



## Forensic audit: Application of accounting, auditing and investigative skills

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### Abstract

Forensic means suitable for use in the court of law. The examinations of a company's financial records to derive evidence which can be used in a court of law is a Forensic Audit. It includes the use of accounting, auditing and Investigative skills to assist in the legal matters. These audits are highly specialised, and the work requires detailed knowledge of fraud investigation techniques and the legal framework. Forensic audit is done in two phases; first one is investigation services and another is litigation services. The audit is being conducted to tackle cases of corruption, asset misappropriation and financial statement fraud. A fraud triangle is most often used tool in forensic auditing that explains three interrelated elements that assist the commission of fraud - pressure, opportunity and rationalization. The reporting stage is the most obvious element in a forensic audit. Forensic audit report is statement of observations gathered and considered while proving conclusive evidence.

**Keywords:** Court proceeding, financial crimes, forensic audit, fraud triangle, investigative skills.

### Introduction

Forensic Audit is a dynamic and strategic tool in combating corruption, financial crimes and frauds through investigations and resolving allegations of fraud and embezzlement. It may be conducted to determine negligence. Forensic is the application of science to crime concerns. Forensic science is science applied to legal matters especially criminal matters.

Forensic audits are highly specialized, and the work requires detailed knowledge of fraud investigation techniques and the legal framework. Forensic accountants are trained to look beyond the numbers and has necessary skills and experience to accept the work. Highly specialized and the work requires detailed knowledge of fraud investigation techniques and the legal framework (civil, criminal laws and human psychology) and to identify substance over form when dealing with an issue.

A forensic auditor is required to have specialist training so that he can understand the legal framework and also has the knowledge of forensic audit techniques. He should also have the expertise in the use of IT tools and techniques that facilitate data recovery and analysis.

A forensic audit, also known as forensic accounting, refers to the application of accounting methods for detection and gathering evidence of frauds, embezzlement, or any other such white-collar crime. It is the application of accounting skills to legal questions.

### Forensic audit is done in two-phases:

- 1. Investigation Services:** At first the auditor begins with an investigation; looking into the accounts and statement, and identifying defects in it. It then moves on to find ways to deal with such defects, which is a reactionary function.
- 2. Litigation Services:** It is entirely possible the frauds detected be resolved within the company itself. However, there are times when they need to be resolved through legal channels. During such situations, forensic auditors give litigation support to the advocates. Their

advice and consultation about the legalities of commercial disputes are very essential. Moreover, they also provide research assistance by giving relevant documents and facts to support a legal claim, and also help decide the extent of damage that is required. They are also called up by the Court as an expert witness for further investigation,

### Areas of Forensic Audit

Areas of Forensic Audit include

- Criminal investigations,
- Cases of professional negligence,
- Fraud investigation and risk /control reviews,
- Arbitration cases,
- Settlement of insurance claims,
- Dispute settlement etc.

### Purpose of Forensic Audit

Forensic audit is being conducted to tackle cases of corruption, asset misappropriation and financial statement fraud.

### Corruption

In Forensic audit, while investigating fraud, auditor would look out for:

**Conflicts of interest:** When fraudster used his/her influence for personal gains detrimental to company. For example, if a manager allows and approves inaccurate expenses of employee with whom he has personal relations. Even though the manager is not benefitted from this approval but he is likely to receive personal benefits after making such inappropriate approvals.

**Bribery:** As the name suggest offering money to get things done or influence a situation one's favour would be bribery.

**Extortion:** In above example, if someone demands money so as to award Tender to other party then it would amount to extortion.

### **Asset Misappropriation**

This is the most common and prevalent fraud carried out by fraudsters. Misappropriation of cash, raising fake invoices, payments made to non-existing suppliers or employees, misuse of assets or theft of Inventory are few examples of such asset misappropriation. For example, a driver uses the office car for his personal holiday trip is said to misappropriate the Asset.

### **Financial statement fraud**

Companies get into such type of frauds so as to show a better performance of the company than what it is actually. This is done so as improve liquidity or ensure top management keep earning the bonuses or due to market pressure on performance.

Some examples of such frauds are - Intentional forgery of accounting records; omitting transactions either revenue or expense transactions, non-disclosures of relevant details from the financial statements; or not applying the requisite financial reporting standards.

### **Conductance of Forensic Audit**

A forensic Audit investigation is conducted in five stages viz.

#### **Step 1: Accepting the Investigation**

A forensic audit is always assigned to an independent firm/group of investigators in order to conduct an unbiased and truthful audit and investigation. Thus, when such a firm receives an invitation to conduct an audit, their first step is to understand the business, identify possible frauds that could exist and determine whether or not they have the necessary tools, skills and expertise to go forward with such on investigation. They need to do an assessment of their own training and knowledge of fraud detection and legal framework. Only when they are satisfied with such considerations, can they go ahead and accept the investigation.

#### **Step 2: Planning the Investigation**

Planning the investigation is the key step in a forensic audit. The auditor(s) must carefully ascertain the goal of the audit so being conducted, and to carefully determine the procedure to achieve it, through the use of effective tools and techniques. Before planning the investigation, they should catalogue possible fraud symptoms,

#### **Symptoms of Fraud**

- Delayed submission of returns information etc.;
- Delayed remittances into Bank;
- Delay or non-preparation of Bank reconciliation statements;
- Lifestyle of promoters/directors and key employees;
- Continued internal control lapses and not following norms of corporate governance.

#### **Internal Indicators**

1. Delay in finalisation of accounts,
2. Frequent changes in Accounting Policies;
3. Continuing Losses;
4. Over drawl of loans or advances;
5. Higher cost per unit of production;
6. High amount of losses or wastage shown in books vis norms,

7. High Investment in group companies,
8. Profit not supported by increased cash availability.

### **They should also be clear on the final categories of the report, which are as follows:**

- Identifying the type of fraud that has been operating, how long it has been operating for, and how the fraud has been concealed,
  1. Identifying the fraudster(s) involved;
  2. Quantifying the financial loss suffered by the client;
  3. Gathering evidence to be used in court proceedings;
  4. Providing advice to prevent the recurrence of the fraud.

### **Fraud Triangle and Fraud Risk**

A fraud triangle is a tool used in forensic auditing that explains three interrelated elements that assist the commission of fraud-Pressure (motive), opportunity (ability to carry out the fraud) and rationalization (justification of dishonest intentions). Fraud risk is the vulnerability a company/organisation has to those who are capable of overcoming the three elements in the fraud triangle. Fraud risk assessment is the identification of fraud risks that exist in the company/organisation. The planning involves the formulation of techniques and procedures that align with the fraud risk and fraud risk management.

Planning also includes the identification of the best way/mode to gather evidence. Thus, it is necessary that ample research should be done regarding certain investigative, analytical, and technology-based techniques, and also related legal process, with regard to the outcome of such investigation.

#### **Step 3: Gathering Evidence**

In forensic auditing specific procedures are carried out in order to produce evidence. Audit techniques and procedures are used to identify and to gather evidence to prove, for example, how long have fraudulent activities existed and carried out in the organization, and how it was conducted and concealed by the perpetrators. In order to continue, it is pertinent that the planning stage has been thoroughly understood by the investigating team, who are skilled in collecting the necessary evidence. It is also important to keep clear sequence of custody until the evidence is presented in court. A logical flow of evidence helps in understanding the fraud and evidence presented in a better manner. If the same is not done then the evidence can be challenged in court, or the court would not admit it.

The Investigators can use the following techniques to gather evidence or data about symptoms, testing controls to gather evidence which identifies the weaknesses, which allowed the fraud to be perpetrated.

- **Analytical Procedure:** Using analytical procedures to compare trends over time or to provide comparatives between different segments of the business applying computer-assisted audit techniques, for example, to identify the timing and location of relevant details being altered in the computer system.
- **Discussions and Interviews:** Discussions and interviews with employees.
- **Substantive Techniques:** Substantive techniques such as reconciliations, cash counts and reviews of documentation.

- **Forensic Data Analysis (FDA):** FDA is the technology used to conduct fraud investigations; the process by which evidence is gathered, summarized and compared with existing different sets of data. The aim here is to detect any anomalies in the data and identify the pattern of such anomalies. to indicate fraudulent activity.

#### Step 4: Reporting

The reporting stage is the most obvious element in a forensic audit. After investigating and gathering evidence, the investigating team is expected to give a report of the findings of the investigation, and also the summary of the evidence and conclusion about the loss suffered due to the fraud. It should also include the plan of the fraud itself, and how it unfolded, basically the whole trail of events, and suggestions to prevent such fraud in the future.

#### Step 5: Court Proceedings

The last stage expands over those audits that lead to legal proceedings. Here the auditors will give litigation support to the Company/Regulators. The auditors are called to Court and also included in the advocacy process. The understanding here is that they are called in because of their skill and expertise in commercial issues and their legal process. It is important that they lay down the facts and findings in an understandable and objective manner for everyone to comprehend so that the desired action can be taken up. They need to simplify the complex accounting processes and issues for others to understand the evidence and its implications.

#### Forensic Audit Report

Forensic Audit Report is statement of observation gathered & considered while proving conclusive evidence. It is a medium through which an auditor expresses his opinion under audit after the forensic audit investigation is completed.

Normally, table of contents of a Forensic Audit Report include the following points:

1. Executive Summary
2. Origin of the audit
3. Audit Objective
4. Proposed Audit Outputs
5. Audit Implementation approach
6. Risk Analysis
7. Internal Environment Risk: Customers, product and Competitors; Financial Management; Human Resource Management, Information Technology: Business processes
8. External Environment Risk: Economy and market situation; political and legal scenario; Technology in the sector
9. Audit Process
10. Preliminary understanding of scope and Incident coverage

#### Summing-up

Forensic Audit may be considered as a technique to ascertain legally the matching of accounting transactions with various accounting, auditing and legal requirements and to ultimately ascertain the occurrence of fraud, if any. Forensic Audit, therefore, is a mixture of accounting, auditing and investigative qualities. The purpose of Forensic Auditing is to determine whether, actually, a fraud has

occurred and apply appropriate techniques in prevention of fraud. Forensic Auditing adds more teeth to the auditing process by gathering evidences of fraud and applying the necessary skills to prevent it.

Forensic auditing entails examining and evaluating a company's or individual's financial statements in order to obtain information that can be used as evidence in a court of law. Forensic auditors must have extensive expertise in accounting and auditing procedures, as well as expert knowledge of the regulatory structure governing forensic auditing. Forensic auditing consists of systematic tests carried out in order to gather and deliver evidence in court. The audit evidence gathered is not only relevant in a court of law, but it may also explain the accused's motivation and occasion for committing a scam or fraud, whether the fraud involved several offenders, and what efforts were made to remove evidence of the fraud. If forensic auditors find anomalies, the forensic auditor's task is to investigate and determine the cause of the fraud, as well as the amount of money involved, the parties involved, and the benefits gained by the parties as a result of the fraud. The forensic audit evidence should be adequate to establish the identities of the fraudsters, the fraud scheme's workings, and the amount of money lost by the group. As a result, a forensic auditor can be called upon during the course of a forensic audit to testify as an expert witness in court.

Finally, it is notable that while conducting a forensic audit, the auditor must ensure:

- Whether the fraud detected is at the management level or employee level?
- What was the reason or motive behind the fraud?
- How is the internal check on cash transactions, raising of Invoices etc.?
- Who is responsible for the checking if all the things are in order in regular intervals?
- What is the nature of fraud-corruption, assets misappropriation or financial misstatement?
- Whether the entries passed are properly reflected in the balance sheet without any omission?
- Whether IT returns are filed every year properly?
- Whether bank entries are reconciled on regular basis? Whether bank statements do not have any discrepancy.

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