

Indicators of Fraud, Investigation and Reporting

Refresher Course on Internal Audit - WIRC

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Recent Changes – Reporting of Fraud

- Section 143(12) of Companies Act, 2013 requires Statutory Auditors along with Company Secretaries and Cost Accountants to report fraud noticed by them in their capacity as such. (01.04.2014)
- Companies Auditors Report Order, 2016 (CARO 2016) paragraph 3(x) requires Statutory Auditors to report to state certain Frauds.
- Section 143(3)(i) of the Act Requires reporting whether the company has adequate internal financial control system in place and operating effectiveness of such controls. (SA 240 states auditors responsibility relating to fraud)
- Section 134(5)(e) requires directors' responsibility statement, in case of listed company , whether it had laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and were operating effectively

Meaning of the term *Internal Financial Controls*

- Explanation :
- The policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business,
- including adherence to company's policies, the safeguarding of its assets, *the prevention and detection of frauds* and errors, the accuracy and completeness of the accounting records,
- and the timely preparation of reliable financial information.”

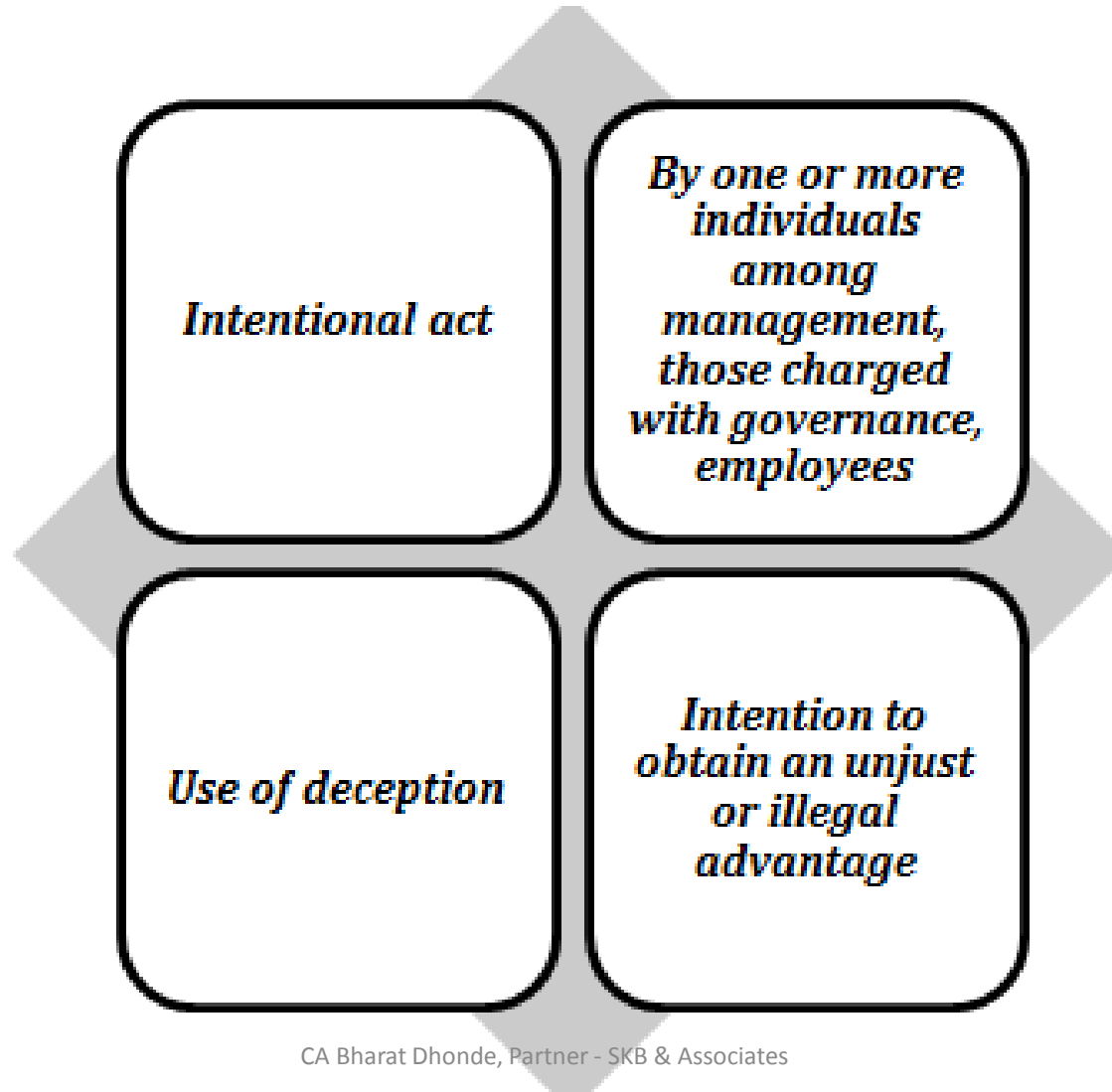
What is the meaning of Fraud ?

- Fraud is defined in explanation (i) to Section 447 as follows
- “fraud” in relation to affairs of **a company or any body corporate**, includes -
- **any act**, omission, concealment of **any fact or abuse of position**
- committed by **any person or any other person with the connivance** in any manner,
- with **intent to deceive**, to **gain undue advantage from**, or to **injure the interests of, the company or its shareholders or its creditors or any other person**,
- whether or not there is any wrongful gain or wrongful loss

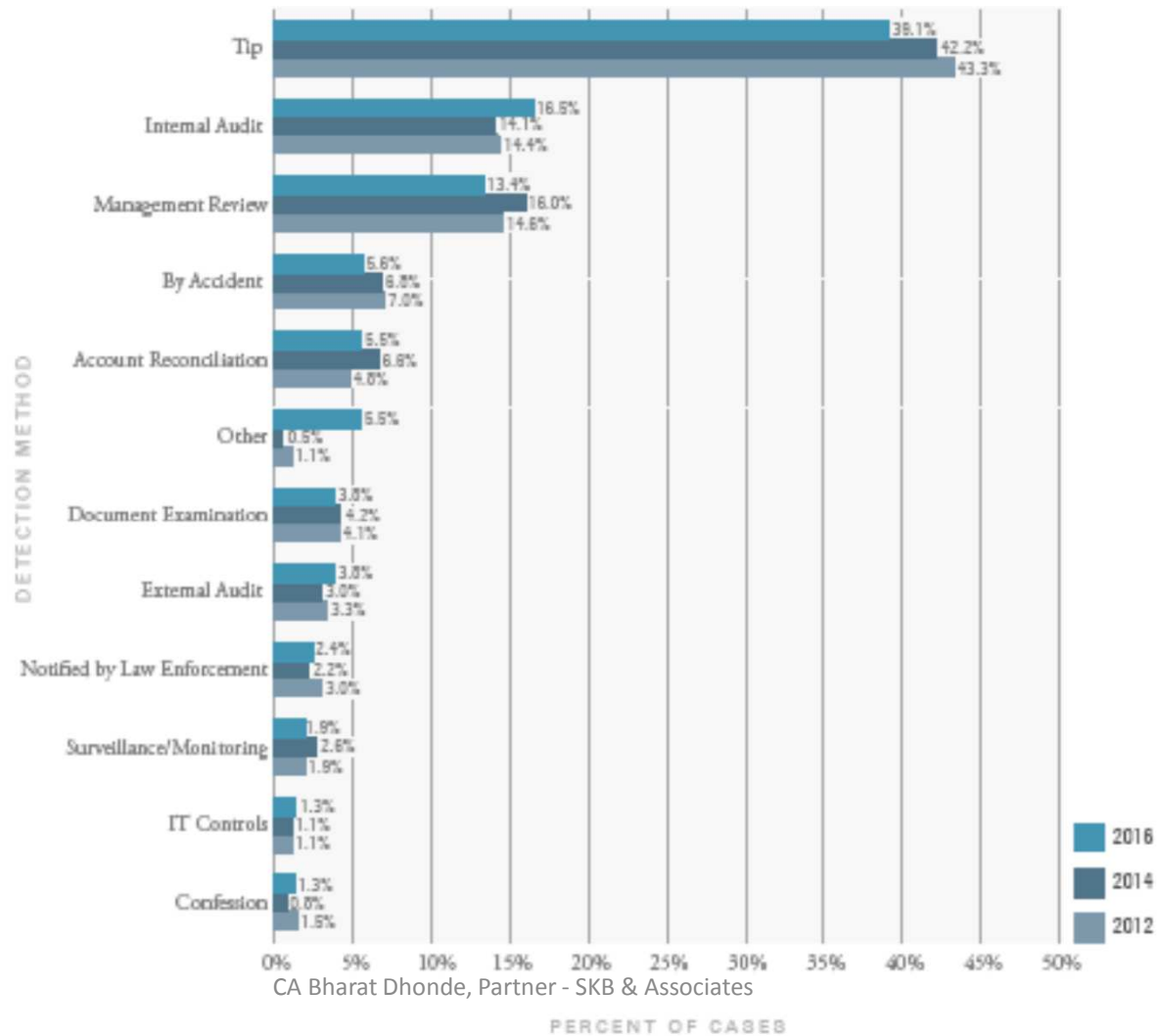
Revised Guidance Note on reporting fraud (2016)

- the Revised Guidance Note states that the inference for “fraud” should be drawn from the SA 240.
- “Fraud”, as per the SA 240 means- “an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.”
- SA 240 also states -
- “Two types of intentional misstatements are relevant to the auditor’s consideration of **fraud-misstatements resulting from fraudulent financial reporting** and
- **misstatements resulting from misappropriation of assets.”**

To Summarise..



How Fraud is Detected – ACFE Report to Nations 2016



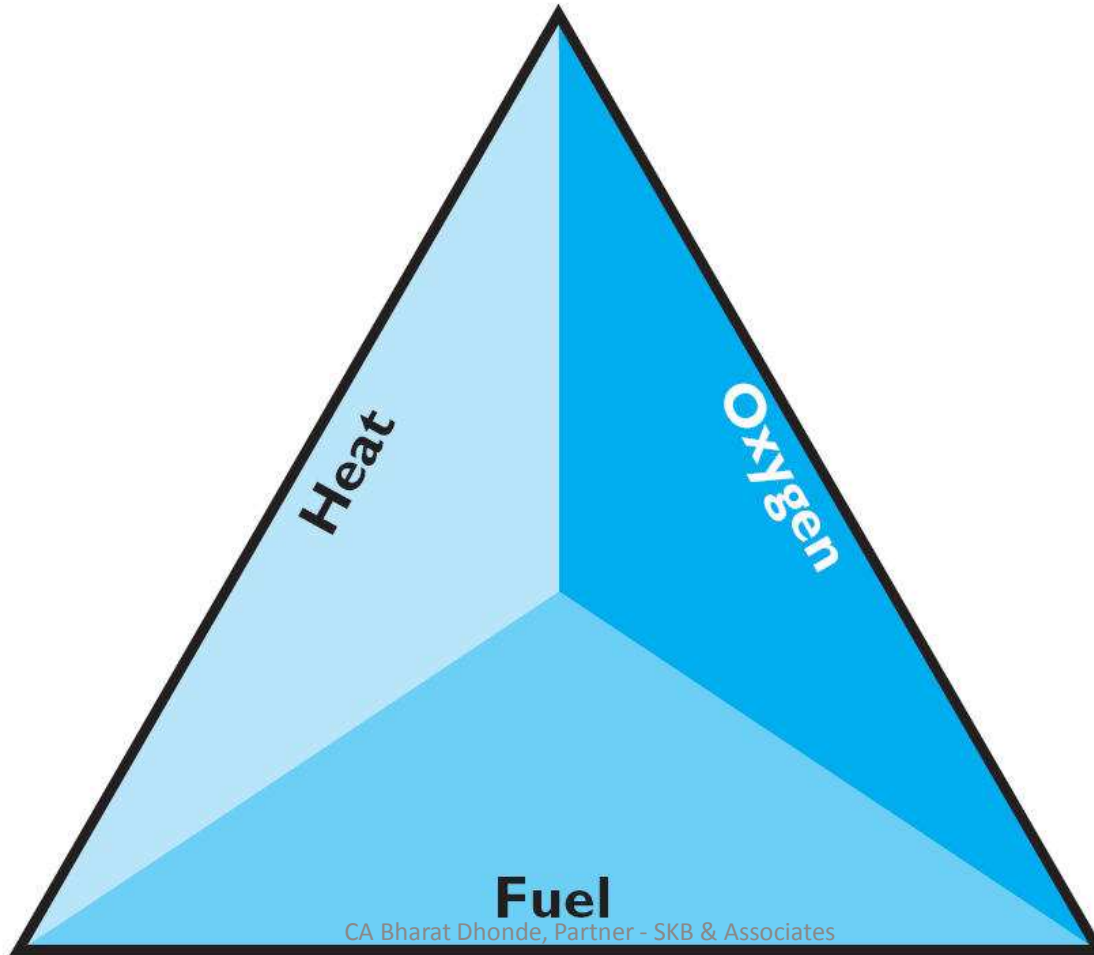
How Fraud is detected – Asia Pacific

Detection Method	Percent of Cases
Tip	45.2%
Internal Audit	15.8%
Management Review	13.1%
External Audit	5.9%
Account Reconciliation	5.0%
Notified by Law Enforcement	4.5%
Other	4.1%
By Accident	2.7%
Document Examination	1.4%
Surveillance/Monitoring	0.9%
IT Controls	0.9%
Confession	0.5%

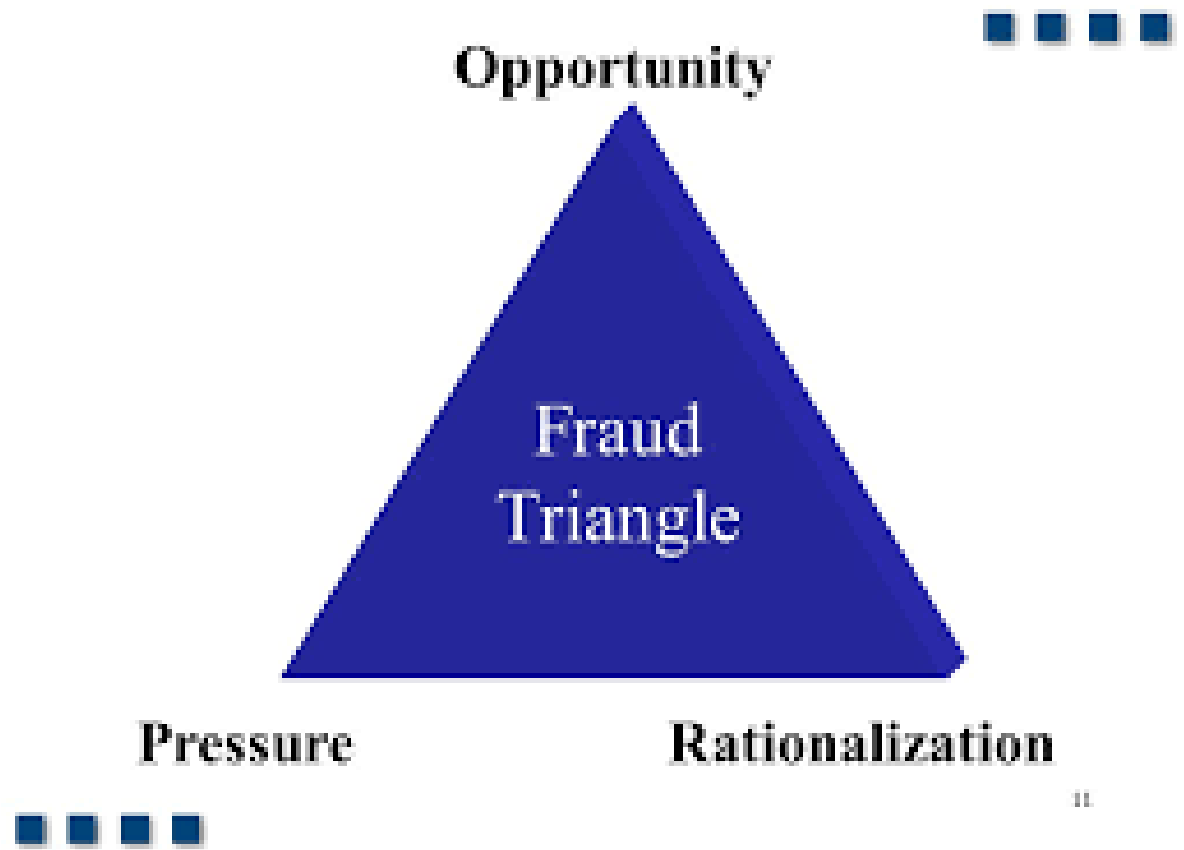
Prevention of Frauds

- The Internal Auditors role in Prevention of Fraud is crucial.
- *Tips* are the largest method of detection.
- Well formulated *Whistle-Blower Policy* is critical for detection of fraud.
- Frauds are committed by *Humans*.
- Understanding *Human behavior and fraudster's Profile*, and understanding why frauds are committed is required to effectively prevent the frauds.

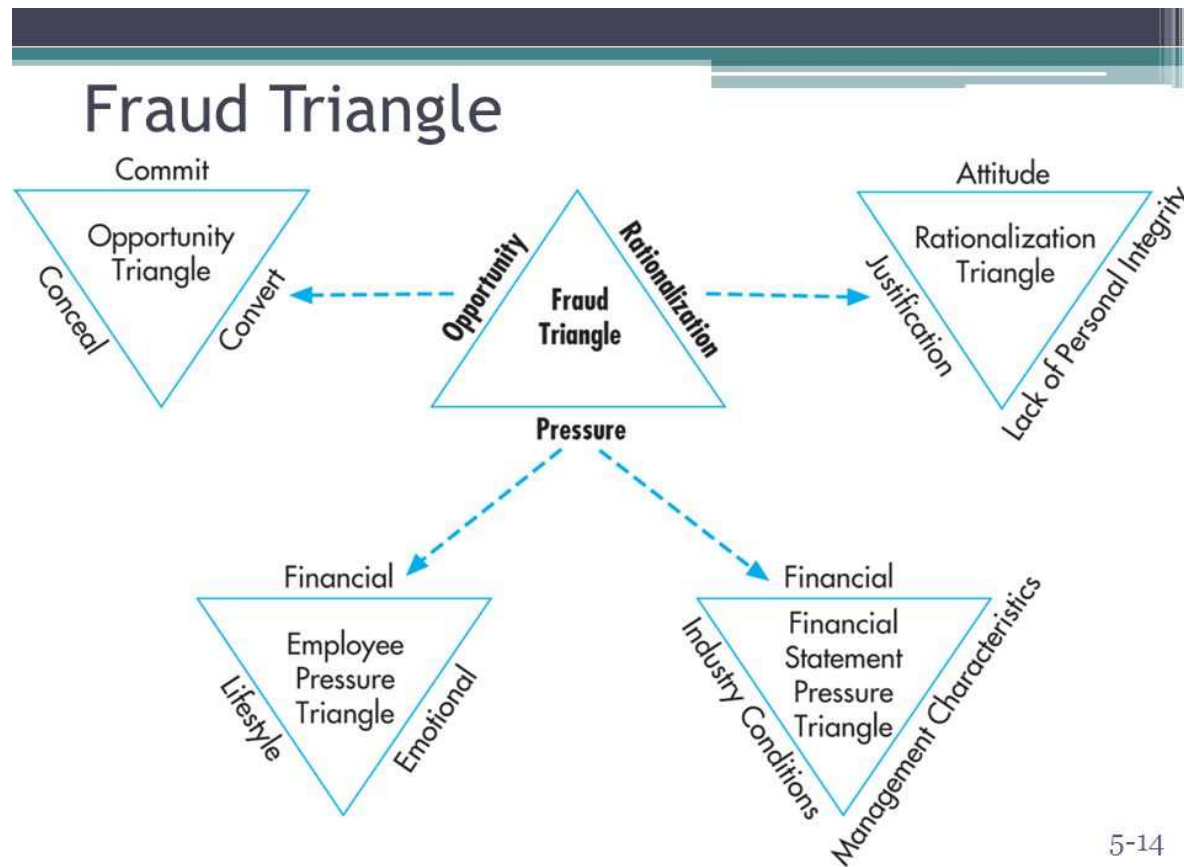
FIRE TRIANGLE



Fraud Triangle



Fraud Triangle



5-14

Pressures leading to Fraud..

- Financial pressures
- Vices
- Work-related pressures
- **Approximately 95 percent of all frauds involve either financial or vice-related pressures**
- Common Financial Pressures:
 - 1. Greed
 - 2. Living beyond one's means
 - 3. High bills or personal debt
 - 4. Poor credit
 - 5. Personal financial losses
 - 6. Unexpected financial needs

Work-Related Pressures

- Getting little recognition
- Feeling job dissatisfaction
- Fear of losing one's job
- Being overlooked for a promotion
- Feeling underpaid

Other Pressures

- Spouse Pressures
- Spouse's lifestyle demands
- Life Pressures
- Family crisis
- Social Pressures
- “Being successful”

Six major factors that increase opportunity:

- 1. Lack of controls
- 2. Inability to judge performance quality
- 3. Failure to discipline fraudsters
- 4. Lack of access to information
- 5. Ignorance, apathy and incapacity
- 6. Lack of audit trail

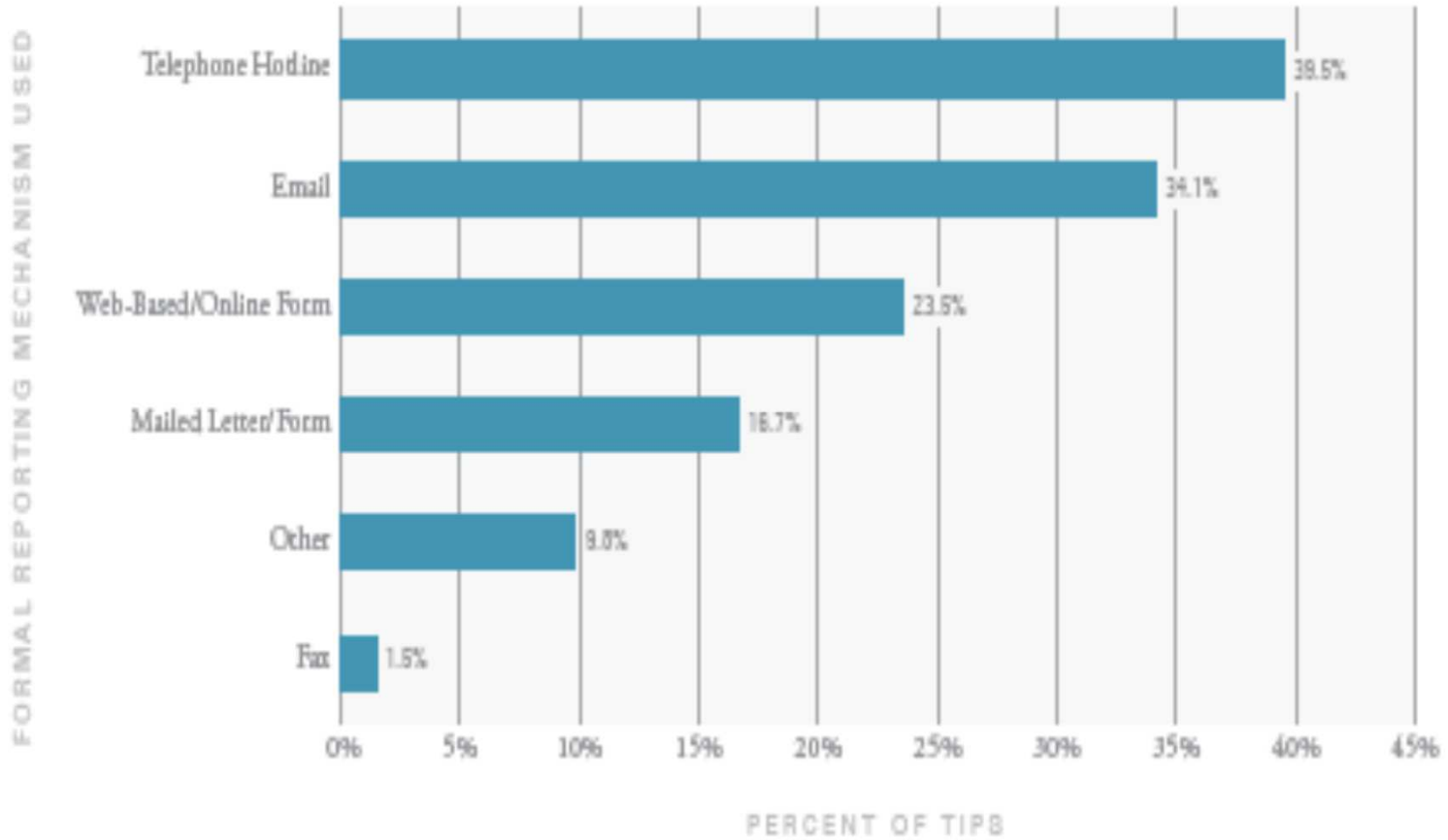
Common rationalizations by perpetrators

- I deserve more
- I am only borrowing the money and will pay it back
- Nobody will get hurt
- It's for a good purpose
- I pay more than my fair share of taxes
- The government wastes money

Prevention Measures- Human Side

- Inculcating high ethical standards
- Background checks of new recruits
- Continuous training and raising the moral of employees
- Written code of conduct to be communicated to employees time and again. Strict adherence to it.
- Set the tone at top
- Written whistle-blower policy

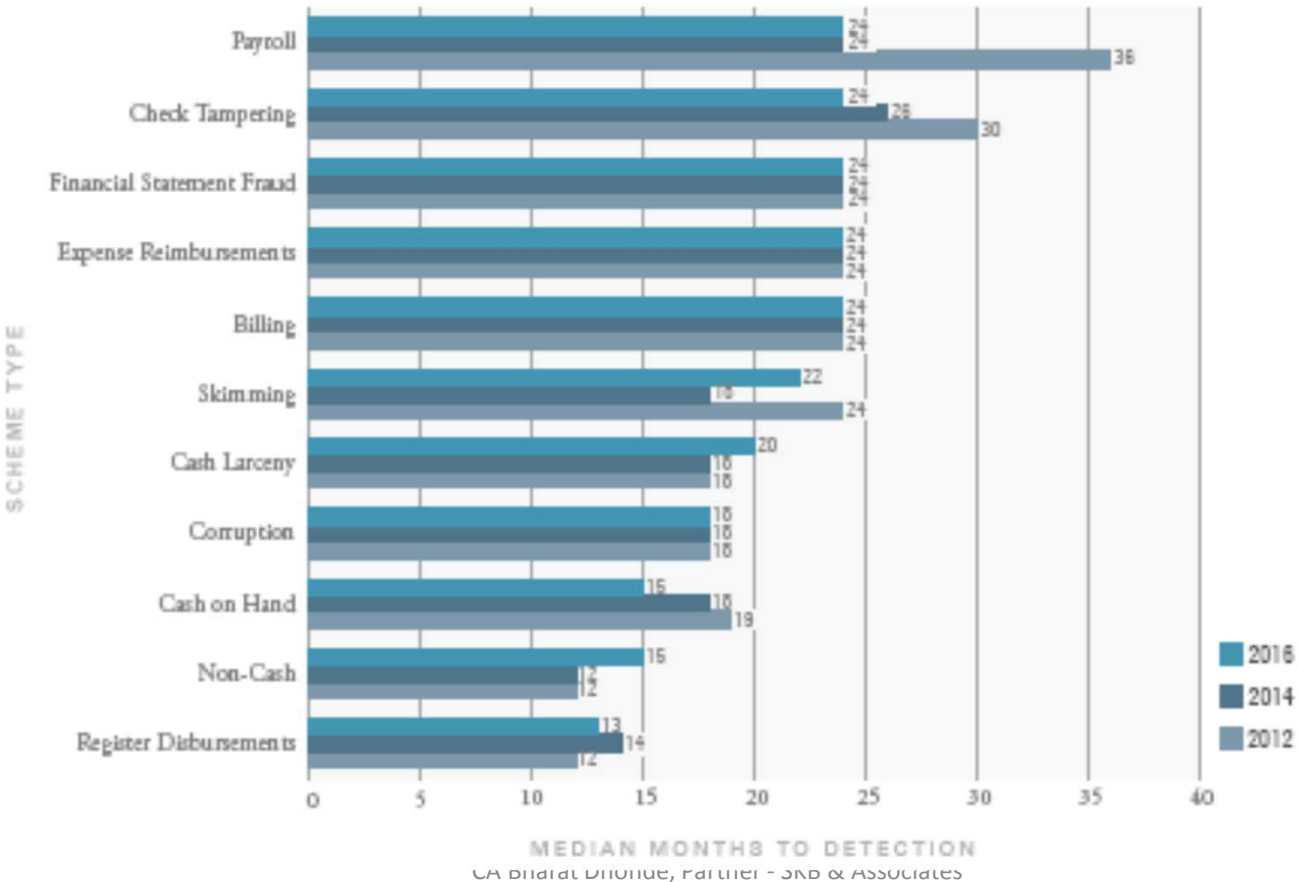
Formal Reporting Mechanism Used by Whistleblower



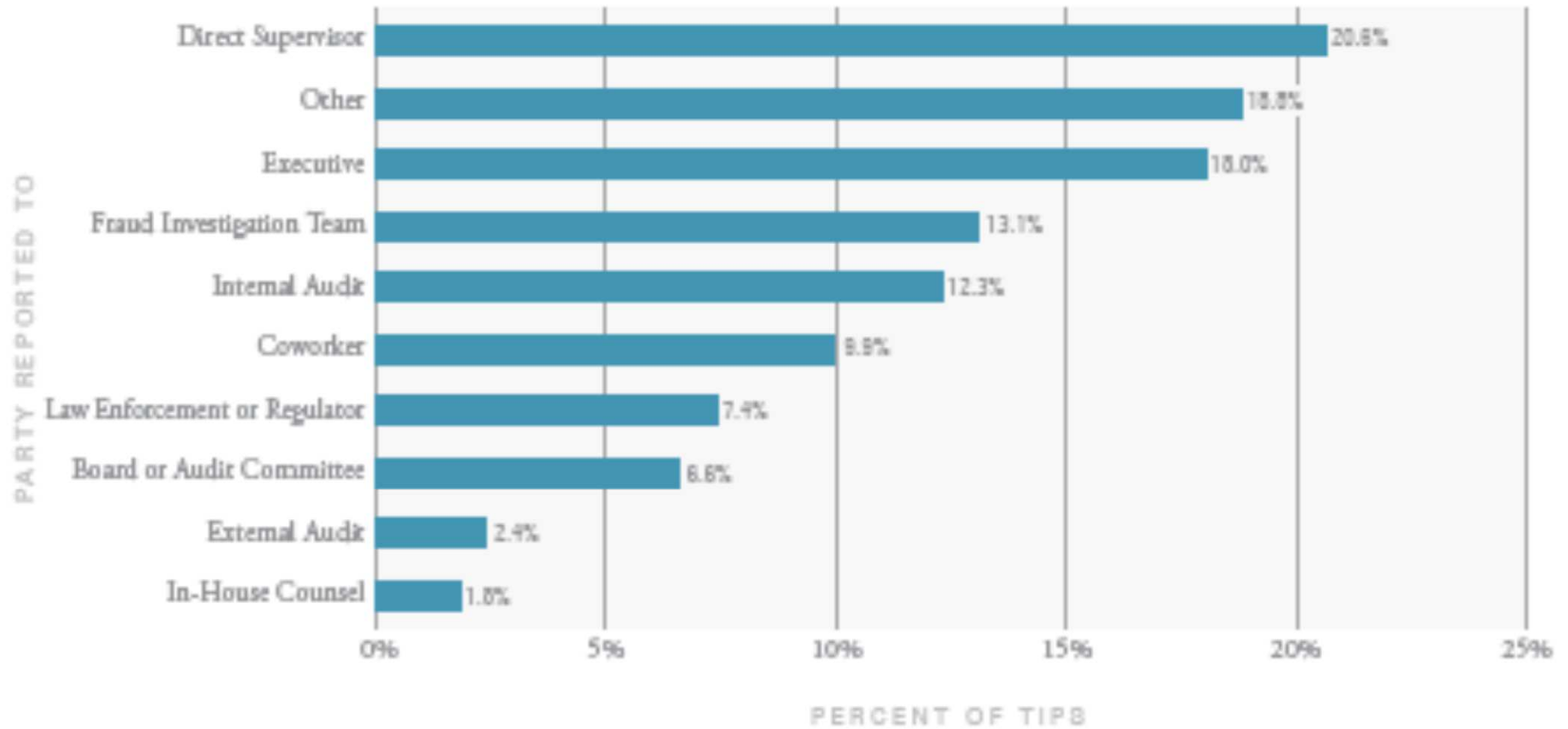
Detection of Fraud

- CAAT Tools, Use of Excel
- **Novel Methods like –**
- Benford's law – Reliability of Data population, facilitates audit sampling
- Relative Size Factor
- Luhn's Algorithm
- Barium Test- to test a systems and it's inbuilt controls specially huge geographical distances
- Birbal Tricks- to unearth fraudulent manipulations
- Application of Inverse logic – incomplete, missing or altered information
- Space-Time Dimension Test – Data mining- Analytical procedures, to cover abnormalities, trends, patterns etc.
- Surprise repetition – repetition with different time may give amazing results
- Tiger Team Tests – To check robustness, resilience of system and controls- penetration test

Median Duration of Fraud Based on Scheme Type



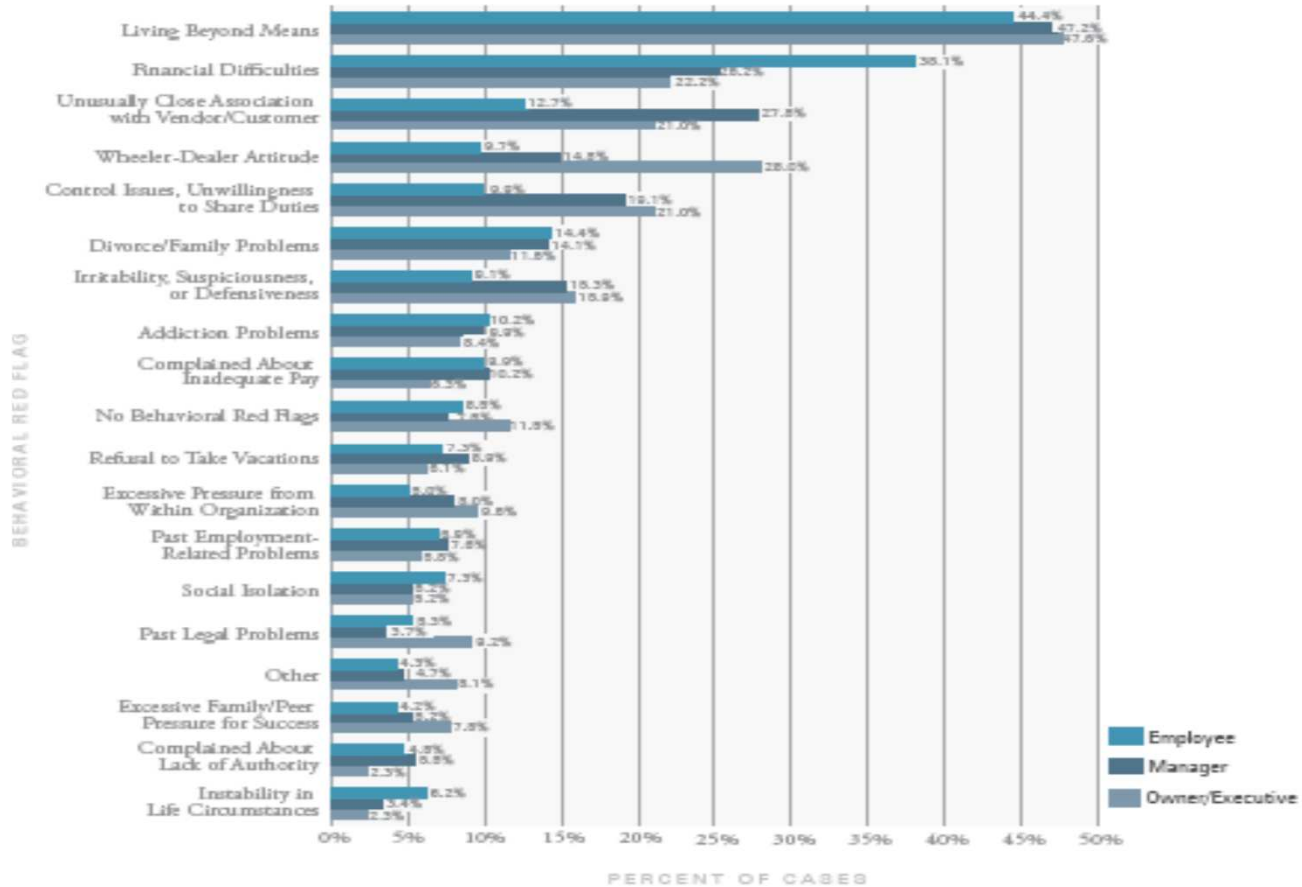
Party to Whom Whistleblower Initially Reported



Behavioral Red Flags

- Living Beyond their means
- A strong desire for Personal Gains
- High Personal Debts
- Close Association with Customers
- Feeling Salary not commensurate with Responsibility
- Strong challenge to beat the system
- Excessive Gambling Habits
- Undue Family or peer pressure
- No recognition for job performance

Behavioral Red Flags Based on Perpetrator's Position





Settlements preferred

In the U.S. the Big Four audit firms have, in recent history, almost always settled because of the fear that one catastrophic jury verdict could shut them down for good. In addition, trials show the public just how often auditors fail to detect fraud. Settlements prevent the public from hearing that in open court and typically put partners' pretrial testimony under confidential court seal forever.

Thank You !!!