Finance and the Forensic

Modern accounting is no longer confined to mere Bookkeeping exercise, reflecting the factual statement of financial affairs and is actually an instrument of control and a tool for various management functions. Various types of accounting such as cost accounting, management accounting, inflationary accounting, financial accounting, etc. are already in place in the field of accounting. But the one that has gained importance in the recent past is "Forensic Accounting". Forensic Accountant is the bloodhound, trying to sniff out fraud and criminal financial transactions through documentary evidence. Forensic Accounting is the integration of accounting, auditing & investigative skills with a view to obtain legal evidences for the arrived at result. Read on to know more…

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The word "Forensic" means "suitable for a court of law". The Forensic Accountant has to look beyond what the number reveals and comprehend the underlying circumstances with analytical mindset. An *accountant's job is basically an intelligent work and the job of forensic accounting is the job of an intelligent accountant*. In the wake of a number of financial scams associated with big corporates and the capital market, securities, misuse of financial outlay in general, the audit exercise come under microscopic scrutiny of the public.

A simple definition of *Forensic Audit is the converse of the basic definition of Auditor,* which is "Auditor should be a watchdog and not the bloodhound".

Forensic Accountant is the bloodhound trying to sniff out fraud and criminal financial transactions through documentary evidence. While the external or statutory auditors look for numbers, the forensic auditors look beyond the numbers, vigilantly going beyond the routine assignment on accounting, auditing, inspection, etc.

Accounting and Annual Report are the language of business activities through which performance communication is made. Forensic Accounting awareness enhances credibility of the accounting profession as well. The purpose of Forensic Accounting is to reduce the likelihood of fraud remaining undetected in business entities, as the statutory audit mechanism may not throw light on all the financial frauds that have taken place in the business operation, during the entire period covered in the audit. With the advent of technology and globalisation of financial transaction, the number of white collar crimes has exponentially grown and auditing requirements need to be sharpened with forensic techniques to establish evidences to book the gentle financial criminal.

Forensic Accounting/Audit

Forensic Accounting is the integration of accounting, auditing & investigative skills with a view to obtain legal evidences for the arrived at result. A Forensic Accountant gathers a lot of information and undertakes detailed analysis producing *irrefutable evidence* in a Court of Law. It is a branch of accounting that uses investigative skills to determine the accuracy of a company's financial statements specifically in a legal dispute.

Any disagreement between what has happened and what should happen financially that involve action from the court of law, is a field area for forensic exercise. It is the practice of utilising the expertise of auditing, knowledge of accounting, aptitude of analytical and investigative skills to assist in application of the same to serve as evidence of economic/financial deals for reporting or establishing proper accountability.

Forensic Audit exercise basically involves investigation into the financial dealings of a commercial entity, more specifically in the context of alleged fraud and *prima-facie* serious financial irregularities, so as to find out the facts. The very important aspect of the Forensic Audit is to gather unassailable evidence to support the findings as it should withstand the admissibility in a court of Law.

Forensic Audit can be requisitioned by the business entity itself to unearth any wrongdoing. In the process, the auditor needs to carry out a lot of background check on both the input for and output from the commercial entity. All major financial outstanding amount shown in Balance Sheet and the closing balances drawn in the Profit and Loss Statement needs to be thoroughly probed into and their veracity and genuineness established beyond doubt to pass through the Forensic Audit. At times, the auditor may have to extend his network to a number of non-financial areas such as e-mails, telephones, online banking transactions, and interview with bankers, suppliers, customers, management and other employees also.

The increasing number of companies and the complexities of business transactions that are mostly done in electronic form to ensure accuracy and speed which put the detection mechanism under the carpet have necessitated the need for Forensic Accountants, thereby giving an impetus to the field of forensic accounting, which is set to grow and develop further.

Forensic Accounting has been growing in stature. Huge expenses incurred in technology advancement, bulk purchase, software procurement, cross border transactions, explode of Information Technology etc., provide ample opportunities for the forensic accountant to tread on and furrow for the wrong doings. The functions of the forensic accountant are akin to the blind man entering a dark room during midnight in search of a black hat that may be there, as he has to go beyond the figures and statements.

Financial Fraud Cases

Forensic Audit envisages to reveal the monetary value of the fraud, the time horizon in which the fraud was committed and the persons involved in that financial impropriety. Some of the practical cases that surfaced and are still in public memory are touched upon in the following paragraphs.

a. In 2006, a major scam was unearthed in the functioning of share allotment process and in this regard, depositories, depository participants and nearly two dozen market operators who allegedly played a role in the creation and usage of large number of fictitious / hypothetically opened demat accounts with an ulterior motive of cornering share allotment in the Initial Public Offer for the retail investors. This was a failure of the operational risk management system in all these players functions that led to the scam. The depositories appear to

have failed to exercise the requisite oversight in adhering to the Know Your Customer (KYC) norms in the functioning of depository participants. It is a clear case of quality becoming a victim of quantity and large volume transactions. The undue profit gained by the allottee of shares was expunged as the gainers were asked to return the illegal profit, accrued to them, through the process of disgorgement.

b. In 2008, the biggest corporate fraud perpetuated by the promoters of Satyam group, one of the then top few IT companies in India, surfaced and it was mainly by cooking up the financial figures. Though the chief promoter indulged in the fraudulent activities during the early part of the first decade of 21st century, like the other similar frauds the promoter cleverly manipulated for nearly 7 to 8 years, to keep it under the carpet.

c. In the later part of 2008, M/s. Lehman Brothers, the largest investment banker filed for bankruptcy, the venerable Merrill Lynch was taken over by Bank of America and the American Insurance Group (AIG), the largest insurer, was bailed out by the US Federal Reserve.

d. In an environment where cost of borrowing is already high, poor inflows from overseas, both through FII and FDI, worsen the funding source, bulk selling by these FII / FBI holdings has the potential to severely impact the capital market in India.

e. In 2000, Enron's fraud was carried out through a labyrinth of off-balance sheet deals, diversion to unrelated non-core activities, divisional accounting gimmicks, through creative financial accounting practices. Enron actually uprooted the audit firm, instead of the latter having a check on the former. Though its derivative related asset yields grew by good numbers, liabilities also piled up rapidly. In order to hide bad investment in derivatives, as well as its poorly performing assets in energy business, it created multiple Special Purpose Vehicles (SPVs).

f. The impact of non-adherence to internal controls

As against the expectation of auditors detecting all the financial wrong doings and misstatements, what is happening is just a compliance audit. Hence there should be an assurance audit. That is, somebody should assure and certify that no financial wrong-doing has happened.

and procedures could be disastrous, as can be noticed from the incident that had taken place in Societe Generale SA, which is the second largest bank in France, by market value, and was considered as a leader in derivatives besides and was regarded as one having good risk management systems. It appears that it detected the fraud at its French markets division during the weekend of 19th January 2008 and a trader, at the futures desk, had taken "massive fraudulent directional positions" in 2007 and 2008 beyond his limited and permitted authority. The unauthorised bets on stock–index futures by the trader caused the largest trading loss in banking history.

g. The surveillance office at Eurex, one of the biggest European exchanges, alerted a compliance officer at the Bank that for several months a specific trader, had engaged in not just one but "several transactions" that had raised red flags. Societe Generale SA taking its own sweet time, responded, when another risk-control expert at the bank replied that there was nothing irregular. Not satisfied by the bank's explanation, the Eurex demanded more details which were provided later and both Eurex and the bank's own risk managers came to know of the fraud by the Trader.

h. Sub-Prime loans are the credit facility given to the borrowers who, in the normal course, do not qualify for loan with market interest rates because of problems in their credit history and also the weak financial status. It's risky for the lender because borrowers usually have lower incomes and a poor record for paying debt, increasing the credit default. It is also risky for borrowers for the reason that it further increases their likelihood of default. The sub-prime lending helped boost the US home ownership to a record level.

i. Borrowers who have a poor credit history looking to buy a house and are prepared to pay, to compensate the high risk, a mortgage rate typically

2% higher than rates charged to people with good credit, approached mortgage brokers or conversely got brokers call them. Big banks and wholesale lenders bought the debt, repackaged them and sold them to Wall Street firms, who further repackaged these loans in Mortgage Backed Securities (MBS) and Collateralised Debt Obligations (CDO), with the aide of Rating Agencies. These structured and financially engineered products very often carry high rates of return and are sold to pension funds, hedge funds and institutions.

j. The Sub-Prime crisis triggered a financial turmoil because of the concept "Originate-Distribute-Forger" model. Sub-prime crises ballooned into a financial crisis because it impacted the financial institutions that leveraged exposures to sub-prime contracts. Hence, the focus of reform should be on financial institutions and also the regulatory architecture.

Anything in excess is not good enough for long and may turn out to be harmful. World.com, Enron, AIG, Merrill Lynch, Lehman Bros, etc. are victims of the excess of a certain thing. Fraud often comes to light either by accident or through voluntary confessions when the situation goes out of control for the fraudster or tip-offs through employees, outsiders, or other haphazard means. Here, only the skill of a Forensic Accountant comes into play.

To handle such a complex situation, an accountant with specialists' skills, knowledge and training is needed to not only smell the rat well in advance but also substantiate the unraveling of a scam before it takes immense proportion, besides collection of proper evidences. A high rate of white-collar crimes resulting from cross border financial transaction and opening up of economy coupled with the belief that the relevant law enforcement agencies do not have the requisite expertise, are to be probed to uncover various types of fraudulences.

The increasing number of companies and the complexities of business transactions that are mostly done in electronic form to ensure accuracy and speed which put the detection mechanism under the carpet, have necessitated the need for Forensic Accountants, thereby giving an impetus to the field of forensic accounting, which is set to grow and develop further.

Audit Assurance

Though it has been the general perception that the detection of fraud or white collar crime or for that matter financial irregularity is part of the accounting function, the fact is that auditors normally carry out their audit assignment on surface value or position on a particular date, within the framework of a company's corporate policies. The procedure adopted by the auditor conforms to Generally Accepted Accounting Principles (GAAP) and the requirements of regulators/ supervisors.

As against the expectation of auditors detecting all the financial wrong doings and misstatements, what is happening is just a compliance audit. Hence there should be an assurance audit. That is, somebody should assure and certify that no financial wrong-doing has happened. This never happens in practice, as the scope of statutory audit is basically a compliance audit and the exercise does not normally uncover or detect frauds, unless it is incidental to the audit exercise as a by-product. There are a number of types of audit such as statutory audit, concurrent audit, internal audit, stock audit, management audit, cost audit, computer audit, information system audit, etc.

In the case of regulated financial entity, there is RBI inspection, branch audit, etc. But all of these are not just enough to give an assurance to the shareholders that as on a particular date, all the financial transactions covered during the period are free from fraud. Forensic Accounting is the application of specialised knowledge and specific analytical skills to stumble upon the evidence of financial transactions.

All these checking and verifying authorities, both internal and external, are expected to pay attention to risk areas, exceptional transactions, unusual as well as repetitive transactions, un-reconciled entries in sensitive accounts, etc. They should expand their scope of work as the situation or sample / test checking warrants and call for specialists / experts in the area of forensic accounting / audit, whenever required.

Forensic Accounting Services

A Forensic Accountant provides a number of services including investigation, confirmation of the fraud, litigation support, etc., which refers to the factual presentation of issues related to existing or pending

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litigation in connection with the fraud and potential one too. Quantification of damages due to the breach of a contract or due to the infringement of a patent/ copyright assists in arriving at out-of-court settlement. Forensic accounting/ audit promises to be the hot career in the days to come and the personnel involved should be unbiased and independent in their assignment.

A Forensic Accounting professional is more a private investigator with sixth or for that matter seventh sense than the stereotypic Financial Accountant. In fact, as the business environment changed from paper-based to electronic chip-based, the demand from a Forensic Accountant is graduated to system-based. He should and is expected to possess sound information technology knowledge to supplement the expertise in the domain of finance and accounts. Formal professional accounting knowledge and skills coupled with the ability to pay attention to the minutest details to facilitate an in-depth analysis and interpretation of data are pre-requisites for taking the profession to greater heights.

The parties involved in possible litigation would be able to clearly understand their own position and may be willing to settle the issue rather than proceed with litigation, which is time-consuming and costly. A Forensic Accountant/Auditor should question the seemingly unimportant and benign transaction/ document and check for the inconsistencies and discrepancies, if any, that may not be noticeable to the naked eyes. When the dispute graduates to presence in courts, the Forensic Accountant, as an expert, may have to testify the witness to assist the court in its deliberations and in deciding the issue, besides forming a professional opinion by accessing all the relevant documents.

Investigation determines whether criminal activities of an insider are involved and to examine about action under vigilance angle, having serious consequences. The Forensic Accountant documents the findings in the form of reports, exhibits and collection of data/paper. Investigation may also involve civil and administrative matters such as searching for hidden assets, interrogation of outside parties, etc.

Asset tracing is a very potential field for the forensic accounting experts. Tracing of financial/bank transactions for converting them into tangible asset is an important aspect of forensic accountant as the unauthorised cash/ money generated, has to be utilised and must change its form into tangible asset, apart from the lavish spending/life style practiced by the fraudster. Tracing and identifying the assets when it is under unlawful possession or control are the basic requirements to track the acts of a financial fraudster.

Corporates engage Forensic Accounting experts to carry out special and specific assignments on irregularities in financial and business operations in a venture, as could be made out from the fact that audit and consultancy firm Grant Thornton, which recently conducted a forensic audit of scam ridden National Spot Exchange Ltd (NSEL), is understood to be engaged by the Forward Markets Commission to do similar exercise for Multi-Commodity Exchange of India, an associate of NSEL.

Both the Central Bureau of Investigation (CBI) and Criminal Investigation Department (CID) personnel are involved in one way or the other in forensic accounting or forensic auditing work. The formation of Serious Fraud Investigation Office (SFIO), a decade ago in 2003, after the Joint Parliamentary Committee's probe into Ketan Parekh scam involving one of the public sector banks, is a stepping stone for the recognition being accorded to forensic accounting concepts. Better tooth is provided in the newly enacted Companies Act 2013. When the loss of financial fraud is over ₹50 lakh or it affects more than 5000 people, it enters the domain of SFIO. One can name any common commodity or product that is connected to a scam associated with the same, be it stamp paper, fodder, telecom, steel, cement, coal, securities, public distribution system, banking, mining, etc.,

As the economy continues to grow, business entities seek to adopt best practices in accounting, improving controls through policy documents, etc.; such entities would be keen to adopt methods to prevent external as well as internal frauds as well as to limit losses from fraud by early identification of risk factors. The requirements of Basel norms for financial institutions, Sarbanes Oxley Act, etc. are focused to reduce the possibility of accounting scams and financial collapse on account of fraudulent transactions, by insisting on better disclosure practices. ■