

# Study on Investigative Audits



**Internal Audit Standards Board**  
**The Institute of Chartered Accountants of India**  
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# Chapter 1

## Introduction

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### Chapter Summary

*The introductory chapter provides an insight into various facets of fraud risk and provides an overview of the contents in the book. An attempt has been made to avoid technical jargons making the contents understandable to the readers. The management perceptions about fraud risk and the specific exclusions from this book are elaborated. The book is meant for Chartered Accountants to strengthen their role as chief financial officers, internal auditors, chief investigating officers, statutory auditors or representing senior management positions in an organisation.*

1.1 A Chartered Accountant in accordance with his professional knowledge base is able to be an efficient co-ordinator in the conduct of investigative assignments and is ably supported by analytical skills, working knowledge in process evaluation and requisite documentation, especially for investigation involving financial crimes. He is, therefore, at an advantage to play the role of a strategist in carrying out investigations. While this study is meant to supplement the role of practicing Chartered Accountants, it would also be an eye opener to the management on how they can engage the services of Chartered Accountants.

1.2 Aspirations, goals, stretch targets, execution excellence and sustained growth are prerequisites for any growing organization. Chartered Accountants do play a major role in strengthening risk assessment process, in capability assessment through performance

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reviews, ensuring value added services, customer focus and support to management in ensuring effective corporate governance that are of significant importance to most professionally managed organizations. An effective governance mechanism encompasses integrity in dealings which also needs to be well ingrained in the organizational core values. All of us know and believe that business integrity is a fundamental need to achieve all these requirements. The biggest challenge for any Chief Executive Officer (CEO) or the Chief Financial Officer (CFO) is to ensure and demonstrate that business integrity issues are paramount to the functioning of their organization.

1.3 While it takes ages to build a business empire, it takes but a few mistakes to bring down the same. One can learn innumerable lessons on how successful corporations decay and very few are lucky to have a resurgence. For this reason, the tone at the top of the management hierarchy on sound value system is of prime importance and the same has to percolate down to the entire organisation. 'Integrity' is a virtue that is to be maintained, irrespective of the size of an organization. To this end, the management defines its core values through a code of conduct for its employees.

1.4 In times of recession or downturn in economy, it becomes difficult to achieve set targets of performance and that can create a conflict in the minds of financial executives to take decisions that are detrimental to them and the organization they represent. Since there is a thin line that divides a genuine mistake from a fraud, it becomes difficult for management to identify the real intent of such actions. The thumb rule is to ascertain whether there is a deception and whether the same has caused damage to the organisation, irrespective, of gains to the person practicing such deception. Chartered Accountants with their understanding of the functioning of the organisation are in a advantageous role in addressing this dilemma of the management.

1.5 Can an organization be insulated from risk of fraud? At best steps could be taken to mitigate the risk of fraud by strengthening

controls and where such risks are inherent to the business environment, ensure a mechanism of timely compilation and reporting of such incidents and ensure corrective steps. There is always a need for this caution in managing the risk of fraud before, during and after the event has occurred. A fraudulent activity may not necessarily be a single event and, therefore, there are chances that an alert management is in a position to notice the leads that are available to identify suspected frauds before extensive damage is done to the organization. The diagnostic review for assessing vulnerabilities to fraud is a step towards deterrence of fraud.

1.6 From a management perspective, any remedial control measure arising out of diagnostic/ internal audit reviews should be subjected to a cost benefit analysis and at times management may be constrained to carry the risk of fraud, on cost considerations. The inclusion of preventive or detective controls would depend on the cost of introducing such controls vis-à-vis the impact analysis of the fraud risk.

1.7 There is a general reluctance in establishing an in-house investigation department considering the impact it has on the morale of the employees and a perceptible negative influence in the minds of the employees towards the internal audit team. The advantage of an in-house investigative team is cost effectiveness; information remains internal to the organization safeguarding the market image. However, for reasons mentioned above, there is a greater tendency to outsource the investigative assignments as there is a greater independence and acceptance of results of investigations carried out by outsourced firms *vis-à-vis* in-house internal audit teams. Irrespective of whether the investigation is conducted by in-house teams or outsourced firms, there is a greater responsibility in these assignments in respecting the dignity of the employees and ensuring utmost caution in dealing with matters relating to investigative assignments.

1.8 Both for the management and the internal audit fraternity it is important to ensure service differentiation between internal audit function and investigative assignments. When does one realize

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that the internal audit gets into the nature of an investigative type of assignment? There is a thin dividing line between mistake and fraud. In internal audit assignments to confirm whether a fraudulent act has occurred the auditor should consider whether there is an element of deception, whether the damages arising to the organisation as a result of the wrongful act is determinable, whether sufficient evidence or trail exists that suggest the involvement of persons to the happening of such wrongful act. The basic requirement of such a situation where internal audit may take the form an investigative assignment is to seek a referendum from the Chief Audit Executive or a designated authority.

1.9 It is the fundamental principle of any investigation that the methodology used for investigation to surface the truth cannot be fraudulent. In any investigative assignment, the rights available under the law of the land must be respected and, therefore, a Chartered Accountant conducting such investigations must ensure that methods used do not circumvent any legal requirement or infringe on the rights of other persons.

As a matter of principle, the ability of the firms in conducting investigation is of paramount importance in awarding an investigative assignment. Similarly, it is essential that the private investigators accept assignments for which they have the domain expertise.

1.10 The principles that apply to the conducting of business efficiently and ethically in a social environment also apply to managing of investigative assignments. Apart from the effectiveness of internal controls, both the management representatives and the investigating authorities must understand the social, political, cultural and legal environment in which the assignments are handled. The planning of any investigation also involves being aware of the local customs, practices and power centres in a given work environment. These factors do influence the outcome of any investigation. In investigative assignments though technically the Chartered Accountant would be in a position to gather evidence or reach a conclusive result, he/ she should be sufficiently aware of the control

environment. He/ she should exercise diligence to safeguard his/ her interest and interest of the client on whose behalf such investigation is conducted in presenting the findings and evidence gathered. These are important factors that may be relevant to the investigative process. These depend on the prevailing situations and circumstances in which the alleged irregularities have occurred, the profile of the alleged perpetrator(s) and the way the investigation progresses.

1.11 This study attempts to share with the reader various facets of an investigative process at a basic level. Readers are requested to use their discretion on a case-to-case basis and use the information in an appropriate manner by adapting and/ or limiting the initiatives to be taken in the conduct of their assignment. The readers may take an independent view on legal advice in managing these kinds of assignments. The term investigation has been used in this publication with reference to investigation of frauds of financial nature.

1.12 The use of specialised software (licensed), proprietary methods and use of gadgets (including specifications), report formats and questionnaires, proprietary methodology of investigative firms are excluded from the purview of this publication. Similarly, investigation in public sector, government offices, the quasi government bodies and vigilance cell in banks and financial institutions, etc. are excluded from the scope of this publication. At times, investigative assignments may go beyond books of account and involve activities such as, background checks, gathering of business intelligence, shadowing of targeted individuals etc, that would be beyond the domain expertise of Chartered Accountants and, therefore, involve the support of specialists. This study also addresses the need for caution where Chartered Accountants engage services of specialists during investigation.

Readers may also refer to other publications of ICAI, other information that are accessible in the public domain for further enriching their knowledge on the subject. Appropriate references are given at the end of this publication.

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## Chapter 2

# Types of Fraudulent Act

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### Chapter Summary

*A Chartered Accountant conducting financial investigation assignments should be familiar with fundamental concepts with reference to what constitutes a financial fraud. The connotations on wrongful practices may vary across organisations. For the purpose, the knowledge of internal processes, policies, procedures and documentation requirements are a prerogative in the conduct of investigations. Similarly, the Chartered Accountant should be familiar with the laws of the state in which investigations are conducted, that would enable him to seek expert opinion from legal counsel on whether based on facts any wrongful act has been committed, before a report is submitted to the client. Such expert legal opinion would enable the Chartered Accountant to exercise caution at each stage of the investigation process to prevent him from getting entrapped in controversies with legal ramifications, that may result in deviation from the core object of the investigation.*

*This chapter elucidates the type of fraudulent acts and the common types of frauds in a corporate entity.*

## Fraud

2.1 Fraud is defined in Standard on Internal Audit (SIA) 11, “*Consideration of Fraud in an Internal Audit*” as an intentional act by one or more individuals among management, those charged with governance, or third parties, involving the use of deception to

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*obtain unjust or illegal advantage. A fraud could take form of misstatement of an information (financial or otherwise) or misappropriation of the assets of the entity.*

The following are, essentially, the components in a fraudulent activity:

- A dishonest intention
- Use of deception
- Personal advantage or loss to a third person
- Generally results in financial/asset loss to an organization and may involve financial misstatements.

2.2 A common example of a fraudulent activity is availing of multiple loan transactions with several financial institutions by gross misrepresentations against the same asset. The value of the asset financed or income of the applicant is misstated to increase the eligibility norms, or make up for no down payment resulting in generation of cash proceeds for the perpetrator of fraud, profiting him at the cost of the company (entity).

2.3 Fraudulent activities are likely to be committed through the use of several mediums including cleverly drafted policy document to cover up follies, entering into fabricated agreements, usurping undue power in the guise of structured delegation, interpretation of conflict of interest in normal business dealings, misrepresentation of documents, photographs, use of pre-printed stationery such as, letter heads etc, mails, telegrams, telephone, and internet (computer crime and internet fraud). The difficulty of checking the identity and legitimacy online, the ease with which hackers can divert browsers to dishonest sites and steal credit card details, the international dimensions of the web and ease with which users can hide their location, all contribute to making internet fraud the fastest growing area of fraud.

2.4 A false document made wholly or in part by forgery is designated “a forged document”. Finger print analysis are assigned

to specialists who are persons having requisite qualification as recognised by the Government. As of now, there are no private institutions in India who are entitled to offer qualifications in this field.

Further, the certification by a handwriting expert is not considered conclusive evidence and, generally, has to be backed by circumstantial evidence. At best such certificate can be construed only as supporting evidence in the eyes of law. The statement of a handwriting expert as witness may be admissible in litigation but not considered sufficient to prove a case. To solicit the services of a handwriting expert, the investigator may probably be able to identify the appropriate person through the offices of the ‘ Government examiner of Questioned Documents’ (located at Shimla, Kolkata, Hyderabad, Delhi under the aegis of the ‘ Central Fingerprint Bureau’).

## **Fraud for Personal Gain**

### **Bribery**

2.5 Money, gift or other favours offered to procure (often illegal or dishonest) action or decision in favour of the giver. Many organizations have laid down strict rules of not paying/ receiving bribes and employees are forewarned of disciplinary action in the event of deviations. These are also relatable to contract fraud or procurement fraud and are, generally, out of books transactions. The internal auditor normally conducts a propriety audit over the veracity of the transactions and review of any undue favours to vendors.

### **Conflict of Interest**

2.6 There are circumstances wherein the officials are in a position of trust and in discharge of their duties face a competing professional or personal interest. Such conflicting interest results in impartial discharge of his/ her duties. A conflict of interest can create an appearance of impropriety that can undermine the confidence in that person or in his professional abilities. Thus,

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conflict of interest may arise from family interests, in which a spouse, child, or other close relative is engaged in a competing business or where goods or services are purchased from such a relative or a firm controlled by a relative. For this reason, many employment applications ask if one is related to a current employee or insist on self declarations.

2.7 The following are some ways to remove mitigate conflict of interest:

- Avoidance of conflicting roles
- Disclosure of conflict
- Abstain from decisions involving role conflicts
- Third party evaluations
- Code of ethics.

### ***(i) Avoidance of Conflict***

The best way to handle conflicts of interests is to avoid them entirely. For example, Under Section 226 of the Companies Act, 1956, a person holding any security (instrument carrying voting rights) of a client company is disqualified to be a statutory auditor.

### ***(ii) Disclosure***

Certain professionals are required either by rules related to their professional organization, or by statute, to disclose an actual or potential conflict of interests. In some instances, the failure to provide full disclosure is a crime.

### ***(iii) Abstention***

Those with a conflict of interests are expected to abstain themselves from decisions where such a conflict exists. The imperative for recusal varies depending upon the circumstance and profession, either as common sense ethics, codified ethics, or by statute.

***(iv) Third-party Evaluations***

Third-party evaluations can also be used as proof that transactions were, in fact, fair (“arm’s-length”). For example, a corporation that leases an office building that is owned by the Chief Executive Officer (CEO) might get an independent evaluation showing what the market rate is for such leases in the locale, to address the conflict of interests that exists between the fiduciary duty of the CEO (to the stockholders) and the personal interest of that CEO (to maximize the income that the CEO gets from owning that office building).

***(v) Codes of Ethics***

Generally, codes of ethics forbid conflicts of interests. Often, however, the specifics can be controversial. Codes of ethics help to minimize problems with conflicts of interests because they can spell out the extent to which such conflicts should be avoided, and what the parties should do where such conflicts are permitted by a code of ethics (disclosure, recusal, etc.). Thus, professionals cannot claim that they were unaware that their improper behavior was unethical. As importantly, the threat of disciplinary action helps to minimize unacceptable conflicts or improper acts when a conflict is unavoidable. However, a code of ethics cannot cover all situations, and would need appropriate interpretations and monitoring mechanism.

## **Corporate Frauds/ Irregularities**

### **Advance Billing**

2.8 Advance billing is a situation where the company officials indulge in booking fictitious sales in anticipation of actual sales. This results in misrepresentation of revenue in the books thereby misleading financiers and stakeholders. When the management treats borrowings from money lenders as customer advances in the books against sale orders or for adjusting bills receivables, the fraudulent act gets unnoticed for an extended period. This situation

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results in a death knell for the corporation as the company is dragged into an irredeemable debt trap.

2.9 In public companies, improprieties in disclosure requirements or “window dressing” involving inflated revenues or costs can amount to fraud and investigations are typically launched by government oversight agencies, such as the Securities and Exchange Board of India, Office of the Comptroller and Auditor General of India, Central Vigilance Commission, and Central Bureau of Investigation, etc.

2.10 Use of shell company, false vendors, purchases of personal nature booked as official expenses enable falsification of accounts and diversion of funds for purposes other than what is intended for. These could also be mechanism for employees or cartel of employees engaging in personal gain at the cost of the company. In the former incident this could be termed as management fraud.

## **Shell/ Dummy Company Schemes**

2.11 Generally, represents a fictitious company or a ‘paper company’ to transfer profits or funds from the main company. This could also involve fictitious bills (mostly for services rendered or consultancy charges that cannot be corroborated) which are used in the name of dummy companies diverting the funds taken from banks and financial institutions. Such a shell company could be floated by employees too to siphon off funds from their legitimate company. The perpetrator could be preparing the payment vouchers or in some cases may be authorised to approve cheques. This could also include procurement of goods such as, for project work that is routed through a shell company to enable diversion of profits.

The books could be falsified by wrong classification of expenses, inflating the expense claims, fictitious expenses or multiple reimbursements. A review of controls, normally, leads to the uncovering of expense booking that are prima facie not incurred.

## **Money Laundering Activities**

2.12 Section 3 of the Prevention of Money Laundering Act, 2002 defines offence of money laundering as under:

“Whosoever directly or indirectly attempts to indulge or knowingly assists or knowingly is a party or is actually involved in any process or activity connected with the proceeds of crime and projecting it as untainted property shall be guilty of offence of money laundering.”

2.13 The person indulging in money laundering looks for avenues with weak banking controls for converting illegal money into the banking system. Any excess credit in the bank accounts that does not belong to the customer or is parked for a temporary period should raise suspicion of such activities. This person indulging in money laundering activity looks for avenues to enter into ‘benami’ (could be called name lending) transactions. Companies with extensive cash handling and inadequate identification process of source of money or about the remitter are susceptible to money laundering activities.

### ***Anti-Money Laundering Measures***

2.14 The financial institutions are generally required to monitor, investigate and report transactions (up to a defined limit) of a suspicious nature to the financial intelligence unit of the central bank in the respective country. For example, a bank must perform due diligence by having proof of a customer’s identity and ensure that the use, source and destination of funds do not involve money laundering.

## **Fraud at Operational Level by Employees**

### **Tampering of Cheques**

2.15 Tampering of cheques, payee name being altered, or preparation of cheques without issue of the cheques to payee, etc., are methods that may also lead to falsification of accounts. The name of the payee in the cheque issued for payment could be

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fabricated to wrongly codify and book against an improper account head. This is difficult to uncover unless balance confirmations are obtained from the vendors.

2.16 A person draws cheque fraudulently in his name or converts a cheque drawn on a third party to his advantage. This could have been done through forgery in signature of the drawer, or misuse of blank cheques (could be even signed cheques or post dated cheques) retained at the back office of the company providing easy access to the perpetrator of the fraud, improper retention of cancelled or time barred cheques, forged endorsement, altering the name of the payee, involve concealed cheque schemes or authorised maker schemes, etc. These cheques could either be drawn or altered favouring the perpetrator of fraud or use for cash withdrawal, or to an accomplice later on sharing the amount misappropriated or in the name of a fictitious entity or a person who could be influenced to part with the amount at a later date.

2.17 Absence or lack of control in preparing the bank reconciliation statements results in employees resorting to wrong coding of cheques to inactive accounts. The person preparing the bank reconciliation statement should preferably be different from the person printing and issuing the cheques. A lack of control in this area can lead to fraudulent encashment or issue of multiple cheques that can be covered up by the 'subject' through an improper accounting process.

## **Off Book Frauds – Skimming**

2.18 In skimming the fraud perpetrator misappropriates the cash before these are recorded in the books or before the sale is recorded in the books. These frauds are difficult to unearth as the cash or collection is taken off before the accounting entries are made in the books. This situation arises especially in unorganized markets and in rural economies where banking habits are relatively under developed. The process gaps allow an employee to divert the cash collected to his personal account under the pretext of safeguarding of organization's cash.

## ***Types of Fraudulent Act***

These are difficult to establish due to absence of audit trails and are more prevalent in businesses that have extensive cash dealings. These are difficult to uncover as the means adopted could include printing of receipts/ bills outside the system. For example, in a trading business of used cars, where the employee or the franchisee outlet manages to sell the car without inward stock and notifying or recording the sales in the books and diverts the amount collected from the customer to his personal account. Such a practice is called skimming.

2.19 The above schemes can be established based on circumstantial evidence or validation through external sources such as, customer balance confirmations (where feasible) and customer copy of the receipts or other documents that are retained by them. These are also further supplemented by external evidence in the form of background checks and surveillance mechanism. Such misrepresentations are noticeable in non-government organizations and by unscrupulous agents who collect the donations from gullible donors and have embezzled the amount for their personal use through the use of unauthorised receipts that are never accounted in the books.

Sales could also be understated through offering of heavy discounts, subventions or commissions that are netted off before recording the sale in the books. This is another form of scheme where employees convert the difference between sale amount and notional discount offered into off book diversion of income for personal gain. Contrary to the above, the booking of purchases without accounting for vendor rebates is another form of off-book diversion of funds.

## **Cash Larceny**

2.20 Cash is misappropriated after the accounting entries are already passed in the books. These are identified through surprise checks and through shortages in cash balances. These occur when there are delays in accounting of cash collections and there are no laid down cash flow controls. In cash intensive business these are covered through adequate insurance cover to ensure

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that claims are lodged once theft of cash is reported. This can also be noticed through altered or forged cash deposit pay-in-slips.

The cash/ collection shortage is also covered up by declaring and accounting the shortage as cash/ cheque in transit. Thus, taking advantage of the communication gap that existed between the central office and remote locations regarding accountability in use of fund transfers. Another form of larceny is pilferage of cheques/ drafts that are in transit and endorsing it in personal name. This carries more risk where companies retain post dated cheques for fund transfers and do not ensure timely independent bank reconciliation statement. Any lack of segregation of duties in preparation of bank reconciliation statement will increase vulnerabilities to fraudulent act.

### ***Teeming and Lading (also known as Lapping)***

2.21 This is also achieved through cash deposits or cheques collected from customers being overlapped with the collections from subsequent customers and the amount collected is diverted to personal account. The ageing of receivables is not a constant, and, therefore, this makes the task of identifying the leakage of collections unless all the customer accounts are reconciled at a single point of time.

## **Fraudulent Disbursements**

2.22 Fraudulent disbursements or reimbursements take place either by issuing or submission of false bills, or personal expense bills being converted into official expenses bills.

Cash shortages are adjusted through false disbursement entries tallying the cash balance in the cash register. These are also called fraudulent register disbursements that may either involve excessive refunds or void sales. The excessive refunds could be by declaring false sales returns. This will result in excessive inventory that will be reflected during physical inventory verification. Alternatively, the customer is not issued a receipt post sale and when the

customer leaves the counter, the sale is reversed in the books. The amount collected is misappropriated. This anomaly surfaces through shortage in physical stock, and the perpetrator of fraud may either resort to destruction of registers or corruption of data or adjusting stock records where he has access in the system. Generally, these frauds are very evident where inventory verification is not done for substantial periods. The other method that is resorted to by the perpetrator of fraud is to inflate the refunds due to a customer and skim the excess refunds.

## **Expense Reimbursement Schemes**

2.23 These fraudulent schemes involve employees resorting to treating their personal expenses as incurred for business purpose and claiming reimbursement. For example, buying stationery for school kids and claiming it from the employer, travels bills claims that are subsequently cancelled without notifying the company, claiming medical or gift expenses that were not incurred or employees travelling together in a single cab but indulging in multiple claims individually, etc. In some cases, employees may get reimbursed by third parties such as, dealers as well as by claiming these expenses from the company. Multiple expense claims based on duplicate bills or photostat copies. These types of frauds are, generally, of lesser magnitude in terms of damages and are managed through in-house investigations.

## **Payroll Fraud**

2.24 The payroll fraud could include payment to non-existent employees or in a contractual arrangement inflating of the manpower resources than those actually deployed while billing the client. It may also include showing higher pay than actual disbursement to employees/ workers, etc.

## **Commission Schemes**

2.25 The salesman exaggerates the sales through fictitious billings to earn higher commission or alter the sales prices of the products sold from those stipulated by the company or share the sales volumes achieved with other employees to share higher commission.

# Chapter 3

## Accountability for Fraud Detection

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### Chapter Summary

*The chapter assesses the role of management, internal auditor and statutory auditor in managing risk of fraud with reference to Standard on Internal Audit (SIA) 11, Clause 49 and CARO requirements.*

3.1 The Board of Directors govern the company operations through their management representatives namely, the Chief Executive Officer and the Chief Financial Officer. This brings to focus striking the right balance between empowering them and ensuring a monitoring mechanism in meeting the responsibility towards stakeholders. However, there are no formal guidelines on the extent of documentation that would be sufficient in drafting of minutes in important meetings where crucial decisions are taken. Except for resolutions passed at the board meetings, the deliberations get under the smokes screen to the detriment of the the stakeholders. Such documentation gaps are noticeable in the event of major scandals that surface, but reflections over the past do not bring in much succour to companies inflicted with fraudulent activities since damage is already done and court litigations go on endlessly due to deficiencies in this basic documentation requirements. It is in these circumstances that the internal audit though seen as a subservient function is expected to fill the gap through its role as a 'watch dog' instead of being a blood hound. The internal audit function analysis the control gap for the management to ensure a voluntary check up on key controls and

## ***Accountability for Fraud Detection***

leakages, if any, in their operations through reporting to the audit committees. The internal audit findings, therefore, provide sufficient leads for the management to pursue further investigations.

3.2 The management of any organisation, generally, has a pragmatic approach towards managing risk of fraud. When the business operations are at a nascent stage, there is either less fund allocation or lesser importance attached to addressing fraud risk or on strengthening of internal controls. Once the business volumes get scaled up there is a sense of overconfidence resulting in management overlooking the control gaps till a major fraudulent act is uncovered. In the initial stages of such incidents, fraudulent activities are either downplayed as insignificant considering the overall operation of the company or these are categorised as inherent risk in the business model of the company. Another reason for complacency is that fraudulent activities that are uncovered always relate to a past period and so least importance is given to such past occurrences. It is in these circumstances that an effective audit process with adequate independence and reporting to highest authority is desirable.

3.3 Foremost the management stands answerable to the stakeholders for business performance, and as a result the internal audit recommendations with reference to strengthening of internal controls tend to get lesser importance in comparison to larger business objectives. Sometimes when observations that are of a serious nature are conveyed to senior management in confidentiality may seldom get officially recorded. In this scenario, the internal audit process tends to lose its independence especially where the reporting structure is interfered with by the Chief executive officer or the Chief financial officer of the company, without a direct reporting to audit committee or chairman of the company.

3.4 The audit process may also be hampered due to restrictions placed by the senior management on direct access to accounting data, IT system or use of audit tools citing information security or insider trading regulations. Further, considering that it is the responsibilities of management in ensuring a robust risk management and governance process, the internal audit function

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tends to be a limited function in assessing the state of internal controls and process gaps without any larger responsibility.

3.5 The primary responsibility for prevention and detection of frauds is that of the management of the entity. The internal auditor should, however, help the management fulfil its responsibilities relating to fraud prevention and detection. Thus, accountability on detection of fraud is with the management. They may engage the services of internal auditors as facilitators. Similarly, the role of statutory auditors on matters relating to reporting on fraudulent is defined under Standard on Auditing (SA) 240 “*The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*”. The reporting requirements as a result are largely dependent on management perspective of the state of internal controls wherein they are expected to declare the maintaining of ethical business standards and disclose irregularities and action thereon. This calls for greater role of internal auditors in confidence building measures on the state of internal controls in the organisation.

## **Role of Management**

3.6 As per Standard on Internal Audit (SIA) 11, “*Consideration of Fraud in an Internal Audit*”.

- (i) *The control environment sets the tone at the top in an entity and greatly impacts the effectiveness of internal controls. It includes the following:*
- *The policies and procedures established by the management to communicate and enforce the culture of integrity and ethical values in the entity.*
  - *management’s commitment to competence.*
  - *management’s philosophy and operating style.*
  - *organizational structure.*
  - *assignment of authority and responsibility.*
  - *human resources policies and practices.*

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- (ii) *The entity's risk assessment process includes the policies and procedures adopted by the management to identify risks that can affect the achievement of the objectives of the entity and to distinguish risks from opportunities. In the context of prevention of frauds, the entity's risk assessment process would include the policies and procedures of the management to identify and assess the risk of frauds, including the possibility of fraudulent financial reporting and misappropriation of assets.*
- (iii) *The information system and communication refers to the policies and procedures established by the management to identify, capture and communicate relevant information to the concerned persons in the entity to enable them to make timely and effective decisions and discharge their responsibilities efficiently. In the context of frauds, such policies and procedures could take form of whistleblower policies and mechanisms, ethics help lines and counseling, training of employees, etc.*
- (iv) *The control activities refer to the policies and procedures established by the management to ensure that the risks identified are responded to as per the policy or the specific decision of the management, as the case may be. In the context of frauds, the control activities include actions taken by management to prevent or detect and correct the frauds or breach of internal controls.*
- (v) *Monitoring refers to continuous supervision and assessment of the internal controls to identify instances of any actual or possible breaches therein and to take corrective action on a timely basis.*

3.7 Paragraph 6 of the Standard on Internal Audit (SIA) 2, "Basic Principles Governing Internal Audit", states as follows:

***"The internal auditor should exercise due professional care, competence and diligence expected of him while carrying out the internal audit. Due professional care signifies that the internal auditor exercises reasonable care in carrying out the work entrusted to him in terms of deciding on aspects such as the extent of work***

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*required to achieve the objectives of the engagement, relative complexity and materiality of the matters subjected to internal audit, assessment of risk management, control and governance processes and cost benefit analysis. Due professional care, however, neither implies nor guarantees infallibility, nor does it require the internal auditor to travel beyond the scope of his engagement.”*

3.8 An internal auditor should, therefore, use his knowledge and skills to reasonably enable him to identify indicators of frauds. However, the internal auditor cannot be expected to possess the expertise of a person with specialized knowledge and skills in detecting and investigating frauds.

A fraud normally occurs in situations where there is an incentive or a pressure to commit fraud, an opportunity to commit fraud or a rationalization for committing fraud. Although, normally, an internal auditor is not expected to possess skills and knowledge of a person expert in detecting and investigating frauds, he should, however, have reasonable knowledge of factors that might increase the risk of opportunities for frauds in an entity and exercise reasonable care and professional skepticism while carrying out internal audit. In addition, the understanding of the design and implementation of the internal controls in an entity would also help the internal auditor to assess the risk of frauds.

3.9 The following paragraphs discuss the approach of the internal auditor regarding this:

- (i) The internal auditor should obtain an understanding of the various aspects of the control environment and evaluate the same as to the operating effectiveness.
- (ii) The internal auditor should obtain an understanding of the policies and procedures adopted by the management to identify risks that can affect the achievement of the objectives of the entity and to distinguish risks from opportunities and evaluate the effectiveness of these policies and procedures. In the context of prevention of frauds, the internal auditor should specifically evaluate the policies and procedures established by the management to identify and assess the

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risk of frauds, including the possibility of fraudulent financial reporting and misappropriation of assets.

- (iii) The internal auditor should assess the operating effectiveness of the policies and procedures established by the management to identify, capture and communicate relevant information to the concerned persons in the entity to enable them to make timely and effective decisions and discharge their responsibilities efficiently.
- (iv) The internal auditor should assess whether the controls implemented by the management to ensure that the risks identified are responded to as per the policy or the specific decision of the management, as the case may be, are in fact working effectively and whether they are effective in prevention or timely detection and correction of the frauds or breach of internal controls.
- (v) The internal auditor should evaluate the mechanism in place for supervision and assessment of the internal controls to identify instances of any actual or possible breaches therein and to take corrective action on a timely basis.
- (vi) The internal auditor should carefully review and assess the conclusions drawn from the audit evidence obtained, as the basis for his findings contained in his report and suggest remedial action. However, in case the internal auditor comes across any actual or suspected fraud or any other misappropriation of assets, he should immediately bring the same to the attention of the management.
- (vii) The internal auditor should document fraud risk factors identified as being present during the internal auditor's assessment process and document the internal auditor's response to any other factors. If during the performance of the internal audit fraud risk factors are identified that cause the internal auditor to believe that additional internal audit procedures are necessary, the internal auditor should document the same.

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3.10 It is important for both the management and the internal audit fraternity to ensure service differentiation between internal audits and investigative assignments. While the skill sets required in executing these assignments may be similar, the objective and scope of coverage in these assignments may vary and, therefore, there is a need for greater understanding between the management and the internal auditors for any further action on any matter arising out of the audit observations.

3.11 The scope of review in an internal audit is, generally, restricted to what is reported in the books of account; while in an investigation the scope of review may extend beyond the books of account. Internal audit may be a trigger to commence an investigation. The following are some major differences between internal audit and investigation:

<b>Internal Audit</b>	<b>Investigation</b>
<ul style="list-style-type: none"><li>● Audits are planned in advance.</li><li>● Materiality in reporting facts is a dominant factor.</li><li>● Primarily governed by statute.</li><li>● References are to basic working paper documentation.</li><li>● Role of reviewing operations, recommending improvements or review costs to determine these are reasonable.</li></ul>	<ul style="list-style-type: none"><li>● Investigations are, generally, in response to events or occurrences.</li><li>● Gathering of evidence is a more dominant factor. Materiality may not be relevant.</li><li>● Governed by specific mandate as decided by management.</li><li>● In addition to working papers, there could be an element of background checks to corroborate evidence/ facts.</li><li>● Traditional role in investigation is to search for civil/ criminal/ ethical violations.</li></ul>

3.12 Auditors and Investigators vary in terms of need for training needs, work approach and deliverables. The mode of conducting interviews in an internal audit differs from that of an investigation. A toolkit used in an investigation may not be used in a normal internal audit assignment. e.g., voice recorders, bugs, cameras or other visual representations, etc. The mode of communicating their work activities and results can vary between an audit and an investigation assignment.

## **Benefits of Co-ordinated Effort between Audit and Investigation**

3.13 Generally, auditors and investigating officers review different aspects of an organisation's operation, contracts and entitlements. Considerable research and time is often devoted to gathering information about the subject. By sharing this knowledge between audit and investigative staffs means averting or minimising duplication in effort and preventing loss of time. Sharing of knowledge can improve the quality of both audit and investigation assignment. Information about past irregularities can and should be used to update audit or investigative approaches thereby assuring that similar irregularities are not overlooked in future audits and investigations. There are occasions where audit and investigative engagements need special expertise. Auditors can and commonly do provide financial auditing expertise to investigating staff in various types of white-collar crime inquiries. Similarly, investigating officers can be of assistance to auditors in tracking down business relationships which may be essential to the audit, such as determining whether there is common control or ownership among companies which potentially results in inter-company transfers with excess profits or bid rigging or result in diversion of funds.

3.14 The top Management must project a positive and co-operative attitude, at the office and in the field. Communications at all levels should be mandated with Audit and Investigating officers knowing each other's role through regular meetings. Co-operation is not just top down: it has to be a bottom up as well. Individual auditors

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and investigating officers must share information about their work. There should be consensus about referrals, the timing and circumstances of advising their counterparts of new developments, and once an investigation or audit is initiated consideration must be given as to how and when to provide feedback as to its progress among the designated officials.

3.15 There should be appropriate recognition and credit to deserving team members. If an auditor sees major accolades going to individuals who develop cases on major findings because of a referral they made, while they receive no credit at all, hard feelings and disagreements will occur and thereafter the co-operation is gone. Conversely, appropriate recognition will stimulate co-operation and get people to actively participate in such assignments.

The commercial officer in a company had acquired clout in the local unit due to his proximity to the plant head. Having won the confidence of his boss, he formed a network of important people in the locality and also with other employees in the plant as an 'honest person' reaching out to people when they most need him. Under the influence of outside elements he started indulging in unethical practices on a small scale. As his confidence grew, his greed overtook his needs and he started indulging in activities clandestinely, which were not in the best interests of the company. This was evident from disgruntled employees within the plant and also from the control gaps highlighted by the internal auditors. As a management representative what would be an important step in ascertaining the facts in this matter?

Based on the internal audit findings, the investigating officer could easily diagnose the problem. He could accordingly plan his strategy by seeking the list of active and non-active contracts, and was able to use the information available in the internal audit report regarding the key findings arising out of ledger scrutiny of billings and payments schedules, ascertaining the level of activities at the plant, the terms of contractual engagement and most importantly the reason for some of the contractors being discontinued. An interaction with the internal auditor would also be useful in defining the objective, scope of coverage and time targets within which the investigative assignments could be completed.

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3.16 An internal auditor was apprehensive of certain irregularities relating to the lifestyle of the 'auditee' vis-à-vis his income levels. However, he considered this beyond his scope of review and, therefore, highlighted his concerns to the management. The Chartered Accountant was called in and the scrutiny of the internal records with the external background checks revealed that the suspect had amassed wealth that was disproportionate to his income, through inappropriate means.

In an internal audit of the payroll function, an auditor stumbled upon falsification of wage records by the management with a view to evade taxes and non-payment of statutory dues. The scope of audit was restricted up to this point by resorting to review of the swipe card entries, review of work station level labour records, and gate records. Any attempt in gathering external evidence to highlight non-existent employees may involve physical inspection, background checks outside the office premises, residence checks, neighbour checks, interviews with fellow employees, etc., and so the later part can be termed as investigative in nature.

3.17 During the audit of a treasury function, physical verification of the key security documents revealed that certain term deposit certificates were not traceable. The auditor pointed out the lacunae in the verification process and highlighted the matter to the management. The matter was referred for investigation and it was noticed that these certificates were pledged and borrowings were adjusted against receivables in the books to tide over the rising level of receivables.

An Information Technology (IT) company in its first year of its operation wanted to project a healthy result. The company had a sub-entity created abroad and the entity was used as a front end company to build up a healthy balance sheet. The internal auditors were required to complete the audit based on the documents and declarations submitted by local management. The auditors had to rely on the contracts signed between the two companies and the fund flow from such entities. The internal auditor had to limit the audit review to the photostat copies of the documents and soft entries in the system of the operations between the main company

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and the 'front' company. The existence of the ultimate customer was questionable and not verifiable by the internal auditor as the audit of the 'front company' was not within the purview of internal audit engagement'. To maintain confidentiality, the auditor had to return back the supporting documents and contracts to the management to safeguard customer specific information and was not allowed to retain even the photostat copies lest the information is leaked out to competitors.

The same auditor was also managing the audit of a banking entity. The project work on getting the financing done for the management was offered to an independent consulting firm at the behest of the audit firm. The management as a confidence building exercise with the auditors, also assigned, a consultancy assignment to define the business process, the accounting manual and to carry out a due diligence exercise to such consulting firm in lieu of arranging of the finance.

The bankers of the company wanted a due diligence exercise to be carried out to establish the credibility of the company operation. This called for an investigation into the billing and realisations of the IT company. The billing was classified into deputing manpower, the process support in developing and customisation of software and implementation of the software. The customer confirmation was received from the front company and the remittances were recorded against each of such billings in a sequential manner. Do you see any conflict in the role of the audit firm? Do you believe this could be a management fraud? How would you carry out this assignment?

3.18 Standard on Auditing (SA) 240 "*The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*" issued by the Institute of Chartered Accountants of India, lays down the objectives of the auditor as follows:

- (a) *To identify and assess the risks of material misstatement in the financial statements due to fraud;*
- (b) *To obtain sufficient appropriate audit evidence about the*

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*assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and*

- (c) *To respond appropriately to identified or suspected fraud.*

The auditor shall make inquiries of management regarding:

- (a) *Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments;*
- (b) *Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist;*
- (c) *Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and*
- (d) *Management's communication, if any, to employees regarding its views on business practices and ethical behaviour.*

An effective internal audit team can be extremely helpful in performing aspects of the oversight function. Their knowledge about the entity may enable them to identify indicators that suggest fraud has been committed.

## **Statement on the Companies (Auditor's Report) Order, 2003**

3.19 Clause 4 (xxi) of the Statement on the Companies (Auditor's Report) Order, 2003, deals with matters relating to reporting on fraudulent activities on whether any fraud on or by the company has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated.

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This clause requires the auditor to report whether any fraud has been noticed or reported either on the company or by the company during the year. If yes, the auditor is required to state the amount involved and the nature of fraud. The clause does not require the auditor to discover the frauds on the company and by the company. The scope of auditor's inquiry under this clause is restricted to frauds 'noticed or reported' during the year. The use of the words "noticed or reported" indicates that the management of the company should have the knowledge about the frauds on the company or by the company that have occurred during the period covered by the auditor's report. It may be noted that this clause of the Order, by requiring the auditor to report whether any fraud on or by the company has been noticed or reported, does not relieve the auditor from his responsibility to consider fraud and error in an audit of financial statements. In other words, irrespective of the auditor's comments under this clause, the auditor is also required to comply with the requirements of Standard on Auditing (SA) 240, "*The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*".

3.20 Although fraud is a broad legal concept, the auditor is concerned with fraudulent acts that cause a material misstatement in the financial statements. Misstatement of the financial statements may not be the objective of some frauds. Auditors do not make legal determinations of whether fraud has actually occurred. Fraud involving one or more members of management or those charged with governance is referred to as "management fraud"; fraud involving only employees of the entity is referred to as "employee fraud". In either case, there may be collusion with third parties outside the entity. In fact, generally speaking, the "management fraud" can be construed as "fraud by the company" while fraud committed by the employees or third parties may be termed as "fraud on the company".

3.21 Two types of intentional misstatements are relevant to the auditor's consideration of fraud— misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.

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Fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting may involve:

- Deception such as manipulation, falsification, or alteration of accounting records or supporting documents from which the financial statements are prepared.
- Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information.
- Intentional misapplication of accounting principles relating to measurement, recognition, classification, presentation, or disclosure.

3.22 Misappropriation of assets involves the theft of an entity's assets. Misappropriation of assets can be accomplished in a variety of ways (including embezzling receipts, stealing physical or intangible assets, or causing an entity to pay for goods and services not received); it is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing.

3.23 Fraudulent financial reporting may be committed by the company because management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target particularly when the consequences to management of failing to meet financial goals can be significant. The auditor must appreciate that a perceived opportunity for fraudulent financial reporting or misappropriation of assets may exist when an individual believes internal control could be circumvented, for example, because the individual is in a position of trust or has knowledge of specific weaknesses in the internal control system.

While planning the audit, the auditor should discuss with other members of the audit team, the susceptibility of the company to material misstatements in the financial statements resulting from

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fraud. While planning, the auditor should also make inquiries of management to determine whether management is aware of any known fraud or suspected fraud that the company is investigating.

3.24 The auditor should examine the reports of the internal auditor with a view to ascertain whether any fraud has been reported or noticed by the management. The auditor should examine the minutes of the audit committee, if available, to ascertain whether any instance of fraud pertaining to the company has been reported and actions taken thereon. The auditor should enquire of the management about any frauds on or by the company that it has noticed or that have been reported to it. The auditor should also discuss the matter with other employees of the company. The auditor should also examine the minute book of the board meeting of the company in this regard.

3.25 The auditor should obtain written representations from management that:

- (i) it acknowledges its responsibility for the implementation and operation of accounting and internal control systems that are designed to prevent and detect fraud and error;
- (ii) it believes the effects of those uncorrected misstatements in financial statements, aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representation;
- (iii) it has disclosed to the auditor all significant facts relating to any frauds or suspected frauds known to management that may have affected the entity; and
- (iv) it has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.

Because management is responsible for adjusting the financial statements to correct material misstatements, it is important that

the auditor obtains written representation from management that any uncorrected misstatements resulting from fraud are, in management's opinion, immaterial, both individually and in the aggregate. Such representations are not a substitute for obtaining sufficient appropriate audit evidence.

## **Clause 49 of the Listing Agreement**

3.26 Clause 49 of the Listing Agreement *inter alia* requires the CEO, i.e., the Managing Director or Manager appointed in terms of the Companies Act, 1955 and the CFO, i.e., the whole time Finance Director or any other person heading the finance function shall certify to the Board that:

- (a) They have reviewed financial statements and the cash flow statement for the year and that to the best of their knowledge and belief:
  - (i) these statements do not contain any materially untrue statement or omit any material fact or contain statements that might be misleading;
  - (ii) these statements together present a true and fair view of the company's affairs and are in compliance with existing accounting standards, applicable laws and regulations.
- (b) There are, to the best of their knowledge and belief, no transactions entered into by the company during the year which are fraudulent, illegal or violative of the company's code of conduct.
- (c) They accept responsibility for establishing and maintaining internal controls and that they have evaluated the effectiveness of the internal control systems of the company and they have disclosed to the auditors and the Audit Committee, deficiencies in the design or operation of internal controls, if any, of which they are aware and the steps they have taken or propose to take to rectify these deficiencies.

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- (d) They have indicated to the auditors and the Audit committee
- (i) significant changes in internal control during the year;
  - (ii) significant changes in accounting policies during the year and that the same have been disclosed in the notes to the financial statements; and
  - (iii) instances of significant fraud of which they have become aware and the involvement therein, if any, of the management or an employee having a significant role in the company's internal control system.

3.27 The above also relate to the role of internal auditors as facilitators or assessors of internal control. Each company should devise back-up procedures as part of its reporting structure that is appropriate for its management and business. Combination of following activity could be helpful in this respect:

- Request back-up certificate from responsible subordinate officer.
- Review functioning and effectiveness of internal auditor and external auditor.
- Review companies financial reporting system and controls with internal auditor and risk manager.
- Solicit views of audit committee, independent directors and legal counsel about adequacy of these procedures.
- Document the process used for review of all of the above.

# Chapter 4

## Corporate Fraud Control Plan

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### Chapter Summary

*The chapter focusses on options available to a corporate entity in managing the risk of fraud. There is an attempt to provide an insight into operation of an investigative cell (in a private entity) and advising the management on creating awareness among employees on fraud alerts through proper code of conduct. The process of escalation of irregularities and reporting to designated authority has also been discussed. Finally, there is a comment on the role of company's legal department in initiating legal action and alternative remedies for settlement of damages. At the end of the chapter there is a suggestion on evolving fraud control strategies to management including instilling of confidence and motivation to employees for ethical behaviour post discovery of fraudulent activity.*

4.1 Any relationship between like minded people largely revolves around mutual trust, faith and respect for each others' opinion. Even in day-to-day business matters there is an element of people outwitting one another to prove their point or achieve a desired objective. However, this is different from the use of deceit. It is pertinent to note that the use of deception has been practiced since time immemorial and compels us to believe that we have to live with this risk eternally despite strengthening of controls. There is always need for this caution in managing the risk of fraud before, during and after the event has occurred. Further, a fraudulent activity may not necessarily be a single event and, therefore, there are chances that an alert management is in a position to notice the leads that are available to identify suspected frauds before

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extensive damage is done to the organization. Materiality in audit findings is a significant factor for follow-up action by management. In fraud parlance this may not always be true as timely detection and remedial action would prevent significant damages. Hence, greater attention would be needed towards fraud risk in the risk management process.

4.2 Most organisations are averse to setting up an in-house investigative cell as the investigation team is exposed to extensive risk that could affect physical security. There is, therefore, more dependence on outsourced agencies who are independent or bring the requisite expertise to conduct investigative assignments. There is also a tendency to downplay irregularities considering that it carries a reputational risk to the organisation. Therefore, where there are internal investigative assignments where trail is destroyed when it is detrimental to the larger business objectives. In a weak control environment with inadequate internal audit system, there is a greater probability of fraud occurrence. From this perspective, let us examine what management ought to do to tackle this menace.

4.3 A CEO faces the task of constantly differentiating the good, bad and the ugly from his most trustworthy team of comrades. He has to run the business in the most pragmatic manner where mutual trust reigns supreme. When an auditor, whistleblower or informer points the needle of suspicion, the concern is manifold; there exists the risk of targeting the wrong person and one cannot rest till action is taken on the erring person. There is a need to draw the right inferences at each stage of investigation and forming an opinion on who are all involved. At times, the scapegoat tends to be the person who is at the front end of the fraudulent act and the person who masterminds the act is never in the picture. He remains unscathed, and thereby emboldened for further committing the fraud or even moves over to another organization before his deeds get unravelled.

Hence, it is essential for an organisation to first ensure that employees are aware of what constitutes a fraud, how they should avoid such acts, stay alert and bring to the notice of the management any deviations that can be construed as fraudulent

to the appropriate authority. The management should also ensure in-built systems to detect frauds. Once detected, it must ensure yet another stream of steps to gather evidence against the perpetrators of fraud.

## **Fraud Detection and Fraud Deterrence**

4.4 Each organization has its own established value systems and, therefore, would like its employees to follow the same through a code of conduct. This also provides the management a medium to interact with employees in defining the ground rules to be followed and actions that are not acceptable. This can also be termed as adhering to the principle of natural justice in amply clarifying to the employee the work culture that is encouraged in the organization. For the purpose, management must define what type of conduct may involve conflict of interest (or potential for a conflict of interest) vis-à-vis the official duties. This may or may not involve any pecuniary interest and may extend to any bias towards third persons in the official dealings/ decisions. Hence, non-competitive pricing of products or unjustified commercial dealings could also be within the purview of this code of conduct

4.5 Generally, employees are the first point of contact in noticing a fraudulent activity arising out of certain unusual or abnormal practices. These remain unreported to the superior reporting officer due to lack of training and awareness among the employees. The insecurity among employees is another reason for not escalating the matter to the reporting authority. Therefore, employees must be made aware of their role in detection as well as deterrence to such fraudulent acts and also apprise them of the reporting process through appropriate mediums.

4.6 Apart from providing abundant opportunity to the employees within the organization to stay away from fraudulent acts and report of any such deceit, it is also essential to set up independent monitoring system or devise strategies which work coherently with the following objectives:

- (a) Identification and reporting of unusual activities;

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- (b) Isolating deviations and surveillance mechanism in the day-to-day operations;
- (c) Use of computer applications and audit tools in keeping track of unusual transactions;
- (d) A robust accounting and management information reporting system; and
- (e) Effective interaction with the Chief Internal Auditor for appropriate audit reviews.

4.7 It is preferable that there should be an effective incident reporting process normally to a designated official (heading the investigative cell or compliance officer) to whom all the suspected activities will be reported. It should also be his responsibility to promptly update the management of such incidents.

The senior management executives need to consistently make an effort in educating the employees and related third parties on how to be alert to fraudulent activities, including suspicious activities and the manner in which the same needs to be communicated. In addition, the internal audit observations can be filtered to identify red flags and used as a medium to apprise employees of internal control gaps in prevention or detection of frauds.

4.8 When a financial fraud is suspected, certain immediate steps may need to be taken to prevent loss of evidence or furtherance of such acts. For the purpose, records and documents are taken in safe custody, and the persons connected with the activities are generally transferred to other activities till the perpetrator of the fraud is identified. The scope and period of coverage is dependent on judgement by the Chartered Accountant and this in turn would determine the time required to complete the assessment process.

These may relate more to the activities impacted due to fraud including fraudsters' access to records, documents and information. Unravelling the modus operandi of the fraudulent act could be equally complex with reference to identifying and deciphering the trail left by the fraudster and in gathering requisite evidence. This

is followed by an assessment of damages arising out of the wrongful act. In case the entity has an insurance cover, the insurer is informed of the incident and thereafter the extent of damages is also notified. The management has the option of either proceeding for legal action or can take disciplinary action on the erring employee or third party if the situation warrants. Where the perpetrator is not known steps may be taken for in-depth investigation either by in-house resource or external agencies.

## **Initiating Investigative Process**

4.9 Once a fraud is reported, a preliminary investigation has to be conducted first to assess and verify the enormity of the act and then the next step is to substantiate it with evidence. It is preferred that this is carried out under the aegis of the Compliance Officer (generally, a Chief Financial Officer or a Chartered Accountant in full time employment with the company).

The Compliance Officer should, generally, be a person of integrity and based on his past track record, should have the ability to manage situations of fraud risk. He is, normally, a person who is trusted by the management in safeguarding the reputation and image of the organization.

4.10 To achieve this objective, a Compliance Officer is an official who by the nature of his duties, generally, reports to the senior most officer in the Company (CEO or Managing Director) and may derive his power from the audit committee or statutory regulator. The Compliance Officer may seek the support of the internal auditor in discharging his duties on matters relating to the investigation.

The Compliance Officer will conduct a preliminary assessment of each situation and depending upon the magnitude of suspected fraud (which is by and large a matter of subjective judgment) will decide whether he has the resources within the organization to carry out a full-fledged investigation and the extent of outsourcing of the investigative activities.

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4.11 The Compliance Officer is, generally, in an advisory role to the senior most officers in the management hierarchy. His roles and responsibility may include the following:

- (a) Interaction with the internal auditor of the company.
- (b) Resource mobilization, either internally or outsourced, in engaging the services of chartered accountant firms for conducting investigation.
  - Sequencing of the events and activities for diagnosis of the problem.
  - Internal control assessment in highlighting vulnerabilities.
  - Preliminary assessment on the role of internal and external persons who are suspected to be involved in the alleged irregularities and details thereof.
  - Damage assessment arising out of the reported incident.
  - Collation of information on suspected fraudulent activity.
- (c) Ensuring a reporting format to the senior management or regulators such as, RBI, IRDA, SEBI, NHB, etc.
- (d) Comment on available evidence to form an opinion.

Considering the sensitivities involved in any information that relates to a fraudulent activity, it is essential that adequate confidentiality is ensured in collating such information and reporting. Based on his report management can form an opinion on the future course of action including referral for legal action, reporting to police authorities, filing of insurance claims, disciplinary action on employees, etc.

## **Managing Fraud Risk**

4.12 The role of an investigating Chartered Accountant is different from that of the line functionaries, as his primary concern would be to corroborate facts based on available evidence, within the

legal realms. Senior executives must give a free hand to the investigating officer and should not intrude into their investigative approach and methodology. Such intrusion tends to be counter productive. The desired course of management action will depend on the regular updates on the progress made in the investigation. It may be noted that just as the senior management is responsible for initiating the investigation, they have a similar right to call off an investigation.

4.13 Post discovery of a fraudulent activity, the manner in which the enquiry process is conducted may be defined through a policy document. This will also include the options available for disciplinary actions that could be explored by the management.

Anti-fraud programs enable the management in identification of areas that are vulnerable to potential fraudulent activities. Where such events are inherent to the business environment, counter measures for identification of irregularities and timely action should be ensured.

4.14 Unless warranted by law or regulatory institutions such as, Reserve Bank of India norms, it is the management's discretion on whether an incident needs to be reported to the police authorities. A weak or inadmissible evidence or reputation risk to the organization is sometimes a reason for not proceeding legally against the erring employees.

The management must also ensure that the above incidents are brought to the notice of the Chief Internal Auditor in a timely manner, including management action plan and corrective steps that are to be taken post discovery of the fraud. There should also be a standard format in which the management informs the audit committee and the board about the status of frauds reported, persons involved, type of fraud, recoveries, corrective measures and regular update on investigations in progress.

## **Management Fraud – From an Audit and Investigation Perspective**

4.15 While evaluating the performance of a Chief Executive Officer

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or reporting of extra ordinary performance by a Chief Financial Officer, there is a need for caution so that such performance do not subsequently turn out to be abnormalities. The consistency in applying the accounting policy is given a greater importance and an error at the outset may remain buried over successive years. The declaratory statements obtained from management akin to a certification of key balance sheet items cannot absolve the auditor from the larger responsibility in the event of a management fraud. The focus of review from an investigation perspective could extend beyond these statements given by the management.

4.16 Since external information is considered a superior form of evidence, it is important that these are not fabricated to convince an auditor. (For example, by operating a fictitious entity in a third party name, funds could be surreptitiously deposited and transferred through a bank account – termed by tax consultants as ‘entry business’). This may also involve creating a ‘front company’ as an intermediary between the entity and the bankers or vendors. The perpetrator of management fraud could use an individual’s identity (name lending) or ‘morphed’ document (such as, pledging the fixed deposit receipts or gold purchase and sale transaction of a third party or the purchase or sale of stocks through a sub-broker). This makes the unravelling of management fraud more challenging. It is in these situations that the efficacy of the internal audit function (in the normal course of business) and the experience of the investigator (once a red flag is identified) are of paramount importance.

4.17 Finally, the need for an abundant caution is a necessity considering that a poorly conducted investigation or a disciplinary action that is unjustified will affect the organization in terms of its reputation. It can also lead to unnecessary defamation suits by the affected person or even lead to destruction of the evidence which is central to an investigation. A poor control environment could also lead to inadmissible/ inadequate evidence in a court of law and a temptation for the employees and outsiders to engage in wrongful deeds tarnishing the image of the organization. To avoid this, the management should ensure an effective internal audit function that monitors the effectiveness of the preventive and corrective steps.

## **Case Studies**

4.18 A company had a project office in India for the release of certificates to students for certain courses through a process of e-learning. The billing and collection were remitted electronically outside the country. Thus, the expense projections (budgets) and actual expenditure became the medium for the foreign company to fund the operations in India. The management of the foreign company considering the increased spend on operating expenses, especially, in hiring of lawyers rising consumer complaints took the assistance of Chartered Accountants in ascertaining the fact of the case.

It come to notice that what started as a need to spend the available funds within the time targets became an allurements for the CEO. He resorted to collecting bills and letter heads and used them in padding expenses. To prevent in-house staff being aware of these acts, he switched over to outsourcing of the accounting function. The accountant kept booking the false bills without being aware of the fraudulent act. A scrutiny of the records revealed that the CEO had opened a manpower consultancy firm in the name of his brother-in-law earning commission for each recruitment in the company, entered into a contract with his sister-in-law for hiring of the most expensive of the car for the company (the monthly instalments being equal to the fixed hire rentals paid by the company), and opened bank accounts in the name of other relatives for payment of exorbitant advertisement expenses. This was camouflaged by ensuring namesake participation in exhibition stalls and campus visits. These resulted in extensive personal gain without incurring such expenses. Surprisingly, the letter head of the lawyers was also misused by the perpetrator of fraud in the process pocketing litigation expenses too. Thus, a scrutiny of the exception reports and unfavourable trends could have provided ample scope for isolating red alerts.

4.19 In decentralised operations there are compulsions for the management to delegate powers to a regional authority including that of defining of policies customised to local needs. Here, such regional managers may not welcome any independent controls or checks on their activities stating that this will hamper their freedom

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to operate effectively. Primarily the cause of fraud in these circumstances is due to absence of filters in the form of exception reports. The absence of incident reporting mechanism, covering up of anomalies by framing policies at a localised level and special approvals are factors that compound the problem.

4.20 In this web based world, the perpetrator of fraud can easily trap a target (there are greater avenues for a fraudster to mislead the management) through sending messages to a personal e-mail or to a unused e-mail account that is not in use by a designated authority. He maintains a record of such e-mails including delivered messages as a follow up action. At a later stage when he is caught in the act of wrongful gain, he points the finger at the senior management official stating that the action was duly notified to the senior management. The perpetrator as a result is able to strengthen his defence and cause nuisance value during the scrutiny process. Thus, misuse of e-mails can be a medium to impact the reputation of persons by the wrongdoer.

4.21 A company was engaged in wholesale trading of agriculture produce through a panel of brokers, the process of entering into a 'sauda' (deal) was, generally, verbal and later on converted into formal documentation released by the back office. Considering the critical nature of the operations, the company representative had to be person of high integrity in day-to-day dealings. The supply and demand in the market along with foreign exchange rates influenced the pricing decisions. The terms of payment were dependent on the past business deals with the broker and the volume of business offered. As a result, the most critical of the activities of entering into deals was retained with the Chief Operating Officer. A new broker was empanelled on trial basis as he was operating for the competitors' as well. This was to ensure to capture a larger market share by the company. Initially, advance payment was insisted by the company and considering the size of business and performance, the credit facility was extended up to seven days. Immediately on extending the credit facility, the broker defaulted in payment resulting in heavy loss to the company.

The internal auditor was called to quantify the extent of damages and study the available documentary evidence. Investigations revealed that the broker's employee had taken advantage of the

verbal 'sauda' process. He had managed to collect the cheque dishonour statements from the company's banker preventing the company to be aware of the cheque dishonours in a timely manner and gave a false presumption that the cheque was under clearing. He then managed to divert the stock and absconded with the amount realised. The obtaining of acknowledgement on the 'sauda chitti' (deal Slip) was not a market practice.

4.22. The user acceptance test is a common phenomenon in software customisation process. There was a dedicated official responsible for creditors' scrutiny and release of payments to vendors. The official befriended the software developer during the customisation process. In the Technical Committee meeting, he managed to convince the management on need for changes to vendor codes while generating the payment vouchers. The person responsible for signing the cheque used to ascertain the vendor dues by referring to the balance in the vendor account in the system. By changing the vendor codes, the perpetrator of fraud resorted to lapping of cheque payments and diverted the duplicate payments to his personal account.

4.23 A Joint Venture company had received advance payments from abroad and as per the terms of contract was supposed to export commodities (processed spices) over a three month period under a forward rate contract. The management noticed that its coffers were empty and the reason for the shortage in funds was not traceable.

The internal auditor was brought in to trace the flow of funds among the various business divisions and group companies. Before initiating the investigation process, the computer system had crashed and the employees expressed their inability to co-operate in the matter. As a result, a single entry system was adopted and details reworked. It was noticed that the advance money was diverted towards payment to rice mills and that the price of 'basmati rice' had dropped down heavily resulting in unviable business option. The advance meant for procurement of spices was no longer available. To maintain their company reputation, the partners to the joint venture had to honour their commitment despite incurring a substantial loss.

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4.24 The scrap committee in a company had decided to categorise the conditions for declaration of scrap and defined parameters for segregation. The stores person (an accomplice with the fraudster) advised the scrap dealer that it would not be possible to declare the round bars as scrap as these exceeded the criteria of two feet in length. Further, the reconciliation of project steel scrap was to be done only at the end of the project and in the mean time calibrations were used for issue and consumption of steel to record stock movement. The steel stock differences were pending for reconciliation and consumption estimates seemed to be off the mark.

The operating management stated the prime reason for high consumption to be errors in calibration in recording of conversions of assorted size of steel items, and the overall difference in stock would be within the two percent deviation limits.

An audit review was recommended into the differences that required item-wise updating of stock record at various stages of work-in-progress. While this was a complex exercise, the internal auditor was called in to investigate into the matter. It came to light that the scarp dealer had coerced the stores personnel to ensure that the round bars and other steel scrap fitted into the criteria for declaration as scrap (by cutting the round bars below two ft in size to fit into the scrap declaration parameter). The damages were assessed and reported to the management for further action.

4.25 The company policy required just in time inventory management system. There was a pile of raw material stock that was creating a problem for the local management in offering justification. Under the pretext of better inventory management these were shipped to other plant locations before fresh orders were again placed. Despite prudent measures the cost of procurement remained uncontrolled. The management called in the auditors to undertake a special investigation into inventory movement system.

The inventory module for the purpose of ageing of stock was using a FIFO method and the GRN date was the key field based on which the ageing of inventory was reported. There were two issues that came to light and revealed that the Plant accountants were portraying efficient inventory management system. The

inventory remained at the transporters warehouse for substantial time while it was knocked out from the transferor company. The transferee company was not required to record stock inward in its books as the stock was in transit. The rotation of stock in the system ensured that the ageing of the stock remained below the stipulated level, as decided by the company management, to meet the just in time model.

4.26 The bankers of a private company had a high lending exposure to a closely held group of companies. They were perturbed by the steep rise in loss booked in one of the companies to which major portion of lending was done. Over the past three years while the top line business was showing encouraging results, the cash flow position was not satisfactory with default in repayment of loan instalments. The management of the company had yet again forecasted poor performance in the following financial year. The bankers feared that the company would opt for insolvency and apply for restructuring of loan to avail concession in rates of financing as applicable to sick companies. Accordingly, they instituted a special audit akin to a financial due diligence to understand the key concerns.

The findings of the special investigation revealed that the current year's financial results were above the targeted level of performance. The management, as a matter of strategy, had created a cushion in the form of forced provision for doubtful debts casting doubts on the genuineness of the customer billings. There were several dealings with a group shell company (paper company) wherein the funds from the parent company were diverted. The procurement of raw material was fabricated as the vendors did not exist at the defined address given on the purchase bills. Fictitious labour contracts were prepared to inflate the wage bill. All these factors resulted in higher cost of operation. Extensive insurance policies were taken for stock and assets of the company. In the past several months, several manufacturing company in the vicinity had incidents of fire where the warehouses were gutted. The bankers appreciated the investigation effort and issued a show cause notice to their client for further action.

# Chapter 5

## Investigative Tools and Techniques

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### Chapter Summary

*The important factor in an investigation is that a Chartered Accountant has to rely on factual information and available evidence in reaching a definitive conclusion. The client, therefore, requires an assurance about the skill sets and comfort on the methodology adopted in conduct of an investigation and in safeguarding of evidence. This chapter deals with the investigation methodology in generating leads, especially, relating to manipulation to financial statements and safeguarding of evidence.*

5.1 The investigator and the client should have a mutual understanding on terms and conditions to withdraw at any stage of the assignment especially under circumstances involving threat to physical safety of the investigation team. The conclusions depend on the scope of the assignment, methodology adopted, extent of independence, and available trail of evidence and any other legal constraint in the conduct of the assignment.

The clients also tend to be apprehensive about the extent of confidential/ classified information that the investigators should be allowed access. The time slot for conclusion of any investigative assignment is a factor that is difficult to determine and has a direct relation to the cost of the assignment. The cost of conducting an investigation may also vary depending upon the specialist manpower resources deployed.

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5.2 The CFOs/ accountants are the gatekeepers of control in any organization and have to exercise due diligence against any false booking of transactions. As a prudent risk management policy, some companies pass on their risk through engagement with distribution network or intermediaries as a cushion to manage their debtors' position/ cash flows or resort to outsourcing of accounting function. However, the following examples illustrate how the control gaps impact the financial statements of such intermediaries:

- (i) To get additional funds/ borrowings the lending agency may review the business performance before disbursement of funds. The sales section may indulge in parking the stock with an intermediary and billing them as customers to disclose a positive business performance. As a result, the role of intermediary (in any business) has to be seen with caution whether it be a local broker/ distributor or off-shore distribution network. For the purpose, a periodic confirmation from the ultimate customer is desirable on veracity of the billings. The receipt of the consideration amount from the end customer under the circumstances is also important. The stock piling with an intermediary should also be a cause for concern. At times, the billing and receipts are not backed by physical transfer of the product billed and this may be further explored for any fictitious billing to boost top line.
- (ii) Generally, the seller/ manufacturer does not have control over billing operations of intermediaries and also on decision on retail prices. This could be another area of concern in validation of retail and market share. The problem is compounded when an employee indulges in fictitious transactions through a 'front company', 'SMEs', 'consultancy firms', etc. Generally, these may belong to a friend or a relative who does not form a part of definition of 'related party' transaction. These may also result in teeming and lading of remittances.
- (iii) Generally, competitors may indulge in strategies to subvert the competition by jacking up the demand by pushing fictitious buyers through the distribution network and have a budget to fund these operations. This induces the

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manufacturer to produce more against demand orders, at a later date the product gets sold in the resale market at a highly discounted price thereby killing competition in a phased manner. Where a push model of sales is followed, the manufacturer ends up with high level of stock and tends to be debt ridden. It is a common practice for CFOs to defend their position by discontinuing the operations or terminating the services of senior employees indulging in abnormalities, to prevent further damage.

- (iv) Fictitious sale, normally, could involve sale and buy back arrangements or bulk deals wherein a third party or a front company is used to inflate the sale projections and billing to overcome depleting sales. Generally, abnormal sales at particular time of year or at the time of closure of accounts require special attention.
- (v) The 'off book', debts or borrowings being shown as realization of debtors is also a method of disguising the cash flow position in the books. Generally, these are resorted to get more funding from bankers. Similarly, false sale projections may also be indicated by showing these borrowings to be advance received from customers towards sale orders.
- (vi) Sudden change in accounting and operational policies needs to be seen from the point of manipulation of financial statements. The accountants may during their internal review notice difficulties in recovery of dues, especially, for debit notes raised towards incidental service conditions such as, billing the customer for warranties, spares, etc. In order to cover up these deficiencies they may resort to issuing of credit note or journal entries for adjusting these dues that may be sometimes not justified. The policy changes may be directed towards removal of audit trail for future by alteration of the terms of conditions with the vendors or customers as the case may be. An external confirmation is highly desirable in these circumstances. The audit trail may have been removed in this manner of detecting any short recovery of dues or adjusting long outstanding advances to vendors.

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- (vii) The pre-shipment and post-shipment packing credit is an interesting activity for validating the overseas billing and collection process. The accountant may find himself in a situation where the billings done are resulting in stock pile up at the off-shore location that may have remained concealed. If the same is done through a distributor or front company, the risk of non-moving stock is a serious cause for concern. Alternatively, the undisclosed sale of stock while sending a pile of stock is also a method to fraudulently divert funds. The concessional rate offered for these transactions may not be available for indefinite period and force the accountants to manipulate the debt covenants. Similarly, the same situation may occur when there is no control over movement of stock or debtors by the manufacturer vis-à-vis dealers/ distributors or intermediaries. Availing of multiple loans or credit against the debtors or stock is also an area of fraud risk concern.
  
- (viii) Outsourcing/ centralization of accounting function is also a method at times used for manipulation of accounts as the fraud is committed through the involvement of booking clerk least suspected of manipulation. The booking clerk in this scenario is bereft of the ground realities and of the business model and also of the control check points. As a result, any fictitious transaction may get processed without evaluation of these control check points. There is a greater reliance on the information supplied by the CFO/ operations team to such outsourced booking clerks.
  
- (ix) For off-shore operations or fund transfers to remote locations, the cash flow position may be doctored to get additional fund allocation (time- cushion in managing operations) from a central authority. This reflects on lack of planning and improper estimate of cash flow needs by accountants. Thus, this is followed by a rationalization of thoughts by accountants that untimely remittance of funds by head office or central office makes it difficult to manage the operations at the remote locations. To show lower balances at month ends and quarter ends, the accountant may be indulging in window dressing of balances, that may result in blocking of idle funds to avoid any inconvenient questions. The periodicity

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of the bank reconciliation process, the extent of uncleared cheques could be indicative of such abnormalities. Sometimes, the cheques payments being of identical amounts, induces accountants to indulge in teeming and lading activities. To remove surplus funds, there is also a tendency to create fictitious transactions or sharing the surplus of such fictitious transactions with vendors.

- (x) Hidden cushions, secret reserves and unjustified provision for doubtful debts are sometimes used to spread the super profits in a year to the subsequent years, especially, when the future revenues are uncertain. This enables the management to spread the risk of declining revenues over a particular time horizon. Generally, an in-depth scrutiny of the bad debts or doubtful debts is not done in these companies citing external limitations.

## **Pre-emptive Measures**

5.3 The following are some pre-emptive measures that can be taken by investigation team:

- (i) Generally a lead and lag analysis and scrutiny of accounts over a three year time horizon would reflect any incident of manipulation by the management.
- (ii) The cash flow analysis with external evidence of source of funds and a balance sheet audit with a reality check of true net worth of the company are highly desirable at periodic intervals.
- (iii) Tracking abnormal trends/ high performers, i.e., a zero trauma' test is also a good measure to ensure timely detection of irregularities. A zero trauma is a management expectation that there are no pleasant surprises or shocks in disclosure of financial results or operating performance. From an investigative perspective any abnormal unreasonable business trend *vis-a-vis* industry experience is a factor that can be further explored. This could be followed up with background checks on persons suspected of irregularities in a covert manner.

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- (iv) Ensure independent vendor audits/ dealer audits, external timely confirmations, job rotations which are confidence building measures. Stoppage of the business or dealings for a brief undefined period is also a desirable practice to detect abnormalities.
- (v) Stock transfers at month end or inter-unit transfers that are not confirmed in a timely manner are also a source of concern in finalization of accounts. The periodicity of such confirmation is also of importance in ensuring better controls.
- (vi) Cut-off procedures for operational documents and input documents for accounting of transactions at the quarter or month end are of significance for any abnormal adjustments and these should include independent scrutiny of journal vouchers, credit notes and debit notes raised.

5.4 The following aspects are important while scrutinising manipulated accounts:

- (i) The change in policy guidelines or operational methodology by management without sufficient justification is another area that is a pointer to a senior management level fraud. Such leads need to be further corroborated with external reviews such as, background checks and identification of possible beneficiaries.
- (ii) The study of board meeting minute books and resolutions are another source of information that provides sufficient leads on any unfavourable decisions, especially, in a closely held company or joint ventures.
- (iii) Where critical accounting entries are centralised with one or two persons in the organisation relating to journal entries or closure of books, then this would need a caution in conduct of investigative assignments. The lack of audit trail on cut-off documentation and Re.1 transactions or creating buffer of documents for creation of fictitious sales or inflating top lines are common examples of gathering leads.

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- (iv) Encouraging creation of fictitious expense bills for employee reimbursements in lieu of staff welfare expenses.
- (v) The submission and maintaining of multiple books of account in different accounting packages. Operational records not synchronizing with the accounting records, etc., are further mechanism to gather leads.
- (vi) Surprise independent balance confirmations from banks, vendors, customers, securities and assets or balance sheet audits are mechanism to establish whether the financial statements reflect true and fair view.
- (vii) The procrastination of stock reconciliation, absence of stock summary, debtors' summary, debtors' confirmations or vendor account reconciliation also are lead indicators.
- (viii) The 'U' alphabet series in any ledger account is important for unreconciled accounts or suspense account. There may be a tendency to adjust unrelated debit and credit balances under a common head and this is a high risk area for potential frauds.
- (ix) The preparation of bank reconciliation statement and data entry or updating of the bank register by the same employee without segregation of duty is also a risk area for perpetration of fraud.
- (x) The absence of supporting documents on cost grounds are also a reason to suspect unauthorized payments such as, absence of itemized bills for telephone bill reimbursement could lead to personal expenses being claimed as official expenses. The use of cash memo bills from stationery shops is a common feature for small denomination expenses frauds. The serial control over these cash memos need to be verified along with other circumstantial factors. Recycling of old bills and invoices through alteration in dates is also a common example for fraudulent expense claims. This is also prevalent in areas where food coupons are distributed to the employees.

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- (xi) Proper documentation for registration of patents, trademarks, copyrights and violations in these areas are categorized as high definition frauds and are difficult to unearth and may require the services of specialists. The copyrights are generally, not quantified adequately and reflected in the financial statements that may result in potential litigation.
- (xii) The scrutiny of non-moving ledger accounts and inactive accounts are good lead indicators for detection of fraudulent activities. The carry forward and brought forward balances should be verified across a substantial period for any past period adjustments whether in stock or any other ledger account.
- (xiii) Any inconsistency in accounting practices over corresponding previous period is an area that would need further scrutiny for any justification for changes in accounting treatment. The lack of transparency in accounting or grouping of accounting heads is also an area that provides leads to suspected irregularities.
- (xiv) The transition to a new accounting package, improper data migration, delays in passing accounting entries, extensive data entry errors are indicators of fraud prone entities. Conflicting roles in Information Technology department in developing and running of programs are areas that may need engaging of information security specialists.
- (xv) The lack of proper segregation between cash book and bank book is a common area for adjusting shortages in cash balances and contra entries.
- (xvi) The periodic non-reconciled inter-unit balances, contra entries, absence of cheque counterfoils or incomplete entries in cheque counterfoils would need further scrutiny that could turn out to be a lead indicator.
- (xvii) Bribery and corrupt practices within the organisation without adequate checks and balances on such officials. Extensive appointing of consultants and liasoning agents are, generally, indicators of organised fraud. Bestowing of discretionary

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power at decentralised locations without a monitoring mechanism is also an indicator.

- (xviii) Organised white collar crime involve inking of contracts in a manner which leads to booking of revenue and expenses in different entities. The accounting policy of these entities could be different and, therefore, window dressing is ensured. The cash flow is also accordingly managed in a manner that is most beneficial to these organisations. However, these may indirectly result in diversion of funds to entities where a section of the management has beneficial interest. Most of these front companies or sub-contracting entities tend to be closely held companies or partnership firms that may not be governed by disclosure norms as applicable to listed corporate entities.

## **Steps/ Methodologies Involved in an Investigation**

### **Preliminary Assessment**

5.5 The primary steps involve extensive planning and brainstorming sessions in getting to a gut feel on whether there is a risk of fraud in the area under review.

### **Generating Investigative Leads**

5.6 The leads are gathered to further strengthen the above perception. First and the foremost challenge are the standards evolved by the management and to ensure a critical review of the policies and procedures that are put in place during the period wherein irregularities are suspected. The lead gathering could involve trend analysis, internal audit findings, process gaps, vulnerabilities testing and the missing link from such employees who have left the organisation or contracts discontinued under suspicious circumstances.

## **Data Analytics and Data Inter-relationships**

5.7 Data analytics focuses on inference, the process of deriving a conclusion based solely on what is already known by the researcher. Banks and credit cards companies, for instance, analyze withdrawal and spending patterns to prevent fraud or to identify theft.

Data analytics as a technique is extremely useful in generating leads and would depend on the area of review. Data inter-relationships involving two independent set of data and logical deduction of sequence of events, time chart analysis by plotting the date and timing of events relating to the leads or irregularities, occurring of events concurrently at two different places involving the same person, comparison of data relating to two independent departments for audit trails such as stores and quality control, standardisation of data and relating it to persons, assets or movement of asset/ people are methodologies, abnormal increase in expenditure relating to a particular department or a person are very useful in generating leads.

5.8 The comparison of the average tare weight of a particular vehicle category, the consistency in consumption standards over a defined period, the physical confirmation of stock or tracking of results of data analysis with a walk through analysis of ground realities provide clues to isolate abnormalities. For example, the reconciliation of stock records with physical inventory, the gate inward of items from gate controls to consumption and stock on hand as against work executed.

Comparison of the quality control reports on rejections, qualitative classification of scrap by manufacturing units before transfer to scrap yard and scrap disposal by stores when properly reconciled would provide a clue on adequacy of scrap billing and collections.

5.9 Fudging of production records across batches in a production line to adjust shortages and surpass quality control tests, the illegal storage of items in stock on behalf of third parties, spurious spare parts from a data analysis of frequent breakdowns and replacements, the use of letter heads and bills of vendors to book

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duplicate bills, use of high standards of consumption for diverting stock (aluminium ingots or other metal items) to other production lines or personal business, the use of stolen goods and rebranding the same through repackaging, frequency of MIS reports, common source of authority and responsibility allowing manipulations (usurping of authority), false accounting entries based on modification to files (especially in excel spreadsheet), false indents and production plans to remove stock of items from plant, mixing of scrap and rejected items in lieu of good stock and adjusting shortages, false incentive schemes resulting in abnormal increase in sales, absence of periodical review of outstanding statements are source of potential leads to unearthing irregularities.

5.10 Cross verification of freight bills with procurement and stock records, third party confirmation for stock retained at places outside the entity are practices that provide leads to any fictitious booking of bills. The use of multiple copies of the freight consignment notes (book copy, consignor or consignee copies) at different locations may lead to splitting of single trips into multiple freight billings.

## **Data Mining**

5.11 Data mining is the process of extracting hidden patterns from data. Data mining is an important tool to transform this data into knowledge. It is commonly used in a wide range of applications such as, marketing, fraud detection and scientific discovery. Data mining can be applied to data sets of any size, and while it can be used to uncover hidden patterns, it cannot uncover patterns which are not already present in the data set.

Use of specific audit tools ensures greater performance in less time. The sample size is no longer a constraint and substantive checks are now feasible on entire population. The developing of scripts (software programs) enable repeated use of a defined logical analysis and are useful in generating exception reports that enable identifying abnormalities over the entire population. The use of these tools has revolutionized the manner in which investigations are conducted by providing linkages to data; intelligence is gathered

in terms of duplicate entries, data inaccuracies, the linkage among sub sets of data for a meaningful analysis, etc.

5.12 The term data mining is often used to apply to the two separate processes of knowledge discovery and reaching definite conclusion. Knowledge discovery provides explicit information that has a readable form and can be understood by a user. Data miners sort through huge data sets using sophisticated software to identify undiscovered patterns and establish hidden relationships.

## **Information Security, Screenings and Detecting Leakages**

5.13 Parallel telephone connections could be a reason for loss of business and information that would require some technical expertise to identify such leakages of information in private offices. The eavesdropping by unauthorised persons within the office premises, unauthorised retrieval/ loss of documents or removal of documents and records in relation to certain events are also a good lead indicator for any discrepancies. Employees sitting late or an accountant or cashier volunteering to undertake multiple tasks on a regular basis or late sitting in office perennially are indicators of abnormal situations. Rotation of employees across locations, mandatory leaves, etc., are good practices that result in uncovering of leads on any suspected fraudulent activities.

5.14 The abnormal entries in system, the unauthorised access, the signing of documents when the employee is not present in office, any favourable treatment to vendors, persistent employee referrals, personal information in HR records such as names of relatives of employees (father, mother, brother, dependent sister) and similar data in vendor or customer records, the use of residence telephone and dummy addresses, creation of work orders to facilitate fictitious billings or procurements, sabotage by competitors through house keeping or other agencies unknown to the client, developing informers within the entity who are in the know of happenings, communication gaps between two locations of the company, use of facsimile machine for fictitious entities operated

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from employee homes, alterations in the input documents and data keyed in the system, etc., may pose threat to information security.

Extraction of deleted files or unauthorised copying of sensitive information from system in pen drives, frequent system breakdown, lack of adequate back up of information or loss of information trail are useful in generating leads.

## **Manipulations in Basic Documentation**

5.15 Use of carbon copies for marking additional figures or manipulating the expense amount is also a methodology that should be related to the basis of billings and whether proper validation exist in the bill passing procedures. Alteration in dates and amount figures or reuse of prior period bills and supportings are also means of manipulation.

Use of two independent receipt books for customer and for company bookings are another source for perpetration of fraudulent activity. Some other sources are duplicate or photostat copies of bills and receipts used for accounting entries and in maintaining of cash book, or use of memorandum books to deceive the customers and maintaining a separate books for accounting records. Improper use of all the copies of a documentation for the intended purpose such as, goods consignment notes (freight, consignor, consignee and book copies), invoice copies (customer, office copy, accounting, book copy), not scrapping and destruction of unused letter heads, invoice and receipt copies, unauthorised use of rubber stamps in bills and records for communication with customers, etc., may get used in fraudulent activity.

## **‘Entrapments’ by Fraudster**

5.16 Luring of potential targets by fraudster using ‘simple vulnerability testing methods’ akin to a trial run before a full fledged fraud is committed. A fraudster, generally, indulges in confidence building measures or rapport with the potential target. For e.g., he may build confidence with the distributor or manufacturer as a preferred customer through regular business transactions and

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ensure prompt payments to create an image of a customer with a reasonably good credit record. This encourages the client to enhance credit limit and the fraudster creates an opportunity and defaults in payment.

5.17 The dry run by the potential fraudster is a common practice wherein the auditors' practices are studied regarding sample size, the documentation review style and time interval between two reviews. The fraudster does a dry run on a sample basis to test vulnerability of getting caught before causing extensive damages. For the purpose, he gets into a position of confidence with the internal audit co-ordination matters. Another method adopted is to create sufficient documentary trail and retain the control within the department rather than allowing an independent verification by an accounts team. At a first glance, the entire documentary trails as required by the auditors are maintained. In such situations, there is a need for cross check or independent confirmation ensured on whether the activity was undertaken.

5.18 The retention of records and documents and the manner of filing of documents for easy retrieval is a factor that also would need close scrutiny. The fraudster tends to maintain the record in a manner that makes the audit process complex within a given time frame. The records and documents may also get transferred to a distant location within a short period of time to prevent access to the internal auditors. Rewriting or creation of records and documents exclusively for internal audit purpose is also a factor that needs caution while conducting investigation assignments.

5.19 The crashing of system or loss of data is a common example that is given by the suspects in an investigative process. At times, situation may demand rebuilding of data using single entry method or based on data from external sources as a part of investigative process. The facility to add suffixes or prefixes to payee names in cheques, identical payment or receipt amount not backed by confirmation from vendors or customers are areas of suspected irregularities. The improper tax registration numbers on sale or purchase invoices or improper telephone numbers or item descriptions, photostat copies instead of originals are indicators of irregularities that would need appropriate scrutiny.

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5.20 The master mind fraudster may use the services of gullible employees or undetectable third parties in indulging in irregularities. In the event of the fraudulent activities being uncovered, the master mind remains elusive due to lack of direct evidence. Under the circumstances, surveillance and background checks is resorted to uncover such remote control based fraudulent activities. Generally, such irregularities are done in connivance unsuspecting third parties outside the organisation. These, generally, surface through a whistleblower mechanism.

## **Logical Deductions**

5.21 The procurement of material when sufficient stock is indicated in the books or not purchasing of material at competitive prices are indicative leads. In a chemical processing or edible oil processing units quantity reconciliation in a reverse direction from output to input (flashing back akin to an ERP system) would provide sufficient direction on manipulation in stock or consumption patterns. The cross check with quality records would provide evidence of any manipulation in records vis-a-vis deviation in quality or adjustment of shortages. Any change in the frequency of MIS reports for each batch production could also be a lead indicator of any manipulation in production records.

## **Lifestyle and Employee Behaviour Pattern**

5.22 The background checks on employees, their movements, their interactions, gathering intelligence on their lifestyle and past track records are effective means to establish integrity of employees.

## **Time/ Motion Study and Documentary Trails**

5.23 The in-out timings of vehicles/ employees during abnormal office timings, the start and end time of activities and comparison with standard timings are examples of gathering leads. The attendance and leave records with reference to employee user IDs are examples relating information against two sets of data.

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5.24 Some examples of diversion of funds include:

- (a) Booking of revenue in an off-shore company while booking the expenses (manpower cost) in a local company with marginal revenue projections. The contracts between the two companies (local and off-shore) tend to be sham contracts that help in doctoring the revenue statements. The terms and conditions of contracts are, generally, termed confidential to the audit team. The internal audits of the revenue and cost statements are based on the information as shared by the management based on certifications. This is a common problem in companies handling projects abroad or foreign companies having project offices in the country. The cost of audit of these entities is considered prohibitive especially involving travel and stay abroad. As a result, these audits of off-shore entities tend to be done locally based on photostat copies as forwarded by such entities. Confirmation of customer billings and cost becomes a constraint in these kind of internal audit assignments.
- (b) The productivity analysis of the manpower cost would provide a ready guide on diversion of revenue to front companies. The expense ratios are of extreme importance in such analysis prior to engaging in a detailed scrutiny. For example, a company employed about 400 labourers for gardening and maintaining of ETP plant. The labourers used to clock in their time cards, but were predominantly used in the farm house of the head of administration department. The labourers used to be again brought back at the company premises during their official time out hours. A surprise count of labourers in a covert manner with the attendance record over a period time revealed ghost workers. A background check revealed that these were deployed for personal purposes.
- (c) The purchase of heavy steel and other machineries through a front company (closely held) and inflating project cost leads to fund diversion to such entities. These are more relevant during end use monitoring or in due diligence audits on behalf of banks and financial institutions.

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- (d) A foundry was sub-contracted the job of preparing moulds for two wheeler hoods. The input material was aluminium ingots that was procured by a listed company and supplied to the front entity on a contractual basis. The front entity has estimated high standards of consumption that resulted in diversion of aluminium ingots for other applications such as, manufacture of fan blades, etc. The standard loss of aluminium ingots was never challenged. Similarly, this is a common problem in supply of MS sheets and other metal items to fabricators.
- (e) Competing bids is also a common method for diverting the business to front companies. Here the front company along with the main corporate entity becomes joint bidders to garner larger market share. This is a common factor for fraudulent activity wherein designated officials start clandestine operations of floating private ventures and diverting business while in employment with the main company.
- (f) Another difficult area of investigation is uncovering of front running practices wherein employees indulge in placing their personal interest first while engaging in large security trading deals on behalf of the company. Fund managers getting secret commissions is also an area of serious concerns that is difficult to uncover and may require the services of specialists especially involving background checks. Most company's except for obtaining declarations from employees do not monitor these dealings as these tend to be managed through brokers or persons who do not come under the purview of term "relatives". The settlement of the deals in these dealings may happen at an uncertain future date or cross deals among entities.
- (g) In a company, cash receipts issued to customers clearly stated the purpose for which the cash was collected and ensured greater transparency on charges that were levied and collected from customers. This provided a trail of account heads and the purpose for which the amount was collected from the customer. This provided greater accountability on usage of funds and detection of any diversion of funds for

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purposes other than what these were meant for. The CFO decided to overcome this problem of accountability by removing the detailed break-up of the charges on the face of the receipt to divert funds for purpose other than what the customer has paid for.

5.25 Certain resources such as IT support and technical support may not be required in every form of investigative assignment. These may, therefore, be outsourced on a need basis to maintain cost competitiveness in execution of the assignment. These agencies are more in the nature of specialised service providers in gathering of evidence. For these agencies an interview with the user can yield valuable information about the system configuration, applications, encryption keys and methodology.

### **Collecting Digital Evidence**

5.26 Digital evidence can be collected from many sources. Obvious sources include computers, cell phones, digital cameras, hard drives, CD-ROM, USB memory devices, and so on. The principles applicable in detection of cyber crime can be applied effectively and consistently to a relational database. Additional copies of database evidence are made in order to preserve the evidence for future presentation during a legal process.

5.27 Other specific practices that have been adopted in the handling of digital evidence include:

- (a) Handle original evidence as little as possible to avoid changing the data.
- (b) Establish and maintain the chain of custody.
- (c) Documenting everything that has been done.
- (d) Only use tools and methods that have been tested and evaluated to validate their accuracy and reliability.

## **Imaging Electronic Media (evidence)**

5.28 The Chartered Accountants should use the support of Technical experts for capture of evidence or for working on a database in the investigation process. The process of creating an exact duplicate of the original evidentiary media is often called **Imaging**. Using a standalone harddrive duplicator or software imaging tools, the entire hard drive is completely duplicated. This is usually done at the sector level, making a bit stream copy of every part of the user accessible areas of the hard drive which can physically store data, rather than duplicating the file system. The original drive is then moved to secure storage to prevent tampering. During imaging, a write protection device or application is used to ensure that no information is introduced onto the evidentiary media during the investigative process.

## **Time Flow and Document Flow Reviews**

5.29 The time flow and document flow analysis with reference to an activity where fraudulent act is suspected provides vital clue on the following:

- (a) The time available for manipulation in data entry;
- (b) The lead and lag between happening of event and recording in system;
- (c) Any mismatch in events in the entire sequence of an activity can be uncovered;
- (d) Any loss of data or human intervention can be uncovered; and
- (e) Any destruction of evidence can be uncovered.

## **CCTV Footage**

5.30 CCTV cameras with various resolutions are fitted at key installations and locations. These have a defined storage period and a back up policy defines the storage of data up to a particular

time period. This provides physical evidence of events happening at sensitive locations for further analysis.

## **Flow Charts**

5.31 There are software tools that enable relational database analysis and provide leads on linkages between people who might be remotely connected in a fraudulent activity or who are associated with a fraudulent activity. As data is captured the critical data such as, address, telephone number, activity and other details are mapped and when the exercise is complete the flow chart displays the linkages.

## **Financial Ratios**

5.32 Financial ratios provide a good insight in identifying areas of concern; these ratios can be considered as a starting point in the analytical process and even help in assessing the impact of fraudulent activity. Unlike the normal evaluation of business performance using these ratios, a shadow profiling of company's activities need to be undertaken that will enable the investigating officer to isolate key concerns. For example, a favourable inventory ratio could be due to improper valuation of inventory, change in consumption standards during the year as compared to the previous year, write-off of inventory, fictitious purchases or inventory considered without booking of purchases, excess provisioning, etc.

5.33 The basic thumb rule for investigative an assignment is to obtain independent corroborative evidence on whatever documentary or circumstantial trail is placed before the investigating team. The simulation techniques of recreating the sequence of events in gathering leads and in defining milestones in the investigative approach would help drive the entire assignment.

## Chapter 6

# Diagnosing Fraud Behaviour

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### Chapter Summary

*Since fraud is usually concealed, material misstatements due to frauds are difficult to detect. Nevertheless, the auditor may identify events or conditions that indicate incentives or pressures to perpetrate fraud, opportunities to carry out the fraud, or rationalizations to justify a fraudulent action.*

*Such events or conditions are referred to as “fraud risk factors”. Fraud risk factors do not necessarily indicate the existence of fraud, however, they often are present in circumstances where fraud exists. When obtaining information about the entity and its environment, the internal auditor should consider whether the information indicates that one or more fraud risk factors are present. The internal auditor should use his professional judgment in determining whether a risk factor is present and should be considered in identifying and assessing the risks of material misstatement due to fraud.*

### Fraud Triangle

6.1 The factors that should be identified and removed to deter fraud (as described above) are best described in the “Fraud Triangle.” This idea was first coined by Donald R. Cressey. There are three Fraud Triangle conditions that are present when a fraud occurs. First, there is an incentive or pressure that provides a reason to commit fraud. Second, there is an opportunity for fraud to be perpetrated (e.g., absence of controls, ineffective controls, or the ability of management to override controls). Third, the

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individuals committing the fraud possess an attitude that enables them to rationalize the fraud.

6.2 The Fraud Triangle describes three factors that are present in every situation of fraud. According to it, the three main factors that induce a person to commit a fraudulent act would be as follows:

- (i) *Motive (or pressure)* – It is the need for committing fraud (need for money, etc.). This is a key ingredient to any illegal activity more relevant to criminal law. Usually, in case of frauds, the motive is quick and easy financial gain. The motive could emanate from economical, social or personal prejudices.
- (ii) *Rationalization* – It is the mindset of the fraudster that justifies him to commit fraud. When a wrongful act is justified, the fraudster is emboldened to carry out such acts.
- (iii) *Opportunity* – It is the situation that enables fraud to occur (often when internal controls are weak or non-existent). A person with fraudulent tendencies looks for opportunities when there is a least likelihood of detection. For the purpose, such a person may indulge in trial runs and test the vulnerability on a sample basis. As the confidence level increases, there is a tendency to increase the frequency of such acts and cause further damages. The fraudster is, generally, aware of the consequences and takes a calculated risk.

6.3 While it is extremely difficult to prepare a comprehensive list of factors that lead to commitment of fraud as these cannot be generalized to any given situation, the following are the reasons that may help identify the perpetrator of fraud or in evaluating whether an organization is susceptible to a fraudulent activity:

- (i) Crossing ethical barriers due to personal pressures such as, performance targets and personal habits.
- (ii) Business strategies overriding control environment and effective governance with undue emphasis on targets and compensation.

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- (iii) Disgruntled employee with revengeful attitude.
- (iv) A liking for breaking defined rules with employees displaying resentment to directions from superiors.
- (v) Greed and deceptive behaviours.
- (vi) Operating and financial decisions are dominated by a single person or few persons acting in concert.
- (vii) 'Subject' normally is evasive to audit queries and has frequent disputes with auditors coupled with a weak control environment. There are obstacles in ensuring proper audits and significant difficulty to audit certain transactions due to absence of adequate audit trails and documentation. There may also be lack of awareness about internal controls. Sometimes, the audit recommendations are not considered pragmatic and are ignored.
- (viii) Undue empowerment of authorities at decentralized locations.
- (ix) Financial results are inconsistent with the industry.
- (x) Excessive cash transactions without adequate control such as, extensive balance confirmations or customer reach out programs.
- (xi) Common Red Flags —
  - Significant inventory surplus/ shortages;
  - Rising trend of operating expenses;
  - Unexplained rise in cost of goods sold;
  - Sudden decrease in profitability;
  - Spurt in material orders at the time of employee resignation; and
  - High level approval of a trivial transaction.

<b><i>Before Fraudulent Act</i></b>	<b><i>After Fraudulent Act</i></b>
Amount in payment voucher approved by receiver before presenting to cashier had a blank before the amount in figures of ₹ 100.	Amount One thousand was inserted in payment voucher approved by receiver before presenting to cashier. (amount altered to ₹ 1,100)
Rupees <span style="float: right;">100</span>	Rupees <span style="float: right;">1,100.00</span>
Total <span style="float: right;">100</span>	Total <span style="float: right;">1,100.00</span>
(One hundred only)	(One thousand one hundred only)

**Fraudster uses simple common sense and not complex logic**

## **Common Indicators of Fraudulent Activities**

6.4 The following are some common indicators of fraudulent activities:

- (i) Alterations made to sensitive documents through:
  - Overwriting on existing contractual rates; or
  - Use of photostat copies to hide manual alterations.
- (ii) Use of internet as a means of deceptive communication.
- (iii) Use of websites as tool for deception.
- (iv) Impersonation and use of scanners for forging signatures.
- (v) Creating avenues to deceive through cleverly drafted policy guidelines.
- (vi) Loss booking through fake vendor bills.
- (vii) False sale orders, financing arrangements and customer realization.
- (viii) False entities and use of fax messages in these names for business.

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- (ix) Fake academic/ qualification certificates.
- (x) Computer generated bills for consultancy or labour bills that cannot be corroborated.
- (xi) Splitting/ duplication of bills.
- (xii) Submission of inflated bills for documentation purposes such as, loan processing, medical reimbursements, etc.
- (xiii) Declaring insolvency and diverting assets to relatives and/ or known persons.
- (xiv) Creating avenues for mishaps for availing insurance claims.
- (xv) Planting persons for sabotage of competitor's product launch.
- (xvi) Stealing of confidential strategic information and selling them to competitors.
- (xvii) Loan borrowed from local money lenders are reflected in books as advance from customers towards sale orders.
- (xviii) Identity theft.

## **Case Studies**

6.5 The following are some case studies on fraudulent activities:

- (i) The audit coordinator in a company was getting impatient on the slow progress on the audit front and was hinting at serious irregularities in several audit areas that need immediate attention. While he was forthcoming with extensive details, a closer view of his responsibilities revealed conflicting roles and override of authority. He was indulging in wrongful activities and was trying to divert attention of the auditors.
- (ii) The stores personnel explained to the auditor that the local scrap dealer was a brother of a local politician and was a powerful man. He suggested them to avoid venturing out for physical verification of stock or any confrontation with the

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scrap dealer. A closer review of the operations revealed that the storekeeper himself was being bribed and was indulging in issuing false gate passes for removal of material. The gate pass for MS and aluminium scrap as per the company policy manual was to be signed by Stores section and for garbage the same was to be signed by Administration department. Incidentally, the gate pass issued by stores section had indicated the item lifted as garbage and not scrap items. The security cell was not aware of the authorised signatory though a manual existed resulting in fraudulent activities.

- (iii) A senior official was getting irritable with the auditors even for trivial audit queries. This made the auditors suspicious. Further investigations revealed that he was engaged in siphoning of funds by manipulating creditors account, bank reconciliation statement and payment vouchers. The primary lacuna was non-verification of the source document by the cheque signing authority and instead the signing officer used to see the balance outstanding in the system. The suspect convinced the software professional to provide a facility of shifting the vendor codes in the system that enabled shifting of the transactions from one ledger account to another without a journal entry. This facilitated the issue of duplicate cheques to the same vendor accounts and misappropriation of funds through opening of dummy bank accounts and tampering of cheques by adding suffixes in the payee name. The internal auditor uncovered the fraudulent act while comparing the vendor related transactions with the material inward entries. The gate passes of earlier years were reused by modification to the input documents to cover up the duplicate entries. The internal auditor also found manual corrections at the input stage of the material inward records. There was no segregation of duty in preparing the bank reconciliation statements. The suspect was involved in software development, in scrutiny of creditors ledger account, in generating of payment vouchers, in preparation of the vendor cheques, took over the charge of assisting in preparation of bank reconciliation statement, was responsible for handover of cheques to vendors and was also in an unenviable position in matters involving strategic decisions.

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- (iv) An employee at a decentralised remote location had no avenue for promotion; yearly pay revisions were low despite his best performance on the work front. Alternate job was difficult to find in the place where he was posted. His income was insufficient to run the household expenses that included payment of house rent, education of two school going children and food expenses. He was frustrated and had lost faith in getting any response from the management. He had the need and was looking for opportunities to bridge the imbalance between his income and expenses.

He booked the creditors' bills (expenses related to office administration expenses) both as cash as well as credit purchases. The cash payments were pocketed by him, and the creditors were paid from the head office by cheque at monthly intervals. The internal audit coverage at such a remote location was not a regular feature. A scrutiny of the petty cash register with the ledger and control check points revealed duplicate entries, both in cash and credit entries, being made by the employee.

- (v) A foreign company engaged in e-education business had its operations in India and funds were remitted on the basis of projections given by the Chief Financial Officer. There was a budget exercise done at the beginning of the calendar year for the following financial year. To the extent the budget remained less utilised, a downward revision was ensured. The time taken to remit the funds was of one month from the foreign Corporate office based on a internal due diligence exercise. The Chief Financial Officer, in order to ease the funds requirement, started indulging in excess provisioning and creating secret reserves. The greed overtook his needs and he started indulging in booking fictitious bills. The collection of letter heads and blank bills from vendors became his habit. Further, booking commission payments and false consultation charges bills were other means he used to inflate the expenses. These enabled him to disclose increased utilisation of sanctioned budget amount. Initially, the Chief Financial Officer used these methods to manage funds shortage in the transit period. For the purpose, he opened bank accounts in the name of relatives who were

## ***Diagnosing Fraud Behaviour***

not part of the definition of the related party transaction disclosure requirements. This also resulted in opening fictitious entities (proprietary firms) for the purpose of transport hire companies, HR consulting firms, recruitment agencies, and advertisement agencies. Contracts were entered with these entities to bring sanctity to the dealings. This resulted in diversion of funds through booking of expenses against these entities. He outsourced the entire accounting function (data entry activity) to ensure that these activities are not detectable by in-house employees. He also gradually replaced old time employees by new recruits known to him and supportive of his actions. During the investigative process, he defended and explained to the internal auditor that the company officials from abroad were victimising him and that there won't be any discrepancy relating to documentation and supporting to the vouchers. This statement under the circumstances gave sufficient lead to the internal auditor and the case was solved in no time as the perpetrator of fraud was fabricating documents to claim fictitious expenses and falsification of financial statements. The required evidence in the form of unused letter heads, rubber stamps of all the entities were recovered from the office premises thereby providing conclusive evidence.

## Chapter 7

# External/ In-house Investigations

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### Chapter Summary

*When does one realize that the internal audit gets into the nature of an investigative assignment? Simply stated it is a matter of common knowledge that when there is a doubt involving dishonest intention then the nature of assignment gets modified. Although there is no ready formula for the conduct of an investigation, it is desirable that such assignments follow a set framework of execution. The chapter elucidates the importance of mandate and confidentiality in an investigation irrespective of whether carried out in-house or through an outsourced agency.*

### Mandate for Investigation

7.1 While starting an internal audit, if we stumble across areas that are touching upon a suspected fraud, pause for a moment; think about the area that is creating an issue for the company, persons who are involved, materiality of the transaction and its impact on the overall operations. Sometimes, the management may be reluctant to spend time for unnecessary work. For instance, issues such as duplicate bill being submitted for Travel Allowance can be handled even by a departmental head without any special investigation. During the internal audit one should be alert to areas that need special attention. It is always preferable to prepare a summary report and submit it to the Head of internal audit department or bring it to the notice of the immediate superior in the reporting hierarchy. The message is not to commence investigation without a formal mandate.

## ***External/ In-house Investigations***

7.2 It could be possible that the internal audit assignment is carried out by outsourced firm in an organization or by an in-house audit cell. The basic requirement when faced with such a situation where audit takes the form of an investigative assignment is to seek a referendum from the Chief Audit Executive. Further, the objective and methodology in an investigation also depend on this mandate. From the client perspective, the investigation by an external investigative firm carries a greater acceptance considering the independent nature of the assignment.

As a matter of principle, the ability of the firms in conducting investigation is of paramount importance in awarding an investigative assignment. Similarly, it is essential that the private investigators accept assignment for which they have the domain expertise. The greatest conflict arises when an investigation is carried out by an investigative arm or a subsidiary in an organization for its competitor.

7.3 During the course of audit one does comes across situations of suspected fraud. In this case, it is better not to come to a hasty conclusion alleging that a particular employee or person has committed a fraud on the company. As an internal auditor, one must put facts in an assertive manner to the extent that the reporting officer may take a serious note of the problem addressed and is convinced that there is a need for a thorough probe. The management's immediate reaction to a fraudulent activity is to seek explanations from the internal auditor on whether any vulnerability was noticed in the past and brought to the notice of the management through their internal audit reports.

7.4 What constitutes a mandate for an investigative assignment ? A mandate provides a medium to clearly understand from the client or the head of the internal audit department, the objective for undertaking an investigative assignment. This is essential in the context of defining the areas of review and the restrictions and the jurisdiction beyond which a person is not supposed to extend his review. It also enables ascertaining the available time limits to conduct the investigation. Where there are time constraints, the investigating officer may find himself at the wrong end, affecting

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the quality of work in execution of the assignment. Delays may result in action being taken on the wrong person, denying promotion or not declaring bonus to a deserving employee in the interim thereby affecting the reputation for the investigating personnel and the client at large.

**The mandate in case of an external investigation covers the following:**

- **Terms of reference**
- **Engagement letter**
- **Investigation methodology**
- **Resource deployment (optional)**
- **Fee structure and expense reimbursements**
- **Limitations and restrictions**
- **Security concerns and safeguards (optional)**
- **Expected deliverables (may not always be feasible to predict)**
- **Reporting requirements.**

7.5 Contrary to the above there are circumstances during an internal audit when a 'perpetrator of fraud' (suspect) would be anxious to know the audit approach of the internal auditor including the audit plan, the scope of coverage and the time schedule during which the audit will be conducted. He will constantly attempt to read the auditors' thought process and is most likely to try to remove the critical files or documents that contain vital information. In case an internal auditor is apprehensive of vital documents being removed or there is sufficient ground to raise suspicions, it is advisable to secure the documents, the photocopy at least and where permissible the original documents too should be kept in a secured manner. The client needs to be formally notified as they may need these documents for further action.

## ***External/ In-house Investigations***

7.6 A screening of the prospective client who approaches for investigative assignments is also preferred by the private investigators. This is due to some considerations. Normally, assignments on behalf of individuals or partnership firms are not accepted as there are difficulties experienced in settling the assignment fee and subsequent recoveries. In exceptional circumstances, where the stakes are high and client relationships matter then such assignments are accepted in the larger business interests. The second important aspect is the background of the client who approaches the investigative agencies. Where the stature of a client involves a reputation risk for the investigative firm, there may be an aversion in conducting assignment for such clients.

7.7 In case of accounting and audit firms that specialize in investigative assignments, clarity of thought must emerge within the investigation firm in relation to conflict of interest that may arise in terms of other client engagements. For instance, in a client relationship the acceptance of the assignment or the outcome of the investigation may result in conflict of interest with reference to the other assignments handled by the same investigating entity.

Abundant caution is required in ascertaining whether the investigative process is being used as a ploy to settle scores in disputes wherein the investigating officer is used as a pawn in the removal of evidence in order to weaken the defence in a legal proceeding. Further, caution is also needed in ensuring that the engaging client is not drawing the investigative firm as a party to a potential litigation or making them a party to a legal suit filed by the engaging client.

## **Letter of Engagement**

7.8 The most important aspect in initiating the investigative process is the preparation of the letter of engagement (LOE). For in-house investigative assignment these could be alternatively supplemented by an inter-office memo (IOM) or a mandate given to a subordinate officer from his reporting superior. Whether it is a LOE or an IOM, there should be abundant clarity in the subject matter for investigation. This should be listed down at the time of

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engaging in a discussion with the management or the concerned superior. Any additional work that is required to be done during the course of the assignment should be backed by separate mandates. In a situation, where the investigative process involves engaging the services of other vendors then the same should be stated clearly to the client. For example, in an investigation involving scrap disposal, for establishing whether the rates negotiated are competitive or to understand impact of fluctuation in steel price, there may be need for engaging the services of a vendor to gather the requisite information.

7.9 When using the services of a vendor, it is essential to verify whether there exists any conflict of interest in engaging his services *vis-à-vis* other assignments handled by him for the client or a competitor/ third party. In some cases, there may exist any relationship wherein the vendor happens to be related to the client or such third party. Alternatively, whether the vendor happens to be related to the person against whose actions as a result of investigation process is being initiated upon. As in the case of LOE and IOM, there has to be a contractual arrangement in engaging the services of a vendor, including a non-disclosure agreement with such vendor as otherwise there could be legal hassles if confidentiality of information is not maintained. Especially, where the vendor is not professional in his approach and happens to be a small time vendor who may not be aware of the implication of his actions. It is essential to make such vendors understand that he or his personnel cannot indulge in loose talk about the matter being investigated in public domain. In the above example of ascertaining the rates for disposal of scrap, the vendor while indulging in 'mystery shopping' should not divulge to any person whether internal to the client company or any outside person of the matter that is under investigation. The agreement with such vendor should include a liability clause for the purpose. In a nutshell, the mandate which the investigating officer has with the vendor should also be properly documented.

7.10 There should be a clear understanding in any investigation process, as to who will be the key contact person. A single point of contact is most preferred and can either be the Chief Financial

Officer or the Chief Executive Officer. The discussions on the matter being investigated should not be delegated to a junior person in the hierarchy. Many a time the client may not be in a position to appreciate this aspect and, therefore, it is imperative that the investigating officer should take the management into confidence in ensuring better control over the investigative process by holding discussions with senior personnel.

## **Non-disclosure Agreement (NDA)**

7.11 There should also be a Confidentiality Agreement or Non-disclosure Agreement (NDA) between the investigating officer and the client. There is a general presumption that such a NDA is required for investigation assignment to be carried out by external agencies. This is not true and such an arrangement is equally applicable to an investigation conducted by an in-house department, and it should be specific to the matter being investigated. As otherwise where this precaution is not taken, there is a tendency to discuss the matter at public places where a person inadvertently reveals classified information. The personnel in charge of investigation, in whatever capacity, should be made aware that they will be held responsible for any leakage of information relating to the matters under investigation. Even within the same department (whether within investigation agency or in the client company), the information on investigation is to be shared on a need to know basis. The members within the investigation department may not be privy to all the information or assignment handled.

## **Case Studies**

7.12 The following are some case studies on aspects discussed above:

- (i) A leading private company had reported loss of nearly ₹ 400 plus crores due to unauthorised investments by the managing director of the company. There is an element of delegation of power in matters relating to investments. Front running (akin to insider trading where employees riding their personal investments along with large scale investments on behalf of

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company) was a common phenomenon in regular business transactions that was difficult to monitor and was left to employees for self-declaration. Matters on business strategies were, generally, discussed at the board level and were not considered appropriate to be discussed with the internal audit functionaries due to strategic nature of the activity. Such a situation brings us to the question that who would be responsible for reporting on management fraud.

The internal auditor would need to define of the scope of the assignment once a mandate is given to him through a letter of engagement. The diversion of funds or assets is a common ground for most investigative assignments. The difficult proposition is to establish that these were unauthorised investments not referred to the board. Generally, a blanket right is given to the senior management within an overall limit. This could be stated as background to the assignments and rights under these powers that were abused. The internal auditor would seek special permission to probe into the aspects relating to diversion of funds to the personal account of the suspect or his relatives through these unauthorised investments. These may involve some part of the review being outsourced to outside firms and referral to legal experts. The investments could be fungible and exchanged for other benefits that are difficult to fathom. These could be cited as limitations. For how long these investments remain vested in various related group companies of the managing director is also a matter that needs to be taken into consideration for highlighting any abnormalities in reporting to the Board.

The above situation clearly highlights that the mandate for investigation is of paramount importance in understanding the management expectations.

- (ii) An investigative firm is appointed a vendor for certain support services. There was a dispute between the main investigative firm and the vendor in sharing of reviews in accordance with the agreed terms. At a later stage, the vendor felt that the amount he had agreed was not sufficient with respect to the

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work assigned to him. He had secured certain vital information during the investigative process. He threatened to sell the information as there was no direct agreement with the client. Where did the investigative firm failed in its engagement finalising process?

There was no confidentiality (non-disclosure) agreement with the sub-contracting firm binding him to act in a defined manner in relation to client information. (The example is illustrative and is not purported to be a real life example.)

## Chapter 8

# Pre-requisites of A Good Investigation

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### Chapter Summary

*In any investigative assignment, the rights available under the law of the land must be respected and awareness of the local laws and regulation is absolutely essential. Whatever may be the compulsions, any violation of the rights of individual or trespass would be counter-productive to the investigative process. While this may sound to be stating the obvious, let us understand the implications of actions to the contrary.*

## Methodology Used for Investigation cannot be Fraudulent

8.1 One ponders 'whether the use of deceit in conduct of investigation is permissible'? It is a fundamental principle to any investigation that the methodology used for investigation to surface the truth cannot be fraudulent. The Indian Penal Code refers to cheating as an act of using deceit on anybody to achieve valuable gain or causing loss to such other person. In the context of an investigation, where there is a use of deceit in ascertaining the truth, such a conduct by the investigating officer may land him into trouble and he may be susceptible to a criminal and/ or civil litigation suit being filed against him. The use of deceit can result in committing the crime of 'cheating' in the eyes of law. For e.g., any misrepresentation by the investigation officer (Chartered Accountant) as representing a company say 'XYZ' and thereby

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gathering information or enabling action or refrain by the subject can result in trouble to the investigation officer. There is a risk of litigation that the investigating officer should bear in mind. Hence, one should refrain from use of illegal means in the conduct of investigative assignments and act within the laws of the land.

8.2 There are two facets to an investigation. First, these may relate to accounting records and documents, largely internal to the organisation with certain validation checks from external agencies. However, in investigative parlance where the accounting entries seem to be concocted or there is a doubt on the veracity of the transactions, external checks may also be needed. The second facet of the investigation involves gathering of information on out of books entries, background checks or surveillance on the suspect or any person external to the organisation. The later aspect of the investigation could preferably be outsourced/ sub-contracted or done by experts or specialisits (qualified professionals other than chartered accountants such as, legal experts or informers) who are in a position to provide advise or corroborative information that could clear the doubt or confirm the wrongful activities. Such specialists/ agencies have a network of contacts in the market and their predominant daily routine consists of engaging in field activity. They are in an advantageous position to collect information, and to assess the market scenario. These agencies are in a position to carry out the field work legitimately too. Instead of carrying out the entire facets of investigation by Chartered Accountants, it is preferable to sub-contract or develop sources/ vendors. It is desirable that appropriate monitoring mechanism is in place for such external vendors/ sub-contracted activities by the Chartered Accountant firms.

8.3 Such an arrangement should be documented through an agreement describing the purpose of the engagement, the deliverables and the use of legitimate means to gather the requisite information or monitor the action. For e.g., let us examine a situation where the company has anonymous information that the bidding process for sale of assets is a facade as the entire operation is done through a team of bidders who are operating in a cartel, and there seems to be a collusion with certain officials in the company

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in fixing the bid price and the entire decision on whom to sell to and the sale price is doctored. As a result, the entire open bid process is clouded as a sham transaction. For gathering information from the market, or bidding for contracts, there are genuine operators whose job is to solicit information within the legal realm. One of the approaches to this investigation could be to engage the services of specialist bidders and ensure engaging surveillance specialists who are better suited to conduct background checks and 'shadowing' targeted individuals, to establish truth about the allegations. Such an arrangement in the conduct of 'mystery' shopping or surveillance is referred to outsourced agencies, which are backed by formal agreements explicitly stating the use of legal means and abundant safeguards in getting the required information. Once a list of vendors is given to these agencies, they normally do possess the skill sets to ascertain whether any relationship exists among vendors, where they meet and whether any cartel exists, etc. This type of work is more suitable to a person who is adept at field work, who can do the surveillance, who has much more network in the market in which these vendors operate, who can within the legally permissible limit intrude into these vendor companies and understand their operations.

8.4 As an investigation process, this work of surveillance can be entrusted to them by ensuring that the terms of engagement with such parties are legal. For instance, it may be stated that a group of vendor companies have given their quote to buy certain material. It may be requested to find out the following:

- (a) Whether the constituents of the groups of vendor companies are related to each other.
- (b) What is the reputation of these companies in the market?
- (c) Are they really dealing in this material?
- (d) Are their partners, proprietors or directors inter-related?

It has to be explicitly stated that keeping in view these objectives, no methods that are contrary to law will be used and all norms will be adhered to. The above ensures protection to the investigating

officer (Chartered Accountants) and the Company that engages these services.

## **Avoid Impersonation during Investigation**

8.5 Impersonation from a fraudster perspective involves identity theft. This is usually a situation where the criminal is trying to assume the identity of another, in order to commit fraud, such as accessing confidential information, or to gain property not belonging to them. This is also known as social engineering.

In this context, impersonation in place of another person/ fictitious person in an investigation is not acceptable. In this scenario, the subject believing the person who is indulging in impersonation may be revealing certain information vital to the investigative process that still will be considered as a deceit. In the eyes of law the investigating person has played a mischief and can be construed as a criminal offence and the investigator can be taken to task in a civil court and even sued for damages or criminal suit may be filed. Thus, in the pursuit of ascertaining the truth in the matter under review, the investigating officer may land in trouble.

8.6 Let us explore another scenario in the context of search and seizure in the investigative process. In a private investigation, where there is information that letter head, quotations, duplicate bills by the purchase officer or buyer are retained in his house, despite there being confirmed information, there is no right to enter the house. Such search operations can be done only in client's office or in such other office where the work is assigned. Even as an internal auditor one cannot search and seize material evidence, from the private desk of the 'subject' without seeking prior permission of the superior officer for possession of such material that can be produced as evidence.

8.7 The legal point of view is that there is no such authority of search and seizure to a private investigator (Chartered Accountant). Suppose bills, letter heads are in the private possession (outside the client's office premises) by the purchase officer; there is no right of search and seizure and trespass in the investigative

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process to the private office or home of the suspect. To conclude, a private investigating officer (Chartered Accountant) does not have the right of search and seizure. One can however carry out search and seizure operations within the office premises (of the client) where he is working for the organization.

**The traits of an Investigator can be summarized as under:**

- **Confidentiality, Honesty, Integrity**
- **Trust/ faith**
- **Composure**
- **Capability, knowledge, skill**
- **Experience.**

## **Precautions in Investigative Assignments**

8.8 The stakes at times in an investigative assignment are high and there are compulsions wherein a suspect tries to indulge in assessing the strength and weakness of the investigating officer (members of the investigating team). He is curious to know the strategies and tries to wipe out evidence or creates stumbling blocks or distractions in the investigative process. It is essential for the investigating officer (Chartered Accountant) to be unbiased, to build trust among the team of investigators and vendors. He should not compromise position during the course of investigation due to threat or other inducements and adhere to the code of conduct norms of the Institute of Chartered Accountants of India. The secrecy of information is also a matter of paramount information, and should be above personal prejudices among the team members. Care should be taken to brief inexperienced team members not to indulge in planting of evidence to improve the chances of success in an investigation. This may prove to be counter productive and harm the investigation process. The biggest task for a lead investigation firm is to prevent the chances of selling or sharing of information to undesirable sources. Thus, it is equally essential to build appropriate checks and controls in the

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investigation process. The management also must take abundant caution in engaging the services of private investigators as the fee largely depends on the man hours spent and scope of the engagement that is not, generally, within the control of the management. There is, therefore, a need for constant updates on the progress made in investigation and ensure that there is no perception that there has been an undue advantages in the minds of parties to the engagement.

8.9 Perhaps the biggest security for an investigating officer is when he represents an organization (a Chartered Accountant firm) or works as a team, as distinguished from working in an individual capacity. This mitigates the threat on the investigating officer (an individual Chartered Accountant) on duty as the suspect is dealing with an organization (firm) and any physical assault or threat to the investigating officer will act against his interest. It is also preferred that there is adequate security cover provided to the investigating team. Such a protection may not be always possible and an investigating officer is expected to exercise diligence in taking decisions and is answerable for his actions.

## **Case Studies**

8.10 The following are case studies highlighting the abovementioned aspects:

- (i) The internal auditors of a reputed multi-national company brought to the notice of the head of the legal department that certain abnormal travel and administration expenses could not be corroborated with the corresponding legal activity. There were fictitious letter heads and rubber stamps of outside entities. The evidence was not in the private office of the persons claiming such expenditure.

The abnormal expenses could be identified through the inadequacies in the supporting documents for travel, local conveyance and recording of minutes. These were not conclusive and similar practices were followed by most other departments within the organisation. Any implication of a

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particular staff in legal department to the exclusion of other departments would have resulted in a biased investigation. Finally, the evidence was available through scrutiny of the itemised cell phone bills, the outward records maintained in the despatch section and the boarding and lodging bills of the concerned employee. These pointed out that the expenses were of personal nature and not related to business activity. The investigation in this manner was finally concluded without resorting to trespass into the suspect's private office to gather the evidence.

- (ii) An internal auditor in the course of audit review and validation of the audit findings was on a field visit on an asset tracing job in a finance company. A review of the R.T.O records revealed that the vehicle had changed hands. The documents that were handed over to a broker for completion of R.T.O formality were misused and vehicle had been sold to a third party under a bank finance arrangement. The finance company officials were not aware of this vehicle changing hands and they had repossessed the vehicle. Since the papers submitted to the R.T.O were cleared by the finance company employee though misused by the broker, the company had no right to repossess the vehicle as the banker had the rightful lien over the asset. The new borrower threatened to register a police complaint against the finance company officials and as a result the vehicle had to be released back.
- (iii) The former employees of a company colluded with outside elements and started a competing business with the company. The company was dealing in a product that was not available in the local market and imported the same from its manufacturing units abroad. These groups of people (former employees) used an insider to divert this product to a place outside the manufacturing unit. The internal auditor summarized the following:
  - (a) In the production planning process, the indents placed were in excess of requirements. There was no confirmation on record of the material shipped vis-à-vis

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indents received from some of the locations.

- (b) The daily MIS was converted into a monthly MIS for monitoring loss in transit and manufacturing loss.
- (c) Certain new local transporters were appointed and contracts entered. The freight bills for these transporters were cleared within 15 days as compared to 30 days of credit allowed to other transporters. Authorization rights/ approvals for freight bills were localized in the recent period of audit that was hitherto approved from Head office.
- (d) The material was shipped to a local unit outside the factory premises and material transshipped to outside elements. The transport operator was a conduit in this process and was paid in cash immediately on transshipment of goods to outside elements. The internal auditor could not trespass into the transit unit as the same belong to outside parties not belonging to the company.
- (e) A review of the local transport freight bills and cross verification with the security guards and outside informer helped establish that the vehicle belonged to the spouse of the indenter employee. The same was corroborated through the R.T.O office records (external validation).
- (f) Based on the reconciliation of the Form F under the Sales Tax Act for inter-state stock transfers, it was concluded that the indents were fabricated and the material was diverted to outside premises amounting to theft of the goods.

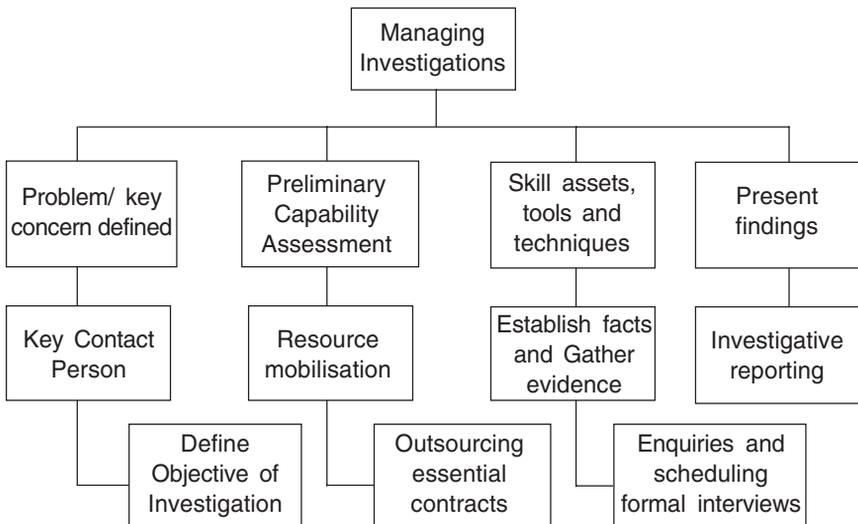
## Chapter 9

# Managing Investigative Assignments

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### Chapter Summary

*This chapter provides an overview of investigative process starting from problem definition, capability assessment, skill sets required, mobilisation of resources, time and cost estimates to final presentation of the results. The importance of planning, client confidentiality and precautions on use of tools and techniques to a limited extent is also elaborated. While an attempt is made to make the reader aware of the pre-requisites of handling an investigative assignments, however, these would primarily depend upon client expectations and status of trails available in carrying out an investigation.*



9.1 The investigators have to conduct assignments in varied business enterprises with varied situations. Fundamentally it is their approach in managing the assignment and skill sets that are important. An investigator may not be fully aware of the domain knowledge of the business enterprise where he is commencing an assignment. However, he must have the ability to quickly grasp information on business process knowledge, people engaged, critical documentation requirement, activity flow and timing of these activities, and also the chain of authority and responsibility within the organization or environment in which the investigation is being conducted. He thereafter looks for any clue based on deviation in these processes. He is expected to apply the skill sets as may be required in a given situation.

### **Problem identification - Key Concerns**

9.2 The objective of carrying out the investigation will depend upon the key concerns expressed by the client. There could be allegations against employees that need to be corroborated like, kickbacks and allurements to employees, appointment of business heads, extension of services of employees as a matter of gratitude, propriety audit for key managers leaving the entity, red flags identified by internal auditors, information gathered from whistleblowers on unusual or unacceptable practices, contractual arrangements to the detriment of the company, misuse of authority, conflict of interest, breach of contract, attempt to sabotage a product launched by third parties or competitors, the leakage of research and development papers, clandestine transfer of secret product formula, damage claim filed on the company and validation thereof, disputes among key constituents of a business entity, formation of dummy companies operating against the interest of the company, misinformation or falsification or distortion in financial results by management, theft on the company, spurious and counterfeit products affecting the companies market share, etc.

### **Preliminary Capability Assessment**

9.3 Vetting of the key concerns is the first step in confidence building exercise with the engagement client. It is imperative for

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both the client and investigative firm to understand the key concerns and assess capabilities in managing the assignment within the legal realms. Similarly, there are assignments that involve conducting of interviews with the suspect or the use of gadgets in a lie detector test which are exclusive rights given only to police authorities under a defined process. It is of common knowledge that these gadgets are not allowed to be used to unearth information by the common man.

## **Key Contacts and Roles**

9.4 A record of key contacts should be maintained and filed properly. Preferably standard format should be put to use for ease of retrieval. There should be a common understanding with the engagement client or the key person with whom the progress of the investigation and other requirement will be discussed. Generally, there is a single point contact person for meeting the investigation needs and he acts as the co-ordinator.

## **Creating Project Codes**

9.5 Each assignment is given a unique project code that is used for all the internal and external communications. The project code enables in keeping track of the time and money spent on the assignment. Any cost overrun is notified to the customer for necessary approvals. This also helps in understanding whether the cost and fee projections are in order. The assignment of project codes also helps in maintaining confidentiality about the client and the assignment handled *vis-à-vis* the outside world.

## **Investigation Methodology**

9.6 Depending upon the nature of the assignment, the approach could be either a covert or an overt approach. A leading foreign company having operations in India approached an investigation firm to discuss whether there is any diversion of business. The foreign company had an Indian arm, a company registered in India and was informed that for conducting business in India, there is a need for operating through such a front end company. The first

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attempt by the investigation firm was to create a relationship of trust with the lead investigator. The condition put forward by the client was that the investigation should be done in a manner that the business interests of the foreign company in India are safeguarded. However, a covert assignment ultimately comes into the open at some stage of the investigation. In the present case, the investigation had to be conducted across the globe involving extensive coordination among two investigative firms one based in India and the other firm based at Canada. The investigation revealed diversion of business by the management personnel in India to a private closely held company. Using the resources of the parent company the persons in India were operating a business within a business and had resorted to activities for personal gain. The investigation efforts included safety of the senior management personnel during their stay in India and also while managing the entire exercise.

The investigators tend to have an overt approach when the fraudulent activity has already been uncovered and is known to the suspect, and there is a likely belief that the evidence could be tampered with or destroyed.

## **Identifying Resources**

9.7 Depending upon the nature of activities based on the preliminary assessment and the geographical spread, the client is given an indication of the resources that will be deployed including stay arrangements, the IT support, and the key safety measures wherever necessary. Further, confidentiality is maintained of the people engaged especially for background checks and field activities. The engagement of law firms for legal support or lead firm where there are various territories is also a matter to be decided in advance to ensure proper co-ordination. The timing of engagement of various team members is also decided as a strategic matter. At this stage, the decision on cost of the investigation is of paramount importance and client acceptance is very important to prevent any disputes at a later stage.

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9.8 Irrespective of the nature of investigative assignment, a conservative approach with utmost care is required to be taken in terms of engagement of resources till the conclusion of the investigative process. This may require many hours of brainstorming, drawing up strategies and simulated exercises to prevent any act that may affect the quality of investigation.

## **Defining the Objective of the Investigation**

9.9 Understanding the objective of the investigation is of utmost importance. Any ambiguity in this area leads to futile efforts and such miscommunication would lead to disputes in settlement of dues for the investigating firm. Hence, the objective of the investigation and background to the investigation should be formally communicated to the investigating team.

## **Drawing the Scope of Coverage**

9.10 In any untoward incident, it is important to shut the doors and draw boundaries. This is a preventive measure from loss of any vital clue and removal of evidence. This also ensures a focused approach towards investigation. In a controlled environment, there are systematic checks and balances that are ensured by a professionally managed company. Any attempt by the suspect to cover up the audit trail will require camouflaging all these checks and balances. A good investigator will take stock of all these controls to be in place in the investigative process. It is important that all the outlets or escape routes in terms of removal of evidence are blocked to prevent any mishap in the investigative process. At this stage, it is essential to define the timelines for the assignment and for various constituents of the investigation team.

## **Safeguards in use of Tools and Techniques in Investigation**

9.11 There are sophisticated tools such as, voice recorders, cameras, bugs, video shoots, CAAT, spying software, frequency analyzers for detecting whether there is any eavesdropping.

Flowcharting and data relational analysis, physical inspection, interviews are some of the techniques that are commonly used in an investigation. The investigating officer must first ascertain whether the local laws and regulations permit the use of the tools, gadgets and methods that will be deployed in the conduct of the investigation.

## **Use of Voice Recorders, Cameras and Video Shooting**

9.12 It is a preferable that any audio or video recording of events be informed to the subject to ensure that these do not infringe privacy laws before engaging in such activities where these are private conversations. Recording of telephone conversation should be with permission from subject and must be informed to him. The responsibility on the investigator for in camera investigation is extremely difficult and requires extra caution in terms of addressing the subject. Any careless recording could lead to negation of evidence and care should be taken not to infringe on the privacy of the individuals. As regards video/ voice recording is concerned, it cannot be construed as substantial evidence and the same can be refuted in the court. At the best it can only be a corroborative evidence.

## **Profiling of Key Suspects and Informants**

9.13 Profiling can be done either on suspects or informants to establish a fact and it helps in progressive steps in an investigation. For example, the frequent loss of cartridges/ stationery in a common pool of printer, an information that administration department accepts bribe in allotting canteen contracts, etc., are situations that normally suit an investigation by a police authority. However, during the course of internal audit when the company officials would prefer to internally investigate the matter then profiling of suspects comes handy. Profiling helps in narrowing down on the suspects out of a group of people involved in an activity.

**In simple terms evidence can be categorized into:**

- a. Testimony**
- b. Documentary evidence including digital evidence**
- c. Physical evidence**
- d. Circumstantial evidence including eye witness and personal observation**

## **Gathering and Interpretation of Evidence**

9.14 In an allegation by a third party that the purchase officer in a company was accepting bribes, a real time pre-audit of the activity was conducted wherein the vendors were engaged to record the proceedings and the profiling was done to establish whether the suspect was engaging in such an activity. During the course of the discussion the purchase officer vehemently stated that there are many others who wanted to engage in a business arrangement and, therefore, something had to be done to promote the business relationship. The place and time of payment of the bribe was finalized and this fact was recorded in the presence of witnesses. On the appointed day when money exchanged hands, the immediate superior who was asked to be present within the premises was informed of the development and when confronted, the suspect had no option but to admit his wrongful act. The role of an independent witness is very important in the entire process. Such an admission before an independent witness is like an extrajudicial confession.

9.15 When an accused is produced before a magistrate during an enquiry or a trial, the investigating officer should produce the case file after having completed the daily diary including the time of investigation. These diaries are an aid to an enquiry or a trial. The entries in this diary are to be filled in a chronological order in an objective manner. These details are not required to be shared with the accused for the simple reason that the details of the informants which are generally kept confidential will be revealed

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and could endanger such an informant. The daily diary improves the credibility of the investigation process. It is advisable that even in a private investigation the investigating officer should maintain a case file and a daily record of events in a chronological manner. This will assist in continuity of investigation in the event of handover of charge to a new investigating officer if such a situation arises.

In such a situation, it is advisable to document the sequence of the events as distinguished from a case diary, i.e., recording the events during the course of investigation. An independent witness to the events with the working notes duly signed would hold well in any investigation.

9.16 Whether during the course of internal audit turning into an investigation or when there is a suspicion on vital evidence being retained in the drawer at the office work station, it is important to gather the evidence in a proper manner, even when these are retained within the office premises of the engagement client. The superiors need to be informed of the intended action. The details of the actions need to be documented including the findings in the sequence of events notings and signed by an independent witness. The extent to which a person can retain his personal belongings in the office premises depends on the rules of the organization. That is the reason some companies impose restrictions by obtaining declaration from employees on limited retention or non-retention of personal belongings including money in the office premises.

Whether it is a case of retention of foreign currency or personal cash in the personal locker in a gymnasium or in office premises, the above process of documenting the evidence is admissible in a court of law. Whether this will stand test of scrutiny is a separate issue. Further, investigation related to activities helps in establishing the source of money to strengthen the test of scrutiny.

## **Schedule of Evidence and Working Papers**

9.17 A schedule of evidence gathered and working papers should be maintained. The working papers should be prepared in a manner under the presumption that these may required to be presented as

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evidence in litigation suits or during the formal interview phase at a later stage in the investigation. The exhibits and key evidence should be kept in a secured manner free from any tampering or destruction.

## **Documenting the Sequence of Events and Related Key Concerns**

9.18 This is an important aspect in any investigation. A well documented investigative process ensures that irrespective of the presence of the investigator at a later date, it is easily understandable and retrievable by successors. Especially when litigation proceedings prolong for long duration, the standards for documentation can be customized to investigating officers' needs and as such there is no standard format that is comprehensively used. This also includes documenting of assumptions at each stage of the investigation.

## **Interview Process**

9.19 The objective of an interview is to establish the truth and, hence, it forms an important aspect of any investigation. There are ground rules for conduct of an interview within legal realms.

## **Presentation of Results including Reporting**

9.20 The presentation of results should be defined at the time of finalizing the engagement terms. The results could be verbal, presentation through visual aids, or formal reports. In private investigations, where the management is not interested in prosecution of the suspect and is only interested in confirmation of a doubt for internal reasons, and then the same is ensured without a formal report being submitted, i.e., through verbal briefing. Where these are issued for limited internal use, the same should be mentioned in the reports. The language of the investigative report should be simple and easily understandable, especially, when submitted to a legal authority or for filing a police complaint. There should be no subjectivity or bias in the report as it is a report from

an independent agency. The investigative reporting and presentation of findings is dealt with in chapter 13 of the Guide.

## **Case Studies**

9.21 The following case studies illustrate situations discussed above:

- (i) Three persons, *viz.*, a business magnate, a prominent socialite and a media person came together at a common event on a trip abroad. Their acquaintances turned into friendship. They decided to give a shape to their relationship by starting a business venture. The socialite assured all help in getting permissions but insisted a sizeable upfront contribution to his social outfit. The business magnate offered financial assistance but had very little time to attend to day-to-day business operations. The business relationship commenced with a share in profit between the business magnate and the media person under a mutually acceptable formula in sharing of profits arising out of the venture. Years passed by, the media person landed in trouble and there arose a reputation risk to the business magnate. The socialite had already distanced himself at the outset. The business magnate was now looking for an avenue to sever his relationships. He summoned his trusted partners and sought clarification on how the business performed. To his surprise, explanations to several queries remained unanswered by the operating management. The Chartered Accountant was approached for ascertaining the areas of revenue leakages and the extent of damages suffered by the client engagement. A review of the financial statements revealed diversion of assets and funds to another entity. The minutes of the meeting could not provide corroborate information on key decisions taken by the operating management. The Chartered Accountant also had a role to conclude the investigation through proper conflict resolution measures and had to quantify the amount to be settled between the parties to the dispute.
- (ii) A foreign company had set up its operations across the globe and was monitoring the business operation through

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designated offices. The company officials were informed that to operate in the line of the business there was a need for an Indian company. The audit head from the designated office had doubts about this requirement and, therefore, approached the Chartered Accountant with caution and requested that the assignment need to be carried out in a covert manner. In the course of the investigation if it is confirmed that there is indeed a need for an Indian company to run the business then there is a need to maintain utmost secrecy in the matter as otherwise this will result in loss of business opportunity the impact of which could be significant. The Chartered Accountant had to plan his strategies in minute detail and studied the fund flow pattern and usage thereof. Under the pretext of change of software applications for accounting package across the globe and for standardisation, the data in the hard disk was copied by the investigation team and was provided to the senior engagement partner of the Chartered Accountant firm for further scrutiny. The operating management had diverted business to their own entity in every 2 out of 3 bids for various projects. The investigation revealed a closely held company was operated in the form of a company within a company resulting in diversion of business to such other company. The entire operating management had to be overhauled.

- (iii) The internal auditor during regular vouching at a manufacturing plant saw several instances of stapler pins being used for the supporting vouchers. These were all photostat copies and originals were retained at the corporate office. The auditor was inquisitive regarding consistent use of stapler pins in the weigh slips considering that the tare weight of the vehicles in the weigh slips was not in line with the carrying capacity of the truck. The management mandated investigation into the matter and it was found that the computerised weigh scale operator was fiddling with the dot matrix printer to ensure that perforations are aligned in a manner that the gross and tare weight slip can be mismatched. This resulted in 3 to 4 tons of steel scrap being clandestinely shipped out of the plant (being the

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difference in the tare of a bigger vehicle being swapped against the gross weight of a smaller capacity vehicle).

- (iv) During an internal audit it was noticed that the scrap lifting time was generally during the change in shift. At a manufacturing plant, there was this urgency to catch the shift bus failing which other means of transport was an expensive proposition for the company employees. With the permission of the senior officials an investigation was done to conduct a surprise check during one of the shift change timings. The perpetrator of fraud observed this urgency factor and considered this as the most vulnerable time to upload and transport aluminium ingots along with the MS scrap from the plant. Around 275 kilograms of aluminium ingots were downloaded from the loaded truck. The scrap dealer accepted his mistake.
  
- (v) The average time in lifting of garbage was, generally, half an hour and the comparison of the gate entry timings revealed an average upload time of one and a half hour that was the normal duration for loading of scrap. The gate pass was prepared and signed by storekeeper while for garbage these gate passes were supposed to be prepared and approved by the administration department. It may be noted that the guidelines for material movement were perfectly in order, there was a scrap disposal committee in place and a scrap disposal manual was also available for referral. The security guards were under a contractual arrangement and were not aware of the signatories to the gate passes. On suggestion from the Chartered Accountant who conducted the investigation, as a preventive measure, the management created separate earmarked area for segregation of scrap material, constructed separate bins, installed a CCTV camera for monitoring the weighment and despatch activity. The authority and responsibility for lifting of scrap was redefined. There was a periodic reconciliation of scrap material ensured and proper segregation of scrap material into capital project scrap and regular production scrap was ensured.
  
- (vi) The management of a leading pharmaceutical company had a peculiar dilemma, the internal audit reports and anonymous

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letters referred to extensive corrupt practices in almost each department, especially, at senior managerial levels. The company operations were comparable to best in the world and, therefore, such allegations were hard to believe. After initial reluctance on whether the management should engage in a full fledged investigation, the matter was referred to the Chartered Accountants. It was agreed that there would be a preliminary assessment which would primarily involve understanding the internal audit perspective on the alleged irregularities. The allegations included extensive bribery in allotting of contracts and superfluous work allotment in civil work, labour contracts, purchases, projects, etc. The objective of the assignment was to gather evidence to substantiate these alleged irregularities. If the alleged irregularities were proved correct then this was to be followed by formal interviews for necessary management action. The Chartered Accountant firm conducting the investigation ensured that all the vital documentation and records were taken possession of. There was a profiling done of all the contract renewals and cancellations. Informants were identified for gathering vital information for reason for cancellation and simultaneous scrutiny of the work orders and bills ensured. The result revealed anomalies in scope of work defined in work orders, conflict of interest in allotment of contracts, and the reconciliation of thinner and paint stock inside the factory revealed disproportionate work execution for the payments made to contractors. There were bills cleared for road repair works that could not be corroborated with the work done and justified. The work measurement sheet was inaccurate. Spilling of work orders to overrule authority levels were noticed. There were group of labourers meant for gardening and ETP plants diverted for personal work in farms. This was corroborated through a physical count of labourers as compared to the punch (pay) cards in the custody of the administration department. The comparative rate of hire of bus for transportation of employees from their homes to offices were compared with similar facility in the vicinity and vast differences in payment were noticed. Drawings for civil work were not in line with the final execution of the work. Rework charges were not adequately explained.

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- (vii) The painting contract work allotments revealed a large number of work order released in the name of select contractors. The grapevine revealed that whenever a senior official from the head office visited the plant even for a small time the entire cabins were painted to ensure that neatness and cleanliness was maintained. The investigator had doubts on whether the painting contract was really executed. The work order of value above ₹ 50,000 was to be referred to a superior officer. All the work orders were within this limit. The management is desirous of appointing you as the investigating officer on this assignment. What would be your approach on this assignment? To provide you a hint, the work order had specifications mentioned in the form of work schedule with number of coats and area to be painted. The bills submitted were in line with the area mentioned on the work order and the work was certified by the authorised signatory to the work order.

A review of the gate records and the stores record was done to identify the extent of paint stock and primer that was brought inside the plant. The paint company provided a mathematical formula on area wise paint consumption. This was applied to the overall estimated and actual area billed by the contractor. The contractor had all the contacts under the earth to wipe the paint on the wall to clean it, and the quantity of thinner had far exceeded the requirement.

- (viii) In manufacturing industries, there are general standards relating to basic cost, pricing and consumption standards for materials, especially, for recording in an ERP system. In a cement manufacturing company, the supply of coal was generally from the collieries. The internal auditor had raised several queries during the routine scrutiny relating to high level of stock as per excise records in some months and at the same time questioned the need for buying the coal stock from the open market. Further, transportation by road resulted in double the cost of procuring directly from collieries by rail. He also noticed that quality of coal had high moisture content and was also high on ash content. The management ordered for investigation in the matter and it was noticed that the physical stock of coal was negligible as compared

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to a significant book stock. When the production records were scrutinised for the previous years, it was noticed that the head of production had resorted to altering the standards coal usage percentage from 22 to 24 percent in the production process. This resulted in covering up the pilferage and diversion of coal stock.

- (ix) A review of the transportation cost in an engineering industry was showing an abnormal increasing trend. The company had many outlets from which the freight operator plied (milk van distribution system). It was noticed that the authorisation of the bills and documentation requirements resulted in multiple goods consignment note being prepared. In a day of 8 hours a vehicle could ply at the most two full (to and fro) trips including the loading and unloading time to a particular destination. A consolidation of the freight payments for the same vehicle across locations revealed that the freight operator had resorted to splitting of a single trip into multiple trips and submitted separate claims through sets of bills at each of the locations of the company for the same trip. The freight operator was a regular contractor for the company for more than a decade and finally had to be blacklisted.
- (x) A regional manager in a chemical plant was in charge of collating indents and production planning. In addition, he was given the charge of handling freight payments. The regional manager by a defined date used to collate the indents from various states across the country. He introduced certain additional indents on his own and in the process imported material and repacked it and sent to his personal warehouse where it was rebranded and sold in the market on cash basis. The material was shown as indented from a place in north India where it was never needed. The material was transported through a mini truck belonging to his wife. He had finalised a rate contract in his wife's name and ensured that the freight payments were made within 15 days of despatch. He had cheated the company of a significant sum of money (₹ 20 million in 2 years). The company wants your opinion in pursuing legal action on the employee. What is the control weakness that would enable the company in succeeding in this endeavour?

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At the year end, for each of the indents received from across the states there was this need for Form F that had to be collected for the purpose of Sales tax. The regional manager in order to cover up his follies had forged the Form F entries that never emanated from the concerned offices in north India.

- (xi) Corruption charges were levied against a plant supervisor and management decided to undertake an in depth investigation into the matter. The Chartered Accountant divided his team into two categories, each team working independently. One of the teams entered the plant and commenced data analysis while the other team was in charge of undertaking field work. The condition was that none of the team members would interact with each other unless the vital evidence was gathered. The in house team meanwhile isolated the list of contractors whose contracts were discontinued over the past two years. A disgruntled contractor was developed as an informant and the external team gathered vital information relating to mode of operation. The vital question was how to prove bribery allegations as these are very difficult to prove in a real time situation. The contractor was asked whether any cheque payment was ever made by him to the company official. There was one incident where about three years back a cheque was issued by the contractor. However, he was illiterate and could not have written the cheque. This made the job simpler. The contractors' bankers were approached and with the help of the contractor the old cheque could be retrieved. The bearer cheque was prepared by the plant supervisor in his handwriting and his father-in-law had gone to the bank for cash withdrawal. To ensure that there are no chances, the HR records were perused to unearth the marriage card of the employee and it was established that it was indeed the father-in-law who had visited the bank. During the formal interview that followed, the plant supervisor readily agreed to the misdeed.
- (xii) A client approached an investigative firm to ascertain misuse of credit card that was sent by courier by Non Resident Indians (NRIs). The courier company had 100 employees who used to carry out sorting and it was difficult to identify

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at any given point of time which groups of employees used to flick the credit card and misuse them. The following steps were taken by the courier company as a control measure:

- Installing of in house CCTV cameras to track pilferage.
- Warning customer not to send credit cards and debit cards through courier.
- Insurance policy as a matter of control was ensured by the credit card companies for any misuse arising out of theft of credit cards.

Despite the above measures, the pilferage and misuse of credit cards could not be controlled. The investigative firm refused to take up the assignment as they did not possess the requisite skill sets to carry out the assignment. The other reason was that the goods bought by the fraudster from the misuse of credit card had exchanged many hands and it was difficult to carry out the investigation without trespassing into the final buyers' home. The client had only the option of referring the matter to police authorities.

# Chapter 10

## The Interview Process

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### Chapter Summary

*Interview forms the major source of evidence and adds colour to opinions. The purpose of an interview is to obtain the truth, to detect deception and to ensure that information gathered is a fact and not an opinion. It is also essential to obtain complete facts. The purpose of the interview also includes obtaining of confession or signed statements. It is an art to establish facts through questioning and expressions without threat, inducements or coercion. The chapter is intended to provide an insight into the preparatory steps, types of interviews and certain attributes of interviewer and interviewee.*

10.1 Interview is the task of obtaining information from witnesses, victims and suspects. This is more of a question and answer session with an informant, witness or suspect designed to get the required information. The information obtained here may be true or false. Generally, an informant is friendly in nature and gives information. The interviewer should also ensure a friendly approach.

The witness is a person who could be friendly, neutral or hostile in nature. The approach to elicit information is through examining the witness. The suspect is a person when there is reasonable suspicion or could be identified as the actual perpetrator. Generally, the suspect tends to be hostile in nature and should be subject to a thorough questioning.

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The fundamental requirement in an interview comprises of extensive planning, conducting the interview according to self governed rules and maintaining notes (recording).

## **Types of Interviews**

10.2 The following are various types of interviews:

- (i) **On the scene interview:** This is similar to an interview done by internal auditors and is not, generally, planned in advance. This is essentially to capture an event on a real time basis.
- (ii) **Formal interview:** These are well planned and involve an objective approach. The following four important facts to be borne in mind by the interviewer in a formal interview:
  - (a) One must not reveal any essential information.
  - (b) All the statements made by the interviewee should be corroborated. This is achieved by series of questions that are meant to further elucidate or provide information that can be cross checked beyond doubt on the statements made by the interviewee.
  - (c) Exploit an advantage secured during questioning. The interview is normally conducted with a limited objective of establishing truth in a matter under suspicion and any response from the interviewee that facilitates this objective should be fully exploited by the interviewer.
  - (d) The objective is to maintain a proper record of all information gathered during interview. This is very essential as the interaction between the interviewer and interviewee could be the basis for any future course of action or deriving a conclusion or could be used in a legal suit. Such a record also prevents any misinterpretation or misunderstanding in ascertaining the facts or denial at a subsequent date.

- (iii) **Group interview:** It is rarely used and involves situations where the target audience could be a group of persons. This is primarily used in labour union discussions or when there is suspicion among a group of people. Various techniques are used to isolate the suspects including planting of interviewees in the group. These interviewees raise contentious issues in the group that are challenged by other group members thereby exposing them. The investigator by his mere observation is able to identify the suspects.

## **Primary Rules for an Interview**

10.3 Privacy is to be maintained during an interview and one must ensure that there are no interruptions by calls through telephones, mobiles, fax machines or other distractions. The interview should be conducted in the client office environment and not at the suspect's place. It should be conducted in a tranquil environment. It is imperative that at any given time during the interview a single person performs the role of the lead interviewer with a specific role assigned to the rest of the members. Group interviews (all the participants talking by turns) should be avoided.

10.4 A good interview comprises of establishing a rapport with the interviewee. There should be no dearth of queries posed to the suspects. The queries should be structured in a manner to uncover relevant facts. Questions should be framed such that all pertinent issues are addressed sufficiently to reach a conclusion. This requires the interviewer to have abundant perseverance. The funnel effect ensures that the questioning process filters irrelevant information and is objective in its scope.

## **Plan the interview**

10.5 The most important aspect in an interview is planning for the interview. The primary question is to decide the manner in which the interview might support the investigative process. The objectives for the interview, therefore, must be defined in line with the desired outcome to facilitate progressive enquiries. There should be constant focus on issues that will elicit new information and

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information that needs to be further corroborated. There is a need to visualise the target and to ensure that the interview proceeds in the planned direction to get to the relevant points and also ensure that the evidence/ facts collected are unassailable. The place of the interview, the number of persons to be present during the interview, knowledge about the regulatory provisions that need to be adhered to, the intended course of actions depending upon the probable outcome of such interviews is a matter to be decided in advance.

## **Preparatory Steps before an Interview**

10.6 Setting the environment where the interview will be held is the first step. This is followed by collecting all equipment such as, writing materials, gadgets, etc., in place. The evidence gathered and the timing is of essence in challenging the interviewee, therefore, the support staff at the interview should be well informed of the requirements.

10.7 A robust mechanism of retrieval of essential documents also must be ensured for an organised conduct of the interview. The availability of the interviewee should be confirmed as otherwise this may result in waste of time and resources. As a part of the advance planning it is essential to ascertain whether the interviewee is likely to be present at the place of the interview. There should be no prior intimation about the purpose of the interview as this will kill the surprise element.

10.8 The timing of the interview should be scheduled appropriately, and the sequence of questions and clusters of topics should also be worked out. The questionnaire and documentation process should be a record of the statements in a chronological order. It is important that there is adequate background check ensured of the target. This includes ascertaining whether witness is a related party of the suspect.

The practice session prior to the interview is termed as a 'Mock Trial' and it enables to simulate the interview conditions. It is an essential part of any interview process wherein one of the investigating team member plays the role of 'devils advocate'.

10.9 There should preferably be a written interview plan to understand the roles of participants as to who would be the lead interviewer, who would take notes, etc. While all the abovementioned procedures are ensured, it is unfortunate that the documentation of the preparatory steps is not usually done adequately in most investigative assignments as this is considered as a cumbersome process.

## **Interview Techniques**

10.10 The interview techniques could be direct technique or commence with a signed statement. Team interrogation, group interview, feigned information, duress, bright lights, denial of requirements, use of force are things that need to be avoided in an interview. Within the legal framework, the interview tactics could vary according to the targets depending on whether the subject is a casual offender or professional criminal with premeditated offences.

## **Questioning the Interviewee**

10.11 The starting point in an interview is to build rapport with the interviewee. Care should be taken to avoid leading questions. Let the target do the talking without any interruption or coercion. Time the questions effectively. There should not be any hesitation in asking silly questions occasionally. As an interviewer, ensure that there are multiple options during the questioning process and seek documentary evidence in support of the subject's version, wherever possible. Lay the foundation for the interview process and pin the interviewee's story. Confront him with contrary evidence when he goes awry in his replies, cut off false denials promptly, break up the interviewee's version and draw out and pin down the interviewee's admission.

## **Documenting the Interview**

10.12 Notes should be taken for the entire interview with the help of a note taker. It should be ensured that sufficient guidelines are

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laid down for taking notes during the interview. These must be more detailed for crucial and formal interviews. These notes may need to be placed as evidence in civil and criminal proceedings.

## **Recording the Interview**

10.13 Extra caution is needed while conducting an in camera interview or using a voice recorder. The interviewer must diligently frame the questions in advance. The interviewee must be informed about the use of voice recorder just before the interview in order not to violate privacy laws. Confessional statements should reflect clarity and interpreters should be used wherever necessary.

## **Why Interviews Fail?**

10.14 The following are some of the reasons for failure in interviews:

- (a) There is lack of planning, preparation and information.
- (b) There could be ignorance or shallow knowledge of facts and events
- (c) Sometimes there is lack of technical knowledge.
- (d) Interviewee could be stubborn and the interviewer is unable to channelize or direct the discussions as per plans and/ or may deviate from the main purpose of interview.
- (e) There is disregard for the legal/ statutory requirements while conducting the interview.

## **Sequence of Events in an Interview**

10.15 As discussed above, the sequence of events in an interview and certain prerequisites are listed as follows:

### **(i) Getting Engaged**

- First impression;
- Managing first contact;

- Creating the right atmosphere;
- Building rapport;
- Addressing needs and concerns; and
- Showing empathy and interest.

## **(ii) Seek Explanations for Interview**

- Reason for interview to establish truth;
- Introduction;
- Ground rules – breaks and refreshments;
- Background and time factor;
- Introduction of exhibits/ documents;
- Explain formalities;
- Explain use of audio/ video recording of interview; and
- Outline of interview.

## **(iii) Keep an Account**

- Setting the scene;
- Obtain an uninterrupted account of happenings;
- Identification of the events, recalling, probing and summarizing; and
- Remain flexible and responsive to information uncovered.

## **(iv) Evaluation and Learning**

- Review the interview critically *vis-à-vis* investigation;
- Improvements needed and learning for others (for rest of the interviewees);
- Manage Interruptions smoothly without disrupting continuity;
- Malfunctioning equipments should be tried and tested prior to the interview; and

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- Be aware of the 'subject' behaviour, especially, the use of aggressive language.

## **General Profile of a Successful Interviewer**

10.16 The following are general profile of a successful interviewer:

### **(i) Posture**

- Upright;
- Frontally aligned;
- Open, no crossed arms or legs;
- Avoid slouching; and
- Always maintain eye contact when asking questions. Look away when suspect gives denials.

### **(ii) Facial Expressions**

- Avoid expressions of disbelief, shock, anger, humour, disgust and skepticism;
- Show interest; and
- Express or display understanding and acceptance for suspect's actions.

### **(iii) Tone of Voice**

- Confident and believable;
- Smooth speech;
- Controlled;
- Modulate at appropriate times; and
- Don't use a skeptical or disbelieving tone.

#### **(iv) Hand Gestures**

- Palms should be up and arms open;
- Avoid negative or strong gestures;
- Be careful about touching as this is not desirable and could be seen as offensive;
- Meet and greet;
- Start with non threatening conversation; and
- Allow interviewee to like you.

#### **(v) Building Rapport**

- Observe interviewee's verbal and non-verbal behaviour;
- Consider use of formal titles e.g., Dr., Mrs., Mr., Sir., etc;
- Never let interviewee take control of the interview; and
- Use observations during pre-interview stage as a basis of comparison during 'behavioural analysis' stage.

## **Characteristics of Body Language of Interviewee**

10.17 The following are some characteristics of body language of an interviewee:

#### **(i) Defensiveness**

- Rigid body;
- Arms and legs crossed tightly;
- Minimal eye contact;
- Head down with chin depressed toward chest;
- Fists clenched; and
- Crossed arms.

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### **(ii) Evaluating**

- Slightly tilted head;
- Sitting on front portion of chair with upper torso forward;
- Hand to cheek gesture; and
- Stroking chin or pulling beard.

### **(iii) Nervousness**

- Clearing throat;
- Hand-to-mouth movements;
- Covering mouth when speaking;
- Tugging at ear;
- Twitching lips or face;
- Playing with objects or fidgeting;
- Shifting weight while sitting or standing;
- Tapping fingers;
- Waving foot and pacing back and forth restlessly; and
- Whistling.

### **(iv) Suspicion/ Secrecy**

- Failing to make eye contact;
- Glancing sideways at you;
- Rubbing or touching nose; and
- Squinting.

### **(v) Needing Reassurance**

- Pinching the fleshy part of hands;

- Gently rubbing or caressing some personal object like, ring, jewellery, watch; and
- Biting fingernails or examining cuticles.

### **(vi) Frustration**

- Tightly clenched hands or shaking fists;
- Hand wringing and rubbing back of neck;
- Controlled short breathing;
- Blind staring;
- Running hands through hair; and
- Stamping foot.

### **(vii) Points to Ponder during Interviews**

- People often lie with words;
- Body language tends to be more honest;
- People don't realise that the body language is being assessed;
- Transitions count more than positions;
- Look for conflict between spoken words and body language;
- Look for clusters of behaviour inconsistent with the spoken word; and
- Be mindful of mirroring behaviours.

## **Interview Techniques Essential**

10.18 The following are some essential elements of interview techniques:

- Active listening and responsive style;
- Proper environment necessary;

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- One person to interact at a time;
- Unbiased regardless of the outcome;
- Record facts and not opinions;
- Read non-verbal communication;
- Detection of deception; and
- Focus on conversational techniques.

## **Queries during Interview**

10.19 The following queries should be considered during an interview:

- What, where, who, when, why and how?
- What was in suspects mind and why did he do it?
- The act – what was done?
- The modus operandi – How?

10.20 The following tips are useful during questioning:

- Use open questions —  
How did you do that?  
What happened next?  
Where were you then?
- Use closed questions only to confirm facts and save time -  
Did you steal the money?
- No leading questions - Having found the safe open did you close the door to make it secure?
- No multi-themed questions - Where did you spend the money and what did you buy for whom and why?

## **Don'ts in an Interview**

10.21 The following should be avoided during an interview process:

- Oppressive or threatening behaviour;
- Offensive language or behaviour;
- Offering inducements;
- Physical force;
- Fabrication or trickery;
- Do not interrupt; and
- Maintain structure, sequence and control.

## **Closure of Interview**

10.22 The following aspects are important during closure of interview:

- Summarize main points;
- Ask subject – add, clarify, change the points;
- Has the subject any questions or comments on the conduct of interview;
- Formally 'sign off'; and
- Actions.

## **Question Typology**

10.23 The question typology is, generally, as follows:

- (i) Introductory- provide the introduction, establish rapport, observe reactions and establish the purpose of interview.
- (ii) Informational – non-confrontational, non-threatening, information gathering and unbiased factual information.

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- (iii) Closing – A positive note, reconfirming the facts, further facts or opinions and stressing the confidentiality.
- (iv) Admission – of incriminating documents, of incriminating conducts or confirms voluntary participation and disclosure.

## **Question Methodology**

10.24 During questioning it is better to be general to specific and reach backward, i.e., from known information to unknown areas. Further, the following are also some important aspects in this regard:

- Start with open questions that make the interviewee talk.
- It should be followed by closed questions to conclude an interview.
- During interview avoid double negative questions.
- Avoiding complex questions lest the interviewee has difficulty in responding.
- Avoid sensitive questions that may irk the interviewee.

Finally, avoid emotive words as interviewee may take control over interview.

# Chapter 11

## Investigation Report\*

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### Chapter Summary

*The purpose and importance of investigative reports stems from the understanding of the terms of the engagement as stipulated by the management. Although an investigation is, normally, conducted always under the presumption that the final outcome and methodology should withstand the test of scrutiny in a court of law. However, private investigations generally end up with briefing the management. The chapter is an attempt to make the readers aware of certain thumb rules that are important in drafting investigative reports.*

11.1 The medium of presentation of the findings vary according to the subject matter under investigation. There are occasions when the management is interested only in material evidence and does not insists on a formal report. There are also occasions where video or power point presentations are made. It is necessary to understand the prerequisites of a good investigative report.

11.2 Each investigative firm has its report format and has its own style of representing facts and evidence to the engagement client. Generally, the formats designed for investigative reporting are consistent with reference to the objective of the investigation. The subject matter of the report could be results of surveillance, violation of patent or trade marks, reporting on background/ reference checks, providing a specialist opinion, conclusive investigative assignments, etc.

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\* Report drafting format may vary in private investigations.

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11.3 The management sees the investigator also as an advisor and is, therefore, consulted for the future course of action once the process of gathering evidence is completed and the report is submitted. He is also expected sometimes to comment on the adequacy of the evidence in seeking a legal remedy. Hence, depending upon the importance of the matter under investigation, the discretion of whether to include such recommendations, opinions or conclusions in the investigative report is with the investigation firm. The investigative reports are restricted to gathering and presenting of evidence to the management.

**Objectives of an Investigative Report**

11.4 The primary objective of an investigative report is to logically present facts and evidence gathered that will enable the management to reach an informed opinion on the subject matter that is under investigation.

**Salient Features of an Investigative Report**

This is an indicative format and can be suitably modified depending upon the nature of assignment.

**(i) A Cover Sheet**

For external investigative firms — With client information, investigation assignment reference, date and header signifying confidentiality of information and Investigation ‘title’.

For in-house investigations – ‘Subject information’ – (name, designation, function, department, location), investigation reference number, year/date, alleged violation, name of investigating officer and department references.

Each page has a similar indication of confidentiality of information.

**(ii) Table of Contents**

(is optional and is, generally, not used in private investigations.)

***(iii) The Report Titles May Contain***

Background – Point of reference in conduct of the investigation.

Introduction – Terms of reference and key contact(s) with representative(s) of engagement client.

Scope of coverage – including place where investigation is being conducted.

***(iv) Other Important Information***

Limitations, constraints, indemnities including exclusions in scope of coverage (if any).

Statement of facts.

Modus operandi and sequence of events .

Comments on available evidence.

Supplementary information on results of surveillance, background checks, interviews, results of engaging the services of expert witness, etc. (wherever relevant).

Explanations and defence offered by subject (wherever relevant).

Conclusions and recommendations (may be qualified depending on sufficiency of evidence).

List of Appendices (Annexure).

List of Witnesses and Exhibits (Annexure).

11.5 The investigative report should enable a reasonable person to reach the same conclusions and understand the recommendations based on the facts presented. There should be abundant caution in ensuring that the report is not circulated to any person other than those entitled to the classified information.

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While drafting the investigation report care should be taken not to deviate from the main objective of the investigative assignment. The following are not desirable in investigative report writing:

- (a) The report covers multiple facets of the problem without reaching a conclusion. The use of words such as, 'appear', 'seems to be', 'perhaps' indicate that the report is inconclusive.
- (b) A careful reading of the findings may result in reaching more than one conclusion.
- (c) Personal bias or subjectivity in reporting facts without a comprehensive review could hamper the final outcome.
- (d) There should not be any offensive or abusive language in the report, especially, against the subject or any other person referred to in the report.
- (e) There should not be any remarks that are sarcastic in nature.
- (f) The report should not reflect a personality clash between the investigating officer and the 'suspect', or written in a manner to appease the engagement client.

## **Planning the Report Contents**

11.6 The investigating officer while drafting the report should obtain opinion from his team members and legal counsel or the reviewing authority on the sufficiency of the evidence gathered, the method of proof to be used, and the proposed recommendations.

Planning a final report is a process that begins at the time an investigation is initiated and is assigned to a designated official in the investigative team. Report writing can be simplified if the evidence is organized in a neat, concise, logical, and easily retrievable manner. The 'specimens', 'photographs', results of analysis, computer generated records (CDs, DVDs etc.) or exhibits need to be kept in a neat and structured manner in a working paper folder.

11.7 In case of a private investigation, the original documents are generally handed over to a superior authority within the organization, whilst a photocopy is retained by the investigative firm. In most investigative assignments post completion the back up exhibits or evidence collected is handed over to the client and not retained by the investigative firm. Such a handover is also formally documented both while collecting the documents, during the course of the investigation as well as when these are given back to the engagement client.

11.8 The investigative working formats must include a 'Summary of Statements given by Witnesses and Records document'. This document should be comprehensive and should list all witnesses contacted and nature of evidence obtained from those witnesses, irrespective of whether these are cited or not in the investigative report. At the same time, this summary information should be brief and to the point. Care should be taken to see that there is no duplication in the documentation.

11.9 In case the report content is witness oriented then numbered files can be established for each witness. The witness's testimony and any supporting document that is obtained from the witness should be appended with each such witness file. A separate witness folder should be created for each person contacted during the investigation and should include such person's identity such as, name, address, telephone number(s), voter ID or any other identities of the witness. Where the evidence is too large to fit neatly into the witness folder, the same should be kept in a readily accessible manner with appropriate location or packed corrugated box duly referenced to the witness folder. Generally, a bar coded packing system for the purpose is ensured. The evidence file retention retrieval process is also managed by specialized agencies and can, therefore, also be outsourced. The work papers that contain vital evidence are also kept sealed (such as, plastic strips that need to be broken to open the seal) and at a secured place by the investigating officer.

## **Report Writing**

11.10 Chartered Accountant firms specialising in investigation normally maintain a document manager that is web based and also retain hard copies at the respective locations where the investigation is in progress. Some of these firms have offices across vast geographies or distant locations across the globe and, therefore, need interactive facility between the investigating officer (investigative staff) and the reviewer (senior engagement partner), who may be centrally located at the Corporate Head office. To ensure standardization in reporting, audit report templates and links are maintained as database in a central server. This allows the investigative team to effectively prepare an integrated, complete and accurate report. The 'pre-designed template' only enables standardization in format and not in content as these largely depend on the drafting skills of the designated investigation team member.

## **Reporting Facts**

11.11 Facts stated must be unbiased and not subjective. The interpretation of facts should preferably be left to the reader as these tend to be consistent in reaching to a common conclusion. This is because any distortion or misrepresentation of facts will diminish the quality of report and credibility of the person preparing the investigative report.

To ensure that the report deals with facts and does not digress into expression of matters that appear to be opinions and vitiate from the objective of the investigative reporting and to ensure that the reading of the report reflects an impersonal attitude, use of personal pronouns should be avoided. An exception to this rule is in situations when there is a need to quote information gathered from witnesses or other persons during the investigative process. It is in this context that a testimony obtained from witness should also be presented fairly. In order to ensure that the report is unbiased, independent and objective the signatory to the investigative report should not refer to themselves as the undersigned, the writer, or your representative (meaning client – agent relationship).

11.12 There is a need for abundant caution in use of quotes in the report. The person drafting the report must extract and represent information from documents with reference to proper context. Any attempt to conceal or omit facts that tend to favour the subject could influence the outcome of the investigation and should be avoided.

## **Accuracy in Reports**

11.13 Investigative reports are the basis for the management to initiate disciplinary and legal actions and, therefore, accuracy of facts is non-negotiable. Inaccuracies can negate the value of the report and diminish the reputation of the investigative firm and also the credibility of the investigation officer including the person drafting the report.

There is a need to draw a distinction between fact and opinion. Avoid using statements such as “the subject could give no plausible explanation”. It is a conclusion and others may find that the explanation is plausible. The report should state what the subject has said and let the evidence show whether the statement is worthy of belief. Do not allow conclusions to surpass the evidence. A conservative statement that is consistent with the facts is stronger than an exaggeration. Exaggerations tend to raise doubt relating to all the evidence presented in the report.

### **Essential of a Good Report**

Fair reporting

Accurate - adequately validating the figures (if any values are quoted) in the report

Complete – including a defined scope of coverage

Brief, concise and relevant

Logical presentation

Structured format with appropriate main and sub-headings

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Grammatically correct

Cross references to annexure and exhibits

Unambiguous, easy understandable and without technical jargons

No offensive remarks on the subject and should be impersonal.

11.14 Restricted circulation (marked strictly confidential), judgment in the choice of words, punctuation that clarifies the meaning, and a correct application of the rules of grammar are essential to accurate reports, appendices, schedules and exhibits. Errors in these essentials have an unfavourable effect upon the mind of the reader. Carelessness in detail, errors in computations and incorrect dates materially affect the value of a report.

Mathematical computations in the report, appendices, schedules, and exhibits should all be verified for accuracy. Although special investigation teams have computer applications that verify that the data and formulae are correct. For review purposes, supply a tape of the computations or the electronic file so that these may be verified.

11.15 Preferably avoid using technical jargons, including those used in accounting and legal parlance. However, in some instances, vernacular terms (or terminologies that are locally prevalent) may be necessary for clarity in reporting the results of investigations, particularly those involving subjects in wrongful activities. The meaning of the particular term should be explained when it is first used in the report. For example, it may be advantageous in a report concerning a pyramid scheme to describe the nature of the operation, including the technical jargons used therein, before presenting evidence of the violation. If numerous technical terms are necessary, it is advisable to prepare a glossary.

11.16 While drafting the report, present the material with the objective that it could be clearly understood by a reader who had no knowledge of the facts surrounding the investigation. The report

drafting person must exercise good judgment in selecting the facts that are material to the matter and ensure that nothing essential to a complete understanding of the investigation is omitted. This is especially true for any information that is favourable to the subject. All statements of material facts relating to the violation should be supported in the investigative report by evidence that will establish the truth and accuracy of the statement. The source of the evidence should be documented. Each statement of material fact in the investigative report, with the exception of statements made in the section on conclusions and recommendations sections, must be supported by evidence citations. These citations must be specific, including page and paragraph numbers. Statements made in the conclusions and recommendations sections must be supported by evidence cited elsewhere in the report. No unsupported statements may appear anywhere in the report.

11.17 All defences of the subject and their representatives must be refuted, and any mitigating circumstances, exculpatory evidence, or other impediments to a prosecution recommendation must also be fully addressed. Speculation concerning potential defences or explanations that have not been raised by the subject and/or their representative should not be included in the report.

If it was impossible to interview a key witness or to take any other pertinent investigative step, this should be explained in the “Other Pertinent Data” section of the report. For example, in an investigation on misappropriation of consideration on sale of product in which the customer was not approachable for being interviewed, the reason the interview could not be conducted should be noted. Addressing such issues will underscore the thoroughness of the investigation and prevent unnecessary requests for supplementary information.

Finally, in order to ensure completeness, the report should be read and revised as often as necessary before it is submitted for review.

## **Brief and Concise**

11.18 Conciseness necessitates removal of all superfluous material. The rule of conciseness applies to the entire report and repetition in the content of the report should be avoided. Schedules, summary exhibits, tables, footnotes, and appendices may be especially useful in reducing the length of the narrative and financial evidence detailed.

## **Logical Presentation**

11.19 A well-written report may lose its effectiveness for lack of a logical presentation. A mass of data indiscriminately presented in the report is confusing and may impair the reader's ability to comprehend the facts relating to the investigation. A well-written report requires adherence to the primary purpose of the report. Irrelevant material should be excluded. Clarity and presentation of communication is important. Each sentence, paragraph, and section of the report should help serve the primary purpose of the report. A well-written report requires careful planning, critical review, and frequent revision by the report writer.

11.20 Each paragraph should be classified according to the subject matter (theme) and any new topic or idea should be the subject of a new paragraph. Any special emphasis can be brought out through a separate sentence or a passage. Such emphasis can also be brought out through numbering, indenting and by use of summary schedules.

11.21 The investigation report is addressed to the designated official of the client engagement. Where interim reports are issued to the client, the same should be stated in the header or footer of the entire report. Similarly, the term confidential should be stated in the header of each page. There is also a reference to the person who is required to be contacted as a representative of the investigating firm. The date of the investigation report will be the date forwarded to the engagement client.

## **Peer Review**

11.22 The investigative report should preferably be referred to a superior officer within the investigation firm to ensure that evidence gathered and conclusions reached are reasonable. Where there is a limitation in arriving at a decision in a matter under investigation, it is important that the report is adequately qualified. Most investigative firms engage the services of a legal expert or ensure that the investigative report is vetted for meeting the legal requirement and to safeguard the interests of both the engagement client as well as the investigation firm.

11.23 Once the investigation report is presented, there should be a process of formal closure of the assignment through a closing meeting. The documentation requirements relating to working paper management and custody thereof should be formally communicated to the client and retention norms should be specified for safekeeping of the records and documents. It is to be ensured that the draft report are stamped and cancelled to prevent misuse of the same. The duplication in papers should be avoided.

There should be clarity in disclaimers in the report and adequate safeguards for the investigative firm in matters of litigation. There should be restricted circulation of the report unless otherwise authorized by the client. At the same time, it should also be ensured that the investigation report is not used for purposes other than those specified for, in the terms of engagement between the client and the investigative firm.

A peer review of the performance of the investigative staff may be conducted at periodic intervals. This should also include reporting norms and retention of working file documentation.

## **The Final Report**

11.24 The final report is a confidential document and its primary purpose is to apprise the superior officers and legal counsel of the organisation of the result of the enquiries with a view to assess the merits and demerits of a matter under investigation and facilitate

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reaching a conclusion. It is imperative that the final report presents a clear, complete and well connected picture of the matter under investigation and explain and analyse the available evidence. This report is generally for in-house use of the business entity and shall not be discussed/ quoted outside the entity. Some important aspects are as follows:

- (i) The typing should be in double space. The ink impression should be dark enough for easy reading. Para numbers should be given.
- (ii) Enquiries/ investigations should be thorough and complete and the information supplied in the final report should be adequate on all points so that it is not necessary for senior officers to raise any avoidable queries.
- (iii) The allegations, facts of the case, evidence available and the opinions and comments should not be mixed up in the final report. They should be dealt with separately and succinctly.
- (iv) Repetition should be avoided. The allegations should be listed in proper order in a clear and definite form and discussed separately in detail.
- (v) The analysis of the facts of the matter under investigation should be kept separate from the opinion. When there are multiple allegations and more than one suspect, care should be taken that the conclusion is drawn for each of the allegations and each of the suspects.
- (vi) If any of the witness could not be questioned or documents could not be obtained, the same should be mentioned clearly with reasons in the final report.
- (vii) There should be no delay in submission of the final report or in furnishing of supplementary information to the senior management to whom the report is addressed. The investigation officer and the legal officer should be given time targets to furnish the report and information sought with their comments.

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- (viii) The opinion received from experts or the relevant portion thereof should be incorporated in the final report.
- (ix) The legal officers should not merely summarise the evidence collected during the investigation or enquiry. They should give a careful analytical note which should interalia, bring out the points to be established and the evidence that substantiates these points. They should highlight the important propositions requiring decision of the senior management. Any further investigation to be done should be set out in the final report.

# Chapter 12

## Legal Action

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### Chapter Summary

*Contrary to management expectations, investigating firms are reluctant to engage in matters relating to court appearances (other than as expert witness) and filing of police complaints, etc. The investigating firm plays an advisory role in these matters. In this chapter, certain basic legal aspects that may be relevant to the management have been examined.*

### Use of Investigation Reports to Pursue Legal Action

12.1 The management may want to proceed legally in filing a complaint with the police authorities once an investigation report is submitted. There is no defined format or the medium (e-mail, telephone call, registered telegrams, etc.) to lodge a police complaint. Police complaint can be lodged by any person, anywhere at any time. In such complaint correct facts only should be stated. The key co-ordinator of the engagement client should engage effectively in defining the process and circumstances of the case to the police authorities. Formal acknowledgement of the complaint filed is advisable and is given by the police authorities especially to corporate representatives. The technical details should be explained in a lucid manner and in matters involving financial crimes the use of internal documentation such as, goods receipt notes, delivery 'challan', gate pass, internal control system and abuse of authority and other matters need to be elucidated clearly to such authority where circumstances warrant. The management should

be in a position to display independent and unbiased approach in stating the facts to the police authorities. The following criteria should be applied to all such investigation reports used for filing a police complaint or registering a legal case:

- (i) Maximum use of appendices (annexure and exhibit) helps in eliminating the need for detailed explanations of each of the supporting exhibits and minor details of the investigation. When appendices are used, each should have complete references to all relevant testimony and documentary evidence.
- (ii) Preferably abbreviations should be avoided.
- (iii) If the facts and circumstances surrounding two or more subject investigations are same or are intermingled, the results of the related investigations should be presented in a single report.
- (iv) It is recommended that a table of contents reflecting report sections and page numbers be submitted as part of the investigation report where the report content in size is significant. However, prior to submitting the investigation report, the page fields should be updated. Generally, in investigation reports the legal format in number of pages is used.
- (v) The table of contents is designed to provide quick reference to important sections of the report. The complexity of the investigation and the circumstances of the investigation will determine the amount of detail to be included in the report. Additional section headings may be included in the investigative report, if warranted. The list of witnesses and exhibits and the title and number of pages of each appendix should be included in the table of contents.

## **First Information Report (for criminal cases)**

12.2 Any person can give information to the police relating to the commission of a cognizable offence and the Criminal Procedure Code provides for the manner in which it is to be recorded. A copy

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of the information has to be given to the informant. An FIR sets the criminal law into motion.

An FIR is not substantive evidence but it can be used to corroborate an informant or to contradict him, if he is called as a witness to a trial. Telephonic complaints can be taken for investigation as suo moto case by the police. Not all complaints can be converted into an FIR unless the police is satisfied prima facie.

12.3 If complaints are not registered then one can approach the local magistrate court under section 156 and the court may if satisfied may register the crime, alternatively it will direct the police under section 202 for investigation and report. It is to be noted that the submission of report is only to explain the facts of the case to the police authorities while lodging a complaint or filing an FIR (in case of criminal cases). The police authorities would be conducting an independent assessment and investigation of the matter brought to their notice.

## **Pros and Cons of using Affidavits**

12.4 When the 'subject' seeks legal remedy there are occasions that there is an allegation that the investigation was not conducted in a fair manner. The investigating officer must take abundant caution when statements are obtained from the 'subject' as proof of irregularity being committed and may have to approach the local magistrate in registering the statements in the presence of an independent witness to ensure that the statements are not retracted subsequently. For example, let us take the example of financial irregularities through offering of excessive discounts by dealers beyond the stipulated limits prescribed by the manufacturer. The situation may involve obtaining of declaratory statements by the staff of the dealer who while replying to the questions raised by team of senior officials of the company may have revealed of the dealer being involved in excessive discounts as against the company policy affecting the company operations. The investigating officer (the chartered accountant or his support team) can be confronted by the owner of the dealership and the statements can be challenged in a court of law stating that the employee of the

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dealer was coerced into making such a statement and that the company officials have not allowed such dealer employee to reach out to the owner. Such a counter allegation may result in retraction of all the statements and claims on the dealer. Under these circumstances, when an investigation assignment involves visiting offices of third parties, the concerned 'subject' who makes the statements should be taken to a local magistrate and an affidavit should be prepared and signed before a local magistrate and duly registered. Being an independent agent, this adds value to the investigative process and makes it difficult for the defence to purge these statements. Even a simple affidavit duly recorded and notarized before Public Notary helps a lot. Any evidence of the facts may be attached to the affidavit. In the above case, if the employee can procure any form, etc., filled by the buyer who got the excessive discount should be attached. The place or territory where the crime has occurred is the place where the complaint has to be lodged.

# Chapter 13

## Investigative Audit and Allied Services

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### Chapter Summary

*The investigative audit field is a unique combination of accounting, investigation and legal knowledge and, therefore, is not restricted to conduct of investigation alone. There are other specialised areas that provide an entire gamut of services that add value to the clients. These are extensions of the skill sets that are required for carrying out the investigative assignments. The salient features and pre-requisites for each of these products are discussed in this chapter.*

### Due Diligence

13.1 The investigative practice is bestowed with one portion of the entire due diligence activities due to its inherent networking of people and ease in gathering and validating data or information. Whenever new alliances are formed or there is a business expansion plan or a merger and acquisition plan that is formulated, due diligence activity comes into prominence. When a company is desirous of venturing into unknown businesses or geographical territories, due diligence activity is immensely useful in situation where there are unfamiliar customers, varying cultures and languages, legalities that make the understanding and controlling of the entity in such a market difficult. There is tendency to conduct this exercise in-house by most corporate and consultants are hired only on a need basis where certain critical information is required.

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Prior to engaging in any business relationship, it is advisable to possess knowledge of the respective company and individuals based on facts and not just perceptions.

13.2 The due diligence activity ensures whether the business of the target company concurs with that projected to the client. It ensures a reputation check on the target and includes activities such as, valuation of the business. It may involve profiling of individuals/ corporate entities for historic background information, positioning in market, reputation check, distribution network, litigation cases, etc, The assignment basically depends on specific requirement of the client. The fee level depends on the information sought by the client. These can be categorised as follows:

- (i) Basic information that is available in the public domain comprising of data base check, data mining, websites search, research reports telephone search, media search (newspapers reports, etc.), credit rating companies research reports, data base updates through 'crisil', ICRA, etc.
- (ii) Financial records review, visit to ROC, search reports, etc.
- (iii) Visit to the target business, asset verification, surveillance, etc.
- (iv) Police check in order to confirm whether the target is not involved in any activities that could pose reputation risk, crime record checks, number of court cases pending against the target, etc.
- (v) Sensitive information relating to the target that is normally not available in public domain such as, civil litigation history, any crime history, corporate affiliations and details thereof in terms of kind of business interest, nature of share holding, history and reputation of those businesses, etc.

## **Integrity Check Services**

13.3 When an investor is looking forward to enter a new business relationship then background checks are the most sought after

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services. Such background checks may involve:

- (a) Review of potential suppliers;
- (b) Entering into a licensing agreement;
- (c) Reviewing prospective joint venture partners;
- (d) Diversifying into new markets;
- (e) Review of existing customers;
- (f) Reviewing potential merger or acquisition targets; and
- (g) Reviewing individuals or small and medium sized firms those are engaged as brokers or consultancy agents for investing company. The background check helps in ascertaining their capability and mode of dealings are within the ethical norms for the investing company.

13.4 The time and money spent on these assignments are generally rewarding for the client and might safeguard them from a significant business risk. In many such assignments giving clean chit to the 'targeted party' is a difficult proposition to substantiate than a negative 'findings' report.

## **Background Checks and Surveillance**

13.5 These are more suited to non accounting professionals and involve extensive field work and data mining. Excellent networking is a prerequisite to handle these kinds of assignments. A typical assignment would consist of ascertaining the reputation of the business partners before entering into a business relationship.

## **Pre-employment Screening**

13.6 Experience has taught many businesses that if they had objectively and comprehensively screened candidates prior to employment, many malpractices such as, conflict of interest, industrial espionage, theft of proprietary information, contravention

of business compliance issues and business fraud might have been avoided.

13.7 Employment screening is an essential process to safeguard any business from hiring persons who are either unqualified or of questionable integrity. Screening applicants through prior and post hiring enquiries is loss prevention in the real sense. This screening can be extended further to business partners, vendors and dealer networks. This is, generally, a volume activity and work profile involves screening of individuals from senior management to the operating level. The senior the hierarchy the higher the information requirements, the time span for completion and resultant service fee levels. For mass employment screening, the fee are generally negotiable and tend to be competitive. This includes resume check, telephone check, database searches, pretext enquiries, review of university records, enquiries with the local police station and other information available in the public domain. The objective is to filter any false claims about qualification, work experience and personal background or identify weakness on account of withheld information that is relevant to employment such as, previous criminal convictions or misconduct.

## **Tackling Ethical Dilemma**

13.8 Every organisation has an in built value system with its own mission statement, code of conduct and core values that need to be imbibed in the work environment. There are several business situations that create a situation of ethical dilemma in the minds of employees that require a greater understanding of these value statements. Whether it is conflict of interests or protection to the whistleblowers, role of ombudsmen, effective upward communication and workshops bring greater clarity in the minds of the operating people. Abundant experience and knowledge of work culture is essential in addressing these issues and is a highly specialised activity. To append a value to these activities is a difficult task.

## **Investigation into Financial Crimes**

13.9 Investigative assignments although of primary importance do not ensure a perennial stream of work. Hence, it is important to ensure a minimum allocated percentage of time in a year towards building these kinds of assignments. This is the only way sustainability can be brought to the investigative practice. This can be achieved through product differentiation between consulting, internal audit and investigative assignments. The resource constraints can hamper the accepting of investigative assignments and, hence, regular updating of skill sets is a critical factor in managing these kinds of assignments.

### **Identify End Use of Funds**

13.10 These assignments are similar to bank audits except that the client could be Non-Government organisations, World Bank projects and many social projects wherein the donor is interested in deriving a comfort about the end use of funds. Any diversion of funds not in accordance with the objective of the organisation would hamper the reputation of the organisation and future in flow of funds.

### **Asset Tracing**

13.11 Asset tracing investigations suit debt recovery process for banks and financial institutions. Asset tracing is desirable but not of the recovery proceeds as these are high risk proposition and are difficult assignments. Accordingly, there is a need for abundant caution in understanding the mandate from the management and deliverables. Asset tracing are also done for merger and acquisition activities as part of due diligence activities of the organisation. In a disproportionate asset case, the asset tracing team plays a major role in evaluating the asset amassed by the employee vis-à-vis his disposable income.

## **Legal Support**

13.12 This practice should be seen from an accounting perspective and involves pre-trial discovery, various forms of alternative dispute resolution in business, providing assistance to lawyers with accounting, business solution, and valuation aspects in legal initiatives. This will include damage analysis or defending a claim for damages. Generally, this should be the preferred practice of Chartered Accountants. This will be inherent strength for the members who already are well versed with court matters.

## **Expert Witness**

13.13 An expert witness or professional witness is a specialist who by virtue of his education, training, skill or experience possesses knowledge beyond that of an average person and sufficient to the extent that his opinion about an evidence or fact with the scope of reference is called an expert opinion.

A qualified expert may testify by giving an opinion or otherwise and such a testimony should be based on sufficient facts or data and should also be a product of reliable principles and methods. The expert witness must have applied the principles and methods reliably to facts of the case in forming an opinion. A Chartered Accountant with his domain professional knowledge can play the role of expert witness effectively.

## **Damage Assessment/ Business Valuation**

13.14 It will require reports from the Chartered Accountants on account of business interruption, loss of stock/ assets, ocean loss claims, fire claim, damages arising out of professional negligence, product liability (warranties) and loss of profits due to disputes, breach of contract, business valuation for new acquisitions, etc.

## **Intellectual Property Rights Protection**

13.15 Some of the investigative firms are backed by retired police officials or army officials and experienced lawyers who have a

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wide network of contacts. They provide adequate training for isolating incidents of counterfeit products being sold in the market. The source of such product is also traced most of the time, and with the help of local police network the operation is successfully completed including seizure of unauthorised machinery, closure of manufacturing facility and suggesting remedial measures to the affected client. This practice also includes corporate brand vulnerability assessment.

## **Anti-Fraud Reviews (AFR)**

13.16 These reviews are a tool for fraud deterrence, and are used for identifying the root cause for the occurrence of a fraudulent activity. This requires improvement in the existing procedures to eliminate the 'fraud enablers'. The short term steps are more procedural and long term changes includes ethics workshops and focussing on cultural changes within the organisation. AFR is a process of assessing the vulnerabilities in the present work environment of a business entity. The process requires visualising fraud scenarios under a set of pre-defined conditions. Identifying the critical areas for review is an important step in this type of assignment. This is followed by creating hypothesis of events called 'triggers for fraud'. The fraud trigger is tested with reference to people, processes, timing, reporting and documentation of activities. The past occurrence of fraud, the frequency of such occurrence over a defined period, the impact on the entity in terms of materiality and on its reputation are influencing factors in the risk profiling process. The exercise concludes with prioritising these risks and suggesting remedial measures. Essentially, this exercise is revisited after a defined time interval.

The diagnostic review for assessing vulnerabilities to fraud is a step towards deterrence of fraud. From a management perspective elimination of fraudulent activities though desirable is improbable. Hence, any remedial measure arising out of diagnostic reviews should be subjected to a cost benefit analysis and should not result in degrading the functioning of business entity.

## **Cyber Crime**

13.17 The services under this category among firms vary depending upon their in-house capabilities. The services include data recovery that enable the retrieval of e-mail messages and deleted documents. The services include creation and maintenance of evidence to ensure proper collection and presentation of data in court, data imaging and information security compliance audits.

## **Case Studies**

13.18 The following case studies illustrate the situations mentioned above:

- (i) The CFO/ CEO of a company had excelled in ensuring a consistent business performance coupled with a hyper growth in business volumes. This has brought in greater expectations from the board members in terms of using their expertise in other new business ventures and similar expectations from the audit committee members in strengthening the internal controls with more delegation of power. This has necessitated reorganisation of the reporting structure including identifying a new breed of leaders who can carry on the good work. The HR Head was summoned and was referred some eligible candidates within the organisation and also to look for new talent outside the business realm. The HR person started profiling the candidates and had reservations on the integrity of the persons to whom the business mantle can be handed over, based on grapevine information. However, to prove this point he was in need of the right feedback and supporting evidence to corroborate facts. An investigation firm was called in to ensure a background check seeking specific information about the candidate without revealing the real objective that he was a potential candidate for a senior position. Do you consider this appropriate in not revealing the true objective?
- (ii) The competitors in a business managed to launch their competing product despite company's best efforts to maintain confidentiality of information. This brought in an element of distrust within task force on information leakages to the

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competitor. The management realised the need for conducting an information security review to identify the control gaps that lead to this mishap time and again. The internal auditor was summoned to undertake a covert assignment (Special audit assignment) to identify the manner in which information reached the competitors.

A part of the assignment required the internal auditor to look into avenues for leakage of information and a specialist was needed on matters relating to use of technology and review of telecommunication lines. Accordingly, a decision was taken to outsource the technical aspects of the review. Using the services of technicians for presence of any bugs and an effective surveillance mechanism they were able to successfully isolate the problem. The technical surveillance revealed that none of the internal task force members were responsible for information leakage.

## Chapter 14

# Market Scenario for Investigative Work

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### Chapter Summary

*The chapter provides an insight into the market scenario for investigative type of work that has a room for all types of operators whether it is a freelancer or a group of persons handling various facets of investigative type of work under a contractual relationship. Infact there is a dirth of operators as the type of work requires exceptional skill sets, risk element and has immense stress in getting the resources for the existing operators. The chapter also deals with client concerns and precautions to be taken in assinging of jobs.*

14.1 In an open economy with a focus on globalization, foreign companies are setting their sights on India and vice versa resulting in forging of alliances giving thrust to due diligence activities. However, any fallout in such relationships at a later stage may give rise to a situation requiring mediation and conflict resolution.

These companies in India that have tie ups with foreign entities do have the risk of facing allegations of manipulation of accounts outside India. These developments could result in unanticipated reputation risk and unforeseen strain in business relationships. The assertion by the management that the Indian operations are insulated from such developments should be seen in the proper perspective. To take a decision on whether to continue or sever the business relationship, management needs to revisit the due diligence exercise done prior to forging an alliance. This exercise can be more ably done by a Chartered Accountant.

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From an investigative services perspective, this is an area to watch out for in the next few decades and has immense potential for the investigative practice.

14.2 This brings the several questions to the forefront like, who is the client, how to vet referral of assignment, how to assess fraud risk, what is the expectation of the client and finally how to make a beginning in an investigation assignment, etc. Generally, investigation is used as a tool for confidence building by borrowers *vis-a-vis* the lenders or could be on behalf of the lenders to ensure checks and balance on safety of their investment or loan disbursed. Here the target client could be a money lender or the borrower client. Similarly, where the assignment is about integrity check or surveillance, the HR department personnel could be the target client.

## **Types of Operators**

14.3 The market scenario for investigative assignments is very encouraging with enough space for all kinds of operators in these types of engagements to the extent permissible under the law. Primarily, this market is unorganized and private investigators can be classified into the following categories:

- (a) Freelancers (retired police officers, ex-army personnel, etc);
- (b) Private detective agencies;
- (c) Risk management firms (with a global network being an advantage);
- (d) Audit firms (proprietary, medium sized partnerships, and large firms);
- (e) In-house departments (on behalf of the management).

14.4 Apart from the above, investigations may be mandated under Statute. For e.g., investigations instituted under direction from regulating authorities (Banks, Financial institutions, Registrar of companies, Reserve Bank of India, Insurance Regulatory and

Development Authority, Securities and Exchange Board of India, etc.) or by Law enforcement agencies (on behalf of the State or Court of Law).

## **Resources in an Investigative Firm**

14.5 Generally, the assistance of retired Intelligence Bureau officers, CBI officers, or Ex-officers of high profile regulatory authorities and former Government officials from investigative background with integrity and proven track record are considered as an essential support for brand building and the training needs within the investigation firms. These officials are also considered essential for field work and form an integral resource in establishing a network of informers and are a source of information vital to the objective of conducting investigation within the legal framework. Since clientele information cannot be shared by investigative firms, the experience of the team members and the presence of a multi-faceted team (CAs, MBAs, Law Graduates, Psychologists, Historians, Sociologists, IT professionals, Statisticians, etc.) become a confidence building measure to ensure core competency. An investigation being a specialized activity involving multi-faceted skill sets, there is a tendency to form limited liability companies that suits brand building too.

14.6 A distinct feature in this field is the high attrition rate among the investigative personnel. Considering the quality of personnel, and risk and skill sets involved, the compensation is generally benchmarked with the best in the industry with reference to other professional services. Cost considerations are a critical factor in the engagement process, both for the management as well as the investigating firm. The engagement fee mainly depends on the time spent and objective of the assignment and may vary from firm to firm, based on their skill sets.

14.7 A Chartered Accountant in accordance with his professional knowledge base is able to be an efficient co-ordinator among these agencies ably supported by analytical skills, working knowledge in process evaluation and requisite documentation, especially for investigation involving financial crimes. He is,

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therefore, at an advantage to play the role of a strategist in carrying out the investigation. However, for field work, services of non-Chartered Accountants may be used.

14.8 For the above agencies, there is also a need to ensure that resources both in terms of manpower or investigative tools are gainfully deployed. Hence, multiple services apart from core investigation are created. This comprises of conducting surveys, research reports, media exposure, periodical representations to management, due diligence, conducting background checks (surveillance), reference checks for appointment of personnel to important posts in an organization, reference checks for HR department (large volume contracts), integrity checks for employees, assignments related to patents and trademarks violations, business ethics workshops, validation of processes for game shows in media, etc. are some examples. An internal auditor who has a better understanding of financial as well as operational audits is more suitable to be engaged in investigative assignments, whenever the situation warrants. It is also desirable for investigating firms to engage in a dialogue with the internal auditors at the planning stage to evolve their strategies.

# Chapter 15

## Way Forward

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### Chapter Summary

*The chapter is intended to encourage the members to hone their skills to look for opportunities and develop resources to ensure greater diligence in executing their professional responsibilities. This practice rather than being seen as fault finding exercise should be construed as confidence building measure that requires the attention of members, management and audit committee representatives.*

### Representations to the Members

15.1 Investigative practice is a specialised field and is a confluence of the fields of Accounting, Law, Information technology, Sociology, Psychology, Journalistic aptitude, Business communication and Business administration. Investigation is a team effort and, therefore, a post qualification course covering any of these fields could immensely help members in honing their skills. This would mean more members take up investigative practice in an endeavour to minimise corruption in society. There is a need for a functional interface between the world of accountants and the legal profession.

15.2 The investigation work in private companies is largely unorganised and unregulated and often involves experimenting on the job at the risk of the engagement client. This creates the need for extensive training workshops in developing the skill sets of members. With the rise in financial crimes, it is imperative that a Chartered Accountant is alert to the new accounting world order in developing processes that enable isolation of fraudulent activities.

## **Representation to Management**

15.3 The management could allocate a budget for addressing risk of fraud as a part of the overall risk management plan. This could include structured anti-fraud programs at pre-defined intervals, keeping in view the existing control environment. Where fraudulent activities are found to be rampant in certain sectors, the formation of an investigative cell by whatever name called to ensure an array of activities including a surveillance mechanism to identify red alerts within the organisation could be an added advantage supplementing the internal audit function.

An in-house coordinator (could be the compliance officer or the chief audit executive) to advice on matters relating to investigative support within the organisation could be designated.

## **Representations to the Audit Committees**

15.4 There is an increasing role of the audit committees (especially, the independent directors) whose expertise could be of immense use in functioning of the enterprise. While the mandate for investigation is a management decision, the audit committee has the right to seek clarification from the management on the action taken on red flags as highlighted by the internal auditors. This strengthens the role of internal audit functionaries in terms of evaluating the control environment of the entity at the same time bringing service differentiation between audit and investigative assignments.

# Appendix A

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## Recommended Reading Material/ Website References for Readers

### Recommended Reading Material

- Constitution of India
- Prevention of Corruption Act, 1988 (applicable mainly to public servants)
- Foreign Corrupt Practices Act of 1977 (applicable to Indian companies having overseas operations)
- The Indian Penal Code, 1860
- The Indian Evidence Act, 1872
- The Code of Criminal Procedure, 1973
- The Civil Procedure Code, 1908
- The Indian Contract Act, 1872
- Law of Torts
- Industrial Disputes Act, 1947
- The Private Detective Agencies (Regulation) Bill, 2007

## ***Study on Investigative Audits***

### **Recommended Websites**

[www.sfo.nic.in](http://www.sfo.nic.in) (organisation to investigate serious financial frauds)

[www.sebi.gov.in](http://www.sebi.gov.in) (on corporate governance)

[www.rbi.org.in](http://www.rbi.org.in) (for fraud monitoring and reporting process)

[www.cvc.nic.in](http://www.cvc.nic.in) (disciplinary action on public servants)

[www.cbi.gov.in](http://www.cbi.gov.in) (investigative approach)

[www.irs.gov](http://www.irs.gov) (for investigation report drafting)