



HKICPA Seminar

Fraud Investigation

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Step 1

Whistleblower Reporting

- A person (usually an existing or former employee) may file whistleblower report using the following ways:
 - Send an email to senior executives and/or members of the Board of Directors;
 - Call the Ethics Hotline or Email the Ethics Mailbox; and
 - Provide such report to the law enforcement bodies.
- Companies, in particular, listed companies always take whistleblower reports seriously.
- Senior Management and Board of Directors moved to quickly appoint an external law firm, and the external law firm recommends a forensic accounting firm to the company.
- The company then engages the forensic accounting firm, to perform an internal investigation based upon the instructions given by the company and the external law firm.

Step 2

Meet with Whistleblower, Preservation of Evidence and Initial Review of Accounting Data

- Company sets up a meeting / conference call with the external law firm and forensic accounting firm to provide background information of the matter to them.
- Based upon the initial understanding of the allegations, the forensic accounting firm develops a work plan, which will be discussed together with the Company, the external law firm and the auditor.
- External law firm and forensic accounting firm attempted in setting up a meeting with the whistleblower to further understand the allegations.
- During the meeting, the lawyer and forensic accountant should explain to the whistleblower that there will be no retaliation for the whistleblower reporting.
- At the same time when the meeting with the whistleblower is taking place, the forensic accounting firm should assist in preserving the electronic records such as email data and accounting records for further analysis later on.
- Forensic accounting firm will then process the data for further analysis later on.
- After the meeting with the whistleblower, the forensic accounting firm will further update the work plan and obtain the final approval from the Company, the external law firm and the auditor prior to executing the work plan.

Step 2

Meet with Whistleblower, Preservation of Evidence and Initial Review of Accounting Data

What is computer forensics?

Computer forensics is a branch of forensic science pertaining to **legal evidence** found in **computers and digital storage media**.

Goal

To explain the context of data. The explanation can be as straightforward as "what information is here?" and as detailed as "what is the sequence of events responsible for the present situation?"

Computer Forensics Process:



Step 2

Meet with Whistleblower, Preservation of Evidence and Initial Review of Accounting Data

State Secrecy and Data Privacy Issues

- China has very strict State Secrecy and Data Privacy laws.
- Companies should consult a qualified lawyer in China before exporting any of the data gathered during forensic investigation out of China.
- Examples of data gathered during forensic investigation include:
 - Copies of account vouchers and supporting documents such as expense reimbursement forms, tax invoices, etc.
 - Copies of electronic communications between different custodians.

Step 3

Review of electronic documents

- Based on the information gathered from the whistleblower and during the course of the project, the forensic accounting firm and the external law firm would put together a keywords list, which will then be shared with the company.
- Once all parties agreed with the keywords list, initial searches will be performed.
- The keywords list will be further refined based on the number of hits from the initial search. Usually there are some generic keywords that were used for an investigation, and we could further adapt the keywords list based on the background information of this matter.
- The external lawyers and forensic accountant will jointly review the electronic documents that contain the keywords.

Step 4

Ratio Analysis and transaction testing

Example 1: What Do the Financial Statements Tell You

		Group		
Note		2007	2006	
		US\$'000	US\$'000	
ASSETS				
Current assets				
A	Cash and bank balances	6	32,121	19,248
B	Trade receivables	7	83,486	58,047
C	Other receivables	8	9,129	5,170
D	Inventories	9	16,215	8,203
Total current assets			140,951	90,668
Non-current assets				
	Investment in subsidiaries	10	-	-
	Investment in associate	11	797	-
	Plant and equipment	12	8,317	9,137
	Intangible asset	13	-	175
	Deferred tax assets	17	-	2
Total non-current assets			9,114	9,314
Total assets			150,065	99,982
LIABILITIES AND EQUITY				
Current liabilities				
E	Trade and other payables	14	56,923	41,532
	Amount due to related party	15	2,071	1,037
F	Short-term borrowings	16	28,276	3,475
	Income tax payable		5,777	5,044
Total current liabilities			93,047	51,088
Non-current liabilities				
	Amount due to related parties	15	3,107	4,148
	Deferred tax liabilities	17	358	-
Total non-current liabilities			3,465	4,148

A Cash at Bank can be important, not because of a lack of cash but because of high reported cash balances, together with high debt.

B Trade Receivables are important because overstated sales lead to overstated receivables, which is probably the most common result of fraud or manipulation.

C Other Receivables (and if relevant, other current assets) can be a dumping ground for bad assets, losses and fraud.

D Inventories can be overstated as a result of misstated purchases (of inventory).

E Trade and Other Payables form part of the calculation of a company's working capital, an important part of warning signs testing.

F Borrowings (short and long term) are important to analyse in conjunction with cash and cashflow

Step 4

Ratio Analysis and transaction testing

Example 1: What Do the Financial Statements Tell You

	Note	Group	
		2007 US\$'000	2006 US\$'000
A Revenue	19	296,865	316,362
Cost of sales		(277,061)	(294,898)
Gross profit		19,804	21,464
Other income	20	628	322
Selling and distribution expenses		(377)	(630)
Administrative expenses		(7,409)	(4,893)
Finance costs	21	(605)	(262)
Share of loss in associate	11	(323)	–
Profit before tax		11,718	16,001
Income tax	22	(2,852)	(3,149)
B Profit for the year	23	8,866	12,852
Earnings per share (cents) – basic and diluted	24	1.50	2.17
C Net cash (used in) from operating activities		(9,932)	16,223
Cash flows used in investing activities			
Proceeds from disposal of plant and equipment		51	564
Purchase of plant and equipment		(568)	(2,498)
Investment in associate		(1,120)	–
D Net cash used in investing activities		(1,637)	(1,934)

A Revenue and its relationship with working capital is a critical component of financial warning signs.

B Profit or Net Income and its relationship to cashflow also form an important component of warning signs testing.

C Operating Cashflow is harder to misstate given the costs of fraud and its relationship to net income is important.

D Free Cashflow (operating cashflow minus capex) similarly is relevant in comparison to net income.

Step 4

Ratio Analysis and transaction testing

Peace Mark (Holdings) Limited

Selected Line Items	2007 HK\$'000	2008 HK\$'000
Turnover	3,040,514	4,177,106
Profit for the year	304,603	471,601
Intangible assets	239,289	2,372,889
Interest in associates	87,300	297,626
Other financial assets	181,057	415,194
Trade deposits and other receivables	266,718	699,355
Trade and other payables	294,789	1,480,513
Interest-bearing borrowings	988,231	5,360,238
NET CASH OUTFLOW FROM OPERATING ACTIVITIES	(270,975)	(370,633)

- Revenue and profit indicate a good looking growth story

Included in amounts due from associates is an amount of HK\$647,596,000 (2007: HK\$115,310,000) advances to associates which are unsecured, interest-bearing at around 2.5% to 7.8%(2007: 6.7%) and is not expected to be realized within one year from the balance sheet date. The remaining balances with associates are unsecured, non-interest bearing and not repayable within the next twelve months.

In 2007, the Group placed an amount of HK\$136,885,000 in the form of long-term deposits to business associates for joint business development purpose. The business development of this project is under progress and the Directors expected that this amount will be injected into a new joint venture next year. Such deposits are unsecured, interest bearing at an annual rate of prime rate plus 1%. The carrying value of the long term deposits approximated to their fair value.

Deposits in aggregate of HK\$190,950,000 was placed with business associates for the development of a retail chain network in Asia. Such deposits are unsecured, interest bearing at annual rate of prime rate plus 1%. The Directors expected that the deposits will not be realized within 24 months from the balance sheet date.

Trade and other deposits, prepayments and other receivables represent trade and rental deposits paid, deposits paid for property, plant and equipment and include unsecured, interest free advances amounted to HK\$198,500,000 made to business associates.

- Days Payables had increased from 17 days to 76 days
- What is the debt being used to fund? Is it productive?
- Operating cashflow is telling a different story to profit

Step 4

Ratio Analysis and transaction testing

Asset Items

- Inventory
 - Consider need for professional valuer/stocktake
 - Details by location, visit major sites
 - Ensure is owned by target
- Other Current Assets
 - Classic area for overstatement
 - Beware of high levels of prepayments, other current assets etc that are often over-looked and can be related party loans/bad assets

26. TRADE DEPOSITS AND OTHER RECEIVABLES

	2008 HK\$'000	Group 2007 HK\$'000
Loans under share incentive scheme (Note a)	151,764	6,018
Trade and other deposits, prepayments and other receivables (Note b)	547,591	250,700
Sale proceeds receivable from the disposal of subsidiaries	-	10,000
	699,355	266,718

(a) Loans under share incentive scheme include advances to employees amounted to HK\$37,000 (2007: HK\$1,278,000) under the group's share incentive schemes. Such advances are interest bearing at an annual rate of 8% (2007: 8%) and are repayable by 12 monthly instalments. According to the rules of the Scheme, the shares purchased under the Schemes will only be released by the Custodian to the employees and eligible participants after they made their final instalment payment. Details of the Share Incentive Schemes are disclosed in Note 36 to the financial statements.

(b) Trade and other deposits, prepayments and other receivables represent trade and rental deposits paid, deposits paid for property, plant and equipment and include unsecured, interest free advances amounted to HK\$198,500,000 made to business associates.

(c) All deposits and other receivables are neither past due nor considered to be impaired at the balance sheet date.

Step 4

Ratio Analysis and transaction testing

Asset Items

- Fixed Assets
 - Sight purchase documentation
 - Who acquired from? Related party?
 - Ensure owned by the target
 - Licensing or similar issues
 - Any revaluations?

Olympus: exposure at last

Investors should pause to reflect on Japanese corporate governance

Investors all over the world should be looking at reported financials a little differently. Tuesday's [admission](#) from Olympus that it fiddled its books to [mask losses](#) on investments made many years ago is a reminder that corporate accounts, certified as "true and fair" by auditors, are an accumulation of human judgments. Whose truth? And whose "fair"?

Sino-Forest Engaged in 'Fraudulent Scheme,' OSC Alleges

By Christopher Donville and Liezel Hill | May 23, 2012 9:35 PM GMT+0800 | [2 Comments](#) [Email](#) [Print](#)

Sino-Forest Corp. cofounder [Allen Chan](#) helped run a "complex fraudulent scheme" that exaggerated the timber producer's assets, secretly benefited from a 2010 acquisition and misled investigators, [Canada's](#) main financial regulator said.

Sino-Forest didn't have "sufficient proof of ownership of the majority of its standing timber assets," the commission said in its 38-page statement.

In one of four "illustrative" examples of alleged fraudulent actions by Sino-Forest that were outlined by the commission, the company purported to buy Chinese standing timber in 2007 that it had already purchased through a subsidiary earlier that year. The so-called "Gengma Fraud #1" resulted in an overstatement of Sino-Forest's timber holdings in the years through 2007-2009, the commission said.

Step 4

Ratio Analysis and transaction testing

Liabilities

- Key risk is understatement and contingent liabilities
- Who are payments being made to?
 - Are they creditors?
 - Are payments greater than balances?
 - Beware of agent arrangements
 - Site checks of key suppliers
 - Sight supporting documents
- Who have guarantees, security and pledges been granted to - hard to detect
- Are all companies with creditors/debt consolidated – ensure have company level financial statements and consolidated financial statements

GHC International Limited

Proforma Invoice

To:
M2S Sdn Bhd Pte Ltd
Rice Wing Industrial Building,
#04-12,
No 2 Eon Wang Road,
Singapore 347995

S/NO.	PARTICULARS	QTY	UNIT PRICE	AMOUNT
1	VRLA Batteries	280	2,200.00	616,000.00
2	Circuit Breaking Sps	170	7,400.00	1,258,000.00
3	Surge Stabiliser	119	900.00	107,100.00
TOTAL US\$				2,071,100.00

Amount in USD: Two Million Seventy One Thousand One Hundred Only

Remarks

Inspection made in the factory. Goods shall be inspected by buyer or end user or U - nominated third party inspection agency before shipment.
Port of Loading: Shanghai/ Ningbo Port China
Port of Destination: Chennai, India
Delivery Time: Last week of May 2009
Payment Terms: As per the agreement

For GHC International Limited,


Authorized Signatory



GHC International Limited, Sheng He, Changshu City, China, Zip Code 214205.

Note the similar format of these invoices

Identical wording and vague description of goods

 Scotia Asia Pte Ltd
C/O Reg No 1906517159

Proforma Invoice

To:
MR. GTL Infrastructure Limited
Marina House,
MIDC Building No 2, Scheme 2,
Mumbai Business Park,
Mumbai
New Mumbai 400 710

Sr.No.	Description	QTY	UNIT PRICE	AMOUNT
1	VRLA Batteries	320	1,450.00	464,000.00
2	Circuit Breaking Sps	142	7,500.00	1,065,000.00
3	Surge Stabiliser	181	1,000.00	181,000.00
TOTAL US\$				2,050,000.00

Amount in Word (United State Dollar) Two Million Thirty Thousand Only

Payment Terms : 55% Advance payment on placement of the order with in 05 days
Cause to issue and SBLC to our banker enabling us to ship
55% Advance payment against the order placed with us

for Scotia Asia Pte Ltd


Authorized Signatory

Address on invoice is different to the address on the company's website

Step 4

Ratio Analysis and transaction testing

Other suspicious features

Client instructions with identical and potentially photocopied signatures

** Please sign & fax to us at (852) 2071-7287 **

UBS AG - HK Branch

Date: 03-Mar-2020

Dr. A/C No. 81650 (KIM DONG RACK / KIM YEDIN RIM)

Please debit from the captioned account and arrange the following telegraphic transfer:

Value date: as soon as possible

Amount: USD 7,200,000

Beneficiary Bank Name: HSBC

Country: Hong Kong

SWIFT CODE: _____

Correspondent Bank: _____

SWIFT CODE: _____

For credit to Beneficiary Account No: 610-746 137-838

Beneficiary Name: Sino Foreign Ltd
(Sino Foreign Ltd)

Please deduct cable fee from the account.

Thank you.

Yours sincerely,

W R B
Client's Signature

Payment Order Authorisation

Amount of Payment Order: USD 7,200,000

Account: 81650

Beneficiary: HSBC

Country: Hong Kong

SWIFT Code: _____

For credit to Beneficiary Account No: 610-746 137-838

Beneficiary Name: Sino Foreign Ltd

Signature: W R B

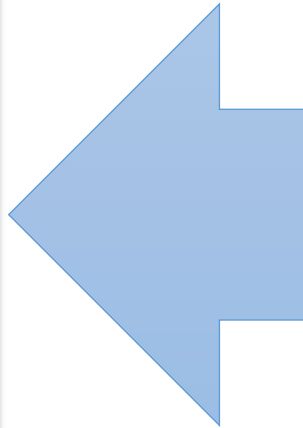
Date: 03-Mar-2020

Authorised by: _____

Signature: _____

Date: _____

Branch: _____



Example of 11Potentially unauthorised payment instructions containing an identical client signatures (across a 15 month period).



Step 5

Interviews with employees and end customers

- Based upon the review of the supporting documents for selected transactions, review and analysis of electronic and accounting data, the external law firm and forensic accounting firm would come up with a list of employees whom they would like to interview to get further understanding about the matter.
- Based upon the results of the initial interviews, additional employees could be selected for interview.
- Interview notes would be prepared after each interview jointly by the forensic accounting firm and the external law firm.

Step 6

Reporting

- Introduction and scope of work
- Executive summary
- Background
- Methodology
- Findings

- Fact findings, not fraud findings

- Recommendations to client:
 - Actions against certain employee, including termination or reporting to law enforcement agencies
 - Control gaps identification
 - Remedial actions