1. OVERVIEW

The number of fraudulent activities and ambiguous financial activities have been accelerating all over the world. Consequently, businesses are exposed to risks of fraudulent activities. With all of the recent corporate accounting scandals at Parmalat, Xerox Corporation, and Satyam Computer Services, and all the high profile corporate frauds at Enron, WorldCom, and HealthSouth followed by Bernie Madoff's colossal ponzi scheme, the media has made Forensic Accounting and Forensic Auditing into a growth industry.

Forensic Auditing has established itself as dynamic and strategic tool in combating corruption, financial crimes and frauds through investigations and resolving allegations of fraud and embezzlement. Thus, a new area of auditing, known as Forensic Audit, was needed to detect the frauds in companies that suspected fraudulent transactions.

“Forensic” means “suitable for use in the court of law”. Bologna said that it is the application of financial skills and investigative mentality to unresolved issues, conducted within the context of the rules of evidence. As an emerging discipline, it encompasses financial expertise, fraud knowledge and a sound knowledge and understanding of business reality and the working of legal system.

However, the definition of Forensic Auditing keeps on changing in response to the growing needs of corporations. Simply stated, Forensic Auditing includes the use of accounting, auditing and investigative skills to assist in legal matters.

Important Definitions:

Forensic: The word forensic comes from the Latin word forensis, meaning "of or before the forum." It is -

Relating to, used in, or appropriate for courts of law or for public discussion or argumentation.

* Source: Shutterstock
Relating to the use of science or technology in the investigation and establishment of facts or evidence in a court of law.

**Forensic Accounting**: The integration of accounting, auditing and investigative skills yields the specialty known as Forensic Accounting. It is the study and interpretation of accounting evidence. It is the application of accounting methods to the tracking and collection of forensic evidence, usually for investigation and prosecution of criminal acts such as embezzlement or fraud.

Forensic Accounting can sometimes be referred to as Forensic Auditing.

**Forensic Investigation**: Also known as forensic audit is the examination of documents and the interviewing of people to extract evidence. Forensic Accounting examines individual or company financial records as an investigative measure that attempts to derive evidence suitable for use in litigation.

**Fraud Auditing**: In a fraud audit one searches for the point where the numbers and/or financial statements do mesh. It is a meticulous review of financial documents conducted when fraud is suspected. Some entities do them as a precaution to prevent fraud from happening and to catch it before the loss magnifies. A Fraud Audit however is not an Investigation. Fraud auditing is used to identify fraudulent transactions, not to figure out how they were created. Fraud auditors often go outside the books of accounts to find fraudulent transactions.

**Red Flag**: Red flags are sign or warning of any impending danger or inappropriate behavior. Red flag do not necessarily indicate the existence of fraud however are indicators that caution needs to be exercised while investigating the situations. Red flags are classified in categories such as financial performance red flag, accounting system red flags, operational red flags and behavioral red flags.

Forensic audit can be conducted in order to prosecute a party for fraud, embezzlement or other financial claims. In addition, an audit may be conducted to determine negligence in addition, an audit may be conducted to determine negligence.

### 2. AUDIT V/S. FORENSIC ACCOUNTING/FORENSIC AUDIT

**How is a forensic accounting analysis different from an audit?**

The general public believes that a financial auditor would detect a fraud if one were being perpetrated during the financial auditor's audit. The truth, however, is that the procedures for financial audits are designed to detect material misstatements, not immaterial frauds. While it is true that many of the financial statements and frauds could have, perhaps should have, been detected by financial auditors, the vast majority of frauds could not be detected with the use of financial audits. Reasons include the dependence of financial auditors on a sample and the auditors' reliance on examining...
the audit trail versus examining the events’ and activities behind the documents. The latter is simply resource prohibitive in terms of costs and time.

There are some basic differences today between the procedures of forensic auditors and those of financial auditors. In comparison, forensic accounting and audit differ in specific ways, as shown below:

### Forensic Accounting

- In response to an event
- Financial investigation
- Finding used as evidence in court or to resolve disputes

### Audit

- Mandatory
- Measures compliance with reporting standards
- Obtain reasonable assurance that financial statements are free of material misstatement

In practice, there are differences in mind set between forensic accounting and audit:

- "Investigative mentality" vs. "professional scepticism". A forensic accountant will often require more extensive corroboration.
- A forensic accountant may focus more on seemingly immaterial transactions.

A forensic accountant will often look for indications of fraud that are not subject to the scope of a financial statement audit.

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>Particulars</th>
<th>Other Audits</th>
<th>Forensic Audit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Objectives</td>
<td>Express an opinion as to ‘True &amp; Fair presentation</td>
<td>Whether fraud has taken place in books</td>
</tr>
<tr>
<td>2.</td>
<td>Techniques</td>
<td>Substantive &amp; Compliance. Sample based</td>
<td>Investigative, substantive or in depth checking</td>
</tr>
<tr>
<td>3.</td>
<td>Period</td>
<td>Normally for a particular accounting period.</td>
<td>No such limitations</td>
</tr>
<tr>
<td>4.</td>
<td>Verification of stock, Estimation</td>
<td>Relies on the management certificate/Management Representation</td>
<td>Independent/verification of suspected/selected items where misappropriation in suspected</td>
</tr>
<tr>
<td></td>
<td>realisable value of assets, provisions,</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>liability etc.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5.</td>
<td>Off balance sheet items (like contracts</td>
<td>Used to vouch the arithmetic accuracy &amp; compliance with procedures.</td>
<td>Regulatory &amp; propriety of these transactions/contracts are examined.</td>
</tr>
</tbody>
</table>
3. FORENSIC AUDITOR

A Forensic Auditor is often retained to analyze, interpret, summarize and present complex financial and business related issues in a manner which is both understandable and properly supported. Forensic Accountants are trained to look beyond the numbers and deal with the business reality of the situation.

A Forensic Auditor must initially consider whether his/her firm has the necessary skills and experience to accept the work. Forensic audits are highly specialized, and the work requires detailed knowledge of fraud investigation techniques and the legal framework.

Forensic Auditors can be engaged in public practice or employed by insurance companies, banks, police forces, government agencies and other organizations.

3.1 A Forensic Auditor is often involved in the following:

- **Fraud Detection:** Investigating and analyzing financial evidence, detecting financial frauds and tracing misappropriated funds.
- **Computer Forensics:** Developing computerized applications to assist in the recovery, analysis and presentation of financial evidence.
- **Fraud Prevention:** Either reviewing internal controls to verify their adequacy or providing consultation in the development and implementation of an internal control framework aligned to an organization’s risk profile.
- **Providing Expert Testimony:** Assisting in legal proceedings, including testifying in court as an expert witness and preparing visual aids to support trial evidence.

In order to properly perform these services a Forensic Auditor must be familiar with legal concepts and procedures and have expertise in the use of IT tools and techniques that facilitate data recovery and analysis. In addition, a Forensic Auditor must be able to identify substance over form when dealing with an issue.
3.2 Forensic Auditors are retained by:

- Lawyers
- Courts and Business Community
- Police Forces
- Banks
- Insurance Companies
- Government Regulatory Bodies and Agencies

3.3 Importance of Forensic Auditors

They can resolve the matters by combining accounting knowledge & experience with respect to:

<table>
<thead>
<tr>
<th>Fraud Prevention</th>
<th>Fraud Detection</th>
<th>Risk Management</th>
</tr>
</thead>
<tbody>
<tr>
<td>Filing requirements</td>
<td>Court systems</td>
<td>Investigative methodologies</td>
</tr>
<tr>
<td>Internal Controls Implementation and Review</td>
<td>Compliance and Regulatory Functions</td>
<td></td>
</tr>
<tr>
<td>Evidence Collection and Analysis</td>
<td>Assignments with regulatory agencies like SEBI, RBI, EOW etc.,</td>
<td></td>
</tr>
<tr>
<td>Professional body to provide expertise and literature in this fast growing field</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Communicating with audiences from attorneys &amp; judges to victims &amp; suspects</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

3.4 Services rendered by Forensic Auditors:

- Crafting questions to be posed
- Responding to questions posed
- Identifying documents to be requested and/or subpoenaed
- Identifying individuals to be most knowledgeable of facts
- Conducting research relevant to facts of the case
- Identifying and preserving key evidence
- Evaluating produced documentation and information for completeness
- Analyzing produced records and other information for facts
- Identifying alternative means to obtain key facts and information
- Providing questions for deposition and cross examination of fact and expert witnesses

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The services rendered by the forensic accountants are in great demand in the following areas:

- **Criminal Investigation:**  
  - Matters relating to financial implications the services of the forensic accountants are availed of. The report of the accountants is considered in preparing and presentation as evidence.

- **Professional Negligence Cases:**  
  - Professional negligence cases are taken up by the forensic accountants. Non-conformation to Generally Accepted Accounting Standards (GAAS) or non-compliance to auditing practices or ethical codes of any profession they are needed to measure the loss due to such professional negligence or shortage in services.

- **Arbitration service:**  
  - Forensic accountants render arbitration and mediation services for the business community. Their expertise in data collection and evidence presentation makes them sought after in this specialized practice area.

- **Fraud Investigation and Risk/Control Reviews:**  
  - Forensic accountants render such services both when called upon to investigate specific cases as well for a review of or for implementation of Internal Controls. Another area of significance is Risk Assessment and Risk Mitigation.

- **Settlement of insurance claims:**  
  - **Insurance companies** engage forensic accountants to have an accurate assessment of claims to be settled.  
  - In case of policyholders seek the help of a forensic accountant when they need to challenge the claim settlement as worked out by the insurance companies. A forensic accountant handles the claims relating to consequential loss policy, property loss due to various risks, fidelity insurance and other types of insurance claims.

- **Dispute settlement:**  
  - Business firms engage forensic accountants to handle contract disputes, construction claims, product liability claims, infringement of patent and trade marks cases, liability arising from breach of contracts and so on.
A forensic accountant should possess not only the broad knowledge of accounting principles, practice and standards but also the knowledge of insurance, banking civil and criminal law and human psychology.

A Forensic Auditor must be open to consider all alternatives, scrutinize the details and at the same time see the big picture. In addition, a Forensic Auditor must be able to listen effectively and communicate clearly and concisely in a timely manner.

4. PROCESS OF FORENSIC ACCOUNTING

Each Forensic Accounting assignment is unique. Accordingly, the actual approach adopted and the procedures performed will be specific to it. However, in general, many Forensic Accounting assignments will include the steps detailed below.
**Step 1. Initialization**

It is vital to clarify and remove all doubts as to the real motive, purpose and utility of the assignment. It is helpful to meet the client to obtain an understanding of the important facts, players and issues at hand. A conflict check should be carried out as soon as the relevant parties are established. It is often useful to carry out a preliminary investigation prior to the development of a detailed plan of action. This will allow subsequent planning to be based upon a more complete understanding of the issues.

**Step 2. Develop Plan**

This plan will take into account the knowledge gained by meeting with the client and carrying out the initial investigation and will set out the objectives to be achieved and the methodology to be utilized to accomplish them.

**Step 3. Obtain Relevant Evidence**

Depending on the nature of the case, this may involve locating documents, economic information, assets, a person or company, another expert or proof of the occurrence of an event. In order to gather detailed evidence, the investigator must understand the specific type of fraud that has been carried out, and how the fraud has been committed. The evidence should be sufficient to ultimately prove the identity of the fraudster(s), the mechanics of the fraud scheme, and the amount of financial loss suffered. It is important that the investigating team is skilled in collecting evidence that can be used in a court case, and in keeping a clear chain of custody until the evidence is presented in court. If any evidence is inconclusive or there are gaps in the chain of custody, then the evidence may be challenged in court, or even become inadmissible. Investigators must be alert to documents being falsified, damaged or destroyed by the suspect(s).

**Step 4. Perform the Analysis**

The actual analysis performed will be dependent upon the nature of the assignment and may involve:

- calculating economic damages;
- summarizing a large number of transactions;
- performing a tracing of assets;
- performing present value calculations utilizing appropriate discount rates;
- performing a regression or sensitivity analysis;
- utilizing a computerized application such as a spreadsheet, database or computer model; and
- utilizing charts and graphics to explain the analysis.
Step 5. Reporting

Issuing an audit report is the final step of a fraud audit. Auditors will include information detailing the fraudulent activity, if any has been found. The client will expect a report containing the findings of the investigation, including a summary of evidence and a conclusion as to the amount of loss suffered as a result of the fraud. The report may include sections on the nature of the assignment, scope of the investigation, approach utilized, limitations of scope and findings and/or opinions. The report will include schedules and graphics necessary to properly support and explain the findings.

The report will also discuss how the fraudster set up the fraud scheme, and which controls, if any, were circumvented. It is also likely that the investigative team will recommend improvements to controls within the organization to prevent any similar frauds occurring in the future.

The forensic auditor should have active listening skills which will enable him to summarize the facts in the report. It should be kept in mind that the report should be based on the facts assimilated during the process and not on the opinion of the person writing the report.

Step 6. Court proceedings

The investigation is likely to lead to legal proceedings against the suspect, and members of the investigative team will probably be involved in any resultant court case. The evidence gathered during the investigation will need to be presented at court, and team members may be called to court to describe the evidence they have gathered and to explain how the suspect was identified.

5. FORENSIC AUDIT TECHNIQUES
Detecting fraud is difficult, especially frauds involving material financial statement misstatements, which occur only in about 2 percent of all financial statements. Fraud is generally concealed and often occurs through collusion. Normally, the documents supporting omitted transactions are not kept in company files. False documentation is often created or legitimate documents are altered to support fictitious transactions. While fraud detection techniques will not identify all fraud, the use of sound techniques can increase the likelihood that misstatements or defalcations will be discovered on a timely basis.

Some of the techniques that a forensic auditor may use are listed below:

(I) General Audit Techniques:
- Testing defenses: A good initial forensic audit technique is to attempt to circumvent these defenses yourself. The weaknesses you find within the organizations control will most probably guide you down the sea path taken by suspected perpetrators. This technique requires you to attempt to put yourself in the shoes and think like your suspect.

(II) Statistical & Mathematical Techniques:
- Trend Analysis: Businesses have cycles and seasons much akin to nature itself. An expense or event within a business that would be analogous to a snowy day in the middle of summer is worth investigating. Careful review of your subject organization's historical norms is necessary in order for you to be able to discern the outlier event should it arise within your investigation.
- 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.

(III) Technology based/Digital Forensics Techniques: Every transaction leaves a digital footprint in today’s computer-driven society. Close scrutiny of relevant emails, accounting records, phone logs and target hard drives is a requisite facet of any modern forensic audit. Before taking steps such as obtaining data from email etc. the forensic auditor should take appropriate legal advice so that it doesn’t amount to invasion of privacy. Digital investigations can become quite complex and require support from trained digital investigators. However, many open-source digital forensics tools are now available to assist you in this phase of the investigation.

| Cross Drive Analysis | EnCase |
| Live Analysis | MD5 |
| Deleted Files | Tracking Log Files |
| Stochastic Forensics | PC System Log |
| Steganography | Free Log Tools |
(IV) **Computer Assisted Auditing Techniques (CAATs):** Changing patterns of businesses, regulatory framework, scarcity of resources at auditors’ disposal on one side and the ever increasing mountainous data on other hand is making audit a complex process. Use of CAATTs is, thus, indispensable to the Auditors and forensic auditors. Computer-assisted audit techniques (CAATs) or computer-assisted audit tools and techniques (CAATTs) are computer programs that the auditors use as part of the audit procedures to process data of audit significance contained in a client’s information systems, without depending on him.

(V) **Generalised Audit Software (GAS):** Generalized Audit Software (GAS) is a class of CAATs that allows auditors to undertake data extraction, querying, manipulation, summarization and analytical tasks. GAS focuses on the fully exploiting the data available in the entity’s application systems in the pursuit of audit objectives. GAS support auditors by allowing them to examine the entity’s data easily, flexibly, independently and interactively in data based auditing.

Using GAS, an auditor can formulate a range of alternative hypotheses for a particular potential misstatement in the subject matter and then test those hypotheses immediately. "What if" scenarios can be developed with the results and the auditors can examine the generated report rapidly. Currently, the latest versions of GAS include the Audit Command Language (ACL), Interactive Data Extraction and Analysis (IDEA) and Panaudit.

(VI) **Common Software Tool (CST):** Due to shortcomings of GASs, CSTs have become popular over a period. Spreadsheets (like MS Excel, Lotus, etc.), RDBMS (like MS Access, etc.) and Report writers (like Crystal reports, etc.) are few examples of CSTs. Their widespread acceptability is due to its instant availability and lower costs. While spreadsheets may be extremely easy to use due to its simplicity and versatility, other CSTs may need some practice.

Whether one uses GAS or CST, it is imperative that the auditor is aware about the manner and processes that have led to the data generation, the control environment revolving around the data and the source from where the data samples are imported into the GAS/CST.

(VII) **Data Mining Techniques:** It is a set of assisted techniques designed to automatically mine large volumes of data for new, hidden or unexpected information 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.

(VIII) **Laboratory Analysis of Physical and Electronic Evidences:**

<table>
<thead>
<tr>
<th>Computer Forensics</th>
<th>Protection/Validation of Evidence</th>
</tr>
</thead>
<tbody>
<tr>
<td>hard disk imaging</td>
<td>Federal Rules of Evidence</td>
</tr>
<tr>
<td>E-mail analysis</td>
<td>Chain of Custody</td>
</tr>
</tbody>
</table>
6. FORENSIC AUDIT REPORT

A Report is a statement of collected & considered facts, so drawn up as to give clear and concise information to persons who are not already in possession of the full facts of the subject matter of the report.

The Forensic Audit Report is nothing but statements of observation gathered & considered while proving conclusive evidence. It is a medium through which an auditor expresses his opinion under audit. It is an important part of the audit as it provides the results of the audit conducted by the auditor.

Points to keep in mind while reporting:

| Clear thinking: | To whom the report is directed | Purpose and aim | Cool and calm thinking to have logical and coherent presentation | Pattern of presentation |
| Keep the reader uppermost in mind | Translate technical matters to layman's language | To visualize the reader's viewpoint |
| Unbiased approach | To mention the view point of the auditee |
| Impact of the report | What be the probable reaction to reporting whether action or decision will follow in quickest possible time or to be treated as of academic interest only. | To remember the universal saying - "don't jump to conclusions" |

Facts and figures to be in proper sequences
The main factors to be considered for the various ways of presentations of written reports are:

Sample Table of Contents of a Forensic Audit Report may include the following:

1. EXECUTIVE SUMMARY
   1.0 Background
   1.1 Origin of the Audit
   1.2 Audit Objective
   1.3 Proposed Audit Outputs
   1.4 Audit Implementation Approach

2. RISK ANALYSIS
   2.1 Internal Environment Risk
      2.1.1 Financial Management
      2.1.2 Customers, Products and Competitors
      2.1.3 Information technology
      2.1.4 Business Process
      2.1.5 Human Resource Management
   2.2 External Environment Forces
      2.2.1 Influence of Economics and relevant Market
      2.2.2 Political and Legal Scenario
      2.2.3 Technology in the Sector

3. AUDIT PROCESS
   3.1. Preliminary understanding of scope and incident coverage
      (i) Identification of all related data elements
      (ii) Preparation of a List of "persons of interest" for interview
(iii) Obtain management approval for scope

3.2. Collect Evidence
3.3. Conduct Interviews
3.4. Analyze findings
3.5. Validate Inferences and conclusions

4. EVIDENCE OF RISK EVENTS
4.1 Conflicts of interest
4.2 Bribery
4.3 Extortion
4.4 Theft
4.5 Fraudulent transactions
4.6 Inventory frauds
4.7 Misuse of assets
4.8 Financial Statement frauds

5. AUDIT RECOMMENDATIONS
5.1 Logical Framework Approach
5.2 Preconditions and Risks

6. GOVERNANCE ON RECOMMENDATION IMPLEMENTATION
6.1 Stakeholders
6.2 Budget Considerations

LIST OF ANNEXURES
Annex 1: Members of the Interviews
Annex 2: Organization Chart of Auditee organization
Annex 3: Financial Performance (YYYY to YYYY)
Annex 4: Audit Recommendation Logical Framework
Annex 5: Analysis of Key Risk Events
TEST YOUR KNOWLEDGE

Theoretical Questions

1. Sri Rajan is above 80 years old and wishes to sell his proprietary business of manufacture of specialty chemicals. Ceta Ltd. wants to buy the business and appoints you to carry out a due diligence audit to decide whether it would be worthwhile to acquire the business.

What procedures you would adopt before you could render any advice to Ceta Ltd.?

2. An American Company engaged in the business of manufacturing and distribution of industrial gases, is interested in acquiring a listed Indian Company having a market share of more than 65% of the industrial gas business in India, request you to conduct a “Due Diligence” of this Indian Company and submit your Report. List out the contents of your Due Diligence Review Report that you will submit to your USA based Client.

3. A nationalised bank received an application from an export company seeking sanction of a term loan to expand the existing sea food processing plant. In this connection, the General Manager, who is in charge of Advances, approaches you to conduct a thorough investigation of this limited company and submit a confidential report based on which he will decide whether to sanction this loan or not.

List out the points you will cover in your investigation before submitting your report to the General Manager.

4. What are the important steps involved while conducting Investigation on behalf of an Incoming Partner?

5. Mr. Clean who proposes to buy the proprietary business of Mr. Perfect, engages you as investigating accountant. Specify the areas which you will cover in your investigation.

6. In a Company, it is suspected that there has been embezzlement in cash receipts. As an investigator, what are the areas that you would verify?

7. J Ltd. is interested in acquiring S Ltd. The valuation of S Ltd. is dependent on future maintainable sales. As the person entrusted to value S Ltd. what factors would you consider in assessing the future maintainable turnover?

8. Briefly mentioned the forensic audit techniques name.

9. Forensic audit is unlike other audits. Explain

10. Enumerate the steps to be undertaken in case of forensic audit process.
Answers to Theoretical Questions

1. Refer Financial Due Diligence given in Para 4 of Unit 1.
2. Refer Para 7 of Unit 1.
3. Refer Para 6.4 of Unit 2.
4. Refer Para 6.2 of Unit 2.
5. Refer Para 5 of Unit 2.
6. Refer Para 5.5.1 of Unit 2.
7. In assessing the turnover which the business would be able to maintain in the future, the following factors should be taken into account:
   (i) **Trend**: Whether in the past, sales have been increasing consistently or they have been fluctuating. A proper study of this phenomenon should be made.
   (ii) **Marketability**: Is it possible to extend the sales into new markets or that these have been fully exploited? Product wise estimation should be made.
   (iii) **Political and economic considerations**: Are the policies pursued by the Government likely to promote the extension of the market for goods to other countries? Whether the sales in the home market are likely to increase or decrease as a result of various emerging economic trends?
   (iv) **Competition**: What is the likely effect on the business if other manufacturers enter the same field or if products which would sell in competition are placed on the market at cheaper price? Is the demand for competing products increasing? Is the company’s share in the total trade constant or has it been fluctuating?
8. Refer Para 5 of Unit 3.
9. Refer Para 2 of Unit 3.
10. Refer Para 4 of Unit 3.