FORENSIC AUDITING

Forensic audit involves examination of legalities by blending the techniques of propriety (VFM audit), regularity and investigative and financial audits. The objective is to find out whether or not true business value has been reflected in the financial statements and in the course of examination to find whether any fraud has taken place.

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Major accounting scandals involving Enron, Worldtel and Parmalat have been widely reported. In all these cases, the methods and purpose of manipulations in financial statements were peculiar to the motives of such manipulations.

In another instance, KPMG Forensic conducted survey of directors of Canada's 75 biggest companies, which revealed that more cases of financial accounting manipulation would emerge in the coming year.

Companies (Auditors' Report) Order, 2003, requires auditors to report, amongst others, "whether any fraud on or by the company has been *noticed* or *reported* during the year. If yes, the nature and the amount involved are to be indicated".

In this background, the techniques of Forensic auditing have gained importance.

Accounts – Sum of Actual and Estimation

Financial statements, compiled on accrual basis, represent the following:

- Actual receipts & payments (cash basis)
- Recognition of certain items of expenditure or income on accrual basis, in accordance with the applicable statements. For example, recognition of sale may be either on appropriation of goods for delivery or on actual delivery, both methods in accordance with standards but as suited to the needs of the entity
- Estimates of provisions and bad/irrecoverable debts, or write back of creditors and provisions no longer required, etc.
- Provisions for various intangible items, like foreign currency fluctuations, retirement benefits based on actuarial valuation or any other basis
- Adjustments on account of prior period transactions

The financial statements cannot be said to present exactly the position of financial affairs. The true and fair presentation is an attribute to the methods adopted in compiling such financial statements. However, the basic tenets of the principles of double entry accounting are to be adhered to in maintenance of books of accounts.

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Accounting Standards

Accounting Standards are only guiding tools in preparation of financial statements. Accounting Standards are epitome of various conventions, concepts, principles and practices to be followed in presentation of financial affairs to reflect a true and fair view. Most of the Accounting Standards are mandatory. These may broadly be classified into:

- **Accounting specific:** For example 'inventory valuation', revenue recognition, provision for employees' retirement benefits, valuation of investments, etc.
- **Reporting and disclosure specific**: For example 'related party transactions', contingents & events occurring after balance sheet date, amalgamation & mergers (mainly basis of valuation) or the treatment of assets acquired out of grant-in-aid, etc.

Financial Reporting and Frauds

Accounts may be falsified to conceal:

(a) Absolute theft of money or money's value (mainly relating to employees frauds).

(b) True results of operations, or financial position of the entity with a view to prevent timely detection of corporate frauds.

'Fraud' refers to 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. Fraudulent financial reporting involves intentional misstatements, in any one or more ways as stated below:

- Deception such as manipulation, falsification or alteration of accounting records or supporting documents.
- Misrepresentation in, or intentional omission from the financial statements, significant events, transactions or other information.
- Intentional, mis-application of accounting principles relating to measurement, recognition, classification, presentation, or disclosure of material transactions.

Motives for Fraudulent Financial Reporting by Management

(a) Management is under pressure, from sources outside or inside the entity, to achieve (perhaps unrealistic) target, where consequences of failure are significant.

(b) To increase the entity's stock price or earnings trend.

(c) To keep the results attuned to knowingly unrealistic/non-achievable forecasts/commitment made to creditors and lenders.

(d) Tax-motivated reasons.

(e) To raise capital either by further issue of shares at a premium and/or through borrowings

Corporate frauds are results of manipulation of accounts and accounting jugglery designed to deceive others for wrongful gains.

Forensic Auditing

This term has not been defined anywhere. However, since the object is to relate the findings of audit by gathering legally tenable evidence and in doing so the corporate veil may be lifted (in case of corporate entities) to identify the fraud and the persons responsible for it (a criminal offence).

The concept of Financial Auditing may be defined as "a concentrated audit of all the transactions of the entity to find the correctness of such transactions and to report whether or not any financial benefit has been attained by way of presenting an unreal picture".

Forensic auditing aims at legal determination of whether fraud has actually occurred. In the process, it also aims at naming the person(s) involved (with a view to take legal action).

Distinction between Statutory Audit and Forensic Audit

S.No.	Particulars	Statutory Audit	Forensic Audit
1.	Objective	Express opinion as to 'true & fair' presentation.	Determine correctness of the accounts or whether any fraud has actually taken place.
2.	Techniques	'Substantive' and 'compliance' procedures.	Analysis of past trend and substantive or 'in depth' checking of selected transactions.
3.	Period	Normally all transactions for the particular accounting period.	No such limitations. Accounts may be examined in detail from the beginning.
4.	Verification of stock, estimation of realizable value of current assets, provisions/ Liability estimation, etc.	Relies on the management certificate/representation of management.	Independent verification of suspected/selected items carried out.
5.	Off balance-sheet items (like contracts etc.)	Used to vouch the arithmetic accuracy & compliance with procedures.	Regularity and propriety of these transactions/contracts are examined.
6.	Adverse findings, if any	Negative opinion or qualified opinion expressed, with/without quantification.	Legal determination of fraud and naming persons behind such frauds.

Detection Techniques

Forensic auditing should focus on significant transactions – both as reflected in financial statements and off balance sheet items The techniques mainly are 'Critical Point Auditing' and 'Propriety Auditing'.

(A) Critical Point Auditing: Critical point auditing technique aims at filtering out the symptoms of fraud from regular and normal transactions in which they are mixed or concealed. For this purpose, financial statements, books, records, etc. are analyzed mainly to find out:

(i) Trend-analysis by tabulating significant financial transactions

(ii) Unusual debits/credits in accounts normally closing to credit/debit balances respectively

(iii) Discrepancies in receivable or payable balances/inventory as evidenced from the non-reconciliation between financial records and corresponding subsidiary records (like physical verification statement, priced stores ledgers, personal ledgers, etc.)

(iv) Accumulation of debit balances in loosely controlled accounts (like deferred revenue expenditure accounts, mandatory spares account – capitalized as addition to respective machinery item, etc.)

(v) False credits to boost sales with corresponding debits to non-existent (dummy) personal accounts

(vi) Cross debits and credits and inter-account transfers

(vii) Weaknesses/inadequacies in internal control/ check systems, like delayed/non-preparation of bank reconciliation statements, etc.

(B) Propriety Audit: Propriety audit is conducted by Supreme Audit Institutions (SAI) to report on whether Government accounts, i.e., all expenditure sanctioned and incurred are need-based and all revenues due to Government have been realized in time and credited to the government account. In conducting the propriety audit, "Value for Money audit" technique aims at lending assurance that economy, efficiency and efficacy have been achieved in the transactions for which expenditure has been incurred or revenue collected is usually applied. The same analogy, with modifications to the principles of propriety of public finance, applies in forensic audit to establish fraudulent intentions if any, on the part of the management. Financial frauds are results of wasteful, unwarranted and unfruitful expenditure or diversion of funds by the investigated entity to another entity.

Examination methods are:

(a) Tests of reasonableness:

- Check weaknesses in internal controls
- Identify questionable transactions – indicating wide fluctuations from the normal ones and not, in general, related to main objectives.
- Review questionable transaction documents for peculiarities, like improper account, classifications, pricing, invoicing, or claims, etc.

(b) Historical Comparisons

- Develop a profile of the entity under investigation, its personnel and beneficiaries, using available information.
- Identify questionable accounts, account balances, and relationships between accounts, for finding out variances from current expectations and past relationships.
- Gather and preserve evidence corroborating asset losses, fraudulent transactions, and financial misstatements.

Off-Balance Sheet Transactions

There are certain transactions not prima facie discussed in the financial statements and nor suitable disclosures made. Since these are intangible in financial statement, or auditor may not consider these as significant or material, no statement/qualification is normally made in auditors' report. These may encompass:

- Significant purchases/sales of raw materials and/or finished goods with only a particular dealer or group companies of such vendor.
- Pattern of consumption of major raw materials/components, indicating excess consumption.
- Over/under-invoicing for capital goods, raw-materials/components, services, etc. as compared to normal arms' length prices for the same. (both in related party transactions and in general)
- Alteration (amendment and deletion) of contractual terms, to pass on otherwise accrued benefit, to holding/group companies.
- Diversion of funds through group companies and setting off such debits as expenditure in accounts with proper authorization before closure of accounts to avoid detection.
- Cost over–runs in major capital expenditure without corresponding benefit or convincing reasons.
- Justifications for non-maintenance of certain basic records, on technical grounds, but with intention to defraud.

Aspects to be covered

Objective of forensic audit is to find whether or not a fraud has taken place. Forensic auditor shall have to examine voluminous and in totality, records and witnesses, if permitted by law. Proper documentation is vital in substantiating the findings. The outcome shall focus on the following, in case of frauds:

- Proving the loss
- Proving the responsibility for the loss
- Proving the method/motive
- Establishing guilty knowledge
- Identifying other beneficiaries.

Skills for Forensic Audit

(a) Knowledge of entity's business and legal environment.

(b) Awareness of computer assisted audit procedures.

(c) Innovative approach and skeptic of routine audit practices.

Application

Forensic Accounting and Audit may be applied in the following areas besides fraud detection:

(a) Conducting due-diligence (especially for segment wise profitability analysis)

(b) Business valuation

(c) Management auditing

(d) Assessing loss before settling insurance claims.

Case Studies

Excerpts from two cases decided by Board for Industrial and Financial Reconstruction (BIFR), for determining erosion in company's net worth are really educative and guide us in application of forensic audit techniques.

M/s. Vivita Ltd. (Case No.113/2003)

Based on Balance Sheet as on 30th June, 2002, showing erosion in net worth, Vivita Ltd. filed a reference U/S 15(1) of Sick Industrial Companies (Special

Provisions) Act, 1985. Secured creditors objected on the grounds, amongst others, that:

(a) Requisite number of directors did not attend the meeting of Board of Directors of the company held to decide on reference to BIFR.

(b) Company indulged in the following:-

- Gave a huge discount of Rs.6.48 crore without any explanation/justification.
- Company devalued its investments by 90% without explaining reasons for such a devaluation.
- Company had written off Rs. 3.97 crore on account of foreign exchange fluctuations.
- Loans and advances had increased by Rs.39.64 crore without any proper/cogent explanation. It was suspected that these funds had been diverted/siphoned off to one of the related/or group companies.
- Addition to gross block included Rs.26 lakhs as land development expenses, actually not incurred, as per inspection carried out by banks.
- Depreciation increased by Rs.1.84 crore despite a fall in fixed assets.
- Steep reduction in the sundry debtors during 2001-02 without any cogent explanation.
- Availed unsecured, secured loans, and increased drawings from cash credit account, all together to the extent of Rs 43 crore.
- Profit earned (operating profit) during the previous year was Rs.12.24 crore on a sale of Rs.96 crore. However, the company reported a huge loss of Rs.40 crore on a marginal fall in sales during 2001-02 to Rs.87 crore.

BIFR observed that the group companies (to which Vivita belonged) referred to BIFR, though engaged in different activities, adopted the pattern of reporting huge losses on slight fall in sales. Marginal fall in the sales and huge losses accompanied with large discounts in a single financial year was common to all the companies.

Vivita's representations and decision of BIFR are briefed as under :-

- ☑ Vivita stated huge discounts were offered to liquidate stock, as it feared trademark infringement proceedings by another company. BIFR did not accept this as sufficient evidence was not made available and hence heavy increase in discounts and losses were not allowed.
- ☑ Devaluation of investments not admitted as Vivita Ltd failed to submit copy of B.O.D. resolution to ascertain whether it was long-term or short-term investment.
- ☑ Accounting jugglery has been committed, in respect of accounting for foreign exchange fluctuation on P&M, only to make its net-worth negative. Hence not allowed.
- ☑ Increase in loans and advances, on the one hand and sundry creditors/other liabilities, on the other, could mean a diversion of funds of the company and increase in losses by providing interest on borrowed funds. For want of complete details, this issue was kept open.
- ☑ Explanation of Vivita Ltd as for increase in depreciation was acceptable.
- ☑ Considering the market practice in the industry of taking advance from buyers and passing the same to the suppliers, BIFR noted that selling prices and the procurement prices are fixed in advance. BIFR set aside Vivita Ltd's contention of losses in trading activities and ruled that losses of the company were overstated by Rs. 34.61 crore on account of increase in raw material consumption.
- ☑ Reduction in sundry debtors could mean diversion of cash flow as the company did not submit explanation.
- ☑ As to increase in loans, details were not available, but in case of unsecured loans, BIFR observed that Vivita Ltd. had given preferential treatment in the payment of unsecured loans at the cost of secured loans.
- ☑ Regarding loss of Rs.40 crore on a marginal fall in the sales, Vivita has not submitted any explanation.

BIFR, re-worked, based on above rulings, the net-worth to be positive and hence rejected the reference u/s 15(1).

BIL Industries Ltd. (33/2002)

Reference (third reference) was made u/s 15(1) of SICA, based on the balance sheet, showing negative net-worth as on 31st March, 2001 (accumulated losses, as per audited balance sheet – Rs.121.83 crore against net-worth of Rs.20.60 crore).

Earlier reference (case no.116/1999) based on its accounts as on 31st March, 1999 was admitted by BIFR. However, AAFIR rejected this reference stating that there was large-scale diversion and siphoning away of funds by the promoters and glaring discrepancies in accounts of financial year 1998. Second reference based on balance sheet as on 31st March, 2000 was rejected by BIFR and the AAFIR upheld BIFR's decision as "Rs.5519.33 lakhs in financial year 1999 and Rs.674.13 lakhs in financial year 2000, i.e., Rs.6193.46 lakhs are not admissible expenses towards losses. As noticed above, the promoters have siphoned away the funds of the company to the extent of over Rs.43 crore in financial year 1999 which they are liable to restore with interest amounting to Rs.9 crore. The loss would further get reduced by Rs.9 crore. These losses to the extent of Rs.7093.46 lakhs would not count towards the accumulated losses. This leaves loss of Rs.1768.87 lakhs against net worth of Rs.2060 lakhs". Net worth thus remains positive.

In this reference, BIFR was informed by secured creditors that total debt which stood at Rs.48.28 crore as on 31.3.1998, increased to Rs.138.87 crores as on 31.3.2001. The debt had mainly increased because of interest, liquidated damages, penal interest etc. If the company had repaid Rs.43 crore towards its debts during 1998-99, instead of allowing the promoter to siphon away these funds, interest burden would not have been more than Rs.5 crore for the three financial years 1998-99, 1999-2000 and 2000-01.

Thus the interest provision to the extent of Rs.86 crore should be disallowed. If adjustments not allowed by AAFIR in second reference amounting to Rs.70.93 crore and the interest of Rs.77 crore provided on funds siphoned away by the promoters, were disallowed, the net-worth would be positive.

BIFR rejected references made for reasons of manipulations of accounts.

Conclusion

Forensic auditing combines legalities alongside the techniques of propriety (VFM audit), regularity, investigative, and financial audits. The main aim is to find out whether or not true business value has been reflected in the financial statements and whether any fraud has taken place.

It differs, altogether, in form and content from the statutory audits of financial statements. It may be beneficially applied in other areas where due diligence exercise is required to be carried out. ■