



# Forensic audit – Opportunities for the future

Prepared for J B Nagar Study Circle of WIRC of ICAI

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**SUSHRUT  
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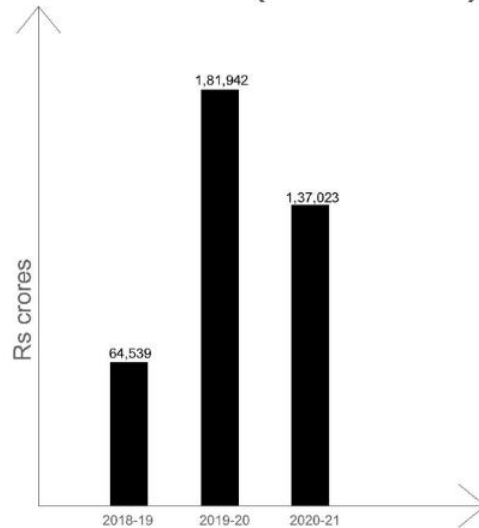
# What is forensic audit

- No specific definition of the word 'forensic audit'
- In common parlance, it is the gathering of evidence to establish any wrongdoing or fraud
- Most commonly used in detection of 'fraud'.

# RBI Annual report – 2020-21

## FRAUDS IN BANKING SECTOR

### Bank Frauds (Advances)



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Source - RBI's Report on trend and progress of Banking in India - 2020-21

- 99% frauds by value pertain to advances
- More advance based frauds in public sector banks
- More card / internet banking transaction frauds (instances) in private sector banks

# What is a fraud

Fraud – various definitions

- Explanation to Section 447 (Punishment for Fraud) of the Companies Act, 2013
- Circular No. RBI/2014-15/85 by RBI dated 1st July 2015 on Fraud Classification and Reporting in Banking Sector, RBI Department of Banking Supervision, Central Office, Mumbai
- Report of RBI Working Group on Information Security, Electronic Banking, Technology Risk Management and Cyber Frauds
- Explanation to Section 45 of the Insurance Act 1938 / Insurance (Amendment) Act, 2015
- Criminal Procedure Code ,1973 and Indian Penal Code, 1860
- Section 17 of the Indian Contract Act, 1872
- SA 240–“Auditors Responsibilities relating to Fraud in Audit of Financial Statements” by ICAI

# Fraud – Companies Act

‘Fraud’ in relation to affairs of a company or any body - corporate, includes:

- a) any act,
- b) Omission,
- c) Concealment of any fact or
- d) Abuse of position committed by any person or any other person with the connivance in any manner, -
  - i. with intent to deceive,
  - ii. to gain undue advantage from, or
  - iii. to injure the interests of,
    - a. the company or
    - b. its shareholders or
    - c. its creditors or any other person,

Whether or not there is any wrongful gain or wrongful loss.’

‘Wrongful gain’ means the gain by unlawful means of property to which the person gaining is not legally entitled;

‘Wrongful loss’ means the loss by unlawful means of property to which the person losing is legally entitled.

# Fraud – Reserve Bank of India

Circular No. RBI/2014-15/85 by RBI dated 1st July 2015 on Fraud Classification and Reporting in Banking Sector

## CLASSIFICATION OF FRAUDS

Based mainly on the provisions of the Indian Penal Code:

- 1) Misappropriation and criminal breach of trust;
- 2) Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property;
- 3) Unauthorised credit facilities extended for reward or for illegal gratification;
- 4) Negligence and cash shortages;
- 5) Cheating and forgery;
- 6) Irregularities in foreign exchange transactions;
- 7) Any other type of fraud not coming under the specific heads as above.

# Types of frauds

Skimming

Cash larceny

Fake bills

Ghost employees

Expense reimbursement schemes

Inventory misuse

Bribery

Kickbacks

Bid rigging

Money laundering

Fictitious revenues booking

Non provision of losses

Incorrect asset valuations

Siphoning of bank loans

Shifting of profits to shell companies

# Financial statement frauds

## Inflating sales

- Dummy sales (high sea sales, circular transactions)
- Sale and leaseback transactions
- Year end sales
- Sale on return basis

## Funds movements

- Loans / advances to 'related' unrelated companies
- Purchases / sales to overseas affiliated entities
- Loans against pledge of shares in case of listed companies



# Money Laundering

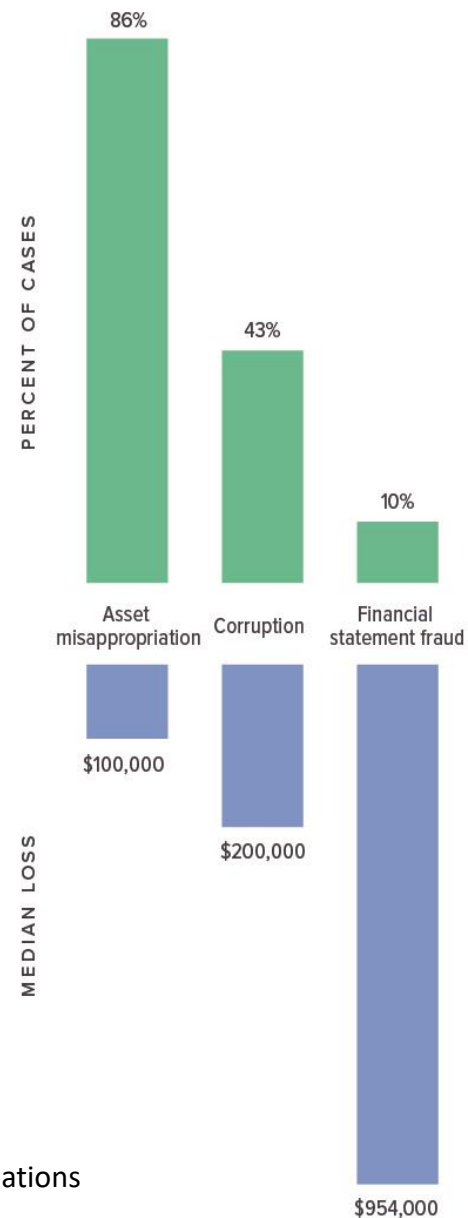
- Structuring – cash broken in smaller deposits to avoid suspicion and reporting
- Cash smuggling and depositing in jurisdictions with banking secrecy and lesser oversight
- Cash intensive businesses – hotels, restaurants, retail stores, casinos, petrol pumps
- Trade – over invoicing purchases (moving money out of country); under invoicing sales to related party based in foreign jurisdiction (shifting profits to another country)
- Shell companies / khoka companies – used to route funds
- Round tripping – money shifted outside country → deposits in bank account in a tax haven → routed through various countries → enters country as FDI
- Bank capture – deposit money in Bank (could be used by ponzi schemes) → get control of bank (mostly cooperative banks or foreign banks in jurisdictions with lower banking controls) considering large quantum of money deposited → transfer money to related parties as loans through banking system → loan turns NPA → Bank collapses

# Money Laundering – FIU

- Key statistics (2019-20)
  - 5.4 lakhs STR
  - 1.54 crores CTR
  - 2.62 lakhs counterfeit currency reports
  - 3.9 crore cross-border wire transfer reports
  - 9.4 lakhs non profit transaction reports
- Detection of unaccounted income of Rs. 1860 crores

# How much does fraud cost?

- Asset misappropriation schemes are the most common and least costly
- Financial statement fraud schemes are least common and most costly

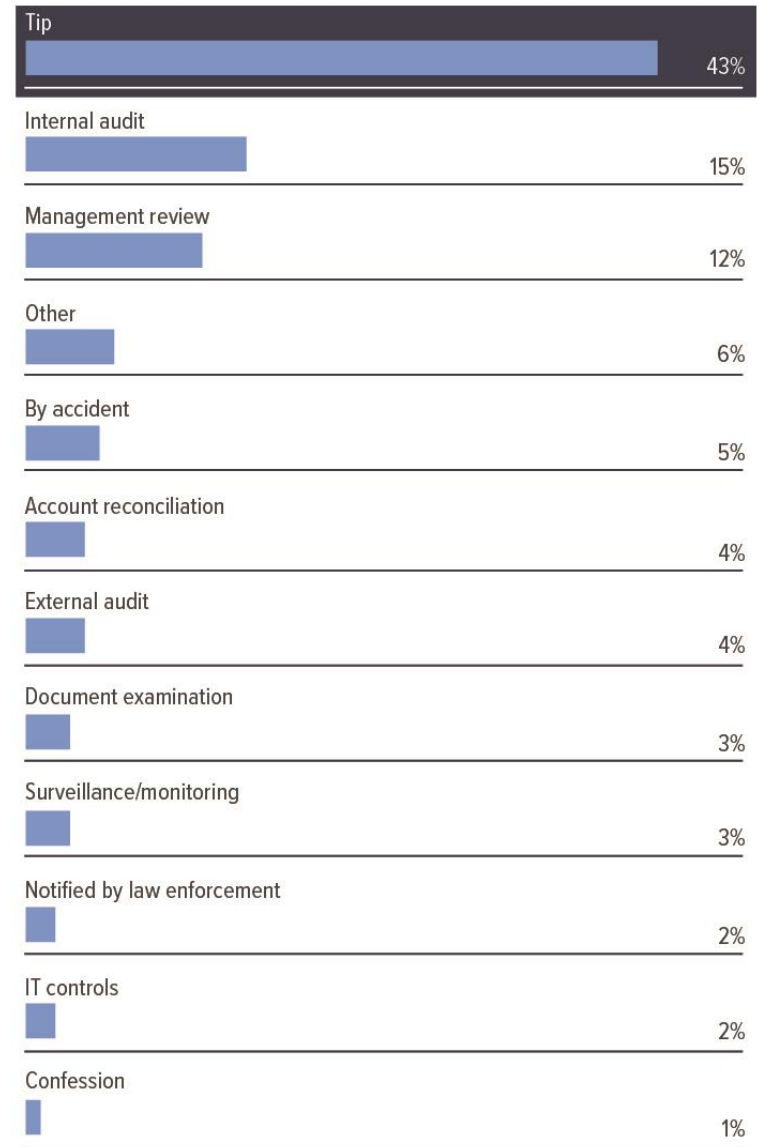


• Source: 2020 – ACFE Report to the Nations

# How is fraud detected

- 43% of frauds are detected by whistleblowers using various means like fraud hotline, emails or through unsigned letters sent through post

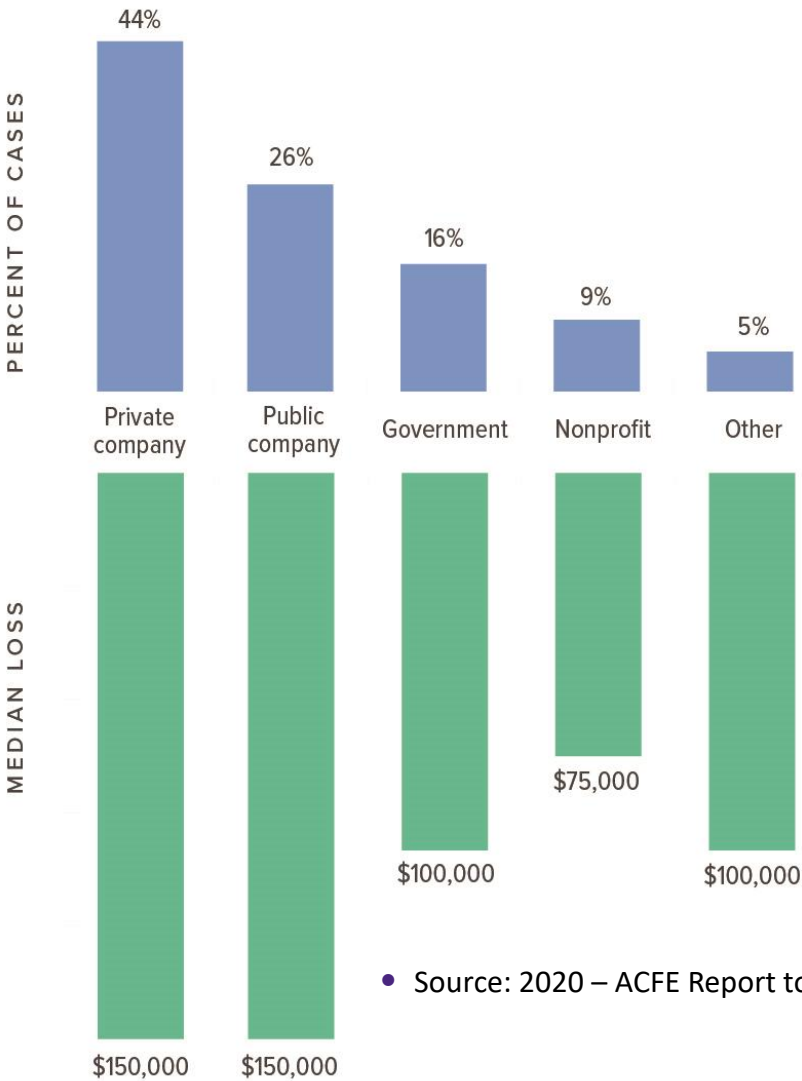
FIG. 9 How is occupational fraud initially detected?



# Frauds – organization type wise

FIG. 14 What types of organizations are victimized by occupational fraud?

- Contrary to general belief, frauds may be affecting private companies more than Government and public companies



• Source: 2020 – ACFE Report to the Nations

# Forensic audit vs statutory audit

| Basis of differentiation                      | Statutory audit   | Forensic audit   |
|---|---|--|
| Objective                                     | Express and opinion as to 'True and Fair' presentation                        | Specific purpose assignment to identify and uncover wrongdoing                             |
| Mindset                                       | Trust but verify  | Pre-suppose wrongdoing   |
| Techniques                                    | Substantive and compliance, sample based                                      | Investigative, substantive or in depth checking  |
| Verification of items of financial statements | Rely on management certificate / management representation                    | Independent verification of suspected / selected items where misappropriation is suspected |
| Off Balance sheet items                       | Focus on identification and disclosure  | Focus on propriety and impact  |
| 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  |

# Types of forensic audit assignments

- Frauds carried out by employees against their organisations
- NPA cases where money lent by bankers is not repaid by borrowers
- Ponzi schemes
- Disproportionate asset cases
- Terrorism related money trail cases
- Transaction audit under IBC
- Forensic due diligence
- Fraud risk assessment

# Skills involved in forensic audit

- Accounting knowledge
- Data analytics (excel or other specialised software) – Idea, ACL, Intella, Encase, Tableau
- Creating and testing hypothesis (ability to think like a fraudster)
- Sound knowledge of various Laws (Banking Laws, PMLA, MPID, PCA, case laws)
- Understanding the business
- Most importantly, 'common sense'



# Gearing up for a forensic audit – steps

- Case background (why situation has reached a forensic audit stage)
- Writing down the allegation
- Understanding end result expected by client (Court of Law / general understanding)
- Basic understanding of the target entity / people
- Reading all relevant Laws, rules, processes
- Creating hypothesis (ability to think like a fraudster)
- Obtaining all necessary information (client location / email / data back up / mobile phones imaging)

# Gearing up for a forensic audit – steps

- Testing hypothesis
  - various analyses,
  - mix of analytical and substantive checks
  - Search words on the hard disks, mobile phones, emails
  - Focus over completeness
- Substance over form
- Gathering evidence
- Writing report

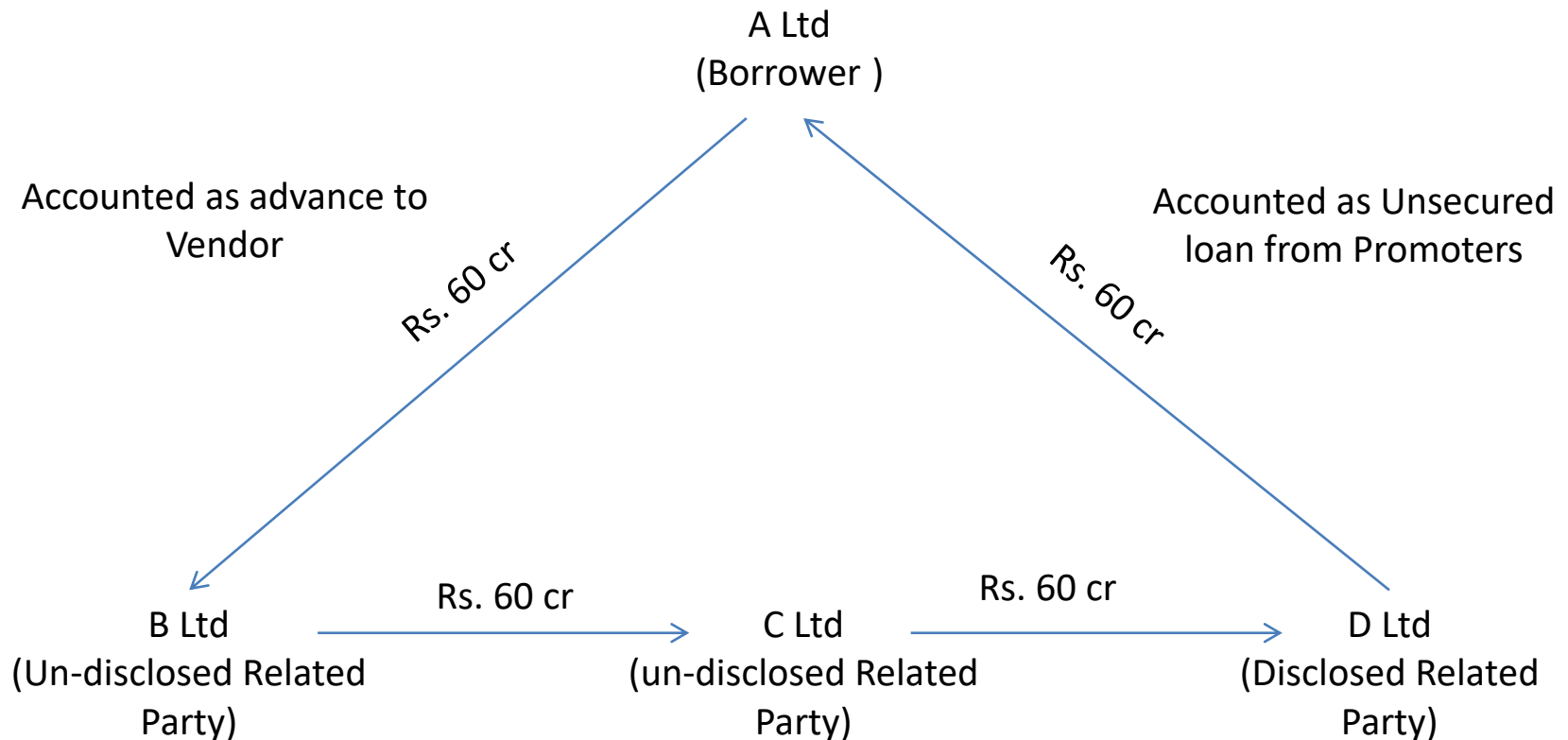
# Forensic audit report

## Sample contents of forensic audit report

- Cover page
- Table of contents
- Introduction and background
- Methodology
- Executive Summary (Summary of observations)
- Detailed observations
- Conclusion
- Recommendations
- Annexures

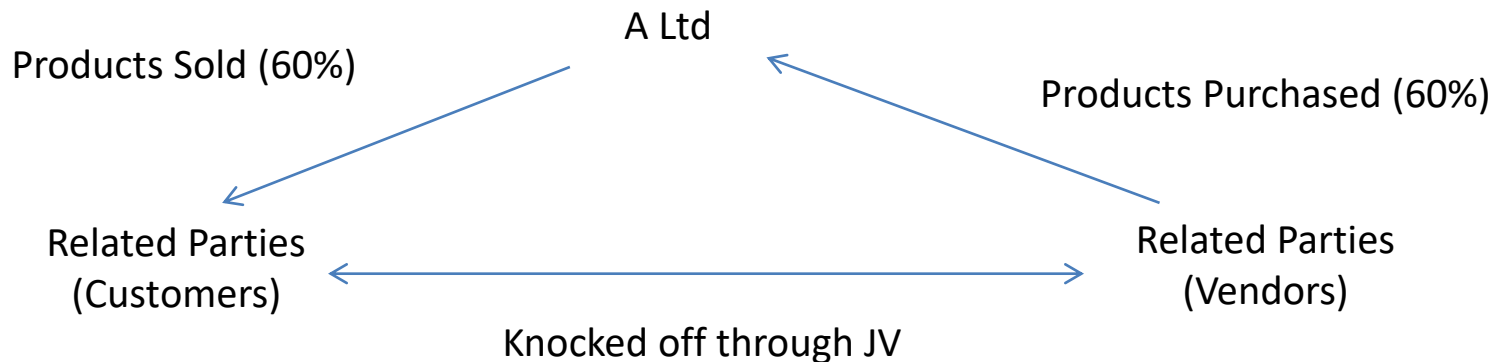
# Case studies – Bank frauds

- Promoter contribution as required by lenders, brought in was funded by Company itself



# Case studies – bank frauds

- Bogus sale and purchases transactions with related parties



\*Purchase of products from one related party not in operation

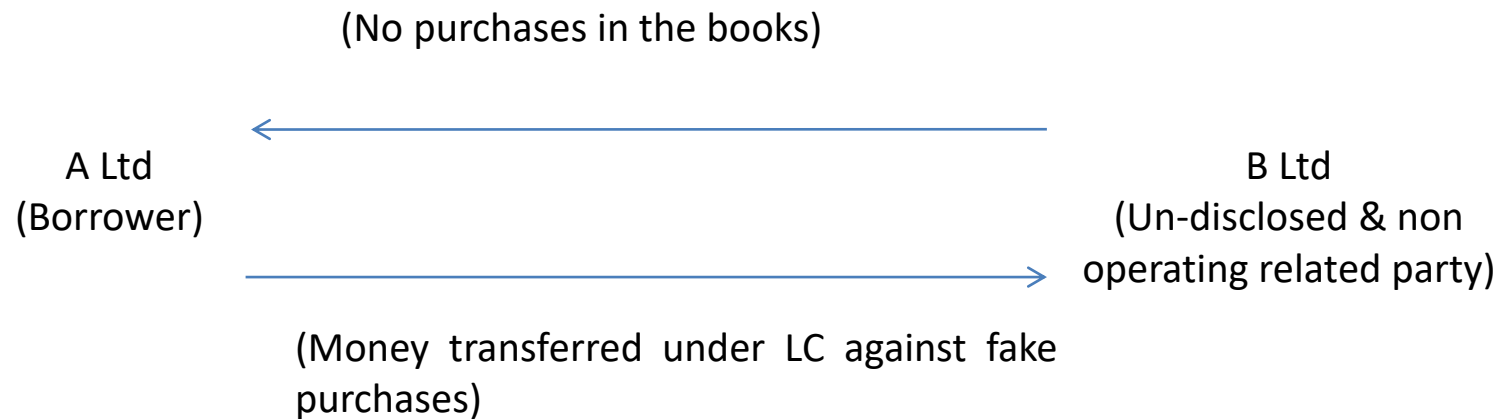
Purpose:

To disclose higher turnover in the financial statements

To obtain a higher drawing power from lenders

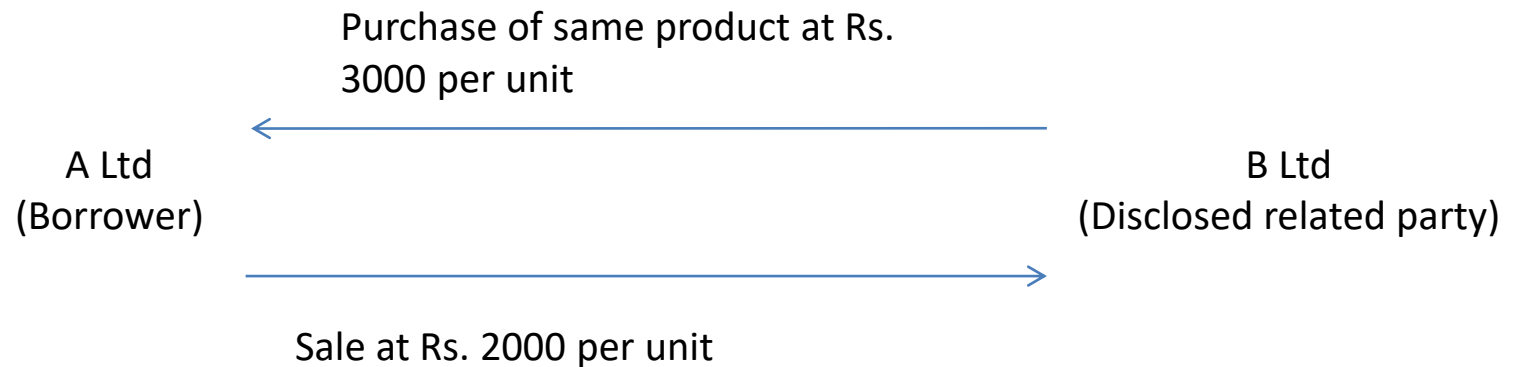
# Case studies – bank frauds

- Siphoning of bank's funds through letters of credit with no underlying transactions



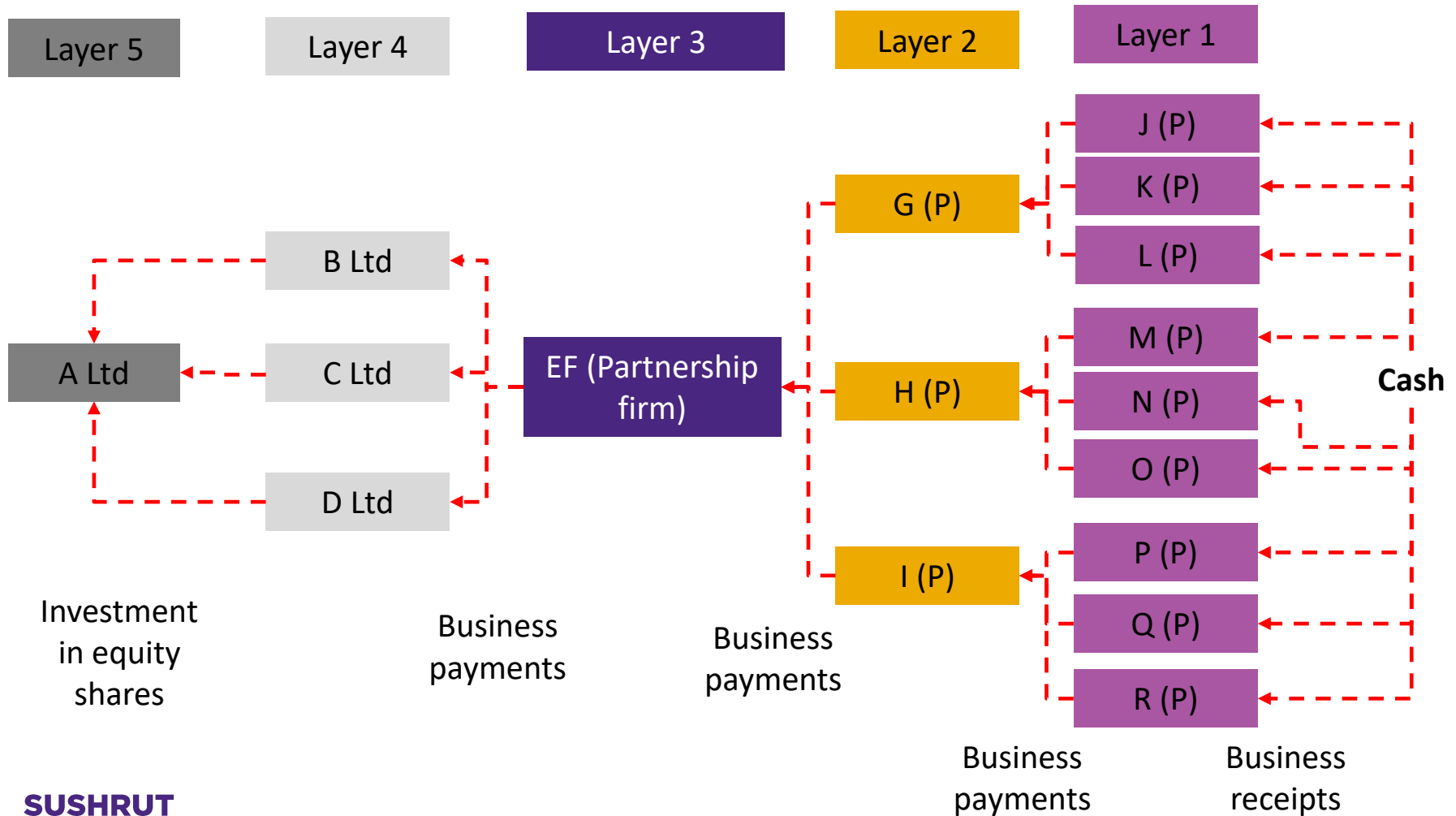
# Case studies – bank frauds

- Siphoning of bank's funds through purchases at higher price than sale of same product



# Case studies – money laundering

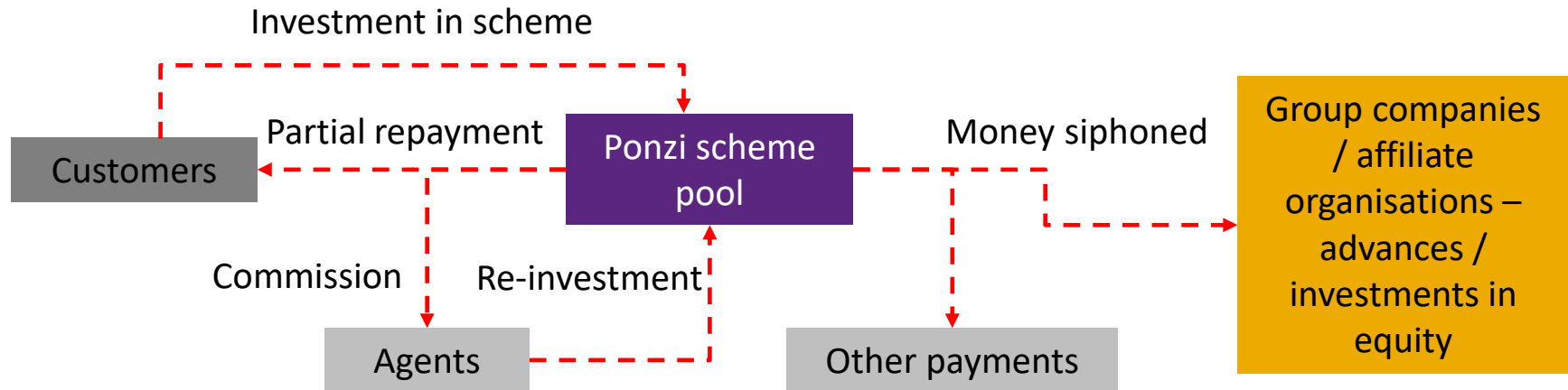
- Illicit method of laundering cash into banking system





# Case studies – Ponzi schemes

- Typical modus operandi of a ponzi scheme



# Forensic audit – red flags to look out for

- Beyond industry performance when rest of industry has suffered a slow down
- Consistent growth in profit before tax while operating cash flows continues to be negative
- Very high level of transactions with related parties
- Transactions with parties which do not appear to be related to nature of business
- High level of bad debts and write offs
- Knocking off debtors against different creditors
- All compliances are impeccable – no interest on TDS or advance tax and no substantial refund
- Frequent changes in accounting and compliance related staff
- Promoter lifestyle which does not seem to be in sync with financial performance of business

# THANK YOU!

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