

ACAE – Kolkata 25-07-2020

# Practical Approach to Forensic Audit

CA. Durgesh Pandey

M Com, FCA, DISA (ICAI), CFE (USA)  
Research Scholar – GFSU

Managing Partner  
DKMS & Associates  
Chartered Accountants  
Ahmedabad



# Facts about Fraud

---



- As per ACFE survey 5% of Global Revenue is lost to Fraud
- Fraud is always intentional and deliberate
- Fraud is hidden
- Efforts are put to hide Frauds in almost all cases

# Forensic Audit

---

- A methodology for resolving fraud allegations from inception to disposition, including obtaining evidence, interviewing, writing reports and testifying.
- Requires that all fraud allegations be handled in a uniform, legal fashion and that they be resolved in a timely manner.
- Specific steps are employed in a logical progression designed to narrow the focus of the inquiry from the general to the specific, eventually centering on a conclusion.



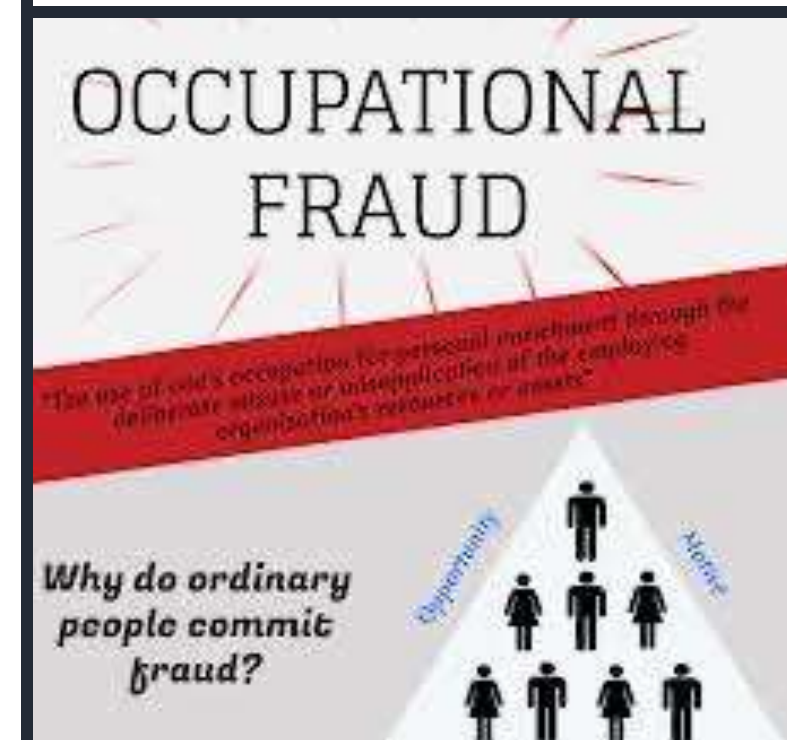
## Corporate Frauds

Occupational Frauds –

As per the ACFE

“The use of one’s **occupation** for personal enrichment through the deliberate misuse or misapplication of the organization's resources or assets.”

© - Durgesh Pandey - DKMS & Associates, Ahmedabad



# Lateral Thinking

---



A sundial has the fewest moving parts of any timepiece. Which has the most?

# Sundial VS Hourglass

---





# Critical Thinking Exercise



- *Anthony and Cleopatra are lying dead on the floor in a villa.*
- *Nearby on the floor is a broken bowl.*
- *There is no mark on either of their bodies. They were not poisoned.*



*Cleopatra*

- *With this information, determine how did they die ?*

~~~~~

- *Trouble with Sons*
- *A woman had two sons who were born on the same hour of the same day of same month of the same year. But they were not twins, and they were not adopted. How could this be so?*

# Critical Thinking Exercise



- This exercise requires the problem solver to guard against jumping to conclusions.
- Fraud examiner or forensic accountant needs to think critically
- Direction of the investigation is often guided by assumptions.
- The difficult challenge is not the questioning of assumptions that investigators had identified as assumptions; but the questioning of the assumptions that investigators are making without realizing that they have made them.
- It is important that investigators continually challenge their investigative approach and outcomes to ensure that the investigation is moving toward a resolution—one that stands up to the scrutiny of others.

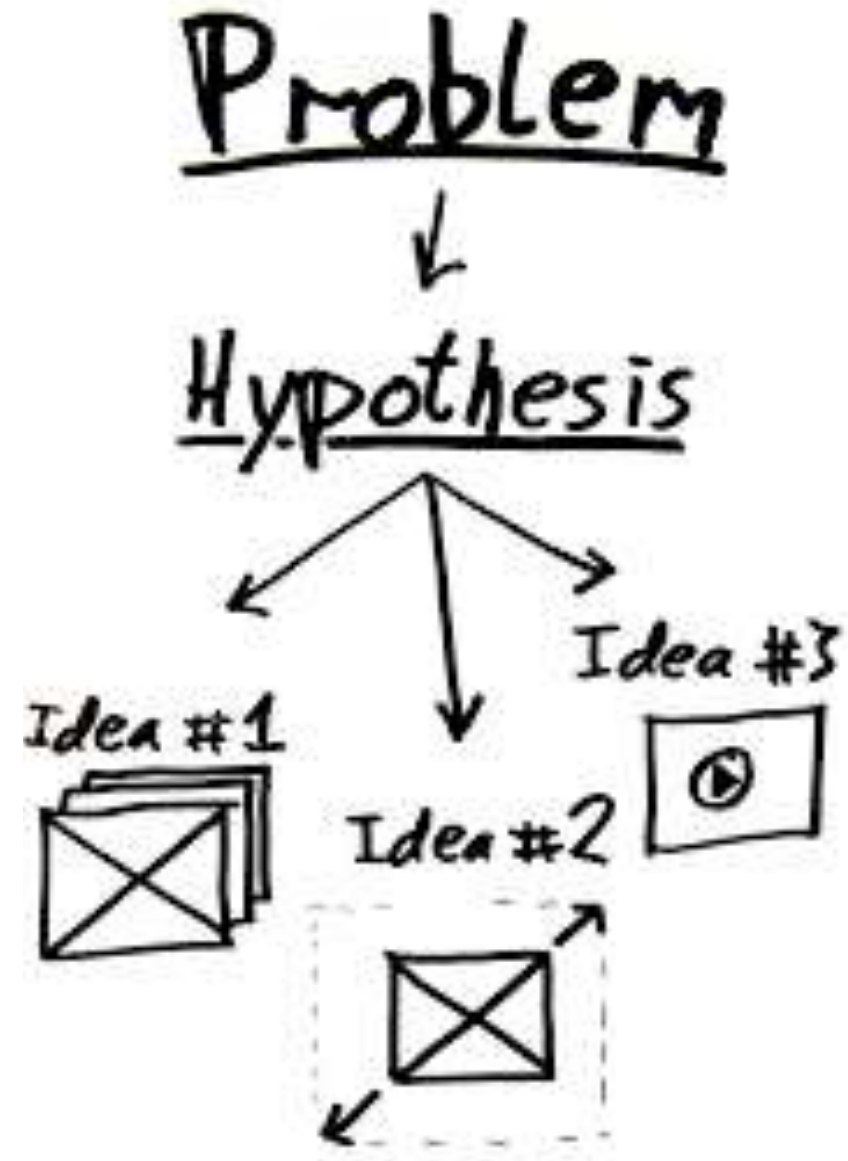


*Cleopatra*



# Investigation – Hypothesis Development

- A hypothesis based on the case must be created
- Alternative Hypothesis should also be developed
- All the Hypothesis are tested one by one
- Evidence is to be collected based on the analysis
- Report is to be strictly based on Results of Hypothesis
- Personal prejudices should not find place in fraud examination



# The Investigation

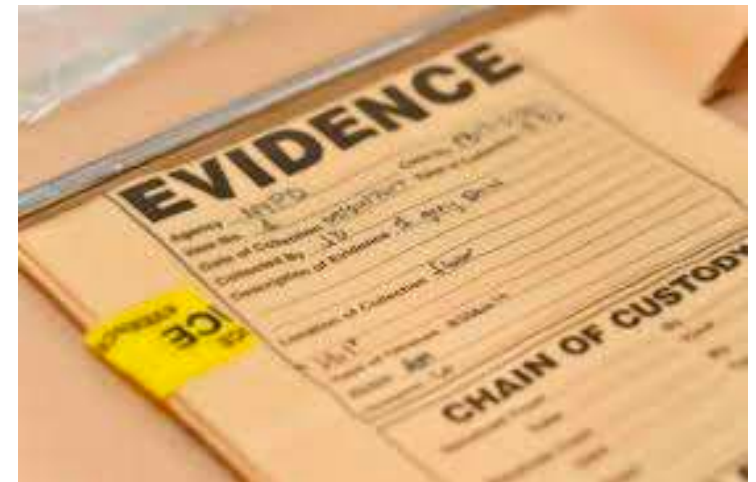


- The Case Story-line:
  - Who?
  - What?
  - Where?
  - When?
  - How?
  - And (possibly) why?

Supported by evidence

# Evidence

- Evidence is
  - anything perceivable by the five senses and
  - any proof such as testimony of witnesses, records, documents, facts, data or tangible objects
  - legally presented at trial
  - to prove a contention and induce a belief in the minds of a judges
- Evidence must address who, what, when, where, how and (possibly) why?
- Successful investigators based their conclusions and the results of their investigations on evidence.



# The Investigation

- Essential investigative tools:
  - The examination of financial statements, books and records, and supporting documents
  - The interview: the process of obtaining relevant information about the matter from those with knowledge



# Case 1 – Procurement Fraud Hospital

- Large Tertiary Care Hospital
- Govt Funding to the tune of ₹200Cr+
- Change in Management was trigger for calling of Forensic Investigation
- Mandate to Audit entire procurement process for past three years
- Alleged that due purchase process was not followed, and favor was extended to few vendors



# Hospital Investigation

- Development of Hypotheses
  - Fraud was committed by favoring few vendors.
- Based on volume and risk it was decided to verify only major items constituting about 20% of volume and 80% of value.
- Care was taken to include all contracts and transactions in those selected items in 20% volume range





# Hospital Investigation

- Perusal of Procurement policy was done prior to investigation
- Detailed records of all RFQ and Tender Invited during the Audit period was called for
- Minutes of meeting and criteria of tenders' restriction was checked
- Process of Bidding was checked for outlier and anomalies
  - Bid Tailoring
  - Bid Specification
- Evaluation of L1 and Tender awardees





# Hospital Investigation

---



- Whether any tender condition was diluted or dispensed/not complied
- Whether sanctity of time and confidentiality was followed
- Difference of in amount of quote between L1 and L2
- Based on this high-risk vendors were selected for further investigation

# Hospital Investigation

---



## Vendor Evaluation

- History of vendor with specific focus on date of incorporation
- Proportion of sale to Hospital to Total Sale of Vendor
- Cross Reference of Vendor address with address of Employees
- Field Verification of Vendor office to check whether the size justifies the volume
- Reference check on such vendors in open market
- Sending enquiries for similar products
- Details whether they have customers other than Hospital
- Volume of sale to such customers

# Hospital Investigation

---



## Employee Investigation

- Internal Control at the procurement level
- Principal of Segregation of duties at Procurement Level
- Behavioral profile of the procurement officer
- Relation between Employee and Vendor (L1 and L2 specifically)
- Social Profile of the Employee
- Verification of Lifestyle of the Employee

# Hospital Investigation

- Findings and Conclusions
  - Favors were extended to few vendors
  - One Vendor company was directly connected to an employee in the Hospital though employee not in procurement department
  - Few Vendor Companies incorporated around the date of Tender
  - Hospital was sole buyer for one Vendor company
  - Few Companies had home offices which did not justify the size and volume of sale
  - Lavish lifestyle of the employee
  - Too close vendor –employee relationship



# Hospital Investigation

- Quantified Fraud Found to the tune of ₹12Cr.
- Hospital sent employees on compulsory leave pending enquiry
- Complaint to law enforcement officers was made
- Vendors were blacklisted
- Stringent and Robust procurement policy was implemented a fresh



## Case 2– Investigative Audit (Stock Reco. for EPC contractor)

- EPC Contractor getting MIS information from site office that there was significant savings in project.
- Savings is for all principal item like Cement, Steel and Sand.
- Savings refers to difference between theoretical consumption of material compared with actual consumption on site.
- Staff at Site including project manager was insisting upon declaration of generous bonus based on savings in the Project
- EPC Contractor's HO orders Investigative Audit



## EPC Contractor - Investigation



- Understanding the client's business is the key to success in such Audits
- Efforts should be made to prepare the detailed process flowchart for mapping of all the activities
- Based on the identified activities, resource can be deployed, and manpower mapping done based on skill set available with Auditor.



## EPC Contract Investigation

- Linear measurement of steel is taken
- Based on weight of cross section of similar material, weight of entire material was extrapolated
- Relation between physical quantity of stock, its measurement and weight was understood by Audit team
- Value derived was value of stock on date of Audit. Further actual consumption was derived with help of measurement book.
- Theory of impossibility was used to explain that there cannot be savings of all three-principle item (Sand, Steel and Cement)



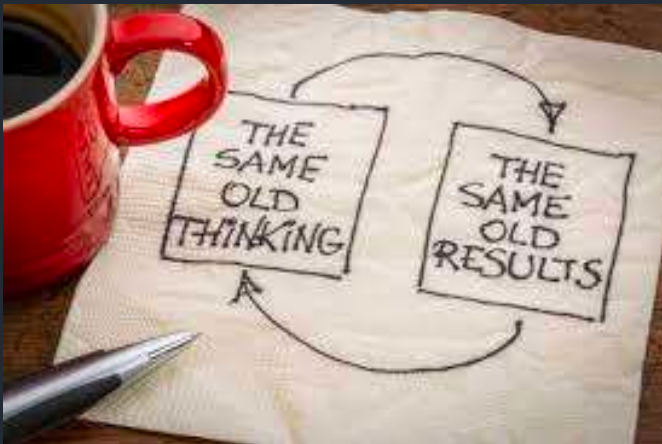
## EPC Contract - Investigation

- At the best it is replacement of high cost cement with low cost sand so essentially sand consumption should increase instead of savings for low cost item
- As scope of Investigation was from beginning of the project, no opening stock existed so essentially Actual Consumption = Total Purchase – Closing stock.
- Actual Consumption compared with consumption figure from measurement book and theoretical consumption.
- As there was difference between measurement book and Actual consumption, measurement book was ignored for further calculation.

| Description<br>Item | No | Length<br>(L)<br>m | Breadth<br>(B)<br>m | Depth/<br>Height<br>(D/H)m | Quantity |
|---------------------|----|--------------------|---------------------|----------------------------|----------|
|                     |    |                    |                     |                            |          |

## EPC Contractor - Investigation

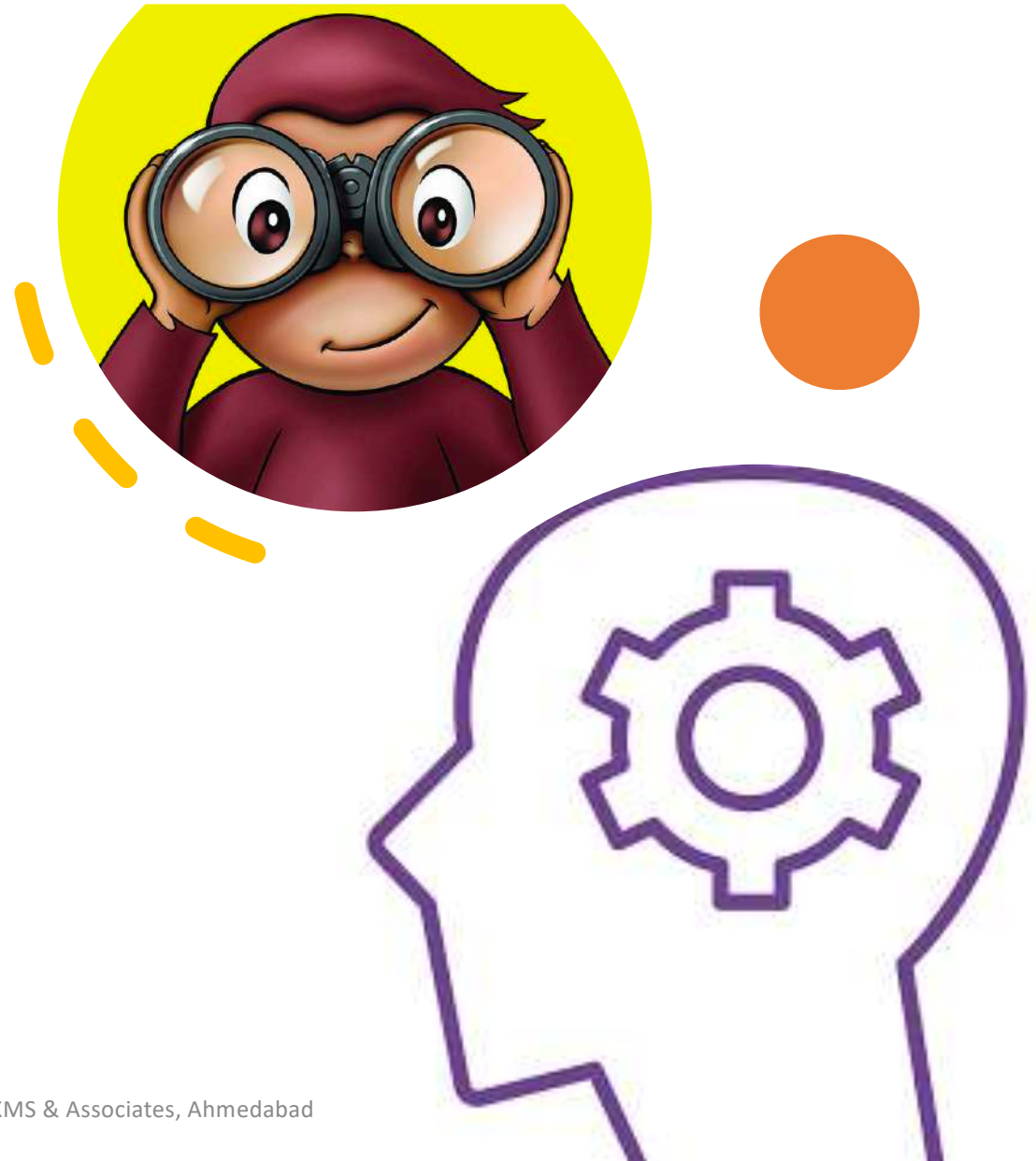
- There was savings in Cement though not to the extent claimed and presented by site office in its MIS reports
- There was excess consumption of Sand instead of savings
- Though there was very small savings in steel.
- However due wastage of steel, which was not part of measurement book, it gave false report of savings of steel. Instead there was excess consumption of steel when compared with quantity bought.
- Total savings as presented by the Site office was reduced by 109% due to above adjustments. So essentially there was wastage rather than saving



When conviction and determination prevent us from exploring alternative options, we limit our potential for thinking critically.

Education is the kindling of a flame, not the filling of a vessel.”  
— **Socrates**

I have no special Talent, I am passionately Curious  
— **Albert Einstein**





Feel Free to contact  
durgesh@dkms.co.in  
+91 98240 16129



# Need for Forensic Audit

## Sec 43

- To Identify Preferential transactions and transactions defrauding Creditors

## Sec 66

- To identify Fraudulent and Wrongful Trading

## Sec 29(1)

- To improve the authenticity of Information Memorandum

## Sec 45

- To Identify Undervalued / Overvalued transactions through related/other entities

## Sec 50

- To identify Extortionate transactions executed by the Promoter to benefit themselves/ relatives/ other parties



## Relevant Provision of IBC related to Forensic Audit

| Sections of the Code | Subject Matter            | Approach                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          |
|----------------------|---------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Sections 43 & 44     | Preferential transactions | <ul style="list-style-type: none"> <li>• Analysis of nature of related party transactions and their impact on the financial statements</li> <li>• Verification whether payments / receipts have been done in accordance with the transaction</li> <li>• Impact of any offset journal entries that may have been passed and its impact</li> <li>• Investigation of preferential transactions (not at arms length) between entities that have taken place in the following manner:               <ul style="list-style-type: none"> <li>■ In case of related parties – two years prior to the date of insolvency</li> <li>■ In any other case – one year prior to the date of insolvency</li> </ul> </li> <li>• Examination of transfer of property / assets/ interest to the benefit of a particular creditor / beneficiary in the presence of an existing debt/ liability such that the creditor is in a beneficial position at the time of distribution of assets</li> <li>• Genuineness of the nature of funds / loans given / received from parties</li> <li>• Authenticity of the claims made by related party creditors</li> <li>• Supporting the legal team in making applications to the Adjudicating Authority</li> </ul> |
| Sections 45 to 49    | Undervalued Transactions  | <ul style="list-style-type: none"> <li>• Evaluation of transactions that have occurred which are significantly less than the value of consideration.</li> <li>• Benchmarking such transactions carried out by the company with peer companies (similar industry) to comment on whether they were carried out at arm's length</li> <li>• Review of transfer pricing orders</li> <li>• Quantification and nature of such transactions</li> <li>• Supporting the legal team in making applications to the Adjudicating Authority</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          |

## Relevant Provision of IBC related to Forensic Audit

| Sections of the Code | Subject Matter                    | Approach                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |
|----------------------|-----------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Section 50           | Extortionate credit transactions  | <ul style="list-style-type: none"> <li>• Ascertaining the nature of receipts of any financial or operational debt during the period within two years preceding the insolvency commencement date</li> <li>• Terms &amp; conditions of such debt (interest rate, repayment terms, security interest etc.)and determine if the same is exorbitant in nature</li> <li>• Whether the parties who provided the loan are genuine parties or are in effect related parties?</li> </ul> |
| Section 66           | Fraudulent and wrongful trading   | <ul style="list-style-type: none"> <li>• Observation of any apparent fraudulent activity by analyzing the financial statements and other supporting documentation</li> <li>• Identification of areas where fraudulent transactions may have occurred</li> <li>• Analyzing additional data based on the findings</li> </ul>                                                                                                                                                     |
| Section 68           | Concealment of Property           | <ul style="list-style-type: none"> <li>• Obtaining any evidence / information of concealment of any property in the books of the Corporate Debtor, by any officer.</li> <li>• Investigation of any fraudulent activity by any officer (e.g. by making false entries into the books of accounts, manipulation, alteration of accounts, etc.)</li> </ul>                                                                                                                         |
| Section 69           | Transactions defrauding creditors | <ul style="list-style-type: none"> <li>• Evaluating transfer of any gift / charge conspired in execution of an order against the property of the corporate debtor.</li> <li>• Concealment or removal of any part of property of corporate debtor without any satisfactory order for payment of money received against the corporate debtor.</li> </ul>                                                                                                                         |
| Section 72           | Wilful and material omissions     | <ul style="list-style-type: none"> <li>• Ascertaining that there is no omission of any wilful and material information relating to the affairs of the corporate debtor.</li> </ul>                                                                                                                                                                                                                                                                                             |

## Relevant Provision of IBC related to Forensic Audit

| Sections of the Code | Subject Matter         | Approach                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
|----------------------|------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Sec 71               | Falsification of Books | <ul style="list-style-type: none"> <li>• Verification that there is no destruction, mutilation, alteration or falsification any books, papers or securities, or making fraudulent entry in any register, books of account or document belonging to the corporate debtor with intent to defraud any person.</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
| Other Aspects        |                        | <ul style="list-style-type: none"> <li>• Detailed analysis of annual financial trends of the company and comment on probable suspicious areas of manipulation, if any</li> <li>• Excessive provisioning / write offs / losses which are not in the ordinary course of business and are unusual in nature</li> <li>• Background check of major customers and vendors of the company to establish if they are the front companies of the promoter</li> <li>• Non-recurring expenditure incurred by the company</li> <li>• Evaluating whether revenue is booked as per the applicable GAAP</li> <li>• Non-moving creditors &amp; debtors</li> <li>• Analytical review of international subsidiaries and associate companies</li> <li>• Exceptional items to the statement of profit and loss</li> </ul> |

# Role of Forensic Auditor in Insolvency

- 
1. Review of Claims
  2. Review of specific transactions
  3. Asset Tracing
  4. Due diligence of Resolution Applicants
  5. Evaluate Insolvency Resolution plan
  6. Evaluate Resolution/ Liquidation

# Review of Specific Transaction

---

## Preferential Transactions (Sec-43)

- Data analytics, review of transactions to identify potential preferential transactions and quantify the financial impact.

## Undervalued Transactions (Sec-45)

- Identify potential undervalued transactions and independent assessment of comparative prices/value.

## Extortionate Credit Transactions (Sec-50)

- Forensic review of banking facilities to identify potential extortionate credit transactions and quantify the financial impact.

## Fraudulent or Wrongful Trading (Sec-66)

- Identify fraudulent transactions through forensic review of books of accounts to determine diversion or siphoning of funds.



# Look Back Period

- Lookback period of one year in case of transaction u/s 43-50 (Except Sec 49)
- Enhanced Lookback period of 2 years in case transaction entered with a related party
- In case the transaction is fraudulent, there is no limitation as to lookback period because essentially the transaction was entered with mala fide intent.
- Care must be taken for invoking Sec 49, as burden of proof is higher in criminal law when compared to civil law. (Fraudulent intent to be proved under criminal Law).

