



## Forensic audit: Amalgam of detective skills and financial acuity

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### Abstract

When it comes to auditing, many of organizations consider it is as simply a statutory requirement for getting the financials examined by a certified accountant to ensure compliance. However, this type of audit (financial audit) is just one of many other types of audits that any organization would undergo. Forensic audit is one among such audits which involves an examination of past financial records of an entity to detect any illegal action, manipulation in the books of accounts, siphoning of funds, etc. The forensic audit begins with the suspicion and doubt and ends with the performance of investigation procedures either to confirm the case or dispel the suspicion.

Unlike financial audits which are focused more on statutory compliance, the forensic audits are designed to investigate the financial records of an entity to derive evidences in support of fraud that can be used in court of law or legal proceedings. In general, Forensic Audit represents an area of finance that combines detective skills and financial acuity. The forensic audit professionals dig deep into financial reports, locate financial transactions and figure out what really happened of various companies and who is the real culprit behind any fraud which has taken place in the company.

Forensic audit is becoming increasingly frequent for top leadership searches as stringent corporate governance norms and increasing stakes are prompting Indian and multinational companies to make sure that the people they take on board have no blotches on their track record. In order to assist in the paramount growth of Indian economy on the global platform under the realm of good governance, transparency, accountability and uprightness, Forensic Audit has become a need of the hour.

**Keywords:** Asset misappropriation, bribery, financial statement fraud, forensic audit, fraud triangle

### Introduction

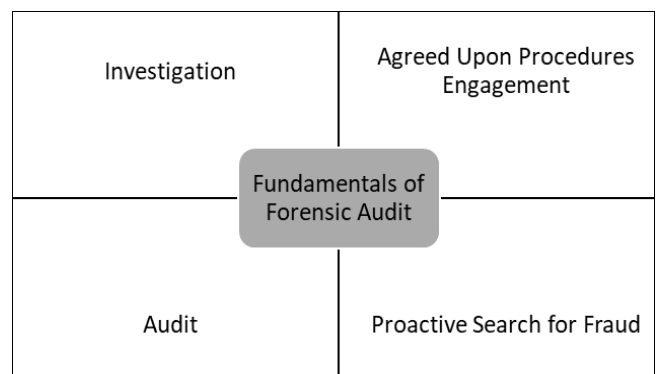
Forensic Auditing in general is referred as a discipline of detecting fraud in the organizations and gathering and presenting financial information in a form of evidences that will be accepted by a court of jurisprudence against perpetrators of economic crimes.

The integration of accounting, auditing, and investigative skills and evidences yields the specialty known as Forensic Auditing which focuses very closely on detecting or preventing financial fraud

- "Forensic" according to the Webster's Dictionary means, "Belonging to, used in or suitable to courts of judicature or to public discussion and debate."
- The word "Auditing is defined as the examination or inspection of various books of accounts by an auditor followed by physical checking of inventory to make sure that all departments are following documented system of recording transactions. It is done to ascertain the accuracy of financial statements provided by the organization.

With India being ranked as the 81 in the Global Corruption Perception Index, the needs for forensic audit become all the more profound to strengthen the corporate culture with the vibes of good governance in the country

The term 'forensic auditing' refers to financial fraud investigation which includes the analysis of various books of accounts to prove or disprove financial fraud and serving as an expert witness in Court to prove or disprove the same. Thus, basically, the forensic auditing is the use of accounting or secretarial skills for legal purposes.



Major Fundamentals of Forensic Audit involves:

1. An audit
  2. An investigation
  3. An agreed-upon procedures engagement
  4. A proactive search for fraud
1. **Forensic Audit:** An examination of evidence regarding an assertion to determine its correspondence to establish criteria carried out in a manner suitable to the court. An example would be a Forensic Audit of sales records to determine the quantum of rent owing under a lease agreement, which is the subject of litigation.
  2. **Forensic Investigation:** The utilization of specialized investigative skills in carrying out an inquiry conducted in such a manner that the outcome will have application to a court of law. A Forensic Investigation may be grounded in accounting, medicine, engineering or some other discipline

**3. Agreed Upon Procedural Engagement:** As the purpose of the forensic audit is ensure that there is no financial deception in the organizations and it collects evidence after the examination of accounts and its records, therefore, it is required that forensic audit is done under the agreed procedures of Audit and Evidence. For instance, for Company Audit, the auditor is required to prepare the audit report in accordance with the Company Auditor's Report Order (CARO) 2016. CARO requires an auditor to report on various aspects of the company, such as fixed assets, inventories, internal audit standards, internal controls, statutory dues, among others.

**4. Predicting the Unpredictable - A Proactive Search:** A Proactive search for fraud comprises a Forensic Audit Thinking. Forensic Audit Thinking involves

- The critical assessment throughout the audit of all evidential matter, and
- Maintaining a higher degree of professional skepticism,
- That fraud may have occurred, is occurring, or will occur in the future.

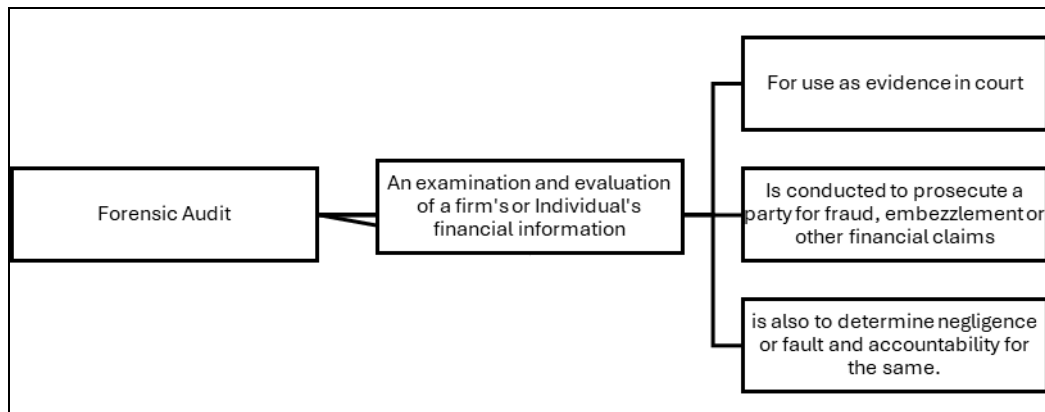
It further involves to decipher pattern, evaluation reports with figures to study their number patterns and comparing them with standards established looking for prima facies area of suspicion.

In this scenario, Forensic auditing aids in detecting, investigating and preventing the frauds. Whether it is stock market fraud or bank fraud or cyber fraud; forensic auditing seems to be on essential tool for investigation and defining accountability of perpetrators.

**Forensic Audit: An Examination of Evidence**

Forensic audit is, in general, referred to as on examination of evidence regarding an assertion to determine its correspondence to established criteria carried out in a manner suitable to the court.

As per the definition given in Investopedia, Forensic Audit is on examination and evaluation of a firm's or individual's financial information for use as evidence in court. A Forensic Audit can be conducted in order to prosecute a party for fraud, embezzlement or other financial claims. in addition, an audit may be conducted to determine negligence or even to determine how much spousal or child support an individual will have to pay,



Jack Bologna and Robert defined Forensic Audit as the application of financial skills and an investigative mentality to unresolved issues, conducted within the context of the rules of evidence. As a discipline, it encompasses financial expertise, fraud knowledge, and a strong knowledge and understanding of business reality and the working of the legal system.

Collin Greenland defines that forensic accounting (or auditing) is the integration of accounting, auditing and Investigative skills in order to provide an accounting analysis suitable for the resolution of disputes (usually but not exclusively) in the courts.

Business Dictionary defines Forensic Audit as the application of accounting methods to the tracking and collection of forensic evidence, usually for investigation and prosecution of criminal acts such as embezzlement or fraud. It further states that forensic audit is also called forensic accounting

**Significance of Forensic Audit**

Forensic auditing has taken an important role in both private and public organizations since the dawn of the 21<sup>st</sup> century especially in the advance economies. The catastrophe of some formerly prominent public companies such as Enron and WorldCom (MCI Inc.) in the late 1990s, coupled with the terrorist attacks of September 11, 2001 and the recent

incidence of fraud taken place in the corporates including the one in the leading public bank of Indian economy, have fuelled the prominence of forensic auditing/accounting, creating a new, important and lucrative specialty. Forensic auditing procedures target mostly financial and operational fraud, discovery of hidden assets, and adherence to federal regulations.

Cressy (2012) in his paper explained that in forensic auditing specific procedures are carried out in order to produce evidence. Audit techniques and procedures are used to identify and to gather evidence to prove, for example, how long have fraudulent activities existed and carried out in the organization, and how it was conducted and concealed by the perpetrators. Evidence may also be gathered to support other issues which would be relevant in the event of a court case.

Further, with the increase in the financial frauds popularly known as white collar crimes, forensic auditing and accounting have risen to prominence for ensuring the directed growth of the corporates and inclusive growth of economy

A Ready Reference to the Significance of Forensic Audit could be rationalized as below:

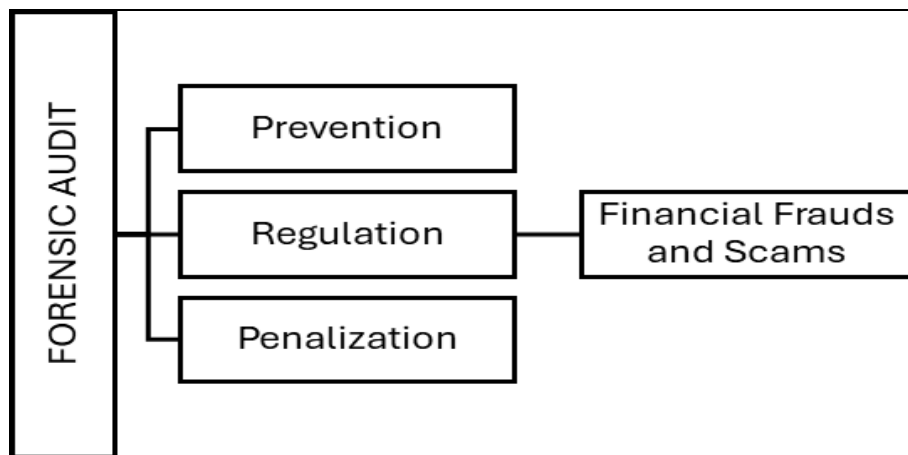
- In general, forensic auditing, which is described as a specialized field of accountancy investigates fraud and analyses financial information to be used in legal proceedings.

- In Forensic Audit, a systematic and independent examination of books, accounts, statutory records, documents and vouchers of an organization is held to ascertain fraud or probability of fraud.
- Much beyond the official documents of the company, the Forensic audit involves lot of field work, trying to talk to multiple stake holders to gather information and then look for evidence to corroborate it and alike.
- It also attempts to identify or to corroborate the culprit behind the fraud.
- It arranges and collects the evidence of the fraud and the person accused of fraud.
- The collected evidence and reviewed facts are used in the legal proceedings which assist the court in granting punishment to the real accused of the fraud.
- Forensic auditing uses accounting, auditing, and investigative skills to conduct investigations into theft

and fraud. It encompasses both Litigation Support and Investigative Accounting.

This makes forensic audit on apt tool in the contemporary times, ensuring financial health of the companies through aiding in the Prevention, Regulation and Penalization of financial frauds and scams.

So, we may opine that Forensic Audit is an examination of a company's financial records to derive evidence which can be used in a court of law or legal proceeding. In the contemporary times, when the Government is looking forward for a robust economy and nation building at par, financial stability is a must in the corporates. Henceforth, Forensic audit submits various recompenses in ensuring commercial health of the companies through aiding in the Prevention, Regulation and Penalization of financial frauds and scams.



**Stages of Forensic Audit**

**Step 1: Accepting the Investigation**

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

**Step 2: Planning the Investigation**

Planning the investigation is the key step in a forensic audit. The auditor(s) must carefully ascertain the goal of the audit so being conducted, and to carefully determine the procedure to achieve it, through the use of effective tools and techniques. Before planning the investigation, they should be clear on the final categories of the report, which are as follows:

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

**Step 3: Fraud Triangle and Fraud Risk**

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

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

**Step 3: Gathering Evidence**

In forensic auditing specific procedures are carried out in order to produce evidence. Audit techniques and procedures are used to identify and to gather evidence to prove, for example, how long have fraudulent activities existed and carried out in the organization, and how it was conducted and concealed by the perpetrators. In order to continue, it is pertinent that the planning stage has been thoroughly understood by the investigating team, who are skilled in collecting the necessary evidence.

#### Step 4: Reporting

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

#### Step 5: Court Proceedings

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

#### Common Areas where Forensic Audit is used

With the increase in financial fraud popularly known as white-collar crime, the forensic accounting and auditing has emerged as prominence to ensure the financial growth for businesses and economy as well. Some of the common areas that are to be detected in forensic audit are:-

- **Asset Misappropriation:** Asset misappropriation is the most prevalent form of fraud. Activities such as creating fake invoices to either existing or non-existing suppliers, payments, misappropriation of cash or theft come under the purview of asset misappropriation.
- **Bribery:** Bribery involves offering money to influence a situation or get things done in one's Favour.
- **Extortion:** The wrongful use of actual or threatened violence, intimidation or force to gain property or money from an entity or individual. If a fraudster demands the same forcefully then that would amount to extortion.
- **Financial Statement fraud:** Financial statement fraud is the deliberate misrepresentation, misstatement or omission of financial statement data for the purpose of misleading the reader and creating a false impression of an organization's financial strength. The most common practice here is deferring revenues or expense in a different time period to give the appearance of consistent earnings or growth.
- **Conflict of interest:** When a fraudster uses influence for personal gains that prove to be detrimental for the company.

#### Forensic Audit - Need of the Hour

Time and again, it has been established that corporate frauds are one of the major hindrances to the inclusive growth of the economy. In any economy the rise in corporate frauds is directly proportionate to the fall of economy. Corporate fraud schemes go beyond the scope of an employee's stated

position, and are marked by their complexity and economic impact on the business, other employees and outside parties. Goldman Sachs on the Impact of PNB Scam on Indian Economy stated that "To global investors. India's economy may seem a bit like a raw mango these days enticing from a distance but bitter to taste, good for pickles, and not much more. Indeed, in the days following the revelation that billionaire jewellers, Nirav Modi and Mehul Choksi, duped India's second-largest government bank, the PNB stock has lost more than a quarter of its market value. Other public sector bank scrips have tumbled, too."

In the previous years too, India has witnessed financial frauds which affected the golden growth of India's economy. The Investigations and risk consulting firm Kroll unearthed in their survey that 69% of companies studied were affected by fraud in Financial Year of 2013, up from 68% in the previous year. The value of fraud, the study found, rose, to 71% from 67%. Insider fraud was particularly rife in India, with 89% of respondents indicating the perpetrator was an insider of some sort a junior, middle management or senior employee, or on agent. That's the reason forensic audit practices have evolved significantly over the last 10-15 years. He added that "earlier the investigations were restricted to books and records but now there is a significant element of Intelligence gathering. The technology, analytics and professional expertise have a greater play in every aspect of forensic auditing".

Indeed, the recent upswing in the financial frauds in India, compelling more management to conduct forensic audits in the interest of our growing economy. Experts on white-collar crimes say forensic auditing is not just gaining prominence, the methods are changing fast.

As of now, the forensic auditing has emerged as a specialized field in the industry that requires a specific skill set to detect the fraud, leaving no scope for overlap. But, to determine when an organization needs forensic auditing is significant to deal with the early warning signals of fraud. Thus, there are few instances on the occurrence of which an entity should direct for forensic audit like

1. Theft of business information or where business systems have been hacked,
2. Issues identified by Whistle Blowers,
3. Reconciliations resulted in unidentified material differences,
4. Suspicious of fraud or illegal activity,
5. Turnover has occurred and balances are showing negative results.

Forensic Audit is assuming greater importance in India and also globally in the wake of numerous financial frauds, unethical business practices and high incidence of cybercrime, In almost every sector and in verticals, there has been some financial frauds and white-collar crimes, which has paved the way for introducing and adopting the Forensic Audit.

#### Summing-up

Along with Reserve Bank of India making forensic audit mandatory for large advances and re-structuring of accounts, the Enforcement Directorate and the Serious Fraud Investigation Office have also emphasized the need for forensic audit following the rise in money laundering and wilful default cases that are plaguing the banking system. They referred to the example that as the enactment

of The Prohibition of Benami Property Transactions Act, 1988 increases the importance of Forensic Audit in the country's fight against financial offenders, there are other levels too, where forensic audit would prove to be a boon in settling down the principles of transparency and integrity in addition to settling down the accountability of real culprit.

The above discussion confirms that in order to assist in the paramount growth of Indian economy on the global platform under the realm of good governance, transparency, accountability and uprightness, Forensic Audit has become a need of the hour. With its key benefits in the form of Objectivity, Credibility, Expert Accounting. Enhanced effectiveness and Efficiency, Forensic Audit assures the growth of the corporates and development of the Indian Economy, which in turn leads to the inclusive growth of the emerging India. Therefore, it becomes imperative that the professionals should be well versed with basic concepts of Forensic Audit in order to effectively implementation the means and techniques of Forensic Audit towards mitigating the corporate frauds and strengthening an efficient corporate culture in India.

Further, in an era of supporting a robust economy of India, which is becoming one of the fastest emerging economies of the world, it is significant to encounter all the challenges affecting the directed growth of the economy. In such the efforts encountering the challenges, the menace of fraud, deception and scam has to be encountered at the first instance in order to promote a viable growth to corporates and economy as a whole. Considering the urgent need to check financial frauds on one side and characteristics of Forensic Audit on other side, which helps in an examination and evaluation of a firm's or individual's financial information for use as evidence in court along with a fact finding process to prosecute a party for fraud, embezzlement or other financial claims, forensic audit is leading the check in the modern day scenario.

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