



Audit of Fraud Fraud Detection Techniques & Forensic Audit

Proceedings of the Course

27.12.2006 to 30.12.2006

Indian Audit & Accounts Department
Regional Training Institute
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From PD's Desk

Undetected white collared larceny robs stakeholders of their wealth. With the advent of information or cyberspace, risk levels on account of fraud have increased. With the rising levels of fraud being reported everywhere; there has been a growing need for equipping the auditors with appropriate knowledge and skills on the subject as a step towards fostering good governance. In this backdrop, Headquarters office, sometime in 2003, declared this institute as a centre of excellence in the area of 'Audit of Fraud'. Courses on this subject are conducted on the lines of the Structured Training Module (STM) prepared by the institute. This is the second course the institute had conducted on the subject.

It is heartening to learn that the course was very well received by the participants as evident from their feed back and performance in the end course evaluation test. Considering robust internal controls remain the first line of degree of defense against fraud, as a part of the training, they were made to work on a project 'assessment of internal controls-audit check list' for presentation on the last day of their training. Their participation, defying the closing hours, was praiseworthy.

Excellence being a matter of continuous process, there is a long way to go for us in this area. Presently, we are working on preparation of 'red flags' (fraud indicators) along with anti-fraud measures for different scenarios, and analysis of factors that led to success of some frauds detected, besides compiling a bank of case studies on the subject. Results of these initiatives would surely enrich the course.

Finally, we hope that the readers of these proceedings would find them useful. Their comments, if any, would definitely help us in fine tuning our future efforts.

Principal Director

REGIONAL TRAINING INSTITUTE, NAGPUR

Course on Audit of Fraud, Fraud Detection Technique and Forensic Audit

Duration of the course : 4 days - 27.12.2006 to 30.12.2006

Objectives of the course : At the end of the course, the participants will be able to

1. Describe the characteristics & categories of fraud & corruption
2. Identify potential indicators of fraud and corruption
3. Indicate the need for planned approach to auditing of fraud and related matters
4. Conduct audit in consideration of potential indicators of fraud and related matters

Date	Forenoon session 10.00 am to 12.45 pm		After noon session 2.15 pm to 5.00 pm
27.12.2006 Wednesday	Inauguration by Shri S.P.S.Yadav Commissioner of Police	Basic concept of fraud and corruption Dr. Sadu Israel Pr. Director	Categories of fraud and corruption Shri S.K.Jakhotia, Asstt. Accountant General
28.12.2006 Thursday	Potential fraud indicators and high risk areas Dr. Sadu Israel, Principal Director		Internal control and risk assessment Shri Sunil Dadhe A.G. (Audit)-II, Nagpur
29.12.2006 Friday	Role of Auditor in consideration of fraud Dr. Sadu Israel, Principal Director		Fraud Investigation and forensic audit Dr. Sadu Israel Pr. Director
30.12.2006 Saturday	Presentation by participants		Valediction Principal Director

Tea breaks : 11.15 am to 11.30 am and 3.30 pm to 3.45 pm

Lunch break : 12.45 pm to 2.15 pm

BACKGROUND

READING MATERIAL

Examination of system of internal control and prevention of fraud and corruption will be an integral part of the audit. The standing order in the Annexure whenever a firm or institution is subjected to the examination of the system of internal control and prevention of fraud and corruption. Some of the subjects to be examined are:

(1) Corruption and fraud are closely interlinked. In fact corruption is a special type of fraud and treated as such in many jurisdictions. In any case both terms are often used interchangeably. The complex distinction as well as corruption and fraud should be well known to the auditors. The Annexure contains some illustrative (but not exhaustive) types of fraud and corruption that the auditors may come across.

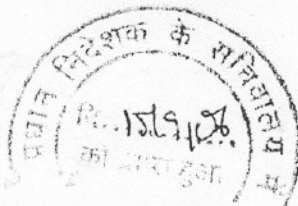
(2) Fraud examination is a part of the normal auditing procedures. It is not a separate branch of audit. The auditors should be aware of the fact that the fraud examination is a part of the normal auditing procedures. The auditors should be aware of the fact that the fraud examination is a part of the normal auditing procedures. The auditors should be aware of the fact that the fraud examination is a part of the normal auditing procedures.

(3) The responsibility for the prevention and detection of fraud and error rests primarily with the management of the audited entity. Through the implementation and continuous operation of accounting and internal systems designed to check fraud, the auditors should be able to detect and prevent the fraud. The auditors should be aware of the fact that the fraud examination is a part of the normal auditing procedures.

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भारत के नियंत्रक-महालेखापरीक्षक का कार्यालय
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OFFICE OF THE
COMPTROLLER & AUDITOR GENERAL
OF INDIA
10, BAHADUR SHAH ZAFAR MARG,
New Delhi - 110 002

दिनांक / DATE _____

6 September 2006

To

All Directors General (Audit) / Principal Accountants General (Audit) / Principal Directors (Audit) / Accountants General (Audit) (as per the mailing list)

Sir / Madam,

Sub: Standing Order on role of Audit in relation to cases of Fraud and Corruption

Introduction

Examination of system for detection and prevention of fraud and corruption will henceforth be an integral part of all regularity audits and also of performance audits, whenever it forms one of the audit (sub) objectives. The standing order in the Annexe to this communication is issued in supersession of the existing instructions on the subject. As and when the need arises detailed guidelines will be issued. Some of the important points to be kept in view are as under:

(1) Corruption and fraud are generally interlinked. In fact corruption is a special type of fraud and treated as such in many jurisdictions. In any case audit teams / officers should be well aware of the complex distinction as well as correlation between the two. Appendix-A to the Annexe contains some illustrative (not exhaustive) types of fraud and corruption that the audit teams may come across.

Fraud examination

(2) Fraud examination is a part of the normal auditing procedures. Fraud has a legal (criminal) connotation. Audit teams/officers do not make legal determinations of whether fraud has actually occurred. Hence, audit teams/officers can put red flags (an indication that further scrutiny of the items would be required) which need further investigation by appropriate agencies. When the evidence is clear, audit teams/officers can come to a conclusion about a suspected fraud and include it in their findings.

Respective responsibilities of management and audit

(3) The responsibility for the prevention and detection of fraud and error rests primarily with the management of the audited entity through the implementation and continued operation of accounting and control systems designed to check fraud. Audit must, however, evaluate and report on the adequacy of the systems in place and competence with which the management has discharged its responsibility in relation

to prevention, detection, response and follow-up/remedial measures in relation to fraud and corruption.

(4) During audit of financial statements, two types of intentional misstatements are relevant to the audit teams/officers, viz., misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. Similar considerations apply in case of performance audits. In performance audits, while selecting themes and issues/sub-issues, the vulnerability to fraud and corruption should be given due consideration.

Professional skepticism

(5) Audit teams/officers should maintain an attitude of professional skepticism (an attitude that includes a questioning mind and a critical assessment of audit evidence) throughout the audit.

Fraud awareness at the audit planning stage

(6) The field offices should carry out independent risk assessment and prioritize their audit planning accordingly. The audit plans in relation to fraud and corruption should focus on high risk areas. Some of the common high risk areas (illustrative) are contracts of service/procurement, inventory and asset management, sanctions/clearances, performance information, revenue receipts, cash management, general expenditure, grants, financial statements, operating information, computerized environment, privatization of government entities and any other areas involving public interface.

(7) While planning audit, the field Accountants General, etc. should assess the risk that fraud may cause to the financial statements to contain material misstatement or record material irregular transactions. Based on the risk assessment, the Accountants General should develop the audit objectives and design audit procedures so as to secure reasonable expectation of detecting and evaluating material misstatement and irregularities arising from fraud and corruption.

Vigilance about fraud at audit execution stage

(8) At the commencement of each audit, information about the fraud and corruption awareness, detection and prevention policy and related environment (including any instances of fraud and corruption noticed since last audit and action taken on such instances including strengthening of internal control systems) should be collected from the audited entity management.

(9) During the course of audit work, the audit teams / officers should be vigilant and seek explanations, if they come across possible fraud indicators. Some illustrative fraud indicators (red flag areas) are given in Appendix-B to the Annexe.

Audit evidence and documentation

(10) Any indication that an irregularity, illegal act, fraud or error may have occurred which could have a material effect on the audit finding / opinion should

cause the audit teams / officers to extend procedures to confirm or dispel such suspicions. Instructions regarding the illustrative procedures to be adopted are given in the Annexe. If the irregularities had a material effect on the accounts, suitable reporting and qualification in the audit opinion may be warranted. Audit should also recommend improvement in the control procedures to management.

(11) IT fraud is an area of concern for Audit. Collecting computer evidence requires careful planning and execution. Audit teams / officers should examine whether appropriate controls are in place in order to ensure the authenticity of computer evidence.

(12) The audit teams/officers should check compliance with the provisions of Rules 29, 33, 34, 37 and 38 of the General Financial Rules (GFRs) 2005 (Appendix-C to the Annexe).

(13) The audit teams/officers should clearly understand that the audit evidence obtained can be only persuasive and not conclusive. While reporting all cases of suspected or presumptive fraud or corruption, they should refrain from making any judgment regarding the existence of fraud or corruption. The evidence should also be capable of proving that the audit teams/officers have discharged their functions with reasonable care and due diligence.

Reporting and follow-up

(14) Reports of individual cases of suspected fraud / corruption should be confidentially addressed, in the first instance, to the controlling authority concerned, with the approval of Group Officers. More serious cases should also be confidentially reported to the Secretary of the Administrative Departments (where they are not the controlling officers) concerned and the investigative authorities like Central/State Vigilance Commission, Lok Ayukta, etc. as applicable in the manner indicated in the Annexe either over the signature of the Accountant General or with his/her approval.

(15) Cases relating to suspected/presumptive fraud and corruption should be specially highlighted in the concerned Inspection Reports, Audit Notes, etc. and also in the Audit Reports. All such cases should be printed in bold type.

(16) While forwarding the Bond Copy of the Audit Reports to Headquarters, the Accountant General should indicate in the forwarding letter the number of cases of fraud and corruption included in the Report together with the money value of the concerned paras. In the submission note of the file relating to the bond copy, the number of cases of suspected/presumptive fraud and corruption in the Report should be highlighted together with the money value of concerned paras.

(17) The draft of the annual post-audit report letter to the Chief Ministers should have a brief mention of issues relating to suspected fraud and corruption where such cases appear in the Audit Reports and the system put in place by the field AsG, etc. to monitor paras relating to fraud / corruption. In addition, all such cases should be taken up immediately after approval of the bond copy with appropriate authorities in the Union and State Governments, viz., Central / State Vigilance Commission, etc. as a follow-up. If such cases have been reported earlier by the AG, reference may be drawn to them with the additional information that these cases have been included in CAG's Audit Report to the Parliament / Legislature.

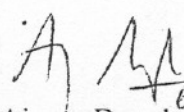
Miscellaneous

(18) The Accountant General may require the Audit teams / officers to provide a Memorandum / Certificate of Assurance which will include, *inter alia*, examination of issues relating to fraud and corruption.

(19) The Accountants General should develop sector specific guidelines/checklists for audit of fraud and corruption in the audit of entities belonging to specific sectors (viz., health, education, works, etc.), for the guidance of the field staff deployed in such audits and furnish a copy of such guidelines/checklists to DG (Audit).

(20) The field offices should submit half-yearly reports on cases of material fraud and corruption noticed by them to the Headquarters Office or through the rationalized management information system, when introduced.

Yours faithfully,


(Ajanta Dayalan)

Director General (Audit)

Encl. As above.

No.127 /Audit (AP)/1-2004

6 September 2006

Copy to all Officers in Headquarters Office.

Sd/

(Ajanta Dayalan)

Director General (Audit)

Annexe to the Standing Order on audit of fraud and corruption

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1. Introduction

1.1 Examination of system for detection and prevention of fraud and corruption will be an integral part of all regularity audits and also of performance audits, when it forms one of the audit (sub) objectives. The present standing order is issued with immediate effect. As and when the need arises detailed guidelines will be issued.

1.2 The provisions contained in the present standing order are in supersession of the existing instructions on the subject.

1.3 The expression 'Accountant General', used in this standing order, includes the Director General of Audit, Principal Accountant General (Audit), Accountant General (Audit) and Principal Director of Audit.

1.4 The expressions 'Auditor' and 'Audit Personnel' include all officials engaged in audit work irrespective of their designation.

2. Fraud examination

Fraud examination is a part of the normal auditing procedures and includes:

- being alert for situations, control weaknesses, inadequacies in record keeping, errors and unusual transactions or results, which could be indicative of fraud, corruption, improper expenditure or lack of probity; and
- focusing audit strategy on areas and operations prone to fraud and corruption by developing effective high risk indicators for fraud.

3. Characteristics of fraud

3.1 Fraud should be distinguished from error. The distinguishing factor between fraud and error is whether the underlying action is intentional or unintentional. For example, the following actions amount to error and not fraud.

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

3.2 The meaning and nature of Fraud can be understood by referring to the following definitions.

- *Fraud is an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage*¹

¹ ISA 240 (IFAC)

- *Fraud involves deliberate misrepresentation of facts and / or significant information to obtain undue or illegal financial advantage¹*

3.3 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 within the audited entity or with third parties outside of the audited entity.

3.4 **Fraud has a legal (criminal) connotation. Auditors do not make legal determinations of whether fraud has actually occurred. They can report suspected or presumptive fraud.**

3.5 Ample caution needs to be exercised before terming an act as ‘Fraud’. For an act to come within the ambit of ‘Fraud’, the following elements are required to be present.

- The act is intentional on the part of one or more individuals working in collusion with each other;
- The object of the act is to obtain or give illegal advantage in violation of the laws, rules and guidelines existing on the subject;
- The intention, collusion and object of obtaining illegal advantage will have to be present when a particular act is committed. An act committed in good faith, which by subsequent turn of events, proves to be incorrect or based on wrong information is not fraud;
- The advantage or benefits to an individual or a group of individuals will have to be tangible and not notional or presumptive; and
- Normally, any such act would cause loss to exchequer or be against public interest.

3.6 Fraud may involve:

- manipulation, falsification or alteration of records or documents;
- misappropriation/ misapplication of assets;
- suppression or omission of the effects of transactions from records or documents;
- recording of transaction without substances; and
- misapplication of accounting policies.

3.7 The mandate of Government Audit is broader than solely that of financial statement auditor and includes responsibility for verification of regularity and performance. Hence, the auditor should be aware of the possibility of fraud not only in the preparation and presentation of financial statements but in other areas covered by regularity (compliance) and performance audits as well.

Considerations of materiality

3.8 Assessments of materiality in Government Audit may often not be restricted to risks of material misstatements in the financial statements, but comprise fraud in the

¹ ASOSAI

context of the broader scope of Government Audit. While determining materiality levels for different audit areas, adjustments to the materiality level that may make audit more responsive to risk arising from fraud and corruption should be considered.

3.9 In Government auditing, it might be appropriate to set lower materiality levels than the private sector auditing to ensure higher levels of accountability of the audited entity and various legal and regulatory requirements. The occurrence of fraud may lead to a qualification of audit opinion, even when the fraud is disclosed in the financial statements.

3.10 Though traditionally materiality has been one of the prime factors to determine the audit priority, in case of fraud detection, since the act is illegal, materiality assumes lower significance. Although the temptation of embezzlement of a lower amount is much less, lack of internal controls may lead to a series of misdemeanors, all of small amounts.

3.11 Audit can not always establish and determine whether a misrepresentation was an error or fraud. While Audit looks at records, fraud examination goes beyond audit. Hence, Audit can put red flags (an indication that further scrutiny of the items would be required) which need further investigation by appropriate agencies and reporting the result to Audit.

4. Characteristics of corruption

4.1. Corruption is a complex issue. The following definitions indicate the nature of corruption.

- *Corruption involves behaviour on the part of officials in the public and private sectors, in which they improperly and unlawfully enrich themselves and/or those close to them, or induce others to do so, by misusing the position in which they are placed¹*
- *Corruption is the abuse of public power for personal gain or for the benefit of a group to which one owes allegiance²*

4.2 An act of corruption would comprise of one or more of the following elements.

- There must be at least two parties, viz., the person who offers the reward or inducement and the party accepting it;
- There must be misuse of office or position of authority for private gain;
- There is either an offer and/or acceptance of inducements;
- An attempt to solicit an offer of inducement or reward as benefit for performance of an official act;
- Any act through which public or entity property is dishonestly misappropriated;
- There may be an attempt to camouflage; and
- Corruption involves breach of trust.

¹ Asian Development Bank

² World Bank

5. Nexus between fraud and corruption

5.1 Corruption and fraud are not mutually exclusive. There is, in most cases, a nexus between the two.

5.2 Fraud is most likely to involve deliberate misrepresentation of information that is recorded and summarized by an entity; its impact can be compared to an accounting error and would involve issues such as measurement, occurrence, and disclosure. Fraud poses a serious problem from an audit perspective because it is normally accompanied by efforts to cover / falsify / misdirect the entity records and reporting. Thus, fraud can directly affect the financial statements and records of the audited entity.

5.3 Quite often, the efforts to misrepresent may involve the management itself. When management gets involved in the perpetration of fraud, the activity assumes the proportion or the additional bearing of corruption. Fraud and corruption are therefore interlinked, although certain types of fraud do not necessarily qualify for being viewed as corruption and can be perpetrated by an individual or a small group to cover lapses.

5.4 One problem which corruption poses for audit is that it is linked with the acts of bribery. It is possible to conceive of situations where bribery may have a direct impact on financial statements. For example, where a tax officer collects a bribe from an entity to provide a tax relief or where an entity pays an influential decision-maker a bribe to secure a contract. In such situations the issue of proper disclosure is involved because the corrupt practice of the illegal payment / expense is normally covered up through an accounting, compliance or reporting fraud.

5.5 In some cases, corruption may have only a consequential, and not a visible and direct effect on the accounting records, for example, when the quality specifications are compromised in a supply order to benefit a supplier.

5.6 In many instances corruption does not necessarily reflect in the transactions that are recorded and reported by the entity. This especially applies to situations where a position of authority or discretion available under rules is misused by an official. Such corruption does not normally get reflected in information that comes in the purview of audit, for example, when a tax officer collects bribery to give a refund which is lawfully due to a taxpayer. Thus, whereas the loss to the auditee is usually fairly apparent in cases of fraud, in the case of corruption, the corrupt employee may benefit from the act, but there may not be any loss to the auditee or effect on financial information.

5.7 Both fraud and corruption are without proper authority and involve breach of trust and therefore are illegal or irregular. They also involve an element of non-transparent conduct or behaviour. In fact corruption is a special type of fraud and treated as such in many jurisdictions. In any case audit teams /officers should be well aware of the complex distinction as well as correlation between the two.

6. Types of fraud and corruption

There are several types of fraud and corruption. Some illustrative types (relating to contracting for goods and services) are indicated in Appendix –A.

7. Respective Responsibilities of Management and Audit

Responsibilities of Management

7.1 It is the responsibility of those charged with governance of the entity to ensure, through oversight of management, that the entity establishes and maintains internal control to provide reasonable assurance with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

7.2 In relation to fraud, it is important to recognise that the responsibility for the prevention and detection of fraud and error rests primarily with the management of the audited entity through the implementation and continued operation of accounting and control systems designed to check fraud. The responsibility for adequate and timely disclosure of any cases of fraud and corruption rest with the management and the responsibility of ensuring reliability and results of operation must include concerns arising from risk of fraud and corruption. The management is expected to document the system established for prevention, detection, response, follow-up and reporting of fraud and corruption.

Responsibilities of Audit

7.3 Detection of fraud is not the primary objective of audit. Audit must, however, evaluate and report on the adequacy and competence with which the management has discharged its responsibility in relation to prevention, detection, response and follow-up/remedial measures in relation to fraud and corruption. The auditor should make the management aware that the absence or lack of application of reliable and valid performance measures and indicators could increase the possibility of occurrence of fraud and corruption.

7.4 Audit should be alert to shortcomings in systems and controls that are likely to provide an environment conducive for fraud and corruption and should recommend to the management measures to improve the control environment and minimize the risk of fraud and corruption.

7.5 Any indication that an irregularity, illegal act, fraud or error may have occurred which could have a material effect on the audit finding / opinion should cause the auditor to extend procedures to confirm or dispel such suspicions.

7.6 It should be borne in mind that if a material fraud was perpetrated but not discovered in audit, the conduct of audit personnel can be called in question, particularly if the evidence was such as would arouse suspicion in an auditor of normal prudence. Hence, the audit personnel need to be aware of the possibilities of fraud at the planning stage and should be vigilant while carrying out the audit work.

8. Considerations of fraud in audit of financial statements

8.1 During audit of financial statements, two types of intentional misstatements are relevant to the auditor, viz., misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.

8.2 Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting may be accomplished by the following:

- Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared;
- Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information; and
- Intentional misapplication of accounting principles relating to the amounts, classification, manner of presentation, or disclosure, etc.

8.3 Misappropriation of assets involves the theft of an entity's assets and can be perpetrated by employees as well as management.

8.4 The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. An auditor obtains reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. An auditor cannot obtain absolute assurance that material misstatements in the financial statements will be detected because of such factors as the use of judgment, the use of testing, the inherent limitations of internal control and the fact that much of the audit evidence available to the auditor is persuasive rather than conclusive in nature.

9. Considerations of fraud in performance audits

9.1 Similar considerations apply in case of performance audits. In performance audits, while selecting objectives, sub-objectives and issues, the vulnerability/risk to fraud and corruption should be given due consideration.

9.2 In the course of performance audit, the effectiveness of internal controls to prevent and detect fraud and corruption should be considered as one of the audit objectives, depending upon the materiality and risk analysis.

9.3 Where the performance audit team comes across any possible indicators of fraud, it should probe the matter further and report its findings. Some of the significant areas for scrutiny from fraud angle could be the integrity of performance information and evidence of delivery of goods and services.

10. Considerations of fraud in receipt audit

10.1 Audit should not in any way substitute itself for the revenue authorities in the performance of their statutory duties. However, Auditors should satisfy themselves that the requirements of legality and regularity are observed in individual assessments and in general that the departmental machinery is sufficiently safeguarded against error, fraud and corruption.

10.2 In the audit of receipts, it would be necessary in the case of a department which is a receiver of public moneys to ascertain what arrangements (internal controls) are in place to ensure the prompt detection, investigation and prevention of irregularities, double refunds, fraudulent or forged refund vouchers or other loss of revenue through fraud, error or wilful omission or negligence to levy or collect taxes or to make refunds. Auditors may also suggest appropriate improvements in the systems and procedures for prevention, detection and reporting of cases of fraud and corruption.

11. Considerations of fraud in audit of World Bank and other externally assisted projects

Audit is responsible for reporting to the funding agency whether the implementing agencies have carried out expenditure on the scheme in accordance with the pattern specified in the project appraisal report relating to the schemes and terms of such assistance and Government of India instructions and to identify matters relating to inadequacies in systems and control, cases of fraud or presumptive fraud, wasteful expenditure and failure of administration to take corrective action on recommendations contained in earlier report.

12. Professional skepticism

12.1 Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. Professional skepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests the existence of fraud having a material effect on audit findings/opinion.

12.2 Due to the characteristics of fraud, the auditor's attitude of professional skepticism assumes particular importance when considering the risks of fraud having material effect. When obtaining reasonable assurance, an auditor should maintain an attitude of professional skepticism throughout the audit, consider the potential for management override of controls and recognize the fact that audit procedures that are effective for detecting error may not be appropriate in the context of an identified risk of fraud having material effect. This is notwithstanding the auditor's past experience with the entity about the honesty and integrity of management and those charged with governance.

13. Fraud awareness at the audit planning stage

Risk assessment

13.1 The field offices should carry out an independent risk assessment and prioritize their audit planning accordingly. This should include consideration of any

information received from the public or media on suspected cases of fraud and corruption. The audit plans should focus on high risk areas, for instance, those areas indicated at paragraph 13.8 (*infra*).

13.2 Though audit cannot insure against frauds, the possibility of their occurrence should be kept in mind while preparing for and conducting audit, by maintaining an attitude of professional skepticism.

13.3 While planning his audit, the auditor should assess the risk that fraud may cause the financial statements to contain material misstatement or record material irregular transactions.

13.4 The auditor may keep in view that the risk of fraud and corruption could be higher in certain organisations like those involved in procurement of goods and services.

13.5 The auditor should have a complete understanding of the audited entity including the environment in which the entity operates, the level of internal control and the past performance of the audited entity especially previous instances of fraud and corruption.

13.6 Based on the risk assessment, the auditor should develop the audit objective and design audit procedures so as to have reasonable expectation of detecting and evaluating material misstatement and irregularities arising from fraud and corruption. In case of high risk audit the audit team should be selected keeping in view the requirement of such audit.

13.7 The field offices should keep in view the need for flexibility in terms of budget, time and expertise of the audit team particularly when fraud and corruption are suspected or discovered in the course of audit.

Identification of areas requiring attention

13.8 An understanding of the audited entity should enable the auditor to identify potential high-risk areas and suitably modify audit procedures and techniques. Given the complexity of transactions and refinement of audit methodologies across the globe, taking expenditure as the sole criterion is simplistic and unsophisticated. The broader definition of fraud risk should cover areas of specific concern to the Government Auditor, although potentially not having a material impact on the financial statements. Some of the common high risk areas (illustrative) are:

- contracts of service/procurement (for example, the fraud risk includes violation of prescribed laws and regulations concerning the procedures for inviting, receiving and processing of tenders, selection of bidders)
- inventory and / asset management;
- sanctions/clearances;
- programme management and performance management information;
- revenue receipts (for example, incorrect valuation of goods, inadmissible duty draw back claims, misuse of exemptions and notifications regarding refund claims, embezzlement through incorrect accountal of receipts, etc)

- cash management;
- expenditure on AC bills;
- grants (like grants-in-aid to autonomous bodies non-governmental organisations; for example, the fraud risk includes violation of prescribed conditions in providing and administering grants by the Government Departments or in spending by the recipients, intentional misstatements in financial reporting in order to receive unlawful grants);
- financial statements;
- operating information (for example, the fraud risk includes overstatement / understatement of accomplishments, progress in meeting performance goals, number of citizens served, programme improvements, compliance with policies, etc. irrespective of whether the possible fraud is related to the entity's financial statements)
- computerized environment;
- privatization of public sector functions (for example, the fraud risk includes non-adoption of open competitive process, manipulation of bidding terms and evaluation criteria, etc.), joint ventures, public-private partnerships, etc.;
- any other areas involving public interface (for example, the fraud risk includes fraud in exercise of public authority like issuing of regulations, permissions and concessions)

13.9 As the first step, during the Preliminary Systems Evaluation, the adequacy of various accounting systems and procedures, whether set out in the form of a manual or otherwise, should be examined and the extent of check of individual transactions should be determined based on the results of such examination. This is all the more necessary since generally a sample of the transactions is checked in audit and audit personnel cannot escape responsibility if significant deficiencies in the accounting systems and procedures lead to misuse or abuse of public moneys. The concept of Systems Audit is that if an in-depth analysis of the mechanics of a system reveals that it is designed with appropriate controls, checks and balances to safeguard against errors, frauds, etc., Audit can reasonably assume, without the necessity of undertaking a detailed examination of the individual events or transactions, that the results produced by the system would be fairly accurate. Evaluation of the efficiency and effectiveness of any system will, however, require sample testing of its actual working.

14. Vigilance about fraud at audit execution stage

Vigilance during the course of audit

14.1 During the course of audit work, the audit personnel should be vigilant and seek explanations, if it comes across possible fraud indicators.

14.2 Auditors need to be alert to deviations from acceptable accounting standards including disclosure requirements particularly when there is suspicion of fraud and corruption.

14.3 The auditor may keep in view that when a fraud is conducted there is a deliberate effort to conceal the facts and distract the auditor.

Fraud indicators

14.4 Some possible fraud indicators (red flag areas) are given in Appendix-B. They are illustrative only, and should not be taken as exhaustive. The audit personnel should exercise professional skepticism and professional judgement in dealing with possible fraud indicators.

14.5 It should also be recognised that failure to appreciate the significance of what appears to be a trifling irregularity may result in failure to discover an important fraud or defalcation. Therefore, notice may be taken of the cumulative effect of numerous petty errors or irregularities as being indicative of carelessness and inefficiency in the maintenance of accounts or in financial administration generally.

14.6 If no satisfactory explanations are offered and the auditor suspects that irregularities may have occurred, he should probe the matter further and inform management of the audited entity. If the irregularities had a material effect on the accounts, suitable qualification in the accounts may be warranted. Audit should also recommend improvement in the control procedures to management for preventing recurrence of bad practices and/or irregularities.

Information to be sought from the audited entity management

14.7 At the commencement of each audit, information about the fraud awareness and related environment should be collected from the audited entity management.

14.8 The information should include *inter alia*:

- Policy and system to prevent and detect fraud / corruption and reporting;
- System to establish accountability for fraud / corruption;
- Fraud / corruption indicators;
- Instances of fraud and corruption noticed since last audit;
- Action taken on such cases, including strengthening of internal control systems;
- Special areas prone to risk of fraud and corruption; and
- Guidelines issued by management with regard to control of fraud and corruption.

15. Audit evidence

Nature of evidence

15.1 The auditors should clearly understand that the audit evidence obtained can be only persuasive and not conclusive. Yet the evidence in case of suspected fraud and corruption ought to be closer to conclusive. While reporting all cases of suspected fraud or corruption, they should refrain from making any judgment regarding the existence of fraud or corruption but should suggest suspected fraud/corruption or presumptive fraud.

Some illustrative checks

15.2 Analytical procedures are helpful in identifying the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters having audit implications. When performing analytical procedures at the planning stage or during the course of audit, unusual or unexpected relationships may indicate risk of fraud.

15.3 Fraud detection measures need to be built in the audit procedures, so that during the audit, the auditor can highlight a transaction for a possible fraud or identify such consistent system failures, which can lead to a fraud. Some of the checks, which could be applied to determine the red flag items during the course of audit, are illustrated below.

- examine the use of delegation of powers particularly in vulnerable areas;
- examine the effectiveness and adequacy of internal controls in various areas;
- check for collusion between the supplier and employees / management;
- examine cases of misuse of financial powers;
- check for false statements and false claims: whether information presented to justify a transaction is incorrect and at the point of time when such information was presented, the person submitting the information had access to correct information;
- examine evidence for cartelization, split purchases, collusive bidding, over and under invoicing and making payments on the basis of false progress reports;
- check for loss of revenue due to evasion and / or non-accountal or receipt;
- examine for payment made for services / supplies not received;
- seek confirmation with other related parties;
- checking of cross-linking of documents for evidence of known wrongdoing; and
- cases of misclassification; etc.

Fraud specific internal controls

15.4 As regards fraud specific internal controls, there could be two types of such controls, viz., active internal controls and passive internal controls. Examples of active internal controls can be the following:

- (i) Signatures and document countersigning procedures;
- (ii) Segregation of duties and functions;
- (iii) Physical asset control;
- (iv) Real time inventory control;
- (v) Document matching and cross linking of documents.

15.5 Wherever the management of the audited entity makes changes and improvements in the internal control system either due to changes in its environment or as a response to previous instances of fraud and corruption, such changes and improvements should be particularly studied and evaluated during audit.

Audit approach

15.6 Since complete evidence about cases of fraud and corruption may not be available to Audit, due care should be exercised in arriving at an audit conclusion. In many circumstances additional tests may have to be performed and additional evidence acquired than would normally be considered appropriate and necessary for arriving at an audit opinion.

15.7 Whenever a material instance of failure to comply with the applicable laws and regulations is observed, the auditor should without automatically assuming the management and staff are dishonest investigate the control failure with an appropriate degree of professional skepticism. He may also examine if the supporting evidence has been tampered in any manner or any individual(s) could have benefited from the material violation.

15.8 When auditors suspect the possibility of fraud and corruption, they should establish whether it has taken place and there has been resultant effect on the financial reporting, especially whether the audit certificate requires qualification. Similar considerations apply in case of performance audits, where there has been effect on the programme execution or performance reporting.

15.9 When auditors intend to report on fraud and corruption, they should ensure the reliability of audit evidence by verifying it with source documents including third party evidence. Auditors should carefully determine how much evidence they should gather in support of audit findings. Auditors should also keep in view that the possibility that the evidence gathered by them and their findings could become the basis for legal or disciplinary proceedings.

15.10 In determining overall responses to address the risk of fraud, the auditor should:

(a) evaluate the accounting and reporting policies used by the entity particularly those related to subjective measurements and complex transactions; and

(b) Incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures, for example—

- performing substantive procedures on selected account balances and assertions not otherwise tested due to their materiality or risk;
- adjusting the timing of audit procedures from that otherwise expected;
- using different sampling methods;
- performing audit procedures at different locations or at locations on an unannounced basis;
- use computer-assisted audit techniques to gather more evidence about data contained in significant accounts or electronic transaction files, to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample;

- design external confirmations;
- supplement such external confirmations with inquiries of non-financial personnel in the entity;
- performing more substantive testing at or near the period end; and
- performing analytical procedures at a more detailed level, etc.

15.11 The auditor may identify a risk of material misstatement due to fraud affecting a number of accounts and assertions, including asset valuation, estimates relating to specific transactions and other significant accrued liabilities. The risk may also relate to significant changes in assumptions relating to recurring estimates. Information gathered through obtaining an understanding of the entity and its environment may assist the auditor in evaluating the reasonableness of such management estimates and underlying judgments and assumptions. A retrospective review of similar management judgments and assumptions applied in prior periods may also provide insight about the reasonableness of judgments and assumptions supporting management estimates.

15.12 To respond to the risk of management override of controls, the auditor should design and perform audit procedures to:

- (a) test the appropriateness of journal entries and other adjustments made in the preparation of financial statements;
- (b) review accounting estimates for biases that could result in material misstatement due to fraud; and
- (c) obtain an understanding of the business rationale of significant transactions that the auditor becomes aware of that are outside of the normal course of business (operations) for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment.

Computer evidence

15.13 Since many records are produced by computers in the usual and ordinary course of work, auditors should understand how to collect and handle those records as audit evidence. Collecting computer evidence requires careful planning and execution. Auditors should examine whether appropriate controls are in place in order to ensure the authenticity of computer evidence.

Compliance with the provisions of GFRs

15.14 The Audit personnel should also check compliance with the provisions of Rules 33, 34, 37 and 38 of the General Financial Rules (GFRs) 2005 (Rules 16 to 19 and 21 of earlier GFRs) regarding:

- reporting losses or shortages of public moneys, departmental revenue or receipts, stamps, opium, stores or other property held by, or on behalf of, Government irrespective of the cause of loss and manner of detection by the subordinate authority concerned to the next higher authority as well as to the Statutory Audit Officer

and to the concerned Principal Accounts Officer, even when such loss has been made good by the party responsible for it, except cases which need not be reported under the provisions of the GFRs;

- bringing cases involving serious irregularities to the notice of Financial Adviser or Chief Accounting Authority of the Ministry or Department concerned and the Controller-General of Accounts, Ministry of Finance, redrawing of amounts lost through misappropriation, defalcation, embezzlement, etc. bearing of loss to Government on account of culpability of Government servants by the Central Government Department or State Government concerned with the Transaction;
- making recovery from the erring Government officials;
- reporting of all cases involving loss of Government money arising from erroneous or irregular issue of cheques or irregular accounting of receipts will be reported to the Controller-General of Accounts along with the circumstances leading to the loss to enable him to take steps to remedy defects in rules or procedures, if any, connected therewith;
- reporting of losses above the prescribed value due to suspected fire, theft, fraud, etc. to the Police for investigation as early as possible; obtaining a formal investigation report should be obtained from the Police Authorities in all cases, which are referred to them;
- fixing of responsibility for loss on the concerned officers;
- prompt disposal of cases of loss at each stage of detection, reporting, write off, final disposal, in cases of losses including action against delinquents and remedial measures

15.15 Extracts of the provisions of these Rules have been given in Appendix-C.

15.16 As the Rules may be amended from time to time, the auditors should ascertain the latest Rules applicable and check compliance.

15.17 Non-reporting of losses or shortages of public moneys, departmental revenue, etc. as required by GFRs can be an indicator suggesting non-transparency and the presence of an element of fraud or corruption (though not conclusive).

15.18 Non-compliance with provisions in Rule 29 of the GFRs for endorsement of sanctions to the Audit Officer could also be an indicator for fraud or corruption in some cases. The risk of non-compliance with GFRs from fraud and corruption angle should also be investigated.

16. IT fraud

Nature of IT fraud

16.1 IT fraud could involve the manipulation of a computer or computer data by whatever method in order to dishonestly obtain money, property or some other advantage of value or to cause loss.

16.2 Computers provide opportunities for their misuse for economic or financial gains. Computer networks can be used to commit crimes from geographically far off places. Frauds committed using computers vary from complex financial frauds to the simpler frauds where computer is only a tool to commit a crime. With some State Governments, Union Government Departments and public sector organisations going for e-commerce / e-payment systems in a large way, possibility of electronic fraud requires attention.

16.3 IT frauds are committed by insiders, outsiders, vendors, competitors, etc. Such frauds are committed by manipulation of input, output or throughput of a computer system. Fraud can also be committed by hacking into the system for causing deliberate damage.

Role of Audit in relation to IT fraud

16.4 Since many records are produced by computers in the usual and ordinary course of work, auditors should understand how to collect and handle those records as audit evidence. Collecting computer evidence requires careful planning and execution. Auditors should examine whether appropriate controls are in place in order to ensure the authenticity of computer evidence.

16.5 The steps in prevention of frauds in computerized systems involve setting up of proper access controls both physical and logical. Physical access controls ensure against unauthorized access to computerized system and logical access controls prevent unauthorized access to data and software for its use and manipulation.

16.6 For auditors, the most effective tool is data enquiry, analysis and reporting software. Powerful interactive software like ACL and IDEA can quickly sift through voluminous electronic data and assist in the detection and prevention of fraud in an organisation. They can be used to process normal data as well as exception reports and audit trails, but demand flexibility and creativity on the part of the auditor. The auditor should have capability to revise and upgrade queries based on the findings from previous queries. Besides having auditing skills, it is important that auditors have intimate knowledge of computerized system to understand the possible modes of fraud so that they can isolate all types of risks to the organisation.

16.7 Increasing use of IT systems by auditees requires that the auditor should have access to reliable and verifiable system-based audit trails to evaluate the internal control. The Auditor has to be particularly aware of the audit trail, of the checks and balances of IT systems, of the levels of control and needs to also have a fair idea of how processing controls can be circumvented by the perpetrator of fraud and how data can be accessed and manipulated. It is particularly important for the auditor of the IT system to assess in his audit the level of security controls built in and if these are in tune with the sensitivity of data.

16.8 In case of fraud involving use of computer systems, the audit personnel should also comply with the instructions on Information Technology Audit (IT Audit) issued by the IT Audit Wing of Headquarters Office and the Comptroller and Auditor General's Manual of Standing Orders (Audit).

17. Documentation

17.1 The auditors should collect adequate documentation which may provide evidence during subsequent enquiries, investigations, court cases, etc.

17.2 The documentation should include *inter alia*:

- (a) The identified and assessed risks of fraud, the overall response of the auditor to the assessed risk of fraud and the nature, timing and extent of audit procedures, and the linkage of those procedures with the assessed risk of fraud;
- (b) The results of the audit procedures, including those designed to address the risk of management override of controls;
- (c) communications about fraud made to management, etc.

17.3 The documentation should also be capable of proving that the Audit personnel have discharged their functions with reasonable care and due diligence and should enable a review of working procedures and working papers.

18. Supervision and review

Supervision and review of the work of audit personnel shall be exercised in accordance with the Auditing Standards of the Comptroller and Auditor General of India and instructions issued from time to time.

19. Reporting

Initial reporting

19.1 Reports of individual cases of suspected/presumptive fraud/corruption should be addressed confidentially, in the first instance, to the controlling authority concerned with the approval of Group Officers. Copies may simultaneously be sent confidentially to higher authority in cases that are regarded to be so grave or serious. In the case of Controlling Officer based audits, the report should be sent confidentially to the concerned Controlling Officer (with a copy to the Chief Controlling Officer concerned) whereas in the case of Drawing and Disbursing Officer based audits, the report should be sent confidentially to the concerned Drawing and Disbursing Officer (with a copy to the Controlling Officer concerned).

19.2 The situations / events that may be suggestive of fraud / presumptive fraud should be highlighted in the inspection reports with a recommendation to the executive for detailed investigation and response.

19.3 The report of the audit party should indicate *inter alia* the scope of audit, main findings, total amount involved, modus operandi of the suspected fraud or the irregularity, accountability for the same and recommendations for improvement of internal control system, fraud prevention and detection measures (including changes in the systems and procedures) to safeguard against recurrence of fraud/ serious financial irregularity.

19.4 In addition to reporting to the management of the audited entity, material/significant cases of fraud and corruption may be reported through separate confidential letters to the specified investigating agency like Central Bureau of Investigation (CBI), Central Vigilance Commission (CVC) in case of Union Government and State Vigilance Commission/Lok Ayukta, etc. in case of State Government with the approval of the Accountant General or by him/her, depending upon the seriousness of the cases. In this connection, the provisions of paragraphs 19.8 to 19.11 (*infra*) may also be seen.

Qualification in Audit Opinion on financial statements

19.5 In case of financial audit, instances of possible fraud and corruption may require making qualification in the Audit Opinion on financial statements, depending upon the materiality of the audit findings. In other cases, they may be reported to entity management in a special letter or in the regular inspection reports, depending upon the circumstances.

19.6 When in the opinion of the auditor the financial statements include material fraudulent transactions, or such transactions have not been adequately disclosed, or the audit conducted by the auditor leads him to the inference that instance(s) of fraud and/or corruption have taken place and when the auditor has adequate evidence to support his conclusion, he should qualify the audit certificate/opinion and/or ensure that his findings are adequately included in his audit report. **However, the term fraud or corruption may not be used in a conclusive sense unless such action is established in a court of law.**

Printing cases relating to fraud and corruption

19.7 Cases relating to suspected/presumptive fraud and corruption should be highlighted in the Inspection Reports, Audit Notes, etc. and also in the Audit Reports. All such cases should be printed in bold type.

Reporting to investigating agencies

19.8 Accountants General, Principal Directors of Audit, etc. should carry out a quarterly review of the audit findings contained in the inspection reports, audit notes, etc. relating to different wings of their offices and bring specific material/significant cases of suspected fraud or corruption.

19.9 While forwarding the Bond Copy of the Audit Reports to Headquarters, the Accountant General, Principal Directors of Audit, etc. should highlight in the forwarding letter the number of cases of suspected fraud and corruption together with the money value of the concerned paras included in the bond copy. All such cases should be taken up immediately after approval of the bond copy with the appropriate vigilance or investigative authorities by the Accountant General, even if these cases were reported to them earlier. Such cases should be forwarded to the vigilance or investigative authorities such as the Central Bureau of Investigation, Central and State Vigilance Commissions, Lok Ayukta, etc. through confidential letters, drawing reference to earlier correspondence, if any, and with additional information that these cases have been included in the CAG's Audit Report to Parliament / State Legislature.

While forwarding such cases, the Accountant General/Principal Director should also send a brief write-up of such cases with details of the names of individuals, firms, address, etc., and any other necessary information available in field offices which are not mentioned in the Audit Report as per our reporting policy. **It should be clearly stated in the communications that in view of the intent of Audit to bring the matter to the notice of Parliament / Legislature, strict confidentiality should be maintained about the matter to avoid any likely breach of privilege of Parliament / Legislature.**

19.10 The communications to vigilance or investigative authorities should clearly indicate that the audit evidence is obtained from the original documents of the audited entity. They should also indicate that the audit findings are based on the test check carried out and the information and records received from the audited entity. The investigative agency should use information given by us as a lead and make their own examination of the primary/original records which are available with the audited entity/Department.

19.11 The reporting to the vigilance or investigative authorities may be completed after approval of the bond copy, without waiting for the availability of printed audit reports. While, for the Audit Reports relating to State Governments and Union Territories, the concerned Accountant General will be the Nodal Officer, for the Audit Reports relating to Union Government, the reports may be sent by the respective report controlling wings under orders of the ADAI/DAI concerned.

19.12 In the submission note to CAG, of the bond copy, the number of cases of fraud and corruption included in the Draft Report should be mentioned together with the money value of concerned paras.

Post-Audit Report letter to the Chief Minister

19.13 The draft of the annual post-Audit Report letter to the Chief Ministers should contain a brief mention of issues relating to fraud and corruption where such cases appear in the Audit Reports. The field Accountants General should put in place a system of monitoring paras relating to fraud / corruption and a brief mention of this should be made in the annual post-audit letters to Chief Ministers. Such letters should be submitted immediately after reports are laid in the State Legislatures.

20. Follow-up

20.1 The field offices shall institute mechanism for recording the cases of fraud and corruption (including possible indicators of fraud and corruption) noticed during the course of audit in separate registers maintained for the purpose. Such cases should be followed up vigorously with the concerned audited entity and with higher executive authorities and should not be settled in a routine manner. All significant cases should be followed up with the Secretary of the Administrative Department concerned.

20.2 In following up on reported cases of fraud and corruption the auditor should determine whether the necessary action is being taken with due regard to urgency that the situation demands and become aware of the changes in the systems and procedures which could be validated through subsequent audits.

20.3 The Accountant General may send annual confidential letters to the Secretaries of the concerned Administrative Departments (in cases where the inspection reports, audit notes, etc. throw a pattern of fraud across the Department) indicating the details of the important cases of suspected fraud and corruption.

20.4 It should be noted that once a matter has been referred to the investigative or vigilance agencies, the responsibility and scope of audit is to provide the information and assistance sought by them in accordance with the extant instructions. The matter may, however, be followed up through discussions in formal meetings with the investigative or vigilance agencies.

21. Additional instructions

Memorandum / Certificate of Assurance to be obtained from the Audit Party

21.1 The Accountant General may require the Audit Party to provide a Memorandum / Certificate of Assurance, which should include, *inter alia*, examination of issues relating to fraud and corruption and compliance with the provisions of this Standing Order and other applicable instructions by the Accountant General supported by detailed documentation.

Database

21.2 Each field office should establish a database of fraud or corruption related audit issues for building a linkage across functional groups to identify red flag items. Change in mode of audit investigation is required to bring out system deficiencies in greater detail rather than mentioning only money value. Red flagged items should bring out the intention and failure of internal control irrespective of money value. The data base should be transparently reviewed by the Accountant General every quarter for further strategy and directions to the field audit parties.

Objection Book

21.3 Cases of fraud or corruption etc. should also be recorded along with cases of misappropriation, defalcation, etc. in an Objection Book in accordance with the instructions contained in the Comptroller and Auditor General's Manual of Standing Orders (Audit) as amended from time to time.

Skill development

21.4 The field offices should have an adequate inventory of skills to deal with cases of fraud and corruption and, for this purpose, arrange for training of their officials at the Regional Training Centres/Institutes.

Developing sector specific guidelines/checklists

21.5 The Accountants General should develop sector specific guidelines/checklists to deal with cases of fraud and corruption in the audit of entities belonging to specific sectors, for the guidance of the field staff deployed in such audits and furnish a copy of such guidelines/checklists to DG (Audit).

Reporting to Headquarters

21.6 The field offices should send half yearly reports on cases of suspected material fraud and corruption noticed by them to the Headquarters Office.

21.7 In view of the ongoing rationalization process of Management Information System (MIS), the half yearly reports may be sent electronically or placed on local intranet in such manner as may be prescribed upon completion of the rationalization of MIS.

Continuance of the existing provisions relating to reports on defalcations and losses

21.8 The existing provisions in the Manual of Standing Orders (Audit) relating to reports on defalcation or loss of public money or property and action to be taken thereon shall continue to be in force.

**Illustrative fraud and corruption
in contracting for goods and services**

Bribery and Kickbacks - Money or any other form of reward or favour is exchanged between a public functionary and a provider of goods and services in order to obtain some benefit e.g. acceptance of substandard goods or obtaining unauthorized information.

Changes in Original Contracts - Changes are made in the original contract requiring flow of additional funds from the government to the contractor or supplier, which may affect the basis on which the contract was awarded to the contractor or supplier in the first instance. This may also involve front-loading of contract in the hope of increasing the price of the original contract through change orders or subsequent modifications to the contract.

Duplicate Payments - The contractor or supplier claims and receives payment for the same service or work done or goods supplied under the same or different contracts.

Collusive or Cartel Bidding - Contractors or suppliers form cartels to fix artificially high prices for goods and services supplied by them.

Conflict of Interest - Contracts are awarded on the basis of vested interests of the decision makers.

Defective Pricing - The contractor or supplier submits inflated invoices.

False Invoices - The contractor or supplier submits invoices for goods that have not been delivered or do not properly represent the quantity or quality of goods and services supplied or work done as per contracted specifications.

False Representations - The contractor falsifies the goods specifications or his ability to provide certain services.

Splitting of Purchases - The purchases of goods and services are split either to avoid open competition or having to seek the approval of higher authority.

Phantom Contractor - Purchases are made from a fake supplier or contractor.

Pilferage of Public Assets - Public funds are used to acquire goods for personal use or public assets pilfered by officials.

Tailored Specifications - Specifications and time limits are manipulated to favor a certain contractor or supplier.

Supply Orders - in excess of, or without establishment the requirement/ need and much ahead of the actual requirement.

Some indicators (red flags) for possible fraud and corruption (illustrative)

Procurement and contracting of goods and services

Requirements defining stage:

- Inadequate needs analysis;
- Inadequate information about potential suppliers;
- Inadequate review of existing and required inventory;
- Unduly short supply period;
- Needs analysis is product rather than needs oriented;
- Someone other than the user defines the user requirements; and
- Unwarranted involvement of senior officials.

Bidding and selection stage:

- The specifications are not clearly defined;
- A very limited number of offers is received;
- Documentation indicates unusual involvement of an official;
- Suspicion about conflict of interest;
- Evidence of early receipt of information by some contractors or suppliers;
- Request for proposal is not properly advertised;
- Unusual handling of the bidding process;
- Evaluation criteria is not consistent for different offerors;
- Exceptions to the tender deadlines;
- Changes in the bids made after their formal receipt;
- Lowest responsive bidder is not selected;
- Contractor or supplier submits unrealistic bid indicating collusion or bid rotation;
- Unusual withdrawal of bids;
- Re-bid results identical to original bids;
- Successful contractors or suppliers use competitors as sub-contractors or sub-suppliers; and
- Justification for single source procurement is inadequate, etc.

Contract performance and evaluation stage:

- Changes in a contract result in the large increase in the cost of goods and services;
- Changes made without adequate explanations;
- Unwarranted contract extension;
- Complaints about the quality of goods and services received;
- Inadequate inspections and quality assurance of goods and services received;
- Evidence of over charging and duplicate billings;
- Dubious invoices;

- Insufficient pre-audit of contractor payments;
- Contracts repeatedly awarded to one contractor; and
- Unduly high labour payments; etc.

Accounting records:

- Missing vouchers;
- Production of photocopies of documents instead of originals;
- Alterations and erasures in accounting records;
- Any unusual accounting entries;
- Discrepancies between control accounts and subsidiary records;
- Discrepancies between predicted figures and actual figures during analytical review procedures; and
- Employees in sensitive posts not taking leave; etc.

Performance Information

- Performance information about delivery of goods / services, assets creation, etc. not supported by original documents and downstream data;
- Theoretical calculations not supported by actual measurements, muster rolls, inspection notes, quality reports, etc;
- Non-production of basic records, viz., asset register, muster roll, measurement books, etc.
- Non-availability of transparent evidence of expenditure and receipts into Government Account; and
- Inconsistency between financial and physical information about progress of scheme / work.

Note: These are only illustrative examples. Accountants General may please prepare a comprehensive list of 'red flag' items in audit of various Departments/sectors and establish procedures to ensure that such items are reckoned while planning the audits, transparently documented and evidence of addressing all such items and their treatment are recorded and retained.

Extracts from the Provisions of General Financial Rules, 2005

Rule 33. Report of Losses:

(1) Any loss or shortage of public moneys, departmental revenue or receipts, stamps, opium, stores or other property held by, or on behalf of, Government irrespective of the cause of loss and manner of detection, shall be immediately reported by the subordinate authority concerned to the next higher authority as well as to the Statutory Audit Officer and to the concerned Principal Accounts Officer, even when such loss has been made good by the party responsible for it. However the following losses need not be reported:

(i) Cases involving losses of revenue due to -

(a) mistakes in assessments which are discovered too late to permit of a supplementary claim being made,

(b) under assessments which are due to interpretation of the law by the local authority being overruled by higher authority after the expiry of the time-limit prescribed under the law, and

(c) refunds allowed on the ground that the claims were time-barred:

(ii) Petty losses of value not exceeding Rupees two thousand.

(2) Cases involving serious irregularities shall be brought to the notice of Financial Adviser or Chief Accounting Authority of the Ministry or Department concerned and the Controller-General of Accounts, Ministry of Finance.

(3) Report of loss contemplated in sub-rule (1) & (2) shall be made at two stages-

(i) An initial report should be made as soon as a suspicion arises that a loss has taken place.

(ii) The final report should be sent to authorities indicated in sub rule (1) & (2) after investigation indicating nature and extent of loss, errors or neglect of rules by which the loss has been caused and the prospects of recovery.

(4) The complete report contemplated in sub-rule 3, shall reach through proper channels to the Head of the Department, who shall finally dispose of the same under the powers delegated to him under the Delegation of Financial Power Rules, 1978. The reports, which he cannot finally dispose of under the delegated powers, shall be submitted to the Government.

(5) An amount lost through misappropriation, defalcation, embezzlement, etc., may be redrawn on a simple receipt pending investigation, recovery or write-off with the approval of the authority competent to write-off the loss in question.

(6) In cases of loss to Government on account of culpability of Government servants, the loss should be borne by the Central Government Department or State Government concerned with the transaction. Similarly, if any recoveries are made from the erring

Government officials in cash, the receipt will be credited to the Central Government Department or the State Government who sustained the loss.

(7) All cases involving loss of Government money arising from erroneous or irregular issue of cheques or irregular accounting of receipts will be reported to the Controller-General of Accounts along with the circumstances leading to the loss, so that he can take steps to remedy defects in rules or procedures, if any, connected therewith.

Rule 34. Loss of Government property due to fire, theft, fraud : Departmental Officers shall, in addition to taking action as prescribed in Rule 33, follow the provisions indicated below in cases involving material loss or destruction of Government property as a result of fire, theft, fraud, etc. -

All losses above the value of Rupees ten thousand due to suspected fire, theft, fraud, etc., shall be invariably reported to the Police for investigation as early as possible.

Once the matter is reported to the Police Authorities, all concerned should assist the Police in their investigation. A formal investigation report should be obtained from the Police Authorities in all cases, which are referred to them.

Rule 37. Responsibility for Losses: An officer shall be held personally responsible for any loss sustained by the Government through fraud or negligence on his part. He will also be held personally responsible for any loss arising from fraud or negligence of any other officer to the extent to which it may be shown that he contributed to the loss by his own action or negligence.

The departmental proceedings for assessment of responsibility for the loss shall be conducted according to the instructions contained in Appendix 1 and those issued by the Ministry of Personnel from time to time.

Rule 38. Prompt disposal of cases of loss: Action at each stage of detection, reporting, write off, final disposal, in cases of losses including action against delinquents and remedial measures should be completed promptly with special attention to action against delinquents and remedial measures, taken to strengthen the control system.

Note: The corresponding provisions in the earlier General Financial Rules are Rules 16, 17, 18, 19 and 21 which should be checked for compliance in relevant cases.

Appendix - 1

Instructions for regulating the enforcement of responsibility for losses, etc.

1. The cardinal principle governing the assessment of responsibility is that, every Government officer should exercise the same vigilance in respect of expenditure from

public fund generally as a person of ordinary prudence would exercise in respect of the expenditure and the custody of his own money. While, the competent authority may, in special cases, condone an officer's honest errors of judgement involving financial loss if the officer can show that he has acted in good faith and done his best up to the limits of his ability and experience, personal liability shall be strictly enforced against all officers who are dishonest, careless or negligent in the duties entrusted to them.

2. In cases where loss is due to delinquencies of subordinate officials and where it appears that this has been facilitated by laxity of supervision on the part of a superior Officer, the latter shall also be called strictly to account and his personal liability in the matter carefully assessed.

3.

(a) The question of enforcing pecuniary liability shall always be considered as well as the question of other forms of disciplinary action. In deciding the degree of an officer's pecuniary liability, it will be necessary to look not only to the circumstances of the case but also to the financial circumstances of the officer, since it should be recognized that the penalty should not be such as to impair his future efficiency.

(b) In particular if the loss has occurred through fraud, every endeavour should be made to recover the whole amount lost from the guilty persons and if laxity of supervision has facilitated the fraud, the supervising officer at fault may properly be penalized either directly by requiring him to make good in money a sufficient proportion of the loss or indirectly by reduction or stoppage of his increments of pay.

(c) It should always be considered whether the depreciated value of the Government property or equipment lost, damaged or destroyed by the carelessness of individuals entrusted with their care should be recovered from the delinquent official. The depreciated value of the stores may be calculated by applying the 20% of depreciation in the case of vehicles, including cycles, and 15% in the case of calculating machines, on the reduced balance every year. The amount to be recovered may be limited to the Government servant's capacity to pay.

4. When a pensionable Government servant is concerned in any irregularity or loss, the authority investigating the case shall bear in mind the provisions contained in Central Civil Services (Pension) Rules 1972 as amended from time to time and immediately inform the Audit Officer and/or the Accounts Officer, as the case may be, responsible for reporting on his title to Pension or Death-Cum-Retirement Gratuity, and the authority competent to sanction Pension or Death-Cum-Retirement Gratuity and it will be the duty of the latter to make a note of the information and see that the Gratuity or Death-Cum-Retirement Gratuity is not paid before a conclusion is arrived at as regards the Government servant's culpability and final orders are issued thereon.

5. The fact that Government servants who were guilty of frauds or irregularities have been demobilized or have retired and have thus escaped punishment, should not be made a justification for absolving those who are also guilty but who still remain in service.

6. It is of the greatest importance to avoid delay in the investigation of any loss due to fraud, negligence, financial irregularity, etc. Should the administrative authority require the assistance of the Audit Officer and/or the Accounts Officer, as the case may be, in pursuing the investigation, he may call on that officer for all vouchers and other documents that may be relevant to the investigation; and if the investigation is complex and he needs the assistance of an expert Audit Officer/ Accounts Officer to unravel it, he should apply forthwith for that assistance to Government which will then negotiate with Audit Officer and/or the Accounts Officer concerned for the services of an investigating staff. Thereafter, the administrative authority and the Audit /Accounts authority shall be personally responsible within their respective spheres, for the expeditious conduct of the enquiry. In any case in which it appears that recourse to judicial proceedings is likely, the Special Police Establishment or the State Police should be associated with the investigation.

7. Depending upon the results of the inquiry, departmental proceedings and/or prosecution shall be instituted at the earliest moment against the delinquent officials concerned and conducted with strict adherence to the Central Civil Services Classification, Control and Appeal) Rules and other instructions prescribed in this regard by Government.

Address during the
**Inauguration of the Seminar on "The Effects of Corruption
on Good Governance and Human Rights"**

09 May 2006: New Delhi

"Righteousness in the heart leads to order in the nation"

I am delighted to participate in the inauguration of the Seminar on "The Effects of Corruption on Good Governance and Human Rights". I am happy that the National Human Rights Commission has taken the initiative of arranging this Seminar, which will give very useful suggestions for improving the governance system in the country. This will also enable maximization of value addition for a given expenditure incurred by the Government in providing the services to the citizens and protect their rights. My greetings to Hon'ble Justice Anand and his team, the social reformers, intellectuals and other delegates participating in the Seminar. I have selected "Righteousness in the heart leads to order in the nation" as the topic for discussion.

Certain experiences in Governance

Before I discuss about the development strategy for promoting corruption-free society, I would like to narrate an

Dr. APJ Abdul Kalam

incident which took place some time back. During the performance audit by CAG of rural employment generation programme implemented by one of the State Governments, it was found that there was fictitious reporting regarding the total employment generated. However it was found that the full money was allotted and shown as spent. Though the reporting claimed that the objectives are fully met, further investigations showed clearly that there were no evidence to corroborate the claims. Thus we can see in the absence of a non-transparent corruption-free system, a well intentioned programme fails to produce the desired results. This clearly shows the effect of corruption on governance and the failure of our system to protect the human rights of all the citizens. However, now I am happy to mention that the State Government has linked the present employment guarantee scheme to Bio-diesel plantation in the rural sector. Such actions, which provide verifiable evidences at various stages of progress (monitoring points) are needed in all sectors of our economy. The next area I would like to discuss is on corruption level as reported in different states based on certain studies.

Based on the study conducted by "Center for Media Studies", it has been found that the corruption levels in Kerala and Himachal Pradesh are less compared to other states in the

country. Can it be due to political awareness and competitiveness? Can it be due to better Human Development Index? Can it be due to alert media? Can it be due to women empowerment? It may be useful for the participants of this seminar to study these aspects and assess the possible reasons so that they can be emulated by other states.

Action oriented seminars

In any Village or a Panchayat or a District, we will always find at least a few corruption free good human beings. We may even find pockets of corruption free societies. If these can be identified and celebrated, we may even create nearly a corruption free state. The real world examples of corruption free individuals and groups and societies, must be discussed in fora like this. The seminar on **"The Effects of Corruption on Good Governance and Human Rights"** should be able to present such examples, so that they can become examples to be followed in the country. A nation can be corruption free only when its states are corruption free, a state can be corruption free only if its districts are corruption free, a district can be corruption free only if its Panchayat are corruption free, a Panchayat can be corruption free only if the people are corruption free, people can be corruption free only if they have imbibed the value system from their childhood.

I Certain experiences in societal life

The creation of a corruption free society depends heavily on the home, the school, the environment, the society and the government, besides the person himself or herself. Let me discuss the various components of this complex fabric.

a. Corruption Free Society starts at Home

On 21st November 2005, I visited Adhichunchanagiri Math, attended a function of FUREC (Foundation for Unity of Religions and Enlightened Citizenship) and interacted with over 54,000 students of various schools and colleges of Karnataka. There a 10th class student Ms. M. Bhavani studying in Adichunchanagiri Composite High School, Sharavathy Nagar, Shimoga asked me the following question.

“Mr. President, I would like to be a citizen in a corruption free nation. Please tell me, as students, all of us how we can contribute?”

Agony of the young mind is reflected in this question. For me it was an important question, since it came from a young mind. I was thinking what type of solutions we could give. My thought process was the following:

I said there are one billion people in the country and nearly 200 million homes. In general there are good citizens everywhere. However, if we find that people in a few million houses are not transparent and not amenable to the laws of the country, what can we do? These houses apart from parents have one daughter or one Son or both. If the parents in these houses are deviating from the transparent path the children can use the tool of love and affection and correct the parents to come back to the right path. I asked all the children assembled in that gathering, in case parents of few children get deviated from transparency, will you children boldly tell your parents, father or mother, you are not doing the right thing, that is what we are taught by you and in the school. Most of the children spontaneously responded, "We will do it". The confidence comes from them that they have love as a tool. Similarly I have also asked the parents in some other meeting, initially there was a silence, later, many of them hesitantly agreed that they would abide by the children's suggestion since it is driven by love. They took an oath from me. The oath was **"I will lead an honest life free from all corruption and will set an example for others to adopt a transparent way of life"**. Finally I told the students that they should start a movement starting from their home. Dear Members, I am confident that the children can reform their families which are not transparent, to lead transparent life?

You may like to spread this message and enlist the youth for this mission of transparent life. Now I would like to discuss about the mission of the teacher in promoting a corruption free society.

b. Mission of the Teacher

School is the next important environment where the character is getting shaped. The prime learning period for the children is five to seventeen years of age. The student spends approximately 25,000 hours in the school campus. Of course, at home, love and affection are imparted but again most of the time of the day is spent in preparing school's homework and study, eat, play and sleep. Hence, the school hours for children are the best time for learning and need best of environment, mission oriented learning with value system. I still hear the echo from *Bestolozzy*, a Greek teacher's saying, "*give me a child for seven years. Afterwards, let the God or devil take the child. They cannot change the child.*" That is the great confidence of the teacher. What a golden mission for the teachers to build character and value system to the students in our schools in the country! The next component I would like to discuss is the importance of moral class for students in the school for elevating their minds.

c. Elevating the young minds

While I was in college, I remember the lectures given by highest authority of the Jesuit institution Rev Father Rector Kalathil of St. Joshep's college, Trichirappalli, Tamilnadu. Every week on Monday, he will take class for an hour. He used to talk about good human beings, present and past, and what makes a good human being. In this class he used to give lectures on personalities such as Buddha, Confucius, St. Augustine, Khalifa Omar, Mahatma Gandhi, Einstein, Abraham Lincoln including some scientific personalities and moral stories linked to our civilizational heritage. He also used to talk about great personalities living in the father's lodge and who had made contribution with values in the service of the people. It is essential in the secondary schools and colleges to arrange a lecture by a great teacher of the institution once in a week for one hour on India's civilizational heritage. This class can be called as a Moral Science Class. That will elevate the young minds to love the country, to love the other human beings and elevate the young to higher planes. The fourth important component for promoting transparent society is the Code of Conduct in high places.

d. Code of Conduct

Now I am reminded of Tamil classic, which brings out the power of righteousness and provides the code of conduct for the people in high and responsible positions:

அரசியல் பிழைத்தோர்க்கு அறம் கூற்றாவதும்

- சிலப்பதிகாரம்

It means, people who are in high and responsible positions, if they go against righteousness, the righteousness itself will get transformed into a destroyer. Whoever deviates from righteousness, whether they are individual or states, they are responsible for their own actions. This message is brought out very clearly by the Elangovadikal in Silapathikaram. Silapathikaram is one of the five great epics written nearly 2000 years ago in Tamil language. So far I have been talking about the strategies needed for creation of enlightened citizens and a corruption free society among the youth phase. Now I would like to discuss the Governance and delivery mechanism for the people, which is one of the requirements of the democratic system.

e. Trust and confidence in Governance

As a part of governance, the Government needs to provide multiple facilities and services to the people. Also,

of my talk deals with the tools for evolving a corruption free society.

II. Methodology of evolving good society

Now I would like to discuss about the use of e-governance as an instrument for elimination of corruption.

a. E-Governance for Corruption free administration

Good governance is being recognized as an important goal by many countries across the world. They have taken up specific initiatives for open government. Freedom of information is being redefined and supported by detailed guidelines. The Internet revolution has proved to be a powerful tool for good governance initiatives and the world is moving towards Internet governance. An important dimension of the Internet potential is the possibility of providing services any time anywhere. Along with this there is a conscious effort to put the citizen as the center of focus of the governance. Citizens are being perceived as customers and clients. E-governance has to be citizen friendly. Delivery of services to citizens is considered as a primary function of the government. Particularly in a democratic nation of a billion people like India, e-Governance should enable seamless access to

these services are required to be constantly upgraded with the use of technology for fulfilling the aspirations of the people. The Government budgets and expends a large amount of funds for fulfilling this goal. The money for the work comes from people through taxes. It is the money collected from the people, which are being spent for the benefit of all the people and particularly the needy. However, when it comes to reaching of the benefits to the common man, the value of the services, which reaches the citizen, has to be increased many folds?

Friends, we have to imagine a scene, I call it, "A scene of sweat". It is the farmers in the agricultural field, it is the fishermen in the rough sea, it is the worker in the industries, teachers in the schools, knowledge workers in the laboratories, knowledge and pharma industries, health workers removing the pain at all times in healthcare institutions and many and many people, have to be remembered always when we take political decision, when we take administrative decision, when we give a judgement and when we conduct this type of seminar what we are having today. I would consider a government machinery corruption free only if the purpose for which the machinery is setup is fulfilled, in letter and spirit with honesty, sincerity and purposefulness. The second part

information and seamless flow of information across the state and central government in the federal setup.

Typical scenario: I visualize an election scenario, where a candidate files his nomination from a particular constituency. Immediately the election officer verifies his/her authenticity from the national citizen ID database through multifactor authentication, through a multipurpose Citizen ID card. His education credentials come from the school or university records. His track record of employment comes from various employers with whom he had worked. His income and wealth resources come from the income-tax department, and other sources. His property record comes from the registration of land authority across the country. His credit history comes from various credit institutions like banks. His/her civic consciousness and citizenship behaviour comes from the police crime record. His legal track records come from the judicial system.

All the details arrive at the computer terminal of the election officer within a few seconds automatically by the act of e-Governance software agents which crawls across the various state and central government web services directories through the network GRID and collects the information automatically and presents the facts in real-time with out any bias. Artificial

intelligence software analyses his credentials and gives a rating on how successful he will be as a politician. Election officer sitting at the remote block of the country decides on the spot and the election process starts. All the voters vote from their home through virtual polling booths. Is it a dream? Is it possible? If possible, when shall we have it?

Can we provide good governance to our one billion people? Can the governance speed up the delivery system? Can the governance differentiate between genuine transactions and spurious transaction? Can the governance ensure immediate action for the genuine cases, which satisfies the checklist for a particular service and pend, the action on spurious transactions? Can this be done by e-governance at a cost affordable by our nation? If we have this system implemented then I can call this as an ideal example of the effective e-Governance system for the citizen. E-Governance system is a means to an end. We need enlightened citizens to realize the full benefits of the e-governance systems. It is people who finally uphold ethics, morality and righteousness.

In Rashtrapati Bhawan we have designed and implemented an e-Governance system to study all the management needs and determine the action requirements to be taken by Rashtrapati Bhavan and other agencies of

government and the relevant institutions both public and private. We are in the process of establishing a total e-governance system with G2G and G2C connectivity.

b. Some visible good practices

Now I would like to discuss some of the visible practices followed by the three pillars of our democracy.

Legislative system: The passing of the Right to Education Act, Right to Information Act 2005, and the National Rural Employment Guarantee Act 2005 are some of the recent examples of the effective functioning of legislative system. These Acts are structured to fulfill the aspirations of our citizens.

Executive system: Some of the key accomplishments of the executive have been the time bound realization of the metro railway system in Delhi, successful though partial e-governance implementation in certain States bringing about substantial transparency in the provision of government to citizen services. A working validated model of railway reservation system and also through the web, virtual university initiative of the three old universities of the country namely Madras, Calcutta and Mumbai and the healthcare

services through the Yeshaswini scheme are the other notable accomplishments of the executive which has positive impact on large number of citizens of the country. Innovative monitoring systems for electrical energy generation and distribution; losses and pilferage; have made a few state electricity boards become profitable institutions.

Judicial system: Delay in justice also adds to corruption. I am extremely happy to see our judicial system has risen to taken on this challenge well. I was also very happy to see, certain cases where the justice was administered speedily. One case pertains to rape case in Rajasthan and Maharashtra and the other pertains to theft cases in Tamil Nadu. These are good models for emulation for speedy justice delivery system. We should increase this in numbers.

Litigation free villages: At this point, I would like to recall one experience I had. When I was in Chitrakoot, Madhya Pradesh, a few months back, I met a great man. Many of you might have heard about this famous 90 years experienced Shri Nanaji Deshmuk. He is instrumental for making 80 villages "litigation free" through DRI (Deendayal Research Institute). This is indeed a successful experiment for resolving the disputes within the families and within the village. Nanaji is proud to say that he is aiming at a beautiful society, an empowered society and above all a society with moral values.

So friends, it is possible to create a corruption free society only by enlisting good human beings, bridging them and spreading the message of their success.

There is another model available in Karnataka. The Lokayukta has become pro-active in unearthing corruption and irregularities in various Government departments. Having the same powers as his counterparts in other States, he visits offices and hospitals to personally check on cases of irregularities and corruption. Due to the proactive action, I understand that Lokayukta has been able unearth property of large values which was amassed disproportionate to known sources of income.

The judgments of the Supreme Court and some High Courts are now available in the Internet. This step has considerably relieved the agony of the litigants and also enables others to use these judgments in their areas of interest. It is a giant leap. It is essential that all other Courts in the country also follow this model and that has to be facilitated by the Law Ministry, State Governments and the higher judiciary. In addition to this, for example, the landmark judgment on the use of CNG, interlinking of rivers will have large impact on the welfare of the society.

Conclusion

Conscience is the light of the Soul that burns within the chambers of our psychological heart. It is as real as life is. It raises the voice in protest whenever anything is thought of or done contrary to the righteousness. Conscience is a form of truth that has been transferred through our genetic stock in the form of the knowledge of our own acts and feelings as right or wrong.

A virtuous and courageous person can alone use the instrument of conscience. He or she can alone hear the inner voice of the soul clearly. In a wicked person this faculty is absent. The sensitive nature of his / her conscience has been destroyed by sin or corruption. Hence he or she is unable to discriminate right from wrong. Those who are leading organizations, business enterprises, institutions and governments should develop this virtue of the ability to use their own conscience. This wisdom of using the clean conscience will enable them to enjoy the freedom.

I inaugurate the seminar and my best wishes for success in the mission of promoting a corruption free society through good governance and ensure protection of human rights of all citizens of the nation. May God bless you.

No.006/VGL/117
Government of India
Central Vigilance Commission

Satarkta Bhawan, Block-A,
GPO Complex, INA,
New Delhi-110023
Dated the 22nd November, 2006

Circular no.40/11/06

Sub: Improving vigilance administration by leveraging technology: Increasing transparency through effective use of websites in discharge of regulatory, enforcement and other functions of Govt. organisations.

The Commission has been receiving a large number of complaints about inordinate delays and arbitrariness in the processing and issue of licenses, permissions, recognitions, various types of clearances, no objection certificates, etc., by various Govt. organisations. Majority of these complaints pertain to delays and non-adherence to the 'first-come-first-served' principle. In a number of cases, there are complaints of ambiguities regarding the documents and information sought for the grant of such licenses, permissions, clearances, etc. There is also a tendency in some organisations to raise piece-meal/questionable queries on applications, often leading to the allegations of corruption. In order to reduce the scope for corruption, there is a need to bring about greater transparency and accountability in the discharge of regulatory, enforcement and other public dealings of the Govt. organisations.

2. Improvement in vigilance administration can be possible only when systems improvements are made to prevent the possibilities of corruption. In order to achieve the desired transparency and curb the malpractices mentioned above, the Central Vigilance Commission, in exercise of the powers conferred on it under Section 8(1)(h) of the CVC Act, 2003, issues the following instructions for compliance by all Govt. departments/organisations/agencies over which the Commission has jurisdiction:-

- i) All Govt. organisations discharging regulatory/enforcement functions or service delivery of any kind, which cause interface with the general public/private businesses, etc., shall provide complete information on their websites regarding the laws, rules and procedures governing the issue of licenses, permissions, clearances, etc. An illustrative list is given in the annexure. Each Ministry should prepare an exhaustive list of such applications/matters and submit a copy of same to the Commission for record and web-monitoring.
- ii) All application forms/proformas should be made available on the websites in a downloadable form. If the organisation concerned wishes to charge for the application form downloaded from the computer, the same may be done at the time of the submission of the application forms.
- iii) All documents to be enclosed or information to be provided by the applicant should be clearly explained on the websites and should also form part of the application forms.

- iv) As far as possible, arrangements should be put in place so that immediately after the receipt of the application, the applicant is informed about the deficiencies, if any, in the documents/information submitted.
- v) Repeated queries in a piece-meal manner should be viewed as a misconduct having vigilance angle.
- vi) All organisations concerned should give adequate publicity about these facilities in the newspapers and such advertisements must give the website addresses of the organisations concerned.

3. In the second stage, the status of individual applications/matters should be made available on the organisation's website and should be updated from time-to-time so that the applicants remain duly informed about the status of their applications.

4. In addition to the manual receipt of applications, all organisations should examine the feasibility of online receipt of applications and, wherever feasible, a timeframe for introducing the facility should be worked out. As a large number of Govt. organisations are opting for e-governance, they may consider integrating the above mentioned measures into their business processes so that duplication is avoided.

5. Instructions at para-2 above shall take effect from 1st January, 2007, and instructions at para-3 shall become effective from 1st April, 2007. All Heads of Organisations/Deptts. are advised to get personally involved in the implementation of these important preventive vigilance measures. They should arrange close monitoring of the progress in order to ensure that the required information is placed on the website in a user-friendly manner before the expiry of the abovementioned deadlines. They should later ensure that the information is updated regularly.

6. This issues with the approval of the Commission.

B. Singh 22/11/06
(Balwinder Singh)
 Addl. Secretary

To,

- 1. The Secretaries of all Ministries/Departments of Govt. of India.
- 2. The Chief Secretaries to all Union Territories.
- 3. The Comptroller & Auditor General of India.
- 4. The Chairman, Union Public Service Commission.
- 5. The Chief Executives of all PSEs/PSBs/Insurance Companies/Autonomous Organisations/Societies.
- 6. The Chief Vigilance Officers in the Ministries/Departments/PSEs/PSBs/Insurance Companies/Autonomous Organisations/Societies.
- 7. President's Secretariat/Vice President's Secretariat/Lok Sabha Secretariat/Rajya Sabha Secretariat/PMO.

Illustrative list1. Land & Building Related Issues

- (i) Applications for mutation; conversion from leasehold to freehold of lands & buildings; approval of building plans by municipal authorities and landowning/regulating agencies like MCD; DDA; NDMC; L&DO and similar agencies in other UTs.
- (ii) Application for registration deeds by Sub-Registrars/Registrars and other applications connected with land record management.
- (iii) Application for allotment of land/flats, etc., by urban development agencies like Delhi Development Authority.

2. Contracts & Procurement.

- (i) Applications for registration of contractors/suppliers/ consultants/ vendors, etc.
- (ii) Status of all bill payments to contractors/suppliers, etc.

3. Transport Sector

Issue of driving licenses, registration of vehicles, fitness certificates, release of impounded vehicles etc. by RTAs.

4. Environment & Pollution Related Matters

Issue of environment and pollution clearances for setting up industries and other projects by Min. of Environment & Forests; Pollution Control Organisations, etc.

5. Food & Hotel Industry

Applications connected with clearances, licenses for food industry/hotels/ restaurants, etc.

6. Ministry of Labour/Ministry of Overseas Indian Affairs.

- (i) Applications by beneficiaries and employers in connection with EPFO; ESI etc.
- (ii) Applications by recruiting/placement agencies and individuals submitted to Protectorate General of Emigrants and the concerned Ministry.
- (iii) Other applications connected with regulatory/enforcement systems of Labour Ministry.

7. CBDT & Income Tax Deptt.

- (i) Application for PAN.
- (ii) Applications submitted by NGOs for exemption from Income Tax.
- (iii) Applications submitted for issue of certificates/income tax clearance for immigration/public contracts or any other purposes.
- (iv) Application for appointment of legal counsels/any other professionals.

8. Customs & Central Excise & DGFT
Applications/cases of Duty Drawback & other export incentives.
9. Telecom (BSNL & MTNL)
Applications for establishing STD booths, etc.
10. Petroleum Sector
Applications for allotment of petrol pumps/gas stations.
11. Ministry of External Affairs
 - (i) Applications for issue of passports.
 - (ii) Applications for issue of visas by Indian Embassies abroad.
12. Ministry of Home Affairs
 - (i) Applications submitted to FRRO.
 - (ii) Applications connected with FCRA.
13. Ministry of Health
Applications for recognition by Medical Council of India and similar other regulatory bodies.
14. Education
 - (i) Applications for accreditation handled by bodies like AICTE & others.
 - (ii) Applications for recognition of schools by Director of Education etc.
 - (iii) Grant of E.C. by Director of Education.
15. Agriculture, Dairying & Fisheries
 - (i) Various clearances/licenses, eg. clearance for operating fishing vessels.
 - (ii) Quarantine related applications.
16. Ministry of Social Justice/Tribal Affairs.
Applications for sanction of funds to NGOs.

REGIONAL TRAINING INSTITUTE
INDIAN AUDIT & ACCOUNTS DEPARTMENT

**"Course on Audit of Fraud and Fraud Detection Techniques &
Forensic Audit"**
(23.11.2005)

NOTE ON

Fraud investigation and Forensic Audit. Overview, learning objective, understanding forensic audit as distinct from normal audit, role and responsibilities of forensic auditor and understanding types of frauds.

By Jayant M. Ranade
Chartered Accountant

1. Introduction

An auditor has to obtain information and explanations in every audit situation not only from documents, books of account and other records, but also by interviewing and having discussions with various members of the staff such as accountants, cashiers, storekeepers, managers, etc. during this process, auditees often make strong assertions and submissions which could influence his opinion. Since his opinion is, to a certain extent, based on such information provided by the auditees, it is important for him to develop the ability to discern axioms, or assertions of truth, from myths, fallacies and erroneous beliefs.

With increasing complexities in corporate frauds including govt entities, the issue of fraud investigation has become extremely relevant to managements and the auditing profession. Most of the frauds involving substantial leakage or pilferage of resources also highlight issues of governance. We have to study the concept of forensic investigation, its relevance, the different types of frauds that are known to take place in the commercial world including government environment. The red flag areas requiring further probe, the process of collection of sustainable evidence, the principles generally applied in arriving at logical conclusions at the end of the investigation.

2. Forensic Audit / Investigation

As modern business world becomes increasingly competitive and complex, fraud and white collar crimes have become more challenging to detect. The spread of information technology and the internet has contributed a significant increase in white collar and economic crimes such as kickbacks, bribes, insider trading, cheque kiting, etc, that their detection calls for special skills in fraud investigation. Auditors are sometimes called upon to conduct extended procedures to probe a fraudulent transaction, in view of their expertise in dealing

with books of accounts and commercial transactions. These could cover cash embezzlements, revenue leakages, suppression of income, inflation of liabilities, etc. In other instances, services of auditors may be required by enforcement agencies like the CBI or economic offences wing to investigate eg. Claims of investors, tax frauds, bank frauds etc to help the team investigation. The term investigation connotes a systematic and in-depth examination or inquiry to establish a fact or to evaluate a specific situation. Taylor and Perry has defined investigation as "Investigation involves inquiry into facts behind the books and accounts into technical, financial and economic position of the business or organization". An investigation requires a special in-depth examination of the particular records or transactions with the objective of establishing a fact or happening or assessing a particular situation.

3. Role of Forensic Auditor to detect frauds Misappropriation & defalcations.

The exact procedure to be followed in conducting investigations to uncover cases of frauds, misappropriations and defalcations varies according to the circumstances of the case. The Forensic auditor has to know, study and analyse, the nature of frauds, psychology of the persons involved in fraud, the transactions and the circumstances which are more prone to frauds and the steps involved in detecting such frauds.

The Auditors have to apply the 3P approach in trying circumstances. Positive attitude, Perseverance and Patience. Virtually all-great men who have accomplished something have applied this 3P approach. Accounting and Auditing are no exceptions to this theory.

3.1 Auditors' difficulties in a computerized environment

Many auditors often face considerable difficulty in keeping pace with information technology and computerization which are constantly evolving at a phenomenal pace. Auditing in a computerized environment can be challenging and intimidating, particularly for those who have limited knowledge and experience in computers. The difficulty is further compounded by the fact that in a computerized environment the audit trail disappears. Many auditors therefore conduct the audit on a 'best judgement basis', a round-the-computer approach. In a lighter vein, the auditor's assessment of the financial information, is on the 'GOK' basis : 'God Only Knows'. On a more serious note, this is a matter of concern.

Does this mean that an auditor who has no knowledge or limited knowledge of computers cannot carry out an audit in a computerised environment? Not at all. Though an auditor himself may not be competent to understand the technical aspects of a computerized application, technical support for that can always be acquired or outsourced. What an auditor really needs most are his professional skill, expertise and judgement. Difficulties in a computerised environment do

exist, but these should never be perceived as unsurmountable. In fact it is the author's experience, that whenever he was placed in a new assignment where accounts were computerized, particularly in extremely large companies, the situation at the commencement of the assignment was invariably intimidating and sometimes even confusing, though he himself had some technical background. The author further unhesitatingly states that what eventually counted was not his technical knowledge, but his knowledge and experience in auditing.

Following is the summary of the procedures which, in most instances the forensic auditor has to perform to investigate fraud.

- a) Ascertain level of authority and nature of duties of the defaulting employee;
- b) Cast and vouch cash book, and obtain certificates of opening and closing balances from the bank;
- c) Check cash book against bank statements, paying particular attention to dates of lodgments to ascertain whether receipts were banked without delay;
- d) Examine original pay-in-slips at the bank and compare with counterfoils, since this may reveal the practice known as 'teeming and lading';
- e) Circularize debtors positively;
- f) Note any apparently irregular cash payments;
- g) Examined cancelled cheques and compare names of payees with details in cash book and invoices;
- h) Obtain duplicates of missing expenditure vouchers;
- i) Vouch all amounts shown as partners' or director's drawings or loans;
- j) Vouch and cast petty cash book;
- k) Confirm names of all employees shown on wages lists with chief accountant or other senior official, and amount payable to them;
- l) If defaulter had access to all books, all postings should be checked and a trial balance extracted;
- m) Confirm all bad debts written off, discount allowances and returns;
- n) Check order book against sales day book or copy sales invoices to detect any sales which have been wholly unrecorded;

- o) Cash sales should be verified against whatever evidence may be available;
- p) Voucher purchase invoices with purchases day book and see that none has been passed through twice;
- q) Obtain duplicates of all missing purchases vouchers;
- r) Compare creditors statements against purchase ledger balances;
- s) Check goods inwards book or order book against invoices to ensure that the latter relate bonafide purchases.
- t) Internal controls in the area where fraud is suspected to have taken place should be thoroughly examined.

5. Types of Frauds

- 5.1 Trojan Horse Frauds
- 5.2 Disaster Frauds
- 5.3 Achilles Heel Frauds
- 5.4 Corporate Espionage
- 5.5 Technical Frauds

6. Various Indications of Frauds

- 6.1 Red Flags
- 6.2 Absence of Rotation of staff
- 6.3 Conflict of interest
- 6.4 Sudden losses
- 6.5 Too good to be true (TGTBT)
- 6.6 Orphan frauds
- 6.7 Frauds that transcend books of account.
- 6.8 Fraud and the mirror trap.
- 6.9 Principle of "Inverse Logic" in fraud detection.

A SEARCH FOR THE POSSIBLE 'INVARIANTS' OF HANDWRITING IN THE WRITINGS OF A PERSON WRITTEN IN TWO DIFFERENT SCRIPTS

—H.M. SAXENA*, P. VENUGUPALA RAO† & R.S. RANA‡

Being a science of comparison, handwriting identification is solely based on the comparison of 'like with the like', this being the most basic principle of examination. As such, peculiar letters, words and their combinations that comprise peculiar writing traits as made out and isolated from the authentic specimen (standards) of the individual, can be justifiably compared with similar matter observed in the disputed writings for arriving at a definite conclusion about their authorship, provided both of them are written in similar scripts and as far as possible, contain similar words and combinations.

However, difficulties arise when the disputed writings comprise of occasional writings written in other script (i.e. different script) as well and comparable 'standard' are taken/provided in one script only. The disputed writings as a whole are suspected to have been written by the same person having some stray figures, letters and a few other 'notations' being common to both of them. There have been instances in certain cases, especially those of 'anonymous letters', 'threatening notes' as well as cases involving 'multiple forgeries' etc. when an indication by a handwriting expert had helped Investigating Officers to labour a bit more and procure authentic comparable record material (in both the scripts) from the suspect(s), on such a specific advice. An effort is made by the authors in this 'paper' to search for possible 'Invariants of Handwriting', especially in respect of the 'Skill', 'Rhythm', 'Relative Size and Proportion', peculiar aspects of 'Angularity', 'Roundedness' as well as the aspect of the 'Relative extent of variation' in the writing etc. as some of the most stable 'writing traits' of the individual writer, which being 'involuntary in nature', are not expected to 'vary' to any undesirable extent even if the writer writes in two different scripts, provided he is more or less equally proficient in both the scripts.

Key words : 'Invariants of Handwriting', 'Peculiar Writing Traits', 'Idiosyncratic Features', Aspects of 'Skill', 'Rhythm', 'Angularity', 'Roundedness' etc., 'Writings in Two Different Scripts', 'Transient Characteristics'.

INTRODUCTION

HANDWRITING is an acquired habit. As an individual grows and becomes proficient in a particular language and script, his individuality

and hence the writing traits get reflected in that script, though it may not necessarily be his or her own mother tongue. It is the case with most

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of the educated persons in India, be in a Government or a Private job, for whom English is the most accepted script in routine official jobs. A person normally possesses the 'functional ability' or an above average proficiency in writing in a script related to his or her mother tongue.⁽⁴⁾ As such, the writer has more or less similar facility of writing at his command in both these scripts and as would be seen there would be sufficient number of 'discerning features'⁽⁵⁾ in his writings so written in two different scripts. In short, the habit of writing and the writing skill as acquired in one script, due to the exigency of the placement of the individual in a particular profession, is bound to transmigrate and get reflected in one way or the other in the other script as well, provided the individual writer has at least a 'functional ability'^(1 & 2) or proficiency in that script as well.

This aspect of transmigration of an 'acquired habit'⁽¹⁾ or 'traits' of writing from one script to the other for an individual has been studied in details and a search is made to locate and fix the possible 'invariants of handwriting' in the writings of a person written in two different scripts. These 'invariants' are quite apart from the 'transient features' of writings mostly seen in the 'pictorial effect of writings'. As shown later on in this paper, this directional approach relating to such peculiar aspects of handwriting analysis is useful in locating and pinpointing the suspect(s) in cases especially those involving multiple forgeries, anonymous letters and threatening letters etc.

Handwriting, although an acquired habit, is also a neuromuscular act.^(1 & 2) Many of the writer's fixed writing habits are 'involuntary in nature' and get reflected or unknowingly go into the different scripts at the command of the writer.

DISCUSSION

The quite an important aspects of handwriting, such as 'the relative size and proportion of the characters', 'legibility', 'flow' and 'rhythm' as well as the aspects of 'angularity' and 'roundedness' of the characters, which are directly related to the 'skill' of the writer, were studied in the writings of a person, who had sufficiently good working knowledge of both the two scripts and was more or less, equally proficient in both of them. The aspects of spacing, alignment and pen pressure etc. were of lesser significance, especially in case of extended writings. The 'arrangement' of various parts of the signatures as well as writings became prominent in case of signature writings done in two different scripts [see Figure 1(A) on p. 33 and Figure 1(B) on p. 34].

Another important aspect of analysis in such a comparison was the 'width to height' ratio of various characters, that appeared quite firm and did not undergo any discernible change, and those characters bore close resemblance or 'semblance' in their formations as seen in two different scripts, thus providing strong pointers towards their common authorship (see Figure 2 on p. 35).

There are other 'idiosyncratic features' in the writing, especially those aspects of the very peculiar formation of certain individual characters that being highly individual and involuntary features of writings that get reflected at ease in both the scripts (see Figure 3 on p. 36).

The aspects relating to the writing skill, especially those of 'tremor of age' or any other 'writing weakness' related to any 'debility' etc. also get reflected in both the scripts or even more in which the writer is proficient (see Figure 4 on p. 37).

Another feature related to the skill of the writer is the exhibition of the simplification, modification of terminal strokes, including other abbreviated forms, especially in case of signatures written in two different scripts (see Figure 5 on p. 38). This being a strong pointer to the signatures written in two different scripts having been written by one and the same person (Actual case example).

Sometimes, now quite often, the degree and extent of variation from the copy book form as seen in one script was found to be equally reflected in the other script for the same writer.

CONCLUSION

Handwriting is a science of comparison, basically it depends upon a comparison of 'like with the like', i.e. characters, alphabets and numerals etc. written in one script are not (in general) compared with their counterparts in the other scripts (apparently being different in their model and design). But the handwriting basically comprises of strokes and curves. The subtle features as observed in the formation of individual characters can be best studied by breaking up of a character in its 'basic forms' and movement of various strokes and curves comprising it can be justifiably compared with the characters bearing close resemblance in

the other script. Such 'subtle characteristics', in fact, directly relate to the 'basic structure' of the writings of an individual written in any script. This type of comparison is most useful way of examining 'highly personalised' and equally 'illegible' signatures written by a writer in two different scripts, which apparently do not reflect the conventional alphabetical forms in the two scripts.

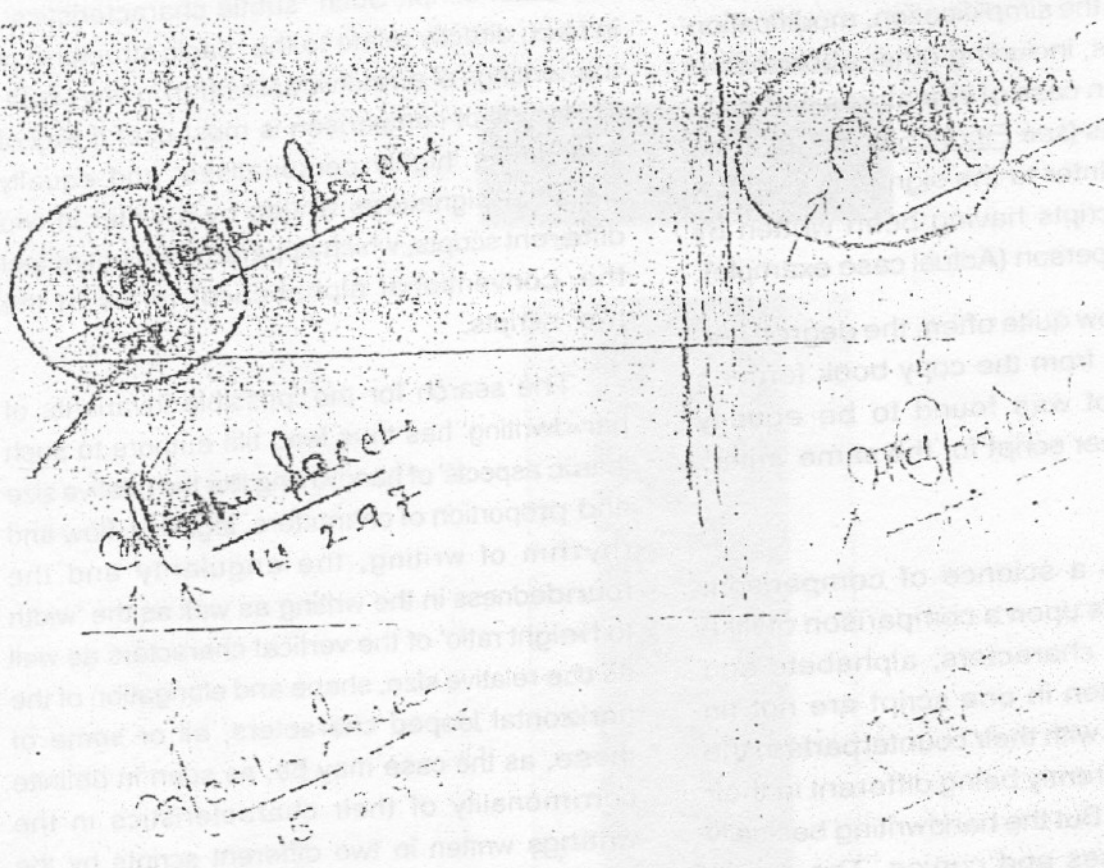
The search for the 'possible invariants of handwriting' has thus lead the authors to such 'basic aspects' of handwriting like the relative size and proportion of characters, legibility, flow and rhythm of writing, the angularity and the roundedness in the writing as well as the 'width to height ratio' of the vertical characters as well as the relative size, shape and elongation of the horizontal looped characters, all or some of these, as the case may be, as seen in definite commonality of their characteristics in the writings written in two different scripts by the writer. Depending upon the significance and prominence of such traits, which have survived the transmigration from one script to the other, the particular suspect may be isolated and his further request and standard writings may be asked for to finally fixing the authorship of such writings, in other script(s) as well. ■

ACKNOWLEDGEMENT

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CDR. Madhu Sanyal

Figure 1 (a)

Similarities in the flourish observed in the terminal parts of the character 'M' in 'Madhu' and 'Dra' with vowel sign of 'Ukar' in 'Madhu' in Hindi; initial characters in both scripts with the peculiar commencement, as a terminal strokes appearing as vowel sign of 'Eekar' in Hindi signals bearing close resemblance with terminal stroke of 'M', as also peculiar alignment and spacing of characters in both.

CBI team reaches Kuala Lumpur

Quattrocchi threatens legal action

New Delhi, Feb 10 (ANI) A two member CBI team, led by additional director N. Revanna Siddaiah, has reached Kuala Lumpur and is in touch with Malaysian authorities seeking their permission to interrogate the Quattrocchi in connection with the Bofors case.

बेरी सिआर्न नामक एक ४६ वर्षीय बॉयोकेमिस्ट के अनुसार अधिक कार्बोहाइड्रेट का मतलब होता है मोटापा या स्थूलता, जो आज कोई भी चाहता है। उन्होंने पश्चिम अमेरिका व अठ यूरोप में अधिक कार्बोहाइड्रेट खाने की रीति के प्रति एक जंग ली हुई रूढ़ि हैं तथा इस विषय पर लिखी उनकी पुस्तक 'सुंदर व जोत' बेतर भेदिक चार्ट में ध्यान पा चुकी है।

Figure 1 (E)

The aspects of "legibility" as well as "flow" and "rhythm" are equally reflected in both the scripts

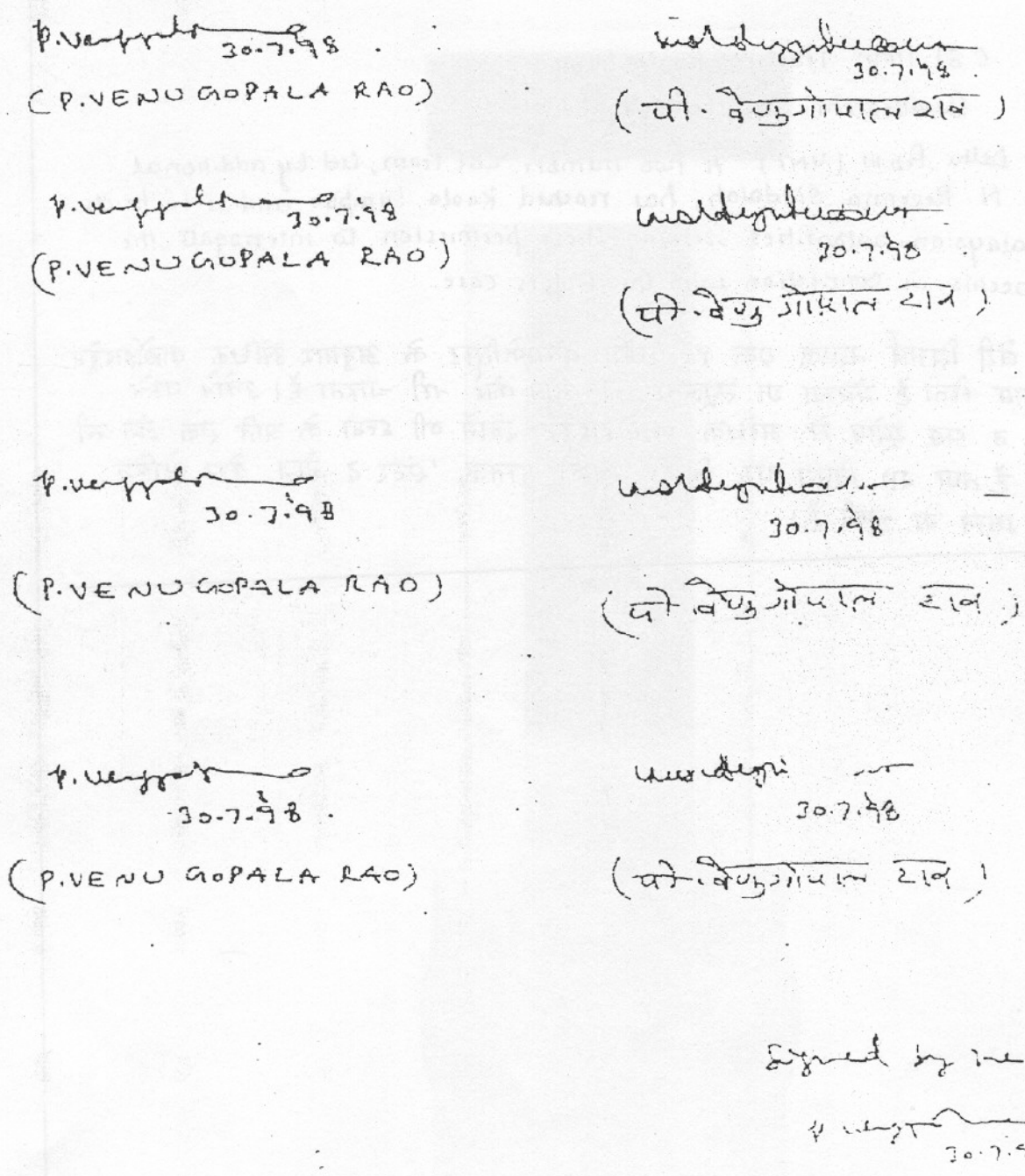


Figure 2

The relative "width to height ratio" of various characters in the signatures is similarly reflected in the signatures of the writer in two different scripts.

మరియు విద్యుత్ నిరోధకతను
 తగ్గించుట మా ప్రసిద్ధ ముంది. ఈ విధంగా విద్యుత్ నిరోధకత
 తగ్గుతున్నప్పుడు మరొకటి. ఈ విధంగా విద్యుత్ నిరోధకత
 తగ్గు చక్క గాఢపడతే ఎదురుగానే కేవల చక్కను అయిపోతుంది
 చెబుతారు.

మరింతగా మరొకటి, అప్పుడు కేవల ఒకే రకమును
 చక్కని చెబుతారు (మరింతగానే విద్యుత్ నిరోధకత) అను వాస్తవంగా
 విద్యుత్ నిరోధకత చక్కదనంగా ప్రయోగించి అందు సాధారణము
 ఈ విధము వల్లే విద్యుత్ విద్యుత్ విద్యుత్ విద్యుత్ విద్యుత్

The modern theory of superconductivity
 was developed by three American scientists
 Bardeen, Cooper and Schrieffer. It was first
 demonstrated by H. Kamerlingh Onnes in 1911
 It is known as the BCS theory after the
 men who developed it. According to their theory
 a superconductor has no electrical resistance
 because of an interactive attraction between

Figure 2

idiosyncratic features

Winnings
24.2.09

(Dr. Lal Mohan Singh)
अ आ इ ई उ ऊ ए ऐ ओ
औं अं अः

क ख ग घ ङ च छ ज
झ ण ट ठ ड ढ
ण् त थ द ध न प फ
ब भ म य र ल व
श ष स ह ण् अ म न

१ २ ३ ४ ५ ६ ७ ८ ९
१० ११ १२ १३ १४ १५
१६ १७ १८ १९ २०

Winnings
24.2.09

Winnings
24.2.09
(Dr. Lal Mohan Singh)

Winnings
25.2.09

Winnings
26.2.09
(Dr. Pyare Lal Singh)

A B C D E F G
H I J K L M N O P
Q R S T U V W
X Y Z

a b c d e f g h
i j k l m n o
p q r s t u v
w x y z

1 2 3 4 5 6 7 8 9 10
11 12 13 14 15 16 17 18 19 20

Winnings
25.2.09

(Dr. Pyare Lal Singh)

Figure 4

The aspect of "tremor of age" is similarly observed in both the scripts.

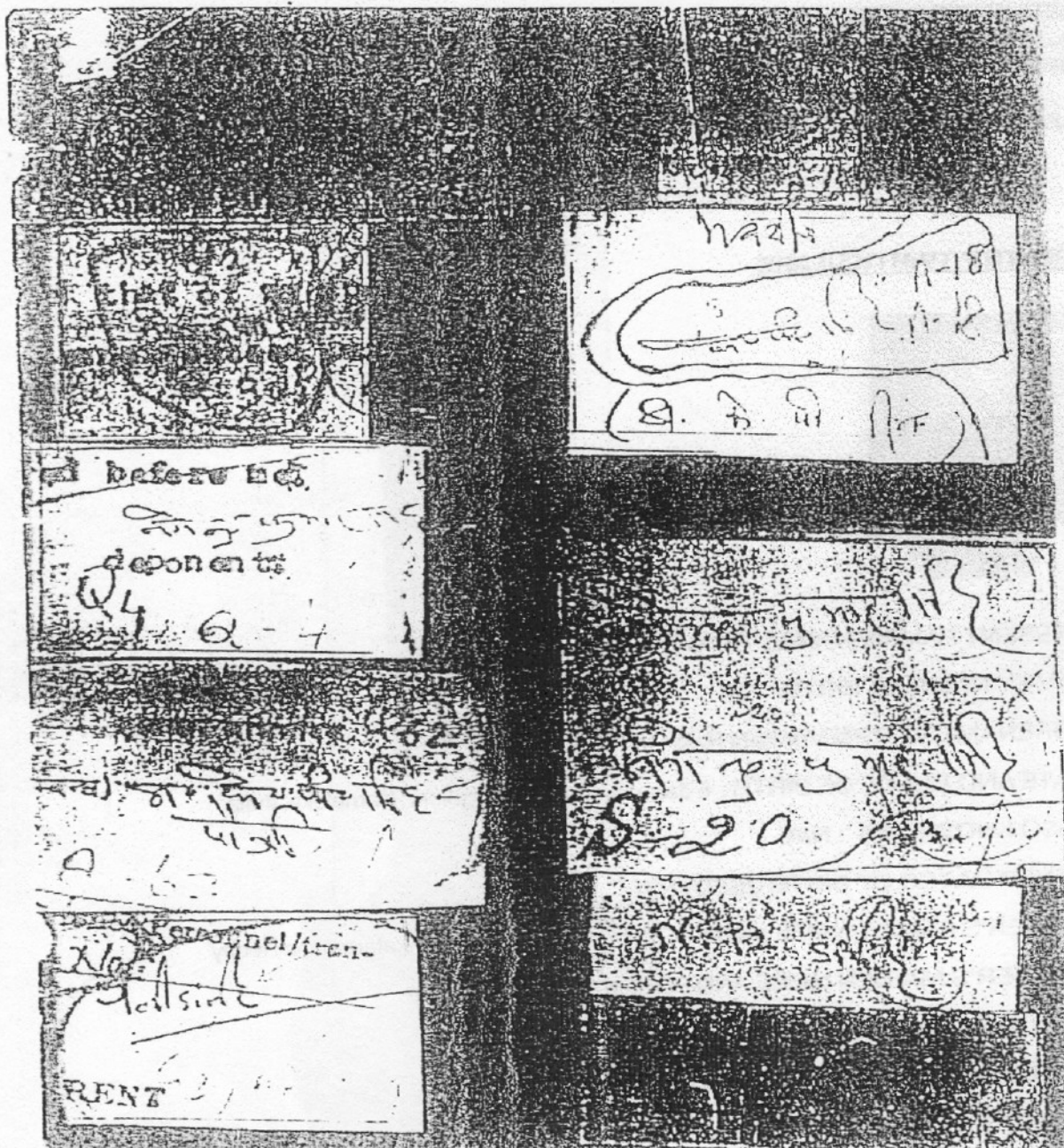


Figure 5

The writer, namely 'K.P. Singh' writes with equal proficiency both in English & Hindi. Simplification of 'ngh' in 'Singh' in his English signatures (Q39, S27, S31 etc.) and 'Singh' in vernacular (Q3, S20 etc.) bear close resemblance in their movement and formation. Signatures in Q2, Q3 & Q4 are forged signatures whose authorship is fixed with the writer.

(Poor visibility across certain documents is due to the faulty paper texture.)

REQUESTING COUNTRY : INDIA

FILE No. : 2006/14776

DATE OF PUBLICATION : 24 March 2006

CIRCULATION TO THE MEDIA (INCLUDING INTERNET) : YES

FUGITIVE WANTED FOR PROSECUTION

1. IDENTITY PARTICULARS



1.1 PRESENT FAMILY NAME : THALA

1.2 FAMILY NAME AT BIRTH : N/A

1.3 FORENAMES : Thala Venkata Raja Reddy

1.4 SEX : M

1.5 DATE AND PLACE OF BIRTH : 5 January 1948—Bangalore, Karnataka, India

1.6 ALSO KNOWN AS : N/A

1.7 OTHER DATES OF BIRTH USED : N/A

1.8 FATHER'S FAMILY NAME AND FORENAMES : THALA Venkataramana Reddy

1.9 MOTHER'S MAIDEN NAME AND FORENAMES : Kausalya

1.10 IDENTITY CONFIRMED

1.11 NATIONALITY : INDIAN (CONFIRMED)

1.12 IDENTITY DOCUMENTS : Indian Passport No. Z 1332482, issued on 13th December 2002 in Bangalore, India

1.13 OCCUPATION : Businessman

1.14 LANGUAGES SPOKEN : Telugu, English

1.15 DESCRIPTION : Hair : Black Eyes : Black

1.16 DISTINGUISHING MARKS AND CHARACTERISTICS : N/A

1.17 DNA CODE : N/A

1.18 REGIONS/COUNTRIES LIKELY TO BE VISITED : Canada, Germany, Thailand, United States

1.19 ADDITIONAL INFORMATION : N/A

REQUESTING COUNTRY : INDIA

FILE No. : 2006/14897

DATE OF PUBLICATION : 28 March 2006

CIRCULATION TO THE MEDIA (INCLUDING INTERNET) : YES

FUGITIVE WANTED FOR PROSECUTION

1. IDENTITY PARTICULARS

1.1 PRESENT FAMILY NAME : DEODHAR

1.2 FAMILY NAME AT BIRTH : DEODHAR

1.3 FORENAMES : Anil

1.4 SEX : M

1.5 DATE AND PLACE OF BIRTH : 13 March 1955—Aurangabad, India

1.6 ALSO KNOWN AS : DEODHAR NEIL

1.7 OTHER DATES OF BIRTH USED : N/A

1.8 FATHER'S FAMILY NAME AND FORENAMES : DEODHAR Nagesh Shankar

1.9 MOTHER'S MAIDEN NAME AND FORENAMES : PRABHA N.

1.10 IDENTITY CONFIRMED

1.11 NATIONALITY : INDIAN (CONFIRMED)

1.12 IDENTITY DOCUMENTS : N/A

1.13 OCCUPATION : N/A

1.14 LANGUAGES SPOKEN : English, Hindi, Marathi

1.15 DESCRIPTION : N/A

1.16 DISTINGUISHING MARKS AND CHARACTERISTICS : N/A

1.17 DNA CODE : N/A

1.18 REGIONS/COUNTRIES LIKELY TO BE VISITED : United States [(a) 10-44, 47 Road, Long Island, New York 11101; (b) c/o Ahok Abhyankar, Greenway West, New Hyde Park, New York 11040]

1.19 ADDITIONAL INFORMATION : N/A

2. JUDICIAL INFORMATION

2.1 SUMMARY OF FACTS OF THE CASE : INDIA:

On 28 July 1997, DEODHAR applied to *Videsh Sanchar Nigam Limited (VSNL)* for a 64 Kbps frame relay circuit to be installed at 36 Kakad Industrial Estate, L.J. Road, Matunga (West), Mumbai. The application was made in the name of *APT Software*. DEODHAR submitted drawings showing communication equipment installed at the premises, when in fact, no such communication equipment was in place. Instead there were twelve telephone lines connected to the 64 Kbps leased line, extended to New York through the relay circuit. By having this arrangement in place, DEODHAR violated legislative provisions, provided an illegal call-back service and caused VSNL to suffer significant losses. As a result of DEODHAR'S actions, the Government of India suffered losses of INR 51,051,000.

2.2 ACCOMPLICES : N/A

2.3 CHARGE : Cheating; establishing, maintaining or working an unauthorised telegraph; intentionally damaging or tampering with telegraphs; responsibility of subscriber to pay bills

2.4 LAW COVERING THE OFFENCE : Section 420 of the Indian Penal Code; Sections 20 and 25(C) of the Indian Telegraph Act, 1885; Rule 440(4) of the Indian Telegraphs Rules, 1951; Section 3(2)(e) of the Prevention of Damage to Public Properties Act, 1984

2.5 MAXIMUM PENALTY POSSIBLE : 7 years' imprisonment and fine

2.6 TIME-LIMIT FOR PROSECUTION OR EXPIRY DATE OF ARREST WARRANT : None

2.7 ARREST WARRANT : No. 66 issued on 27 January 2005 by the Judicial Authorities in Mumbai, India

Name of signatory : N/A

COPY OF ARREST WARRANT AVAILABLE AT THE GENERAL SECRETARIAT IN THE LANGUAGE USED BY THE REQUESTING COUNTRY : YES

3. ACTION TO BE TAKEN IF TRACED

3.1 IMMEDIATELY INFORM INTERPOL NEW DELHI (NCB reference : IP-2/04/2006 of 23 March 2006) AND THE ICPO-INTERPOL GENERAL SECRETARIAT THAT THE FUGITIVE HAS BEEN FOUND.

3.2 FOR COUNTRIES WHICH CONSIDER RED NOTICES TO BE VALID REQUESTS FOR PROVISIONAL ARREST, PLEASE PROVISIONALLY ARREST THE FUGITIVE.

EXTRADITION WILL BE REQUESTED FROM ANY COUNTRY WITH WHICH THE REQUESTING COUNTRY IS LINKED BY A BILATERAL EXTRADITION TREATY, AN EXTRADITION CONVENTION OR BY ANY OTHER CONVENTION OR TREATY CONTAINING PROVISIONS ON EXTRADITION.

Reading Material from Structured Training Module (STM)

CHAPTER: I

Basic concepts of fraud and corruption

Overview

This chapter will introduce the trainee participants to the need for fraud audit, fraud recognition, the basic nature of fraud and the elements by which we recognize fraud. In addition, the participants will also be acquainted with an understanding of "corruption" as the latter has become a pervasive phenomenon and is often, inextricably linked with fraud, causing considerable leakage of public resources and betrayal of public trust.

Learning Objectives

Given the trainee's audit experience, the trainee should be able to understand and recognize the elements of fraud, appreciate the environment/factors contributing to/having the potential to give rise to fraudulent behaviour.

Importance of fraud recognition

The need for fraud awareness and recognition among audit fraternity has arisen in recent times due to the multiplicity of corporate scams at the global level and in govt. entities, especially because most of these scams have happened with the collusion of the higher managements such as the Enron, World com. etc. Corruption in government results in public waste, erodes accountability and credibility of state institutions and reduces their effectiveness. Recent instances are – LOC scam of Assam, Fodder scam of Bihar and the more recent stamp scam that have been perpetrated with the help and connivance of higher functionaries. A central issue raised in the wake of these scams is whether these could have been prevented by audit, bringing the role of audit in prevention and detection of frauds to center-stage. As corruption involving misuse of public office or funds weakens the structures of accountability, there has been a growing concern both among auditing fraternity at large and the supreme audit institutions to strengthen the auditing processes and standards of auditing to fight fraud and corruption.

What is fraud recognition?

Fraud recognition refers to the cognizance of the characteristic features of fraud, the factors that may give rise to frauds in an entity, the potential indicators of fraud and the

Guidance Note

internal environment, in particular, the efficacy of the internal checks and controls that would influence the entity's predilection to fraud.

Fraud and corruption include both those acts committed by the government employees or management of an auditee (internal fraud and corruption), and those perpetrated against the auditee by outside individuals or groups (external fraud and corruption). Internal fraud and corruption may result in benefits being obtained either from organization (e.g. theft of cash/assets, falsification of records to obtain bonuses) or misuse of office. The latter may not result in immediate loss to the entity, but it may result in a civil liability for restitution where positions of trust have been abused. Examples of external fraud and corruption include making fraudulent claims for government grants and benefits; or suppliers issuing false or duplicate invoices.

The loss to the entity in case of fraudulent financial reporting can be derived from the financial statements: in cases of corruption, involving abuse of discretion, it may not be apparent. Both fraud and corruption are by definition without proper authority and involve breach of trust, being perpetrated by those in a position to subvert decision-making process.

KTP 1: Defining the word 'Financial Fraud'

Fraud: Dictionary meaning of the word "fraud" is criminal deception. Fraud involves an act of deceit or intention to deceive with the object to gain an advantage to the party himself. Under the Indian Penal Code, the word 'fraudulently' has been used synonymously with dishonest intention to cause a specified offence. It has been judicially held that by fraud is meant an intention to deceive; whether it be from an expectation of advantage to the party himself or from the ill-will towards the other is immaterial".

Financial fraud is in general recognized to have the following ingredients:

- intention to hold out a false representation with the object of deceiving
- the defendant acts upon the said act or information given out by the plaintiff
- consequently, an unfair gain accrues to the plaintiff or there is risk of loss/injury to the plaintiff

It refers to intentional misrepresentation of financial or non-financial by one or more individuals among management, employees or third parties to obtain an undue or illegal

advantage at the expense of the victims, being the intended recipients or users of such misrepresentation. In this regard, any act with intent to defraud, through destruction, alteration, falsification of books or records including electronic record, or omits material particulars by a person acting in the capacity of an officer or servant is liable to the offence of falsification of accounts under the Indian Penal Code. It is also necessary to stress that while fraud is a broad legal concept, it is not the job of auditors to make legal determination of fraud, though they are expected to recognize the essence of fraud as distinguished from unintentional acts of omission or commission in relation to the financial statements of the audited entity.

XVI INCOSAI Uruguay 1998 viewed fraud as a legal concept, which involves act of deceit, trickery, concealment, or breach of confidence that are used to gain some unfair or dishonest advantage; an unlawful interaction between two entities, where one party intentionally deceives the other through the means of false representation in order to gain illicit and unjust advantage.

According to SPASAI Fraud Guide, " fraud is a generic term which embraces all the means that human ingenuity can devise, which are resorted to by one individual, to get an advantage over another by false representations. There is no finite rule to define fraud as it includes surprise, trick, cunning and unfair ways by which another is cheated.

The Canadian Audit Guide 21 on Fraud Awareness refers to fraud as an action where there is a loss of a valuable resources resulting from a false representation made knowingly, without belief in its truth. Such actions could result in charges being laid under various applicable Canadian laws.

According to National Audit Office of UK, fraud involves the use of deception to obtain an unjust or illegal financial advantage as well as intentional misstatements in, or omissions of amounts or disclosures from, an entity's accounting records or financial statements. It also includes theft, whether or not accompanied by misstatements of accounting records or financial statements.

The Fraud Examiners Manual defines fraud as any intentional or deliberate act to deprive another of property or money by guile, deception or other unfair means. Similarly International Standard of Auditing (240) also treats fraud as an intentional act by one

or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

ISA (International Standards on Auditing ISA-240) defines '*fraud*' as "*intentional act by one or more individuals among management, those charged with governance, employees or third parties involving the use of deception to obtain an unjust or illegal advantage.*"

ASOSAI Guidelines also define fraud "as involving deliberate misrepresentation of facts/significant information to obtain undue or illegal advantage."

It is thus agreed that financial fraud generally involves the following:

- falsification of accounting records
- misappropriation of assets or theft
- suppression or omission of material transactions from records
- recording of transactions without substance
- intentional misapplication of accounting policies
- willful misrepresentation of transactions or the entity's state of affairs

Thus, fraud or fraudulent transactions pose a serious challenge to audit as the recorded or reported information to audit seeks to mislead the user and the problem is compounded when the fraud is perpetrated in collusion with management.

KTP 2: Defining the word "Corruption":

When management aids and abets in fraudulent activity, there is a great possibility that corruption is also involved.

Corruption, as defined in INTOSAI guidelines involves effort to influence and/or the abuse of public authority through the giving or the acceptance of inducement or illegal reward for personal or private advantage.

Thus, corruption would refer to

- giving, receiving, soliciting anything of value in order to influence a public servant in the performance or failure to perform the lawful duties of that official. In most cases, bribe payments are disguised and fraudulently reported. And have a direct impact on financial statements as for example a bribe payment given to an influential decision-maker to secure a business contract,

- abuse of discretion vested in a public servant to serve private purposes. In these cases, often, the decisions may not be reflected in the financial statements but these involve betrayal of public trust and jeopardize public accountability

Corruption is a complex issue. While its roots are grounded in a country's particular social and cultural history, political and economic development, bureaucratic traditions and policies, one can generalize to state that corruption tends to flourish when institutions are weak and economic policies distort the marketplace. Transparency International, has thus found India to be consistently one of the least transparent nations i.e. with a very high corruption perception index.

The Asian Development Bank in the Anti-corruption Policy defined 'Corruption involves behaviour on the part of officials in the public and private sectors, in which they improperly and unlawfully enrich themselves and/or those close to them, or induce others to do so, by misusing the position in which they are placed'.

The Chartered Institute of Public Finance and Accountancy of UK defines corruption as the offering, giving, soliciting or accepting of an inducement or reward, which may influence the action of any person. That is, an individual receives a bribe as a reward or incentive for action or inaction contrary to the proper conduct of his or her duties, for the direct benefit of a third party.

The World Bank defines corruption as the abuse of public power for personal gain or for the benefit of a group to which one owes allegiance.

Under the Prevention of Corruption Act, 1988,

- Any public servant accepting or agreeing to accept any gratification for himself or any other person as motive for any official act in discharge of official duties has committed an offence
- Any public servant accepting for himself or for any other person any gratification as a motive for inducing any public servant to do any official act in the exercise of official act is punishable
- An act is punishable if any person accepts such gratification for inducing by his personal influence any other public servant to do any favour or disfavour in the exercise of official duties.

- A public servant habitually accepting any gratification other than legal remuneration as a motive or obtains valuable thing without adequate consideration or by dishonest means misappropriates any property entrusted to him is liable for the offence of criminal misconduct.

The Act also makes any person aiding or abetting a public servant in the commission of the above offence is also liable to punishment.

KTP 3: Recognise fraud and corruption by their basic elements

From the above discussion, the basic elements of fraud and corruption are summarized below:

Elements of fraud:

1. There must be at least two parties to the fraud, namely the perpetrator and the party who was or could have been harmed by the fraud, otherwise known as the victim;
2. A material omission or false representation which may consist of false statements and claims must be made knowingly by the perpetrator; Example,
 - An employee prepares and submits monthly payroll and intentionally falsifies the document by not reporting unpaid leave taken while the supervisor was away on business. As a result, the employee is paid for the time not worked. The victim is the employer and the loss is the money wrongfully paid to the employee.
3. There must be intent by the perpetrator that the false representation be acted upon by the victim;
4. There must be either actual injury or a risk of injury to the victim as a result of the reliance;
5. Fraud involves betrayal of trust in all cases where there is a breach of fiduciary duty- an act is committed that is not in the best financial interest of an organization.
6. Fraud constituting criminal breach of trust is both a civil and criminal offence in India and attracts both civil and criminal liability.

KTP 4: Distinguish between fraud and error

An error may consist of :

- Oversight or misrepresentation of facts
- Misapplication of accounting policies/principles in terms of measurement, recognition, classification, presentation and disclosure

An error is essentially unintentional: therefore, the person committing an error does not seek to conceal the mistake. The chances of detection of the error are thus higher, unlike in the case of a fraud that usually involves cover-up devices such as collusion, forgery, deliberate omission to record material transactions, intentional misrepresentations made to the auditor. Whether a material misstatement will fall within the ambit of fraud will depend on the following:

1. Whether the act is intentional on the part of one or more individuals working in collusion with each other;
2. Whether the object of the act is to obtain or give illegal advantage in violation of the laws, rules and guidelines existing on the subject;
3. Whether the intention, collusion and object of obtaining illegal advantage are present when a particular act is committed. An act committed in good faith which by subsequent turn of events, proves to be incorrect or based on wrong information is not fraud.
4. Whether the advantage or benefits to an individual or group of individuals is tangible and not notional or presumptive.
5. Whether any such act causes loss to exchequer or is against public interest.

Elements of Corruption:

- There must be at least two parties to an act of corruption, namely the person who offers the reward or inducement and the party accepting it;
- There must be misuse of office or position of authority for private gain;
- There is either an offer and/or acceptance of inducements;
- An attempt to solicit an offer of inducement or reward as benefit for performance of an official act;
- Any act through which public or entity property is dishonestly misappropriated;
- Corruption also involves breach of trust in that the perpetrator of the offence causes significant injury to public interest through improper use of discretion or abuse of authority. The victim is the govt. agency and ultimately the public at large.

- An act of corruption is a civil offence and a criminal misconduct as defined in the Prevention of Corruption Act and is punishable with fine and/ or imprisonment.

The problem which corruption poses for audit is that it presents as acts of bribery. It is possible to conceive of situations where bribery may have a direct impact on financial statements, for example where a corporation pays an influential decision-maker a bribe to secure a contract. In such a situation, the issue of proper disclosure is involved because the corrupt practice of the illegal payment/ expense is normally covered up through an accounting or reporting fraud. However in many instances corruption does not necessarily result into transactions that are recorded and reported by the entity. This especially applies to situations where an official in the govt. or public sector encashes a position of authority or discretion available under rules. Such corruption, which because of its widespread prevalence, may be most responsible for undermining the social fabric and the credibility and functioning of state institutions, does not normally get reflected in information that comes in the purview of audit.

KTP 4: Audit Mandate

It is the primary responsibility of management to provide the necessary safeguards and adequate controls in place to deter fraud and corruption: hence, the responsibility for detection of fraud and audit also rests with management. However, this does not relieve the auditor of his responsibility to provide a credible assurance on the audited entity's finances and that the responsibility for such assurance extends to the weaknesses in the internal control systems that are reviewed by him in the discharge of his professional duties.

Usually, the right to conduct an audit of fraud and corruption cases is considered to be inherent in the audit mandate of a supreme audit institution. Thus under the DPC'S Act of the C&AG of India, the entity is obliged to provide relevant information and documents sought by the C&AG as may be deemed necessary in the furtherance of discharge of audit functions that would consist of giving necessary assurance about the entity's financial accounting systems and information.

In the light of spurt in various frauds involving huge public funds including the corporate sector, there has been a growing expectation among the public that the auditors, public

auditors in particular, play a more vigilant role in the prevention of these frauds and economic crimes.

The ASOSAI guidelines therefore, recommended that SAIs actively consider a formal policy strategy for deterring fraud and corruption in the organizations covered in their audit jurisdiction. However, if an SAI feels constrained in its investigation of suspected fraud or corruption cases in the performance of its normal audit work, it should seek reinforcement of its audit mandate. This reinforcement could be in the shape of a regularity provision specifying that the SAI would be notified in all cases where fraud or corruption are suspected or reported.

SAIs agreed that they should be independent and have adequate mandates that enable them to effectively contribute to the fight against fraud and corruption. It was inter-alia agreed that where possible, SAI should:

1. Seek an adequate level of financial and operative independence and breadth of audit coverage;
2. take a more active role in evaluating the efficiency and effectiveness of financial and internal control systems and aggressively follow up on SAIs recommendations;
3. focus audit strategy more on areas and operations prone to fraud and corruption by developing effective high risk indicators for fraud;
4. establish an effective means for the public dissemination of audit reports and relevant information including, establishing good relationship with the media;
5. produce relevant audit reports that are understandable and user-friendly;
6. consider a closer cooperation and appropriate exchange of information with other national and international bodies fighting corruption;
7. intensify the exchange of experiences on fraud and corruption with other SAIs.
8. encourage the establishment of guidance for financial disclosure by public servants and monitor compliance as part of the ongoing audit process;
9. encourage the establishment of a personnel management procedures for the public service that selects, retains, and motivates honest, competent employees;

10. use the INTOSAI Code of Ethics to promote higher ethical standards and code of ethics for the public service;
11. consider the establishment of a well publicized means to receive and process information from the public on perceived irregularities; and
12. continue work regarding fraud and corruption through INTOSAI's existing committees and working groups, for example the Auditing Standards committee will consider these issues as part of developing implementation guidance as part of a broader standard frame work.

Summary:

Fraud and corruption both pose serious challenges to audit, as they seek to mislead and distort the true state of financial and non-financial affairs of the entity. Fraud awareness or recognition amongst public auditors is necessary to play a vigilant role in containing frauds by ensuring correction of system deficiencies and building up effective system controls and checks in the audited entities.

References:

1. **Contemporary Auditing- Kamal Gupta**
2. **ASOSAI Guidelines- Treatment of fraud and corruption**

Day 1 – Session III

Session Title : Categories of fraud and corruption		Session-at-a-glance	
Session Learning Objective	Key Points to be covered	Methods	Time
The participants will understand the nature of fraud and corruption and be able to apply the concepts to auditing situations.	<ul style="list-style-type: none"> ➤ KTP 1: Understand the categories of fraud ➤ KTP 2 : Understand the categories of corruption 	Lecture/Slide	5 mts
		Lecture/Slides Exercise 1.3 & Exercise 1.4	30 mts
		Lecture/Slide Exercise 1.5	30 mts
		Lecture/Slide	10 mts
Materials Required Multi Media Projector Exercise 1.3, 1.4 and 1.5 Solution to Exercise 1.3, 1.4 and 1.5 Slides			
		Total	75 mts
Notes :			

Session Title: Categories of fraud and corruption.

Session Guide: Shri

Instructor's Guide	Reference	Participants response
<p>Session Title2 : Categories of fraud and corruption</p> <p>Session Overview:</p> <p>Welcome the participants to the session.</p> <p>Explain: The significance of appreciation by auditors of different forms of fraud and factors responsible for their occurrence to be able to effectively assist managements to rectify deficiencies.</p> <p>Tell: The session will cover:</p> <ul style="list-style-type: none"> • Broad forms of fraud • Types of fraud-that are committed at the employee and management level, the various ways in which fraud is committed. Differentiate corruption from fraud and how it is interlinked with fraud. • Types of corruption prevalent in public entities. <p>Learning Objective:</p> <p>The participants will understand the nature of fraud and corruption and be able to apply the concepts to practical auditing situations.</p> <p>KTP 1: Understand the categories of fraud.</p> <p>Tell: Recall what was learnt in the previous session. Now that they know that the fraud is criminal deception involving an intentional act of deceit to deceive the other with the object to gain an advantage,</p> <p>Ask: 'What is the nature of fraud and at what level they are committed?' Note down their responses on flip chart, then have a discussion with the participants on their responses and thereafter give your opinion on screen through slides. To test their knowledge, divide them in groups and give them an exercise or two instances of fraud under(a) misappropriation of cash/assets and (b) manipulation of accounts and ask them to match with the particular category of fraud-employees and management. After the exercise is completed give them your suggested answer to check their responses.</p>	<p>Slide/lecture/5 mts</p> <p>Lecture/Slides/ Exercise 1.3 & Exercise 1.4 /30 mts.</p>	<p>Participants should know the nature and category of fraud</p>

Exercise 1.3 (Based on material supplied by Dy. Director (P & T) Nagpur)

Objective- To identify whether a fraud has occurred and how?

Accounts officer (Cash) in MTNL had issued VCC cards to Sub- Divisional Engineer off the customer service center for sale to public regularly. SDE concerned was required to remit the sale proceeds to AO(Cash). AO (Cash) had not reconciled the amount received from SDE with the value of VCC cards issued to him. At the end of the year, it was found that the SDE had not remitted Rs.3.5 lakh to A.O.Cash) and the amount was found to be missing from the records.

Do you think whether a fraud has occurred. Describe the fraud and suggest how the event was facilitated.

<p>suggested answer to check their responses.</p> <p>Show: The slide summarizing statistics collected by Association of Certified Fraud Examiners (US) that is highly revealing of the kind of frauds that take place in the real world.</p> <p>KTP 2: Understand categories of corruption</p> <p>Corruption: Refresh the participants on the definition of corruption.</p> <p>Ask: To identify the victim and beneficiary in two different situations involving misuse of public office Get the responses of the participants, note them on flip chart separately for both the situations. Then ask them to identify the difference between two. Ask them who is the victim in first situation and in the second situation? In the first situation what does the public servant do? (misuses his position and extracts bribe from citizen to perform his normal work for which he is paid for) and, in the second situation what for and under what circumstances the decision makers favor the other party? (small favor for big prize, here both are corrupt, some times the decision makers work under pressure)</p> <p>Thus we can categorise corruption in two categories Exploitative Corruption; and Collusive Corruption. (Slide). These two categories further can be termed as demand side corruption and other is supply side corruption.</p> <p>Summarise the key points and end the session.</p>	<p>Lecture/Slide/ Exercise 1.5 /30mts</p>	<p>Participants should know the nature of corruption, its' categories and sides of corruption.</p>
	<p>Lecture/slide/10mts</p>	

Exercise 1.4

ABC Ltd, is a company whose business has grown at a remarkable pace during the last three years. With increase in profits, the company also became liable to increased taxation. The managing director of the company directed to the financial officer to find means to decrease/ minimize the tax liability.

As a result, the accounts of the company were overhauled and the taxable profit was reduced.

It was found that the proportion of administrative expenses was much higher than was normally the case as compared to the previous years. On closer scrutiny, the travel expenses accounted for bulk of the increase during the year. A sizable portion was claimed as donation to a charitable trust that was created during the year. Most of the members of the Trust Board were also represented on the Board of the company and the donations were claimed as tax deductible.

The accounts reflected expenses attributable to personnel of the household of the managing director and were not on the regular payroll of the company.

A sizable amount of provisioning was done by way of reserves for bad debts that have not yet matured.

Examine whether the accounts represented a true and fair view for income tax purposes. If not, indicate why it might constitute a fraud.

Suggested solution to Exercise 1.3

Prima facie, this is a case of fraud through misappropriation of cash on the part of SDE who failed to render regular accounts and remit sale proceeds of the VCC cards to A.O. (Cash) . Had regular reconciliation been carried out by A.O.(Cash), it should have been possible to prevent or detect early the fact of misappropriation as soon as the same happened.

Suggested solution to exercise 1.4

Auditors are not concerned with actual determinations of illegality per se. At the same time, they have to be alert to unusual circumstances or factors that could trigger/motivate for fraudulent activity.

Tax auditor would need to examine the reasons for sudden drop in taxable income despite increased profitability achieved during the year.

This will involve scrutiny of all expenses including reserves provided for as well as incomes reported. Charging of personal expenses on company account is not permissible and is clearly disallowable. The tax auditor would need to probe travel expenses to ensure that these are legitimate expenses and not mixed up with personal expenses i.e incurred only for the purpose of earning income.

Also, the inclusion of names of household personnel in the payroll of the company would need to be questioned and clearly disallowed.

The provisioning of a doubtful debt that had not yet matured also needs to be investigated, unless there are specific reasons for the same.

Above all, the formation of the trust needs to be closely examined for two reasons:

- The management of the trust was not independent of the company management and therefore, more a proxy for the company rather than any public interest
- The sources of funding of the Trust would reveal whether the company retained a predominant stake in the ownership and management of the Trust.

If, on investigation, the auditor comes to the conclusion that the functioning of the Trust was severely jeopardized on account of close interdependence, the tax auditor may conclude that the formation of the Trust was a sham and a fraudulent device through misrepresentation of facts to avail improper tax deductions through disguised donations. In this case, the intended victim would be the revenue authorities and the public at large.

CHAPTER: II

Categories of fraud and corruption and factors influencing fraud and corruption.

Overview:

There is a growing expectation amongst the concerned public that auditors play a key role in the detection of frauds in view of the fact that they are responsible for attestation of the materiality of the true and fair view or the integrity of the financial statements that provide a key information resource for the various stakeholders whether shareholders, potential investors or the financiers. In the case of a statutory body, the stakeholders of the audited accounts would be the lending agencies, the public accounts committee and the taxpayer or the general public. While auditors are certainly concerned with fraud prevention and detection, auditors are, in the first instance, expected to recognize the basic forms of fraud, the ways in which these are committed, the factors and the causes responsible for the crime to be able to perform further audit investigation. This chapter covers the following issues:

- Classification of fraud and corruption;
- Types of fraud and corruption;
- Factors influencing fraud and corruption;
- Causes- motivational and organizational- of occurrence of fraud and corruption.

Learning objective:

Given the idea about the categories and types of fraud and corruption, various factors influencing fraud and corruption and root causes of occurrence of fraud and corruption, the participants will be able to assess the organization environment in terms of susceptibility to fraud and understand the various ways in which frauds take place.

KTP 1: Understanding basic forms of fraud

Fraud involves deliberate misstatement of fact(s) that misleads the party to whom the same is intended.

Studies have revealed that broadly, fraud and fraudulent financial reporting is committed at two levels are

- Involving manipulation of accounts and records, falsification, suppression of material facts or wrong application of accounting principles. In most cases, these practices are resorted by the management staff or those charged with corporate governance with the object of obtaining finance under false pretences or concealing a material worsening of the entity's accounts or for covering up an unauthorized or illegal use of funds. These could also involve fraudulent financial reporting- whether through slush funds, shell companies or kickback schemes.
- Involving misappropriation of cash or embezzlement and assets such as goods or other valuable documents, etc. These are often committed at employee level.

Some statistics about financial reporting fraud collected by the Association of Certified Fraud Examiners (US) are of special interest in this context:

- Fraud and abuse costs employers in the U.S. an average of \$9 per employee and costs U.S. organizations more than \$400 billion annually.
- Losses caused by **managers are four times** those caused by employees.
- Median losses caused by **executives are 16 times** those of their employees
- Nearly 75% of the offences were committed by the male staff.
- The most costly abuses occurred in organizations with less than 100 employees.

The methods employed in the abuse were asset misappropriation, fraudulent statements and bribery and corruption.

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. Management fraud can be said to be a zero-sum game as the gains made by the managers are equivalent to the losses of others involved in it. According to the Institute of Internal Auditors " **Fraud encompasses an array of irregularities and illegal acts characterized by intentional deception. It can be perpetrated for the benefit of or to the detriment of the entity, and by persons outside as well as inside the entity**". It is evident that management fraud causes the most severe damage to society.

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 – one is to deceive financial statement users by fraudulent financial reporting such as manipulation, falsification or alteration of accounting records or supporting documents from which the financial statements are prepared, or intentional omission from the financial statements of events, transactions or other significant information, or intentional misapplication of accounting principles relating to measurement, recognition, classification, presentation or disclosure. Second is to conceal the fact by false or misleading records or documents mostly related to misappropriation of assets.

The above categories of fraud further can be divided in two parts – one is direct fraud and another is indirect fraud. Direct frauds are those that are apparent from the records itself. For example A company treasurer died and his company later found that \$ 4.9 million of funds were missing. Indirect fraud requires investigation / probe to establish and is time consuming. For example A purchasing executive signed for inferior products because the manufacturer was giving him the kickbacks.

Some of the common **Modus Operandi** normally used for committing fraud may be -

Category	Modus operandi
Misappropriation of cash or embezzlement of cash	Receipts side of cash book
	<ol style="list-style-type: none"> Omitting to enter cash which has been received; Recording less amount of cash than what has actually been received; Writing a lower amount on the counterfoils and entering full amount on the receipt to be issued Accounting for fictitious payment; Recording more payment than what has actually been paid; Payments side of cash book <ul style="list-style-type: none"> False charging of personal expenses Double payments against one purchase transaction Inclusion of dummy workers in wage bill False credit to various personal accounts to be withdrawn later through fictitious or duplicate invoices or by

Other forms of cash embezzlement	<p>showing sales returns or through suppression of suppliers' on account rebates, discounts, etc</p> <ul style="list-style-type: none"> • Amount collected from one customer is misappropriated and the amount received from another customer is credited to the account of the former customer to the extent of amount misappropriated. The process is cycled. This is also known as teeming and lading. • Depositing funds in an account at one branch by using the bank's inter branch account settlement process and withdrawing funds from a different branch; the account imbalance is hidden by making other fraudulent transfers later on • Using correction entries in bank account to embezzle money from accounts, transferring funds other accounts to cover the shortages. • Kiting- when a bank allows withdrawals to be made on cheques but for which the actual funds have not yet been collected from the bank on which the cheques are drawn. • Lapping occurs when a person steals cash from payment of accounts receivable, and continuously uses cash from other payments of accounts receivables to conceal the initial theft ('laps' two consecutive accounts
Misappropriation of goods and services	<ul style="list-style-type: none"> a) Omitting to enter goods which have been received; b) Recording less quantity of goods than what has actually been received; c) Recording excess issue of quantity than what has been actually issued; d) Manipulation falsification or alteration of records or documents. e) Procurement of low quality goods <p>Hiring services at high prices</p>
Manipulation of accounts	<ul style="list-style-type: none"> • Under-valuation or over-valuation of stock • Showing fictitious purchase or sale • Wrong allocation of revenue and

to attack a problem is to understand its nature and the underlying causes responsible for the same. Corruption can be classified as being *Exploitative and Collusive*.

Exploitative corruption occurs when a public servant misuses his position to make the citizen who interacts with his office a victim and extracts bribes to perform his normal work, which he is paid for. In all most all the offices dealing with the public we find corruption right at the cutting edge level because many a time the victim is helpless.

Collusive corruption occurs when there is collusion between decision makers and the beneficiaries. This could be between the corrupt businessmen and corrupt politicians, between corrupt businessmen and corrupt bureaucrats or all three. Exploitative Corruption is regarded as demand side of corruption. The public servants are on the demand side of corruption and has been attracting the attention of the media. Collusive corruption is regarded as supply side of corruption where thundering silence is maintained because it offers a good price and is viewed from the supply side. In monetary terms, it is a small price to pay for a bigger benefit. In most cases the transactions may not be reflected in the accounts or may be fraudulently reported and the unfortunate victim is the public at large and the taxpayer.

Fraud and corruption are typically perpetrated in the following ways:

- **Conflict of Interest** occurs when a person or organization acts on behalf of another individual or organization and has a hidden bias or self-interest in a transaction that is potentially adverse to the interests of the organization being represented and the hidden bias or interest is not disclosed to the organization being represented. When such a biased action results in economic or financial loss to the organization or the individual on whose behalf the person is acting, then fraud has occurred.

Conflict of interest can exist on its own, or can be part of bribery.

Conflict of interest can also occur when an organization has a hidden interest or benefit from the outcome of an event or transaction. Eg. If govt. officials, acting on behalf of the government, either alone or in conspiracy with providers of services obtain public funds and use these for purposes other than those intended or authorized.

	<p>capital expenditure</p> <ul style="list-style-type: none"> • Recording next year's revenue as income for the current period or not recording revenue for the current period as income for the current period • Showing more profit than what is actually earned or showing less profit than what is actually earned through inflated expenses to evade tax liability • Over or under-invoicing • Keeping books open after close of accounting period in order to record sales transactions after the past period • Provision of discounts, rights of return, extended credit terms of customers to induce intake than normal.
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Fraud is committed either by individual or in collusion with third parties, by using forged documents, by deliberate failure to record genuine transactions or by intentional misrepresentations for personal gain. Fraud at management side is committed normally to get more commission on profit, to create more confidence and to attract the attention of the investors in issues of shares of the company and/ or to obtain further credit facility from the banker or financial institutions or to suppress true income of the company to evade tax liability or simply the availability of opportunities to make excess or windfall profits. Frauds could also be perpetrated by disgruntled employees in collusion with competitors to cause economic or financial damage to their employers. Computer crimes are committed for illicit personal gain and to destroy the files and data security.

KTP-2: Understanding forms of corruption

Corruption has been acknowledged as the most insidious assault on both corporate governance and strikes at the roots of financial and public accountability. The word corruption refers to lack of integrity or an act of bribery. Acceptance of bribes and abuse of discretion or office in the discharge of public duties by a public servant for securing private benefits at the expense of public exchequer is a common phenomenon in many countries of SAIs. The ASOSAI has expressed a serious concern for fighting fraud and corruption through providing specific guidelines to SAIs for strengthening audit procedures within to detect fraud and corruption in high places. As always, the best way

Thus, conflict of interest may be characterised by absence of arm's length transaction or related-party transactions or serving two masters that results in gain to one party at the expense of the other.

What may initially start in the interests of the organisation may soon be done in self-interest, too. The fraud at Enron, for eg. started as fraudulent financial reporting and soon led to conflicts of interest.

- **Phantom Contractor** is a non-existent company whose invoice is submitted for payment by a person involved in the purchase process.
- **Purchases for Personal Use.** A person may purchase items intended for personal use or may make excess purchases of items needed, some of which are then diverted to personal use.
- **Split Purchases.** Contracts are split into two or more segments to circumvent the procurement authority limitations, and thus to avoid competitive bidding. This may involve bribery from the contractor to a person of the other party..
- **Collusive Bidding, Price Fixing for Bid Rigging.** Groups of prospective contractors for a contract form an agreement or arrangement, to eliminate or limit competition. This agreement may also involve bribery.
- **Progress Payment Fraud.** The contractor requests progress payments based on falsified information submitted to the other party.
- **Over or Under Invoicing.** Occurs when there is deliberate misstatement of the invoice value as compared with goods or services received or supplied.
- **Extortion** is the use of authority to secure unlawful pecuniary gain or advantage.
- **Nepotism and Favoritism** unlawful use of public office to favour relatives and friends.
- **Tax or duty evasion** through false representation of facts or claims as regards true income or dutiable goods could be both fraud and bribery if there is prima- facie evidence of negligence on the part of the govt. official
- **Computer Fraud** is any fraudulent behaviour connected with computerization by which a person intends to gain a dishonest advantage. For instance, salami –slicing is a computer fraud where fractions of interest calculations are transferred to a personal account.

KTP 3: Factors influencing fraud and corruption:

Conduct Rules prescribe restrictions on the conduct of a government servant. He should maintain absolute integrity, devotion to duty and do nothing that is unbecoming of a government servant. In every day life, a public servant abuses his authority in order to obtain extra money either by foul play in official dealing or from the public by unfair means. The factors that normally influence fraud and corruption are of two types – motivational and organizational. The motivational factors are mostly related to individual and organizational factors to the total environment. Motivation, perceived opportunity and rationalisation are the elements that generally underlie the acts of fraud and corruption.

Self-motivational factors

1. **Economic motivation** – financial need or gain is the most common motivation for fraud and corruption. Often, persons convicted of fraud and corruption complain that they had unbearable financial problems/stress for which there was no legitimate recourse.
2. **Greed** – Enjoyment of better lifestyle provokes a person to commit fraud and corruption. Persons with power and authority often commit fraud and corruption because they are motivated by greed and also believe that they will not be prosecuted even if the fraud is detected.
3. **Prestige or recognition** – Persons may feel they deserve more prestige or more recognition. These persons are often motivated by jealousy, revenge, anger or pride. They often believe that they are superior to others that they are shrewd enough to confound and confuse others and can commit fraud and corruption without being discovered or detected

Moral superiority –Persons may also be motivated by a cause or value that they feel are morally superior to those of the victim, or the government in this case.

Organizational Factors:

The organizational environment and its perceptions play a major causative role in perpetration of fraud and corruption. The environment of an organization creates an opportunity to perpetrator to commit fraud and corruption.

1. Where management is perceived as insensitive, insecure, impulsive or too strict, ill-treats employees and judges performance either on short term results or without considering operational constraints, the disgruntlement in the employee is likely to result in instances of fraud and corruption.
2. System and procedures adopted in organizations and organizational policies are particularly important. An organization in which the corporate policies are unclear, there is inadequate internal control, excessive regulations, inadequate accountability or history of programme abuse is likely to have more instances of fraud and corruption.
3. Poor management structure and policies are indicated by a high turn over of employees, absenteeism, poor documentation, low awareness of regulatory requirement and lack of transparency in reward systems.
4. Very often the perpetrator of fraud and corruption rationalizes his actions with some kind of justification. For instance an employee accused of fraud and corruption is likely to rationalize his action by saying or believing that his low pay justifies the action or since everybody is doing that he is also well within his right to do it; while a contractor could justify his acts of fraud and corruption as a cost of doing business or problems of securing contract from a government entity.

An understanding of the organizational environment will enable an auditor to assess whether there is a higher risk of fraud and corruption in the entity and make suitable changes in the audit plan accordingly.

Fraud involves motivation to commit fraud and a perceived opportunity to do so. Individuals might be motivated to misappropriate assets, for example because the individuals are living beyond their means. Fraudulent financial reporting may be committed 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. 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.

Summary

Fraud can be committed by employees or management with or without collusion with third parties to the detriment of an organization or individual to obtain illegal or private gain. Auditors have to be well versed with the ways in which fraud can be committed and should have a sound appreciation of the motivational and organizational environment factors responsible for its occurrence.

References:

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CHAPTER: III

How to identify potential fraud and high risk areas

Overview: Having dealt with the characteristics of fraud and corruption and the ways in which these are committed, we now explore the possibilities or the circumstances under which fraud is expected to occur. The following session deals with various fraud indicators in terms of business and organization environment, unusual transactions either on the part of employees or management or both.

Learning objective: Given the key indicators of fraud and corruption in terms of macro and micro level of the entity, and a knowledge of the sensitive and risk prone areas, the participants will be able to independently undertake a filtration process for identification of fraud risk areas.

KTP.1: Understanding the indicators of fraud and corruption.

Fraud now-a-days is a very common phenomena. It is an offence that is often shrouded in ambiguity and it is sometimes difficult even to determine whether or not fraud has actually been committed. Only the symptoms of fraud may possibly alert the management or the auditors to the wrongdoing though many such fraud symptoms may go unnoticed and in some cases, signals that are recognized are not vigorously pursued. As explained in previous chapters, the intent in a financial fraud is to divert or misdirect assets or information while preventing disclosure. These two requirements cause a trail of irregularities to be left behind and may serve to alert the astute and determined manager, accountant or investigator. The two main areas of financial fraud already reiterated are:

- Manipulation of the financial statements by those charged with governance either to meet business and financial expectations, ward off a competitor or to obtain an indirect personal gain such as keeping one's job.
- Abstracting of assets

As part of their professional engagement, the auditors should ask certain key questions in the early phase of the investigation to determine potential risk in terms of manipulation of financial or accounting records and abstraction of cash.

Risk in terms of manipulation of the financial statements: The study or knowledge of the entity's business and business environment and industry conditions is key to understanding whether the risk of manipulation of financial statements or accounts of the entity is high or low. If the answer is positive in the following areas, the risk in terms of material misstatement is fairly high:

- Have the entity's operations deteriorated recently?
- Do present business conditions indicate potential future difficulties for the entity?
- Is the entity likely to have difficulty in meeting its financial obligations as they become due?
- Is there any intention either to liquidate or to curtail significantly the scale of operations?
- Does the entity propose to raise substantial additional finance in the near future?
- Is there likely to be a contest for control of the entity in the near future?
- Is there likely to be a change of control of the entity in the near future?
- Is more than the usual significance likely to be attached to financial statements?

(b) Risk in terms of abstraction of Assets/Cash:

As in the case of (a), if the answer is 'yes' in the following case, the risk in terms of embezzlement or misappropriation of cash may be higher than otherwise.

- Are excessive discretionary powers granted either to new employees or to employees of comparatively low caliber?
- Are wage levels below the average for either the locality or the industry?
- Is there unexplained extravagance by any employees (especially those who are in key positions and have custody of assets)?
- Does any employee refuse to take his due holiday (which may be because he wishes to avoid having his duties subjected to the independent scrutiny of a relief employee)?
- Are any employees either excessively uncooperative or antagonistic towards the auditors or are they excessively cooperative?
- Does a single individual unaccountably dominate the activities of any department, branch or activity?
- Are accounting records consistently written up a long time after the transactions have taken place?

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- vii) Does the sole source procurement system exist?
- viii) Does the employee often visit a resort?
- ix) Does the employee engage in gambling?
- x) Is there any sudden change in the employee's behaviour?
- xi) Is the life style of the employee above the level of his source of income?
- xii) Are the things done with disregards of rules/procedure/system?

Corruption has progressively increased both horizontally and vertically. It may not be possible to root out corruption completely at all levels, but certainly it is possible to roll it down to tolerable limits. Broadly speaking, there are four categories of public servants:

- i) Honest and Efficient
- ii) Honest and inefficient
- iii) Dishonest and efficient
- iv) Dishonest and inefficient.

A strict watch is required over the third category of 'Dishonest and efficient' employees.

Having evaluated the business environment, we can look for further fraud indicators classifiable as symptoms attributable to management and to the employees or both. Some of these indicators are readily recognizable as anomalies in terms of unusual trends, unusual practices, strange events, or unusual employee behaviour.

Management's fraud symptoms: When pressure, opportunity and rationalization come together, fraud occurs. Since most people have pressures they rationalize their activities. When internal controls are significantly absent or over-ridden, an opportunity to commit fraud is facilitated. Weak controls could include lack of segregation of duties, lack of independent checks, lack of proper documentation and record-keeping and an inadequate accounting system.

The following are some risk indicators of financial reporting fraud calling for further investigation:

- Excessive changes in accounting policies or disregard for Generally Accepted Accounting Principles (GAAP)
- Refusal/failure to allow an independent audit or subtle attempts to direct the audit may indicate an attempt to hide problems
- Excessive destruction of controlled documents or missing critical documents

- Are filing systems such that, for no apparent reason, documents are difficult to retrieve?

A positive answer to any of these questions does not necessarily mean that fraud is taking place. However, a positive answer does indicate that auditors need to consider carrying out further audit tests to overcome the inherent risks. The decision to extend tests will depend upon the combination of various factors and will require consultation between the team members and senior responsible officer.

No matter how sophisticated auditing techniques become, there can never be any effective substitute for verification by means of **direct inspection**, and it is worth noting that many notorious frauds might have come to light much earlier had the auditors concerned paid more attention to this rather obvious point.

The case of **McKesson and Robbins Inc swindle** arose in the U.S. during the 1930s from a conspiracy between the four brothers who headed this large pharmaceutical company, to make the company appear to be far more profitable and financially more substantial than it really was. This was achieved by fabricating documentation which purported to reflect transactions that had, in fact, never taken place. The illusion was therefore created of a vast amount of trading activity which was entirely fictitious, which the auditors meticulously authenticated via the forged documentation. They were regarded by the U.S. SEC as negligent in the execution of their duties in view of their failure(a) to confirm the stock levels by direct inspection and (b) to confirm the level of debtors by direct circularization. These assets were overstated by no less than \$25 million. Following this case, these two procedures became mandatory for the auditors in the U.S.

Corruption : A 'yes' answer of the following questions may indicate risk of corruption.

- i) Are the right things being delayed?
- ii) Are the wrong things being quickly done?
- iii) Is there a system to get the thing done through mediator?
- iv) Are the excessive powers given to one and the same person?
- v) Does the officer exercise discretionary powers injudiciously?
- vi) Is the pressure being brought on the decision makers?

- Excessive number of photocopies of invoices in files may be due to altered invoices in which case both internal and external copies of invoices should be compared.
- Excessive cash transactions are a poor business practice and should lead to further enquiry.
- Excessive bad debt write-offs may indicate a scheme for an employee to split kickbacks with a co-conspirator on the outside.
- Sale of assets for less than adequate consideration may indicate a sham transaction with no economic substance. This issue is very important in tax frauds.
- Assets are sold but possession is maintained. Whether there is a genuine buyer-seller relationship?
- Failure to reconcile bank statements.
- Excessive or unpaid loans to non-critical employees need careful scrutiny for these may not be loans. In many tax evasion cases, loan repayment is important to gauge whether these were sham loans or genuine.
- Presence of entities that are off the book and transactions with related parties not disclosed.
- Growth in revenue and income without corresponding growth in cash flow
- Earnings trends that do not reflect the general trend of earnings in the industry.

Employees' fraud Symptoms

Excessive voids: Voided sales slips could mean that the sale was rung up, the payment diverted to the use of the perpetrator, and the sales slip subsequently voided to cover the theft.

Excessive Credit Memos: Similar to excessive voids, this technique can be used to cover the theft of cash. A credit memo to a phony customer is written out, and the cash is taken to make total cash balance.

Increasing Reconciling Items: Stolen deposits, or bogus cheques written, are frequently not removed, or covered, from the reconciliation. Hence, over a period of time, the reconciling items tend to increase.

General Ledger Out-of-Balance: When funds, merchandise, or assets are stolen and not covered by a fictitious entry, the general ledger will be out of balance. An inventory of the merchandise or cash is needed to confirm the existence of the missing assets.

Adjustments to Receivable or Payable: In cases where customer payments are misappropriated, adjustments to receivables can be made to cover shortage. Where payables are adjusted, the perpetrator can use a phony billing scheme to convert cash to his or her own use.

Excess Purchases: Excess purchases can be used to cover fraud in two ways:

- i) Fictitious purchases are used to convert funds
- ii) Excessive purchases may indicate a possible payoff of purchasing agent.

Duplicate Payments: Duplicate payments are sometimes converted to the use of an employee. The employee may notice the duplicate payment, then he or she may prepare a phony endorsement of the cheque.

Ghost Employees: Ghost employee schemes are frequently uncovered when an auditor, fraud examiner, or other individual distributes pay cheques to employees. Missing or otherwise unaccounted for employees could indicate the existence of a ghost employee scheme.

Employee Expense Accounts: Employees frequently conceal fraud in their individual expense account reimbursements. These reimbursements should be scrutinized for reasonableness and trends, especially in the area of cash transactions on the expense account.

Inventory Shortages: Normal shrinkage over a period of time can be computed through historical analysis. Excessive shrinkage could explain a host of fraudulent activity, from embezzlement to theft of inventory.

Increased Scrap : In the manufacturing process, an increased amount of scrap could indicate a scheme to steal and resell this material. Scrap is a favorite target of embezzlers because it is usually subject to less scrutiny than regular inventory.

Large Payments to Individuals: Excessively large payments to individuals may indicate instances of fraudulent disbursement.

Employees' Overtime : Employees being paid for overtime hours not worked by altering time sheets before or after management approval.

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Write-off of Accounts Receivable: Comparing the write-off of receivables by customers may lead to information indicating that the employee has absconded with customer payments.

Post Office Boxes as Shipping Addresses: In instances where merchandise is shipped to a post office box, this may indicate that an employee is shipping to a bogus purchaser.

Behavioural symptoms or anomalies

Management

Some of the common elements noticeable in management induced profits are:

- Anomalies in the accountability of the manager for his performance
- Belief on the part of the official/manager that they will not be prosecuted
- Visible change in the lifestyle of the manager/official(s), proving personal use of the fraudulent gains
- Ability of the perpetrators to exercise significant control on the fraudulent activity.
- Usage of the services of middlemen to a significant extent.

Employees

- The perpetrator will often display unusual behaviour, that when taken as a whole is a strong indicator of fraud.
- The fraudster may not ever take a vacation or call in sick in fear of being caught. He or she may not assign out work even when overloaded.
- Other symptom may be changes in behavior such as increased drinking, smoking, defensiveness, and unusual irritability and suspiciousness.

Tips and Complaints: Fraud consists of three elements, theft act, concealment and conversion. Fraud can be detected at all the three stages. Auditors have to rely on tips and complaints from others. Frequently tips and complaints will be received which indicate that a fraudulent action is going on. Complaints have been known to be some of the best sources of fraud and should be taken seriously. Although all too often, the motives of the complainant may be suspect, the allegations usually have merit that warrant further investigation.

Often, there are individual who help the person reach or realize personal ambitions within or without the organization and may not gain anything for themselves, but later become whistle-blowers. These also should receive due attention of the auditors especially involving cases of corruption.

KTP 3: Identification of additional risk indicators- Red Flags

In addition to the above, the auditors are expected to recognize risk indicators or sensitive areas evidenced by financial ratios, changes in personnel, or other anomalous trends such as:

Insufficient Working Capital : This may indicate such problems as over expansion, decrease in revenues, transfer of funds to other companies, insufficient credit, and excessive expenditures. The auditor should be on the lookout for diversions of funds to personal use through such methods as unrecorded sales and falsified expenditures.

Rapid Turnover in Financial Positions: Loss of key accounting and other financial personnel may signify inadequate performance and result in weaknesses in internal control.

Use of Sole-Source Procurement: Good procurement practices encourage competition to assure that the organization is obtaining the required materials or equipments at the best price. Sole-source procurement, if not adequately justified, indicates potential favoritism or kickbacks.

Excessive Travel Costs: In reviewing the travel, the auditor is on the lookout for unauthorized or personal trips, entertainment, costs in excess of those allowed by the organization, and unsupported travel and other expenses.

Transfer of Funds between Affiliated Companies or Divisions: A pattern of transfer of funds between companies or divisions may indicate unauthorized borrowings, cover up of shortages, or inadequate control over funds.

Change in Outside Auditors: In some instances the change in outside auditors may indicate differences of opinion as to the appropriate method of handling certain

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operations. There may be a reluctance on the part of management to disclose problems or events that are significant.

Excessive Consultant Costs or Legal Fees: These may be indicative of abuses in having services performed on the outside, favoritism and undisclosed problems within the organization which require extensive legal work.

Downward Trends in Key Financial Figures and Ratios : The use of ratio, change, and trend analysis may indicate problems in certain areas which require follow-up. Downward trends may be symptomatic of significant losses, diversion of funds and resources and inadequate control over operations.

Reported Conflicts of Interest : The auditor should be aware of any rumors or allegations of conflicts of interest pertaining to outside employment, vendor arrangements, and relationship between employees. Company transactions with officer's or employees should be carefully scrutinized. Use of management fronts, such as interlocking directorates, alter egos, special purpose entities, etc. are red flags as these are used for concealing true ownership control and may conceal organisational conflicts of interest.

Unexplained Shortages in Physical Assets: Inadequate physical shortage may lead to pilfering or other diversion of assets. Shortages in assets should be analyzed carefully to determine their cause.

Decreases in Performance : One division of a company may be performing less adequately than other division. In addition, there may be a decrease in performance from prior experience. The reasons should be determined for indication of poor management or possible wrongdoing.

Management Control by Few Individuals: Domination of an organization by one or a few individuals may provide the opportunity for diversion of assets or other manipulations.

Collection Difficulties : Problems in collecting on receivables should be analyzed to determine whether there are fictitious sales or diversion of funds received from collections.

RTW Nagpur *Multiple Bank Accounts:* The use of a large number of bank accounts, in excess of what is normally needed, indicates possible diversions of funds or cover-up of illegal transactions. Transfers among these account, and to personal bank accounts, should be reviewed carefully.

Late Reports : Reports may be consistently delayed so that the preparer can manipulate data to cover up fraudulent actions.

Copies Used for Payment to Creditors: Rather than making payments based on original invoices, copies may be used to hide duplicate payments and kickbacks.

Shortages, Overages and Out-of-Balance Conditions: These may be symptoms of a larger problem, and explanation should be obtained as to the variances.

Cheques or Other Documents Written in Even Amounts: For example, a cheque might read Rs.10,000 or Rs.3,500 when it might normally be expected to be in odd amounts, such as Rs.10,261 or Rs. 3532.

Summary: Auditors need to understand and identify potential fraud risk areas emanating from the organization environment, business conditions, other varied indicators of fraud attributable to management and behavioural characteristics of employees to be able to effectively determine the appropriate areas of audit probe for maximum results.

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CHAPTER : IV

Internal Control and Risk Assessment

Overview; We have seen in previous chapters that the design of internal control and procedures is a major determinant of fraud risk in an entity. The following chapter seeks to highlight the importance of internal control systems, the limitations of internal controls and their significance in the performance of risk assessment including fraud risk by an auditor. The chapter also deals with different kinds of risk embedded in audit risk and determining materiality in risk with reference to various business or entity functions.

Learning Objective: Given the specific standards of individual components of internal control system and security measures and the prevailing system of different areas of operation of an entity, the participants will be able to identify and evaluate the performance of the internal control system and assess the audit risk to select appropriate audit test and procedure.

KTP. 1. Understanding components of Internal Control System.

Internal control is an essential prerequisite for efficient and effective management of an organization. Risk is a component of internal control. It plays an important role in determining the appropriate control procedures the management has to put in place. In fact, in much of fraudulent financial reporting that also involved corruption, experience has shown that this is occasioned by deficiencies in corporate governance and internal control. In fact a study undertaken by the Committee of Sponsoring Organisations in the U.S. revealed the following:

- Typical financial reporting fraud schemes involved overstatement of revenues and assets and in more than half the cases, revenues were recorded prematurely or fictitiously and about half of the fraud involved overstating assets by understating allowances for receivables, overstating the value of tangible assets and/or recording non-existent assets.
- Most frauds in financial companies reporting among public companies was committed by smaller corporations, with well below \$100million in assets.

- Top senior executives were frequently involved. In 83% of the cases, the CEO, the CFO or both were named as being associated with the financial statement fraud.
- The boards of directors of these companies were dominated by insiders and directors with significant equity ownership and little experience of serving on the boards of other companies.
- Most audit committees met only about once a year or the company had no committee at all.
- Audit firms of all sizes were associated with companies committing fraudulent reporting fraud.
- Some companies committing fraud were experiencing net losses or were close to break-even positions before the fraud. Pressures of financial strain may have provided incentives for some companies.

The above instances of irregularities arose significantly on account of **poor internal systems approach or on account of the controls being overridden by the management.**

With the enactment of Sarbanes-Oxley Act in the U.S. laying down stringent disclosure requirements and code of ethics among principal financial officers of listed companies, a recent survey conducted by Price water house coopers of 136 CFOs , has revealed that over 90% have reported changes in controls and compliance practices as a result of the legislation.

In view of the centrality of internal control to determining audit risk, especially in regard to fraud, it is worth considering the principles of control more closely. Standard Audit Practice (6) defines thus:

Internal Control System” means all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management’s objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management’s policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records and the timely preparation of reliable financial information.

Internal controls consist of an entire process instituted by the senior management designed to provide reasonable assurance regarding

- (a) efficiency of operations,
- (b) the reliability of financial reporting and
- (c) compliance with applicable laws and regulations.

Basic Postulate of SAI India

One of the basic postulates of auditing standards as laid down in SAI India's auditing standards is that the existence of an adequate system of internal control minimizes the risk of errors and irregularities. It is the responsibility of audited entity to develop adequate internal control systems to protect its resources. It is also obliged to ensure that controls are in place and functioning to help ensure that applicable statutes and regulations are complied with and decision-making is guided by propriety and prudence. This does not relieve the auditor from the responsibility of overseeing the effectiveness of the internal control process in the audited entity and suggesting remedial measures, where appropriate.

Scope and Coverage

While the scope of internal controls permeates all aspects of the organization, in essence, it comprises:

- (a) control environment; and
- (b) the control procedures

The **control environment** is what sets the tone of an organization and provides discipline and structure, it includes the integrity and competence of the entity's personnel: management's philosophy and operating style and the way authority and powers have been delegated.

- a) the entity's organizational structure and the methods of assigning authority and responsibility (including segregation of duties and supervisory functions);
- b) the functions of the board of directors and its committees/governing body
- c) management's philosophy and operating style
- d) management's control system including internal audit function, personnel policies and procedures.

Control procedures means those policies and procedures in addition to the control environment which management has established to achieve the entity's specific objectives.

RTI Nagpur Internal control procedures may include;

- Reporting and reviewing reconciliation
- Checking the arithmetical accuracy of records
- Controlling applications and environment of computer information systems by establishing controls over (a) changes to computer program (b) access to data files
- Maintaining and reviewing control accounts and related subsidiary ledgers
- Approving and controlling of documents
- Comparing internal data with external sources of information.
- Comparing the results of physical verification of cash, fixed assets, investment and inventory with corresponding accounting records
- Restricting direct access to assets, records and information
- Comparing and analyzing financial results with the corresponding budgeted figures.

The essence of internal control lies in the separation of three functions – (1) Authorization (2) Custody and (3) Recording. It is, of course, the responsibility of management to devise and establish the plan of the organization and to supervise its day-to-day operation.

Function	Entailing
Authorization	The initiation of contractual obligations on company's behalf or The sanction by a competent authority for a particular transaction in a govt. environment
Custody	The handling of assets involved in the transaction..
Recording	The creation of documentary evidence of the transaction and its entries in the accounting records.

Notes: (a) Adequate management supervision over all the three aspects of activity is essential at all times.

(b) In a well organized business the adequacy of internal control will be evidenced in a clear and up-to-date plan of the organization.

Inherent Limitations on the effectiveness of internal control:

No internal control system, however elaborate, can by itself guarantee efficient administration and the completeness and accuracy of the records; nor can it be proof

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against fraudulent collusion, especially on the part of those holding positions of authority or trust

Internal controls depending on segregation of duties can be avoided by collusion.

- Authorization controls can be abused by the person in whom the authority is vested.
- Management is frequently in a position to override controls which it has itself set up.
- Human error due to errors of judgment or interpretation, to misunderstanding, carelessness, fatigue or distraction may undermine the effective operation of internal control
- Controls prescribed may not keep pace with changes in conditions
- Most controls are directed at transactions of usual nature. Therefore transactions of unusual nature might escape being subjected to rigorous control.

KTP: 2 Assessment and evaluation of Internal control system.

An important INTOSAI guidance and one that is also postulated under SAI India is that the auditor should assess the extent of reliance that might be placed on internal controls, including internal audit arrangements.

The auditor's objective in evaluating and testing internal controls is to determine the degree of reliance which he may place on the information contained in the accounting records. If he obtains reasonable assurance by means of completeness and accuracy of the accounting records and the validity of entries therein, he may limit the extent of his substantive test. Because of the inherent limitations in even the most effective internal control system, it will not be possible for the auditor to rely solely on its operation as basis for his opinion on the financial statements. In some entities, the auditor may be unable to determine whether all the transactions have been reflected in the accounting records unless there are effective internal controls.

Procedures: Audit procedure in relation to internal controls.

1. Ascertain and examine the internal control system and make a preliminary evaluation of the effectiveness of its component controls and to decide the extent of his reliance thereon. This can be tested by tracing one or two transactions from the accounting system.

2. Study the documentation designed by the auditee such as organizational chart , job descriptions with their authorities and responsibilities, flow chart, procedure manual. Such documentation can take a variety of forms but might be based on questions asking either;
 - (a) whether controls exist which meet specified overall control objectives; or
 - (b) whether there are controls which prevent or detect particular specified errors or omissions.

Where this preliminary evaluation indicates that there are controls that meet the objective that the auditor has identified, he should design and carry out compliance tests if he wishes to rely on them. Where, however, the preliminary evaluation discloses weaknesses in, or the absence of, internal controls, such that material error or omission could arise in the accounting records or financial statements, the auditor will move directly to designing and carrying out substantive tests.

Compliance tests:

The auditor should undertake compliance procedure in order to find out whether or not the controls on which he intends to rely based on his review of the system have been effectively complied with in practice throughout the period. This can be done by selecting representative samples from different categories of transactions and examining them in depth, especially with regard to the procedural and control aspects. Thus, an auditor may select a few purchase invoices at random and examine all the related documents right from the purchase requisition slip to the payment to the supplier. At each stage the auditor should see whether the procedures and controls have been followed as prescribed and whether the transaction has taken place as stipulated in the flow chart or in the procedure manual. The purpose of compliance procedures is to provide reasonable assurance that internal controls are being applied as prescribed. Compliance procedures are intended to provide evidence to the auditor about the following assertions.

- (a) Existence : that the internal control exists.
- (b) Effectiveness: that the internal control is operating effectively.
- (c) Continuity: that the internal control has so operated throughout the period of intended reliance.

Reliance on Internal Audit: Internal audit is an element of the internal control system set up by management. The extent to which the external auditor is able to take account of

the work of internal auditor will depend on his assessment of the effectiveness of the internal audit function. In making this assessment, the external auditor will be concerned with.

- (a) the degree of independence of the internal auditor from those whose responsibilities he is reviewing;
- (b) the number of suitably qualified and experienced staff employed in the internal audit function;
- (c) the scope, extent, direction and timing of the tests made by the internal auditor;
- (d) the evidence available of the work done by the internal auditor and of the review of that work;
- (e) the extent to which management takes action based upon the reports of internal audit function.

If the relevant internal audit work has been carried out effectively, the external auditor may be able to reduce the level of his tests.

Reporting to Management on Internal Controls: It is important that the auditor should report as soon as practicable, significant weaknesses in internal controls that come to his attention during the course of an audit to an appropriately senior level management of the entity. Such report should indicate that the weaknesses notified are only those that have come to the attention of the auditor during the course of his normal audit work and are not necessarily all the weaknesses that may exist.

The fact that the auditor reports weaknesses in internal controls to management does not absolve:

- (a) *management from its responsibility for the maintenance of an adequate internal control system; or*
- (b) *the auditor from the need to consider the effect of such weaknesses on the extent of his audit work and on his audit opinion.*

Types of internal controls: Following is a description of some of the types of controls on which the auditor may seek to place some degree of reliance.

- (a) **Organization:** There should be a plan of organization, defining and allocating responsibilities and identifying lines of reporting for all aspects of the entity's

operations including controls. The delegation of authority and responsibility should be clearly specified.

- (b) **Segregation of duties:** Segregation of duties reduces the risk of intentional manipulation or error and increases the element of checking. Functions that should be separated include those of authorization, execution, custody, recording and, in the case of a computer-based accounting system, systems development and daily operations.
- (c) **Physical:** Mainly concerned with the custody of assets and involve procedures and security measures designed to ensure that access to assets is limited to authorized personnel. This includes both direct access and indirect access via documentation. These controls assume importance in the case of valuable, portable, exchangeable or desirable assets.
- (d) **Authorization and approval:** All transactions should require authorization at an appropriate level of management. The limits of these authorizations should be specified.
- (e) **Arithmetical and accounting:** Transactions to be recorded and processed have been authorized, that they are all included and that they are correctly recorded and accurately processed. Such controls include checking the arithmetical accuracy of the records, the maintenance and checking of totals, reconciliation, control accounts and trial balances, and accounting for documents.
- (f) **Personnel:** There should be procedures to ensure that personnel have capabilities commensurate with their responsibilities. Inevitably, the proper functioning of any system depends on the competence and integrity of those operating it. The qualifications, selection and training as well as the innate personal characteristics of the personnel involved are important features to be considered in setting up any control system.
- (g) **Supervision:** Any system of internal control should include the supervision by responsible officials of day-to-day transactions and the recording thereof.
- (h) **Management:** There should be overall supervisory control of the management over the accounts, budgets, internal audit function and any other special review procedures.

Control in computerized Environment:

Computer systems are also subject to controls, that can be classified into :

1. Application controls and;
2. General Controls.

Application controls are those that ensure that data are processed completely, accurately and in a timely manner. Application controls, as the name suggests, are specific to the application and include :

- (1) input controls such as data validation and batching
- (2) run-to-run controls to check file totals at key stages in processing, and
- (3) controls over output to ensure accuracy, restricted access and timeliness

General controls include the systems development standards operated by the organization, the controls that apply to the operation of the computer installation, and over system software. All these usually affect the number of applications.

The aspect of internal control that is exclusively concerned with the prevention and early detection of errors and fraud is usually referred to as 'internal check'. And this will therefore involve the arrangement of book-keeping and other clerical duties in such a way as to ensure:

- (i) **that no single task is executed from its beginning to its conclusion by only one person; and**
- (ii) **that the work of each clerk engaged upon a task is subject to an independent check in the course of another's duties.**

Following is the example of Internal Control Weakness identified in the scams reported in recent past.

(1) Letter of Credit System (LOC scam of Assam); and (2) Excess drawals in Animal Husbandry Department (Fodder Scam of Bihar).

LOC Scam: In this scam it was observed that a number of official of nine state departments including the Veterinary department were involved in the withdrawal of a huge amount of money (Rs.112.12 crore), far exceeding the budget allotment, through fake LOCs during the period 1981-82 to 1994-95. These were facilitated by the following weaknesses in the system:

- (a) The delegation of powers of withdrawals of funds was extended by Secretary/Head of the department to the lower level officers (DDO) in general

RTI Nagpur which resulted into collusion between the DDO/TO by producing fake LOC's at the treasuries indicating absence of strategic control in the system to prevent such collusion.

- (b) The Director of Veterinary Department had approved and sanctioned crores of rupees without ensuring that the work were implemented at the site, which indicates again failure of strategic controls.
- (c) Drawals were made in excess of Budget allotment, which indicates **absence of budgetary financial control in the system**
- (d) The LOC's were typed in the office of the Director of Veterinary Department and brought in a bunch for signatures of deputy Secretary. No check was made in the Secretariat, which indicates that there was absence of internal control on documentation.
- (e) No tax was deducted at source in respect of supplier's bills and the treasury officers also failed to submit the accounts to A.G. regularly as required under the rules which indicates **absence of compliance controls**.

Bihar Fodder Scam: In this scam it was observed that during the period 1987-88 to 1994-95, Animal Husbandry Department incurred expenditure of Rs.947.24 crore as against the Budgetary Provision of Rs.442.13 crore. Thus there was **excess drawal of Rs.505.11 crore** during the said period. The excess drawal remained undetected for a period of about seven years. These were facilitated by the following weaknesses in the system:

- There was **delay in receipt** of the accounts by AG after the prescribed date. This ranged from 5 to 16 months leading to **heavy exclusions on initial accounts** while compiling the monthly civil accounts. This indicates lack of compliance control.
- The excess drawal could have been brought to the notice of the state Government through monthly accounts by AG which was not done due to non-rendering of the initial accounts by the treasuries. This indicates **lack of monitoring of budgetary control functions**.
- Excess drawal came to notice at the end of financial year while forwarding the draft appropriation accounts since 1987-88. **Non-monitoring of the progressive expenditure and appropriation registers of DDOs indicates lack of internal control in monitoring the progressive expenditure at unit level.**

- The inspection of treasuries was not conducted at regular intervals, which could have discouraged the treasury officials continuing with the irregularities. Irregular inspection indicates slackness in the compliance of the system.

KTP: 3 : Correlation of risk with internal controls

Dictionary meaning of the word 'Risk' is hazard, chance of bad consequence, loss etc. But risk is not necessarily associated with an undesirable outcome but is only indicative of the uncertainty in the outcome and refers to a whole range of uncertain outcomes. Audit risk refers to the potential risk that the auditor gives an inappropriate opinion in an auditing situation, eg., he may give an unqualified opinion on financial statements that are materially misstated. Audit risk is, in turn dependent, inter alia, on the existence of internal controls that will guide audit procedures to be performed for testing the reliability of financial information.

The standard auditing practice requires that the auditor should obtain an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach. The auditor should use professional judgment to assess audit risk and to design audit procedures to ensure that it is reduced to an acceptably low level. These requirements, have been formulated in SAI India's auditing standards as under :

While planning an audit-

- an auditor should specify the objectives to meet them
- determine the materiality of matters to be considered
- review the internal audit of the audited entity and its work program
- assess the extent of internal reliance that might be placed on internal audit and other controls
- **determine the most efficient and effective audit approach.**

The determination of a most appropriate audit approach depends upon risk assessment carried out by audit that would be based on past record of the entity, the management's experience, the internal controls, the business environment, etc. The objective is to avoid over-auditing in low risk situations and under-auditing in high risk situations.

KTP-4 Understanding components of Audit risk

Risk analysis is the professional judgment of auditors to assess the components of overall audit risks and to design audit procedures accordingly. To minimize audit risk , auditors

emphasize the need to standardize all aspects of auditing viz. planning, controlling, reviewing, testing, recording and reporting etc. These help in focusing the audit and selection of the significant areas and their examination on priority. Indicators of risk are identified for each component and prescribed techniques are applied to assess the prevalence and degree of the risks. For example, quality of accounting system and internal control system comprise the **control environment** and control procedure is assessed to find out the degree of **control risk**. Assessment of **inherent risk** and **control risk** influence audit at the planning stage and audit programme accordingly is developed. There are a number of criteria available on the basis of which an auditor can come to a conclusion whether IR and CR are high, medium or low.

- The Auditor has to keep in mind the following general principles of **system audit** while analyzing the risk-.System deficiencies-
 - These include (1) Organizational analysis (2) System of authorization and recording (3) System of accounting (4) System of internal control (5) Evaluation of the standard of quality and performance (6) Examination of the adequacy of internal control and (7) reviews and evaluation of the system, as a whole.
- causes of departures from or special relaxations of prescribed procedures
- Causes for not initiating action on important points on proper time and at the appropriate level
- Documentation procedure.

Risk Model: There would always be some risk that audit fails to discover all material errors, even when 100% of the transactions are audited.. Audit reports are expected to give a true and fair view of the state of affairs of the auditee unit, ensuring that no material irregularities are left out. Audit conclusions and opinions are, however, rarely based on **cent per cent check** of auditee's records. Thus there is an element of risk that audit findings based on a less than cent per cent check may leave out important and material irregularities. This risk is defined as **audit risk (AR)**. Recognizing this, the auditor defines an 'Audit risk' that is acceptable or conversely the assurance desired to provide that audit assertions/opinions are correct. Using this assurance as input, he defines a sample, using statistical sampling methods, for audit tests and the results projected to the entire population. This approach prescribes a uniform audit scrutiny for all transactions in the universe. However, all transactions are not equally risky and they

may not be treated as such otherwise less risky transactions may cost heavily while risky transaction may not be detected. Therefore risk model is an analytical tool for planning and execution. This approach detects high risk areas where audit effort can be concentrated. Audit can thus focus on areas which are likely to generate better assurance instead of sampling and testing of larger but low risk areas .

The Risk Model can be expressed by the following equation:

$$\text{OAR} = \text{IR} \times \text{CR} \times \text{DR}$$

OAR is the **overall audit risk** acceptable to the auditor

IR is the **inherent risk**, ie. The risk that an error will occur in the first place

CR is the **control risk**, i.e. the risk that internal controls will fail to detect the error

DR is the **detection risk**, i.e. the risk that the audit procedures will fail to detect the error.

Inherent Risk (IR) :Refers to possibility of a material irregularities taking place in the auditee unit. Inherent risk is the susceptibility of an account balance or class of transactions to misstatement that could be material, either individually or when aggregated with other mis-statements in other balances or classes, assuming that there were no related internal control. It is also the function of the entity's business and its environment and the nature of the account balance or class of transactions.

2. Control Risk (CR) : Refers to the chance of the Control Mechanism of the auditee unit not detecting and setting it right. Control risk is the risk that a misstatement that could occur in an account balance or class of transactions and that could be material, either individually or when aggregated with misstatements in other balances or classes, will not be prevented or detected and corrected on a timely basis by the accounting and internal control systems.

3. Detection Risk (DR) : Refers to the likelihood of audit procedures not detecting material errors. Detection risk is the risk that an auditor's substantive procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material, either individually or when aggregated with misstatements in other balances or classes of transactions and may arise due to selection of an inappropriate or inadequate sample or use of an inappropriate auditing procedure.

The Auditor has to first assess inherent and control risk in the entity, and then to design and perform appropriate compliance and substantive procedures that provide sufficient

assurance that the product of the risks identified is less than or equal to the overall audit risk that the auditor is willing to accept. If the inherent risk and control risk are low, the auditor will be required to provide less assurance from the substantive tests, while if the inherent risk and control risk are high, the amount of assurance required from substantive audit tests will be high. Thus the auditor assesses the inherent risk and control risk and solves the equation for detection risk.

Detection Risk (DR) is the combination of **two risks**; (i) analytical procedure risk (**AP**) i.e. analytical procedure may fail to detect material error and (ii) test of detail risk (**TD**) i.e. detailed test procedure may fail to detect the material errors. Thus the risk model can be expressed as under.

$$DR = AP \times TD$$

$$OAR = IR \times CR \times AP \times TD$$

The detection risk may be modified depending on the discretion of the auditor by changing the effectiveness of the auditing procedures, while he makes an assessment of the inherent and control risk and decides about the total acceptable audit risk.

It is thus evident that where the auditor believes that the inherent and control risks are high, the level of detection risk that the auditor can take will be low. For e.g. where an auditor finds that certain transactions are more prone to misstatement and the internal controls are not effective, he may apply tests of details and analytical procedures to a greater extent that the total risk is kept within the acceptable limit.

There is an inverse relationship between the combined level of inherent and control risks and detection risk in the sense that in case the auditor assesses the inherent risk as low and his evaluation of control risk is also low, then he can afford to keep detection risk at high. On the contrary, suppose the auditor finds the inherent risk as medium and there are corresponding reasonably effective controls and the control risk is judged at medium level, the auditor will have to design his substantive procedures, keeping the detection risk also at medium level.

Importance of Materiality in risk model.

While risk is concerned with the likelihood of error, materiality deals with the extent to which we can tolerate error. Materiality relates to the maximum possible mis-

statement per SAI India's auditing standards, a matter may be judged material if knowledge of it would be likely to influence the user of the audit report. Nor only in terms of value but also the inherent nature of an item or a group of items may also render a matter material e.g. mandatory disclosure requirements of the statutes regardless of the amounts involved. In addition to materiality by value and nature, a matter may be material because of the context in which it occurs.

Thus, materiality should be considered by the auditor when (i) determining the nature, timing and extent of audit procedures, and (b) evaluating the effect of misstatement. The level of materiality also determines the level of audit risk in view of the inverse relationship between the two- higher the materiality level, the lower the audit risk and vice versa. The auditor needs to do just enough work to conclude that the maximum possible mis-statement/error at the desired level of assurance is less than the materiality. That is, the auditor may set the tolerable error at 50% of the materiality level to ensure that the aggregate of misstatements detected through the examination of the audit sample and those remaining undetected does not exceed the materiality level.

The auditor is concerned only with the material errors. Risk assessment will thus focus on the likelihood of material error. To use the risk model the auditor has to thus specify the materiality level along with the overall assurance required from the audit.

Assessment of Inherent and Control Risk:

Assessment of inherent risk can not be precise, and is largely a matter of broad judgment. It will depend on a variety of factors such as the activities of auditee organization (such as purchases, contract management, civil construction) past history of financial irregularities, compulsions of management to show better results etc. Assessment of internal control is made on the basis of a study of the systems followed in the auditee organization followed by compliance testing to vouch for its efficacy. There are a number of criteria available on the basis of which an auditor can come to the conclusion whether IR and CR are high, medium or low.

When assessing inherent risk and control risk in accordance with AAS 6 (Revised), "Risk Assessment and Internal Control" the auditor in considering the risk of material misstatement resulting from fraud should see whether fraud risk factors are present that indicate the possibility of either fraudulent financial reporting or misappropriation of assets.

Fraud is usually concealed and is very difficult to detect. The auditor has to identify events or conditions that provide an opportunity, a motive or a means to commit fraud or indicate that fraud may already have occurred based on his professional judgment. Such events or conditions are referred to as 'fraud risk factors'. For example, a document may be missing, a general ledger may be out of balance or an analytical procedure may not make sense. However these conditions may be the result of circumstances other than fraud. Therefore fraud risk factors do not necessarily indicate the existence of fraud, however, they often have been present in circumstances where frauds have occurred. The presence of fraud risk factors may affect the auditor's assessment of inherent risk or control risk.

The presence of fraud risk factors may indicate that the auditor will be unable to assess control risk at less than high for certain financial statement assertions. On the other hand, the auditor may be able to identify internal controls designed to mitigate those fraud risk factors that the auditor can test to support a control risk assessment below high.

The following table presents some of the fraud risk factors arising from (1) misstatement resulting from fraudulent financial reporting and (2) from misappropriation of assets.

Management's characteristics and influence over the control environment	Industry conditions	Operating characteristics and Financial stability.
i) Significant payments by way of compensation such as bonus, stock options or other incentives. ii) Excessive increase in stock priced or earnings trend through unusually aggressive accounting practices iii) Engaging analysts, creditors and third parties to achieving unduly aggressive or unrealistic forecasts. iv) Using inappropriate means to minimize reported earnings for tax motivated reasons. v) Disregard of entity's values or ethics.	i) New accounting, statutory or regulatory requirement affect the financial stability or profitability. ii) High degree of competition or market saturation declining margins. iii) Business failure and significant decline in customer demand. iv) Rapid changes in the industry such as high vulnerability to rapidly changing technology or rapid product obsolescence.	i) Inability to generate cash flows from operation despite earnings growth. ii) Significant pressure to obtain additional capital necessary to stay competitive. iii) Significant transactions are not in the ordinary course. iv) Significant transactions are not audited. v) Significant, unusual or highly complex transactions. vi) Significant bank accounts or subsidiary or branch operations.

<p>vi) Management is dominated by single person or a small group.</p> <p>Vii) Absence of monitoring significant controls.</p> <p>viii) Fails to correct known material weaknesses in internal control on a timely basis.</p> <p>ix) Setting unduly aggressive financial targets.</p> <p>x) Significant disregard for regulatory authorities.</p> <p>xi) Employing ineffective accounting, information technology or internal auditing staff.</p> <p>xii) non-financial management excessively participates in selecting accounting principles and determining estimates.</p> <p>xiii) High turnover of management, counsel or board members.</p> <p>xiii) Frequent disputes with the current and predecessor auditor on accounting, auditing or reporting matters.</p> <p>xiv) Unreasonable demands on the auditor, including unreasonable time constraints for completion of audit and issuance of audit report.</p> <p>xv) Domineering behaviour with the Auditor on the scope of auditor's work.</p> <p>xvi) little attention being paid to financial reporting matters, accounting and internal control systems by those charged with governance.</p>		<p>vii) Overly complex organisational structure.</p> <p>vii) Unusual rapid growth or profitability as compared with that of other companies in the same industry.</p> <p>viii) highly dependent on debt, marginal ability to meet debt repayment</p> <p>ix) Unrealistically aggressive sales or profitability incentive programs.</p> <p>x) Threat of imminent bankruptcy, foreclosure or hostile takeover.</p> <p>xi) Significant pending transactions.</p> <p>xii) Poor or deteriorating financial position.</p>
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Fraud Risk factors relating to misstatements resulting from misappropriation of assets.

This may be grouped in following two categories.

The extent of the auditor's consideration of the fraud risk factors in category 2 is influenced by the degree to which fraud risk factors in category 1 are present

Susceptibility of Assets to misappropriation	Control
<ol style="list-style-type: none">1. Large amounts of cash on hand2. Inventory size is small but high value and high demand3. Easily convertible assets such as bearer bonds, computer chips.4. Small size fixed assets with marketability and lack of ownership identification.	<ol style="list-style-type: none">1. Lack of appropriate management oversight (inadequate supervision, inadequate monitoring of remote location).2. Lack of procedure to screen job applicants for positions.3. Inadequate record keeping4. Lack of segregation of duties or independent checks.5. Absence of system of authorization and approval of transactions.6. Poor physical safeguards over cash, investments, inventory or fixed assets7. Lack of timely and appropriate documentation for transactions8. Lack of mandatory vacations for employees performing key control functions.

Understanding risk measurement:

Measurement of risk is necessary to avoid over-auditing in low risk areas and under-auditing in high risk areas. The measurement of risk is done with reference to the indicators of significance, sensitivity and highest rated risk prone items /areas by applying a matrix as 'High', 'Medium', 'Low' assigning to each item/area. The indicators of significance, sensitivity and high-rated risk prone area are to be decided setting materiality level based on auditors previous experience and judgment and assessment of client's business and organizational structure, job chart and employee's past record. Materiality is a relative factor and any decision on materiality will require a base to be selected such as total revenue or total expenditure or total asset etc.

- Normally, low risk areas are those that require the application of routine 'nuts and bolts' audit procedures in the ordinary course of vouching, casting, checking etc. at both compliance and substantive stages, usually occupying up to 80 per cent of all audit effort. High- risk areas are those that carry sensitivity and criticality in terms of transactions such as
- Budget and budgetary provisions;
- Disclosure of liabilities and assets;
- Post balance sheet review and of subsequent events,
- Analytical review on draft financial statements;
- Identifying high value items and 'error-prone' conditions

In addition to the above, Government department and Public Sector Undertaking, following are the high risk areas. The auditor has to identify the extent of risk to specific areas with reference to significance and sensitivity involved in particular transaction for detailed probe.

- Contracts of service/procurement
- Inventory and Asset management
- Area with public interface
- Revenue Receipt (Incorrect valuation, incorrect exemption or misuse of exemption,
- Incorrect accountable of receipt, incorrect duty draw back or refund
- Cash management
- Financial Statements
- Fraud in computerized environment
- Grant-in-aid.

Statistical Sampling.

Sampling means testing less than 100 per cent of the items in the population for some characteristic and then drawing a conclusion about that characteristic for the entire population. Traditionally, auditors use 'test check' (judgmental sampling ie. Non-statistical sampling) approach on the basis of his judgment. This technique may be effective if properly analyzed. However, it can not measure the sampling risk and audit can not draw a common conclusion applicable to the entire population. **Auditing Standard requires that audit evidence collected should be sufficient to support its finding. As the evidence collected is based on the check of selected records and**

transactions, sample selection and its size become crucial. Broadly there are two types of sampling namely judgment sampling and statistical sampling.

Judgment Sampling: Under this method selection is based on the knowledge and judgment of the auditor over the auditee unit. It is generally used in cases where the auditor is well acquainted with the strengths and weakness of the auditee unit, past results of audit etc. The conclusions reached through judgment sampling can not be generalized.

Statistical Sampling: Under this method of selection, the auditor is able to draw inferences on the entire population to which the selected sample relates. It also enables the auditor to determine the sample size corresponding to the assurance level he is seeking to secure. Statistical sampling, however can be resorted to only when there is information on the whole population and every item in the population has an equal chance of being selected. Statistical sampling is widely used for sample selection in a number of SAIs all over the world. The statistical sampling has several variants, such as Simple random sampling, stratified sampling, monetary unit sampling, cluster sampling, etc.

Sampling methods: There are different ways in which a statistical sample can be selected.

- (i) A simple random sampling ensures that every member of the population has an equal chance of selection, but the population should be homogeneous (ii) In cases where the population is non-homogeneous, a stratified sampling would be a better option. Here the population is sub-divided into homogeneous groups and then a random sampling is done on the groups ensuring a better representative sample. Each sampling method has its practical use and limitation. The auditor uses his judgment in determining which kind of sampling is best suited to his audit job.

Designing sample: Following are three basic stages –

- (a) Determining the sample size
- (b) Selecting the sample and performing substantive audit tests on the sample
- (c) Projecting the results.

The first stage includes (i) defining clearly target population and error/exception that audit wishes to test (ii) the tolerable error or the maximum error the auditor is willing to accept and still conclude that the auditee is following the procedure properly (iii) Confidence level or the level of assurance that audit needs to provide (iv) the occurrence

rate or population proportion which is the proportion of item in the population having the error / exception that audit wishes to test.

The second stage includes which method of sampling would be the appropriate for performing substantive audit test. Random selection is made where each item in the population has a equal chance of selection. In a systematic selection one or two items are selected randomly and other items are selected by adding the average sampling interval. In the cell sampling method, the population is divided into a number of cells and one item is selected from each cell randomly. Auditing software, e.g. IDEA is an efficient tool for sample selection

In the third stage, the test results need to be projected to the population and a conclusion has to be reached whether the auditor can place an assurance on the system.

Summary:

The effectiveness of internal controls system in an entity is an important component of fraud risk analysis that a public auditor ought to keep in view while designing the audit plan. The audit approach should be based on a risk assessment that takes into account the inherent risk that is given by the overall business environment, nature of the transaction, organization structure and the control risk influenced by the adequacy of controls in key areas. Depending on the presence of fraud risk factors the auditor may decide that the inherent and or the control risk is high and may accordingly determine that the detection risk should be kept low. The auditor then has to decide on the materiality i.e. the tolerable error of misstatement, keeping in view the overall volume of transactions reported upon, such as sales, net profit, etc and performs analytical and detail tests on a selected sample and projects the results.

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CHAPTER : V.

Responsibility of audit in consideration of fraud

Overview

The following chapter discusses the respective roles of management of the audited entities and the auditor in the prevention and detection of fraud and the recognized audit standards that are expected to be followed by the auditor in the case of fraudulent transactions that may have a material significance on the financial position of the audited entity. The ASOSAI guidelines and SAI India auditing standards discussed simultaneously to highlight the convergence in audit standards in regard to the treatment of fraud in audit planning, execution and reporting.

Learning Objective : The participants are expected to familiarize themselves with the auditing standards prescribed by SAI India in regard to efficient, economic and effective audit approach for execution of audit plan that incorporates risk assessment carried out by the auditor, the sustainability of audit evidence in respect of audit findings in relation to fraud and the related reporting requirements

KTP 2. Know the Role and Responsibility of Management.

The primary responsibility for the prevention and detection of fraud and error rests with both those charged with the governance and the management of an entity. The responsibilities of those charged with governance and management may vary from entity to entity. This responsibility consists in:

- setting a culture of high ethics of governance
- providing adequate control environment to facilitate not only, fulfillment of management objectives, but also to detect irregularities in fraud and error
- providing integrity in the accounting and financial reporting systems
- ensuring compliance with laws and statutory regulations

The above responsibilities include well-designed internal control systems, clearly defined and segregation of duties between individuals to avoid manipulation of records and provision of an effective internal oversight mechanism.

In addition to the above, management has the responsibility to take certain preventative measures to minimize the risks of fraud and corruption:

- (a) there should be uniform company-wide accounting policy;
- (b) spot checking of books and inventories is required to make sure internal reporting procedures are duly followed;
- (c) there should be sound system of internal control;
- (d) the background checks of employees are necessary before they are introduced in a company and update those checks periodically;
- (e) periodical review of customers' and suppliers' views are necessary;
- (f) protect computerized data and communications as well as confidential information;
- (g) make a policy that no employee is exempt from accountability and responsibility for even indirect types of fraud;
- (h) review the loopholes, weakness pointed out by the auditors and take appropriate prompt action to set right the defects.

Role of audit in prevention and detection of fraud

While management is primarily responsible for management of risks of fraud and corruption through safeguard mechanisms, audit is expected to make a proactive contribution through effective communication of audit findings. Audit is expected to provide a reasonable assurance that the financial statements taken as a whole, are free from material misstatement, whether through fraud or error. While the burden of providing the assurance on the integrity of the accounting and financial information of the audited entity is cast on the auditor, it is also accepted that auditors cannot be held responsible for the prevention and detection of fraud. The responsibilities of the auditor in detection of fraud, take into account certain inherent limitations of audit as follows:

- Even though audit may be well-planned and performed in accordance with well-established auditing principles and standards, there is an inherent risk that material misstatements may not be detected.
- As audit relies on use of judgment, testing and much of the evidence that is available may be persuasive, the assurance that can be given is only reasonable and not a guarantee.

- In case of fraud, the risk of non-detection is much higher, depending on extent of concealment and collusion.
- In case fraud is perpetrated through **management over-rides**, resulting in falsification of the records, chances of non-detection may be higher.

Auditing Standards in relation to Fraud detection- Financial audit

The increased frequency of fraud and corruption and the growing public expectations have led to the redefinition of the auditors' responsibility in the area of fraud detection in the U.S. and incorporation of a separate Statement of Auditing Standards, devoted solely to the auditor's consideration of misstatements due to fraud. **The Revised Standard (240)** requires the auditor to maintain an attitude of professional skepticism recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience with the entity about the honesty and integrity of management and those charged with governance. The standard lays down further requirements of the auditor in regard to identification of the risks, determine overall responses to address the risks of material misstatement due to fraud, design of audit procedures to respond to management control overrides, considering whether an identified misstatement may be indicative of fraud, obtaining written representations from management, etc. In India, the **Auditing and Assurance Standard was recently revised (AAS4)**, to bring them, on par with, the revised ISA 240.

The revised AAS 4 specifically provides that 'when planning and performing audit procedures and evaluating and reporting the results thereof, the auditor should consider the risk of material misstatements in the financial statements resulting from fraud or error. It lays down further requirements as under:

- Auditors to adopt a professional skepticism in planning and performance of audit- in regard to matters that increase the materiality of risk from fraud, circumstances that are suspect, evidence questioning management's representations
- Active engagement with team members regarding susceptibility of the entity to fraud
- Inquiries with management to obtain an understanding of and management's assessment of the risk of material mis-statement and evaluation of the internal systems put in place to address such risk and whether management is aware of any known fraud that has affected the entity

- Performing procedures, when auditor encounters circumstances indicative of a risk of mis-statement
- Considering whether an identified mis-statement is indicative of fraud and if yes, the implications in relation to other aspects of audit, particularly the reliability of management representations
- Considering the necessity of disclosure where a significant fraud has occurred, where no disclosure is provided
- Consider auditor's responsibility to communicate information relating to mis-statement to management and if, necessary to law enforcement agencies

Responsibility of SAI- India- Regarding fraud detection in India

In keeping with the developments in the auditing standards issued by professional bodies, international audit institutions like the ASOSAI have also prescribed certain audit guidelines in regard to treatment of fraud and corruption. Though no specific standards in regard to fraud have been issued by SAI, India, these auditing standards could be derived from the broad auditing principles enunciated by SAI India as discussed below:

Materiality

ASOSAI Guidance states that " while determining materiality levels for different audit areas, SAIs may take into account adjustments to the materiality level that may make audit more responsive to risk arising from fraud and corruption."

The basic postulate of SAI India requires that the SAI should comply with INTOSAI auditing standards in all matters that are deemed material and SAI should apply its own judgment to the diverse situations that arise in the course of Govt. auditing.

The element of responsiveness to risk from fraud and corruption is reflected in the requirement under SAI India thus-

In the observance of Auditing Standards, the auditor must exercise own judgment in determining auditing procedures in the circumstances, to afford a reasonable basis for his/her opinion and the content of the report. This would include determination of materiality in case of a fraud risk situation whereby the auditor may perform enhanced testing procedures to keep the detection risk to acceptable levels.

In this regard, SAI India's Auditing Standards also makes it clear that the audit objectives may be akin to those in the private sector in the audit of financial statements in public sector enterprises, the govt. auditor may apply standard audit practices issued by ICAI.

Responsibility for disclosure

ASOSAI Guidance provide that the responsibility for adequate and timely disclosure of any case of fraud and correction rests with the management and the responsibility of ensuring reliability and results of operation must include concerns arising from risk of fraud and corruption and the role of SAI is to ensure that this responsibility has been discharged with competence.

SAI India auditing standards provide that the management of the audited entity is responsible for correctness and sufficiency of the form and content of financial reports and other related information. SAI India also emphasizes that consistent application of acceptable accounting standards should facilitate expression of fair opinion on the financial results of the audited entity. Also, SAI India also advises the Govt. on acceptable accounting standards for financial reporting and disclosure relevant to the needs of Govt. Such advice would extend to disclosures relating to fraud or involving corrective mechanisms for prevention of frauds.

Responsibility for controls

ASOSAI Guidance suggests that while the responsibility to maintaining systems and controls rests with the management, SAIs must be alert to situations conducive to fraud and corruption, should pro-actively report to the management to improve the control environment to minimize the risk of fraud and corruption.

This requirement is implicit in SAI India's Auditing Standards (4.7) that lays down "The responsibility of audited entity to develop adequate internal control systems to protect its resources does not relieve the auditor from submitting proposals and recommendations to the audited entity whose controls are found to be inadequate or missing.

Responsibility for performance indicators

ASOSAI Guidance suggests “ The auditor should make the management aware that the absence or lack of application of reliable valid performance indicators could increase the possibility of occurrence of fraud and corruption.”

SAI India Auditing Standards (4.5 &4.10) lays emphasis on the need for audited entities developing specific and measurable objectives and valid performance measures in order to ensure greater accountability.

Responsibility for objectivity

In addition, SAI India postulates that SAI needs to avoid conflict of interest situations to perform its role effectively. Such objectivity is critical to effectively fight against fraud and corruption.

Field standards in relation to Planning of Audit

While designing of an effective and efficient audit plan, an auditor must consider the following, based on ASOSAI and SAI India auditing standards r:

(1) Knowledge of Business of entity

- (a) Nature of the business or activities of the entity, its services and its objectives;
- (b) Circumstances or environment in which the entity is functioning.

(2) Control Environment:

- (a) the strengths, quality, and effectiveness of management
- (b) management’s overall controls (e.g. degree of supervision)
- (c) general segregation of duties
- (d) existence and effectiveness of any internal audit function
- (e) information technology environment.

(3) Accounts areas:

- (a) susceptibility to fraud
- (b) significance of each account area in the context of overall materiality
- (c) accounting methods
- (d) related party transactions
- (e) unusual transactions

(4) Internal controls:

- (a) segregation of duties
- (b) authorization
- (c) completeness and accuracy of accounting data
- (d) safeguard procedures (e.g. signing of cheques)
- (e) comprehensiveness of controls (e.g. including all relevant subsystems)
- (f) where accounting procedure are computerized, the auditor should be concerned to ensure that a lack of computer controls cannot be exploited to suppress evidence that an irregularity may exist or indeed to allow an irregularity to occur.
- (g) System of internal audit (effectiveness and degree of independence.)

Risk assessment

The above inputs help the auditor in forming a valid risk assessment of the audited entity. In addition, the auditor should also consider the information and tips received from the public on suspected cases of fraud or corruption in the audited entity. The auditor must assess the risk that fraud may cause a material statement to the financial statements or recording of irregular transactions.

In addition, the auditor must consider enhanced risk of fraud in the case of organizations dealing with procurement of goods and services.

Also, the auditor needs to develop a professional skepticism in a high risk area, because of the high probability of concealment of facts or attempts to distract from the audit trail. Based on the risk assessment of the audited entity, the auditor develops specific audit objectives and scope of audit is determined taking into consideration the strength of the internal control systems.

Testing: Before an audit plan is put into action, it is tested through a preliminary study using audited entity data base and other data bases, where relevant, whereby the line of enquiry or investigation is firmed up. The decisions that the auditor makes during the planning phase of the audit and, where appropriate, and when evaluating the system of internal control will help him to design his tests to obtain relevant and reliable audit evidence sufficient to enable him to draw reasonable conclusion.

In carrying out his procedures, the auditor may discover circumstances that could be indicative of irregularities such as :

- (a) missing vouchers or documents
- (b) evidence of falsified documents
- (c) unsatisfactory explanations
- (d) figures, trends or results which do not accord with expectations
- (e) unexplained items on reconciliation or suspense accounts
- (f) evidence of disputes
- (g) evidence of unduly lavish life styles by officers and employees
- (h) unusual investment of funds held in a fiduciary capacity
- (i) evidence that the system of internal control is not operating as it was believed or intended to
- (j) Unauthorized access to computerized system, data and software.

The auditor's programme of work needs to be sufficiently flexible to follow up any such points arising and any irregularities or errors detected. In addition to detailed substantive tests, analytical review procedures should be used during field work. If during the course of audit the auditor obtains information indicating the possible existence of errors or irregularities, and does not require additional testing, he can conclude otherwise he should perform appropriate additional tests. If, after additional testing, it appears that an error or irregularity has occurred, he should consider its nature, find out causes and; measure likely effect/impact on the financial statement, analyzing and projecting the results of his tests.

Red Flag Items in Government Sectors:

Some of the checks which could be applied to determine **the red flag items** during the course of audit (Government sectors) are illustrated as under:

1. Examine delegation of power particularly in vulnerable areas
2. Examine the effectiveness and adequacy of internal controls
3. Check for collusion between the supplier and employees/management
4. Check for overriding of internal controls by the management
5. Examine cases of misuse of financial powers
6. Look for collusion between the employees or management, type of functional department/entity and nature of its services/business

7. Check for false statements and false claims: where information presented to justify a transaction is incorrect and at the point of time when such information was presented, the person submitting the information had access to correct information.
8. Examine evidence for certification, split purchases, collusive bidding, over and under invoicing and making payments on the basis of false progress reports.
9. Check for loss of revenue due to evasion and/or non-accountable or receipt
10. Examine payments made for services/supplies not received
11. Seek legal/expert opinions in matter of suspicions
12. Check cross-linking of documents for evidence of known wrongdoing.
13. Examine suspense account age wise
14. Examine financial sanctions issued during the last month of the financial year and purchases made there against.
15. Examine status of the reconciliation of the financial transaction made during the year between treasury/bank and department
16. Status of the confirmation of inventory items.
17. Reappropriation of accounts/funds made as against the allocated budget head wise.

Red Flag Areas in Contracts of Procurements

It has been observed that contracts of procurement of services/ goods is an identified high risk area because of high value of financial implication and scope for violation of system/procedure in awarding contracts. Auditors are advised to look out for warning signs corresponding to each stage. The below noted warning signs (Illustrative) indicate the increased risk factor in contract and serve as red flags for the auditor. This has been divided in three parts.

I Requirements defining stage

1. Inadequate needs analysis
2. Unduly short supply period;
3. Tailored user requirements;
4. Unwarranted involvement of senior officials.

II. Bidding and selection stage

- The specifications are not clearly defined
- A very limited number of offers are received
- Documentation indicates unusual involvement of an official;
- Suspicion about conflict of interest
- Evidence of early receipt of information by some contractors;
- Unusual handling of the bidding process;
- Evaluation criteria are not consistent for different vendors;
- Methodology for 'loading' in bid evaluation;
- Changes in the bids made after their formal receipt;
- Lowest responsive bidder is not selected without adequate justification;
- Contractor submits unrealistic bid indicating collusion or bid rotation

III. Contract performance and evaluation stage:

- ◆ Non-inclusion of important conditions in contracts (relating to performance etc.);
- ◆ Changes in a contract result in huge increase in the cost of goods and services;
- ◆ Changes in specifications made without adequate explanations;
- ◆ Unwarranted contract extension;
- ◆ Complaints about the quality of goods and services received;
- ◆ Evidence of over charging and duplicate billings;
- ◆ Dubious invoices;
- ◆ Insufficient pre-audit of contractor payments;
- ◆ Contracts repeatedly awarded to one contractor.

Red flag areas of corruption:

While it is difficult to establish corruption, it is a major risk factor affecting high value contracts involving works or procurement, that may involve sometimes substandard procurement, inflated costing, inappropriate selection of projects, etc. In the case of a typical works contract, the following areas special scrutiny:

- (a) Investigation and selection of site
- (b) Preparation of estimate

- (c) Awarding of contract and purchase of materials
- (d) Execution of work
- (e) Sanction of extra item
- (f) Escalation
- (g) Measurement
- (h) Settlement of final claims
- (i) Arbitration

Field Standard in regard to audit evidence

Auditor's conclusions should be based on competent, relevant and reasonable evidence as regards the activity or function under audit. Thus, data selection and sampling techniques play a crucial role in ensuring data reliability. The degree of ensuring such reliability is enhanced, when auditors intend to report on fraud or corruption in which auditors need to determine the extent to which audit needs to gather evidence. The degree of compliance procedures also indicates the level of assurance that can be placed on the reliability of evidence. Substantive procedures relate to the assurance regarding existence of an asset or liability, rights and obligations, occurrence of a transaction of an event or a transaction, completeness of transactions, valuation, measurement of a transaction and classification and disclosure.

Gathering Audit Evidence: In searching for the evidence of fraud and corruption the auditor must:

- ◆ Always search for the strongest possible evidence;
- ◆ Investigate without delay, as evidence can be destroyed, lost or forgotten;
- ◆ Not ignore small clues or leads;
- ◆ Look for facts that confirm or refute suspicions;
- ◆ Concentrate on the weakest point in the fraud and corruption;
- ◆ Identify and summarize the evidence indicating that fraud and corruption may have been committed;
- ◆ Identify the possible scenario of fraud and /or corruption;
- ◆ Summarize and explain the accounting and control systems involved, the paper trail involved in the transaction, and the deviations from the systems;
- ◆ Explain patterns used in covering up the fraud and corruption;

- ◆ Identify the possible extent of the fraud and corruption; and
- ◆ Consider the possibility of collusion.

Sources of Evidence:

1. **Documents from the auditee :** Original or photocopy depending upon their importance.
2. **Report of Internal Auditor :** Identified instances of deviation from normal procedure.
3. **Interviews:** Of employees. They may have noticed internal control failure of managers and fraudulent activities perpetrated by other employees. Interview may be useful in detecting material misstatements caused by fraud and corruption.
4. **Inspection/Observation:** indicating observations of possibility of fraud and corruption (forged document, inventory not in existence or inferior quality),
5. **Questionnaires:** help in gathering important clues and information.
6. **Confirmation with third parties:** Sometimes auditors obtained confirmation directly from third party (e.g. bank balance from bank, debtor's balance confirmation). If the figures not tallying, find out the reasons for discrepancy.
7. **Results of Analytical Review:** can indicate abnormal trends in figures.
8. **Expert opinion :** can be obtained about suspicious case. The expert's opinion becomes an evidence.

ASOSAI Guidelines suggest that besides verifying audit evidence with reference to source documents, they should also obtain third party evidence when auditors intend to report on fraud. In general, audit evidence from external sources is more reliable than audit evidence generated internally, especially when the third parties involved are not related to the audited entity. The auditors' recourse to the external confirmation would depend upon the **materiality** of the transaction and whether the detection risk would be kept to an acceptable level.

When audit evidence is generated through computer data, audit will have to ensure that appropriate controls are in place in order to ensure the authenticity of computer evidence.

Reporting Standard- Fraud matters

The reporting function of the auditor embraces both the Auditor's opinion on a set of financial statements and the Auditor's report on regularity, performance audit and the periodic inspection reports of the audited entity. The report sets out the objectives of audit, the scope of audit, the findings in regard to facts and sets out conclusions on the basis of well-documented evidence, expresses the auditor's opinion as regards the financial position of the audited entity and on performance of the audited entity, and makes recommendations for corrective measures by the executive.

SAI India auditing standards lays down the following, in the case of reporting in regard to a fraudulent practice or serious financial irregularities:

- The written report prepared by the auditor should indicate
 - The scope and methodology of audit
 - Main findings
 - Total amount involved
 - Modus operandi of fraud
 - Accountability
 - Deficiencies in internal control systems that facilitated the fraud and Recommendations for improvement of internal control systems
 - Fraud prevention and detection measures to safeguard against fraud/ serious financial irregularity

SAI India auditing standards also requires that auditors should follow-up whether satisfactory action was taken or not, on the audit reports.

Besides fraudulent practice, auditors are also expected to report relevant information to specified parties in the govt, when they find significant non-compliance or abuse of discretion(which frequently is indicative of corrupt practice). Non-compliance comprises illegal acts and violations of provisions of contracts or grant agreements. While reporting on an illegal act, auditors do not make a determination of the illegality that lies within the jurisdiction of a court of law. In some cases, the audited entities are required by law to report certain fraud or illegal acts to external agencies such as Central/State Vigilance

Commission or investigation agency as the CBI. If the audited entity fails to communicate such illegal acts as reported by the auditor, the failure in compliance is included in the auditor's report.

Auditors should obtain sufficient, competent and relevant evidence- eg- by confirmation with third parties to corroborate assertions by management that it has reported fraud or illegal acts.

When auditors are also required to report indications of certain types of fraud or illegal acts to law enforcement agencies, they may also consult whether such information would compromise investigative or legal proceedings.

Audit of financial statements

The report on the financial statements should describe the scope of the auditors' testing of compliance with laws and regulations and internal control procedures over financial reporting and present the results of those tests. In presenting the results of those tests, the report should include fraud, illegal acts or other material non-compliance and material deficiencies in internal control.

In addition, the auditors must address the effect such material non-compliance or fraud may have on the report on the financial statements and express audit opinion accordingly.

Types of Audit opinion

Unqualified opinion: Where an auditor gives an opinion on the various matters without any reservations, it is an unqualified opinion. Examp. 'in our opinion and to the best of our information and according to the explanations given to us, the balance sheet and the profit and loss account give a true and fair view of the state of affairs and working results.....' Such an opinion is given when the auditor is satisfied that

- The financial statements have been prepared based on acceptable accounting standards and policies have been consistently applied
- The statements comply with statutory requirements
- The view presented by the statements is consistent with the auditor's knowledge of the audited entity
- There is adequate disclosure of all material matters relevant to the financial statements

Qualified opinion: Where an auditor gives an opinion subject to certain reservations, he is said to have given a qualified opinion. Examp. If the Auditor gives objection or reservation in the audit report and states ; 'subject to the above, we report that the balance sheet shows a true and fair view....' When he expresses qualified opinion he should give the reasons for qualification.

Adverse (or Negative) Opinion: Where the auditor concludes that he does not agree with the affirmations to be made and his disagreement is fundamental that a qualified opinion in some respects would not be adequate, he gives an adverse opinion, stating that the financial statements do not represent a true and fair view of the state of affairs and the working results of the enterprise. This opinion is given where the accounts are materially distorted and the reasons are assigned therefor. As per SAI India auditing standards, the effect of such observations on the financial statements should preferably be quantified.

Disclaimer of Opinion: Where an auditor fails to obtain sufficient appropriate audit evidence to warrant an expression of opinion he makes a disclaimer of opinion. In this case the auditor may state that he is unable to express an opinion because he has not been able to obtain sufficient evidence to form an opinion. Exam. 'We have been unable to verify the existence and value of the fixed assets of the company. Hence we are unable to state whether the balance sheet shows a true and fair view.....'

The above requirements are also reflected in ASOSAI guidelines that suggest

" When in the opinion of the auditor the financial statements include material fraudulent transactions, or such transactions have not been adequately disclosed, or the audit conducted by the auditor leads him to the conclusion that instances of fraud and or corruption have taken place and when the auditor has adequate evidence to support his conclusion, he should qualify the audit certificate and /or ensure that his findings are adequately included in his audit report

Summary

Notwithstanding the limited though vital role of audit in fraud control, management always tends to look to them in fraud matters. When a fraudulent act is committed, the question is invariably asked "where were the auditors"? or "when was the last audit

conducted"? The burden is thus placed on the auditors as to **why their last examination did not reveal the fraud, or at least disclose the internal control weakness that led to the fraud.** The auditor's responsibility is thus seen as doing their work in such a professional manner that if fraud exists, the chances are that it will be exposed. In addition management expects the auditors to perceive opportunities to provide more prevention, since prevention is preferable to detection where frauds are concerned.

No internal control plan can prevent an employee from stealing cash that he handles and no internal control can prevent a purchasing agent from colluding with supplier. Also, no control can be expected to disclose a fraud the instant it is committed. Still, management looks to the auditors to be imaginative in the application of comprehensive and well-thought-out audit programs so that if fraud exists, there is a reasonable assurance that it will be discovered. In this process, certain well-tested auditing standards prescribed by the professional auditing bodies and the supreme audit institutions should be followed by the auditors to be able to provide a reasonable assurance

References:

- 1. ASOSAI Guidelines- treatment of fraud and corruption**
- 2. CAG's Auditing Standards**
- 3. Emile Woolf- Auditing Today**

CHAPTER – VI

Fraud investigation and forensic audit

Overview:

With increasing complexities in corporate frauds including govt entities, the issue of fraud investigation has become extremely relevant to managements and the auditing profession. Most of the frauds involving substantial leakage or pilferage of resources also highlight issues of governance. The following chapter deals with the concept of forensic investigation, its relevance, the different types of frauds that are known to take place in the commercial world including government environment, red flag areas requiring further probe, the process of collection of sustainable evidence, the principles generally applied in arriving at logical conclusions at the end of the investigation.

Learning Objective:: Given the changing nature of fraud/theft and multifarious duties and roles to be performed by professional Accountant/Auditor to investigate fraud and corruption, participants will be able to determine best approach in selecting the audit procedure that may be appropriate to circumstance surrounding the irregularity.

KTP:1. Know the word 'Forensic Audit/Investigation'

As modern business world becomes increasingly competitive and complex, fraud and white collar crimes have become more challenging to detect. The spread of information technology and the internet has contributed a significant increase in white collar and economic crimes such as kickbacks, bribes, insider trading, cheque kiting, etc, that their detection calls for special skills in fraud investigation. Auditors are sometimes called upon to conduct extended procedures to probe a fraudulent transaction, in view of their expertise in dealing with books of accounts and commercial transactions. These could cover cash embezzlements, revenue leakages, suppression of income, inflation of liabilities, etc. In other instances, services of auditors may be required by enforcement agencies like the CBI or economic offences wing to investigate eg. Claims of investors, tax frauds, bank frauds etc to help the team investigation. The term investigation connotes a systematic and in-depth examination or inquiry to establish a fact or to evaluate a specific situation. Taylor and Perry has defined investigation as " Investigation involves inquiry

into facts behind the books and accounts into technical, financial and economic position of the business or organisation". An investigation requires a special in-depth examination of the particular records or transactions with the objective of establishing a fact or happening or assessing a particular situation. The term forensic has been defined by the WEBSTER'S Dictionary as "belonging to, used in, or suitable to courts of judicature or to public discussins and debate" In accounting terms, the word forensic deals with the relation and application of finacial facts to legal probems. Modern forensic accounting first emerged in 1970s and early 1980s in USA. Insider stock trading fraud cases and the scandals in the savings and loan business were played a key role behind the emergence of this profession that specialise in the detection and collection of conclusive evidence that can establish the perpetration of a crime.

The Forensic Accountant /Auditor not only looks into the intricacies of accounts, but he will also review employees records, view the physical plant, interview employees, monitor cash and inventory flows and use various methods to determine how items in the financial statement of the entity came to be. He looks for a clue. He will not only see the origin of transaction till its final apearance in the books of account but also watch the body language of the individuals concerned. It is not just a matter of tables and figures. He has to change his role depending upon the situation.

Understanding the difference between Normal audit and Forensic audit.

The basic differences between the nature, objectives and approach of an audit and those of an investigation, are as follows:

Normal audit	Forensic audit
1. The scope and objectives of normal audit are broad and general.	1.The scope and objectives of Forensic audit are normally narrow and specific e.g. selected area.
2. An Auditor in normal audit normally relies upon persuasive evidence.	2.Forensic audit looks for substantive and in some cases even conclusive evidence.
3. The audit conclusions are mostly based on presumption' records made available	3.Forensic audit does not accept a fact as correct until it is substantiated. He cannot

to audit, rules and regulations applicable to the entity.	presume that in the absence of suspicious circumstances, a figure or a stated fact is necessarily correct.
4. The auditor is bound by accounting conventions, ^{policy} policies and disclosure requirements.	4. Forensic auditor is not bound ^{by} to these requirement due to very nature and purpose of investigation.
5. Audit procedures are laid down in manuals.	5. There are no audit procedures that are unique to fraud situations. Each case is different and requires study and analysis to decide the best approach.
6. Conventional auditing operates from an assumption of honesty.	6. Forensic auditing on the other hand treats all figures as suspect until otherwise proved.

KTP 3. Role of Forensic Auditor to detect frauds, Misappropriation and defalcations.

The exact procedure to be followed in conducting investigations to uncover cases of frauds, misappropriations and defalcations varies according to the circumstances of the case. The Forensic auditor has to know, study and analyse, the nature of frauds, psychology of the persons involved in fraud, the transactions and the circumstances which are more prone to frauds and the steps involved in detecting such frauds.

KOHLER'S Dictionary for Accountants defines fraud as "the practice of deception or artifice with the intention of cheating or ^{injuring} another." Such deceptions can be broadly classified in two broad categories.

1. Frauds involving the manipulation ~~of~~ of the records and the accounts, usually by the Senior officers, with a view to benefitting in some way ^{from} the false picture which they convey (e.g. obtaining finance under false pretences, or concealing a material worsening of the company's true position);

2. frauds, usually by employees, involving the theft, misappropriation or embezzlement of the company's funds, usually in the form of cash or of its other assets (such as goods held in a ware house).

The first category fraud concerns the auditor to a great extent since they may vitiating the true and fair view of the financial statements. In the second category of fraud a person who commits frauds, defalcations, embezzlement is normally an amateur. He is often a trusted employee leading a respectable life. He finds certain weaknesses in the internal control system by experience of working in the situation and sees an opportunity to commit the fraud. In difficult circumstances, he gets tempted and commits theft. Most of the defalcations involve stealing of cash cheques and goods and are followed by steps to conceal the theft by suppression or misrepresentation of facts.

The Forensic auditor may start his investigation into an alleged fraud with a general scrutiny of all the relevant transactions, followed by a closer scrutiny of some of them considered to be indicative of the actual happenings and finally he may hold few of them seem to hold vital clues to the fraud for thorough investigation. He designs program of investigation in such a way to eliminate the various possibilities till the facts are established. He prepares working papers of the work carried out by ^{him} ~~him~~ such as examining evidences, minutes of the discussions, relevant statements and supporting schedules for finalising his report. His conclusions of the investigation should be clear and to the point with supported by evidences.

Following is the summary of the procedures which, in most instances the forensic auditor has to perform to investigate fraud.

- (a) ascertain level of authority and nature of duties of the defaulting employee;
- (b) cast and vouch cash book, and obtain certificates of opening and closing balances from the bank;
- (c) check cash book against bank statements, paying particular attention to dates of lodgements to ascertain whether receipts were banked without delay;
- (d) examine original pay-in-slips at the bank and compare with counterfoils, since this may reveal the practice known as 'teeming and lading';
- (e) circularize debtors positively;
- (f) note any apparently irregular cash payments;

- (g) examined cancelled cheques and compare names of payees with details in cash book and invoices;
- (h) obtain duplicates of missing expenditure vouchers;
- (i) vouch all amounts shown as partners' or director's drawings or loans;
- (j) vouch and cast petty cash book;
- (k) confirm names of all employees shown on wages lists with chief accountant or other senior official, and amount payable to them;
- (l) if defaulter had access to all books, all postings should be checked and a trial balance extracted;
- (m) confirm all bad debts written off, discount allowances and returns;
- (n) check order book against sales day book or copy-sales invoices to detect any sales which have been wholly unrecorded;
- (o) cash sales should be verified against whatever evidence may be available;
- (p) vouch purchase invoices with purchases day book and see that none has been passed through twice;
- (q) obtain duplicates of all missing purchases vouchers;
- (r) compare creditors statements against purchase ledger balances;
- (s) check goods inwards book or order book against invoices to ensure that the latter relate bonafide purchases.
- (t) Internal controls in the area where fraud is suspected to have taken place should be thoroughly examined.

The Forensic auditor examines the transactions minutely. He may apply two ^{approaches} ~~approaches~~ in this regard, first is, to identify the type of fraud with the use of discovery sampling techniques and having found the evidence of the fraud he may proceed to analyse further. Alternatively he may examine all the related transactions in depth. Once fraud is uncovered, other activities of the employees may have to be examined to detect possible fraudulent actions. Since the nature of fraud varies from company to company, he should be more creative to tackle the situation.

Types of frauds

The Institute of Chartered Accountants of India, in their publication on 'Detection of frauds' has identified the following types of frauds that have been known to happen

Trojan Horse frauds

These frauds are often committed in two phases. The perpetrator, in this type, undertakes an act towards committing a fraud, in the first phase, to test whether the system is able to detect the aberration and when, the act goes unnoticed, the perpetrator, after satisfying himself that the risk is minimal, carries out the crime. In principle, a fraudster uses an object, act or some kind of atest as a Trojan Horse to evaluate the level of risk or safety in a given situation. These type of situations demand effective preventive measures by constant check of key controls ^{and} perhaps use of dummy teams to break the system to test the resilience and to tone up the systems.

Disaster frauds

These frauds happen under the cover of confusion and calamity whereby the fraudster puts to dishonest use of knowledge of asset location, access key information by suppressing evidence, as normal controls break down. This is the reason why disaster situations are often investigated in great detail by insurance companies to establish bona fides. Very often, the calamity itself could have been triggered by the fraudster, with a view to escaping detection. Such situations require thorough investigation of events happening prior to the disaster and subsequently, and effective leads are found by sifting of unusual occurrences from the normal ones.

Achilles Heel Frauds

In these frauds, the fraudster takes advantage of the weakest link in the chain and exploits the weakness to his own end. This could happen in cases where the accounting system installed is not customised but bought off the shelf and controls aspect was not given much thought when the decision was made. Thus system testing is very essential not only at the beginning but also during implementation to rectify potential flaws.

Corporate espionage

These frauds are caused by selling sensitive corporate information to the highest bidder. Such crimes also are on the increase in proportion to the tremendous increase in the value of information. These types of frauds can be checked by strict screening of personnel allowed to handle sensitive information, establishing security protocol that should also include EDP personnel.

Technical fraud

This category pertains to industrial ^{processes} ~~processes~~, that have manual quality control systems, whereby quality control personnel, either through negligence or collusion with vendors, allow inferior products, to be manufactured, though the entire process may happen in the manufacturing site. Such type of fraud often come to light only through physical verification of stocks and stores.

Red flags

The fraud indicators or more popularly known as 'red flag areas' that were previously dealt with are critical to fraud detection system. Some of these are reproduced, as these provide valuable clues:

Absence of rotation of staff

Low turnover of staff or prolonged stationing of personnel at the same assignment may facilitate development of unhealthy vested interests. This may in turn, evidence in the form of personnel never proceeding on leave or unwillingness to delegate authority.

Conflict of interest

When an employee of an organisation, be it a company or in the govt. sector occupying a senior level develops a close relationship with an external party- eg. lender or supplier, the financial interests of the entity are likely to be jeopardised, as these may not be placed in precedence over those of the private or hidden agenda of the employee.

Sudden losses

An entity suddenly starts to incur losses that was to have been profitable all along. This could happen when accounts are window-dressed and losses are camouflged and funds are siphoned off, through inflation of expenses or suppression of income. Such phenomena are very common in the case of tax frauds.

Too good to be true

When there is a sudden increase in profits, the reasons for the same should be well-analysed both in terms of external and internal factors. This calls for a tight monitoring of performance indicators, especially those of the operational areas that directly affect

profitability. Otherwise, the increase in profitability may be achieved through diversion of capital assets or through sale of capital assets that could be a warning indicator.

Orphan funds'

Funds that are held in fiduciary capacity and for which there is no accountability are liable to be ^{more} often misused as neither the donor concerns himself about the usage of the funds nor does the beneficiary have a direct claim in respect of such funds. These funds provide a fertile ground for fraud perpetration.

Disaster situations

These situations also give rise to frauds- whereby conditions can be contrived to make actual evidence of fraud disappear.

Missing documentation

This is the strongest indicator of fraud, especially if it pertains to sensitive information. Often, missing records are attributed to misplacement, shifting of premises, flooding, etc.

Irrational behaviour

Overly rude or secretive behaviour of an employee may be caused to avoid being found out or to cover up some guilt.

Development of a checklist

In addition to the usual checklist for normal audit, the checklist may be adapted to throw up 'red flags', in situations of weak internal controls, that involves skill and judgment, in asking the right questions in the right place. This is illustrated through an exercise.

Fraud investigation significantly differs from normal audit in the sense that normal audit is guided by a standardised checklist while in the case of fraud investigation, a unique and customised approach works best.

Also, much of normal audit relies on persuasive evidence as the main objective is to express an opinion or an assurance in regard to the reliability of the financial information of the audited entity whereas fraud investigation ^{looks} ~~seeks~~ ^{on} out evidence that can prove or disprove conditions of fraud or otherwise. Most fraud investigations begin with allegations of fraud received or on the issue of audit report that could be to determine

- Reasons for shortfall in inventory or cash pointed out in an audit report, the procedural deficiency and the perpetrators involved
- Reasons for a sudden drop in performance levels eg. profit, turnover, in a particular branch, where allegations of corruption have been received.

To be meaningful, every fraud assignment must have specific objectives, be clear as to whom the findings will be reported, the scope of authority or discretion vested in the examiner and the confidentiality of the matters reported upon.

Evidence Gathering techniques

Gathering evidence for detection of fraud is the most vital stage of a fraud investigation and the types of evidence gathered depend upon the situation and the judgment of the fraud investigator. Normally, prior to the evidence collection stage, the investigator conducts a thorough study of internal environment including the controls mechanisms and interviews the personnel concerned. The objective is to appreciate whether factors exist or are conducive for the perpetration of a fraud

Collection of direct evidence

Direct evidence are those that are available in the form of documents, records and other information from the organisation itself. In such examination, fraud investigation team may even consist of a handwriting expert, in the case of suspected forgeries, to establish the authenticity of the documents. Such investigation differs from normal examination in the sense that detailed scrutiny of all accounts or records pertaining to a specific function falling within the zone of suspicion is made. Such documentary evidence is also supplemented through interviews of the concerned employees and their responses meticulously documented.

Indirect evidence

These pertain to field checks or verification procedures, by way of corroboration, of statements of fact or claims. These could pertain to physical verification of cash, stocks, or other assets as represented in the books of account or such other account balances held with third parties, verification of payroll disbursements to unearth 'ghost workers', verification of vendor's credentials and their facilities, physical verification or technical inspection of physical facilities constructed or under construction

Examination of trends and relationships

Apart from analysis of financial data normally carried out by auditors', industry data could be analysed for unusual variations and these anomalies investigated further. For instance, the investigator may analyse how often purchases have been made from a particular vendor and on what terms and compare the terms offered by the vendor to other entities during the period of scrutiny with the object of finding any special favours that were, if any, offered. Another lead could be to check the time taken to clear the vendors' bills to ascertain whether there is any deviation from the routine time taken. Any such leads point out a possible nexus between the purchase department and the supplier.

Such type of data analysis could also extend to non-financial data, eg, employee attendance register regarding punctuality and leave pattern to determine any anomalies that may lead to or indicate plausible involvement of the employee in a suspected activity.

Sting operations

This is an investigator's decoy plan or trap to catch the fraudster red-handed and if successful, is the most direct evidence that can establish the crime. These are often resorted to, when it is difficult to obtain sufficient evidence to implicate the perpetrator.

Exit interviews

After collection of evidence, the examiner narrows down the fraud suspects list for personal interviews. The purpose is two-fold:

- To seek an explanation from the suspect and to enable a fair chance of hearing.
- To confront the suspect with the inconsistencies in the submissions made by him or to confront one suspect with another where their submissions are contradictory.

Normally, such interviews are planned carefully in advance so that innocence or guilt is established as an outcome.

Reliability of evidence

The tenets of evidence that are applicable to audit also apply to a forensic investigation

- External evidence is usually more reliable than internal evidence
- Internal evidence is more reliable when internal controls are satisfactory.
- Written or documentary evidence is more reliable than oral representations

- Evidence obtained by the auditor is more reliable than that obtained through the auditee.

Aids to collect evidence

- Anything that is physically verifiable
- Inference- Arriving at the truth through inductive reasoning/logic.
- Description- used in cases where this is the most effective way of identifying and establishing a fact.
- Through the process of identifying and eliminating the absurdity in fraud situations
- Theory of inverse logic- Through elimination of all possibilities that do not add up to the truth. Thus an attempt is made to arrive at closer to truth by eliminating false situations.eg. In the Salad swindle case, the fact that the aggregate quantity of oil stock that was hypothecated exceeded the total quantity of salad oil stocks in the entire country showed that this was an absurd and false situation.
- Distrust the obvious-Sometimes mistakes appear to be trivial and not worth a second glance but may indicate something serious and important. The truth in such cases is carefully camouflaged that the human mind tends to get influenced by what it sees and hears. These situations call for 'distrust the obvious'
 - An accountant credited an amount of Rs.10,55,000 received from one debtor A to another debtor B. The mistake was noticed during the account reconciliation with the concerned debtor A who was not given the credit. Actually, it was a calculated error to facilitate B to make him eligible for the company's target achievement scheme where a debtor had to clear all his dues promptly. By giving the debtor even temporary credit for funds received from some other party, the debtor became eligible for the incentive and later at the time of correction of the error the matter would become history and forgotten. Obviously, the accountant received some favour in return from the debtor

Evaluation of the evidence

Once all the information relevant to the investigation have been collected, these must be reviewed to ensure all the clues available fit into the totality of the evidence and there is no disharmony or inconsistencies in the evidence suggesting more than one solution. The

fraud investigator, while looking for the guilt, expounds the subject matter of the objective, namely whether the accountant is guilty of favouring the debtor

The next step is to find flaws in the allegations

- In this case, the investigator lists out all doubts
 - All allegations are anonymous
 - The accountant had a good track record
 - The accountant honoured all the bills timely
 - No negative aspects were revealed from previous employment
- The next step is to examine the facts and evidence in support of all the allegations
 - The accountant had been found to have granted discounts to debtor B in the past, when none were due. Other debtors were not similarly rewarded.
 - Records of debtor B showed that the debtor had had dealings with the accountant who was offered concessions. This supplies the motive for the accountant to extend improper credit facility to debtor B.
 - The accountant had received a free holiday package from Debtor B soon after extension of the credit facility.
- Now, the investigator is required to confront the accountant with the above documented evidence not only to enable an opportunity to be heard but also for confirmation of the incriminating evidence.
- As the accountant was unable to explain the mutual favours tendered between himself and the debtor B and in the absence of any other similar favours extended by the accountant to any other party, the conclusion is unavoidable that the accountant had committed an indiscretion.

In the above example, the investigator would have had to use the red flag to develop the investigation and build up a conclusive case.

Reporting an investigation

The most important part of a fraud investigation is the report containing the findings and the conclusions. The report is generally expected to follow the format as below:

- Define the objective and scope of the investigation, listing the terms of reference
- Conclusions as regards the establishment of guilt or otherwise, with lists of suspects and wrongdoing specified

- Findings under each term of reference
- Investigation methodology
- Constraints and limitations
- Recommendations
- Exhibits and appendices containing expert opinions and analysis in support of the findings of the investigation.

Summary

Fraud investigation has assumed considerable significance in the wake of increasing fraud and corruption involving huge amounts of leakage of resources both in the govt. and in the corporate world requiring special skills of a criminal investigator and a skilled auditor. Often, the team also consists of multi-disciplinary experts depending upon the type and complexity of the fraud. The job of a forensic investigator is to conduct a detailed examination of relevant events, transactions, records including behaviour of concerned persons that may form part of pre-defined scope of audit in order to make conclusive findings that can be acted upon in a court of law. This kind of investigation obviously differs from a normal audit scrutiny that is intended to provide a reasonable assurance in regard to the reliability of the information that is based upon the approach of materiality of risk. Also, audit findings have persuasive evidentiary value and where these have indicated a possible fraud or fraudulent practice, the fraud investigator's skills are required to take the investigation to its logical conclusion.

References:

1. **Auditing Today- Third Edition By Emile Woolf**
2. **Detection of Frauds- ICAI- Professional Development Series**



4

Case studies
used in the course
(other than those in the STM)

AUDIT OF ANIMAL HUSBANDRY **FRAUD IN THE STATE OF BIHAR**

- Nearly 7 Billion rupees were fraudulently drawn from the government treasuries by the officials of AH Department
- SAI India investigated into the fraudulent transactions and brought out a special report
- Audit was based on conventional fraud auditing techniques supported by the extensive use of computerised database

- Officers of AH Department were to draw funds for budgeted activity from the government treasury
- They withdrew large amount of funds on the basis of claims for fictitious supply of medicines, animal feed and medical equipment etc.

- The treasury officers did not check the bills properly and see the budget provisions
- Budget controlling officer of the department ignored the fraudulent withdrawals by not linking them with his budget
- He underreported the expenditure to the finance department
- The excess drawal of funds was totally inconsistent with the current programme of the department

- Treasury officers used various pretexts to avoid sending the paid vouchers to the AG who compiled the accounts of the government
- Thus the fraud was concealed for several years

- Thus the transactions could not be audited as disbursing officers did not provide documents to the auditors on the pretext that Public Accounts Committee has seized them .
- The Chairman of PAC was actually in league with corrupt officers and just issued a letter asking for the documents as a cover

TASK BEFORE AUDIT

- Audit had to investigate the subversion of the financial and administrative controls and systems in the government
- The departments involved were Finance Department, Animal Husbandry Department and the Treasuries
- The treasuries were located at several districts over a huge geographical area

- Preliminary scrutiny suggested that various political executives and Bureaucrats acted together in illegal withdrawal of funds
- The Finance Department and the treasury officers overlooked all prescribed checks and participated in the fraud

The audit thrust areas

- How suppliers obtain payment without actually supplying goods and what was the total amount of such payments
- How false certificate of receipt of goods were recorded
- How system of checking/approval of suppliers bills was subverted in the department and in the treasuries
- How accounts and budgetary control and reporting systems were manipulated

- CAG decided to create a computerised database by capturing all relevant information contained in the vouchers and surplus invoices
- Each record had 22 fields

- The analysis of database provided a dramatic result
- Who had drawn the bills and on what date
- The amount of drawal
- Fictitious allotment of funds
- Classification of expenditure as per the budget head
- Treasury Officer who made the payment

- The officer wise information of drawls, period and quantum of drawls was precisely known through the database
- Small offices drew disproportionately large amounts
- They reportedly purchased disproportionate quantity of fodder and medicine

- This information was crossed checked with manufacturers of medicines, veterinary hospitals and Animal firms
- The manufacturers did not supply such large quantity of medicines
- Hospitals never received the medicines
- The animals in the Government firms could not consume so much of medicine and fodder

- Department had only few small schemes and programmes but very large amounts were drawn against such schemes
- Finance Department overlooked the flouting the cash drawal limits from treasuries
- Cash flow managers ignored the signals coming from the monthly reports of the Central Bank

- Grouping of purchase of different of feed medicines equipment showed great distortion in the proportion of these items

- The political executives patronised the officers involved in the fraud by retaining them for 10 to 15 years in their offices against a tenure of 3 to 5 years
- The Director of the AH Department who was deeply involved in this fraud was appointed illegally by the Minister against the Court order

INCOME TAX EVASION

- Information on the suppliers helped in locating their identity and their role in the fraud
- The database helped in linking the government officers and the suppliers
- The check of Income-tax and Sales-tax records revealed that amounts received by them was not included in their tax returns

- The fraud showed a syndicated network of top level politicians, senior bureaucrats, legislators and suppliers
- They collectively plundered public funds and kept the entire operation under wrap for a long period

- Criminal investigating agency launched prosecution against large number of very senior political leaders, bureaucrats and suppliers
- Many of the politicians including Chief Minister of the State went to jail, many bureaucrats and Chairman of Public Accounts Committee went to jail
- Cases of money laundering were detected
- Properties, cash and jewelry were recovered

- CAG's audit investigation proved his ability to investigate into high level corruption and loot of public funds
- This audit also helped developing fraud audit techniques and several similar frauds could be successfully audited
- Results of audit laid to initiative in reforming the system

AARA PAARA

Fraudulent expenditure on Physical Verification of Saw Mills (Audit Report of Chhattisgarh 2004-2005)

Start

Sr. DAG GPF finds Complaint – "on the floor"

- ☐ Major Scam in Raipur Forest Circle
- ☐ 5 divisions named
- ☐ Flying squad
- ☐ Period mentioned
- ☐ Verification of saw mills

Q1 : Have we done any audit?

What did the IR say?

☐ IR of Udanti Forest Division under CF Raipur

- Documents not produced to audit : for cheque drawals of approx. Rs 1.3 crore

☐ Next Step??

Examination of Vouchers

☐ Vouchers located in old records

☐ Clear indicators of fraud

☐ Problem : to prove it

☐ Audit of CF Raipur started

Activity

- ☐ Expenditure incurred on physical verification of saw mills by Flying Squad during Dec2002- Feb2004
 - ☐ Dramatis personae : CF, Raipur, Flying squad (Ranger+5 FG) and 5 DFOs.
 - ☐ Spreading, measuring and restacking of logs in Aara/saw mills using labourers and reconciling with mill stock records.
-

Evidence

- ☐ Order by CF to 2 divisions to pay for bills submitted by flying squad
 - Did not specify type of exp. : Blanket order
 - F Squad Exp. : Should be borne by CF office
 - ☐ Splitting of expenditure over five Divisions and Conservator of Forest, Raipur.
 - ☐ 36 Cheques drawn far in excess of prescribed limits.(1.5 lakh vs 13.98 lakh)
-

Evidence

- ☐ Expenditure incurred without budget allotment and booked in STT
 - ☐ Financial powers of CF – 5 lakh – Not approved by any higher authority
 - ☐ List of officers posted : DFO became CF and the activity picked up
 - ☐ Compilation of 727 Vouchers' (PV) data for Rs 2.29 crore in 200 days
-

Evidence

- ☐ Enormity of scale:
 - 262842 cu met of wood, 2832148 logs
 - 13844 labourers, 4300 gangmen, 295116 man days
 - As many as 28 inspected on a single day
 - Avg. of 70 labourers per mill per day
 - ☐ Conducted on Sundays, state and national holidays, CL days.
 - ☐ Indications of forgery: signatures on vouchers and acquittance roll
 - ☐ Only these Vouchers passed without verification by SDOs.
-

Evidence

- ☐ Most saw mills were in Raipur, little expenditure from Raipur Div.
 - ☐ Falsification of records:
 - List of 523 licensed saw mills in circle
 - List of 269 inspected: both furnished by CF
 - 132 vouchers did not figure in 269
 - 36 vouchers did not figure in 523
 - 2 Vouchers for closed saw mills
 - ☐ Not a single offence detected
-

Evidence - TA Bills

- ☐ Members total of travelled 286608 Kms.
 - ☐ Places mentioned in TA Bills do not correlate with the location of saw mills stated to have been inspected.
 - ☐ Identical TA bills for all 6 members of the Flying squad.
-

Reporting

- ☐ FS prepared for fraud of Rs 2.29 lakh.
 - ☐ Handed over copy personally to Pr. Secy. Forest. In July 2005
 - ☐ He informed that a Dept. Investigation had been ordered a year back but nothing was happening.
 - ☐ Requested for a questionnaire for PCCF
 - ☐ Reported in local press soon after new Pr. Secy joined.
-

-
- ☐ Press reporters landed up seeking info. They had seen our FS.
 - ☐ Deptt. Investigation concluded in Sept. 2005.
 - ☐ Reply to FS furnished. All audit findings accepted
 - ☐ Article in Hindi India Today : Deptt. Investigation. Audit was not mentioned
 - ☐ Report signed in Jan. 2006.
 - ☐ Submitted May 2006
 - ☐ No action yet
-

The reply and justification furnished by the O/o Conservator of Forest, Raipur Circle is not tenable. Section 7 of the "M.P. Kashiba Chitran (Amendment) Bill, 1984" provides for inspection of any sawmill by the licensing authority or any person authorized by him. The order from the O/o P.C.C.F., Raipur, is also an instruction to divisions to conduct inspection of licensed saw mills on a regular basis as per roster. It does not carry any instructions for the Flying Squad. Neither of the two authorities provide for physical verification of the sawmills involving such large expenditure. The physical verification of the sawmills involves spreading, counting, measurement and stacking of logs, which requires large expenditure on labour payment. On the other hand as per various rules and instructions of the department, inspection of saw mills involves verifying operating licences issued by D.F.Os, ensuring the mills keep accounts of timber and checking whether they are submitting returns regularly to D.F.Os. The two activities are thus distinct and different. Inspection involves negligible expenditure, whereas physical verification. Moreover, the maximum financial powers delegated to C.F. for any item of works expenditure is Rs.5 lakhs, whereas the expenditure in this activity was more than Rs.2 Crore. There was also no separate budgetary allotment for this activity, as this was not projected to higher authorities.

Scrutiny of records also revealed that the expenditure incurred by the Flying Squad on physical verification of saw mills of Rs. 2.29 crores was charged under State Trading in Timber (S.T.T.) "Wages". The detailed instructions under (1989) by the department showing items of expenditure to be adjusted under the head S.T.T. does not include expenditure incurred on physical verification of saw mills. Only expenditure incurred on exploitation worked in coupes is chargeable under detailed head "Wages" under S.T.T. Conservator office also stated that no separate head has been prescribed by the department for this work, therefore it was charged under S.T.T. The reply further substantiates that this was an unusual nature of work as no accounting head is prescribed for such items of expenditure.

अन्य दस्तावेजों में भी यह स्पष्ट है कि इन व्ययों में अलग बजटिंग व्यवस्था का अभाव है। अतः उक्त व्ययों को S.T.T. के अंतर्गत ही व्यय करने की आवश्यकता है।

समस्त का कुल है प्रारम्भिक अवधि (1989-90) से 2002-03 तक 2.29 करोड़ रुपये का कुल व्यय। इस व्यय में से 192 करोड़ रुपये 255 गैर पंजीकृत उद्योगों (जिनमें 437 उद्योग शामिल हैं) पर लागू हुए हैं। शेष 3 करोड़ रुपये 632 पंजीकृत उद्योगों पर लागू हैं। कुल व्यय 2,29,32,947/- (दो करोड़ बीस लाख रुपये) है। (प्रतिवेदन क्रमांक-82)

जिन उद्योगों में इन व्ययों की मदद से अलग बजटिंग का अभाव है, वे हैं: (1) उद्योगों में अलग बजटिंग का अभाव है। (2) उद्योगों में अलग बजटिंग का अभाव है। (3) उद्योगों में अलग बजटिंग का अभाव है।

समस्त का कुल है प्रारम्भिक अवधि (1989-90) से 2002-03 तक 2.29 करोड़ रुपये का कुल व्यय। इस व्यय में से 192 करोड़ रुपये 255 गैर पंजीकृत उद्योगों (जिनमें 437 उद्योग शामिल हैं) पर लागू हुए हैं। शेष 3 करोड़ रुपये 632 पंजीकृत उद्योगों पर लागू हैं। कुल व्यय 2,29,32,947/- (दो करोड़ बीस लाख रुपये) है। (प्रतिवेदन क्रमांक-82)

Therefore, it is clearly established that the physical verification was an unusual item of work and the Conservator of Forest, Raipur Circle, issued orders for an activity much beyond his authority without obtaining approval of competent authority.

Further, audit scrutiny also revealed that 168 number of physical verification were carried out during the months from December, 2002 to July 2003, i.e. even before the issue of the undiminished orders by C.F. in August, 2003. The authority on which these physical verification were conducted may be intimated to audit.

Irregularities in disposal of funds:
(a) The Conservator of Forest, Raipur Circle issued orders to D.F.O., Udaipur Division (June 2003) and D.F.O. Mahasamund Forest Division (August 2003) instructing them to make payment for all bills submitted by Flying Squad of Raipur Forest Circle. The orders to Udaipur Division was given 94-FOR/1, the instruction to Flying Squad for conducting physical verification. The orders did not specify the nature of activity for which bills would be submitted by Flying Squad and was a blanket instruction. Since the Flying Squad is under the direct control of C.F., Raipur, the expenses of the Flying Squad should normally be debited from the funds available in Conservator's office. Only Rs.17.49 lakh was spent on physical verification from funds drawn from C.F. office. On the other hand, based on these two orders, these two divisions paid more than Rs. 1.5 crore on the physical verification conducted by the Flying Squad. Other 3 divisions of Raipur circle also made similar payments. The department may intimate the authority on which such payments were made. The reasons why the C.F. ordered for splitting of the disbursements and expenditure may be furnished to audit.

The Flying Squad drew large amounts in Forest advances from the five divisions and C.F. office (Rs.2.50 crore). Most of the amount was used for physical verification. Further irregularities were observed in disposal of funds from the 5 divisions and Conservator's Office.

अतः स्पष्ट है कि उक्त व्ययों में अलग बजटिंग व्यवस्था का अभाव है। अतः उक्त व्ययों को S.T.T. के अंतर्गत ही व्यय करने की आवश्यकता है।

(b) उद्योगों में अलग बजटिंग व्यवस्था का अभाव है। अतः उक्त व्ययों को S.T.T. के अंतर्गत ही व्यय करने की आवश्यकता है।

Introduction

9th GLOBAL FRAUD SURVEYS-RISING RISK LEVELS IN INDIA-

Ernst & Young

We are pleased to present the results of our 9th Global Fraud Survey. This time the focus of our Global Survey was on "Fraud Risks in Emerging Markets". Considering that India is a dominating force in the emerging markets, we had expanded the scope of the survey to gain additional insights into the fraud risk scenario in India.

The India supplement is the result of interviewing senior personnel from 50 leading corporate houses and understanding how fraud is perceived and managed in the country.

Workplace fraud happens every day and its impact is a major drain on the bottom line of Corporate India. Media has reported a manifold increase in frauds being committed in the country. Moreover, incidence and scale of white-collar crime have risen in the wake of fraudulent practitioners adopting modern technologies to serve their ulterior motives. Yet, we believe that only about 20% of the frauds are reported in the public domain as several such cases are either discovered but not made public or have not been detected.

Fraud impacts organizations in other, less tangible ways than the most obvious damage of direct financial loss. The areas of potential damage include deteriorating workforce morale and destroying brand perception. Such damage, though difficult to quantify, can have a serious impact on an organization's value.

Recent regulatory changes such as Sarbanes-Oxley Act of 2002 and Clause 49 of the Listing Agreement have added to the already existing pressure on organizations to improve their fraud fighting efforts. Listed organizations are now statutorily required to ensure that they develop and implement effective fraud prevention programs, controls and risk assessments.

Stakeholders everywhere are also exerting greater pressure on Board of Directors/management of companies to step up the prevention, detection, investigation and reporting of frauds. They are becoming increasingly intolerant to financial statement frauds and failures in corporate governance. Most companies have come to realise that fraud prevention and detection are no longer viewed as just best practices but are integral to corporate governance. Any complacency in this regard could lead to serious consequences.

At a conceptual level, combating frauds requires both an understanding of how and why they happen as well as the ways to minimise the damages. We, at Ernst & Young, India, command several years of experience in the field of fraud prevention, detection and investigation. Our Fraud Investigation & Dispute Services team comprises forensic & fraud investigators, business risk professionals, industry specialists and IT security experts.

We adopt an integrated approach, combining the expertise of experienced professionals, their technical excellence and knowledge across global platforms, to provide you with focused solutions. We believe this will supplement your senior management's efforts to (i) appreciate the risks of fraud, (ii) recognise the early warning signals, (iii) adopt appropriate preventive measures, and (iv) act decisively if and when fraud is suspected or discovered.

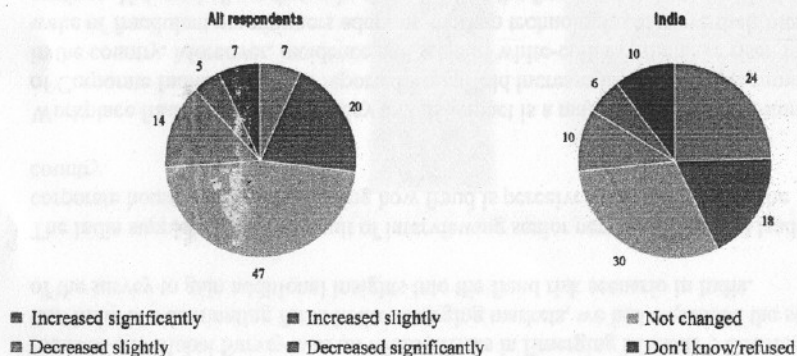
Key Findings

Rising Levels of Fraud

- 42% of the senior corporate professionals in India when interviewed said the incidence of fraud has increased, with over 24% of noting an alarming rise in the trend. This was in sharp contrast to the global findings wherein only 27% of the respondents felt that fraud had increased in the last two years, and only 7% said the increase was significant.
- Similarly, 40% of the respondents from India said that fraud was largely prevalent in their respective business sectors, while over 12% of them felt the phenomenon was widespread. In contrast, only 26% of the respondents worldwide felt that fraud was prevalent in their respective business sectors, with only 5% of them maintaining that the risk was widespread.

Fig 1. Rising Levels of Fraud

To what extent, if at all, have global levels of fraud changed in your business sector over the last 2 years?



42 % of Indian companies feel that levels of fraud have increased in the last two years

Fraud risk assessment is today a key consideration for companies investing in emerging markets. Many of these companies apparently decided against investing in these markets after making their own fraud risk assessments, a trend attested by 21% of the respondents globally and 14% of the respondents from India. All this highlights a greater need for companies in emerging markets like India to formulate anti-fraud policies, particularly those that do not conduct periodic fraud risk assessments.

Greatest Fraud Risks

- Respondents from India viewed internal fraud in collusion with third parties (36%) as the greatest risk to their organisations in emerging country operations.
- Exposure to corruption and bribery (29%), financial statement fraud (14%) and misappropriation of assets (5%) were cited as the other key risks.

We believe these findings nevertheless underestimate the risk of financial statement fraud. Management at local operating units in remote locations is likely to come under pressure to report inaccurate results and provide justification for the same. Such practices if not detected early could lead to accumulated losses that are material to the parent company/office. To explain this, while the implementation of International Financial Reporting Standards (IFRS) may be seen as a positive step, the transition to new accounting standards, whereby the change from local GAAP to IFRS might negatively impact a subsidiary's historical results, could pressure managers to commit financial statement fraud.

The risk of fraud and business disputes can emerge almost anywhere

Victims of Fraud

About 14% of respondents from India admitted to having experienced significant fraud in the last two years compared to 19% of the respondents worldwide who had similar experiences. However, we believe the incidence of fraud in India could be much higher as a significant number of cases apparently go unreported or are not detected.

Combating Fraud: What works?

Robust internal controls remain the first line of defense against fraud, but anti-fraud controls are not always integrated under an anti-fraud programme. They are usually monitored separately for operational efficiency.

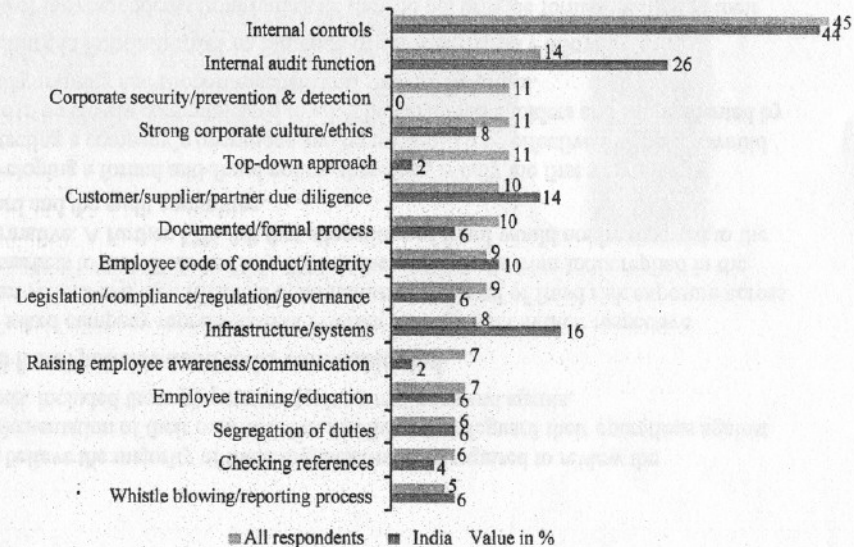
- 44% of Indian companies considered internal controls as key to success in fraud prevention and detection while 26% attributed success in this regard to the internal audit function.
- 70% of the respondents from India felt their organisations follow standard procedures to tackle allegations or suspicions of fraud. A whopping 98% were confident that their control systems and procedures were adequate to identify and investigate fraud promptly with about 48% of them stating that they were 'very confident'.
- 12% of the respondents stated that frauds were usually detected by accident than design. Our experience suggests that a significant number of frauds are likely to be detected accidentally.
- Over 38% of the respondents revealed they do not have in place a formal or documented anti-fraud policy, whereas only 29% of the respondents from the developed markets maintained a similar line. This indicates that although issues of corporate governance and international regulatory provisions have captured the attention of a wider audience in India, their focus on internal controls has not extended to adoption of formal anti-fraud policies.

“ 38% of companies today do not have a formal anti-fraud policy ”

Pertinent to note that the adoption of a formal anti-fraud policy will go a long way to strengthen the internal controls, thereby raising the confidence levels of employees, partners and suppliers around the world. In our view, many of the organisations do not properly assess the fraud risks while designing their control systems and procedures, and as a result their control systems are not geared to detect fraud. Even where controls exist, they may be rendered ineffective by management override or collusion. In such a situation, companies are well advised to adopt anti-fraud policies on a war-footing.

Fig 2. Factors Determining Success of Approach To Fraud

What do you consider to be the most important factors that determine the success of an organisation's approach to fraud prevention and detection



“ Having robust internal control systems that changes with the dynamics of the business is an important tool to combat fraud ”

Key Findings

Anti-fraud Policies – Coverage

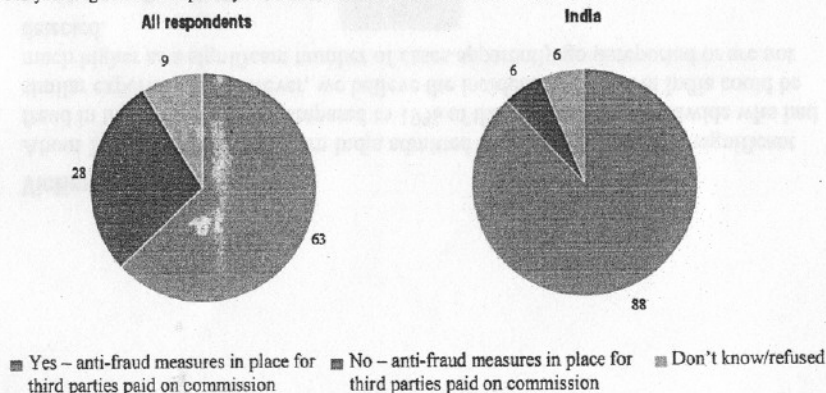
The increasing focus of regulators and law enforcement agencies worldwide to undertake anti-bribery and anti-corruption initiatives is proof of the daunting risks that corporations face today. There are indeed risks attached to working with third parties or intermediaries in international markets. Further, in competing for resources, companies are often required to pay commissions or succession fees.

In light of this, 76% of the respondents from India agreed that their organisations work with intermediaries or agents who are paid on commission basis. Only 12% of the respondents said their companies have no specific anti-fraud measure to forestall any malafide act of third parties. We believe a larger number of companies in India do not have any specific measure to tackle third party fraud since the results from this exercise relate primarily to organizations that have set industry benchmarks and are not likely to be representative of all companies operating in the country. Most of the companies in the country are seen to be far removed from industry best practices.

Further, we observed that a significant percentage of the organisations that possess anti-fraud policies seem to be under-communicating the same to their joint venture partners, agents and intermediaries in the emerging markets.

Fig 3. Anti-fraud Measures for Intermediaries and Third Parties

Does your organisation explicitly consider anti-fraud measures when it enters a new market?



We believe the majority of these organisations are required to review the implementation of their own anti-fraud policies to safeguard their operations against frauds, included those perpetrated by intermediaries and agents.

Anti fraud policies need to be communicated

We asked company representatives if senior management in their respective organisations had identified and communicated the level of fraud risk exposure across all markets to their Boards. Only 76% of the respondents from India replied in the affirmative. A further 12% felt that allegations of fraud would not be reported to the Board and the audit committee.

Developing a formal anti-fraud policy, therefore, is only the first step towards protecting a company's operations and reputation. To be effective, the policy would have to be clearly communicated to all appropriate stakeholders and supplemented by quality training and support mechanisms, such as, helplines.

Training is Fundamental to Success of an Anti-fraud Policy

68% of the respondents from India said they do not provide formal training to their employees to understand and implement anti-fraud policies. The nature of this communication itself stands questioned with 70% of the respondents admitting that anti-fraud programmes were not communicated to their respective employees in the local language.

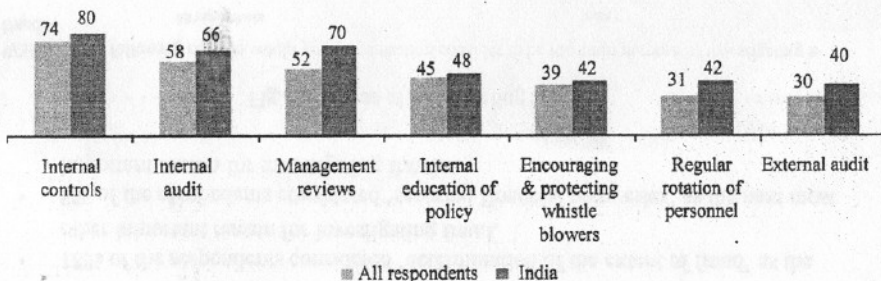
36% of the respondents considered facilitation fees as a common business practice in their respective business sectors. However, two-thirds (68%) of them said they regularly pay facilitation fees and admitted that their employees were not trained to spot the difference between facilitation fees and payments abetting corruption. It emerges that even companies that commonly pay facilitation fees, and have an anti-fraud policy in place, do not effectively communicate the same to their management and staff.

“ Internal control systems need to be bolstered by development & communication of comprehensive & formal anti-fraud policies ”

Factors Contributing to Success in Fraud Prevention of Fraud

- 70% of the respondents from India considered 'internal controls' and 'internal audit' in organisations as the key support systems for fraud prevention and detection.
- Only 24% of the respondents from India viewed corporate security/prevention and detection, corporate culture/ethics, top-down approach, documented formal processes, legislation or employee awareness building and training as key to prevention of and detection of fraud, unlike 59% of the respondents worldwide who considered the above factors as instrumental in fraud prevention and detection. Indian companies are, therefore, well advised to pay greater attention to these factors in their endeavour to check fraudulent practices.

Fig. 4 Factors Contributing to Success in Prevention of Fraud



Existence of high level of internal controls & continuous monitoring through internal audit remain the most important factors to fraud prevention and detection

- CFO of Business Unit, India

The Importance of Independence

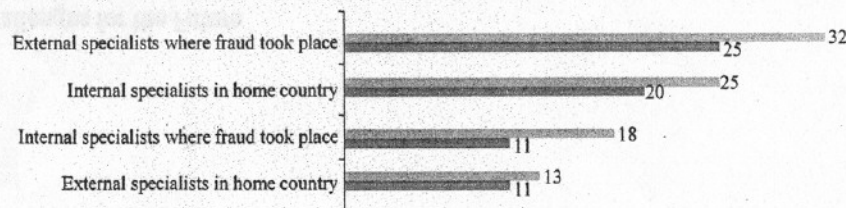
When asked to suggest how they would initiate fraud investigation outside their home country, 36% of the respondents from the developed countries said they would opt for external specialists in the country where the fraud has occurred. In contrast, only 25% of the respondents in India said they would enlist the services of specialist advisors to tackle such situations. This, we believe, may be attributed to reasons, such as, failure to recognize that external advisors could indeed have a more nuanced understanding of the local laws and customs, and the lack of appreciation of the importance of independent investigators when a fraud may have a financial statement impact, or when investigative findings will need to be shared with regulators.

Among the other options, deploying internal specialists is seen as the next most plausible option. This is because companies in general seek a quick understanding of the problem while keeping a lid on expenses. However it should be ensured that the resources deployed are adequately trained/ equipped to handle the situation (including legal requirements.)

Quite often, the decision to enlist the services of external legal and accounting professionals is shaped by the availability and familiarity of internal resources, on the one hand, and issues pertaining to independence, incremental cost, and enhanced credibility of external resources, on the other. If the alleged wrongdoing is expected to have a financial statement impact or if senior management involvement is suspected, enlisting of independent investigative resources would be more appropriate, especially for public companies, and those in highly regulated industries.

Fig. 5 Specialists Preferred

In response to fraud incidents in countries outside the home/domestic market, which of the following types of specialist advisors and investigators would you typically prefer to use



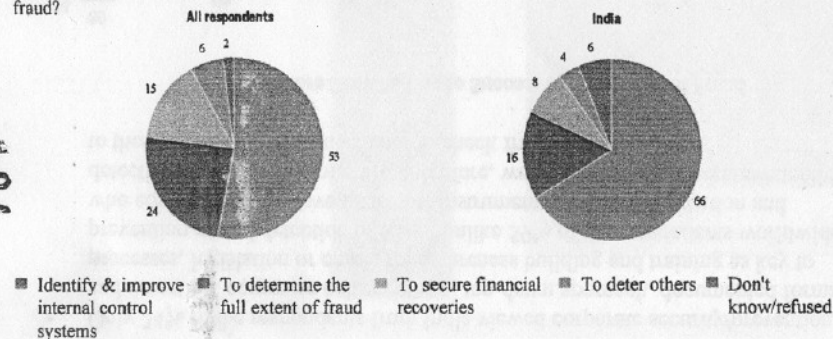
Key Findings

Objective of investigating fraud

- 68% of the respondents in India considered 'identification and improvement of internal control systems' as the main purpose of investigating fraud.
- 18% of the respondents considered 'determination of the extent of fraud' as the other important reason for investigating fraud.
- 8% of the respondents considered 'securing financial recoveries' as the next most important reason for investigating fraud.

Fig. 6 Purpose of Investigating Fraud

Which of the following reasons would your organisation consider to be the main purpose of investigating a fraud?



Prosecution of fraudsters

We asked the respondents whether they would file a criminal complaint or name the individual as a deterrent to others in the event that their organisation needed to terminate a person's employment for causes related to fraud or dishonesty. Only 66% of the respondents felt they would consider filing a criminal complaint or naming the individual as a deterrent to others in such circumstances, while 20% of the respondents said that no criminal complaint would be made in such circumstances.

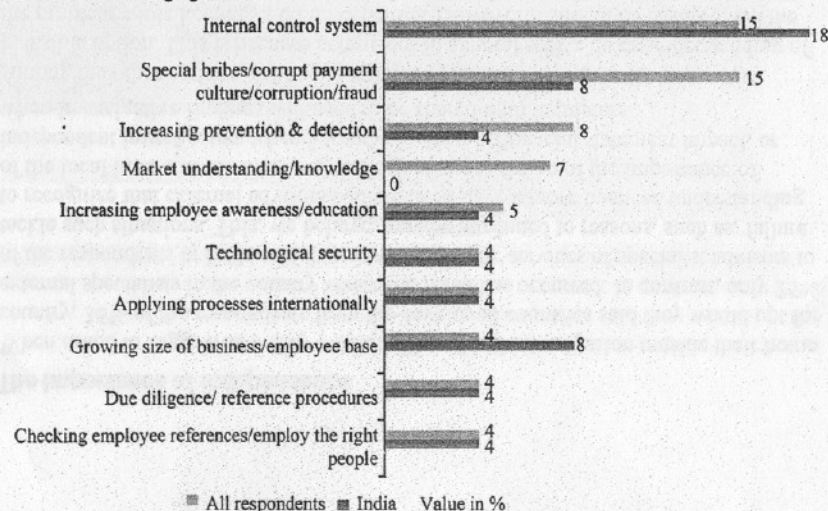
Hence, even organisations that have a policy of reporting all frauds do not proceed with filing a complaint and pressing charges in every case. They would prefer to steer clear of any negative publicity or a long-drawn judicial process, particularly if they see the probability of prosecution or recovery of stolen assets is very low.

Challenges for the Future

18% of the respondents considered 'internal control system' (18%), 'special bribes/illegal payments/other corrupt practices/fraud' (8%) or 'growing size of business/employee base' (8%) as the biggest challenges for their respective organisations in the next two years in relation to the risk of fraud in emerging markets. However, the respondents acknowledged that improvement of fraud prevention and detection systems, building employee awareness regarding the issue, due diligence for mitigating risks from third party relationships, market understanding/knowledge, and instituting appropriate technological security would also pose significant challenges to their organisations in the emerging markets in the next two years.

Fig. 7 Challenges For the Future

What do you perceive to be the biggest challenges for your organisation in the next two years in relation to the risk of fraud in emerging markets



“ Growing our business in relation to the opportunities in the market place without compromising our values is the biggest challenge today ”

- Managing Director of Business Unit, India

The Way Forward

Fraud is a concept that is generally understood but whose characteristics are often not recognised until it is too late. It is often thought of as a victimless crime, although we could all be victims of it, as individuals or as businesses. Corporate fraud costs businesses hundreds of millions of pounds each year. It affects livelihoods and is an all-too common cause of corporate failure. Fraud remains an immediate and significant threat to all organisations across geographies.

Prevention is better than cure

In today's business environment with increased legislative and regulatory requirements, there is a greater need for organisations to understand and address fraud risks. The likelihood and extent of fraud can be reduced by implementing timely and effective anti-fraud programmes. Fraud prevention and detection also make good business sense as they provide cost savings to organisations. Apart from the development of comprehensive policies and procedures, implementation of anti-fraud programmes requires effective communication, implementation and compliance monitoring. This can be achieved by adopting the following three steps:

- I. **Create an anti-fraud environment:** Management should strive hard to create an environment where people believe that fraudulent acts will not be tolerated. A zero tolerance level should be established for fraud/other dishonest acts. This can be achieved by adopting a (i) fraud policy, (ii) code of business conduct/ethics policy, (iii) whistle blower policy and provision of fraud hotlines, (iv) fraud response plan, and by holding fraud awareness training and workshops.
- II. **Undertake comprehensive fraud risk assessment:** Every organisation has inherent and specific fraud risks that depend on factors, such as, industry size, organisation structure, internal controls environment, geographical location, etc. Organisations are increasingly considering fraud risk as part of their company-wide risk assessment programmes.

- III. **Implement Adequate Oversight/Monitoring:** Adequate monitoring procedures should be established to review and improve the effectiveness of anti-fraud programmes and controls.

Once suspected or discovered, investigating fraud is a specialist task requiring experience and technical skill. There is no doubt that fraud is best prevented, rather than dealt with after the fact. Unfortunately, there is no foolproof method of preventing fraud, although a range of fraud prevention techniques are known to be successful. Various techniques may be used to pro-actively test for fraud profiles, and to further investigate so that fraud incidents are effectively tackled. The most effective and appropriate response to the problem of fraud involves a combination of fraud prevention, detection and investigation techniques.

“ Fraud is expensive and disruptive, making prevention preferable to investigation and recovery. Preventing fraud before it happens is the ultimate goal of a successful fraud prevention & awareness program ”

Survey approach

From February through April 2006 our researchers² interviewed senior decision-makers in large organisations. The sample was structured to include respondents from key positions of the company including the finance function, risk, internal audit and business unit leaders.

Interviews were conducted across 19 countries. In India, 50 corporations were interviewed. The break-up of the profile of companies and respondents is as given alongside

²The telephone based survey was conducted by Taylor Nelson Sofres.

Job Title	India Respondent	Industries Covered
CFO/Financial Director/ Financial Manager.	26	Diversified Industrial Products
CEO/ COO	7	Consumer products
Head of Legal	6	Banking, Capital Markets and Insurance
Head/MD of Business Unit	4	Technology
Head of Internal Audit/ CRO/Risk Manager	4	Chemicals, Mining and Utilities
Company Secretary	2	Automotive
Head of Fraud/Security	1	Biotechnology and Pharmaceuticals
		Construction
		Media and Entertainment
Total	50	Retail and Wholesale

Johann Graf Lambsdorff¹

The Corruption Perceptions Index, now in its eleventh year, aims to provide data on extensive perceptions of corruption within countries. These perceptions enhance our understanding of real levels of corruption from one country to another. The CPI is a composite index, making use of surveys of business people and assessments by country analysts.

Overall, 16 sources were included in the 2005 CPI, originating from 10 independent institutions and using data compiled between 2003 and 2005. The sources used were: (1) Columbia University; (2) the Economist Intelligence Unit; (3) Freedom House; (4) Information International from Beirut (Lebanon); (5) the International Institute for Management Development (in Lausanne); (6) the Merchant International Group Limited (in London); (7) the Political and Economic Risk Consultancy (in Hong Kong); (8) the United Nations Economic Commission for Africa; (9) the World Economic Forum; (10) the World Markets Research Centre (in London). The number of countries in the CPI 2005 increased to 159 from 146 in 2004.

For an analysis of the medium-term corruption trends that can be discerned from the CPI data series, see Chapter 10 in this volume. A more detailed description of the methodology is available at www.transparency.org/surveys/index.html#cpi or at www.icgg.org.

Country Rank	Country	2005 CPI score ^a	Surveys used ^b	Standard deviation ^c	High-low range ^d	Confidence range ^e
1	Iceland	9.7	8	0.2	9.3 – 9.8	9.5 – 9.7
2	Finland	9.6	9	0.2	9.3 – 9.8	9.5 – 9.7
	New Zealand	9.6	9	0.2	9.3 – 9.7	9.5 – 9.7
4	Denmark	9.5	10	0.3	8.7 – 9.8	9.3 – 9.6
5	Singapore	9.4	12	0.2	9.0 – 9.7	9.3 – 9.5
6	Sweden	9.2	10	0.3	8.7 – 9.6	9.0 – 9.3
7	Switzerland	9.1	9	0.3	8.5 – 9.4	8.9 – 9.2
8	Norway	8.9	9	0.6	7.9 – 9.5	8.5 – 9.1
9	Australia	8.8	13	0.8	6.7 – 9.5	8.4 – 9.1

Country Rank	Country	2005 CPI score ^a	Surveys used ^b	Standard deviation ^c	High-low range ^d	Confidence range ^e
10	Austria	8.7	9	0.5	8.1-9.3	8.4-9.0
11	Netherlands	8.6	9	0.5	7.8-9.4	8.3-8.9
	United Kingdom	8.6	11	0.5	7.7-9.3	8.3-8.8
13	Luxembourg	8.5	8	0.7	7.7-9.6	8.1-8.9
14	Canada	8.4	11	0.9	6.5-9.4	7.9-8.8
15	Hong Kong	8.3	12	1.1	5.5-9.4	7.7-8.7
16	Germany	8.2	10	0.6	7.5-9.2	7.9-8.5
17	USA	7.6	12	1.0	5.3-8.5	7.0-8.0
18	France	7.5	11	0.8	5.5-9.0	7.0-7.8
19	Belgium	7.4	9	0.9	5.6-9.0	6.9-7.9
	Ireland	7.4	10	1.0	5.5-8.7	6.9-7.9
21	Chile	7.3	10	0.9	5.5-8.7	6.8-7.7
	Japan	7.3	14	1.2	5.5-9.0	6.7-7.8
23	Spain	7.0	10	0.7	5.6-8.1	6.6-7.4
24	Barbados	6.9	3	1.2	5.7-8.1	5.7-7.3
25	Malta	6.6	5	1.6	5.1-9.0	5.4-7.7
26	Portugal	6.5	9	1.2	5.0-7.8	5.9-7.1
27	Estonia	6.4	11	1.1	5.1-9.0	6.0-7.0
28	Israel	6.3	10	1.2	4.2-8.5	5.7-6.9
	Oman	6.3	5	1.5	4.2-8.0	5.2-7.3
30	United Arab Emirates	6.2	6	1.4	4.5-8.2	5.3-7.1
31	Slovenia	6.1	11	1.2	4.8-8.7	5.7-6.8
32	Botswana	5.9	8	1.4	4.4-8.1	5.1-6.7
	Qatar	5.9	5	0.6	5.5-6.9	5.6-6.4
	Taiwan	5.9	14	1.0	3.7-7.7	5.4-6.3
	Uruguay	5.9	6	0.6	5.5-6.9	5.6-6.4
36	Bahrain	5.8	6	0.7	4.7-6.9	5.3-6.3
37	Cyprus	5.7	5	0.5	4.9-6.2	5.3-6.0
	Jordan	5.7	10	1.0	3.4-6.9	5.1-6.1
39	Malaysia	5.1	14	1.2	3.4-8.0	4.6-5.6
40	Hungary	5.0	11	0.5	4.1-5.7	4.7-5.2
	Italy	5.0	9	0.8	4.1-6.2	4.6-5.4
	South Korea	5.0	12	0.7	3.8-5.8	4.6-5.3
43	Tunisia	4.9	7	1.1	3.7-6.9	4.4-5.6
44	Lithuania	4.8	8	0.6	4.0-5.5	4.5-5.1
45	Kuwait	4.7	6	1.0	3.4-5.7	4.0-5.2
46	South Africa	4.5	11	0.6	3.4-5.6	4.2-4.8
47	Czech Republic	4.3	10	1.4	2.7-7.7	3.7-5.1
	Greece	4.3	9	0.8	3.7-5.7	3.9-4.7
	Namibia	4.3	8	1.0	3.4-6.2	3.8-4.9

Country Rank	Country	2005 CPI score ^a	Surveys used ^b	Standard deviation ^c	High-low range ^d	Confidence range ^e
51	Slovakia	4.3	10	1.0	3.2 - 5.7	3.8 - 4.8
	Costa Rica	4.2	7	0.9	3.4 - 5.5	3.7 - 4.7
	El Salvador	4.2	6	1.1	2.6 - 5.5	3.5 - 4.8
	Latvia	4.2	7	0.7	3.6 - 5.5	3.8 - 4.6
55	Mauritius	4.2	6	1.2	2.5 - 5.7	3.4 - 5.0
	Bulgaria	4.0	8	1.1	2.7 - 5.6	3.4 - 4.6
	Colombia	4.0	9	0.8	2.7 - 5.6	3.6 - 4.4
	Fiji	4.0	3	1.0	3.4 - 5.1	3.4 - 4.6
59	Seychelles	4.0	3	0.4	3.5 - 4.2	3.5 - 4.2
	Cuba	3.8	4	1.6	1.7 - 5.5	2.3 - 4.7
	Thailand	3.8	13	0.6	2.6 - 4.7	3.5 - 4.1
	Trinidad and Tobago	3.8	6	1.0	2.7 - 5.5	3.3 - 4.5
62	Belize	3.7	3	0.4	3.4 - 4.1	3.4 - 4.1
	Brazil	3.7	10	0.5	2.7 - 4.4	3.5 - 3.9
64	Jamaica	3.6	6	0.3	3.4 - 4.1	3.4 - 3.8
65	Ghana	3.5	8	0.8	2.6 - 5.1	3.2 - 4.0
	Mexico	3.5	10	0.5	2.7 - 4.5	3.3 - 3.7
	Panama	3.5	7	0.8	2.6 - 5.1	3.1 - 4.1
	Peru	3.5	7	0.6	2.6 - 4.1	3.1 - 3.8
70	Turkey	3.5	11	1.0	2.2 - 5.3	3.1 - 4.0
	Burkina Faso	3.4	3	0.7	2.7 - 4.2	2.7 - 3.9
	Croatia	3.4	7	0.4	3.0 - 4.2	3.2 - 3.7
	Egypt	3.4	9	0.8	2.3 - 5.1	3.0 - 3.9
	Lesotho	3.4	3	0.8	2.6 - 4.1	2.6 - 3.9
	Poland	3.4	11	1.0	2.5 - 5.7	3.0 - 3.9
	Saudi Arabia	3.4	5	1.0	2.0 - 4.5	2.7 - 4.1
	Syria	3.4	5	1.1	2.2 - 5.1	2.8 - 4.2
77	Laos	3.3	3	2.0	2.1 - 5.5	2.1 - 4.4
78	China	3.2	14	0.6	2.2 - 4.1	2.9 - 3.5
	Morocco	3.2	8	0.7	2.2 - 4.1	2.8 - 3.6
	Senegal	3.2	6	0.6	2.5 - 4.2	2.8 - 3.6
	Sri Lanka	3.2	7	0.7	2.2 - 4.1	2.7 - 3.6
83	Suriname	3.2	3	1.0	2.2 - 4.1	2.2 - 3.6
	Lebanon	3.1	4	0.4	2.7 - 3.5	2.7 - 3.3
	Rwanda	3.1	3	1.7	2.1 - 5.1	2.1 - 4.1
85	Dominican Republic	3.0	6	0.8	2.0 - 4.2	2.5 - 3.6
	Mongolia	3.0	4	0.8	2.2 - 4.2	2.4 - 3.6
	Romania	3.0	11	0.9	2.0 - 5.1	2.6 - 3.5
88	Armenia	2.9	4	0.5	2.4 - 3.4	2.5 - 3.2

Country Rank	Country	2005 CPI score ^a	Surveys used ^b	Standard deviation ^c	High-low range ^d	Confidence range ^e
	Benin	2.9	5	1.3	1.7 - 5.1	2.1 - 4.0
	Bosnia and Herzegovina	2.9	6	0.4	2.4 - 3.4	2.7 - 3.1
	Gabon	2.9	4	1.0	2.1 - 4.1	2.1 - 3.6
	India	2.9	14	0.5	2.1 - 3.5	2.7 - 3.1
	Iran	2.9	5	0.8	1.7 - 3.5	2.3 - 3.3
	Mali	2.9	8	1.2	1.5 - 5.1	2.3 - 3.6
	Moldova	2.9	5	1.1	1.9 - 4.6	2.3 - 3.7
	Tanzania	2.9	8	0.5	2.1 - 3.5	2.6 - 3.1
97	Algeria	2.8	7	0.7	2.0 - 4.2	2.5 - 3.3
	Argentina	2.8	10	0.6	1.8 - 3.5	2.5 - 3.1
	Madagascar	2.8	5	1.2	1.7 - 4.2	1.9 - 3.7
	Malawi	2.8	7	0.9	2.0 - 4.6	2.3 - 3.4
	Mozambique	2.8	8	0.6	2.1 - 3.5	2.4 - 3.1
	Serbia and Montenegro	2.8	7	0.7	2.2 - 4.1	2.5 - 3.3
103	Gambia	2.7	7	0.7	1.7 - 3.9	2.3 - 3.1
	Macedonia	2.7	7	0.7	2.2 - 4.1	2.4 - 3.2
	Swaziland	2.7	3	0.7	2.0 - 3.4	2.0 - 3.1
	Yemen	2.7	5	0.5	2.2 - 3.6	2.4 - 3.2
107	Belarus	2.6	5	1.4	1.7 - 5.1	1.9 - 3.8
	Eritrea	2.6	3	1.3	1.7 - 4.2	1.7 - 3.5
	Honduras	2.6	7	0.6	1.6 - 3.5	2.2 - 3.0
	Kazakhstan	2.6	6	0.8	1.8 - 4.1	2.2 - 3.2
	Nicaragua	2.6	7	0.4	2.1 - 3.0	2.4 - 2.8
	Palestine	2.6	3	0.5	2.1 - 3.1	2.1 - 2.8
	Ukraine	2.6	8	0.3	2.2 - 3.0	2.4 - 2.8
	Vietnam	2.6	10	0.6	1.7 - 3.5	2.3 - 2.9
	Zambia	2.6	7	0.5	2.1 - 3.4	2.3 - 2.9
	Zimbabwe	2.6	7	0.8	1.4 - 3.6	2.1 - 3.0
117	Afghanistan	2.5	3	1.1	1.6 - 3.7	1.6 - 3.2
	Bolivia	2.5	6	0.5	2.0 - 3.5	2.3 - 2.9
	Ecuador	2.5	6	0.6	1.9 - 3.5	2.2 - 2.9
	Guatemala	2.5	7	0.6	1.7 - 3.5	2.1 - 2.8
	Guyana	2.5	3	0.4	2.0 - 2.7	2.0 - 2.7
	Libya	2.5	4	0.7	1.8 - 3.4	2.0 - 3.0
	Nepal	2.5	4	0.7	1.7 - 3.4	1.9 - 3.0
	Philippines	2.5	13	0.6	1.5 - 3.5	2.3 - 2.8
	Uganda	2.5	8	0.5	2.0 - 3.5	2.2 - 2.8
126	Albania	2.4	3	0.4	2.1 - 2.8	2.1 - 2.7
	Niger	2.4	4	0.3	2.1 - 2.7	2.2 - 2.6

Country Rank	Country	2005 CPI score ^a	Surveys used ^b	Standard deviation ^c	High-low range ^d	Confidence range ^e
130	Russia	2.4	12	0.3	1.9 - 3.0	2.3 - 2.6
	Sierra Leone	2.4	3	0.5	2.1 - 3.0	2.1 - 2.7
	Burundi	2.3	3	0.3	2.1 - 2.7	2.1 - 2.5
	Cambodia	2.3	4	0.5	1.7 - 2.7	1.9 - 2.5
	Congo, Republic	2.3	4	0.4	2.0 - 3.0	2.1 - 2.6
	Georgia	2.3	6	0.5	1.7 - 2.7	2.0 - 2.6
	Kyrgyzstan	2.3	5	0.4	1.9 - 2.7	2.1 - 2.5
	Papua New Guinea	2.3	4	0.5	1.7 - 2.7	1.9 - 2.6
	Venezuela	2.3	10	0.2	2.0 - 2.5	2.2 - 2.4
137	Azerbaijan	2.2	6	0.5	1.7 - 3.0	1.9 - 2.5
	Cameroon	2.2	6	0.4	1.8 - 2.7	2.0 - 2.5
	Ethiopia	2.2	8	0.4	1.7 - 2.8	2.0 - 2.5
	Indonesia	2.2	13	0.4	1.7 - 3.3	2.1 - 2.5
	Iraq	2.2	4	1.0	1.4 - 3.6	1.5 - 2.9
	Liberia	2.2	3	0.1	2.1 - 2.4	2.1 - 2.3
	Uzbekistan	2.2	5	0.2	2.0 - 2.5	2.1 - 2.4
	Congo, Democratic Republic	2.1	4	0.4	1.6 - 2.5	1.8 - 2.3
	Kenya	2.1	8	0.5	1.4 - 3.0	1.8 - 2.4
144	Pakistan	2.1	7	0.7	1.3 - 3.4	1.7 - 2.6
	Paraguay	2.1	7	0.4	1.6 - 2.7	1.9 - 2.3
	Somalia	2.1	3	0.4	1.6 - 2.4	1.6 - 2.2
	Sudan	2.1	5	0.2	1.7 - 2.3	1.9 - 2.2
	Tajikistan	2.1	5	0.4	1.7 - 2.7	1.9 - 2.4
	Angola	2.0	5	0.2	1.6 - 2.2	1.8 - 2.1
	Cote d'Ivoire	1.9	4	0.3	1.6 - 2.2	1.7 - 2.1
	Equatorial Guinea	1.9	3	0.3	1.6 - 2.2	1.6 - 2.1
	Nigeria	1.9	9	0.3	1.4 - 2.2	1.7 - 2.0
151	Haiti	1.8	4	0.5	1.4 - 2.5	1.5 - 2.1
	Myanmar	1.8	4	0.2	1.6 - 2.2	1.7 - 2.0
	Turkmenistan	1.8	4	0.2	1.6 - 2.2	1.7 - 2.0
152	Bangladesh	1.7	7	0.5	1.0 - 2.4	1.4 - 2.0
	Chad	1.7	6	0.6	1.0 - 2.7	1.3 - 2.1

a. '2005 CPI score' relates to perceptions of the degree of corruption as seen by business people, academics and risk analysts, and ranges between 10 (highly clean) and 0 (highly corrupt).

b. 'Surveys used' refers to the number of surveys that assessed a country's performance. A total of 16 surveys were used from 10 independent institutions, and at least three surveys were required for a country to be included in the CPI.

- c. 'Standard deviation' indicates differences in the values given by the sources: the greater the standard deviation, the greater the differences in perceptions of a country among the sources.
- d. 'High-low range' provides the highest and lowest values given by the different sources.
- e. 'Confidence range' provides a range of possible values of the CPI score. This reflects how a country's score may vary, depending on measurement precision. Nominally, with 5 per cent probability when few sources are available, an unbiased estimate of the mean coverage probability is lower than the nominal value of 90 per cent. It is 65.3 per cent for 3 sources; 78.4 per cent for 5 sources; 80.2 per cent for 6 sources and 81.8 per cent for 7 sources.

1. Johann Graf Lambsdorff is chair in economic theory at the University of Passau (Germany) and a research consultant to Transparency International, for whom he has coordinated and carried out the CPI since 1995.

Regional Training Institute
Course on Audit of Fraud and Fraud Detection Techniques
27.12.2006 – 30.12.2006

Project for presentation by participants

1. Background

Internal control consists of rules, orders and procedures designed to provide management with a reasonable assurance that the entity is functioning in the manner intended and is likely to achieve its objectives. Such a system consists of methods and policies designed to prevent fraud, minimize errors, promote operating efficiency and to achieve compliance with established policies to protect resources against loss due to waste, abuse and mis-management. A good internal control system should enable managers to ensure efficient, effective and economic utilization of resources. Internal auditors as an independent entity, examine and evaluate the level of compliance to the departmental rules and procedures and provide independent assurance to the management on the adequacy or otherwise of the existing internal controls.

The Government of Maharashtra administers health services to the public through hospitals and dispensaries and also implements various programmes for controlling water borne, vector borne and other diseases. As of March 2005, there were 26 General Hospitals, 1,814 Primary Health Centres (PHCs) existing in the State. Audit carried out an evaluation of the internal control mechanism and internal audit system in the Public Health Department.

2. Organisational set-up

The Secretary, Public Health Department is responsible for planning and evaluation of programmes at State level. The health services programmes are implemented through the Director General of Health Services (DGHS) who is assisted by three Joint Directors (JD) of Public Health, Leprosy and Malaria and Filaria. The JDs are

assisted at circle level by the Deputy Director of Health Services (DDHS) for water-borne diseases and by the Assistant Director of Health Services (ADHS) for vector-borne diseases. The DDHS controls and water-borne diseases through hospitals and PHCs. The ADHS implements the schemes through the district Malaria Officers.

For urban areas at district level, the public health services are provided by the Civil Surgeons incharge of the General Hospitals, and at taluka level by the Medical Officers of the Rural Hospitals and the Cottage Hospitals. For rural population of villages, the services are provided by the District Health Officers (DHS) of the Zilla Parishads (ZPs) through the PHCs headed by the Medical Officers (MO).

The Controller of Accounts and Audit (CAA) in the office of the JDHS (Health), Pune is responsible for conducting internal audit of all units of the Public Health Department in the State.

3. Audit objectives

The audit objectives were to examine the adequacy and effectiveness of :

- Budgetary controls
- Financial controls including administrative and operational controls,
- Procurement controls,
- Manpower management,
- Organisational controls and
- System of Internal Audit.

4. Task

- i) Prepare relevant Audit checklist for examination during the audit in order to achieve each of the audit objectives stated above so as to prevent fraud and minimize errors.
- ii) Each Group should present their output on 30.12.2006 FN for evaluation.

**AUDIT OF FRAUD FRAUD DETECTION TECHNIQUES AND FORENSIC AUDIT
MARK LIST**

30-12-06

Sl. No.	Name of the participant	Design	Theory	Project	General Assement	Total	Grade	Rank
1	J. Viswanadham	Sr.AO	31	35	10	76	A	
2	S.M. Tijare	Sr.AO	39	35	10	84	A	
3	N.D Hinnariya	AO	25	33	10	68	B	
4	B.V. Vijaya Saradhi	AO	34	32	10	76	A	
5	A.K. Bhattacharjee	AAO	43	33	10	86	A	
6	Shaik Suleman	AAO	29	33	10	72	B	
7	A.V.N. Pantulu	AAO	38	35	10	83	A	
8	K. Vamana Murty	AAO	31	35	10	76	A	
9	M.P.A. Sarma	AAO	32	35	10	77	A	
10	A.S. Chauthaiwala	AAO	33	33	10	76	A	
11	Akhilesh Gaur	AAO	18	32	10	60	B	
12	Abant Kumar Panda	AAO	42	35	10	87	A	THIRD
13	S.S. Surakhe	AAO	31	35	10	76	A	
14	Noel Roy	AAO	34	32	10	76	A	
15	S.D. Bhowmik	AAO	25	32	10	67	B	
16	S.M. Tetu	SO	33	35	10	78	A	
17	Imteyaz Ahmad	SO	26	32	10	68	B	
18	S. Dhan Raj Reddy	SO	39	35	10	84	A	
19	Amit Kumar	SO	36	33	10	79	A	
20	Navin Kumar Shrivastava	SO	43	35	10	88	A	SECOND
21	Ashok Kumar Chaudhary	SO	39	32	10	81	A	
22	Kunal Bose	SO	47	35	10	92	A	FIRST
23	S. Sanjeeva Reddy	Sr.Adr.	19	33	10	62	B	

GRADE A	17	74%
GRADE B	6	26%

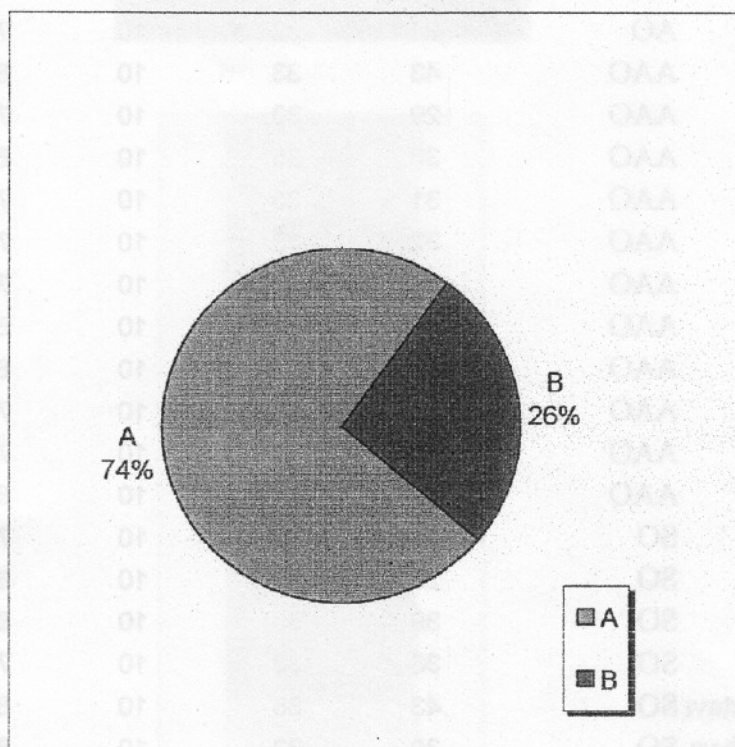
FIRST	Kunal Bose
SECOND	Navin Kumar Shrivastava
THIRD	Abant Kumar Panda

PRINCIPAL DIRECTOR

Name of the Course: Audit of Fraud, Fraud Detection Technique & Forensic Audit

Total No. of participants : 23

Performance in the End Course Evaluation Test¹



¹ A Grade .. $\geq 75\%$, B Grade .. $\geq 60\%$, C Grade .. $\geq 50\%$, D Grade: $< 50\%$

REGIONAL TRAINING INSITUTE, 26/1, CIVIL LINES NAGPUR

LIST OF PARTICIPANTS

Course Code: 63

Course: AUDIT OF FRAUD,FRAUD DETECTION TECHNIQUE AND FOR

Duration: 27-Dec-06 To 30-Dec-06

Sr. No.	Enrl No.	Name _Designation	Office
1	990	Shri.B.V.V.Saradhi, AO	Pr.Accountant General(Civil Audit),Saifabad,Andhra Pradesh,Andhra Pradesh,Hyderabad-500004
		<u>Comp. Awarness</u>	
2	991	Shri.Amit Kumar, SO	Pr.Accountant General(Civil Audit),Saifabad,Andhra Pradesh,Andhra Pradesh,Hyderabad-500004
		<u>Comp. Awarness</u>	
3	992	Shri, S.Dhanraj Reddy, SO	Pr.Accountant General(Civil Audit),Saifabad,Andhra Pradesh,Andhra Pradesh,Hyderabad-500004
		<u>Comp. Awarness</u>	
4	993	Shri.Imteyaz Ahmed, SO	Accountant General(A&E)-II,Civil Lines,Maharashtra,Maharashtra,Nagpur
		<u>Comp. Awarness</u>	
5	994	Shri.A.S.Chauthaiwale, AAO	Accountant General(A&E)-II,Civil Lines,Maharashtra,Maharashtra,Nagpur
		<u>Comp. Awarness</u>	
6	995	Shri. Sunil Surakhe, AAO	Accountant General(A&E)-II,Civil Lines,Maharashtra,Maharashtra,Nagpur
		<u>Comp. Awarness</u>	
7	996	Shri.S.M.Tijare, SR.AO	Accountant General(A&E)-II,Civil Lines,Maharashtra,Maharashtra,Nagpur
		<u>Comp. Awarness</u>	
8	997	Shri.S.M.Tetu, SO	Accountant General (Works & Receipt Audit),53- Arera Hills,,Hoshangabad Road,MadhyaPradesh,Bhopal-462 011
		<u>Comp. Awarness</u>	

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Sr. No.	Enrl No.	Name Designation	Office
9	998	Shri.Ashok Kumar Chaudhary, SO	Accountant General (Works & Receipt Audit),53- Arera Hills,,Hoshangabad Road,MadhyaPradesh,Bhopal-462 011
		<u>Comp. Awarness</u>	
10	999	Shri.Navin Kumar Shrivastva, SO	Accountant General (Works & Receipt Audit),53- Arera Hills,,Hoshangabad Road,MadhyaPradesh,Bhopal-462 011
		<u>Comp. Awarness</u>	
11	1000	Shri.M.P.A.Sarma, AAO	Principal Director of Commercial Audit,and ex Officio Member Audit Board,,AG's Office Complex,Saifabad,Andhra Pradesh,Hyderabad
		<u>Comp. Awarness</u>	
12	1001	Shri.J. Viswanadham, SR.AO	Principal Director of Commercial Audit,and ex Officio Member Audit Board,,AG's Office Complex,Saifabad,Andhra Pradesh,Hyderabad
		<u>Comp. Awarness</u>	
13	1002	Shri.Noel Roy, AAO	Accountant General (Works & Receipt Audit),53- Arera Hills,,Hoshangabad Road,MadhyaPradesh,Bhopal-462 011
		<u>Comp. Awarness</u>	
14	1003	Shri.Sheikh Suleman, AAO	Accountant General (Works & Receipt Audit),53- Arera Hills,,Hoshangabad Road,MadhyaPradesh,Bhopal-462 011
		<u>Comp. Awarness</u>	
15	1004	Shri.Abant Kumar Panda, AAO	Accountant General,12/27, Raman Mandir Ward,,Bilaspur Road, Fafdia,Chattisgarha,Raipur- 492009
		<u>Comp. Awarness</u>	
16	1005	Shri.A.V.N.Pantulu, AAO	Accountant General,12/27, Raman Mandir Ward,,Bilaspur Road, Fafdia,Chattisgarha,Raipur- 492009
		<u>Comp. Awarness</u>	

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Sr. No.	Enrl No.	Name Designation	Office
17	1006	Shri Saumitra Datta Bhowmik, AAO <u>Comp. Awareness</u>	Principal Director of Audit, W.C.Rly, 2nd FLOOR, D.R.M.BUILDING,, M.P, Jabalpur 482001
18	1007	Shri.Ashokranjan .K.Bhattacharjee, AAO <u>Comp. Awareness</u>	Accountant General(A&E)-II, Civil Lines, Maharashtra, Maharashtra, Nagpur
19	1008	Shri N.D.Hinnariya, AO <u>Comp. Awareness</u>	Principal Director of Audit, W.C.Rly, 2nd FLOOR, D.R.M.BUILDING,, M.P, Jabalpur 482001
20	1009	Shri.Kumal Bose, SO <u>Comp. Awareness</u>	Director of Audit, Post and Telegraphs, Audit Office, Lata Complex, Nampally, Andhrya Pradesh, Hyderabad
21	1010	Shri.Akhilesh Gaur, AAO <u>Comp. Awareness</u>	Director of Audit, Post and Telegraphs, Audit Office, Lata Complex, Nampally, Andhrya Pradesh, Hyderabad
22	1011	Shri S.Sanjeeva Reddy, SR.AUDITOR <u>Comp. Awareness</u>	Director of Audit, Post and Telegraphs, Audit Office, Lata Complex, Nampally, Andhrya Pradesh, Hyderabad
23	1012	Shri K.Vanana Murty, AAO <u>Comp. Awareness</u>	Principal Director of Audit, South Central Railway,, Andhra Pradesh,, Secunderabad - 500 071

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