



# **Concept of Frauds**

## ***DFA – Module 1 :***

**Arijit Chakraborty**  
***November 07, 2021***

# Forensic Accounting vs. Fraud/ Forensic Auditing

## ***Forensic Auditor:***

An accountant especially skilled in auditing who is generally engaged in auditing with a view toward fraud discovery, documentation, and reporting.

## **Forensic Accounting**

the action of identifying, recording, settling, extracting, sorting, reporting, and verifying past financial data or other accounting activities for settling current or prospective legal disputes or using such past financial data for projecting future financial data to settle legal disputes.

# What is fraud?

1. Fraud is the ***intentional*** use of false or misleading information in an ***attempt*** to illegally deprive another person or entity of money, property, or legal rights.
2. In order to constitute fraud, the party making the false statement ***must know or believe*** that it is untrue or incorrect and intended to ***deceive*** the other party.
3. Fraud may be prosecuted as both a criminal and civil offense.
4. Criminal punishments for fraud can include a combination of prison, fines, and restitution to victims
5. **Remedies for fraud** = rescission (i.e., reversal) of a fraudulently obtained agreement or transaction, recovery of a monetary award to compensate for harm caused, punitive damages to punish or deter the misconduct

## **Fraud may involve**

- Manipulation, falsification or alteration of records or documents
- Misappropriation/misapplication of assets.
- Suppression or omission of the effects of the transaction from records and documents
- Recording of transaction without substances/material/services
- Misapplication of accounting policies
- Integrity issues
- Bribery

## **Fraud should be distinguished from error:**

### **The following actions amount to error and not fraud**

- A mistake in gathering or processing data from which financial statements are prepared.
- An incorrect accounting estimates arising from oversight or misinterpretation of facts; and
- A mistake in the application of accounting principles relating to measurement, recognition classification presentation or disclosure.

# Corruption/corrupt practice

- **Corruption** is a form of dishonesty or criminal offense or undertaken by a person or organization entrusted with a position of authority,
- to acquire illicit benefit or abuse power for one's private gain.
- Corrupt Practice means = offering, giving, receiving or soliciting, directly or indirectly, of anything of value to influence improperly the actions of another party.

# Forensic Audit – Role

- A forensic audit is an analysis and review of the financial records of a company or person to extract facts, which can be used in a court of law.
- Forensic auditing is a speciality in the accounting industry, and most major accounting firms have a department forensic auditing.
- **Forensic audits include** = the experience in accounting and auditing practices as well as expert knowledge of forensic audits & legal framework
- Forensic audits cover a large spectrum of investigative activities.
- There may be a forensic audit to prosecute a party for fraud, embezzlement or other financial crimes.
- The auditor may be called in during the process of a forensic audit to serve as an expert witness during trial proceedings.
- Forensic audits could also include situations that do not involve financial fraud, such as bankruptcy filing disputes, closures of businesses, and divorces

# REASONS FOR CONDUCTING A FORENSIC AUDIT

- Forensic audit investigations may expose, or confirm, various kinds of illegal activities.
- Normally, instead of a normal audit, a forensic audit is used if there is a possibility that the evidence gathered **would be used in court.**
- The forensic audit process is similar to a traditional financial audit - planning, gathering evidence, and writing a report - *with the additional step of a possible appearance in court.*  
The lawyers on both sides offer evidence that the crime is either discovered or disproved, which decides the harm sustained.
- They explain their conclusions to the defendant should the case go to trial before the judge.

**FORENSIC AUDIT= preventive + detective control**



## Functions of Forensic Audit Function:

A forensic audit comprises the following steps:

1. **Planning the Investigation:** The forensic auditor and the team will plan their investigation in order to meet their objectives.
2. **Collecting Evidence:** The evidence gathered should be sufficient to prove in court the identity of the fraudster(s), reveal the details of the fraud scheme and document the financial loss suffered and the parties affected by the fraud.
3. **Reporting:** A forensic audit will need a written report on the crime to be given to the client, so that if they desire, they can continue to file a legal case.
4. **Court Proceedings:** During court proceedings, the forensic investigator must be present to clarify the evidence collected and how the suspect(s) were found by the team.

## **Need of Forensic Audit:**

- i. Theft of business information/ business systems hacked - Eg Air India,
- ii. Issues identified by Whistle Blowers – eg in ICICI Bank case
- iii. Reconciliations resulted in unidentified material differences- PNB
- iv. Suspicion of fraud or illegal activity – eg ILFS case, Cox & Kings
- v. Turnover has occurred and balances are showing negative results.
- vi. Other red flags identified by business partners , funding agencies – Eg Jet Airways case
- vii . Actual occurrence of fraud – Eg Satyam

## **• Forensic Audit Procedures:**

1. Incentives-a motive that derives a person to commit fraud.
2. Attitude-an ability to rationalize the fraudulent behaviour.
3. Opportunity-that enable a person to commit fraud

# **Analytics of Bribe & corruption - Klitgaard Formula**

$$C = M + D - A$$

Where:

C – corruption

M – monopoly

D – discretion

A - accountability

# **Analytics of Bribe & corruption - World Bank Formula**

$$C = O + G - D - P$$

Where:

C – Corruption

O – Opportunity

G – Gains

D – Detection

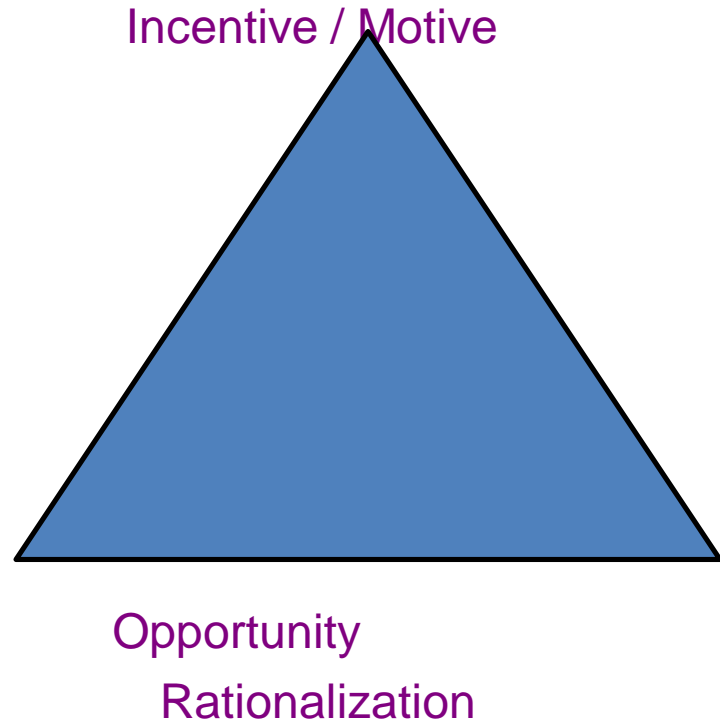
P - Penalty

# Fraud Triangle

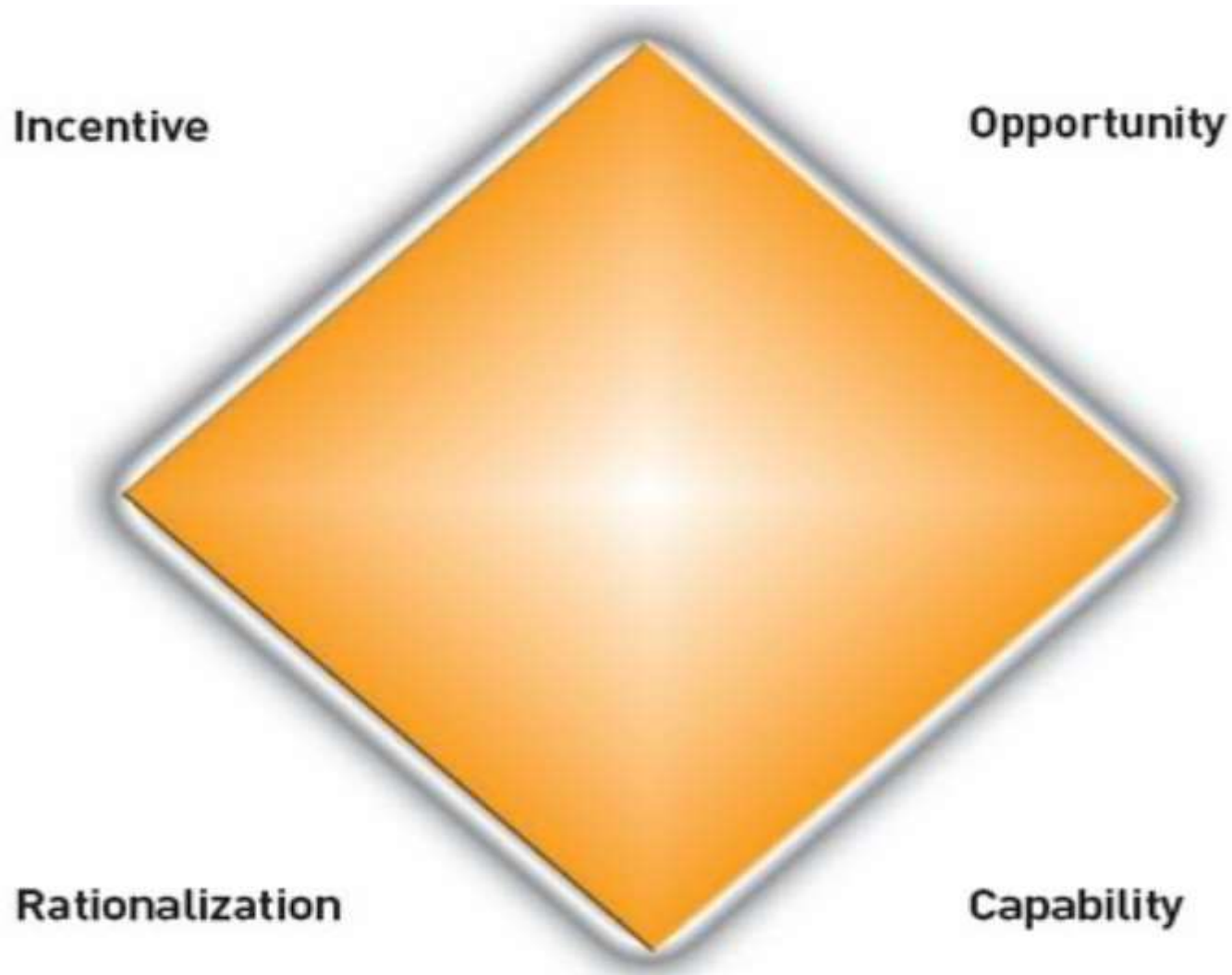
- A criminologist, **Donald R. Cressey**, coined the Fraud Triangle.
- Describes 3 main causes of fraud and corruption.
- In any organisation, 2 out of every 3 people will commit fraud if all 3 conditions are present i.e. they have pressure (incentive or motive), opportunity (absence of controls) and rationalization (justification for wrongdoing).

# The Fraud Triangle – Psychology of Fraudster

- **Motive**
- **Rationalization**
- **Opportunity**



# Fraud Diamond



# Fraudster's mental make-up

1. **Incentive:** *I want to, or have a need to, commit fraud.*
2. **Opportunity:** *There is a weakness in the system that the right person could exploit. Fraud is possible.*
3. **Rationalization:** *I have convinced myself that this fraudulent behavior is worth the risks. I also have justification, if I get caught & also to convince my conscience*
4. **Capability:** *I have the necessary traits and abilities to be the right person to pull it off. I have recognized this particular fraud opportunity and can turn it into reality.*