

# **Forensic Accounting -Contemporary Relevance with Special Reference to India**



*The increase in the corporate scandals and revenue leakage in the recent past has forced professional accounting bodies to think beyond statutory audit. Forensic Accounting is that branch of accounting which uses investigative skills to determine the accuracy of a company's financial statement. Forensic Accounting can be defined as the science of gathering and presenting financial information in a manner that will be accepted by a court of jurisprudence, against perpetrators of crimes related to finance. This concept assumes significance for institutions willing to put in efforts to fight frauds and striving to build a strong and ethical reputation. Its application extends in industries like telecom, infrastructure, IT, pharmaceuticals as well as in sorting disputes over hidden assets in divorce cases. The author strongly feels that Forensic Accounting, being the need of the hour, should not only be incorporated as a usual process in an organisation but also be introduced in courses having Accountancy as the principal subject.*



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## Introduction

Xerox (USA, 2000), Enron (USA, 2001) and Worldcom's (USA, 2002) falsifying of financial results, Nortel's (Canada, 2003) ill-advised distribution of corporate bonuses to top 43 managers, Lehman Brothers' (USA, 2010) failure to disclose Repo 105 transactions to its investors, Olympus Corporation's

# Accounting

(Japan, 2011) loss-hiding arrangements, and, in India, names like UTI (2000), Ketan Parekh and Harshad Mehta stock market scams, and Satyam (2008), etc., have been raising questions on the credibility of the accounting and auditing fraternity.

Such unrelenting series of national and international corporate scandals and embarrassing audit failures in the past few decades have led the experts in the field of accounting and auditing to think beyond their traditional roles. To say that *auditors are not bloodhounds but only watchdogs* is passé now. Stakeholders expect auditors to take responsibility for fraud detection which demands an auditor to perform the role of a thorough investigator to find material frauds in the financial statement. The work of an auditor is no longer limited to ensure that the financial statements show a true and fair picture; rather the spotlight is now on fraud-detection, investigation and solution-seeking.

The ever-increasing expectations from the auditor are only fair in cases where the fraud is detectable, and where such frauds or corruption could have been identified in the regular audit process. But where fraud is consciously concealed, detection of fraud is hard to come by and it is difficult to pin the auditors due to the very limitation of the audit scope. It is important to fill in the gap between the expectation of the public and the regular audit scope. This leads to a demand for a new skill-set amongst the accountants and the auditors. Considering this need, Maurice Paulobet coined the term *Forensic Accounting*, with tripartite skills – accounting, auditing and investigative techniques – to assist in legal matters.

In India, *Kautilya* was the first person to mention 40 ways of embezzlement in his famous *Arthashastra*. It was then that these people had recognised the need for experts to detect frauds in the business world. Though the concept of

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*forensic accounting* is not new, there has been a serious lack of awareness in this regard. A plethora of high-profile corporate scandals and stricter reporting and internal control regulations have brought to light the importance of *forensic accounting* in business.

## Forensic Accounting: Need of the Hour

Traditional auditing has a focus on error identification and prevention. It is a process to ensure that accountants have followed the prescribed accounting policies, principles and practices. This determination is based on evidence and is a matter of fact. But this process has, time and again, proved insufficient in detecting frauds. *Forensic accounting* is the science that deals with the relation and application of financial, accounting, tax and auditing knowledge to analyse, investigate, inquire, test and examine matters related to white collar crimes. *Forensic accounting* offers the highest level of assurance that is suitable for legal review.

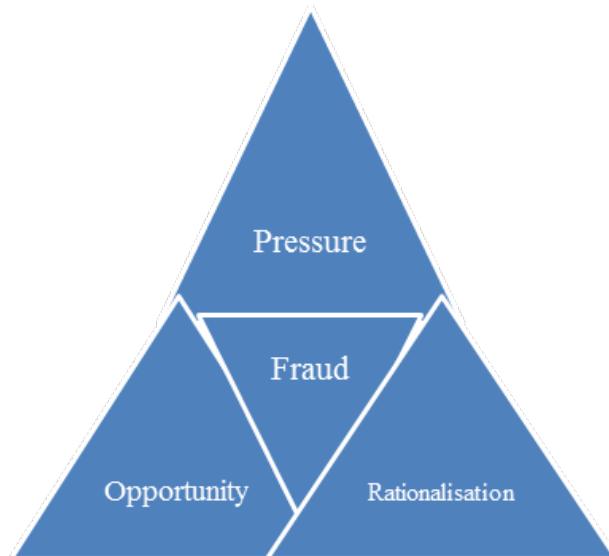
Forensic accountants are financial detectives with an investigative mind who aim at pulling out latent truths from financial statements. They are expected to provide impartial/unbiased evidence to assist in court proceedings. They are not expected to give their opinions. Instead, the reports issued often provide answers to questions like how, where, what, why and who. It is important to note that it is the Court that determines frauds and not the forensic accountant. (David Malamed)

## Fraud vs. Forensic Accounting

The primary work of a Forensic Accountant (FA) is to detect frauds. So it becomes important to understand what fraud means. A deliberate false representation of a matter of fact by issuing false or misleading statements, or by concealment of what should have been disclosed, with an intention to deceive another and illegitimately gain something at the loss of another is considered to be a fraud. According to the Association of Certified Fraud Examiners (ACFE), fraud is '*deception or misrepresentation that an individual or entity makes knowing that the misrepresentation could result in some unauthorised benefit to the individual or to the entity or some other party*'.

At this stage, it is inevitable to understand the circumstances that lead to fraud, to be able to identify them. These are popularly fitted in to the concept of

*Fraud Triangle* (Hansen & Peterson, 2010<sup>1</sup>), which portrays the coexistence of three main elements that may push a person to commit a fraud:



Any person who is observed to be entrapped in these circumstances can be a prospective fraudster. Deterring and detecting fraud becomes easy, if the pressures that fraudsters may face which might drive them to commit fraud are well understood. These are the motivating factors behind the crime. Knowing the most likely places to look for fraud on an organisation's financials will also increase our likelihood of detecting these white-collar crimes. An FA is expected to identify what the risk areas of an organisation are and how these risks can be exploited, and collect information, perform certain investigations based on different techniques using different tools, analyse the results and present them with recommendations of protecting the organisation from such exploitation of risks.

Of the many frauds in the corporate world, *financial statement frauds* affect a large number of people. When the financial statements of an organisation are manipulated to hide certain happenings or to show the kind of position of a business which does not exist, are called *financial statement frauds*. The most significant factor leading to this fraud is pressure on the management to show earnings of the business. Commonly-observed financial statement frauds are showing inflated revenue, round-tripping, asset overstatement, concealing the liabilities, reserve manipulation, understatement of expenses, embezzlement of cash, misappropriation of goods, omission of a material

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information, improper disclosure, adopting cookie-jar accounting practices, wherein a firm understates the revenue and maintains it as a reserve for future periods to cover a bad performance, etc. Such practices enable the management to remove the appearance of volatility from the operations from the records.

An FA may be appointed to detect and prevent such frauds. An FA starts identifying the *red flags* in the financial statements and probes into the root of such items/transactions to uproot the fraud, if any. *Red flag* is a term used to denote a warning sign for those items in a financial statement, which lead to scepticism over the authenticity of an item, a transaction, or an activity. It is a set of circumstances that are unusual in nature or are different from regular/usual activity. Some prominent *red flags* are increased revenues without corresponding increase in the cash flow over time, strong revenue growth when peer companies are experiencing weak sales, significant unexplained increases in fixed assets, recurring negative cash flow from operation while reported earning show an increasing trend and the earnings growth rate is positive, etc. On identifying the possible fraud activities, an FA then gathers all possible information about that activity from different sources, investigates that matter, using various computer applications and tools he/she reaches certain conclusions and prepares a report to assist the legal action to be taken.

In the US, *medicare frauds* are a growing problem. Some of them were detected because of the suspicious manner in which they were billed. An ENT doctor billing for pregnancy ultrasounds, a dermatologist billing for heart tests, a psychiatrist billing for MRIs, etc. (Sanchez, 2012)

*Insurance frauds* are not unheard of in India. Frauds like staging an event of loss or accident, claiming exaggerated amount, illegitimately obtaining health insurance when people are not qualified to get an insurance cover, providing

<sup>1</sup> A Comparison of Auditors' and Accounting Students' Ability to Identify Fraud Risk ! *Journal of Forensic Studies in Accounting and Business*, pp. 11–19.

# Accounting

false information of a pre-existing illness and then claiming refund of the expenses incurred towards its treatment, multiple claims for same event/illness/loss *via* different insurance policies, fire insurance frauds where obsolete stock are set to fire by the company itself and then insurance companies are called upon to fill in the loss, goods are insured against theft and then they are staged to have been stolen, *etc.*, are observed in India.

The Times of India (2004) reported a case of insurance fraud in Ahmedabad, where a CID (Crime and Railways) official Deputy Superintendent of CID (Crime and Railways) was charged with fraud for facilitating a fake insurance claim racket where natural deaths were proved as unnatural and insurance was claimed on them.

In such cases, a team of FAs could perform computer-assisted audit techniques (CAATs) to search databases for suspicious billings such as the ones mentioned above, *e.g.* where an ENT doctor billed for pregnancy ultrasounds and dates on which a doctor performed many more procedures than would be possible to perform in a day. If such transactions are found, they would warrant further investigation. Such CAATs, clubbed with other procedures, may help uncover the extent of fraud. Once the extent of the fraud is determined, an FA would need to prepare a case for the court. Here, an FA has to perform a difficult task of presenting complex financial data in a way that is easily understandable to the judge or the jury. This information is accepted as valid evidence in the court of law. (Sanchez, 2012)

Another popular white-collar crime is *banking frauds*. In the financial year 2010-11, banks in Mumbai reported 787 cases of fraud involving ₹1,049 crore according to a document obtained under Right to Information (RTI) Act from the Reserve Bank of India, reported DNA in 2012. Commonly-observed frauds in this sector are fraudulent investments by bankers, fraudulent loans granted, wire frauds, forging documents, accounting frauds, money laundering, credit/debit card frauds, misreporting of NPAs, *etc.* By appointing a team of FAs, banks can bring down the extent of frauds. FAs constantly work towards detecting frauds which enables its early detection and implementation of remedial measures.

Fraud examination has three dimensions—fraud detection, fraud investigation and fraud prevention. *Detection* is the process to be carried out by an auditor,

*investigation* is the work of law enforcement officials and *prevention* is expected by the management. An FA may be appointed by different institutions to carry out all these processes.

## FA: Skill-Set

Forensic accounting work can be broadly divided into two categories: investigative accounting covering fraud investigation and *litigation support* that requires skills from valuation to technology assessment. This would require photographic and video support, witness statements, evidence collection, police interviews, history usage, *etc.*

Services of an FA can be taken for all kinds of corruption litigates, enterprise assessments, damage and loss estimations, insurance disputes, rising problems from contracts, issues concerning patent, copyright and trademark, parting or merger litigates concerning enterprises, bankruptcy litigates, financial fraud litigates, financial disputes concerning divorce, *etc.* (Bozkurt, 2000) Such a wide range of applicability and expectation-set calls for a specialisation on the part of an FA.

While engaging a team of FAs, it is important to consider the following three areas:



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These are essential to ensure that expected results are delivered. An FA team fluent in financial statements for a manufacturing or retail company at a national level might be lost trying to navigate through the information of a multi-national engineering company to identify possible fraud of oil and gas reserve.

An FA needs to have a thorough knowledge in subjects like accounting, auditing, law, research techniques, psychology, criminology, etc. Soft skills that are a must are independence and objectivity, an ability to sort through unnecessary and nonsensical responses, a willingness to be cross-examined in the court, investigative persistence, knowledge of the situation under dispute, an eye for a possible alternative perspective, analytical techniques, evaluation abilities, effective communication skills to present complex information in an understandable manner, patience, for some court proceedings can spread over many years, knowledge of many aspects of law to be able to communicate efficiently with lawyers, etc. Role of an FA is proactive and reactive both. All in all, an FA needs to be *street-smart* and be able to think *out-of-the-box*.

### Forensic Accounting in India—Prospects and Problems

With the rise in the Indian economy, financial statement frauds are rising. In the year 2002, investors must have approximately lost a whooping ₹3,000 crore due to white-collar crimes, reported *The Indian Express* in 2002. We are a decade ahead in time and the increase in these figures can only be imagined. The infamous Satyam scam of 2008 followed by the CWG scam and the 2G Spectrum scam heightened the need for the development of Forensic Accounting as a profession in India.

The reported financial scandals have eroded investor confidence and have made Forensic Accounting an attractive career opportunity for accountants to combat fraud. This makes Forensic Accounting a fastest growing area of accounting today.

Forensic Accounting developed as a profession in the U.S. in the 1990's, but India took its first step in this direction only a few years back. India has established The Forensic Research Foundation for the investigations of frauds. SFIO (Serious Fraud Investigative Office) is a multi-disciplinary division of Department of Corporate Affairs of the Government of India, which looks into violation of laws like IT, FEMA, RBI Act etc. SFIO recognises CFE (Certified Forensic Examiner) as a qualification for the purpose of recruitment. 'Economic Offenses Wing' is a specialised department of the CBI (Central Bureau of Investigation) to deal with financial frauds. CVC (Central Vigilance Commission) handles the occupational frauds like corruption.

Some big private firms provide consultancy to their clients in fighting fraud. They have a dedicated team of forensic accountants to cater to the requirement of these clients. Going by the age-old proverb, *prevention is better than cure*, some giant companies like HDFC, Standard Life, Bharti Airtel, Tata Motors, etc., have started appointing FAs to keep a check on the organisation's working and financial records. This strongly suggests good employment opportunities for FAs in the coming years, which in turn demands professional courses to create such experts. But this has not yet been acknowledged by institutes imparting education in India as there are barely any courses developed in this regard. Institutions, therefore, have an opportunity too to introduce and offer courses in forensic analysis.

*India Forensics*, founded in the year 2005, is a Pune-based training and education centre engaged in fraud examination, security, risk management and forensic accounting in India. In India FAs are called Certified Forensic Accounting Professionals. ICAI (The Institute of Chartered Accountants of India) too had launched a Certificate course on Forensic Accounting and Fraud Detection in the year 2009.

Problem diagnosis and evaluation skills often are barely taught in many courses (Rosen, 2006). An FA needs to know the strengths and especially, the limitations of different aspects of Accounting and Finance. Teaching these days revolves around scoring high in exams rather than proper and broader understanding and implications of the subject. Memorising accounting concepts, principles and standards without proper understanding of the

# Accounting

same is a huge problem with today's youth. Another glaring problem faced is the lack of knowledge of the world around. Most students when poised with a question on accounting or finance are able to respond with their crammed knowledge but if they are asked any application based question, only a few are able to connect to the practical nuances. So is the case past or present happenings in the field of commerce. It is of utmost importance to stay connected with the recent developments as well as have sound information about the past happenings and judgements by the court to become an expert FA.

Also, it was observed during the literature review for the given paper that there is a great deficiency of existing literature related to forensic accounting in the Indian context. Indian literature related to frauds focuses largely on *bank frauds* and *money laundering*. There is an urgent need to fill the lacuna caused by the absence of literature related to forensic accounting.

## Conclusion

With the ever-increasing pressure on employees to achieve targets and on the management to show growth of earning only increases the probabilities to fraud being committed in any organisation. Traditional auditing is getting less effective day by day to keep a moral check over the employees and the management. Hence, to fight this ever-increasing risk, some organisations have now recognised the importance of employing experts in the field for early and timely detection of frauds. When an organisation suspects a fraud, it may hire an FA to investigate the matter, document the findings and make recommendations. Qualified FAs have the required technical and legal experience to investigate a given concern, follow leads, establish audit trials of questionable transactions, organise evidence for external review and law enforcement bodies and to testify in court. These accountants use specialised software tools to help them perform their task. Each fraud investigation is unique and requires strong critical thinking skills. So, a multidisciplinary investigative team can be developed by selecting individuals who possesses skills in electronic evidence gathering and preservation, interviewing techniques, etc.

This in turn increases the demand of FAs which is not met due to lack of academic facilities. It is of great importance that the courses developed must include

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training and hands-on experience to tackle fraud examination and forensic accounting investigation assignments.

In 1996, *The Wall Street Journal* called forensic accountants *accounting profession's new glamour kids*. Primary obstacles in the delivery of forensic accounting education are institutional in nature, i.e. faculty, administration, curriculum structure, and not a perceived lack of demand by employers and students. It is also believed that exposure to Forensic Accounting will promote ethical behaviour. It will teach FAs to think in a certain way that is needed to detect major frauds sooner and more often, reducing the cost of fraud to society and freeing up taxpayer and other resources for more productive uses. (Seda et al, 2008)

It is time that accounting profession recognises that accounting and finance world need fraud-specific education in order to be effective in fighting against fraud. New courses concentrating on sharpening the ability of the accountants to fight such frauds need to be developed. While it is encouraging to note the emergence and depth of forensic accounting programs in the higher education systems in foreign countries, there still appears a gap between the demand for FAs and its supply in India due to lack of university-based education in this field. With our country being embroiled in financial frauds of serious magnitudes, the time seems just right for us to take a step forward and introduce FA as an essential, if not a core area of learning and research. ■