

## **8. Emerging Role of Forensic Audit and Valuation - A Study of Selected Scams in India**

**Dr. Sanjeev Kumar Bansal, Dr. Roopali Batra**

Assistant Professor, Department of Management and Hospitality,  
I. K. Gujral Punjab Technical University,  
Jalandhar, Punjab, India.

**Kriti Kishor**

Research Scholar, Department of Management and Hospitality,  
I. K. Gujral Punjab Technical University,  
Jalandhar, Punjab, India.

### ***Abstract:***

*The core of any nation's prosperity is its robust and resilient economy. It should come as no surprise that economic development is a key factor in keeping a country on its feet. Economic shocks must be maintained at narrowest. Financial as well as corporate frauds and fraudulent activities have proliferated and provide numerous issues for the global economy. ABG Shipyard Scam, Nirav Modi scam, Vijay Mallya scam, Satyam computers scam, Harshad Mehta scam etc. are the examples of corporate and financial scams which shook the Indian economy.*

*The notion of forensic accounting and forensic audit has gained attention due to the recent rise in fraud cases and the government's inability to combat fraud. This paper aims at inspecting and analyzing the intensified instances of various scams in India and role of forensic audit in uncovering these and ensuring fair business valuation. The magnitude of intensified scams analyzed in this paper clarify that there is undeniably need of a strict regulatory jurisdiction. A detailed in depth understanding of the process adopted by perpetrators to make money at the cost of public interest is important for framing policies, even important to Forensic accountants for combating scams and limiting fraud incidents. Thus, it is the need of the hour that regulatory/professional bodies and corporate practitioners make serious efforts to ensure effective implementation of forensic accounting and audit.*

### **8.1 Introduction:**

Corporate and banking scams have been increasing rapidly during the last few decades. These scams have become a real threat for the developing economies like India. For combating these scams forensic accounting has emerged as a new budding field of accounting. The first economist who clearly saw the demand for forensic accountants was Kautilya. A forensic accountant serves as a bloodhound of accounting. (Singh, 2012; Saha, 2014).

According to KPMG, “Forensic accounting is defined as assistance in disputes which are likely to involve litigation, arbitration, expert determination, mediation or an enquiry by an appropriate regulatory authority, and investigations of suspected fraud, irregularity or impropriety which could potentially lead to civil, criminal or disciplinary proceedings.”

Forensic audits on the other hand require accounting and auditing procedures and expert knowledge about the legal framework of such an audit. As both the disciplines engage in financial evidence, forensic audit is frequently used interchangeably with forensic accounting. However, the two terms are distinct since they employ different processes, methodologies, and instruments (<https://indiaforensic.com/forensic-audit-vs-forensic-accounting/>)

There are two different forms of frauds, which one must understand before defining both terms:

**(a) Frauds against business:** These crimes are typically committed by customers, vendors, or staff working collectively.

**(b) Frauds for business:** These frauds are typically conducted by founders and stockholders to defraud banks, various authorities, and regulators.

While Forensic Accounting deals with frauds against business and Forensic Audit relates to fraud for business (<https://indiaforensic.com/forensic-audit-vs-forensic-accounting/>). Forensic audit is detailed analysis and review of the financial records of a company or person to extract facts, which can be used in a court of law.

## **8.2 Role of Forensic Audit in Valuation:**

The role of forensic audit in valuation is pivotal, as it ensures the accuracy, reliability, and integrity of financial information, which are essential components in determining the fair value of an asset, business, or investment. Here's a more focused breakdown of the role of forensic audit in valuation:

- 1. Verification of Financial Statements:** Forensic audit scrutinizes financial statements to ensure that they present a true and fair view of the entity's financial position. This verification is fundamental for valuation as it forms the basis for assessing the historical and projected financial performance.
- 2. Detection of Financial Irregularities:** Forensic audit identifies any financial irregularities, discrepancies, or fraud within the organization. By uncovering hidden liabilities, inflated revenues, undisclosed expenses, or other anomalies, forensic audit ensures that the valuation is based on accurate and transparent financial data.
- 3. Assessment of Quality of Earnings:** Forensic audit evaluates the quality of earnings by analyzing the sustainability and reliability of revenue streams, profit margins, and cash flows which is crucial for deriving accurate valuation metrics and projections.
- 4. Evaluation of Asset Values:** In cases where valuation involves tangible or intangible assets, forensic audit assesses the validity and valuation of these assets by verifying asset ownership, existence, valuation methods.

- 5. Risk Assessment and Mitigation:** Forensic audit identifies and assesses various risks, including financial, operational, regulatory, and compliance risks. Later valuers can adjust discount rates, capitalization rates, or valuation multiples to reflect the associated risks adequately, thereby arriving at a more realistic valuation.
- 6. Validation of Assumptions and Projections:** Forensic audit validates the assumptions, forecasts, and projections used in the valuation models. By ensuring the accuracy and reasonableness of these assumptions, forensic audit enhances the reliability and credibility of the valuation results.
- 7. Support for Due Diligence:** Forensic audit provides valuable insights and documentation that support the due diligence process, especially in mergers, acquisitions, or investments. By uncovering potential red flags or issues, forensic audit enables buyers, investors, or stakeholders to make informed decisions and negotiate transaction terms effectively.
- 8. Enhancement of Credibility and Transparency:** Incorporating findings from forensic audit into the valuation process enhances the credibility, transparency, and trustworthiness of the valuation report. Stakeholders, including investors, regulators, or potential acquirers, have greater confidence in the valuation results knowing that they are based on reliable financial information.

In essence, the role of forensic audit in valuation is multifaceted, encompassing verification, detection, assessment, validation, and risk mitigation aspects. By ensuring the accuracy and integrity of financial information, forensic audit contributes significantly to the robustness, reliability, and credibility of the valuation process and results.

### **8.3 Objective and Methodology:**

This paper aims at inspecting and analysing the intensified instances of various scams and role of forensic audit in India.

The present research is analytical in nature as based on available forensic audit reports, a few recent scams is selected and analysed in detail. The secondary data has been obtained from available literature, articles of business newspapers, journals, report of the RBI, and relevant websites.

### **8.4 Recent Scams in India Which Trembled the Indian Economy:**

According to a recent RBI report, in 2021-22, number of frauds reported 9,103 in 2021-22 as against 7,359 in 2020-21.

Forensic Audit came into limelight due to regulatory requirements. Forensic Audit played a major role in detecting various biggest scams of India. Some of these have been explained below:

#### **(1) DHFL Scam:**

The DHFL scam, the largest financial fraud in Indian history, involved around Rs 34,000 crore and the defrauding of 17 banks in total.

**Exposing the Scam:** The promoters of DHFL and its affiliated companies, according to Cobrapost (an investigative platform), allegedly conducted a "systematic fraud" to steal public funds in 2019. Furthermore, DHFL was disbursing money to a "dubious" shell that was affiliated with the firm's stakeholders. The lender banks hired KPMG to undertake a forensic audit of DHFL from 2015 to 2018 as a result of this exposure by cobrapost.

**Forensic Audit:** Forensic Audit by KPMG perceived that "large amounts were disbursed as loans & advances by the borrower company to a number of inter-connected entities." (The Indian Express- <https://theprint.in/india/probing-rs-34615-crore-bank-fraud-involving-dhfl-cbi-finds-expensive-watches-paintings/1059266/>)

## **(2) ABG Shipyard Scam:**

ABG Shipyard's scam is considered as India's biggest bank fraud. The company operated in repairing and manufacturing of ships. ABG Shipyard took loan worth Rs 22,852 crore from a consortium of 28 banks.

**Unearthing the scam:** - The company stated that due to the financial crisis of the year 2008, the company had scarcity of working capital which caused the liquidity and financial problem. So, during 2005-2010 the company started taking huge loans from banks, and instead of reinvesting that amount back in the company, they decided to earn more through the bank loans and they started transferring these loans to the related parties. They were using the round tripping technique. From 2013 onwards, the company started defaulting on repayment of loans.

**Forensic Audit:** - A consortium of 28 banks appointed Ernst and Young LLP to conduct a Forensic Audit of ABG Shipyard. The audit revealed that fraud was conducted through "embezzlement, pilfering, and criminal breach of trust, to gain illegally at the cost of bank's funds." – (The Economic Times- <https://economictimes.indiatimes.com/news/india/the-abg-shipyard-scam-inaction-on-red-flags-as-indias-biggest-bank-fraud-unfolded/articleshow/89613817.cms>)

## **(3) Cox and Kings Scam:**

Cox and Kings was set up in 1758 in India. It was the ancient travel agency in the world. Now a two-and-a-half-century-old travel agency is bankrupt. The amount involved in this scam was approximate Rs 21,000 crore.

**Uncovering the scam:** - Financial position of Cox and Kings was not so really bad until 2011. Things started deteriorating after its acquisition of U.K. travel company named as Holiday Break for Rs 2250 crore in year 2012. It was finally sold at loss and company was burdened with huge debts. The company yet managed to hide its reality until in June 2019; it defaulted on repayment of its commercial paper to tune of Rs 150 crore. The company's board of directors were suspected that the company had cash and bank balance to the tune of Rs 1830 crore, still company is defaulting on repayment of a commercial paper of just Rs 150 crore. The fact was that those bank balances were not in existence.

**Forensic Audit:** - Forensic Audit was done by PricewaterhouseCoopers (PwC), report had disclosed scam of worth over Rs 21,000 crore in the four financial years between 2015-16 and 2018-19. According to PwC report, the company owed a total amount of Rs 5,500 crore to various banks. The audit revealed that most of the transactions took place without a loan agreement and without proper approvals from the company's board of directors. C&K advanced Rs 1,100 crore to Alok Industries, although they did not have any business relationships with each other. In investment it was found that Alok Industries CFO (Sunil Khandelwal) was the brother of C&K CFO (Anil Khandelwal). PwC also reported that C&K had siphoned a large sum of money through suspicious loans. In its draft report, PwC said "C&K had indulged in falsification of financial statements by overstating their sales figures and understating debt position. Several fictitious transactions were also reported, projecting a wrong financial position of C&K."- (According to the reports published by the Indian Express-<https://theleaflet.in/the-curious-case-of-cox-kings/>)

#### (4) PNB Nirav Modi Scam:

This fraud came into light in 2018 and relates to fraudulent LoUs (Letter of Undertakings) worth Rs. 11,400 crores issued by PNB (Brady House Branch, Mumbai). The key players of this scam were Nirav Modi and his associates who colluded with senior PNB employees.

**Exposing the scam:** -Two PNB's employees were sending unauthorized LoUs to Nirav Modi Firm from last few years. When one of them retired, then a new employee joined his position. A representative of Nirav Modi firm approached PNB on January 16, 2018 with a request for LOUs to make payment to its overseas suppliers. The bank demanded a 100% cash margin for issuing LOUs, but the representative of Nirav Modi Firm said they had received LOUs without any such collateral in the past. PNB's employee suspected fraud and began digging into transactions history.

**Forensic Audit:** - PNB has appointed Belgium based consultancy firm BDO for forensic audit. In Forensic Audit Report, Modi, his uncle Mehul Choksi and their organizations were blamed for deceiving the bank of approximate Rs 13,500 crore. It was the result of gross negligence of PNB's auditors, which were held guilty in the case. NOSTRO accounts were overlooked by the overseas banks such as Allahabad Bank, Axis Bank and Union Bank of India. Few officials of PNB were charge sheeted for their failure to implement several circulars & caution notices issued by the RBI regarding reconciliation of SWIFT messages and core banking systems.

**Table 8.1: Recent Indian Scams and Forensic Audit.**

Scam	Approximate Amount Involved (in Rs.)	Forensic Audit Firm	Forensic Audit Report Observations
DHFL Scam (2010-2018)	34,000 crores	KPMG	The lender company provided large sums as loans and advances to numerous associated entities.

<b>Scam</b>	<b>Approximate Amount Involved (in Rs.)</b>	<b>Forensic Audit Firm</b>	<b>Forensic Audit Report Observations</b>
ABG Shipyard Scam (2012-2017)	22,852 crores	Ernst & Young	The fraud was committed with the intent to gain illegally at the cost of the bank's money through "funds diversion, embezzlement, including criminal breaches of trust."
Cox and Kings Scam (2015-2018)	21,000 crores	PwC	By inflating company's revenue data and understating their debt position, it had falsified financial documents. A number of bogus transactions that misrepresented C&K's financial situation were also disclosed.
PNB Nirav Modi Scam (2011-2018)	11,400 crores	BDO	Two PNB officials were sending to Nirav Modi Firm, unauthorized letters of undertaking. The reconciliation of SWIFT message and core banking systems was not implemented.

From the above discussion it is evident that scams have become a real threat for emerging nations like India. After experiencing the scams, forensic audit was used as a mechanism to dig out the scam history and investigate the fair valuation of assets.

But after splurging huge amount through scams what is the benefit to hire forensic auditor (it's no use crying over spilled milk), instead organization should opt forensic accounting as an early warning mechanism.

### **8.5 Conclusion and Implications:**

The magnitude of intensified scams analyzed in this paper clarify that there is undeniably need of a strict regulatory jurisdiction. Financial frauds have disastrous consequences. The present study analyzed the process adopted by perpetrators to make money at the cost of public interest, resulting in loss of corporate reputation and public trust.

A detailed in depth understanding of this process is important for framing policies, even important to Forensic accountants, CAs & other practitioners for combating scams and limiting fraud incidents. Organizations should employ forensic accounting as a preventive and investigative tool. Forensic audit has the potential to contribute significantly to the robustness and credibility of the valuation process and results.

Many scams involving thousands of crores can be prevented if forensic accounting is strictly followed in the financial and corporate sectors. According to the reports of the companies like Riskpro Management Consulting Private Limited- for every rupee invested in the forensic accounting function, the forensic accountant has saved at least seven rupees for the company. This means a return on investment of 700% (P&G, 2016).

Despite its proven benefits in combating frauds and preventing financial crimes, Forensic Accounting and audit is still at a nascent stage in developing economies like India, thus it is the need of the hour that regulatory/professional bodies and corporate practitioners make serious efforts to ensure effective implementation of forensic accounting and auditing.

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