FORENSIC ACCOUNTING- Concept

Forensic auditing is a comprehensive auditing tool. Once it is completed, the organization's key stakeholders should capitalize on the work by implementing controls to reduce the risk associated with the event identified as having material and significant ratings and being most likely to occur. The strength of current controls in place and whether they are preventive controls or detective controls are taken into consideration. Can the current controls be overridden or circumvented? Future audit programmers should include test on the design and implementation of these controls. If an event has been identified as inconsequential, forensic auditors may decide to take no action; even so, at least it would be documented and management would be aware of its existence. The forensic risk assessment is not the end of the process. Circumstances change constantly and some changes may trigger the need to revise the assessment. A fraud risk assessment process should be ongoing, dynamic and reflect the organization's current business conditions. Forensic auditing combines legalities alongside the techniques of propriety (VFM audit), regularly, investigate 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. In future, more and more organizations will be adopting forensic auditing tools to strengthen their systems and controls, given its inherent strength and advantages

Expectation from Chartered Accountant is rising from day to day and this scenario calls for services of chartered accountant in non- conventional areas of practice as well. Forensic Accounting is one such area which mainly requires core knowledge of accounting as well ass legal representation. Forensic Accounting essentially requires "think beyond the number and think beyond the box".

This article deals with –

- Role of forensic accountant
- Different aspects of forensic accounting
- Techniques of forensic accounting and
- Forensic accountant status in Indian scenario

"Auditor should be watchdog and not be the bloodhound". It's a good quote that every auditor should know. This quote makes the definition of Forensic accountants even simpler. The forensic Accountant is a bloodhound of Bookkeeping. These bloodhounds sniff out fraud and criminal transactions in bank, corporate entity or from any other organization's financial records. They hound for the conclusive evidences. External Auditors find out the deliberate misstatements only but the Forensic Accountants find out the misstatements deliberately. External auditors look at the numbers but the forensic auditors look beyond the numbers.

Introduction:

Forensic accounting is a broadly mixture of Accounting, Finance, Law, Computerization, Ethics and Criminology, with focus on the prevention and detection of financial frauds. And conduct of investigation to undertake and assist in litigation which supports to book the wrong doers (by the spirit of specialization). The traits of the forensic Accountants could be compared to well bake Pizza. The base of forensic accounting is Accounting knowledge. Size and the extent of baking decide the quality of the Pizza. A middle layer is a dispersed knowledge of auditing, internal controls, risk assessment and fraud detection. It is like the spread of the cheese in Pizza. The toppings of this Pizza are a basic understanding of the legal environment. The legal environment is essential in order to support the litigations. The Cherry on the toppings of the pizza is a strong set of communication skills, both written and oral. It is just the beautification part. Perfect combination of the Pizza base, Cheese spread and good toppings make the pizza delicious and the Forensic Auditor the perfect. It's a combination that will be in demand for as long as human nature exists.

How it is different than accounting:

1.As we know auditor can only check for compliances of (in companies' books) GAAP, AS and company policies. But forensic accountants detect the fraud in the suspected fraudulent transaction of the company.

2.Forensic accounting looks at the accounting in wider perspective rather than in different segments such as data entry, record keeping, preparation and record keeping.

3.The primary orientation of forensic accounting is explanatory analysis (cause and effect) of phenomenon.

4.Forensic accounting focuses on detection of financial frauds by linking data knowledge and insight together for prevention and detection of fraud by establishing and placing the accounting system on right track, it also creates difference (as it promote fears in the mind of wrong doers that there is likelihood of they being caught and punished)

Role of Forensic accountants:

1.Forensic accounting involves a financial detective (Forensic accountant) with a suspicious mind, who acts as a financial bloodhound, some one with "sixth sense" that enables reconstruction of past accounting transactions and an individual who looks beyond the numbers.

2.Investigation and analysis of financial evidence.

3.Developing computerized applications to assists in the analysis and presentation of financial evidence.

4.Assisting in legal proceedings, and acts as an experts in evidence findings.

5.Forensic accountant now a days are needed to attack on –

§ Growing cyber crime, security scams

§ Cooperative banks bursting

§ Embezzlement, negligence and Frauds.

§ Malpractices and employees theft etc.

In a nutshell, following services can be provided by Forensic accountant

Quantifying the impact of lost earning

- Construction delay, stolen trade secrete
- Insurances disputes, damage/loss estimate
- Disturbance damages, loss of goodwill
- Assessment of potential business compensation cost
- Consultation on business defalcation minimization
- Breach of contracts, partnership dispute resolution
- Investigations and misappropriation
- Provides evidences as an expert , investigate professional negligence
- Tax matters and tax advocacy
- Reconstruction of accounting records. Etc.

Core knowledge of forensic accountants:

- Expert in accounting and financial systems
- Professionals skills and competency
- Critical analysis skills
- Understanding of frauds, money laundering
- Bribery and corruption
- Proficiency in computer operations and knowledge of networking systems.
- Understanding of human psychology.
- Interpretation and communication skills
- Knowledge of company's governance policies.
- Command of civil and criminal laws as well as legal system. Etc.

<u>The techniques in forensic accounting:</u>

Tools for examination of evidence as a part of forensic accounting are like ratio analysis, cash flow technique standard statistical tools.

Now a day's forensic accountant has technology available to obtain or source data, sort and analyzed data and even quantify and stratify results through computer audit software application and various other technologies.

This enables the forensic accountant to pinpoint theft of assets for fidelity bond coverage, proof of losses for insurance or litigations, and illegal payments by corporations.

Some Technique is as follows:

A. Theory of relative size factor (RSF)

It enlightened all unusual fluctuations which are highly vulnerable for the fraud and error. RSF is measured as the ratio of the largest number to 2^{nd} largest number of given set. In practice there exist certain limits (e.g. financial) for each entity such as vendors, employee, customers etc. these limit may be defined or analyzed from the available data, if not defined. If there is any stray instance of single transaction that is way beyond the normal range, then there is a need to investigate further, into it.

It helps in better detection of anomalies or outer liners. In this method the records that falls outside the prescribed range are suspected of error or fraud. These records or fields need to relate to other variables or factors in order to find relationship, thus establishing the truth.

B. Ben ford's Law:

It is mathematical tool, and is one of the various ways to determine whether variables under study are a case of unintentional error or frauds. On detecting any such phenomenon, the variable under study is subjected to detailed scrutiny. The laws state that the fabricated figures (as indicator of fraud) possess a different pattern from valid figures.

The steps of Ben ford's law are very simple once the variable or field of financial importance is decided, the left most digit of variable under study extracted and summarized for entire population.

The summarization is done by classifying the first digit field and calculating its observed count percentage then Ben ford's set is applied.

A parametric test called the Z- test, is carried out to measure the significance of variable between two population i.e. Ben ford's percentage numbers for first digit and observed percentage of first digit for particular level of confidence. If the data confirms to the percentage of Ben ford's law, it means that the data is Ben ford's set. I.e. there are 68% (almost 2/3) chances of no fraud or error.

The first digit may not always be the only relevant field. Ben ford has given separate set for 2nd, 3rd ---- and for last digit as well.

It also works for combination numbers, decimal numbers and rounded numbers.

There are many advantage of Ben fords law like it is not affected by scale in variance, and is of help when there are no supporting documents to prove the authenticity of the transactions.

C. CAATs (Computer Assisted Audit Tools)

CAATs are computer programs that the auditor use as part of the audit procedure to process data of audit significance contained in the clients' information systems without depending on him.

CAAT helps auditor to perform various auditing procedure such as:

- Testing details of transaction and balances.
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- Redoing calculations performance by accounting system.

Forensic accounting software comes into two varieties:

1. Data Extraction and financial analysis software:

Conduct the spreadsheet analysis such as payroll, billing, accounts receivables and payment to vendors etc.

2. Financial analysis software:

It prepared the monthly/quarterly/yearly financial statements and benchmarks the ratios between the different accounts such as billing by revenue or supply cost as % of revenue.

C. DATA MINING TECHNIQUE

It is a set of computer assisted technique designed to automatically mine large volume of data for new hidden or unexpected information or pattern. There are the following ways of data mining process:

a) **Discovery**:

Knowledge of pattern in data

b) **Predictive modeling and derivations** :

Predict outcomes and guess data for new value items. In deviation data analyzed and apply the specific modeling.

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Detecting suspicious pattern in the data. It mostly uses deterministic graphical technique. Generally method involves is known as “pattern matching” to extract any suspicion.

D. RATIO ANALYSIS

A financial ratio gives indication of financial health of the company.

Ratio analysis is help to data analysis and fraud detection.

Commonly employed ratios are:

1. Ratio of highest value to lowest value(Max/min)

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3. Ratio of current year to previous year.

Use of ratios are in forensic accounting when document are missing

E.g. cost of the goods sold 35% of sale.

FORENSIC AUDITOR/ ACCOUNTATS UNDER INDIAN STATUE:

There is no mention of forensic accountant in Indian statue so far but there are various provisions related to forensic accountant.

A. INVESTIGATION AND INSPECTION

Forensic accountant help to police, other investigating authorities in collecting the evidences.

Sec.78- Information technology act 2000

Sec.209A, 227- Companies act 1956

Sec.6- Banker book evidence act 1891

Sec.17, 18- Prevention of corruption act.

B. EXPERT OPPINION

Forensic accountant may see carefully examine the balance sheet and use his skill to find out whether any fraud or anomaly committed by giving expert opinion.

E.g. Sec.45, 118- Indian Evidence act 1872

Sec.293- Criminal procedure act 1973

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- **Disposal of Fixed assets:**

Required auditors to report to affect that if substantial parts of the fixed assets have been disposed off during the year, whether it has affected the going concern status.

In order to carry out the corollary and reference to the Sec. 293 of companies act, 1956. AS-24(Discontinuing operations) and to AAS-16 (Going concern) and thereafter make his observations on this matter.

- **Report on fraud:**

If any fraud on or by the company has been noticed or reported during the year. Following provisions CARO 2003 are important in this respect.

A .AAS-4 (Revised) guide the auditor to obtain a management representation letter as the fraud reported and detected during the year because of the nature of fraud and the difficulties encountered by the auditor in detecting material misstatement in the financial statements resulting from fraud.

Accordingly it may be concluded that, it is enough if the auditor expresses his opinion on fraud noticed and reported by the management and not expected to be a detective to approach his work with suspicion.

B. Another major issue under this clause is that it also requires reporting of fraud committed by company. The auditor is left with no clues and is expected to travel beyond the books to search for market information about fraud committed by the company, which is highly illogical.

D. TRANSACTION WITH RELATED PARTIES

Focus primary reporting whether transaction needs to be entered into the register in pursuance of sec 301 of the companies' act 1956. This clause may be considered as further step to investor's protection. However, major issue here is that the audit focus has to be shifted intensified towards proprietary areas to find out the transaction that need to entered (scrutiny of all entries) and then to check the register for actual recording.

Conclusion:

The importance of forensic accountant's role in the detection of fraud is continuously growing.

Armed with combination of skills, these financial detectives are today important assets to modern legal teams.

In the backdrop of increasing levels of frauds, the demand for forensic accountants is bound to substantially increase in future.

Nearly 40 percent of the top 100 American accounting firms are expanding their forensics and fraud services, according to Accounting Today. If this data is of some sense to Indian scenario then the day is not far away when forensic practice will contribute maximum to the total revenue of the Indian CA firm. Far from the humdrum stereotypic accountant your mind might have initially conjured, the forensic accounting professional is more of a private investigator with a financial sixth sense than the bookkeeper with a green eyeshade

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“Thrill seeking and accountancy is not, whatever you may think, mutually exclusive.

Forensic accountancy can be a high profile and fascinating blend of legal and numerical problem solving where you are key to beating the bad guys. There’s nothing better than that thrill of getting the final bit of evidence that pieces the jigsaw together”. - mark Alden

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Paramount importance of Forensic accountants:

Internal corporate and other process control resources may alleged to fraud, damages. And not effective as to specialized skill of fact gathering process dilution. Forensic accountant in such situations are of paramount service provider.

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From,
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Wro0265845
Cell:9922516162