



Forensic Audit: Substitute or Supplement to Audit

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Forensic audit in recent news



Nov 28, 2017 06:38 PM IST | Source: PTI

SEBI orders forensic audit of [REDACTED]

Markets regulator SEBI has ordered a forensic audit of [REDACTED], which figures among 331 suspected shell companies, after finding prima facie evidence of misrepresentation of financials by the firm.

Corporate insolvency: Forensic audit needed on promoters bidding for stressed assets

Nov 22, 2017 08:05 AM IST | Source: PTI

SEBI orders forensic audit against two companies

SEBI on Tuesday ordered forensic audits against [REDACTED] and [REDACTED] Industries Ltd to check possible misuse of funds even as the regulator lifted trading curbs imposed on them.

2,500 [REDACTED] homebuyers file application in SC seeking forensic audit of accounts of [REDACTED]

Specialists to conduct forensic audit of shell companies, says BSE chief

Now, [REDACTED] accounts to undergo forensic audit

Police say the forensic audit will help establish a clear connect with the fund trail.

Source: Various internet sites

IRPs initiate fresh forensic audit of [REDACTED] accounts

Interim resolution professionals (IRPs) have ordered fresh audits of [REDACTED] amid tighter scrutiny regarding clearance of turnaround plans

IPs do forensic audits to track bidders' agenda

By Saloni Shukla, Sachin Dave, ET Bureau | Updated: Nov 14, 2017, 09:29 AM IST

Mumbai: Facing tightening scrutiny and fearing litigation, insolvency professionals are conducting forensic audits — mainly a detailed background check — on bidders for stressed companies.

Nov 15, 2017 03:12 PM IST | Source: Moneycontrol.com

[REDACTED] submits forensic audit report on co-location case

[REDACTED] forex case: FinMin appoints EY for forensic audit

Auditors: Watchdog or Bloodhound?



1896

"Auditor is watch dog and not a bloodhound". Further, "An Auditor is not bound to be a detective, or, to approach his work with suspicion.. He is justified in believing tried servants of the company.." Lord Justice Lopes in Kingston Cotton Mills Case, 1896

Emerging Regulatory expectations in India

2002

RBI issues circular requiring an auditor performing internal, external or institutional audit of a bank, to refer to RBI if he finds anything susceptible to fraud or fraudulent activity or act of excess power or smell any foul play in any transaction. Any deliberate failure to do the same would render the auditor liable to action

2009

SA 240 – Auditor's responsibilities relating to fraud in an audit of financial statements

1. Maintaining professional skepticism throughout the audit
2. Discussion within engagement team on how and where entity's financial statements may be susceptible to material misstatement due to fraud
3. Perform specific risk assessment procedures for identifying risk of material misstatement due to fraud
4. In case of material misstatement due to fraud/suspected fraud, consider withdrawing from engagement and following reporting requirements

Auditors: Watchdog or Bloodhound?



2014

Section 143(12) of Companies Act, 2013 requires that if an auditor, in course of his audit, has reason to believe that fraud of rupees one crore or above is/has been committed against the company by its officers/employees, then he shall report the same to the Central Govt. In case of fraud amount is less than a crore, auditor shall report the matter to Audit Committee or the Board.

2015

Fraud on or by the Company noticed or reported during the year, including nature and amount involved, to be reported under CARO, 2015.

2016

ICAI issues guidance note on reporting of fraud u/s 143(12) of the Companies Act, 2013 requiring Auditor to report nature of fraud, approximate amount involved and parties involved.

Regulatory expectations outside India

IIA Guidance on Fraud – 1210.A2

Internal auditors must have sufficient knowledge to evaluate the risk of fraud and the manner in which it is managed by the organization, but are not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud.

PCAOB Auditing Standard No. 5 (SOX)

The auditor should evaluate whether the company's controls sufficiently address identified risks of material misstatement due to fraud and controls intended to address the risk of management override of other controls



Stakeholder expectations

Chartered Accountants are the Financial Doctors of our Economy

Demonetisation: Govt hands 34 CA's names to ICAI for money laundering investigation

Flaws in internal audit function come to fore

Panel proposes powers to SEBI to act against audit firms

Auditor, Regulator, Rater: Can They Get Away with a Consent Plea?

TOWARDS BAD LOAN RESOLUTION

Banks should be made fraud proof by tightening internal audit, concurrent audit, legal audit and information system audit. Dedicated legal audit is very important in view of documentations fraud. Legal documents and certificates should be properly examined by banks before giving loans. Information system audit brings out the defects in transaction in core banking environment. It all depends on bank management how best they can utilise the audit mechanism to improve the banks' health.

Regulator could bar audit firm from dealing with listed companies

The Securities and Exchange Board of India (SEBI), which has time till July to pass an order against [REDACTED] in the matter related to [REDACTED] Services, could bar the auditor from dealing with listed companies for a certain period of time on charges related to alleged negligence and professional lapses while being the auditors of erstwhile IT major.

Source: Various internet sites

Audit vis-à-vis Forensic Audit



Accountancy Profession: Convergence and Sustainability in Digital Era

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Area	Audit	Forensic Audit
Objective	<ul style="list-style-type: none"> - Audit seeks to provide assurance that the records conform to GAAP - detect any material misstatements <p>Internal Audit involves thorough auditing to evaluate effectiveness of internal control policies & reviewing compliance</p>	<ul style="list-style-type: none"> - Detect frauds - Determine extent of damage - Gather evidence for use in a Court of Law
Report	Statement from the Auditor whether books are fair representation of Company's financial position	No standard format – Thorough, complete and well-documented evidence to argue results in Court, if needed
Purpose of report	To evaluate financial strength of Company	Fact-based document for use in lawsuit/litigation
Materiality threshold	Yes	No
Methods	Financial analysis, sampling, document review, Management discussion	Advanced data analysis, computer forensic review, field investigations, interviews (where required)
Documentation	Basis for auditor's conclusions, support for auditor's representation	Facts & Evidence based since likely to be used as evidence in litigation or civil proceedings

Why audits normally fail to detect even large scale/long running frauds ?



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- Perceptions about promoter/management
- Focus on form rather than substance - Methodology, checklists, materiality, etc "Relativity applies to physics, not ethics." - Albert Einstein
- Silo approach rather than comprehensive review
- Audit procedures & protocols are well known to the auditee and are predictable
- Undue reliance on internal controls without testing efficacy & presuming them to be sound
- Reliance on random sample of transactions – lack of in-depth review of those sample transactions
- Lack of time – undue focus on time line/due date
- Not familiar with/up-to-date with latest fraud scenarios



- Aggressive management attitude towards financial reporting coupled with consistent growth in results
- Operating margins significantly different than normal industry trends
- Frequent changes in key management personnel, specially, CFO
- Failure to rectify repeated weaknesses in controls reported by external/internal auditors
- Large number of related parties – as employees or as vendors
- No independent review & approval for transactions related to promoters/CEO
- Evasive or inconsistent responses to questions raised/information sought by auditors/investors/directors



- Significant acquisition activity without adequate justification
- Rapid growth or unusual profitability especially compared to that of other companies in the same industry.
- Recurring negative cash flows from operations while reporting earnings and earnings growth.
- Significant transactions with related parties or special purpose entities not in the ordinary course of business or where those entities are not audited or are audited by another firm.
- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult “substance over form” questions.
- A significant volume of sales to entities whose substance and ownership is not known.

Auditor in limelight – Shell Companies



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CA institute to take a crack at defining 'shell company'

The long wait may finally be over. The legal lacuna on shell companies may soon get filled with the CA Institute, which is the regulator of audit profession, now looking to define a "Shell Company" for the purpose of effective regulatory action against such firms.

Auditors come under lens amid crackdown on shell companies

The auditors' role is also being scrutinized into for not raising the red flag in such cases have come to the fore. The listed companies have reported a mismatch in financial statements, sharp erosion in net worth, siphoning off funds to group and promoter entities, sources said.

Professional scepticism?

Govt looks for 'actual beneficiaries' of shell firms; directors may face up to 10-year jail

The government has also identified chartered accountants, company secretaries and cost accountants associated with shell firms in certain cases.

Banks told to scan accounts of shell companies' promoters, directors

According to the latest figures released by RBI, loss incurred by banks due to frauds went up 72% to Rs 16,770 crore in 2016-17 from Rs 9,750 crore in 2012-13. A senior bank executive said banks have stepped up the vigil on such promoters and are taking steps to protect their interest.

Government Deregisters Over 2 Lakh Firms In Crackdown On Shell Companies

"Action has been initiated to restrict the operation of bank accounts of such companies."

NSE, BSE initiate audit of 100 'shell' firms

Sources said the exchanges were in the process of appointing an audit panel

Shell companies: Sebi panel to look into complaints of errors in classification

The Sebi sub-committee will help firms erroneously classified as shell companies make representations to the corporate affairs ministry for relief

Source: Various internet sites



Following is a list of illustrative red flags that may be indicative of shell companies and may be noted in the course of audit:

1. Vendor invoices are sequentially numbered
2. Date on first vendor invoice is within 90 days of incorporation date of vendor entity
3. Same phone number, address, tax registration number or email address of multiple vendors (noted either in documents or vendor master)
4. Name of the entity indicates a different nature of business than what is provided to the Company
5. Desktop/Database searches on the entity not yielding results
6. Vague description & inadequate documentation of work done by the vendor
7. Vendor financials do not have significant revenue or assets

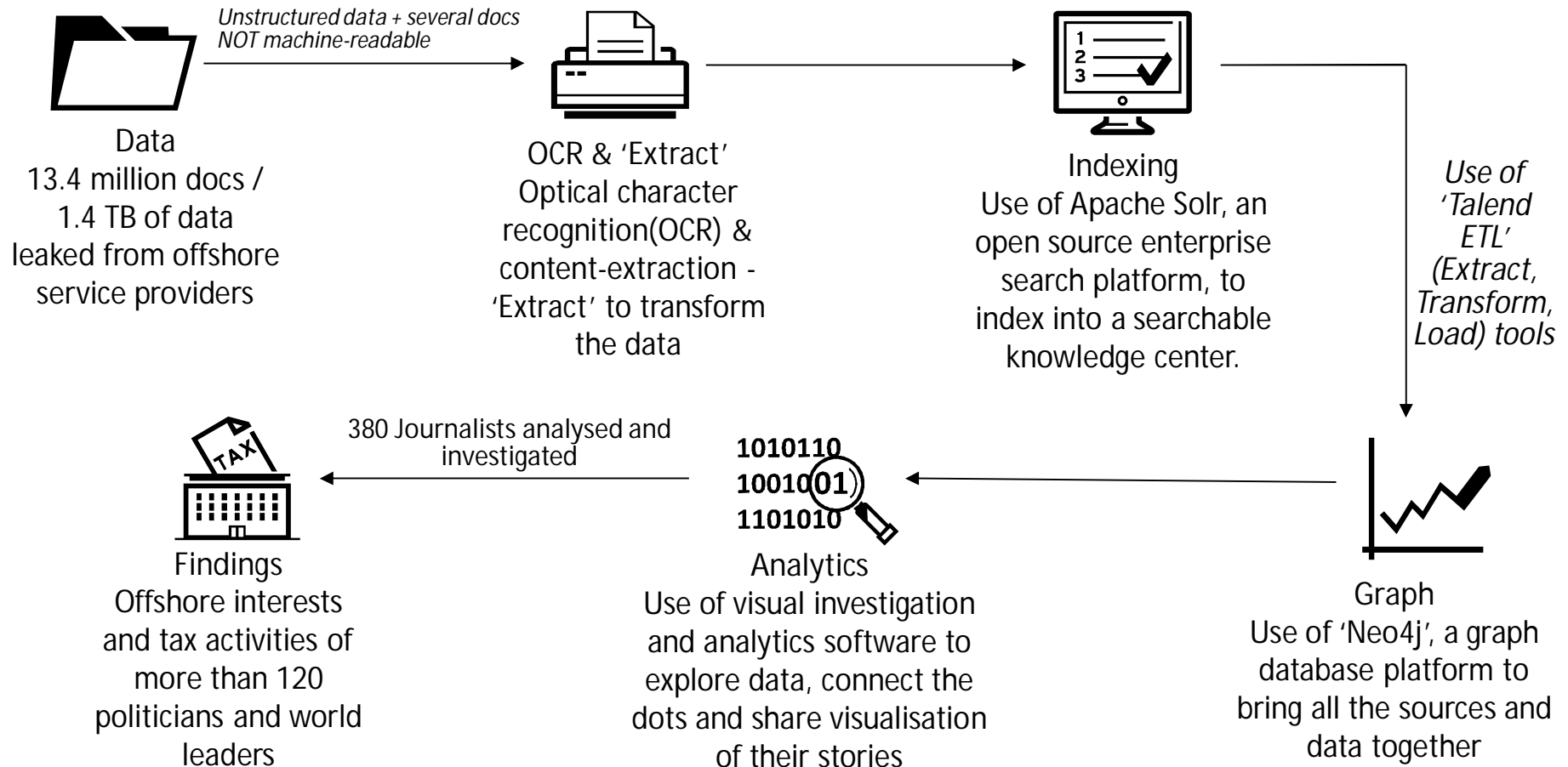
“What the mind knows, the eyes will detect”

Impact of Technology on forensic audits

Illustrative case study – Paradise Papers



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With just 20 member core team, ICIJ was able to organize an efficient and reproducible process for 380 journalists to investigate millions of documents for the Paradise Papers.

Source: <http://dataconomy.com/2017/11/big-data-technology-transforming-fraud-investigations>

Concluding remarks...



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- Risk of Fraud has increased in recent times
- Frauds are being committed in new forms and innovative methods
- There is an increase in expectations from auditors (internal/ external) for proactive detection and reporting of frauds.
- Penal provisions if an auditor is found guilty
- Auditors should acquire basic skills required for detection of frauds as part of audit procedures
- Mix things up and be unpredictable, so that no one can take advantage of your routines

"India has lost more not on account of the crookedness of the wicked, but the ignorance of wise" - Chanakya



Thank you

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