Overview of Fraud and Forensic Audit

- CA Vicky Gala

Overview of Fraud

Definition of Fraud

Companies Act 2013

*As per the explanation to Sec 447 of Chapter XXIX , "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**;*

The Indian Contract Act, 1872

*As per Sec 17, 'Fraud' means and includes any of the following **acts** committed by a party to a contract, or with his connivance, or by his agent, **with intent to** deceive another party thereto of his agent, or to induce him to enter into the contract.*

(1) the suggestion, as a fact, of that which is not true, by one who does not believe it to be true;

(2) the active concealment of a fact by one having knowledge or belief of the fact;

(3) a promise made without any intention of performing it;

(4) any other act fitted to deceive;

(5) any such act or omission as the law specially declares to be fraudulent.

The Indian Penal Code, 1860

The term "Fraudulently" is defined as a person is said to do a thing fraudulently if he does that thing with **intent to defraud** but not otherwise.

Definition of Fraud

Reserve Bank of India

The Reserve Bank had, *per se,* not defined the term 'fraud' in its guidelines on Frauds. A definition of fraud was, however, suggested in the context of electronic banking in the Report of RBI Working Group on Information Security, Electronic Banking, Technology Risk Management and Cyber Frauds, which reads as under:

*'A **deliberate act** of omission or commission by any person, carried out in the course of a banking transaction or in the books of accounts maintained manually or under computer system in banks, resulting into **wrongful gain** to any person for a temporary period or otherwise, **with or without any monetary loss** to the bank'.*

The Institute of Chartered Accountants of India

*SA 240 – The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements, issued by the ICAI defines fraud as 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*

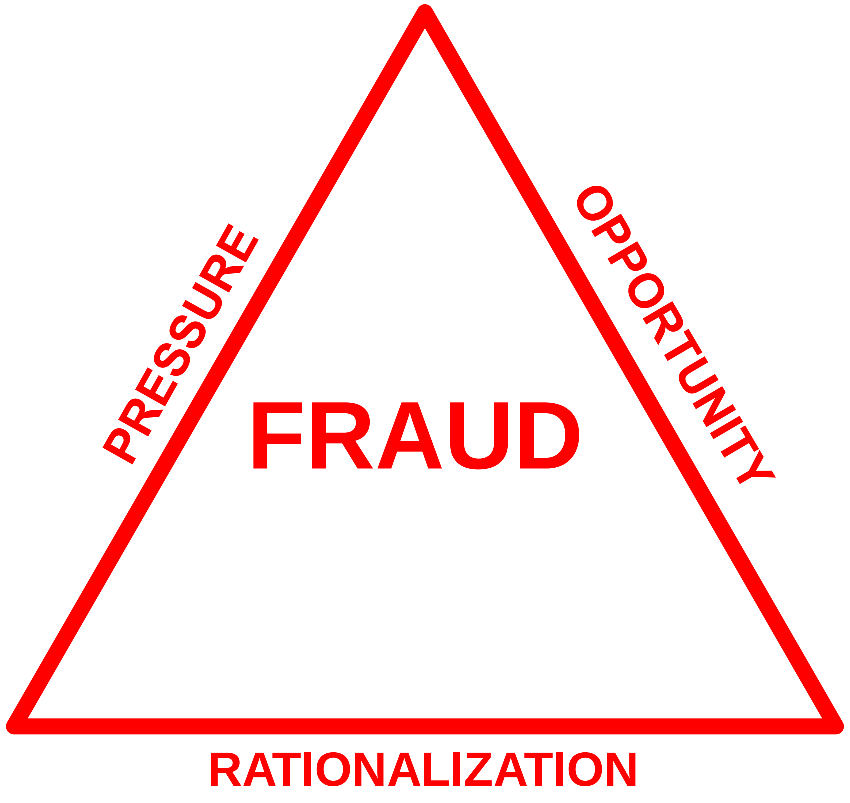
Fraud Auditing, Forensic Accounting & Forensic Investigation

Fraud Auditing	• In a fraud audit one searches for the point where the numbers and/or financial statements do not 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 account to find fraudulent transactions
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 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.

Source: Study on Forensic Accounting and Fraud Detection

Fraud Triangle Theory and Fraud Diamond Theory

. The Fraud Triangle Theory



. The Fraud Diamond Theory

Crowe's Fraud Pentagon

General Audit Vs Forensic Audit

	General Audit	Forensic Audit
Objectives	Express an opinion as to 'True & Fair presentation	Whether fraud has taken place in books
Techniques	Substantive & Compliance. Sample based	Investigative, substantive or in depth checking
Period	Normally for a particular accounting period	No such limitations
Verification of stock	• Sample based physical verification • Relies on the Management Representation	Independent verification of selected items where misappropriation is suspected
Off balance sheet items	Used to vouch the arithmetic accuracy & compliance with procedures	Regulatory & propriety of these transactions / contracts are examined
Adverse findings, if any	Negative opinion or qualified opinion expressed with/without quantification	Legal determination of fraud impact and identification of perpetrators depending on scope

How to identify Fraud?

Fraud Concentration (illustrative)

Parameters	Low Concentration	High Concentration
Business Focus	Customer Satisfaction	Profit Sensitive
Financial Reporting	Transparent	Complex and Opaque
Leadership style	Participative	Authoritative
Budgeting	Realistic and Flexible	Aggressive and Stringent
Employee Salary	Market Equivalent	Below market equivalent
Tone at the Top	Strong ethics; Lead by example	Sub-standard governance and ethics
Independence of internal auditors	Reporting to Audit Committee	Reporting to Senior Management leads
Customer complaints	Few / Nil	Many and repetitive

Common issues identified during audit

No practice of obtaining competitive quotes. Entire dependence on one vendor for a particular material/service

Increase in the value of inventory Y-o- Y with no policy around periodic stock count

High number of round amount petty cash invoices with inadequate supporting documents

Increasing debtors ageing

Repetitive issues in Internal Audit report

Requestor, processor and authorizer for payments is the same individual. Lack of segregation of duties

High value of sales booked during quarter/year ends with subsequent reversals

Intercompany account balances remain unmatched at period ends.

High value of sale or purchase transactions with related parties

Reinstatement of earlier bank account number in the vendor master post remittance to the vendor

Common issues identified during audit

- One time vendor code not being monitored
- Sponsored training workshop for a new customer to explain product feature and specification
- Use of borrowed funds for purpose other than what it was sanctioned for
- Extravagant lifestyle change of employee involved in payment processing or vendor on-boarding department
- Capitalization of operational expenses
- Same security being mortgaged with multiple lenders
- Sale of mortgaged property without obtaining NOC from the lenders
- Non disclosure of contingent liabilities in the annual report
- Excessive number of manual journal entries passed
- Increase in overheads without corresponding increase in production

Applicable Laws

Illustrative List of Applicable Laws – Within India

Governing Code/Act	Other Important acts
The Information Technology Act 2000, Amended 2008	The Foreign Exchange Management Act, 1999
Indian Penal Code, 1860	The Companies Act, 2013
Civil Procedure Code, 1908	Indian Evidence Act, 1872
The Prevention of Money Laundering Act, 2002	Indian Contract Act, 1872
The Prevention of Corruption (Amendment) Act, 2018 (POCA) Amendment to POCA, 1988	

Illustrative List of Applicable Laws – Outside India

Fraud Act, 2006 – UK	The Fraud Act 2006 is an Act of the Parliament of the United Kingdom which affects England and Wales and Northern Ireland. It was enacted to make provision for, and in connection with, criminal liability for fraud and obtaining services dishonestly.
Bribery Act, 2010 – UK	The Bribery Act 2010 was introduced to update and enhance UK law on bribery including foreign bribery in order to address better the requirements of the 1997 OECD anti-bribery Convention. It is now among the strictest legislation internationally on bribery.
Foreign Corrupt Practices Act, 1977 – USA	The Foreign Corrupt Practices Act of 1977 is a United States federal law known primarily for two of its main provisions: one that addresses accounting transparency requirements under the Securities Exchange Act of 1934 and another concerning bribery of foreign officials.
OECD Anti Bribery Convention	The OECD Anti-Bribery Convention is an anti-corruption convention of the OECD aimed at reducing political corruption and corporate crime in developing countries, by encouraging sanctions against bribery in international business transactions carried out by companies based in the Convention member countries.
U.N. Convention against Corruption	The United Nations Convention against Corruption is the only legally binding international anti-corruption multilateral treaty. Negotiated by member states of the United Nations it has been adopted by the UN General Assembly in October 2003 and entered into force in December 2005.

Company Act and CARO

Responsibilities of Statutory Auditor

- Reporting on fraud by the statutory auditor is not a separate engagement and is part of the performance of the duties as an auditor of the financial statements of the company

- As per Sec 143(12) of the Companies Act, 2013 if an auditor of a company, **in the course of the performance of his duties as auditor**, has **reason to believe that an offence of fraud** is being or has been committed in the company by **its officers or employees**, then the auditor must ensure that he reports the matter to appropriate authorities.

- Fraud committed by third parties, vendors and contract employees are not covered by Sec 143(12) of the Companies Act, 2013.

- CARO 2016 also requires reporting on fraud where:
    - Fraud is committed by the Management of the Company or
    - Fraud is committed on the Company by its officers or employees

- Auditor needs to disclose the nature and amount of fraud in CARO

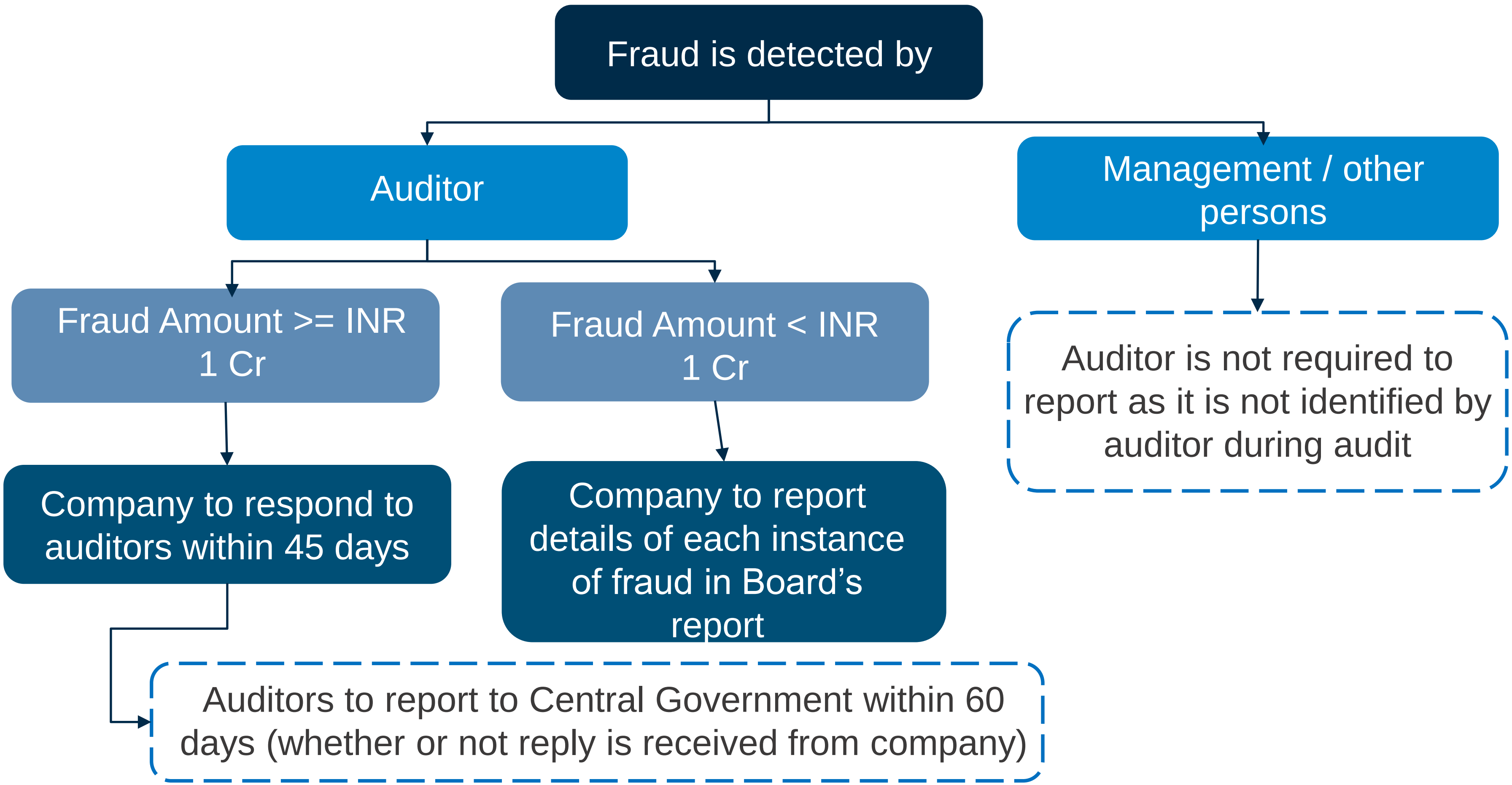
Responsibilities of Statutory Auditor

CARO reporting Vs Section 143(12) reporting

Particulars	CARO	Sec 143 (12)
Type of fraud covered	Fraud committed by the company or fraud on the company by its officers or employees	Fraud committed against the Company by its officers or employees
Coverage	Fraud noticed or reported during the year	Fraud identified during the audit
Amount of fraud	All the amount of fraud needs to be reported	Fraud below Rs 1 Crore needs to be reported to Board / audit committee and fraud above Rs 1 Crore needs to be reported to Central Government

Responsibilities of Statutory Auditor

Reporting requirement for auditors u/s 143(12)



Forensic Audit

Forensic Audit – Work Streams

Forensic Audit – Work Streams

Fraud Prevention

- Reviewing internal controls to verify their adequacy
- 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
- Preparing visual aid to support trail evidence

Fraud Detection

- Investigating and analyzing financial evidence
- Detecting financial frauds and tracing misappropriated funds

Computer Forensics

- Developing computerized application to assist in the recovery
- Analysis and presentation of financial evidence

Forensic Data Analysis

- Examine un-structured data with regard to incidents of financial crime
- Discover and analyze patterns of fraudulent activities

Forensic Audit – Process

Step 1: Initialization

- Clarify the real motive, purpose and utility of the assignment
- Meet the client to obtain an understanding of the important facts, parties involved and issues at hand
- Carry out necessary conflict checks

Step 2: Develop a Plan

- Develop a plan based on the knowledge gained from client meeting
- Define the objectives to be achieved and the methodology to be used to achieve them

Step 3: Obtain Relevant Evidence

- Understand the specific type of fraud that has been committed and how it has been committed
- Gather evidence depending upon the nature of the case, which may involve
  - locating documents
  - economic information
  - proof of occurrence of an event

Step 4: Perform Analysis

- Summarize humongous data
- Perform Data Integrity checks
- Perform asset tracing
- Utilize computerized applications for data analytics
- Prepare charts and graphics providing outliers

Step 5: Reporting

- Report should be based on the facts assimilated during the process and not on opinion of the person writing the report
- The report should contain
  - Background
  - Scope
  - Approach
  - Limitations to Scope
  - Findings
  - Summary of evidence
  - Notice to Readers

Step 6: Court Proceedings

- Investigation is likely to lead to legal proceedings against the suspect
- Evidence gathered during the investigation may need to be provided to law enforcement authorities and/ or presented at court
- Investigative team may have to explain the work and findings

Forensic Lens in Audit

Case 1

A manufacturing company reported a fuel shortage of INR 220 million (i.e. 28 percent of its annual consumption) during its annual stock verification citing reasons of inadequate fuel management, evaporation and less productivity.

The shortage noted was significantly alarming and a newly appointed statutory auditor of a company raised queries during the year end review. Based on this, the Company performed a detailed investigative review of the fuel inward, internal movement and storage activities.

Procedures performed:

Incoming

- Density Factor analysis for inward fuel
- Verification of delivery challans
- Weighbridge data analysis
- Surprise checks on incoming truck verification
- RFID checks

Internal movement, Storage and Consumption

- Consumption vs Productivity per storage Fuel tank
- Forklift consumption analysis (Video footage for days of excessive usage for outliers)
- On-site visit to verify employee vehicles pathway
- Calibration study for Flow-meters

Case 1

Outcome:

- Theft of fuel in transit resulting into shortage in incoming vehicles. This was un-reported due to uncalibrated flowmeters.
- Weigh Bridge operators were provided RFIDs of trucks to record purchases that have not visited the factory premises.
- Three employees (each in a shift) siphoned fuel under pretext of forklift re-fueling and sold to nearest petrol pump.
- Incoming trucks were not physically checked. Tanker locks were not replaced since 3 years.
- Fuel was been utilized for polishing and cleaning activities, which was not accounted for.
- Fuel reconciliation was .performed for last 5 years basis calculated incoming fuel using density factor analysis. Hence, overall loss of INR 208 out of INR 220 million could be recomputed due to the above findings.
- Interviews were carried out with suspected employees and the law enforcement agency could recover INR 60 million from the employees involved in theft.
- A recovery claim was submitted by the Company to the petroleum company for INR 125 million of fuel lost in transit.

Case 2

Newly appointed statutory auditors of a listed entity (target) engaged in providing Information Technology Service, expressed inability to continue within 6 months. The reasons cited by auditors included multiple indicators of fraud and lack of documentary evidence to substantiate company's transactions.

The Board of the company also received a whistleblower complaint regarding irregularities in the operations of the company. Regulators appointed private agencies to conduct an investigation of the company.

Key observations noted were as follows:

- Sales worth INR 700 Cr to 20 parties with corresponding procurement of INR 600 Cr from one vendor.
- Email reviews indicated, that both customer order and purchase orders were routed to the same individual
- Inadequate documentation indicating negotiation and competitive bidding before executing transactions with vendors.
- Inadequate proof of deliveries in terms of transporter/lorry receipts to justify the transactions
- Both customer and purchase orders were being handled by employees not related to the respective function within the Company
- Majority of sales transactions were recorded at month ends

Thank You

Questions

?