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Forensic Accounting and Fraud Examination in India

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Abstract:

Forensic accounting in India has come to limelight only recently due to rapid increase in white collar crimes. It helps companies in accomplishing their organization's objectives, with a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes. It is the contribution of accounting, auditing and investigative skills. A large global accounting firm believes the market is sufficiently large to support an independent unit devoted to 'Forensic Accounting'. The objective of the paper is to study: the role of forensic accounting in fraud examination in India and to understand the various applications of forensic accounting in Indian firms. In India unfortunately it is being used as an investigative tool, rather than a preventive tool. If forensic auditing is made mandatory in various sectors, many of the scams can be restricted. It has been suggested that appointment of forensic accountants should be made mandatory in public sectors and large scale companies for the sustainable development of the economy.

Keywords: forensic accounting, white-collar crimes, fraud detections, approaches & investigations

1. Introduction

Forensic accounting is a rapidly growing area of accounting concerned with the detection and prevention of financial fraud and white-collar criminal activities. Cracking down on fraud is critical for a country that needs investment. According to KPMG Fraud Survey white-collar crime in corporate India has witnessed a substantial increase over the last two years. The integration of accounting, auditing, and investigative skills yields the specialty known as Forensic Accounting which focuses very closely on detecting or preventing accounting fraud. "Forensic", according to the Webster's Dictionary means, "Belonging to, used in or suitable to courts of judicature or to public discussion and debate." The word accounting is defined as "The art of recording, classifying and summarizing, in a significant manner and in terms of money, transaction and events which are, in part at least, of financial character, and interpreting the results thereof. The term 'Forensic Accounting' Forensic accounting, sometimes called investigative accounting is the application of a specialized knowledge and specific skills to identify transactions which are not authentic and gather the evidence regarding the same. The job demands reporting, where the accountability of the fraud is established and the report is considered as evidence in the court of law or in the administrative proceeding. It is often said Accountants look at the numbers but Forensic accountants look behind the numbers (Okoye 2009). Forensic accountants are trained to look beyond the numbers and deal with the business realities of the situation. Analysis, interpretation, summarization and presentation of complex financial and business related issues are prominent features of the profession (Bhasin 2007). With India being ranked as the 88th most corrupt nation, the need for forensic accountants becomes all the more profound.

2. Objectives of the Study

- To understand the role of forensic accounting in fraud examination in India.
- To examine the various applications of forensic accounting in Indian firms

3. Research Methodology

This paper is based on secondary data. The term 'Forensic Accounting' refers to financial fraud investigation which includes the analysis of accounting records to prove or Disprove financial fraud and serving as an expert witness in Court .Forensic accounting is very important tool to Detect, investigate and prevent the frauds.

4. Forensic Accounting in India- Implementation & Progress

While forensic accounting developed as early as 1995 in USA, it put its first step in India just few years back. In India, forensic accounting has risen to prominence because of increased financial frauds popularly known as white collar crimes. The shortage of respect and perception in India's law enforcement agencies plus the price at which white collar crimes have enhanced , has prompted the improvement of forensic accounting in India. Forensic accounting though a new field in Indian accounting world has tremendous potential as a new practice area for Indian CAs. Indian CAs with their extensive theoretical education and practical experience can create forensic accounting and auditing as their niche area.

India forensic center of studies was established by CA Mayur Joshi in the year 2005. Post Satyam fiasco, it started providing certifications and specializations such as CFAP (Certified Forensic Accounting Professional) in Information Technology, Insurance, Anti-Money Laundry expert, certified bank forensic accounting. CFAP is a person who has undergone training in the field of forensic accounting, forensic auditing, litigation support and investigative accounting to effectively handle the investigation of financial frauds and give expert testimony in the court of law. Chartered accountancy firms such as Sharad Joshi chartered accountants do provide these services. A Delhi based firm S.K Jain also investigated the world famous Xerox fraud case. But by and large this area is dominated by the big four consultancy firms such as Deloitte, KMPG, price water house coopers and Ernst and young. In order to curb the increasing financial fraud cases, scams Government of India has established three four agencies that combat frauds as follows:

4.1. SFIO (Serious Fraud Investigation Office)

It was the first agency established by Government of India under ministry of corporate affairs which looks into the frauds that involves the violations of multiple laws such as Income Tax, FEMA and RBI Act etc. Formation of SFIO is really a landmark development for forensic Accountants. SFIO recognize CFE (certified forensic expert) as the designation for the purpose of employment and empanelment.

4.2. CBI (Central Bureau of Investigation)

It has its specialized wing to deal with the financial frauds called as "economic offenses wing".

4.3. CVC (Central Vigilance Commission)

It is the place which handles the crucial part of the occupational frauds viz. Corruption. It also helps in the bank fraud cases. Some of the initiatives taken by regulatory bodies show a positive sign in preventing scams. To prevent scams in financial sector, RBI has asked banks to include forensic accounting practices. SEBI has decided to create a "forensic cell" to improve the quality of the financial information disclosed and to assist in detection o financial irregularities so as to serve as an effective early warning mechanism. The future of forensic accounting in India is poised to grow at a rapid pace.

5. Types of Frauds

Following are the types of frauds:

- Bank frauds
- Corporate frauds
- Cyber frauds
- Securities frauds
- Identity theft
- Insurance Frauds

5.1. Bank Frauds

It is the use of potentially illegal means to obtain money, assets, or other property owned or held by a bank or financial institution, or to obtain money from depositors by fraudulently posturing as a bank or other financial institution. In many instances, bank fraud is a criminal offence. The number of bank frauds in India is substantial. It is increasing with the course of time in all the major operational areas in banking. Bank fraud is a big illegal business in today's world.

5.2. Corporate Frauds

It is an unlawful activity undertaken by an individual or a company to give an advantage to the perpetrating company. In India, it has raised from 37% in 2010 to 45% till date.

5.3. Cyber Frauds

Cybercrime refers to any crime that involves a computer and a network. The computer may have been used in the commission of a crime, or it may be the target. Net crime is criminal exploitation of the Internet. Dr. Debarati Halder and Dr. K. Jaishankar (2011) define

Cybercrimes as: "Offences that are committed against individuals or groups of individuals with a criminal motive to intentionally harm the reputation of the victim or cause physical or mental harm to the victim directly or indirectly, using modern telecommunication networks such as Internet (Chat rooms, emails, notice boards and groups) and mobile phones (SMS/MMS)". Such crimes may threaten a nation's security and financial health.

5.4. Securities Frauds

Securities fraud, also known as stock fraud and investment fraud, is a deceptive practice in the stock market that induces investors to make purchase or sale decisions on the basis of false information, frequently resulting in losses, in violation of securities laws. Offer of risky investment opportunities to unsophisticated investors who are unable to evaluate risk adequately and cannot afford loss of capital is a central problem. Similarly, policyholders seek the help of a forensic accountant when they need to challenge the claim settlement as worked out by the insurance companies. A forensic accountant handles the claims relating to consequential loss policy, property loss due to various risks, fidelity insurance and other types of insurance claims

5.5. Identity Theft

The fastest-growing type of fraud in the world is identity theft. It occurs when the fraudster uses your credit card or bank account information to buy items and then charge them.

5.6. Insurance Frauds

There is different type of frauds in insurance sectors. E.g. health insurance, claims fraud, false claims, insurance speculations, application frauds etc.

6. Scams in India

Forensic Accounting has come in to lime light in India only in the recent past due to rapid increase in the white collar crimes and due to the perception that Indian Judicial law is not stern to unveil the frauds. It is being used in almost all the sectors like banks, financial institutions, politics, corporate companies, insurance companies etc. as our country has witnessed many frauds in the past few years with the increase in modern technology. Some of scams that took place are as follows:

Scandal	Year reported	Scope	Key Players	Summary
Satyam Scam	2009	Rs.14000 crore	Ramalinga Raju & his family, CFO & other top level management, Auditors & Board of Directors	Falsified revenues, margins and cash balance, operating profit artificially boosted from 61 crores to 649 crores,
2G Spectrum	2010	Rs. 1760 billion	A Raja, MK Kanimozhi, Nira Radia, Many Telecom Cos	Irregularities in awarding spectrum licenses. License issued on first cum first serve basis instead of auction. Advancing of cutoff date which is illegal.
Common-wealth games	2010	Rs. 35000 crores	Suresh Kalmadi & other organizing committee members, 2 private companies & Govt officials	Allegations of corruptions and mismanagement by the organizing committee, delay in the construction of main venue leading to misuse of funds, infrastructural compromise, hefty payments made in the name of non-existing parties
Uttar Pradesh NRHM scam	2010	Rs.10,000 crores	Mayawati, Babu singh Kushwaha	Top politicians and bureaucrats are alleged to have siphoned off a massive sum estimated at (US\$1.6 billion) from the National Rural Health Mission, a central government program meant to improve health care delivery in rural areas.
Indian Coal allocation Scam	2012	Rs. 1.86 lakh crore	Comptroller and Auditor general of India, the coal Ministry, many electric boards & private companies	coal blocks allotted, not auctioned, leading to estimated losses as per the Comptroller and Auditor General of India.
VVIP Chopper deal scam	2013	Rs. 362 crores	Augusta Westland Company, Former IAF chief SP Tyagi & his cousins, politicians, Govt officials & several middlemen.	It has been alleged that former IAF chief has accepted bribes to win contract worth Rs. 36 billion.

Table 1

7. Role of Forensic Accountant

A Forensic Accountant is often retained to analyze, interpret, summarize and present complex financial and business-related issues in a manner that is both understandable and properly supported. Forensic Accountants can be engaged in Public Practice or employed by insurance companies, banks, police forces, government agencies and other organizations.

7.1. Criminal Investigations

The forensic accountant would use his/her investigative accounting skills to examine the documentary and other available evidence to give his/her expert opinion on the matter. Their services could also be required by Government departments, the Revenue Commissioners, the Fire Brigade, etc for investigative purposes. Practicing forensic accountants could be called upon by the police to assist them in criminal investigations which could either relate to individuals or corporate bodies.

7.2. Personal Injury Claims

Where losses arise as a result of personal injury, insurance companies sometimes seek expert opinion from a forensic accountant before deciding whether the claim is valid and how much to pay.

7.3. Fraud Investigations

Forensic accountants might be called upon to assist in business investigations which could involve funds tracing, asset identification and recovery, forensic intelligence gathering and due diligence review. In cases involving fraud perpetrated by an employee, the forensic accountant will be required to give his/her expert opinion about the nature and extent of fraud and the likely individual or group of individuals who have committed the crime. The forensic expert undertakes a detailed review of the available documentary evidence and forms his/her opinion based on the information gleaned during the course of that review.

7.4. Matrimonial Disputes

Solicitors often need the services of forensic accountants in divorce cases involving disputes about matrimonial assets. Assignments of this sort might require the forensic accountants to trace, locate and evaluate assets. Such assets, for instance, might technically be owned by a business in which one of the parties to the divorce case has a share. The assets would need to be accurately valued to ensure equity when splitting the divorcing couple's assets and liabilities.

7.5. Professional Negligence

The forensic accountant might be approached in a professional negligence matter to investigate whether professional negligence has taken place and to quantify the loss which has resulted from the negligence. A matter such as this could arise between any professional and their client. The professional might be an accountant, a lawyer, an engineer etc. The forensic expert uses his/her investigative skills to provide the services required for this assignment.

7.6. Expert Witness Cases

Forensic accountants often attend court to testify in civil and criminal court hearings, as expert witnesses. In such cases, they attend to present investigative evidence to the court so as to assist the presiding judge in deciding the outcome of the case.

7.7. Mediation and Arbitration

Some forensic accountants because of their specialist training they would have received in legal mediation and arbitration, have extended their forensic accounting practices to include providing Alternative Dispute Resolution (ADR) services to clients. This service involves the forensic accountant resolving both mediation and arbitration disputes which otherwise would have been expensive and time consuming for individuals or businesses involved in commercial disputes with a third party.

7.8. Litigation Consultancy

Working with lawyers and their clients engaged in litigation and assisting with evidence, strategy and case preparation. Computer Forensics: Assisting in electronic data recovery and enforcement of IP rights etc.

7.9. Computer Forensics

Assisting in electronic data recovery and enforcement of IP rights etc.

8. Role of Forensic Accountants Under Indian Statutes

There is no mention of Forensic accountants in the Indian statutes so far, but there are various provisions related to Forensic accountants/auditors in the statutes⁶. It can be categorized under the following heads:

8.1. Investigation and Inspection

Forensic auditors may help the Police, ACB and other investigating authorities in collecting evidences and other investigation purposes. For example section 157 Cr. P.C, 1973; section 17, 18 of the Prevention of Corruption Act, 1988; Section 6 of The Bankers Books Evidence Act, 1891; Section 78 of Information Technology Act, 2000; Section 209A, 227 of the Companies Act, 1956 wherein the

Court or Police may require the skills of Forensic accountants while inspecting any books in so far as related to the accounts of an accused.

8.2. Expert Opinion

Forensic accountants may see and carefully examine the accounts and balance sheets and use his skills to find out whether there is any fraud committed or any anomaly associated with it by giving his expert opinion. This finds place in for example s.45, s.118 of Indian Evidence Act, 1872; s.293 of Cr. P.C, 1973.

8.3. Forensic Accounting under Caro (The Companies Auditor's Report Order, 2003)

It can be categorized under following heads:

8.3.1. Disposal of Fixed Assets

CARO, 2003 requires the auditor to report to the effect that if a substantial part of fixed assets have been disposed off during the year, whether it has affected the going concern status. In order to carry out the duties, the auditor has to draw a corollary and reference to the section 293 Companies Act, 1956, AS 24 (Discontinuing Operations) and to AAS 16 (Going Concern) and thereafter make his observations on this matter.

8.3.2. Report On Frauds

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

- AAS 4 (Revised) guides the Auditor to obtain a management representation letter as the frauds reported and detected during the year because of the nature of the fraud and the difficulties encountered by the Auditors in detecting material misstatements in the financial statements resulting from fraud. Accordingly, it may be concluded that it is enough if the Auditor expresses his opinion on the frauds noticed and reported by the management and not expected to be a detective to approach his work with suspicion.
- Another major issue under this clause is that it also requires reporting of frauds committed by the Company. The Auditor is left with no clues and is expected to travel beyond the books, to search for market information about frauds committed by the Company, which is highly illogical.

8.3.3. Transactions with Related Parties

The focus of the primary reporting under this clause is to report whether transactions that need to be entered into a Register in pursuance of Section 301 of the Companies Act, 1956 have been so entered. This Clause may be considered as a further step towards the investor's protection. However, the major issue here is that the audit focus has to be shifted further intensified towards proprietary areas to find out the transactions that need to be entered (a thorough scrutiny of all entries in the books of accounts may be needed); and then to check the Register for actual recording of the same Mere reliance on the 301 Register is not enough and the Auditor has to scrutinize Form No.24AA (Disclosure of interest by the Directors) to ascertain likely transactions that need to be entered in the 301 Register.

9. Dealing with Fraud-Current Model

There are four stages in the model shown in Fig.

- **The first stage**—fraud incident—raises consciousness, while training and other prevention criteria are out of the question. In such an environment, a fraudulent event occurs. Then the company moves to crisis mode because it wants to identify the fraudster and is too eager to prevent the event from becoming known publicly, save losses, and reduce the impact of fraud on the organization.
- **The second stage** is the investigation stage - All security procedures and internal control are included in this stage. Much of the investigation is conducted by interviewing and document examination. The investigation might not end up with a decision but could take long time and be costly at the end of the day.

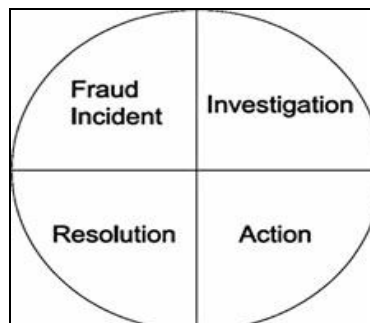


Figure 1

- **Before the third stage** begins, investigation is completed and the company decides how to take action against the fraudster. There are four possible decision actions: do nothing, fire the fraudster, transfer the fraudster to another section, or fire the fraudster and start legal proceeding.
- **In fourth stage**, the file is closed, the employee is changed, and new controls are applied or not applied, and the problem is resolved. In this model, nothing is done after this fourth stage until a new fraudulent event takes place. Fraudulent events do not decrease; they might in fact become a chronic problem.

10. Practices of Forensic Accounting in India

The conventional accounting and auditing with the help of different accounting tools like ratio technique, cash flow technique, a standard statistical tool examination of evidences are all part of forensic accounting. The fast-changing world of information technology and the exponential increase in the use of computer systems threaten the forensic accounting fraternity. The technology used by criminals and fraudsters is changing constantly and forensic accounting need to stay on top of their game to prevent and detect these fraudulent practices. All Indian accountants are not information technology savvy. Some of the techniques involved in Forensic Accounting to examine the frauds are:

10.1. Benford's Law

It refers to the frequency distribution of digits in many (but not all) real-life sources of data. In this distribution, 1 occurs as the leading digit about 30% of the time, while larger digits occur in that position less frequently: 9 as the first digit less than 5% of the time. Benford's Law also concerns the expected distribution for digits beyond the first, which approach a uniform distribution. On detecting any such phenomenon, the variable under study is subjected to a detailed scrutiny. Accounts receivable, accounts payable, sales and expenses data are all based on values from two types of variables being multiplied together i.e. prices and quantities. Alone, prices and quantities are unlikely to conform to Benford's law, but are likely to when multiplied together. Such accounting data is also likely to be right skewed. Transaction level accounting data for a large firm would almost always have a very large number of observations. If some accounting data is expected to conform to Benford's law but doesn't, it doesn't necessarily mean the data is fraudulent. It would however provide a good reason for further investigation. Auditors have long applied various forms of digital analysis when performing analytical procedures. For example, auditors often analyze payment amounts to test for duplicate payments. They also check for missing check or invoice numbers. Benford's law looks at an entire account to determine if the numbers fall into the expected distribution. It also works for combination numbers, decimal numbers and rounded numbers. There are many advantages of Benford's Law like it is not affected by scale invariance, and is of help when there is no supporting document to prove the authenticity of the transactions

10.2. Theory of relative size factor (RSF)

It highlights all unusual fluctuations, which may be routed from fraud or genuine errors. RSF is measured as the ratio of the largest number to the second largest number of the given set. The RSF test finds subsets where the largest number is out of line with the remaining numbers and is possibly an error. It has detected errors in accounts payable when staff miscoded the decimal point in the invoice amount. The relative size factor (RSF) for a subset is: $RSF = \text{Largest number in subset} / \text{Second largest number in subset}$. For example, a high RSF in payroll data could signal an overtime error and a high RSF for inventories could signal a calculation or count error. If there is any stray instance of 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 outliers. In practice, there exist certain limits (e.g. financial) for each entity such as vendor, customer, employee, etc. This test finds identical entries, such as duplicate payments in accounts payable. While many AP systems can make this identification, duplicates may still occur if some of the purchase details are miskeyed or when there are a number of payment centers or multiple payment systems. Duplicates are detected when all the payment data are analyzed together. This test can also be used in inventory, payroll, accounts receivable and sales.

10.3. Computer Assisted Auditing Tools (CAATs)

CAATs are computer programs that the auditor use as part of the audit procedures to process data of audit significance contained in a client's information system, without depending on him. CAATs are the practice of using computers to automate the audit processes. CAATs normally include using basic office productivity software such as spreadsheet, word processors and text editing programs. Using CAATs the auditor can select every claim that had a date of service after the policy termination date. The auditor then can determine if any claims were inappropriately paid. CAATs provide auditors with tools that can identify unexpected or unexplained patterns in data that may indicate fraud. Whether the CAATs is simple or complex, data analysis provides many benefits in the prevention and detection of fraud. Evaluations of financial information made by studying plausible relationships among both financial and non-financial data to assess whether account balances appear reasonable.

10.4. Data Mining Techniques

Data mining techniques are providing great aid in financial accounting fraud detection, since dealing with the large data volumes and complexities of financial data are big challenges for forensic accounting. The implementation of data mining techniques for fraud detection follows the traditional information flow of data mining, which begins with feature selection followed by representation, data collection and management, pre - processing, data mining, post-processing, and performance evaluation. Collapses of high profile

companies have left a dirty smear on the effectiveness of corporate governance, quality of financial reports, and credibility of audit functions. The detection of accounting fraud using traditional internal audit procedures is a difficult or sometimes an impossible task. First, the auditors usually lack the required knowledge concerning the characteristics of accounting fraud. Second, as the fraudulent manipulation of accounting data is so infrequent, most of the auditors lack the experience and expertise needed to detect and prevent frauds. Finally, the other concern people of finance department like Chief Financial Officer (CFO), financial managers and accountants are intentionally trying to deceive the internal or external auditors.

10.5. Ratio Analysis

Another useful fraud detection technique is the calculation of data analysis ratios for key numeric fields. Like financial ratios that give indications of the financial health of a company, data analysis ratios report on the fraud health by identifying possible symptoms of fraud. Detection of financial statement fraud is on the front burner. With billions of losses behind us from such companies as Enron, Tyco, and WorldCom, the numbers of cases has slowed but not stopped.

Three commonly employed ratios are: -

- The ratio of the highest value to the lowest value (Max/min);
- The ratio of the highest value to the second highest Value (max/max2); and
- The ratio of the current year to the previous year.

For example, to arrive at overhead costs per direct labor hour – Total overhead costs might be divided by total direct labor hours. Ratio analysis may help a forensic accountant to estimate expenses.

11. Conclusion

Forensic accounting in India is relatively a new area of study, a series of working definitions and sharing of corporate experiences should be undertaken and encouraged to ensure a common understanding. Indeed, there is great future in forensic accounting as a separate "niche" consulting. It is being used as an investigative tool, rather than a preventive tool. If forensic auditing is made mandatory in various sectors many of the scams can be restricted. There is also a need to make a new Law for the prosecution of fraudsters, irrespective of their domicile and such Law should always be framed keeping in mind the uses of information technology in fraudulent practices. To prevent scams in financial sector, RBI has also asked banks to include forensic auditing practices. While majority of CAs have excellent analytical skills, they need to acknowledge that 'forensic' services require 'specialized' training as well as real-life 'practical' corporate experience.

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