked, it provides incentive to enlarge the scope of operation. Systematic methods are used to manipulate transactions or events and are carefully concealed to ensure that they do not come to the notice of a common observer.

Essence of Scepticism in Audits

A careful audit will observe many things amiss in the normal functioning of an organisation. To substantiate the statement, three incidents are being reported that reveal the essence of scepticism in audit.

- The tool manager in an organisation was never replaced and he had worked in this department from the time he was appointed. The management had no intention of replacing him as he had mastered the technique of issuing the tools to the user department without loss of time. On account of his expertise and quick reflexes, tool audits did not reveal any discrepancy in the number or nature of the tools at his disposal. A careful scrutiny revealed that the tools had to be replaced very often and on many occasions it was affecting the production. Not only were the tools expensive but were causing significant production losses, which went unnoticed by the superiors. The frequency of purchase of tools revealed something abnormal and had to be investigated. The tool manager was very vehement in reporting that the production team did not possess the required skills and, therefore, the tools had to be replaced very often. The auditor was not fully satisfied with the answer

and waited for an occasion to trap the tool manager.

When an occasion arose to purchase a costly tool, the auditor waited to see its performance. The tool that should have lasted several years gave way within months providing an opportunity to the auditor to resume his investigation. On a careful scrutiny, it was found that the tool manager was in the habit of replacing second hand tools in the place of new ones. He had also managed to procure second hand tools at the cost of new ones with the connivance of suppliers.

- A financial institution had lendable resources that were being provided as loans repayable in instalments. Also, there was a system of parking idle resources in long and short term deposits. The borrowers were required to pay the instalments of fixed amounts in a certain time period and for installments paid they would collect the receipts from the institution. Bank accounts would be reconciled from time to time to ensure that payments were actually received without being dishonoured. The act of depositing the cheques and reconciling the bank accounts were given to the same individual whose work was subject to perennial audits. The individual was systematically reconciling the accounts providing no room for any audit comments. This act had gone on for several years and no discrepancy was noticed at any stage. Since the transactions were large in number, the reconciliation statement prepared by the official was being accepted without much scrutiny. Also, there were no occasions of

long pending items at any time whatsoever.

A close scrutiny of the transactions revealed that a particular customer had the habit of dishonouring cheques, but his account remained clean and within the prescribed limits. It was believed that the dishonoured cheques were represented again and the amount was realised. But the reality showed otherwise. The dishonoured cheques were being adjusted against interest receipts of long and short term deposits of the organisation, thereby the discrepancy never came to light for several years. Since the interest from deposits was running into several lakhs, it did not give room for any suspicion of any manipulation. An internal adjustment did not also throw an imbalance in the reconciliation statement at any point of time. By the time the issue came to light, the institutional resources were short by a few crores.

- Understatement of revenue is also resorted to by receiving the credits from the customers and immediately drawing out the money. The credits and debits being similar are not reflected in the books and the bank reconciliation statement is prepared by marking contra in the bank statement. If the transactions are heavy, the contra entries go unnoticed, even to a careful observer, when they are accompanied by large number of cheque dishonours.

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need for integrating forensic audit to meet specific requirements. Just as the army depends on commandos for risky ventures along with the infantry battalions, so also forensic audit has to be integrated with normal audits when things seem to go out of hand. Chartered accountants specially trained in this endeavour will provide a good base for focused audits. All deviations from normal transactions or any transaction that has been carried out without authorisation may be subject to special audit by forensic auditors.

Frauds and Corruption as per ASOSAI

In this context it is relevant to highlight the efforts of Asian Organisation of Supreme Audit Institution (ASOSAI), which in the year 2001 initiated a project for strengthening the regional training capability to improve audit skills for fraud detection. The object of this was to lay down guidelines that would become useful reference and guidance material for the auditors to be sensitised to concerns arising from fraud and corruption.

Fraud involves deliberate misrepresentation of facts and/or significant information to obtain undue or illegal financial advantage. Corruption involves effort to influence and/or the abuse of public authority through the giving or acceptance of inducement or illegal reward for undue personal or private advantage. ”

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The basic elements of fraud that are often found in today's literature include:

- There must be at least two parties to fraud namely, the perpetrator and the party who was or could have been harmed by fraud, otherwise known as the victim;
- A material omission or false representation must be made knowingly by the perpetrator;
- There must be an intent by the perpetrator that the false representation be acted upon by the victim;

- The victim must have the legal right to rely on the representation;
- There must be either actual injury or a risk of injury to the victim as a result of reliance;
- There is an attempt to camouflage; and
- Fraud involves the betrayal of trust.

In most organisations there is a betrayal of trust for the private advantage and benefit of the individual. In order to ensure that it does not come into public gaze, they are often concealed and the forensic auditors and investigators have to muster all their skills to bring them to the surface.

Similarly the elements of corruption as available in the public domain include:

- There must be at least two parties to an act of corruption, namely the person who offers the reward or inducement and the party accepting it;
- There must be a misuse of office or position of authority for private gain;
- There is either an offer and/or acceptance of inducements;
- An attempt to solicit an offer of inducement or reward as benefit for performance of an official act;
- Any act through which public or the entity's property is dishonestly misappropriated;
- There may be an attempt to camouflage;

Corruption involves breach of trust. It is deep rooted in social

and cultural history of a country. Corruption generally flourishes if the institutions are weak and economic policies distort the marketplace.

The forensic auditor, by understanding fundamental issues relating to fraud and corruption like the definition, elements and motivational factors, has to mark the perceived high risk areas. As accountants we understand that some of the risk areas would include:

- Procurement and service contracts;
- Inventory management;
- Sanctions and clearances;
- Work execution;
- Receipts and cash management;
- General expenditure;
- Jobs involving public interface;
- Computer fraud.

It is the fundamental duty of the managements and those who are at the helm of affairs to ensure that there are adequate controls and that they are efficiently and effectively operating. The auditors, by virtue of their experience and practice will help the management to identify good controls or to verify that the controls are working as expected. The forensic auditors should, therefore, be equipped with institutional internal control mechanism and a plethora of standards issued by various institutions to be able to justify their work. With all this, an element of scepticism has to ride the auditor's mind to take him to a safe destination.



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Skimming, Lapping and Padding for Forensic Auditors

One area of concern for the forensic auditors is revenue skimming. The management attempts to skim revenues with the object of paying fewer taxes or the employee skims cash sales to pocket the money. Rents are not often deposited into accounts or collections made from borrowers do not often reach the coffers of the lending institutions. Parallel receipts are issued to customers and they don't get recorded in the books. Example of skimming dishonoured cheques of customers and skimming revenues by withdrawing the amounts have already been elaborated in earlier paragraphs.

Similarly, fraudsters have the tendency of lapping wherein collections from one customer are posted into another. This does not last very long and people with less

experience engage in such acts. Veteran fraudsters often adopt techniques that are less revealing. Lapping practice is often seen in small institutions when account books are also handled by people who handle cash. Management often fails to understand that non-compatible jobs have to be segregated.

Employees get into the tendency of refunding amounts which are received in excess, or, there are payments to be made on account of material rejects. Though the customer may have written off such amounts in his books amounts will be pending as payables in the supplier's books, employees of the supplier's organisation will find ways of insisting for refunds resulting in refund skimming.

We have cases of padding whereby employers accept non-business related expenditure, inflated bills, expenses made on self made vouchers, multiple reimbursements, etc., and still remain silent as they are important to the business. Even if the auditors were to bring it to their notice, employers and management often justify that they are petty when compared to the amount of business that such employees bring in. Another form of padding expenses is to pay consultants professional fees to offset cash expenses paid as bribe in departments. Many of us understand many such silent activities, which often reflect upon the culture and weakness in the institutional structure.

Many of these frauds develop a pattern over time and distort ratios that are generally not noticed by the persons perpetrating frauds. Analytical review will reveal grossly misleading non-comparable ratios and the examination of the pattern can help the auditor to reach the perpetrator. Also, one must watch for an increase in customer's credit balances as this would have

resulted from under-invoicing to pay less taxes and duties, while the customer would have tendered the full amount. Excess amount received over billing would remain perched in the customer's account as advance received.

Pattern Indicators of Skimming and Lapping

There are certain indicators that would appear as an established pattern that needs to be flagged for investigation. In relation to skimming, the indicators could be-

- Declining revenues while the industry is doing well;
- Discrepancy in customer balances when confirmations are called for;
- Cost of sales ratio being on the ascent without reason;
- Ratio of cash sales to the overall sales is on the decline.

In relation to lapping, the red flags could appear as under:

- Billing errors as a matter of routine;

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- Excessive write-offs;
- Recovery slowing down;
- Delay in posting customers' accounts;
- Complaints from customers;
- Customer's confirmation does not agree with ledger balances.

When skimming and lapping are read together, we observe that there are frauds that are happening, which go through the books and some others happen without being recorded in the books. In all criminal acts unlike the civil acts, the evidence has to be beyond doubt. Hence, off-book frauds are more difficult and require greater ingenuity for establishing evidences.

Value for Money Audits

What exactly is the requirement in normal audits and forensic audits? If the auditor understands it right, the process of audit or investigation should 'focus on value for money'. It is a combination of audit of rules and regulation, efficiency cum performance audit and propriety audit. The financial audit will

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become all comprehensive, and of course it may be segmented with an effective internal audit followed by statutory audit, both of them being independent from the management and owners.

Value for money audit does not merely focus on regularity of expenditure and the connected rules, but goes further to identify wasteful and avoidable expenditure, deficiencies in collection of revenue, framing of wrong policies, wrongful interpretation, efficiency and effectiveness in implementing the shareholders expectation, etc. It is just not enough to be sticking to traditional methods of audit and then lamenting about the systems. There is a great deal of responsibility on the audit fraternity to provide value added services with the intention of doing public good. Any excuse in handling this opportunity and responsibility lacks justification and a sheltered approach has many pitfalls.

Value for money audit has a great impact on public expenditure and social programmes. No resources can be waste however small is the resource and be it men, material or natural resources. The process of value for money audit rests on three pillars, i.e., economy, efficiency and effectiveness. Unless this is seen in the right perspective, there can be no justification for any work done or performed by government, management or auditors. There are no auditing procedures to detect fraud with absolute assurance. It is creative and requires a holistic approach with great deal of effort going into it. All of us justify our stand, accepting limitations as they are, and seldom make attempts to correct them. Since the process is cumbersome, audit has always made attempts to avoid it. Under these circumstances it is hard to have effective forensic auditors. Also, it is not without reason that public may then have

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poor perception of the auditing fraternity.

Conclusion

In the past, accountants and auditors were obsessed with tallying the figures and carefully checking on numbers. The world has become a complicated place and now it requires not merely checking numbers but requires a qualitative mind to be able to apply all the analytical skills. Rule based standards are becoming futile and principle based approaches are gaining ground in the accounting and audit field. There has always been a public gaze on auditors more so when scandals or erupting like volcanoes. A forensic mind is the need of the hour and practices have to cope up with swift change in the economic environment and degradation of moral values of some unscrupulous elements intending to loot public money and resources. As auditors we must not lose sight of our primary responsibility to shareholders and public. We can fit the garb only if we stand to justify what public expect from us. Do we consider this as an opportunity or responsibility and for the auditor it is both. ■