

PREVENTING FINANCIAL FRAUD THROUGH 'FORENSIC ACCOUNTING'

There has been a surge in commercial litigations in recent times entailing greater demand of the services of forensic accountants. This article deals with different aspects of forensic accountancy, discusses as to where the Forensic Auditors may be of help and highlights various provisions related to Forensic Accountants under the Indian statutes.

Thrill seeking and accountancy are not, whatever you may think, mutually exclusive. Forensic accountancy can be a high profile and fascinating blend of legal and numerical problem solving where you are key to beating the bad guys. There's nothing better than that thrill of getting the final bit of evidence that pieces the jigsaw together – **Mark Alden.**

In the backdrop of highly competitive business environment, there has been a surge in commercial litigations. The complex nature of financial and accounting issues make the scenario more complicated. This has resulted in the greater demand of specialist financial skills in detecting and investigating fraudulent actions. In cases where an investigation concerns embezzlement by a corporate officer, environmental mishaps, or allegations of tax fraud, counsel may not always possess the investigative resources needed to gather all the relevant facts. In the course of conducting internal corporate investigations, counsel may require specialised assistance in the fact-gathering process. In such situations, the services of a forensic accountant are of paramount importance.

The term Forensic Accounting encompasses a wide range of activities including:

- *The Expert Witness* – preparation of formal Reports for filing in Court and giving evidence as an Expert
- *Litigation Consultancy* – working with lawyers and their clients engaged in litigation and assisting with evidence, strategy and case

preparation.

- *Fraud Detection* – assisting clients in detecting financial fraud by employees and others and tracing misappropriated funds.
- *Computer Forensics* – assisting in electronic data recovery and enforcement of IP rights etc.

General Nature of Forensic Accountancy Work

Forensic accounting (or at least, accounting expert witnessing) can be traced as far back as 1817 to a court decision. According to *The Accountant's Handbook on Fraud & Commercial Crime*, forensic accounting is defined as: the application of financial skills and an investigative mentality to unresolved issues, conducted within the context of the rules of evidence. Forensic Accounting broadly is a mixture of Accounting, Finance, Law, Computerisation, Ethics, and Criminology, with focus on prevention and detection of financial frauds and conduct of investigation to undertake and assist in litigation support to book the wrong doers. Forensic accounting looks at the accounting in a wider perspective rather than in different segments such as data entry, record keeping, preparation, and finalisation of accounts. Forensic accounting is not limited to the correctness of accounts; it encompasses accounting, investigative accounting, investigative audit, and litigation support. Forensic accounting focuses on detection of financial frauds by linking the data knowledge and insight together and prevention of fraud by establishment and placing the accounting system on right track, it also creates deterrence (as it promotes fear in the mind of wrong doers that there is likelihood of their being caught and punished).



– **Dr. G.S. Mehta***
and **Tarun Mathur****

(* The author is a member of the Institute. **The author is law student at National Law University, Jodhpur.)

Role of Forensic Accountants

Forensic Accountancy involves a financial detective (Forensic Accountant) with a suspicious mind, a financial bloodhound, someone with a 'sixth sense' that enables reconstruction of past accounting transactions and an individual who looks beyond the numbers. A forensic accountant's primary duty is to analyze, interpret, summarize and present complex financial and business-related issues in a manner that is both readily understandable by the layman and properly supported by evidence. The forensic accountant's activities are relevant to various types of business and personal legal disputes. Much of the work is connected with an evaluation of past and projected profits as well as appraising and preparing business valuations. In general, this type of expertise is useful in litigation involving loss of profits, breaches of contract, fraud, tax investigations and professional negligence. The appropriate skills are also useful in situations relating to personal injury and fatal accidents as well as libel or matrimonial disputes. The involvement of a forensic accountant at the beginning of the litigation process often acts as a catalyst in bringing proceedings to an early termination and in curtailing unnecessary legal costs. In any case, it is the objectivity and independence of the accountant in evaluating a case, which are likely to be of principal importance.

This new and groundbreaking accounting has two main areas (where the Forensic accountants need to put their skills) :- (1) Litigation Support and investigation and (2) Dispute Resolution. The former represents the factual representation of economic issues related to existing litigation. If the dispute reaches the courtroom, the forensic accountant may testify as an expert witness. Whereas in the latter forensic accounting professional quantifies damages sustained by parties involved in legal disputes and can assist in resolving disputes, even before they reach the courtrooms.

The Techniques in Forensic Accounting

The conventional accounting and auditing with the help of different accounting tools like ratio technique, cash flow technique, a standard

statistical tool examination of evidences are all part of forensic accounting.

In cases involving significant amounts of data, the present-day forensic accountant has technology available to obtain or source data, sort and analyse data and even quantify and stratify results through computer audit software applications and various other techniques. This enables the forensic accountant to pinpoint theft of assets for fidelity bond coverage, proof of losses for insurance or recovery through litigation, and illegal payments by corporations. Some of the techniques involved in Forensic Accounting are:

(1) Benford's Law: It is a mathematical tool, and is one of the various ways to determine whether variable under study is a case of unintentional errors (mistakes) or fraud. On detecting any such phenomenon, the variable under study is subjected to a detailed scrutiny. The law states that fabricated figures (as indicator of fraud) possess a different pattern from random (or valid) figures. The steps of Benford's law are very simple. Once the variable or field of financial importance is decided, the left most digit of variable under study is extracted and summarised for entire population. The summarisation is done by classifying the first digit field and calculating its observed count percentage. Then Benford's set is applied. A parametric test called the Z-test, is carried out to measure the significance of variance between the two populations, i.e. Benford's percentage numbers for first digit and observed percentage of first digit for a particular level of confidence. If the data confirms to the percentage of Benford's law, it means that the data is Benford's set, i.e. there is 68% (almost 2/3rd) chance of no error or fraud. The first digit may not always be the only relevant field. Benford has given separate sets for 2nd, 3rd, ... and for last digit as well. It also works for combination numbers, decimal numbers and rounded numbers. There are many advantages of Benford's Law like it is not affected by scale invariance, and is of help when there is no supporting document to prove the authenticity of the transactions.

(2) Theory of relative size factor (RSF): It highlights all unusual fluctuations, which may

be routed from fraud or genuine errors. RSF is measured as the ratio of the largest number to the second largest number of the given set. In practice there exist certain limits (e.g. financial) for each entity such as vendor, customer, employee, etc. These limits may be defined or analysed from the available data-if not defined. If there is any stray instance of single transaction that is way beyond the normal range, then there is a need to investigate further into it. It helps in better detection of anomalies or outliers. In this method the records that fall outside the prescribed range are suspected of errors or fraud. These records or fields need to relate to other variables or factors in order to find the relationship, thus establishing the truth.

(3) Computer Assisted Auditing Tools (CAATs): CAATs are computer programs that the auditor use as part of the audit procedures to process data of audit significance contained in a client's information systems, without depending on him. CAAT helps auditors to perform various auditing procedures such as: (a) Testing details of transactions and balances, (b) identifying inconsistencies or significant fluctuations, (c) Testing general as well as application control of computer systems. (d) Sampling programs to extract data for audit testing, and (e) Redoing calculations performed by accounting systems. Forensic accounting software (for accounting purposes) comes in two different varieties: data extraction software and financial analysis software. Data extraction software is designed to conduct spreadsheet analyses on all the company's computer database records, such as billings, accounts receivable, payments to vendors, payroll, and purchasing. Unusual, inconsistent fluctuations or 'anomalies' are then detected and investigated. Financial analysis software uses monthly, quarterly, or annual financial statements, and benchmarks the 'ratios' between different accounts such as billings by revenues or supply costs as a percentage of revenue. Other computer software that forensic accountants might use include so-called 'spy' software.

(4) Data mining techniques: It is a set of computer-assisted techniques designed to automatically mine large volumes of data for

new, hidden or unexpected informations or patterns. Data mining techniques are categorized in three ways: Discovery, Predictive modeling and Deviation and Link analysis. It discovers the usual knowledge or patterns in data, without a predefined idea or hypothesis about what the pattern may be, i.e. without any prior knowledge of fraud. It explains various affinities, association, trends and variations in the form of conditional logic. In predictive modeling, patterns discovered from the database are used to predict the outcome and to guess data for new value items. In Deviation analysis the norm is found first, and then those items are detected that deviate from the usual within a given threshold (to find anomalies by extracted patterns). Link discovery has emerged recently for detecting a suspicious pattern. It mostly uses deterministic graphical techniques, Bayesian probabilistic casual networks. This method involves "pattern matching" algorithm to 'extract' any rare or suspicious cases.

(5) Ratio Analysis: Another useful fraud detection technique is the calculation of data analysis ratios for key numeric fields. Like financial ratios that give indications of the financial health of a company, data analysis ratios report on the fraud health by identifying possible symptoms of fraud. Three commonly employed ratios are—

1. the ratio of the highest value to the lowest value (max/min);
2. the ratio of the highest value to the second highest value (max/max2); and
3. the ratio of the current year to the previous year

Using ratio analysis, a financial expert studies relationships between specified costs and some measure of production, such as units sold, dollars of sales or direct labor hours. For example, to arrive at overhead costs per direct labor hour - Total overhead costs might be divided by total direct labor hours.

Ratio analysis may help a forensic accountant estimate expenses. For example, one company's cost of goods sold (cost to produce the items being sold) rarely deviates from 35 percent of sales. If documentation for the year under audit is missing,

we can use this 35 percent estimate to determine a reasonable amount for cost of goods sold.

Forensic Accountants: How Different?

Apart from the basic ability of verifying information, the skills and expertise of investigative accountants differ significantly from those applicable to conventional auditing and accounting work. The expert accountant is expected to identify rapidly the key financial issues and to place these in a legal context. The subsequent stage of producing a report is of equal importance, since this is the mode by which the financial aspects of a case are brought to life for the lawyers and for the court. The accountant may subsequently be involved either in giving formal evidence or in assisting counsel to grasp complex financial matters.

A forensic accountant is someone with a combination of skills. Beyond being a CA, a forensic accounting has auditing and investigating capabilities that are ideal for detailing the complexity of litigation involving tax and finance. A forensic accountant is extremely helpful with the investigative accounting needed for litigation support, particularly in cases that involve mountains of ledger sheets, bank statements and receipts. A forensic accountant can take a seemingly needle-in-a-haystack pile of financial information and distill it into the important elements that need to be presented clearly and concisely as courtroom testimony.

Need Of Forensic Accounting

The forensic accountants are used by attorneys in a broad range of activities from expert witness testimony to special counsel's investigation of fraud, to bolster corporate governance.

Such services include factfinding in both discovery and analysis of relevant data for fraud investigations; damage claims; lost property calculations; valuations of business; and determination of matrimonial assets in divorce actions, and expert testimony with respect to these findings. Following flowchart will make clear where the Forensic Accounting techniques can be used:

Forensic Accountants become involved in a wide range of investigations, spanning a myriad range of industries. These include:

(1) Criminal Investigations: This field covers probes and investigations on behalf of police forces. A Forensic Accountant's report is prepared with the objective of presenting evidence in a professional and concise manner. Recently, Report of the Justice R.S. Pathak inquiry authority in the matter of the independent inquiry committee report on the United Nations Oil - For - Food programme relating to contract no. m/09/54 and contract no. m/10/57 observed that -

"It is observed further that if any discrepancy was found in the documents, it looked into the matter with great care and conducted a due diligence in it. It also availed the services of the Forensic Accounting Unit to solve the financial aspects of the inquiry. It also had the assistance of the Jordan National Bank, which helped in establishing the financial aspects of the matter."

(2) Shareholders and Partnership Disputes: These assignments often involve a detailed analysis of numerous years of accounting records to quantify the issues in dispute. For example, a common issue that often arises is the compensation and benefits received by each of the disputing shareholders or partners.

(3) Business Interruption/Other Types of Insurance Claims: Insurance policies differ significantly as to their terms and conditions. Accordingly, these assignments involve a detailed review of the policy to investigate coverage issues and the appropriate method of calculating the loss. A Forensic Accountant is often asked to assist from either an insured or insurer's perspective in the settlement of a case. The role of an accountant retained in an insurance matter will largely be dependent upon the nature of the claim and the underlying issues.

There are various activities that the accountant is often asked to assist with:

- The accountant can be used to form a preliminary view of the quantum of the claim.

This can be helpful in assessing whether and to what extent an interim payment can or should be made. A preliminary assessment of the possible size of the claim can also help with developing the strategy for handling the claim.

- The accountant retained can assist with reviewing the insured's approach to quantifying the claim. By having this sort of involvement, it is often possible to help the insured focus on the claim as allowed under the policy. This can help smoothen the process and avoid unexpected issues.
- When the claim is submitted, the accountants can assist in reviewing and commenting on it. Depending on the quality and basis of calculation, it may be necessary to go further than a simple critique of the report. The role of the accountant will usually extend to a consideration of the overall reasonableness of the claim.

(4) Business/Employee Fraud Investigations:

Business investigations can involve funds tracing, asset identification and recovery, forensic intelligence gathering and due diligence reviews. Employee fraud investigations often involve procedures to determine the existence, nature and extent of fraud and may concern the identification of a perpetrator. These investigations often entail interviews of personnel who had access to the funds and a detailed review of the documentary evidence.

(5) Business Economic Losses: Examples of assignments involving business economic losses include contract disputes, construction claims, expropriations, product liability claims, trademark and patent infringements and losses stemming from a breach of a non-competition agreement.

Forensic Auditors/Accountants Under Indian Statutes

There is no mention of Forensic accountants in the Indian statutes so far but there are various provisions related to Forensic accountants/auditors in the statutes. It can be categorized under the following heads:

(1) Investigation and Inspection: Forensic auditors may help the Police, ACB and other investigating authorities in collecting evidences and other investigation purposes. For example section 157 Cr.P.C, 1973; section 17,18 of Prevention of Corruption Act, 1988; Section 6 of The Bankers Books Evidence Act, 1891; Section 78 of Information Technology Act, 2000; Section 209A, 227 of the Companies Act, 1956 wherein the Court or Police may require the skills of Forensic accountants while inspecting any books in so far as related to the accounts of an accused.

(2) Expert opinion: Forensic accountants may see and carefully examine the accounts and balance sheets and use his skills to find out whether there is any fraud committed or any anomaly associated with it by giving his expert opinion. This finds place in for example s.45, s.118 of Indian Evidence Act, 1872; s.293 of Cr.P.C, 1973.

(3) Forensic Accounting under CARO (The Companies (Auditor's Report) Order, 2003): It can be categorised under following heads:

- Disposal Of Fixed Assets:* CARO, 2003 requires the auditor to report to the effect that if a substantial part of fixed assets have been disposed off during the year, whether it has affected the going concern status. In order to carry out the duties, the auditor has to draw a corollary and reference to the section 293 Companies Act, 1956, AS 24 ('Discontinuing Operations') and to AAS 16 (Going Concern) and thereafter make his observations on this matter.
- Report On Frauds:* If any fraud on or by the company has been noticed or reported during the year. Following provisions CARO, 2003 are important in this aspect:
 - AAS 4(Revised) guides the Auditor to obtain a management representation letter as the frauds reported and detected during the year because of the nature of the fraud and the difficulties encountered by the Auditors in detecting material mis-statements in the financial statements resulting from fraud. Accordingly, it may be concluded that it is enough if the Auditor expresses his opinion on the frauds

noticed and reported by the management and not expected to be a detective to approach his work with suspicion

- Another major issue under this clause is that it also requires reporting of frauds committed by the Company. The Auditor is left with no clues and is expected to travel beyond the books to search for market information about frauds committed by the Company, which is highly illogical.

(iii) *Transactions with related parties:* The focus of the primary reporting under this clause is to report whether transactions that need to be entered into a Register in pursuance of Section 301 of the Companies Act, 1956 have been so entered. This Clause may be considered as a further step towards the investor's protection. However, the major issue here is that the audit focus has to be shifted/ further intensified towards proprietary areas to find out the transactions that need to be entered (a thorough scrutiny of all entries in the books of accounts may be needed); and then to check the Register for actual recording of the same

Mere reliance on the 301 Register is not enough and the Auditor has to scrutinise Form No.24AA (Disclosure of interest by the Directors) to ascertain likely transactions that need to be entered in the 301 Register.

Forensic Accountant: An Asset to Legal Team

A forensic accountant's primary duty is to analyze, interpret, summarise and present complex financial and business-related issues in a manner that is both readily understandable by the layman and properly supported by evidence. In addition, a forensic accountant must also be familiar with legal concepts and procedures, including the ability to differentiate between substance and form when grappling with any issue.

A well-trained forensic auditor can provide the following services:

- Review of financial books and records for suspicious or unusual transactions warranting

further attention; Search for potential preferential payments and fraudulent transfers; Prepare analyses of pre-and post-petition financial statements;

- Locate diverted funds or assets of the debtor; Identify misappropriated assets; identify reversible insider transactions; Analyze business operations and performance;
- Evaluate the factors contributing to the debtor's current financial condition and future viability; Analyze business plans and financial projections to determine the feasibility of reorganization
- Analyse monthly operating reports to ascertain business trends and issues warranting further investigation e.g. the services of Forensic Accountant is of great significance when there is Merger and Amalgamations of the Companies with reference to preparing of 'due diligence' report of the amalgamating and amalgamated companies.
- Analyse, interpret, summarise and present complex financial and business-related issues in a manner that is both readily understandable and supported by pertinent data and analyses performed in accordance with procedures recognized in the profession
- Prepare visual aids to support trial evidence; analyze questionable accounting practices; provide analyses to support motions; provide analyses of debtor's court motions
- Validate the stated reasons for the bankruptcy filing and provide expert testimony.

Conclusion

The importance of the forensic accountant's role in the detection of fraud is continuously growing. Armed with combination of skills, these financial detectives are today important assets to modern legal teams. In the backdrop of increasing levels of frauds, the demand for forensic accountants is bound to substantially increase in the future. □