

PREVENTING FINANCIAL FRAUD THROUGH 'FORENSIC ACCOUNTING'

There has been a surge in commercial litigations in recent times entailing greater demand of the services of forensic accountants. This article deals with different aspects of forensic accountancy and discusses as to where the Forensic Accountants may be of help.

Thrill seeking and accountancy are 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**.

“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 more simple.

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.

Forensic accountant takes a more proactive, skeptical approach in examining the books of Accounting. They make no assumption of management integrity (if they can assume so then there is no need for their appointment) show less concerns for the arithmetical accuracy have nothing to do with the Accounting or Assurance standards but are keen in exposing any possibility of fraud.

The term Forensic Accounting encompasses a wide range of activities including:

- The expert witness – preparation of formal reports for filing in Court and giving evidence as an Expert
- Litigation Consultancy – working with lawyers and their clients engaged in litigation and assisting with evidence, strategy and case preparation.
- Fraud Detection – assisting clients in detecting financial fraud by employees and others and tracing misappropriated funds.
- Computer Forensics – assisting in electronic data recovery and enforcement of IP rights etc...

General Nature of Forensic Accountancy Work

Forensic accounting (or at least, accounting expert witnessing) can be traced as far back as 1817 to a court decision. According to *The Accountant's Handbook on Fraud & Commercial Crime*, forensic accounting is defined as: *the application of financial skills and an investigative mentality to unresolved issues, conducted within the context of the rules of evidence.*

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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.

Forensic accounting is the application of a specialized knowledge and specific skills to stumble upon the evidence of economic transactions. 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.

In addition to the specialized knowledge about the techniques of finding out the frauds one needs patience and analytical mindset. One has to look beyond the numbers and grasp the substance of the situation. It is basically the work of the intelligent accountants. He needs to question seemingly benign document and look for inconsistencies. He searches for evidence of criminal conduct or assists in the determination of, or rebuttal of, claimed damages.

He requires the ability to think. Far from being an ability that is specific to success in any particular field, developing the ability to think enhances a person's chances of success in life, thus increasing a person's worth in today's society.

Sherlock Holmes was probably the most famous practitioner being the Forensic Chemist. But the *Kautilya* was the first economist who openly recognized the need of the forensic accountants. He mentioned forty ways of embezzlement centuries ago.

The Techniques in Forensic Accounting

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.

In cases involving significant amounts of data, the present day forensic accountant has technology available to obtain or source data, sort and analyze data and even quantify and stratify results through computer audit software applications and various other techniques. This enables the forensic accountant to pinpoint theft of assets for fidelity bond coverage, proof of losses for insurance or recovery through litigation, and illegal payments by corporations. Some of the techniques involved in forensic accounting are:

1. Benford's law: It is a mathematical tool and is one of the various ways to determine whether variable under study is a case of unintentional errors (mistakes) or fraud. On detecting any such phenomenon, the variable under study is subjected to a detailed scrutiny. The law states that fabricated figures possess a different pattern from random (or valid) figures. The steps of Benford'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 and calculating its observed count percentage. Then Benford's set is applied. A parametric test called the Z test is carried out to measure the significance of variance between the two populations, i.e. Benford's percentage numbers for first digit and observed percentage of first digit for a particular level of confidence. If the data confirms to the percentage of Benford's law, it means that the data is Benford's set, i.e. there is 68% chance of no error or fraud. The first digit may not always be the only relevant field. Benford has given separate sets for 2nd, 3rd, and for last digit as well. 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.

2. Theory of relative size factor: 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. In this method the records that fall outside the prescribed range are suspected of errors or fraud. These records or fields need to relate to other variables or factors in order to find the relationship, thus establishing the truth.

3. Computer Assisted Auditing tools (CAATs): CAATs are computer programs that auditor use as part of the audit procedures to process data of audit significance contained in a client's information systems, without depending on him. CAAT helps auditor to perform various auditing procedures such as:

- a) Testing details of transactions and balances
- b) Identifying inconsistencies of significant fluctuations
- c) Testing general as well as application control of computer systems
- d) Sampling programs to extract data for audit testing, and
- e) Redoing calculations performed by accounting systems

Forensic accounting software (for accounting purpose) comes into two different varieties:

- Data extraction software: It is designed to conduct spreadsheet analysis on all the company's computer database records such as billings, account receivable, payments to vendors, payroll & purchasing.
- Financial analysis software: It uses monthly, quarterly or annual financial statements and benchmarks the ratios between different accounts such as billings by revenues or supply cost as a percentage of revenue.

Other computer software that forensic accountants might use include so- called 'spy' software.

4. Data mining techniques: It is a set of computer assisted techniques designed to automatically, mine large volumes of data for new, hidden or unexpected information or patterns. Data mining techniques can be categorized in three ways:

- Discovery: It discovers the usual knowledge or patterns in data without any prior knowledge of fraud.
- Predictive modeling: In this, patterns discovered from the database are used to predict the outcome and to guess data for new value items.
- Deviation analysis: In this the norm is found first, and those items are

detected that deviate from the usual within a given threshold. Link discovery has emerged recently for detecting a suspicious pattern. It mostly uses deterministic graphical techniques, Bayesian probabilistic causal networks. This method involves "pattern matching" algorithm to 'extract' any rare or suspicious cases.

5. Ratio Analysis: Another useful fraud detection technique is the calculation of data analysis ratios. Three commonly employed ratios are-

- ✓ The ratio of the highest value to the lowest value
- ✓ The ratio of the highest value to the second highest value and
- ✓ The ratio of the current year to the previous year.

Forensic Accountants: How Different?

A Forensic Accountant is someone with a combination of skills. Beyond being a CA, a forensic accounting has auditing and investigating capabilities that are ideal for detailing the complexity of litigation involving tax and finance. A Forensic accountant can take a seemingly needle in-a-haystack pile of financial information and distill it into the important elements that need to be presented clearly and concisely as courtroom testimony.

Need for Forensic accountant:

The forensic accountants are used by attorneys in a broad range of activities from expert witness testimony to special counsel's investigation of fraud, to bolster corporate governance. Forensic accountants become involved in a wide range of investigations, spanning a myriad range of industries. These include:

- Criminal Investigations
- Shareholders and Partnership disputes
- Business Interruption/Other types of insurance claims
- Business/Employee fraud investigations
- Business economic losses

Indian Scenario:

In India the formation of Serious Fraud Investigation Office is the landmark creation for the Forensic Accountants. Growing cyber crimes, failure of regulators to track the security scams, Sathyam scandal - all are pinpointing the need of forensic accounting, irrespective of whether we understand the need or not.

In the Indian context the Forensic Accountants are the most required in the wake of the growing frauds. The law enforcement officers are the experts of analyzing the fingerprints and the Narcotics but what about the digital evidence analysis. Very few know about it.

It's a thrill of hunt. *Maurice E. Peloubet* who coined the term Forensic Accountant in 1946 said that the preparation of financial statements has some but not all of the characteristics of forensic accounting.

This statement is enough for the chartered accountants in India to foray in this field. It is new child on the block. Both CBI and CID cops do the forensic accounting work. Until recently there was no separate community in India. But now movement of India forensic community is gathering the pace.

The growing number of regulator and the administrative agencies will demand the services in the nature of forensic practice. Chartered Accountants are going to find themselves more involved in what is essentially a type of forensic practice. The changing nature of the Accounting and Auditing & assurance standards also confirms this.

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.

BPO Industry:

With such a massive growth in the industry, incidents of fraud were bound to occur and the industry has been hit by some serious fraud charges in recent years, because of which it has been under the scanner for sometime now.

BPO employees have been accused of selling personal and confidential financial information of UK citizens to those willing to pay a price. There have been instances of employees selling bank account and credit card details of customers and even sharing of personal details like phone numbers etc.

Yet the industry doesn't even have a definition as to what constitutes a fraud. As per the Indiaforensic Consultancy Service (ICS) survey, "most call centre employees would treat frauds just like any other complaint."

"Fraud means that social security numbers should not be noted but I have seen many employees noting it; even our boss notes them down sometimes, so to whom we are supposed to report the fraud," a BPO employee was quoted as saying in the survey.

Conclusion:

The importance of the 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 the future.