



## CHAPTER AT A GLANCE

### Introduction

In general, Forensic Audit represents an area of finance that combines detective skills and financial acuity. The forensic audit professionals dig deep into financial reports, locate financial transactions and figure out what really happened at various companies and who is the real culprit behind any fraud which has taken place in the company.

They cover areas such as:

1. Frauds Finding,
2. Fraud detection and prevention techniques;
3. Fraud related auditing;
4. Investigation and analysis of financial evidence;
5. Development of computerized applications to assist in the analysis and presentation of financial evidence;
6. Communication of findings in the form of reports, exhibits and collections of documents; and
7. Assistance in legal proceedings, including testifying in court as expert witness and preparing visual aids to support trial evidence, etc

### What is Fraud

'Fraud', in general, refers to a wrongful or criminal deception practiced which is intended to result in financial or personal gain to oneself and a financial or personal loss to the other. As per Business Dictionary, 'Fraud' is an act or course of deception, an intentional concealment, omission, or perversion of truth, to:

- (1) Gain unlawful or unfair advantage,
- (2) Induce another to part with some valuable item or surrender a legal right, or
- (3) Inflict injury in some manner.

'Wilful fraud' is a criminal offence which calls for severe penalties, and its prosecution and punishment (like that of a murder) is not bound by the statute of limitation.

### ELEMENTS OF FRAUD

1. False and Wilful representation or Assertion.
2. Perpetrator of Representation.
3. Intention to deceive.
4. Representation must relate to a fact.
5. Active concealment of facts.
6. Promise made without intention of performing it.
7. Representation must have actually deceived the other party.
8. Any other act fitted to deceive.

9. Any such Act or omission that the law specially declares as void.  
 10. Wrongful Loss and Wrongful Gain is Immaterial.

#### **Forensic Audit: Meaning and Significance**

As, it has been thoroughly laid down in the previous discussion that fraud is a termite to growth, development and prosperity, in general, and to the progression of the corporates and economy, in specific. And therefore, the Government is quite dynamic in regulating and preventing the practices of fraud as well as any likelihood of fraud from Indian economy. In addition, with various laws constituting civil as well as criminal liability for the accused, it is important that fraud should be detected at the first instance and further accused should be penalized with the appropriate punishment in order to introduce the element of deterrence for the anticipated frausters, while preventing them from playing any fraud in future.

#### **Meaning of Audit**

Audit, in general, refers to the examination or inspection of various books of accounts by an auditor followed by physical checking of inventory to make sure that all departments are following documented system of recording transactions. It is done to ascertain the accuracy of financial statements provided by the organization.

Audit can be done internally by employees or heads of a particular department and externally by an outside firm or an independent auditor. The idea is to check and verify the accounts by an independent authority to ensure that all books of accounts are made in a fair manner and there is no misrepresentation or fraud that is being conducted.

#### **Meaning of Forensic Audit**

Forensic audit is, in general, referred to as an examination of evidence regarding an assertion to determine its correspondence to established criteria carried out in a manner suitable to the court.

As per the definition given in Investopedia, Forensic Audit is an examination and evaluation of a firm's or individual's financial information for use as evidence in court. A Forensic Audit can be conducted in order to prosecute a party for fraud, embezzlement or other financial claims. In addition, an audit may be conducted to determine negligence or even to determine how much spousal or child support an individual will have to pay.

#### **Significance of Forensic Audit**

A Ready Reference to the Significance of Forensic Audit could be rationalized as below:

- In general, forensic auditing, which is described as a specialized field of accountancy investigates fraud and analyses financial information to be used in legal proceedings.
- In Forensic Audit, a systematic and independent examination of books, accounts, statutory records, documents and vouchers of an organization is held to ascertain fraud or probability of fraud.
- Much beyond the official documents of the company, the Forensic audit involves lot of

field work, trying to talk to multiple stake holders to gather information and then look for evidence to corroborate it and a like.

- It also attempts to identify or to corroborate the culprit behind the fraud.
- It arranges and collects the evidences of the fraud and the person accused of fraud.
- The collected evidences and reviewed facts are used in the legal proceedings which assist the court in granting punishment to the real accused of the fraud.
- Forensic auditing uses accounting, auditing, and investigative skills to conduct investigations into theft and fraud. It encompasses both Litigation Support and Investigative Accounting.

#### **Key Advantages**

1. Detection and Responsibility of Corruption.
2. Detection of Asset Misappropriation.
3. Detection of Financial Statement Fraud.
4. Fraud Identification and Prevention.
5. Making Sound Investment Decisions.
6. Formulation of Economic Policies.
7. Rewarding Career Opportunity.

#### **Forensic Audit vis-à-vis Audit**

Major difference between Audit and Forensic Audit is discussed as below 26 :

- Objective of financial auditing is to express opinion as to 'true & fair' presentation. Forensic Audit determines correctness of the accounts or whether any fraud has actually taken place.
- Techniques used in the financial auditing are more of 'Substantive' and 'compliance' procedures. The techniques used in the forensic auditing are analysis of past trend and substantive or 'in depth' checking of selected transactions.
- Normally all transactions for the particular accounting period are covered under the financial audits. Forensic audits don't face any such limitations. Forensic auditors may be appointed to examine the accounts from the beginning.
- For ascertaining the accuracy of the current assets and the liabilities financial auditor relies on the management certificate or representation of management. Forensic auditors are required to carry out the independent verification of suspected or selected items.
- Whenever the financial auditor has adverse findings, then the auditor expresses the qualified opinion, with/without quantification. In case of the adverse findings, the forensic auditors are required to quantify the damages to the clients and is also supposed to point the culprit. Many a times, Legal action will be sought.

## Practical Questions

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**2019 - Dec [6]** (a) Raj & Company has been dealing with reputed company's TVs. They are the agents of many company's TVs. They offer instalment systems payments which attracts customers and their turnover has been improving. They have a spacious office where TVs are displayed which naturally tempts the customers to visit and buy. Adjacent to their office they have taken a warehouse to keep stock of TVs received from companies and would draw stocks from the warehouse as and when required. They maintain necessary records like goods received report, sales register and stock statement on daily basis. They have the system of maintaining parallel stock ledger at the office also. There was an outbreak of fire in the warehouse and stocks and records have been completely destroyed. Raj & Company preferred their claim with the underwriters for ₹15 lakh being the cost of 50 TVs, which seems to be very high according to Insurance Company.

Insurance Company is of the view that the claim requires to be probed before accepting. They doubt that there is a possibility of manipulation in the claim.

If you are appointed as Forensic Auditor

- (i) What investigation would you follow to detect the genuineness of the claim? (4 marks)
- (ii) Highlight the important differences between audit and forensic audit.

(4 marks)

TOPIC NOT YET ASKED BUT EQUALLY IMPORTANT FOR THE EXAMINATION

## SHORT NOTES

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**Q1.** Write Short note on fraud.

**Answer:**

'Fraud', in general, refers to a wrongful or criminal deception practiced which is intended to result in financial or personal gain to oneself and a financial or personal loss to the other. As per Business Dictionary, 'Fraud' is an act or course of deception, an intentional concealment, omission, or perversion of truth, to:

1. Gain unlawful or unfair advantage,
2. Induce another to part with some valuable item or surrender a legal right, or
3. Inflict injury in some manner.

'Wilful fraud' is a criminal offence which calls for severe penalties, and its prosecution and punishment (like that of a murder) is not bound by the statute of limitation.

In law, fraud is a deliberate deception to secure unfair or unlawful gain, or to deprive a victim of a legal right.

Fraud can also be a civil wrong (i.e., a fraud victim may sue the fraud perpetrator to avoid the fraud or recover monetary compensation), a criminal wrong (i.e., a fraud perpetrator may be prosecuted and imprisoned by governmental authorities) or it may cause no loss of money, property or legal right but still be an element of another civil or criminal wrong.

The ultimate object of practising fraud may be some monetary gain or other benefit, such as, obtaining a passport or travel document, driver's license or qualifying for a mortgage by way of false statements.

As per Black Law Dictionary, 'Fraud' refers to 'All multifarious means which human ingenuity can devise, and which are resorted to by one individual to get an advantage over another by false suggestions or suppression of the truth. It includes all surprises, tricks, cunning or dissembling, and any unfair way which another is cheated.

'Fraud' is most commonly practiced in the acts of buying or selling of property, including real estate, personal property, and intangible property, such as, stocks, bonds, and copyrights. Indian law under various statutes criminalizes fraud, but not all cases graduate to the level of criminality. Prosecutors also have discretion in determining which case to pursue and which not. Victims may also seek redress in civil court, provided that the fraud conducted does not affect the society at large.

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**Q2.** Write short note on Audit.

**Answer:**

**Meaning of Audit:**

Audit, in general, refers to the examination or inspection of various books of accounts by an auditor followed by physical checking of inventory to make sure that all departments are following documented system of recording transactions. It is done to ascertain the accuracy of financial statements provided by the organization. Audit can be done internally by employees or heads of a particular department and externally by an outside firm or an independent auditor. The idea is to check and verify the accounts by an independent authority to ensure that all books of accounts are made in a fair manner and there is no misrepresentation or fraud that is being conducted.

**Audit : An Adhering Significance:**

The word audit is derived from a Latin word "audire" which means "to hear".

During the medieval times when manual book-keeping was prevalent, auditors in Britain used to hear the accounts read out for them and checked that the organization's personnel were not negligent or fraudulent.

Any subject matter may be audited. Auditing is a safeguard measure not only in medieval times, rather it is in existence since ancient times.

As per the description referred by Loeb and Shamoo, Audit provides third party assurance to various stakeholders that the subject matter is free from material misstatement. The term is most frequently applied to audits of the

financial information relating to a legal person. Other areas which are commonly audited include, secretarial & compliance audit, internal controls, quality management, project management, water management, and energy conservation.

In view of Audits' imperative value for detecting the fraud and ensuing financial health of the corporate, auditing has become such a ubiquitous phenomenon in the corporate and the public sector that professionals started to specialize the process of auditing, wherein forensic audit is also one specialized branch of audit having specific objectives in operation.

During the Audit, the auditor perceives and recognizes the propositions before them for examination, obtains evidence, evaluates the same and formulates an opinion on the basis of his judgment which is communicated through their audit report.

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### **DISTINGUISH BETWEEN**

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**Q3.** Write down the similarities and differences between Audit and Forensic Audit.

**Answer:**

**Forensic Audit vis-a-vis Audit:**

**Major difference between Audit and Forensic Audit is discussed as below:**

- Objective of financial auditing is to express opinion as to 'true & fair' presentation. Forensic Audit determines correctness of the accounts or whether any fraud has actually taken place.
- Techniques used in the financial auditing are more of 'Substantive' and 'compliance' procedures. The techniques used in the forensic auditing are analysis of past trend and substantive or 'in depth' checking of selected transactions.
- Normally all transactions for the particular accounting period are covered under the financial audits. Forensic audits don't face any such limitations. Forensic auditors may be appointed to examine the accounts from the beginning.
- For ascertaining the accuracy of the current assets and the liabilities financial auditor relies on the management certificate or representation of management. Forensic auditors are required to carry out the independent verification of suspected or selected items.

- Whenever the financial auditor has adverse findings, then the auditor expresses the qualified opinion, with/without quantification. In case of the adverse findings, the forensic auditors are required to quantify the damages to the clients and is also supposed to point the culprit. Many a times, Legal action will be sought.

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## DESCRIPTIVE QUESTIONS

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**Q4.** Write a note explaining Meaning and Definition under the Companies Act, 2013 as well as Criminal Procedure Code, 1973.

**Answer:**

**Meaning and Definition under Companies Act, 2013:**

Explanation of Section 447 of Companies Act 2013 defines Fraud and related terms as below:

- (i) 'Fraud' in relation to affairs of a company or anybody corporate, includes any act, omission, concealment of any fact or abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss;
- (ii) 'Wrongful gain' means the gain by unlawful means of property to which the person gaining is not legally entitled;
- (iii) 'Wrongful loss' means the loss by unlawful means of property to which the person losing is legally entitled.

In the context of this definition, it could be said that Corporate Fraud is a Fraud in relation to affairs of a company or any corporate body as defined in the explanations of Section 447 of Companies Act 2013, which 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.



**Meaning and Definition under Criminal Procedure Code, 1973:**

The Code of Criminal Procedure, 1973 is the procedural law providing the machinery for punishment of offenders under substantive criminal law. The Code contains elaborate details/provisions regarding the procedure to be followed in every investigation, inquiry and trial, for every offence under the IPC or any other criminal law. In general, the Code does not provide for the definition of various terms rather it only describes certain limited terms like Complaint, Cognizable Offence, Warrant Case and alike, which helps in the interpretation of the Code. For rest of the terms, section 2(y) of Code says that "words and expressions used herein and not defined but defined in the Indian Penal Code (45 of 1860) have the meanings respectively assigned to them in that Code." Therefore, to understand the meaning of 'Fraud' in the sphere of criminal law, one has to take recourse of Indian Penal Code, 1860.

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**Q5.** What do you mean by Forensic Audit? Discuss its need and significance in detail.

**Answer:**

**Meaning of Forensic Audit:**

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As per the definition given in Investopedia, Forensic Audit is an examination and evaluation of a firm's or individual's financial information for use as evidence in court. A Forensic Audit can be conducted in order to prosecute a party for fraud, embezzlement or other financial claims. In addition, an audit may be conducted to determine negligence or even to determine how much spousal or child support an individual will have to pay.

**Significance of Forensic Audit:**

Forensic auditing has taken an important role in both private and public organizations since the dawn of the 21<sup>st</sup> century especially in the advance economies. The catastrophe of some formerly prominent public companies such as Enron and World Com (MCI Inc.) in the late 1990s, coupled with the terrorist attacks of September 11, 2001 and the recent incidence of frauds taken place in the cooperates including the one in the leading public bank of Indian economy, have fueled the prominence of forensic auditing/ accounting, creating a new, important and lucrative specialty. Forensic auditing procedures target mostly financial and operational fraud, discovery of hidden assets, and adherence to federal regulations.

A Ready Reference to the Significance of Forensic Audit could be rationalized as below:

- In general, forensic auditing, which is described as a specialized field of accountancy investigates fraud and analyses financial information to be used in legal proceedings.
- In Forensic Audit, a systematic and independent examination of books, accounts, statutory records, documents and vouchers of an organization is held to ascertain fraud or probability of fraud.

- Much beyond the official documents of the company, the Forensic audit involves lot of field work, trying to talk to multiple stake holders to gather information and then look for evidence to corroborate it and alike.
- It also attempts to identify or to corroborate the culprit behind the fraud.
- It arranges and collects the evidences of the fraud and the person accused of fraud.
- The collected evidences and reviewed facts are used in the legal proceedings which assist the court in granting punishment to the real accused of the fraud.
- Forensic auditing uses accounting, auditing, and investigative skills to conduct investigations into theft and fraud. It encompasses both Litigation Support and Investigative Accounting.

**Key Benefits of Forensic Audit:**

As we have discussed clearly that Forensic Audit is an examination of a company's financial records to derive evidence which can be used in a court of law or legal proceeding. In the contemporary times, when the Government is looking forward for a robust economy and nation building at par, financial stability is a must in the corporates. Henceforth, Forensic audit submits various recompenses in ensuring commercial health of the companies through aiding in the Prevention, Regulation and Penalization of financial frauds and scams.

**Key Advantages:**

In this context, few key benefits of Forensic Audit are listed below:

1. Detection and Responsibility of Corruption.
2. Detection of Asset Misappropriation.
3. Detection of Financial Statement Fraud
4. Fraud Identification and Prevention
5. Marking Sound Investment Decision
6. Formulation of Economic Policies
7. Rewarding Career Opportunity

**Other Advantages:**

- **Objectivity and Credibility:** An external party as a forensic auditor would be far more independent and objective than an internal auditor or company accountant who ultimately reports to management on his findings. An established firm of forensic auditors and its team would also have credibility stemming from the firm's reputation, network and track record.
- **Accounting Expertise and Industry Knowledge:** An external forensic auditor would add to the organization's investigation team with breadth and depth of experience and deep industry expertise in handling frauds of the nature encountered by the organization.
- **Provision of Valuable Manpower Resources:** An organization in the midst of reorganization and restructuring following a major fraud would hardly have the full-time resources to handle a broad-based exhaustive investigation. The forensic audit and his team of assistants would provide the much needed experienced resources, thereby freeing the organization's staff for other more immediate management demands. This

is all the more critical when the nature of the fraud calls for management to move quickly to contain the problem and when resources cannot be mobilized in time.

- **Enhanced Effectiveness and Efficiency:** This arises from the additional dimension and depth which experienced individuals in fraud investigation bring with them to focus on the issues at hand. Such individuals are specialists in rooting out fraud and would recognize transactions normally passed over by the organization's accountants or auditors.

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**Q6.** Discuss the elements of Frauds and Civil and Criminal Remedies available against it.

**Answer:**

**ELEMENTS OF FRAUD:**

**1. False and Wilful representation or Assertion:**

To constitute fraud there must be some representation or assertion, which is untrue. In the absence of representation or assertion except in the following two cases, there can be no fraud.

- Where silence may itself amount to fraud, and
- Where there is active concealment of facts

The person making the representation should not believe it to be true, otherwise he/she will not be guilty of fraud. Moreover, to constitute fraud, the false representation must have been made wilfully or intentionally.

**2. Perpetrator of Representation:** The false representation or misstatement must have been made by a party to the contract or by anyone with its connivance, or by its agent. If a stranger makes the misstatement to the contract, it cannot result in fraud.

**3. Intention to deceive:** Intention to deceive the other party is the essence of fraud. In order to commit a fraud, one person asserts or misstates the fact with the intention that it should be acted upon. As a matter of fact, misrepresentation elevates to the level of fraud when it is prefixed by the element of intention to deceive the other party.

**4. Representation must relate to a fact:** The representation made by the party must relate to a fact, which is material to the formation of the contract. A mere statement of opinion, belief, or commendation cannot be treated as fraud.

**5. Active concealment of facts:** 'Active concealment' must be distinguished from 'passive concealment'. Passive concealment implies mere silence as to material facts, which barring a few cases, does not amount to fraud. Whereas, active concealment implies 'when the party takes positive or deliberate steps to prevent information from reaching the other party and this is treated as fraud.'

**6. Promise made without intention of performing it:** If a person while entering into a contract has no intention to perform his/her promise, there is a fraud on his/her part, for the intention to deceive the other party is there from the very beginning.

7. **Representation must have actually deceived the other party:** The representation made with the intention to deceive must actually deceive. The party, induced by fraudulent statement, must have relied on it to accord its consent.
8. **Any other act fitted to deceive:** The expression 'any other act fitted to deceive' obviously means any act, which is done with the intention of committing fraud. This category includes all tricks, dissembling, and other unfair ways, which are used by cunning and clever people to cheat others.
9. **Any such Act or omission that the law specially declares as void:** This category includes the act or omission that the law specially declares to be fraudulent. For example, the Insolvency Act and the Companies Act declare certain kinds of transfers to be fraudulent. Similarly, under the Transfer of Property Act, the transferor of real estate is bound to disclose to the transferee the following details:
  - Material defects, if any, in the property such as, cracks in the wall or in beams, and/or
  - Any defect or dispute as regards transferor's title, such as property is subject to encumbrance, i.e., mortgaged or is subject to some dispute pending in a court of law. An omission to make such disclosure on the part of transferor amounts to fraud.
10. **Wrongful Loss and Wrongful Gain is Immaterial.** For the purposes of "Fraud" under the Companies Act, 2013, it is immaterial whether there has been some wrongful loss to one and/or wrong gain to another. The only important thing is intention to deceive and the act or omission actually deceiving the victim. Common corporate frauds for example are, if the CMD husband benefits from a loan transaction sanctioned by her it is a fraud. If a CEO take bribe to approve a contract that is a fraud.

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