CHAPTER 17

DUE DILIGENCE, INVESTIGATION & FORENSIC ACCOUNTING

LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Know the concept of Due Diligence, Investigation and Forensic Accounting.
- Differentiate between Audit and Investigation.
- Know the steps to be taken at the time of Investigation.
- Understand the purpose of Due diligence and content of its report.
- Gain knowledge of FAIS, Forensic Accounting Investigation Report.

CHAPTER OVERVIEW

Due Diligence	Investigation	Forensic Acounting
• Purpose • Classification • Work Approach to Due Diligence • Content of Due Diligence Report	• Steps in Investigation • Special Issues in Investigations • Audit V/s. Investigation	• Meaning • Fraud and Procedures • FAIS • Foresnic Accounting Investigation Report

K, a CA final student, was curious about the concepts of *"Due Diligence", "Investigation" and "forensic accounting"*. The terms sounded familiar to him but he lacked knowledge about fine distinctions among these. *"Due Diligence"* broadly means taking care before entering into agreement or transaction with a party which a reasonable person ought to take. Can it be performed by anyone? Of course. It is not an exclusive activity bracketed for Chartered Accountants.

"Investigation" is aimed at establishing a fact or a happening or assessing a situation. Reasons for investigation are varied. Like, a Chartered accountant may be engaged to discover whether a fraud has occurred or to conduct an investigation where an entity proposes to buy a business. Its purpose is specific. It is not in the nature of general prudence and care.

"Forensic accounting" relates to use of professional accounting skills in matters involving the possibility of fraud to collect relevant evidence and facts which could help support an expert view for *potential or actual civil or criminal litigation. The evidence should be suitable for use in a court of law or before a regulatory body.*

K was reading a report about a Surat based company whose forensic accounting was conducted by a firm empaneled by the Indian Banks' Association (IBA). The facts of the company made interesting reading. It was engaged in importing raw diamonds, exporting diamonds after finishing and catering to the domestic market. The company was availing credit facilities amounting to ₹250 crore from a consortium of bankers consisting of 5 banks. The credit facilities consisted of cash credit limit, packing credit limit, Bills purchased limit, LCs issued and term loans. The account was declared NPA due to failure to meet repayment obligations, devolved LCs and overdrawn accounts. The company had also trade transactions with its sister concerns.

How should Forensic Professional have proceeded with? The approach in forensic accounting is on gathering facts and evidence and a critical examination of all the evidence with respect to violations. It includes review of data over period of time to identify red flags and use of computer assisted techniques to find digital evidence stored in the system. Review of documentation and gathering market intelligence is next crucial step. Interviews with identified employees can be of great help.

It would also include answer to the questions like whether funding availed by the company from banks was required. It may turn out that the credit requirements of the borrower were not assessed properly, and the company was provided credit facilities disproportionate to its requirements. It would require analysis of PCL and bills purchased facilities to understand the purpose. There may be forex transactions not in accordance with imports and exports. Transactions with sister concerns would require to be analysed for probable fund diversion and siphoning off. It would help in digging out trails for end use of funds.

He was surprised to learn that Standards exist in this field too. Forensic Accounting and Investigation Standards (FAIS) enhance the quality of forensic accounting and investigation services rendered by Chartered Accountants.

1. DUE DILIGENCE REVIEW

Due Diligence is used to investigate and evaluate a business opportunity, verify Agreements, encumbrances on the assets, Assets – their title and ownership, intellectual Property, Health, Safety and Environment Laws, etc. It implies a general duty to exercise care in any transaction. Most legal definition of due diligence describes it as a measure of prudence activity, or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent person under the particular circumstance, not measured by any absolute standard but depends on the relative facts of the special case.

Due diligence is a process of investigation, performed by investors, into the details of a potential investment such as an examination of operations and management and the verification of material facts. It entails conducting inquiries for the purpose of timely, sufficient and accurate disclosure of all material statements/information or documents, which may influence the outcome of the transaction. Due diligence involves a careful study of the financial as well as non-financial possibilities for successful implementation of restructuring plans.

Due diligence involves an analysis carried out before acquiring a controlling interest in a company to determine that the conditions of the business conform with what has been presented about the target business. Also, due diligence can apply to recommendation for an investment or advancing a loan/credit.

Due Diligence may also be required to be performed in cases of corporate restructuring, venture capital financing, lending, leveraged buyouts, public offerings, disinvestment, corporatisation, etc. Sometimes, in a restructuring exercise, while the unit may remain within a group, it may pass from under the charge of one management team to that of another team. This situation also gives rise to the need for a due diligence review.

One such emerging area is around mandatory human rights and environmental due diligence. The OECD Due Diligence Guidance for Responsible Business Conduct (RBC) set out the expectation that how an enterprises can carry out risk-based due diligence. Under OECD RBC due diligence standards, enterprises are expected to carry out risk-based due diligence to identify, prevent, mitigate and account for how they address actual and potential adverse impacts to people, society and the planet.

DIFFERENCE BETWEEN DUE DILIGENCE AND AUDIT

It needs to be underlined that due diligence is different from audit. An audit is an independent examination and evaluation of the financial statements of an organization with a view to express an opinion thereon. Whereas due diligence refers to an examination of a potential investment to confirm all material facts of the prospective business opportunity. It involves reviewing financial and non-financial records as deemed relevant and material. In essence, due diligence aims to take the care that a reasonable person should take before entering into an agreement or a transaction with another party.

2. IMPORTANCE OF DUE DILIGENCE

When a business opportunity first arises, it continues throughout the talks, initial data collection and evaluation commence. Thorough detailed due diligence is typically conducted after the parties involved in a proposed transaction have agreed in principle that a deal should be pursued and after a preliminary understanding has been reached, but prior to the signing of a binding contract.

The purpose of due diligence is to assist the purchaser or the investor in finding out all the care that a reasonable person can, about the business he is acquiring or investing in prior to completion of the transaction including its critical success factors as well as its strength and weaknesses.

In addition, it may expose problems or potential problems that can be addressed in the price negotiations or by dealing suitable clauses in the contractual documentation, in particular, warranty and or indemnity provisions.

There are many reasons for carrying out due diligence including:
To confirm that the business is what it appears to be;
To identify potential 'deal killer' defects in the target company and avoid a bad business transaction;
To gain information that will be useful for valuing assets, defining representations and warranties, and/or negotiating price concessions; and
To verify that the transaction complies with investment or acquisition criteria.

3. CLASSIFICATION OF DUE-DILIGENCE

Due Diligence can be sub-classified into discipline-wise exercises in following manner:

(i) **Commercial/Operational Due Diligence**: It is generally performed by the concerned acquire enterprise involving an evaluation from commercial, strategic and operational perspectives. For example, whether proposed merger would create operational synergies.

(ii) **Financial Due Diligence**: It involves analysis of the books of accounts and other information pertaining to financial matters of the entity. It should be performed after completion of commercial due diligence.

(iii) **Tax Due Diligence**: It is a separate due diligence exercise but since it is an integral component of the financial status of a company, it is generally included in the financial due diligence. The accountant has to look at the tax effect of the merger or acquisition.

(iv) **Information Systems Due Diligence**: It pertains to all computer systems and related matter of the entity.

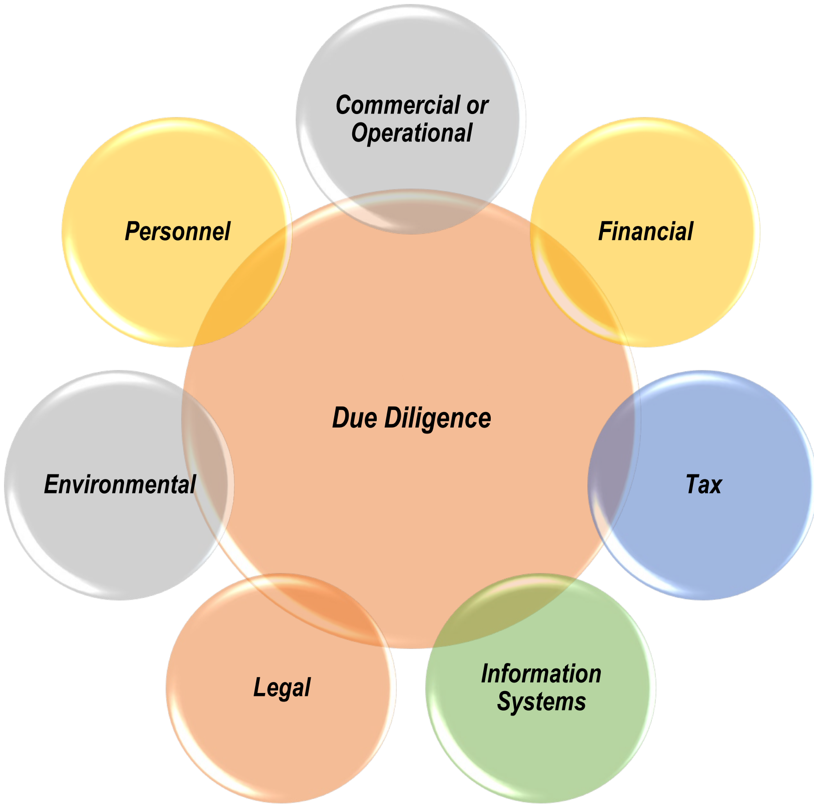
(v) **Legal Due Diligence**: This may be required where legal aspects of functioning of the entity are reviewed.

example

1. The legal aspects of property owned by the entity or compliance with various statutory requirements under various laws.

(vi) **Environmental Due Diligence**: It is carried out in order to study the entity's environment, its flexibility and adaptiveness to the acquirer entity.

(vii) **Personnel Due Diligence**: It is carried out to ascertain that the entity's personnel policies are in line or can be changed to suit the requirements of the restructuring.



Financial Due Diligence

At times, the financial due diligence review is interpreted as a complete due diligence review since it is supposed to ascertain the financial implications of all the other due diligence reviews. This is, however, not appropriate. The term 'financial due diligence' should be used with caution. Unless the scope of financial due diligence to be performed is wide enough to cover all the aspects, it should not be confused with overall due diligence review.

It can be understood from the foregoing that the role of financial due diligence commences only after a price has been agreed for the business or a restructuring plan is framed. The initial price and other decisions are taken based on net worth as well as trend of profitability of the target company, with an assumption that all contingent liabilities that may impact the future of the business have been recorded. The principal objective of financial due diligence, therefore, is usually to look behind the veil of initial information provided by the company and to assess the benefits and costs of the proposed acquisition/merger by inquiring into all relevant aspects of the past, present and future of the business to be acquired/merged with.

In order to achieve its objective, the due diligence process can include any or all of the following objectives for individual areas of the verification:

- Brief description of the history of business
- The background and standing of promoters
- Accounting policies and practices followed by the organization
- Management information systems
- Details of management structure
- Trading results both past and the recent past
- Assets and liabilities as per latest balance sheet
- Current status of Income tax assessments including appeals pending against tax liabilities assessed by tax authority.
- Cash flow patterns
- Brief description of commercial and/or other activities carried out by the organization
- The projection of future profitability

If a full-fledged financial due diligence is conducted, it would include the following matters, *inter alia*, in its scope:

(a)	Brief history of the target company and background of its promoter;	(b)	Accounting policies;
(c)	Review of financial statements;	(d)	Taxation;
(e)	Cash flow;	(f)	Financial Projection;
(g)	Management and employees;	(h)	Statutory Compliance.

(a) Brief history of the target company and background of its promoters - The accountant should begin the financial due diligence review by looking into the history of the company and the background of the promoters.

The details of how the company was set up and who were the original promoters has to be gone into, before verification of financial data in detail. An eye into the history of the target company may reveal its turning points, survival strategies adopted by the target company from time to time, the market share enjoyed by the target company and changes therein, product life cycle and adequacy of resources. It could also help the accountant in determining whether, in the past, any regulatory requirements have had an impact on the business of the target company. Broadly, the accountant should make relevant enquiries about the history of target's business products, markets, suppliers, expenses, operations. This could, inter alia, include the following:

♦ Nature of business(es)

2. Manufacturer/ trader, wholesaler,

financial services, import/export.

♦ Location of production facilities, warehouses, offices.

♦ Employment

3. By location, supply, wage levels, union contracts, pension commitments, government regulation.

♦ Products or services and markets

4. Major customers and contracts, terms of payment, profit margins, market share, competitors, exports, pricing policies, reputation of products, warranties, order book, trends, marketing strategy and objectives, manufacturing processes.

♦ History of the business with important suppliers of goods and services

5. Long-term contracts, stability of supply, terms of payment, imports, methods of delivery such as "just-in-time".

♦ Inventories

6. Locations,

Quantities.

♦ Franchises, licenses, patents.

♦ Important expense categories.

♦ Research and development.

♦ Foreign currency assets, liabilities and transactions.

♦ Legislation and regulation that significantly affect the entity.

♦ Information systems.

(b) Accounting policies - The accountant should study the accounting policies being followed by the target company and ascertain whether any accounting policy is inappropriate.

The accountant should also see the effects of the recent changes in the accounting policies. The target company might have changed its accounting policies in the recent past keeping in view its intention of offering itself for sale.

The overall scope has to be based on the accounting policies adopted by the management. The accountant has to look at any material effect of accounting policies on the overall profitability and their correctness. It is reiterated that the accountant should have a detailed look at all material changes in Accounting Policies in the period subjected to review very carefully.

The accountant's report should include a summary of significant accounting policies used by the target company, that changes that have been made to the accounting policies in the recent past, the areas in which accounting policies followed by the target company are different from those adopted by the acquiring enterprise, the effect of such differences.

(c) Review of Financial Statements - Before commencing the review of each of the aspect covered by the financial statements, **the accountant should examine whether the financial statements of the target company have been prepared in accordance with the Statute governing the target company, Framework for Preparation and Presentation of the Financial Statements and the relevant Accounting Standards**. If not, the accountant should record the deviations from the above and consider whether it warrant an inclusion in the final report on due diligence.

After having an overall view of the financial statements, as mentioned in the above paragraphs, **the accountant should review the operating results of the target company in great detail**. It is important to make an evaluation of the profit reported by the target company. The reason being that the price of the target company would be largely based upon its operating results.

The accountant should consider the presence of an extraordinary item of income or expense that might have affected the operating results of the target company.

It is advisable to compare the actual figures with the budgeted figures for the period under review and those of the previous accounting period. This comparison could lead the accountant to the reasons behind the variations. It is important that **the trading results for the past four to five years are compared and the trend of normal operating profit arrived at.**

The normal operating profits should further be benchmarked against other similar companies. Besides the above, and based on the trend of operating results, the accountant has to advise the acquiring enterprise, through due diligence report, on the indicative valuation of the business.

In the case of many enterprises, the valuation is mainly based on the value of net worth only. For valuation of immovable properties and plant, if required, the assistance of expert valuers could also to be taken. The exercise to evaluate the balance sheet of the target company has to take into consideration the basis upon which assets have been valued and liabilities have been recognised. The net worth of the business has to be arrived at by taking into account the impact of over/under valuation of assets and liabilities. The accountant should pay particular attention to the valuation of intangible assets.

The objective of the Due Diligence exercise will be to look specifically for any hidden liabilities or over-valued assets.

7. Hidden Liabilities:

- The company may not show any show cause notices which have not matured into demands, as contingent liabilities. These may be material and important.
- The company may have given "Letters of Comfort" to the banks and Financial Institutions. Since these are not "guarantees", these may not be disclosed in the Balance sheet of the target company.
- The Company may have sold some subsidiaries/businesses and may have agreed to take over and indemnify all liabilities and contingent liabilities of the same prior to the date of transfer. These may not be reflected in the books of accounts of the company.
- Product and other liability claims; warranty liabilities; product returns/discounts; liquidated damages for late deliveries etc. and all litigation.
- Tax liabilities under the direct and indirect taxes.
- Long pending sales tax assessments.
- Pending final assessments of customs duty where provisional assessment only has been completed.
- Agreement to buy back shares sold at a stated price.
- Future lease liabilities.
- Environmental problems/claims/third party claims.
- Unfunded gratuity/superannuation/leave salary liabilities; incorrect gratuity valuations.
- Huge labour claims under negotiation when the labour wage agreement has already expired.
- Unresolved labour litigations

8. Over-Valued Assets:

- Uncollected/uncollectable receivables.
- Obsolete, slow non-moving inventories or inventories valued above NRV, huge inventories of packing materials etc. with name of company.
- Underused or obsolete Plant and Machinery and their spares; asset values which have been impaired due to sudden fall in market value etc.
- Assets carried at much more than current market value due to capitalization of expenditure/foreign exchange fluctuation, or capitalization of expenditure mainly in the nature of revenue.
- Litigated assets and property.
- Investments carried at cost though realizable value is much lower.
- Investments carrying a very low rate of income / return.
- Infructuous project expenditure/deferred revenue expenditure etc.
- Group Company balances under reconciliation etc.
- Intangible assets of no value.

(d) Taxation - Tax due diligence is a separate due diligence exercise but since it is an integral component of the financial status of a company, it is generally included in the financial due diligence. It is important to check if the company is regular in paying various taxes to the Government. The accountant has to also look at the tax effects of the merger or acquisition.

(e) Cash Flow - A review of historical cash flows and their pattern would reflect the cash generating abilities of the target company and should highlight the major trends. It is important to know if the company is able to meet its cash requirements through internal accruals or does it have to seek external help from time to time.

It is necessary to check that:

(a) Is the company able to honor its commitments to its trade payables, to the banks, to government and other stakeholders?

(b) How well is the company able to turn its trade receivables and inventories?

(c) How well does it deploy its funds?

(d) Are there any funds lying idle or is the company able to reap maximum benefits out of the available funds?

(e) What is the investment pattern of the company and are they easily realisable?

(f) Financial Projections - The accountant should obtain from the target company the projections for the next five years with detailed assumptions and workings. He should ask the target company to give projections on optimistic, pessimistic and most likely bases.

9. The accountant evaluates the appropriateness of assumption used in the preparation and presentation of financial projections. If the accountant is of the opinion that as assumption used by the target company is unrealistic, the accountant should consider its impact on the overall valuation of the company. He should offer his comments on all the assumptions, highlighting those which, in his opinion are not inappropriate. In case he feels the projections provided by the target company are not achievable or aggressive he has to mention this in his report. He should thoroughly check the arithmetical accuracy of the calculations made for financial projections.

(g) Management and Employees - In most of the companies which are available for take over the problem of excess work force is often witnessed. It is important to work out how much of the labour force has to be retained. It is also important to judge the job profile of the administrative and managerial staff to gauge which of these matches the requirements of the new incumbents. Due to the complex set of labour laws applicable to them, companies often have to face protracted litigation from its workforce, and it is important to gauge the likely impact of such litigation.

10. It is important to see if all employee benefits like Provident Fund (P.F.), Employees State Insurance (E.S.I.), Gratuity, leave and Superannuation have been properly paid/ provided for/funded. In case of un-funded Gratuity, an actuarial valuation of the liability has to be obtained from a reputed actuary.

The assumptions regarding the increase in salaries, interest rate, retirement etc. have to be gone into to see if they are reasonable. It is also necessary to see if the basic salary /wage considered for the valuation is correct and includes all elements subject to payment of Gratuity. In the case of PF, ESI etc. the accountant has to see if all eligible employees have been covered.

It is very important to consider the pay packages of the key employees as this can be a crucial factor in future costs. One has to carefully look at Employees Stock Option Plans; deferred compensation plans; Economic Value Addition and other performance linked pay; sales incentives that have been promised etc. It is also important to identify the key employees who will not continue after the acquisition either because they are not willing to continue or because they are to be transferred to another company within the 'group' of the target company.

(h) Statutory Compliance - During due diligence this is one aspect that has to be investigated in detail. It is important therefore, to make a list of laws/ statues that are applicable to the entity as well as to make a checklist of compliance required from the company under those laws. If the company has not been regular in its legal compliance it could lead to punitive charges under the law. These may have to be quantified and factored into the financial results of the company.

TEST YOUR UNDERSTANDING 1

CA Y is employed with a leading private sector BDFP Bank posted in Noida branch. One of the existing borrowers has approached the branch with a proposal to sanction fresh term loan of ₹5 crore with commensurate increase in working capital credit facilities relating to expansion of its garment manufacturing unit. While performing due diligence, he notices that the company was formed just two years ago and had availed term loan of ₹ 10 crore and cash credit facilities of ₹5 crore respectively. Its sales have increased from ₹ 25 crores in the first year to ₹45 crores in the year just ended. It is generating cash profits and is timely servicing its debts.

The borrower was catering to the domestic market earlier. However, now it is in the process of procuring export orders and working diligently in this regard. The expansion plans are in line with development in the area of marketing relating to exports.

However, there are a large number of units catering to domestic and export market of garments in Noida, Delhi and surrounding areas. There is also a demand slump in the biggest US market.

Besides, the unit is family-based and relies upon the marketing skills of its main promoter. There is lack of well-paid qualified staff with the borrower to deal effectively with its customers both domestic as well as foreign.

He starts jotting down and elaborating above points. Identify what he is trying to do as part of due diligence.

4. WORK APPROACH TO DUE DILIGENCE

The purchase of business in many instances is the largest and most expensive assets purchase in lifetime and therefore some caution should be exercised through the due diligence process. Therefore, assessing the businesses' fair value passes through.

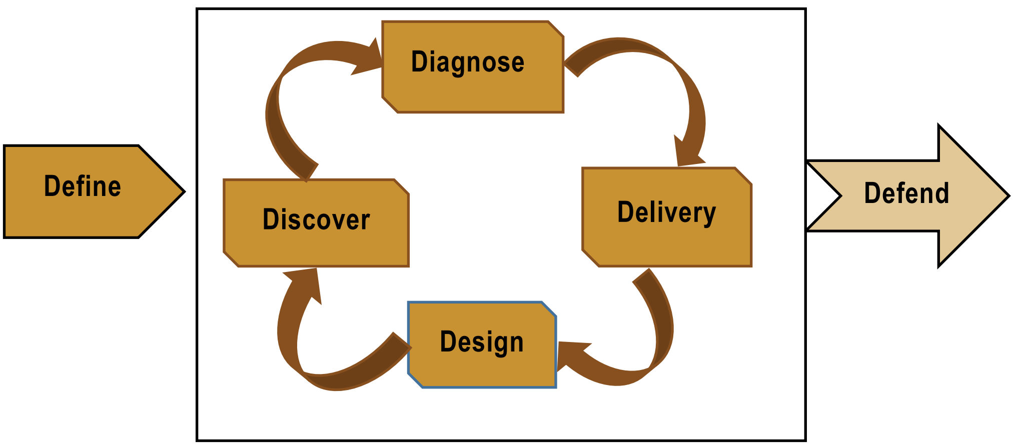
Reviewing and reporting on the financials submitted by the target company.

Assessing the business first hand by a site visit (if applicable).

Working through the due diligence process with the acquisitioning company or investor by defining the key areas.

Helping prepare an offer based on completion of due diligence.

Discovering the correct strategy is always challenging, and even more so during challenging economic circumstances. Each situation is unique. The variables are numerous, including factors such as company age, markets, geography, price levels, competitive dynamics, to name but a few. But when a company and its products are turned to match market needs and expectations-that is, the decision makers and influencers involved in purchase decision-exceptional changes in performance can occur. However, comprehensive model that describes this approach to the work is illustrated in the figure below:



5. HOW TO CONDUCT DUE DILIGENCE

- Start with an open mind. Do not assume that anything wrong will be found and look for it. What needs to be done is to identify trouble spots and ask for explanations.
- Get the best team of people. If you do not have a group of people inside your firm that can do the task (e.g. lack of staff, lack of people who know the new business because you are acquiring a business in an unrelated area, etc.), there are due diligence experts that you can hire. When hiring such professionals, look for their experience record in the industry.

- Get help in all areas like finance, tax accounting, legal, marketing, technology, and any others relevant to the assignment so that you get a 360-degree view of the acquisition candidate.
- Talk to customers, suppliers, business partners, and employees are great resources.
- Take a risk management approach. So, while you want to do your research, you also want to make sure that you do not antagonise the team of people of the target company by bogging them down with loads of questions.
- Prepare a comprehensive report detailing the compliances and substantive risks/issues.

6. CONTENTS OF A DUE DILIGENCE REPORT

The contents of a due diligence report will always vary with individual circumstances. Following headings are illustrative:

Example of Headings of a Due Diligence Report
♦ Executive Summary
♦ Introduction
♦ Background of Target company
♦ Objective of due diligence
♦ Terms of reference and scope of verification
♦ Brief history of the company
♦ Share holding pattern
♦ Observations on the review
♦ Assessment of management structure
♦ Assessment of financial liabilities
♦ Assessment of valuation of assets
♦ Comments on properties, terms of leases, lien and encumbrances.
♦ Assessment of operating results
♦ Assessment of taxation and statutory liabilities
♦ Assessment of possible liabilities on account of litigation and legal proceedings against the company

♦	Assessment of net worth
♦	Interlocking investments and financial obligations with group / associates companies, amounts receivables subject to litigation, any other likely liability which is not provided for in the books of account
♦	SWOT Analysis
♦	Comments on future projections
♦	Status of charges, liens, mortgages, assets and properties of the company
♦	Suggestion on ways and means including affidavits, indemnities, to be executed to cover unforeseen and undetected contingent liabilities
♦	Suggestions on various aspects to be taken care of before and after the proposed merger/acquisition.

7. INVESTIGATION

The term investigation implies a systematic and in-depth examination or inquiry to establish a fact or to evaluate a specific situation. In other words, investigation means "inquiry into facts". Professional accountants are often required to investigate the accounts or the related matters and records of the enterprise. The term investigation may be defined as an examination of books and records preliminary to financing or for any other specified purpose, sometimes differing in scope from the ordinary audit. Thus, investigation covers areas of financing decisions, investment decisions, fraud or profitability determination or cost determination etc.

7.1 Audit versus Investigation

Investigation differs substantially from an audit assignment. Audit aims at collection of sufficient appropriate audit evidence to enable the auditor to form a judgement and express an opinion on the financial statements or other data under examination. An investigation, on the other hand, requires special in-depth examination of the particular records or transaction with the objective of establishing a part or happening or assessing a particular situation. The scope of audit is broad based and general in nature whereas investigation is narrow and specific.

The difference is tabulated below:

Basis of Difference	Investigation	Audit
(i) Objective	An investigation aims at establishing a fact or a happening or at assessing a particular situation.	The main objective of an audit is to verify whether the financial statements display a true and fair view of the state of affairs and the working results of an entity.
(ii) Scope	The scope of investigation may be governed by statute, or it may be non- statutory.	The scope of audit is wide and in case of statutory audit the scope of work is determined by the provisions of relevant law.
(iii) Periodicity	The work is not limited by rigid time frame. It may cover several years, as the outcome of the same is not certain.	The audit is carried on either quarterly, half-yearly or yearly.
(iv) Nature	Requires a detailed study and examination of facts and figures. Investigation is voluntary in nature.	Involves tests checking or sample technique to draw evidence for forming a judgement and expression of opinion. It is mandatory for companies.
(v) Inherent Limitations	No inherent limitation owing to its nature of engagement.	Audit suffers from inherent limitation.
(vi) Evidence	It seeks conclusive evidence.	Audit is mainly concerned with prima- facie evidence.
(vii) Observance of Accounting Principles	It is analytical in nature and requires a thorough mind, capable of observing, collecting and evaluating facts.	Is governed by compliance with generally accepted accounting principles, audit procedures and disclosure requirements.
(viii) Appointing Agency	Even third party can appoint Investigator	Auditor is appointed by owner/ shareholders of company/ enterprise
(ix) Reporting	The outcome is reported to the person(s) on whose behalf investigation is carried out.	The outcome is reported to the owners of the business entity.

The approach to an investigation is different from that followed in an audit. An investigation involves a more detailed examination of the selected areas than what is required in an audit. An investigation seeks substantive and, in some of the cases, even conclusive evidence as compared to audit which mainly relies on persuasive evidence.

An investigator does not accept a stated fact as correct until it is substantiated. An auditor, in the absence of suspicious circumstances, relies on stated facts or figures. An auditor has to see whether the method of valuation and other accounting policies have been properly made in the financial statements or not. An investigator, however, is not bound by accounting conventions, policies and disclosure requirements. An auditor does not suspect unless circumstances are there to arouse suspicion, while an investigator approaches the work with a frame of mind to suspect, verify and satisfy.

The auditor seeks to report what he finds in the normal course of examination of the accounts adopting generally followed techniques unless circumstances call for a special probe: fraud, error, irregularity, whatever comes to the auditor's notice in the usual course of checking, are all looked into in depth and sometimes investigation results from the prima facie findings of the auditor.

8. STEPS IN INVESTIGATION

As investigation involves a variety of situations, it is not possible to lay down any standardised procedure. However, usually, an investigation requires the following steps in order of sequence:

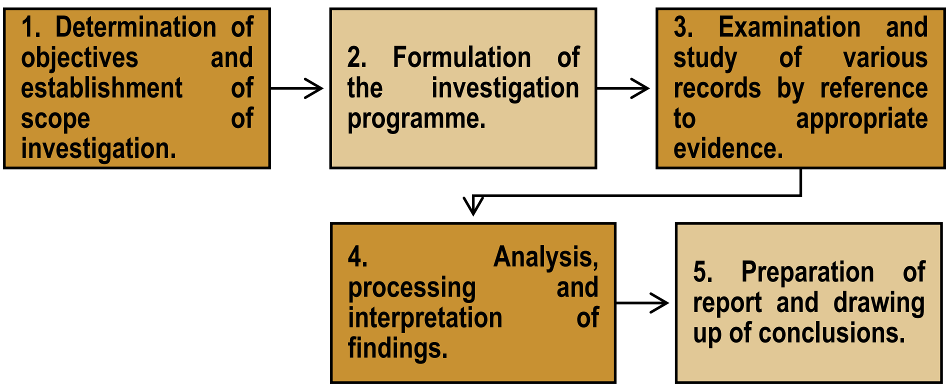


Diagram showing Sequence of Steps for Investigation

Step 1: Determination of objectives and establishment of scope of investigation

At the stage of acceptance of the assignment, the investigator should be absolutely clear about what is sought to be achieved by the investigation. If instructions from the client leave matters vague and non-specific, it would be proper for the investigator to have the matters discussed and obtain clearly written instructions covering the object, the scope and purpose of investigations and the issues incidental thereto.

The period to be covered under investigation should be clearly specified. The results of investigation are often seriously affected owing to changes in circumstances which have occurred since it was contemplated, e.g., devaluation, import restrictions, starting of a new division, etc. Therefore, the purpose of the investigation should be borne in mind while determining the period which an investigation should cover.

Step 2: Formulation of the investigation programme

It is not possible to draw up one programme to serve different types of investigations which a professional accountant is called upon to carry out, for their scope and content have to be determined on a consideration of circumstances peculiar to each business or situation. The investigation programme should be drawn up having regard to:

(a) The nature of the business.

(b) The structure of business organization.

(c) The instructions from the client embodying the objectives and scope of work.

(d) The consequent scope and depth of investigation.

(e) The necessity to extend the investigation into books and records belonging to others.

(f) The investigator should concentrate on areas considered relevant rather than to undertake a wide-ranging verification.

The programme should also be flexible so that knowledge gained with the progress of work can be used to extend, reduce or modify the extent and areas of checking.

11. In case of an investigation on suspected payment of wages to ghost workers, the investigator should scan the areas having a bearing on the determination of wages and payments thereof. He should concentrate on time and job cards, appointment and terminatio of workers, attendance records, internal controls, internal checks, and preparation of wage sheets, withdrawal of money from bank for payment of wages and the actual disbursement of wages.

A conscious effort in investigation programming should be devoted to localise the enquiry into the relevant areas and, for that purpose, the initial wider base of inquiry should be gradually narrowed and fixed at a level that is meaningful. Matters not found to have a bearing on the subject matter of investigation should be gradually and progressively eliminated. This procedure alone will enable an in-depth examination of the matters relevant to the investigation.

Step 3: Collection of Evidence

Through examination, the investigator would be gathering relevant evidence connected with the matters to be investigated. In the course of examination of the documents and records, the investigator may require to obtain oral explanations from various personnel of the concerned business. In case his client is a person external to the business, it may be necessary for the investigator to get the matter formally agreed to by the business through the client. The investigator should look for the most convincing evidence; he should seek and examine all the available evidence and by a process of elimination and corroboration, should endeavour to reach at the truth of the matter. He, unlike the auditor, is not to restrict himself to *prima facie* evidence ordinarily available. He should examine it and if circumstances demand should try to obtain evidence that may have to be specifically procured. The investigating accountant can take help of external experts/ persons like, related parties outside the organization, valuation experts etc. to obtain specific evidence. Further, the work of investigating accountant should ensure that the process of obtaining evidence does not interfere with the regular work of client.

12. In the matter of valuation of land, he should definitely have regard to the available evidence as per records of the business and records of any bid received for the land. In addition, he should have regard to the prices at which land was sold or purchased in the neighbourhood around the same time. This may require him to obtain evidence even by going to the land registration office. He may also call for the report of experts in land valuation.

Step 4: Analysis and Interpretation of Findings

Careful analysis and correlation of facts and figures will be necessary before the investigator can reach his conclusion. The conclusion should be well reasoned, backed by established facts and evidenced by proper records/ data. He must analyse the data objectively on the basis of evidence gathered by him and should not draw conclusions according to pre-conceived notions. While interpreting the figures, the investigator must keep in mind various factors e.g. the political and economic considerations, competition faced by the business, historical pattern of the data, nature of the business, etc. The interpretation should be brief, clear and free from doubts.

Step 5: Reporting of findings

Like all other work of an accountant, an investigation results in a report. It is submitted and addressed to the party at whose instance the investigation has been carried out. The nature of the report is governed mainly by two factors –

(a) The instructions given by the client as regards the special aspects of the business which are required to be investigated;

(b) The findings of the investigating accountant/ investigator.

The important issues to be kept in mind by the investigator while preparing his report are as follows:	
(i)	The report should not contain anything which is not relevant either to highlight the nature of the investigation or the final outcome thereof.
(ii)	Every word or expression used should be properly considered so that the possibility of arriving at a different meaning or interpretation other than the one intended by the investigator can be minimized.
(iii)	Relevant facts and conclusions should be properly linked with evidence.
(iv)	Bases and assumptions made should be explicitly stated. Reasonableness of the bases and assumptions made should be well examined and care should be taken to see that none of the bases and assumptions can be considered to be in conflict with the objective of the investigation. For example, in an investigation into over-stocking of raw materials, inventories and spares etc. it should not be assumed that the ordering levels indicated on bin cards provide fair guidance about acquisition of further materials. Also, since investigation is a fact-finding assignment, assumptions should be made only when it is unavoidably necessary.
(v)	The report should clearly spell out the nature and objective of the assignment accepted its scope and limitations, if any.
(vi)	The report should be made in paragraph form with headings for the paragraphs. Any detailed data and figures supporting any finding may be given in Annexures.
(vii)	The report should also state restrictions or limitations, if any, imposed on the instructions given by the client. Preferably the reasons for placing such restrictions and their impact on the final result should also be stated.
(viii)	The opinion of the investigator should appear in the final paragraph of the report.

Due to non-availability of standardised procedure and lack of professional guidance, investigation calls for extreme care, caution and circumspection on the part of the investigator in exercising his judgement and discretion. Investigation often has a characteristic of very intimate and direct involvement of parties whose interest may be affected. Therefore, unlike auditing, chances of one or the other of the parties challenging the finding of the investigation are far greater.

9. SPECIAL ISSUES IN INVESTIGATIONS

Investigations broadly range between two extremes; on the one hand there are those in respect of which complete accounts, documents, records and other information are available, and on the other, those in respect of which little information, besides published accounts and statistical data, is available. Then again, investigation may cover the whole of accounting or may relate to only a part or parts of accounting as may be specified. Some more issues often arise in investigation. They are stated below:

(a) **Whether an investigator is required to undertake a cent per cent verification approach or whether he can adopt selective verification -** The answer to this question depends on the exact circumstances of the case under investigation. If the investigator has to establish the amount of cash defalcated by the cashier, he has probably no option but to carefully examine all the cash vouchers and related records. On the other hand, if he is to arrive at the profitability of a concern, he may verify constituent transactions on a selective basis taking extreme care to see that no material transaction that affects profit has remained concealed from his eyes. In investigation, it is always safer to go by statistically recognised sampling methods than to depend on the so-called "test checks" where circumstances permit selective verification.

(b) **Whether the investigator can put reliance on the already audited statement of account-** Here also no dogmatic views are possible. If the investigation has been launched because of some doubt in the audited statement of account, no question of reliance on the audited statement of account arises. However, if the investigator has been requested to establish value of a business or a share or the amount of goodwill payable by an incoming partner, ordinarily the investigator would be entitled to put reliance on audited materials made available to him unless, in the course of his test verification, he finds the audit to have been carried on very casually or unless his terms of appointment clearly require to test everything afresh.

It was held in the case of Short & Compton v. Brackert (1904) that an accountant, when making an investigation for an incoming partner, was entitled to assume that the figures appearing in the books were correct.

In another case, Mead v. Ball Baker & Co. (1911), it was held that an accountant, when acting as an adviser to a proposed investor in a limited company, was not expected to check errors in stock sheets and the omission of liabilities.

These cases were decided a long time ago. Therefore, much reliance cannot be placed on them. It is, therefore, desirable for the investigator to ascertain from the client, in advance, in writing, whether the audited statements of account produced to him should be taken as correct.

If the statements of account produced before the investigator were not audited by a qualified accountant, then of course there arises a natural duty to get the figures in the accounts properly checked and verified. However, when the accounts produced to the investigator have been specially prepared by a professional accountant, who knows or ought to have known that these were prepared for purposes of the investigation, he could accept them as correct relying on the principle of liability to third parties settled in the famous Hedley Byrne's case. Nevertheless, it would be prudent to see first that such accounts were prepared with objectivity and that no bias has crept in to give advantage to the person on whose behalf these were prepared.

(c) **Whether an investigator necessarily requires assistance of expert -** Often an investigator may feel the necessity of obtaining views and opinions of experts in various fields to properly conduct the investigation. It would be therefore, proper for the investigator to get the written general consent of his client, to refer special matters for views of different experts at the beginning of investigation and he should settle the question of costs for obtaining the views and other related implications.

(d) **Investigation out of disputes and conflicting claims -** Cases for investigation sometimes arise out of disputes and conflicting claims. It is needless to highlight that the investigator should remain above disputes or conflicting claims and be alert to the possibilities of the information or documents made available to him to be prejudiced. Even the client, overtly or covertly, may try to influence his reports. A seller of a business or controlling shares may request him to see that he gets the most favourable price. Similarly, if he is appointed by the buyer, he may be requested to deliberately depress the value. The investigator should keep him scrupulously professional and should keep the interest of all the involved parties in view.

This is a challenging task and probably no other professional work offers this much of challenge. This work is exciting too and requires not only the best of skill but of a high degree of maturity and experience.

(e) **Basis of opinion of an investor-** The investigator should refrain from issuing speculative opinion. He should confine his opinion to the established facts and nothing more. If the facts, as conveyed through the books, records, papers and other evidence, are not capable of being properly established, he should not express an opinion or, if at all he expresses any opinion, he should qualify the opinion by clearly stating the reasons therefor. This problem may particularly arise in cases where incomplete books and records are produced for investigation.

(f) **Whether an investigator can make futuristic statements – Even if the appointing authority is willing to obtain a futuristic statement,** the investigator should refuse to be futuristic. He may assume that the established trend in the business will continue in the near future, in the absence of any contrary evidence, in arriving at the present value of a business. He, however, should not project the trend into any future years to establish a value.

(g) **Whether to retain working papers or not -** Another important precaution is that the investigating accountant should retain in his files full notes of the work carried out, copies of schedules and all working papers, annexures, facts, figures, record of conversations and the like. Also, the working papers should link the figures as shown by the books of business with the final figures produced by the investigating accountant. Wherever required the investigator should take representation letter from the appointing authority. In the absence thereof, he would not be able to explain the figures when he is called upon to give evidence in a court of law to support his figures; for quite often the conclusions of the accountant are challenged by parties whose interest is adversely affected by his findings, for example, when the value of shares of a company taken over by the Government has been determined by him. This will also be of immense help to the investigator in correlating facts and events and later in drafting the report.

10. SPECIAL ASPECTS IN CONNECTION WITH BUSINESS INVESTIGATIONS

We discuss below the factors to be considered by a professional accountant while carrying out the investigation for attaining satisfactory results:

(a) **Studying the overall picture -** In such a business investigation, it is of utmost importance first to have an overall picture of the position of the business which is being investigated before the details are gone into. This is because figures are only symbols; and it is impossible to interpret them intelligently without knowledge of the background in which they have emerged.

13. For investigating the accounts of a group of companies, it would not be possible to know the manner in which the profits had emerged in the past unless a chart is prepared, showing the relationship of different companies comprising the group; whether as subsidiaries or not, the nature of transactions entered into by one unit in the group with another or others and the terms on which this has been done. Further, it is important to know whether the business is engaged in the manufacture of one or two important lines of products, is principally processing materials or is concerned only with the sale of a single product. Also, whether it is a business which depends for its success on imported raw materials or supply of parts and components from ancillary businesses or uses indigenous materials and parts which are manufactured locally.

14. If the business is labour-intensive, its future profitability would be dependent on the availability of skilled labour and relations of the management with the trade unions. Labour relations thus can affect the future profitability of the business. The method of distribution of products, either through wholesalers or retailers, also must be examined. Apart from these preliminary enquiries, the investigating accountant should study:

(i) the character of management;

(ii) the economic and political forces to which the business is subject; and

(iii) the position it enjoys in the market as against its competitors.

At times, political or economic factors also may affect the fortunes of a business; for example, labour disturbances, changes in government policies in the matter of levy of excise and custom duties, imports, etc. It is, therefore, necessary that the impact of all these factors should be studied and their effect on the business judged on a consideration of the profits in the past. For studying the economic and financial position of the business, the following should be considered:

(i) The adequacy or otherwise of fixed and working capital. Are these sufficient for the growth of the business?

(ii) What will be the trend of the sales and profits in the future? Establishing the trend of sales, product-wise and area-wise will ordinarily help in drawing a conclusion on whether the trend will be maintained in the future.

(iii) Whether the profit which the business could be expected to maintain in the future would yield an adequate return on the capital employed?

(iv) Whether the business is operating at its 100 percent capacity or improvements can be made to reach at full productivity?

(b) Statement of Profit and Loss - To study the Statement of Profit and Loss of a concern, it is necessary to consider each item, included therein, in relation to the corresponding items in the Statement of Profit and Loss of the previous years. It is, therefore. necessary that a summary, in columnar form, should be prepared of the balances included in the Statement of Profit and Loss of the business for a period, say, of 5 to 7 years.

In the foregoing summary, in the place of figures of opening and closing inventories, the figures of inventory consumed, for each product, in different years should be entered. It should also be verified that the inventories have been valued on a consistent basis throughout the period under review. If there has been a change, the values of inventories should be adjusted. Further, in the summary, the gross profit ratios and the ratios showing the relationship between various items of expenses and sales should be entered. The trend of these ratios should be examined and, if there is a wide divergence in them, an explanation for the same should be sought. In the preparation of the summary attention should also be paid to the following matters:

Turnover - The figures of sales should be broken down between the various products sold to show variations in turnover of individual products from year to year. In this way, it would be possible to find out the products the sales of which have been increasing and those the sales of which have been falling.

By reference to the list of customers, in the Order Books, it should be ascertained whether the business has a very large turnover with a few customers or a small turnover with several customers.

The Order Books should also be examined to find out if fictitious sales have been entered in any year to boost up profits. If so, the figures of sales of the year or years should be adjusted.

If the business consists of activities which are dissimilar in operation, like manufacturing and agency, then apart from splitting the income between the two sources, expenses should also be apportioned between them to separately arrive at the figures of profit from each of the activities.

Wage structure - The method of computing wages and the rates of wages should be examined. On occasions a business may have to pay higher wages than those prevailing in other business in the same neighborhood in pursuance of an industrial award. Another factor which is important to consider in this connection is the relationship of the business with its workers/ labour unions. A business which has suffered several industrial disputes, strikes, etc. and has had its working interrupted by them frequently cannot be expected to prosper unless a proper settlement is reached with workers' unions.

Depreciation and Maintenance - The charge on account of depreciation and maintenance of machinery and other assets included in the accounts of different years should be compared to verify that depreciation has been provided from year to year on a consistent basis and that it is adequate. Also, the necessary adjustment in the depreciation charge should be made if it is the practice of the company to write off the assets on a renewal basis.

Further, if assets have been revalued, it should be confirmed that depreciation on the increased valuation has been adjusted. Generally, with age, the cost of maintenance of assets should increase. If it has not, the reason thereof should be ascertained.

In case of leasehold property, it should be ascertained whether an adequate provision has been made for the dilapidation charge which may be payable at the end of the lease.

Further, compliance of relevant AS should also be verified.

Managerial Remuneration - It should be verified that the remuneration payable to various members of managerial personnel is not excessive in relation to the profits of the business after taking into account the time devoted by each of them. However, it could also be that no or only a nominal remuneration has been charged in the accounts. In either case, an adjustment should be made to arrive at true profitability of the concern. Further, in case of company, requirement of relevant section of the Companies Act, 2013 is to be seen. It has to be assured that calculation of profit for arriving at the remuneration is correct.

Exceptional and **non-recurring items -** It is customary to adjust exceptional items in the summary of Statement of Profit and Loss in order that they may not obscure the trend of the profits. In the matter of non-recurring items, it is necessary to remember that adjustments are to be made in respect of exceptional items which do not recur from year to year or can be considered exceptional having regard to their materiality or periodicity.

In this connection, it is worthwhile to examine the income tax assessment orders of the business to find out the items which have been treated as revenue but have been considered inadmissible by the taxing authority. Where the effect of these has been abnormal on the tax paid by the company from year to year, suitable adjustments should be made in the figures of taxes paid, as well as in the assets amounts. Likewise, adjustments should be made in respect of exceptional profits and losses like, profit or loss on sale of obsolete asset.

Repairs and maintenance - It is one of the recurring expenses of a business. Occasionally it is noticed that this expenditure is unduly heavy in some of the years, while quite low in some others. Generally, companies, as a matter of routine undertake major repairs, overhauls and maintenance programme at an interval of 3 or 4 years while running repairs and maintenance continue in the usual manner which gives rise to fluctuating charges in the accounts unless periodic major expenses are treated as deferred expenditure.

Besides, due to wrong allocation of expenses between capital and revenue, repair charges may appear to be heavy or low. If fluctuating and abnormal charges for repairs is noticed, it would be the duty of the investigating accountant to scrutinise this head thoroughly to establish correct and normal charge for repairs.

Unusual year - A company's record of profitability may show a trend of increasing or decreasing profit or loss or it may be highly erratic and fluctuating. Where a definite trend is discernible, the job of the investigating accountant is somewhat simplified. He can adopt recent years' record of profitability as the basis for estimating future maintainable profit having regard to the inflationary state in the economy. But if the same is fluctuating, there would be more demand on judgement of the accountant in selecting the period to be covered for estimation of profitability. In such cases it may even be necessary to take into consideration results of past 9 to 10 years with a view to iron out the fluctuation. If, however, it is noticed that results of one or more years under scrutiny were materially vitiated by exceptional factors like a long-term industrial dispute, natural calamities, pandemic, fire, war, ravage etc., the investigating accountant should eliminate such year / years from consideration altogether since they do not reflect the results obtained through normal business.

(c) Balance Sheet - Fixed Assets - Fixed assets, usually, are shown in accounts at cost less depreciation but the accounts do not show the ages of different assets. It is desirable, therefore, to obtain age analysis of various items of fixed assets. Assets which are old or are obsolete would naturally have to be replaced. It should be seen that their values are not in excess of the value of service that they could be expected to render to the business during the balance period of their active life and the amount they would fetch on sale as scrap. Title deeds should be verified to ascertain the extent of enterprise's ownership in such assets, like land and building jointly owned by two or more companies or their subsidiaries.

In addition, from a study of the maintenance expenses incurred from year to year, it should be judged whether the assets have been properly maintained. If not, it might be necessary to incur heavy expenditure on repairs to put them in a proper working order. In such a case, an allowance for this factor should be made in the value of assets. More particularly, it should be seen that if ass ets have been revalued, the increased depreciation charge has been adjusted against profit. Further, investigator has to assure whether assets whose recoverable amount is less than carrying amount are impaired and requirement of AS 28, "Impairment of Asset", has been complied.

Investments -Investments should be broadly classified into long term investments and current investments. A current investment is by its nature readily realisable and is intended to be held for not more than one year. All other investments are long term investments.

Current investments are valued on the basis of lower of cost and fair value determined either on an individual investment basis or by category of investment but not on an overall basis.

Long-term investments are usually carried at cost. However, when there is a permanent decline in the value of long-term investments, the carrying amount should be reduced to recognise the decline. The carrying amount of long-term investments is determined on an individual investment basis. Interest, dividends and rentals receivable in connection with investment are generally regarded as income. However, in some cases, such receipts represent recovery of cost and should therefore be reduced from, the cost of investment (e.g. dividend out of pre-acquisition profits).

Inventories - It should be seen that inventories have been valued consistently and that the basis of valuation was such that the value placed on inventories did not include any element of profit. Also, there should be due allowance for damaged, obsolete and slow-moving inventories. In some cases, physical verification of inventories is necessary where the inventories belonging to the entity are held by other parties. Examine the appropriateness of valuation of work in progress as disclosed in the books.

Trade Receivables - In assessing their value, the following should be taken into account:

(i) Whether provision for bad debts have been made in the years in which the relevant sales took place instead of in the year in which they have been written off, except when debts have had to be written off on account of a slump or a fall in international prices, during a period subsequent to the period in which sales had taken place.

(ii) The length of the credit period allowed or any excessive discounts allowed throughout the period under investigation, to determine whether it has been necessary to increase continually the credit period in order to affect the sales. If it has been so, it would indicate that the demand for the goods manufactured by the concern in the market has been diminishing gradually.

(iii) Debts should be classified according to their age. This would disclose the character of the parties with whom the company trades and the amount of working capital that will be necessarily blocked on this account in the course of business. Determine Debtors to Sales Ratio.

Other liquid assets - It should be ascertained that the assets so described are readily realisable. Money with a bank in liquidation should be taken only to the extent guaranteed by Deposit Insurance Scheme.

Idle assets -On a scrutiny, it may appear that certain assets are remaining idle and are not being properly applied in the business. These may come from all sections of assets. For example, certain plant and machinery may have been put to use after a considerable period of time after acquisition. Some of the fixed assets may be awaiting installation even at the valuation time. The company may hold large cash and bank balances, not warranted by the need of the business. Then again, there may be instances of obsolete and slow-moving inventories of large value in the accounts of the company. It would be the duty of the investigating accountant to eliminate these idle assets, if any, after proper identification from the net worth of the business. However, proper value of these assets may be separately added to the value of the business.

Liabilities - The important matter to investigate in this regard is whether those are stated fully or understated or overstated. In other words, whether the profits of the business have been inflated by suppression of liabilities or there are any free reserves included in the liabilities. In either case, an adjustment would be necessary. Secondly, it should be ascertained that liabilities are not unduly large or are not outstanding for a long time, in such cases, it would be necessary to pay off some of them which would cause a drain on the liquid resources of the concern. The fact should be stated in the report.

Taxation - Orders in respect of assessments completed should be studied and it should be verified that an adequate provision has been made in respect of liabilities for taxes which have not been assessed. Also, it should be seen that in the past there has been no reopening of assessments. If so, the company may be liable for an undisclosed sum of taxes plus penalties. Any temporary tax benefit should also be disregarded.

Capital - In this regard, it is necessary to ascertain:

(i) Whether the capital is well balanced. This would not be the case if the number of debentures and preference share capital are disproportionately large as compared to the equity capital. Low equity capital would handicap the company in raising further equity capital, on favourable terms for financing the business or to pay off capital commitment. Further, when the capital is highly geared, it would affect the value of the equity capital;

(ii) That the amount of capital is reasonable compared to the value of fixed assets and the amount of working capital required. The terms associated with the issue of the capital should also be studied; restriction on transferability of shares usually depresses the value of share and of the business.

(d) Interpretation of figures - Fixed Assets - The amount of capital expenditure which would be necessary in the future for the continuation of the business, in its existing stage, should be assessed having regard to the under-mentioned factors:

(i) the amount required for the replacement of assets when these would become worn out or obsolete;

(ii) the expenditure which will be necessary to replace obsolete machinery by more sophisticated machinery for manufacturing different types of goods for which there is demand.

Turnover - In assessing the turnover which the business would be able to maintain in the future, the following factors should be taken into account:

(i) Trend: Whether in the past sales have been increasing consistently or they have been fluctuating. A proper study of this phenomenon should be made.

(ii) Marketability: Is it possible to extend the sales into new markets or that these have been fully exploited? Product wise estimation should be made.

(iii) Political and economic considerations: Are the policies pursued by the Government likely to promote the extension of the market for goods to other countries? Whether the sales in the home market are likely to increase or decrease as a result of various emerging economic trends?

(iv) Competition: What is the likely effect on the business if other manufacturers enter the same field or if products which would sell in competition are placed on the market at cheaper price? Is the demand for competing products increasing? Is the company's share in the total trade constant or has it been fluctuating?

Working Capital - In making assessment of the working capital requirements in the future, the following matters should be taken into account:

(i) Has the ratio of inventory to turnover been increasing and if so, is it a continuing or only a temporary trend?

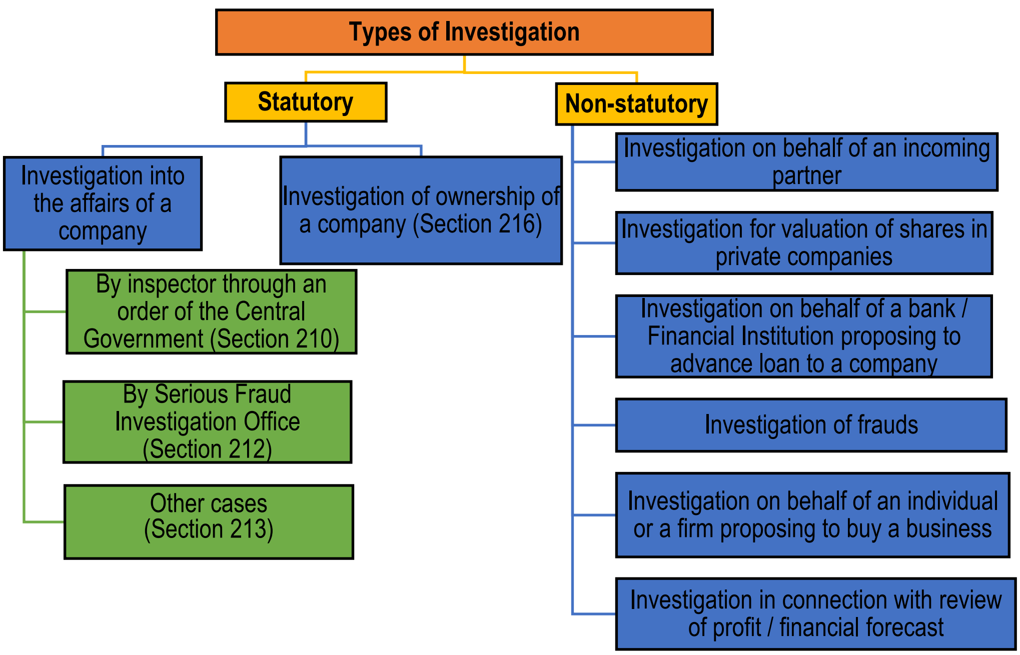
(ii) Are the trade payables being paid promptly or is there a backlog which will have to be dealt with?

(iii) What will be the effect on inventory, trade receivables and trade payables, if the turnover is increased or if new products are introduced?

Estimating Future Maintainable Profits - Fluctuations in profits during the years under review should be examined after adjusting the profits for extraneous factors, if any, that had given rise to fluctuations to determine whether the factors responsible for the fluctuations were temporary or was likely to recur in future. A statement should be prepared showing separately the profits after depreciation earned in each of the years during the period under review, after making adjustments therein, if considered necessary, as regards factors which have been responsible for any extraordinary increase in profits. If the percentage of profits before taxation to capital has been stable or has been increasing, it would indicate that the business would continue to earn the same rate of profit as it has done in the past. If, on the other hand, the percentage has been falling, and there is no evidence that the factors responsible therefore have ceased to operate, investment of further capital in the business would not be commercially advisable.

11. TYPES OF INVESTIGATION

The different types of investigation that a chartered accountant is usually called upon to carry out are given hereunder:



Statutory - By an inspector under Sections 210, 212, 213 and 216 of the Companies Act, 2013 – discussed in detail in Self-Paced Module Set A.

Non-statutory - These are listed as under:

(a)	Investigation on behalf of an incoming partner.
(b)	Investigation for valuation of shares in private companies.
(c)	Investigation on behalf of a bank proposing to advance loan to a company.
(d)	Investigation of frauds.
(e)	Investigation on behalf of an individual or a firm proposing to buy a business.
(f)	Investigation in connection with review of profit/financial forecast.

11.1 Investigation on behalf of an Incoming Partner

The general approach of the investigating accountant in this type of investigation would be more or less similar, irrespective of the nature of business of the firm-manufacturing, trading or rendering a service.

Primarily, an incoming partner would be interested to know whether the terms offered to him are reasonable having regard to the nature of the business, profit records, capital contribution, personal capability of the existing partners, socio-economic setting, etc., and whether he would be capable of deriving continuing benefit by the way of return on capital to be contributed and remuneration for services to be rendered, which can be justified by the overall economic conditions prevailing and other considerations considering his own personality and achievements. In addition, he would be interested to ascertain whether the capital to be contributed by him would be safe and applied usefully.

Broadly, the steps involved are the following:

(a)	Ascertainment of the history of the inception and growth of the firm.
(b)	Study of the provisions of the deed of partnership, particularly for composition of partners, their capital contribution, drawing rights, retirement benefits, job allocation, financial management, goodwill, etc.
(c)	Scrutiny of the record of profitability of the firm's business over a suitable number of years, with usual adjustments that are necessary in ascertaining the true record of business profits. Particular attention should, however, be paid to the nature of partners' remuneration, which may be excessive or inadequate in relation to the nature and

	profitability of the business, qualification and expertise of the partners and such other factors as may be relevant.
(d)	Examination of the asset and liability position to determine the tangible asset backing for the partner's investment, appraisal of the value of intangibles like goodwill, know how, patents, etc. impending liabilities including contingent liabilities and those pending for tax assessment. In case of firms rendering services, the question of tangible asset backing usually is not important, provided the firm's profit record, business coverage and standing of the partners are of the acceptable order.
(e)	Position of orders at hand and the range and quality of clientele should be thoroughly examined, which the firm is presently operating.
(f)	Position and terms of loan finance would call for careful scrutiny to assess its usefulness and implication for the overall financial position; reason for its absence or negative impact should be studied.
(g)	It would be interesting to study the composition and quality of key personnel employed by the firm and any likelihood of their leaving the organisation in the near future.
(h)	Various important contractual and legal obligations should be ascertained and their nature studied. It may be the case that the firm has standing agreement with the employees as regards salary and wages, bonus, gratuity and other incidental benefits. Full impact of such standing agreements would be gauged before a final decision is reached.
(i)	Reasons for the offer of admission to a new partner should be ascertained and it should be determined whether the same synchronises with the retirement of any senior partner whose association may have had considerable bearing on the firm's success.
(j)	Appraisal of the record of capital employed and the rate of return. It is necessary to have a comparison with alternative business avenues for investments and evaluation of possible results on a changed capital and organisation structure, if any, envisaged along with the admission of the partner.
(k)	It would be useful to have a firsthand knowledge about the specialisation, if any, attained by the firm in any of its activities.
(l)	Manner of computation of goodwill on admission as also on retirement, if any, should be ascertained.
(m)	Whether any special clause exists in the deed of partnership to allow admission in future of a new partner, who may be specified, on concessional terms.
(n)	Whether the incomplete contracts which will be transferred to the reconstituted firm will be a liability or a loss.

It would always be worthwhile to remember that, in a partnership, personal considerations count predominantly over other considerations and assessment of standing of the firm, standing and reliability of other partners, their personal reputation and the goodwill enjoyed by the products/services of the firm are important.

On the basis of the broad frame of considerations as given above, the investigating accountant should devise his own considerations in each case which may be quite diverse. Additional considerations may come up in the case of service-rendering firms where profit and business record, goodwill of the firm and of individual partners would assume greater significance.

Again, in the case of industrial firms, the network of customers, their scatter, size, etc., would be relevant for consideration.

11.2 Investigation for Valuation of Shares in Private Companies

The importance should be given on various purposes for which such a valuation is necessary, the different bases on which valuation is possible and the variety of economic factors, on a consideration whereof the price so determined needs to be adjusted.

The necessity for valuation of shares of a private company arises, for under the Companies Act,2013 a private company must restrict the transfer of its shares. In consequence, the shares of a private company do not have a free market in which their prices could be determined by interaction of the forces of supply and demand.

In respect of equity shares, there are two main methods of valuation. According to the *first* method, value is determined on the basis of the net worth of the company. The amount of net worth is divided by the number of shares comprising the equity capital to arrive at the value for one share. When this method is followed, goodwill of the business, and non-trading assets (like investments) based on the estimated future maintainable profit, is included among the assets to arrive at the amount of net worth. According to the *second* method, the average profit earned by the business during the preceding 5 to 7 years is computed. Afterwards, on the assumption that the same would continue to be earned in the future, the value of business is calculated by capitalising it at a reasonable rate of interest. If the rate assumed is high, the value of the business would be smaller. Correspondingly, it would be high if the rate of interest applied is low. A provision of the risk factor and restriction on transfers in the value of shares is made by varying the rate of interest applied. The rate of return that an investor expects to earn in a business of the type in which the company is engaged, is ascertained from the prices of the shares of companies engaged in a similar business quoted on the stock exchange.

The value of preference shares is estimated on the basis of the yield on preference shares of companies engaged in a similar trade or industry after making allowance for factors like restriction on transferability, average rate of earnings as compared to the rate of dividend, etc.

Special features -

Net worth basis

(a) Each asset should be revalued by taking into account its utility to the business as a going concern. The value of different assets, on a revaluation, may be either more or less in comparison to their book values.

16. The book value of safes and furniture in the case of a bank is usually much less as compared to their utility. On the other hand, the book value of intangible assets, e.g., leasehold rights, patents, goodwill, etc., in case of an industrial concern may be higher in comparison with the advantage which accrues to it from these assets. In both the cases, the assets should be revalued at their replacement cost i.e., the cost of similar assets at the prevailing market price, reduced by the amount of depreciation which they would have suffered, if they were in use during the period that the corresponding assets have been in use. But the cost adopted, in cash, should be the cost of the assets as were originally purchased or that of their substitutes considered more suitable in the circumstances of the case.

(b) The value of goodwill of a business is primarily dependent on its capacity to earn super-profit and the period over which these are expected to arise. The super profits that the business would earn in the future are estimated on the basis of profits earned in the past, after making an allowance therein for the continuation or otherwise of favourable factors, which in the past had enabled the business to earn super-profits. This is usually a difficult matter since, for the purpose, it is necessary to analyse the trend of economic, social and political forces which have an impact on the profitability of the business.

17. The installed capacity must be viewed against future national requirements on taking into account the government's licensing policy. Again, government policies like controls over selling price or advantages of marketing through its own organisations will have to be considered since any change therein might seriously affect the profit structure. Therefore, to determine the impact of these factors, the accountant must have knowledge of the company's working and experience of the business in general.

Yield basis

(a) The value of shares on yield basis is arrived at on the basis of present value of the right to receive dividends in the future. Since dividends can be paid only out of profits, in this case also, it is necessary to determine the amounts of profits which the company would be earning in future as well as the amounts thereof which would be distributed as dividend from year to year. In short, it is an exercise of projecting the trend of profits and predicting the policy that the company might follow in the matter of declaration of dividends.

(b) The rate at which the amount of dividends should be capitalised is decided on taking into account the risk that shareholders are taking in the matter of declaration of dividends being continued in future, assessed in the background of past history of the company, the amount of reserves the company possesses, both secret and those disclosed in its books, future prospects of the line of manufacture or trade in which the company is engaged and the impact of various social and political factors that are likely to emerge on the company's profitability. Since the effect of these factors is reflected in the prices at which the shares of companies engaged in similar trades and businesses are quoted on the Stock Exchange, the investigating accountant should consider them. This would help him to know the rate at which their dividends were being capitalised. He should adopt the average rate of return expected by investors in the shares of such companies but it should be applied only after making due allowance for the factors peculiar to the case, such as restrictions on transfer of shares, majority holding, etc. In any valuation of shares, with the transfer of shares control is also to pass, a separate value should be ascertained for the control and added to the value otherwise obtained either on net worth basis or yield basis.

11.3 Investigation on behalf of a Bank/ Financial Institution Proposing to Advance/Loan to a Company

A bank is primarily interested in knowing the purpose for which a loan is required, the sources from which it would be repaid and the security that would be available to it, if the borrower fails to pay back the loan. **On these considerations, the investigating accountant, in the course of his enquiry, should attempt to collect information on the under-mentioned points:**

(i)	The purpose for which the loan is required and the manner in which the borrower proposes to invest the amount of the loan.
(ii)	The schedule of repayment of loan submitted by the borrower, particularly the assumptions made therein as regards amounts of profits that will be earned in cash and the amount of cash that would be available for the repayment of loan to confirm that they

	are reasonable and valid in the circumstances of the case. Institutional lenders now-a-days rely more, for repayment of loans, on the annual profits and loss, and on the values of assets mortgaged to them.
(iii)	The financial standing and reputation for business integrity enjoyed by directors and officers of the company.
(iv)	Whether the company is authorised by the Memorandum or the Articles of Association to borrow money for the purpose for which the loan will be used.
(v)	The history of growth and development of the company and its performance during the past 5 years.
(vi)	How the economic position of the company would be affected by economic, political and social changes that are likely to take place during the period of loan.
(viii)	Whether any loan application to any other Bank or Financial Institution was made, and if so, the reasons for rejection thereof.

To investigate the profitability of the business for judging the accuracy of the schedule of repayment furnished by the borrower, as well as the value of the security in the form of assets of the business already possessed and those which will be created out of the loan, the investigating accountant should take the under-mentioned steps:

(a) Prepare a condensed income statement from the Statement of Profit and Loss for the previous five years, showing separately therein various items of income and expenses, the amounts of gross and net profits earned, and taxes paid annually during each of the five years. The amount of maintainable profits determined on the basis of foregoing statement should be increased by the amount by which these would increase on the investment of borrowed funds.

(b) Compute the under-mentioned ratios separately and then include them in the statement to show the trend as well as changes that have taken place in the financial position of the company:

(i) Sales to Average Inventories held.

(ii) Sales to Fixed Assets.

(iii) Equity to Fixed Assets.

(iv) Current Assets to Current Liabilities.

(v) Quick Assets (the current assets that are readily realisable) to Quick Liabilities.

(vi) Equity to Long Term Loans.

(vii) Sales to Book Debts.

(viii) Return on Capital Employed.

(c) Enter in a separate part of the statement the break-up of annual sales product-wise to show their trend.

Steps involved in the verification of assets and liabilities included in the Balance Sheet of the borrower company which has been furnished to the Bank - The investigating accountant should prepare schedules of assets and liabilities of the borrower and include in the particulars stated below:

(a) Fixed assets - A full description of each asset its gross value, the rate at which depreciation has been charged and the total depreciation written off. In case the rate at which depreciation has been adjusted is inadequate, the fact should be stated. In case any asset is encumbered, the amount of the charge and its nature should be disclosed. In case an asset has been revalued recently, the amount by which the value of the asset has been decreased or increased on revaluation should be stated along with the date of revaluation. If considered necessary, he may also comment on the revaluation and its basis.

(b) Inventory - The value of different types of inventories held (raw materials, work-in-progress and finished goods) and the basis on which these have been valued.

Details as regards the nature and composition of finished goods should be disclosed. Slow-moving or obsolete items should be separately stated along with the amounts of allowances, if any, made in their valuation. For assessing redundancy, the changes that have occurred in important items of inventory subsequent to the date of the Balance Sheet, either due to conversion into finished goods or sale, should be considered.

If any inventory has been pledged as a security for a loan the amount of loan should be disclosed.

(c) Trade Receivables, including bills receivable - Their composition should be disclosed to indicate the nature of different types of debts that are outstanding for recovery; also whether the debts were being collected within the period of credit as well as the fact whether any debts are considered bad or doubtful and the provision if any, that has been made against them.

Further, the total amount outstanding at the close of the period should be segregated as follows:
(i) debts due in respect of which the period of credit has not expired;
(ii) debts due within six months; and
(iii) debts due but not recovered for over six months.

If any debts are due from directors or other officers or employees of the company, the particulars thereof should be stated. Amounts due from subsidiary and affiliated concerns, as well as those considered abnormal should be disclosed. The recoveries out of various debts subsequent to the date of the Balance sheet should be stated.

(d) **Investments -** The schedule of investments should be prepared. It should disclose the date of purchase, cost and the nominal and market value of each investment. If any investment is pledged as security for a loan, full particulars of the loan should be given.

(e) **Secured and Unsecured Loans -** Debentures and other secured loans should be included together in a separate schedule. Against the debentures and each secured loan, the amounts outstanding for payments along with due dates of payment should be shown. In case any debentures have been issued as a collateral security, the fact should be stated. Particulars of assets pledged or those on which a charge has been created for re-payment of a liability should be disclosed. Details of loans proposed to be obtained from Promoters/ Directors/ Related Parties should be stated separately. In case any unsecured loan is to be repaid prior to repayment of Bank loan, its terms and conditions should be verified.

(f) **Provision of Taxation -** The previous year's up to which taxes have been assessed or assessment order received should be ascertained. If provision for taxes not assessed appears to be inadequate, the fact should be stated along with the extent of the shortfall.

(g) **Other Liabilities -** It should be stated whether all the liabilities, actual and contingent, are correctly disclosed. Also, an analysis according to ages of trade payables should be given to show that the company has been meeting its obligations in time and has not been depending on trade credit for its working capital requirements.

(h) **Insurance -** A schedule of insurance policies giving details of risks covered, the date of payment of last premiums and their value should be attached as an annexure to the statements of assets, together with a report as to whether or not the insurance-cover appears to be adequate, having regard to the value of assets.

(i) **Contingent Liabilities -** By making direct enquiries from the borrower company, from members of its staff, perusal of the files of parties to whom any loan has been advanced for example, those of machinery suppliers and the legal adviser. The investigating accountant should ascertain particulars of any contingent liabilities which have not been disclosed. In case, there are any, these should be included in a schedule and attached to the report.

11.4 Investigation of Frauds

In the Companies Act, 2013 meaning of fraud has been considered in two specific sections viz. Section 143(10), where the SAs specified by the ICAI are deemed to be the auditing standards for purposes of the Act, which, inter alia, define fraud, and in Section 447, where punishment for fraud has been prescribed.

Fraud has been defined in paragraph 11(a) of SA 240, "The Auditor's responsibilities Relating to Fraud in an Audit of Financial Statements" 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.'

In the context of stating the provisions for punishment for fraud, Section 447 of the Act has explained the term 'fraud' as "fraud in relation to affairs of a company or any body corporate, includes any act, omission, concealment of fact or abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss."

This Section further explains the terms 'wrongful gain' and 'wrongful loss' to mean the gain by unlawful means of property to which the person gaining is not legally entitled; and the loss by unlawful means of property to which the person losing is legally entitled, respectively.

11.4.1. Types of Frauds

Frauds may broadly be categorized as –

Fraudulent Financial Reporting	Misappropriation of Assets	Corruption
• Alteration or falsification of records & documents • Misrepresentation in or intentional omission of events, transactions or information • Intentional misapplication of accounting principles • Fictitious Journal Entries • Adjusting assumptions and changing Judgments • Omitting, advancing or delaying the recognition of events or transactions. • Abnormal Year End Transactions. • Improper Asset Valuation • Overstatement of Revenue or Understatement of Liabilities	• Embezzlement of receipts in respect of written-off accounts – Skimming or Cash Larceny • Stealing physical assets or intellectual properties • Introduction of fictitious vendors • Payroll Schemes – Ghost Employees, Falsified Wages, & Commission Schemes • Reimbursement Schemes – Mischaracterised Expenses, Multiple Reimbursement, & Fictitious Expenses • Using entities assets for personal use.	• Conflict of Interest • Bribery • Illegal Gratuities • Money Laundering

Fraudulent Entries

- Late entry
- No entry
- Part entry
- Inserting wrong entries to divert attention

Sales Frauds

- Price enhancement
- Omission to make receipt of sale of scrap.
- Billing and sales reversals in amusement parks.
- Food production yield ratio in hotels and suppression of Revenue.
- Using or hiring assets of the company in lean period
- Omission in preparation of dispatch note for sale
- Sale of Assets recorded as Income
- Cash sale adjusted as credit sale.
- Writing off a good debt as bad & irrecoverable

Collection Frauds

- Defalcation of contributions to charity funds
- Crediting donation to loan accounts.
- Rental collected in cash but not recorded.

Expenses Frauds

- Entering ineligible discount
- Overcharging expenses
- Falsification of documents
- Untimely payment
- Introduction of fictitious vendor.
- Unnecessary/ huge provisioning of expenses.

Payroll Frauds

- Extra number of employees
- Extra hours
- Calculation of net pay by transferring rounding off amount to personal account.
- Not deactivating the retired employees' IDs
- Fictitious employees/ workers paid salary.

Data Frauds

- Change in computer data
- Destroy, suppress or insert records
- Using open fields in computerized accounting system

Technology related Frauds

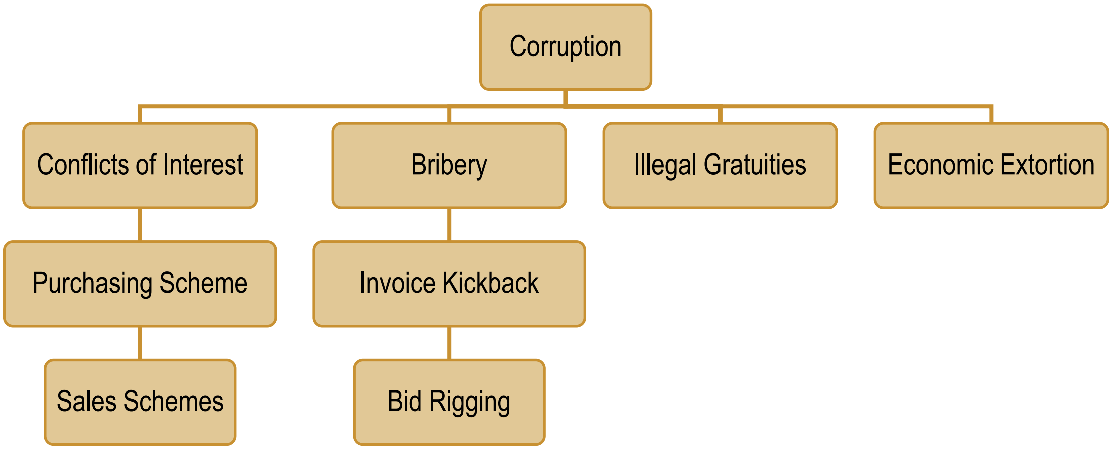
- Employing hostile Software Programs or malware attacks
- Phishing mails
- Vishing – Voice Mail
- Smishing - Text messages
- Whaling – Targeted phishing on high network individuals
- Card duplications
- Stealing confidential data

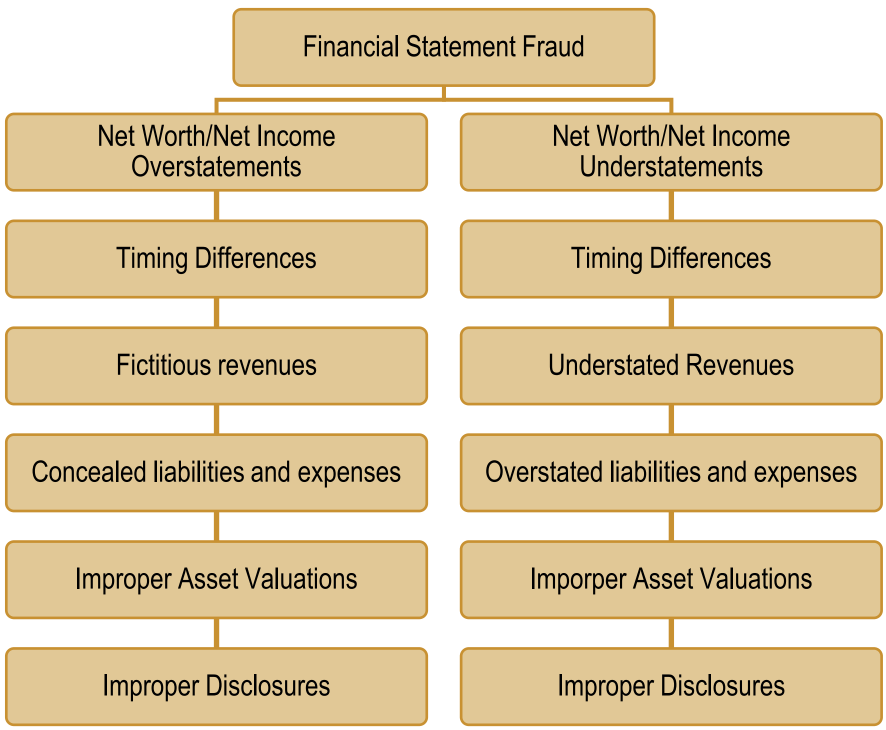
Banking related Frauds

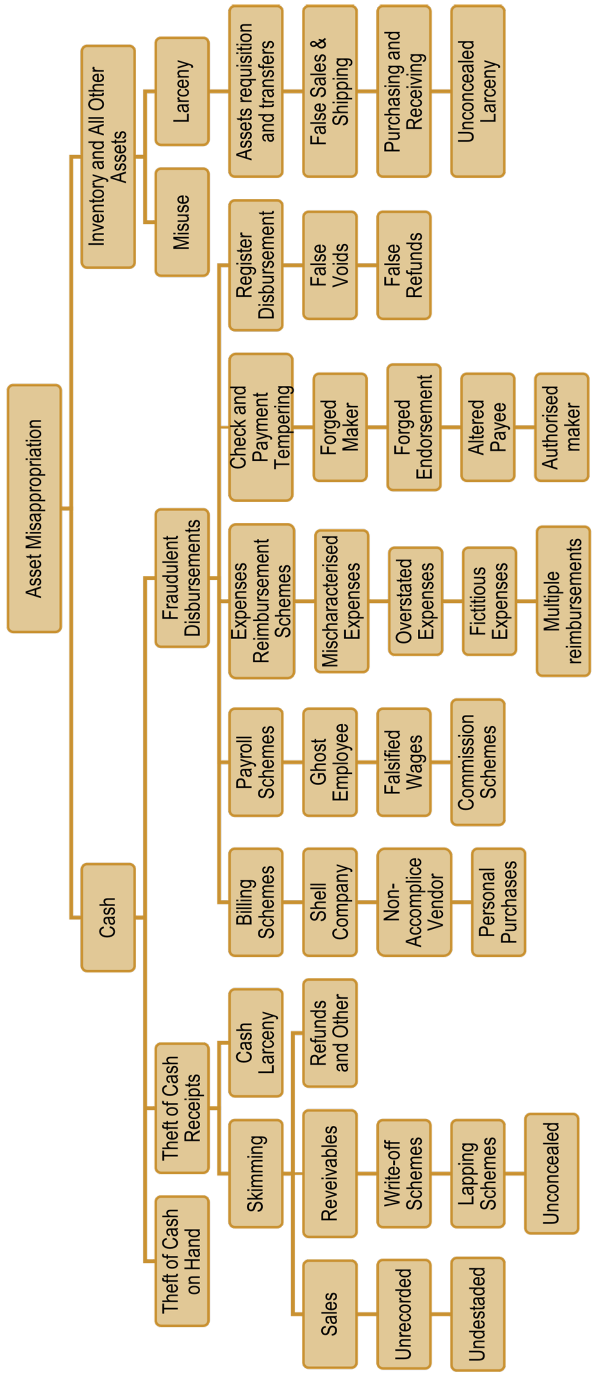
- Forged Signatures
- Cheque Frauds - Alteration in amounts, Alteration in accounts titles, Kite flying
- Cash lending during working hours
- Missing notes in bundles
- Use of same notes bundles by two branches
- Wrong posting in other accounts
- Misuse of sensitive stationery
- ATM transaction misuse
- Using PINs of debit card/credit card holder
- Advances - inflated stock statements, inflated projections, forged/duplicate land documents, L/Cs

Others

- Teaming and Lading
- Process houses mixing inferior quality material to sale good quality material
- Pilferage and theft in super markets
- Selling classified information,
- Withholding information from customer about free product schemes, discount and concession.
- Enhancement of performance
- Taking advantage of disaster or natural calamity.
- Trust FDs
- Fictitious journal entries to inflate expenses or income.


Corruption
Conflicts of Interest
Bribery
Illegal Gratuities
Economic Extortion
Purchasing Scheme
Invoice Kickback
Sales Schemes
Bid Rigging


Financial Statement Fraud
Net Worth/Net Income Overstatements
Net Worth/Net Income Understatements
Timing Differences
Timing Differences
Fictitious revenues
Understated Revenues
Concealed liabilities and expenses
Overstated liabilities and expenses
Improper Asset Valuations
Imporper Asset Valuations
Improper Disclosures
Improper Disclosures



Source: Occupational Fraud 2022: A Report to the Nations

Frauds may be classified as defalcations involving misappropriation, either of money or that of goods, and manipulation of accounts not involving a defalcation. The detections of manipulations of accounts being one of the objects of an audit, for the detection of frauds perpetrated for misappropriating either money or goods, knowledge of the various circumstances under which these may be committed and that of different forms they take is essential. On this account, a brief description thereof at different level is given below:

1. **Fraud for Personal Gains**

   Bribery: Money, gift or other favours offered to procure (often illegal or dishonest) action or decision in favour of the giver. These are also relatable to contract fraud or procurement fraud and are, generally, out of books transactions. The auditor normally conducts a propriety audit over the veracity of the transactions and review of any undue favours to vendors.

   When money, gift or other favours are offered to public official to influence an official act of government then such kind of Bribery is called Official Bribery. In contrast to Commercial Bribery or favours to vendors, in case of Official Bribery, Company usually is criminally prosecuted.

2. **Corporate Frauds/ Irregularities**

   (i) **Advance Billing:** Advance billing is a situation where the company officials indulge in booking fictitious sales in anticipation of actual sales. This results in misrepresentation of revenue in the books thereby misleading financers and stakeholders. When the management treats borrowings from money lenders as customer advances in the books against sale orders or for adjusting bills receivables, the fraudulent act gets unnoticed for an extended period. This situation results in a death knell for the corporation as the company is dragged into an irredeemable debt trap.

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

   (ii) **Shell/ Dummy Company Schemes:** Generally, represents a fictitious company or a ‘paper company’ to transfer profits or funds from the main company. This could also involve fictitious bills (mostly for services rendered or consultancy charges that cannot be corroborated) which are used in the name of dummy companies diverting the funds taken from banks and financial institutions.

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

(iii) Money-Laundering Activities: As per the Prevention of Money-Laundering Act, 2002, "whosoever directly or indirectly attempts to indulge or knowingly assists or knowingly is a party or is actually involved in any process or activity connected with the proceeds of crime and projecting it as untainted property shall be guilty of offence of money-laundering."

The person indulging in money laundering looks for avenues with weak banking controls for converting illegal money into the banking system. Any excess credit in the bank accounts that does not belong to the customer or is parked for a temporary period should raise suspicion of such activities. This person indulging in money laundering activity looks for avenues to enter into 'benami' (could be called 'proxy' name lending) transactions. Companies with extensive cash handling and inadequate control over source of money or involved in remittance of money for import/ export of goods etc. are susceptible to money laundering activities.

3. Fraud at Operational Level Employees

(i) Tampering of Cheques/Drafts/On-line payments/receipts: Tampering of cheques, payee name being altered, or preparation of cheques without the same being issued to payee, etc., are methods that may also lead to falsification of accounts.

On-line payments generally are considered a transparent mechanism to prevent the above frauds. The ATM is a popular technological advancement that has inherent control gaps. For example, credit cards once swiped the transaction is put through in the system without the need for a signature of the payer. Similarly, unauthorised credits in bank accounts through ATMs are an immense source of threat to recipients including bribery allegations, unless they lodge a complaint with the bankers or the regulatory authorities in a prompt manner of such unauthorised credits to their accounts/or company bank accounts.

Care should be taken that the name of the payee in the payment transactions in books and cheque issued therein for payment is not fabricated to wrongly codify and book against an improper account head.

(ii) Off Book Frauds: In off book frauds, the fraud perpetrator misappropriates the cash before these are recorded in the books or before the sale is recorded in the books.

These frauds are difficult to unearth as the cash or collection is taken off before the accounting entries are made in the books. This situation arises especially in unorganized markets and in rural economies where banking habits are relatively under developed. These are difficult to establish due to absence of audit trails and are more prevalent in businesses that have extensive cash dealings. These are difficult to uncover as the means adopted could include printing of receipts/ bills outside the system.

The above fraudulent schemes can be established based on circumstantial evidence or validation through external sources such as, customer balance confirmations (where feasible) and customer copy of the receipts or other documents that are retained by them. These are also further supplemented by external evidence in the form of background checks and surveillance mechanism. Verification of all the receipts and issues of stock recorded in stock register is another way to identify this type of fraud.

(iii) Cash Misappropriation: Cash is misappropriated after the accounting entries are already passed in the books. These are identified through surprise checks and through shortages in cash balances. These occur when there are delays in accounting of cash collections and there are no laid down cash flow controls. Unaccounted money in any form in an entity is a serious red flag in uncovering of irregularities. Improper daily fund monitoring mechanism is another factor that results in creating unauthorised float by employees in their personal account or in fictitious surrogate (proxy) entities by fraudsters.

(iv) Teeming and Lading: This is also achieved through cash deposits or cheques collected from customers being overlapped with the collections from subsequent customers and the amount collected is diverted to personal account. Reconciliation of customer accounts at a single point of time and confirmation from customers for amounts outstanding in their accounts helps in identifying any leakage in collections.

(v) Fraudulent Disbursements: Fraudulent disbursements or reimbursements take place either by issuing or submission of false bills, or personal expense bills being converted into official expenses bills. The other method that is resorted to by the perpetrator of fraud is to inflate the refunds due to a customer and skim the excess refunds.

(vi) **Expense Reimbursement Schemes:** These fraudulent schemes involve employees resorting to treating their personal expenses as incurred for business purpose and claiming reimbursement. In some cases, employees may get reimbursed by third parties (such as distributors) as well as by claiming these expenses from the company. Multiple expense claims based on duplicate bills or photostat copies.

(vii) **Payroll Fraud:** The payroll fraud could include payment to non-existent employees or in a contractual arrangement inflating of the manpower resources than those actually deployed while billing the client. It may also include showing higher pay than actual disbursement to employees/ workers, etc. The process would require a detailed review of statutory declarations/filings under various labour law statutes including disclosures in financial statements of retirement benefits such as P.F, Gratuity and Superannuation benefits from an evidence gathering perspective.

(viii) **Commission Schemes:** The salesman exaggerates the sales through fictitious billings to earn higher commission or alter the sales prices of the products sold from those stipulated by the company or share the sales volumes achieved with other employees to share higher commission. Commission schemes in mega deals backed by legal documents are often tools used to camouflage kickbacks. These are often difficult to uncover and would need to be supplemented by the monetary trails across entities and geographies.

Procedure for Investigation of Fraud: Before proceeding to investigate frauds of the type afore mentioned, the investigating accountant should ascertain the exact duties of the person concerned who is suspected to have committed a fraud; his relationship to the general routine of the office, and the circumstances in which any known instances of defalcation have come to light. Such an enquiry would give a clue to promising avenues of investigation. Greater the authority of the individual suspected of a fraud, wider would be the field which would have to be covered by the investigation. At times, an accountant is called upon to investigate a suspected fraud, the details or the nature whereof is not known. In such a case, for localising the source of the fraud, the investigating accountant will have to study the financial and accounting structure of the organisation. As a first step, he should examine the line of responsibility between the various members of the staff. He should have a look at the system of internal control in operation for spotting out the weaknesses, if any, that may exist in it. Relying on the above study, he should direct his enquiry towards those aspects of the business where there has been excessive control in the hands of single persons/ employee, without any supervision by any other person/ employee or, any other inherent weakness that may be in existence in the system.

Some of the situations in which money may be embezzled and the various forms that such frauds usually take place alongwith their investigation procedure include the following:

(a) **Cash receipts -** In cases like holding back cash sales, collections by travelling salesmen, V.P.P receipts, or casual receipts, e.g., sales of scrap, recoveries out of debts written off earlier, etc., the amount or amounts of receipts embezzled may be subsequently covered up by the perpetrator adopting one or other of the under-mentioned devices:

(i) Issuing a receipt to the payee for the full amount collected and entering only a part of the amount on the counterfoil.

(ii) Showing a larger cash discount than actually allowed.

(iii) Adjusting a fictitious credit in the account of a customer for the value of goods returned by him.

(iv) Adjusting a cash sale as a credit sale, and raising a debit in the account of the customer.

(v) Writing off a good debt as bad and irrecoverable to cover up the amount collected which has been misappropriated.

(vi) Short-debiting the customer's account in the ledger with an intention to withdraw the difference when the full amount payable by him is collected.

(vii) Under-casting the receipts side of the Cash Book or over-casting the payment side.

(viii) Carrying over a shorter total of the receipts from one page of the Cash Book to the next or over-carrying the total of the payment from one page of the Cash Book to the next with a view to covering up misappropriation; either short banking of cash collection or a part of the amount of withdrawal from the bank.

Verification of Cash Receipts: On the assumption that some of these may have been diverted before being entered in the books, evidence as regards income received from different sources should be scrutinised, e.g., inventory, sales summaries, rental registers, correspondence with customers, advices of travelling salesmen and counterfoils or receipts. Carbon copies of receipts marked 'duplicate', should be scrutinised to confirm that they are in fact copies of receipts issued earlier. In addition, by recalling paying-in-slips from the bank the details of cash deposited on each day should be compared with those shown in the Cash

Book. The record of sales of scrap of waste paper, that of collection of rents from labourers temporarily accommodated in the company's quarters, that of refunds of amounts deposited with the electric supply co., or any other Government authorities should be examined for finding out if any of these amounts have been misappropriated. Cash sales should be vouched in detail. Recoveries from customers and sundry parties should be checked with the copies of receipts issued to them; deductions made on account of cash discounts should be reviewed. All withdrawals from the bank should be checked by reference to corresponding entries in the bank pass book.

(b) Inflating cash payment – Cash payment frauds may be in the form of:

(i) Making double payment of an invoice or paying a false invoice.

(ii) Paying personal expenses out of the business by falsifying details. e.g., showing betting losses as advertisement charges.

(iii) Withdrawing unclaimed credit balances of customers or amounts falsely credited in the accounts of parties.

(iv) Falsely adjusting a refund in the account of a customer and withdrawing the credit balance.

(v) Wrong totalling of the wage sheets and misappropriating the excess amount withdrawn from the bank for payment of wages.

Verification of Cash Payments: All the evidence as regards cash payments made, including acknowledgement by parties for payments shown to have been made to them, should be carefully scrutinised. In the case where a figure appears to have been erased or altered on the receipts issued by the party, on reference to the party concerned, the actual amount paid to him should be confirmed. The same procedure should be adopted in respect of amounts acknowledged on blank papers. All payments by bearer cheques should be examined. The system of recording of wages should be reviewed, specially as regards possible over-totalling of wage sheets, and entries in them of dummy workmen. The system of ordering and receiving goods should be reviewed so as to confirm that no payment has been made in respect of supplies which have not been received. Confirmations should be obtained from partners or Directors in respect of amounts shown to have been paid to them.

The Petty Cash Book should be vouched and totaled. Special attention should be paid to payments made on account of salaries and wages; confirmation should be obtained from the management that all payments of such salaries and wages were made to persons who were actually in the service of the company. All the withdrawals from the bank should be checked by reference to entries in the bank's pass book. All the bills receivable or payable should be checked by reference to the Bills Books.

(c) Frauds through suppliers' ledger -

(i) Adjusting fictitious or duplicate invoices as purchases in the accounts of suppliers and subsequently misappropriating the amounts when payments are made to the suppliers in respect of these invoices.

(ii) Suppressing the Credit Notes issued by suppliers and withdrawing the corresponding amounts not claimed by them.

(iii) Withdrawing amounts unclaimed by suppliers, for one reason or another by showing that the same have been paid to them.

(iv) Accepting purchase invoices at prices considerably higher than their market prices and collecting the excess amount, paid in cash, from the suppliers.

Verification of balances in suppliers' ledger - The Purchase Journal should be vouched by reference to entries in the Goods Inward Book and the suppliers' invoices to confirm that amounts credited to the accounts of suppliers were in respect of goods, which were duly received and the suppliers' accounts had been credited correctly. All the suppliers should be requested to furnish statements of their accounts to see whether or not any balance is outstanding or due so as to confirm that allowances and rebates given by them have been correctly adjusted and were duly authorized by the authorized person/ officer. Examine the system of internal control in relation to purchase orders issued and identify possibilities of collusion with suppliers.

(d) Customers' ledger -

(i) By the 'teeming and lading' method, i.e., misappropriating the amount collected from a customer and crediting his account by the amount paid by him only when an amount is subsequently collected from another customer; repeating this practice with several items collected and depositing back the amount or amounts so misappropriated before the close of the year.

(ii) Misappropriating the amount collected from a customer and subsequently adjusting his account by crediting the amount on account of allowance or a rebate for excess price charged.

(iii) Crediting the amount received from a customer to the account of another customer and subsequently withdrawing the amount wrongly credited.

Verification of balances in customers' ledger: Special attention should be paid to allowances adjusted on account of goods returned or difference in price or on any other account as well as to amounts written off as bad debts. To confirm that the accounts of customers have been debited in respect of goods supplied to them, entries in the Order Book should be cross-checked with those in the Sales Day Book where the same is kept. The investigating accountant should obtain confirmation of customers in respect of the amounts standing in their accounts. Those of them who have no balance in their accounts should be requested to confirm the statement of their account (which should be sent to them) for ascertaining that the entries shown therein were genuine.

(e) Inventory Frauds-Inventory frauds are many and varied but here we are concerned with misappropriation of goods and their concealment.

(i) Employees may simply remove goods from the premises.

(ii) Theft of goods may be concealed by writing them off as damaged goods, etc.

(iii) Inventory records may be manipulated by employees who have committed theft so that book quantities tally with the actual quantities of inventories in hand.

(iv) Inflating the quantities issued for production is another way of defalcating raw materials and store items.

(v) Stocks actually dispatched but not entered in sales/ debtor's account.

Verification Procedure for Defalcation of inventory - It may be of trading stock, raw materials, manufacturing stores, tools or of other similar items (readily) capable of conversion into cash. The loss may be the result of a theft by an employee once or repeatedly over a long period, when the same have not been detected. Such thefts usually are possible through collusion among a number of persons. Therefore, for their detection, the entire system of receipts, storage and dispatch of all goods, etc. should be reviewed to localise the weakness in the system.

The determination of factors which have been responsible for the theft and the establishment of guilt would be difficult in the absence of: (a) a system of inventory control, and existence of detailed record of the movement of inventory, or (b) availability of sufficient data from which such a record can be constructed. The first step in such an investigation is to establish the different items of inventory defalcated and their quantities by checking physically the quantities in inventory held and those shown by the Inventory Book. Investigating accountant should ascertain the exact duties of persons handling the stocks received in and issued from store for production/ sale or any other purpose. Identify the excessive control in the hands of a single person, without any supervision as it will widen the scope of investigation.

Afterwards, all the receipts and issues of inventory recorded in the Inventory Book should be verified by reference to entries in the Goods Inward and Outward Registers and the documentary evidence as regards purchases and sales. This would reveal the particulars of inventory not received but paid for as well as that issued but not charged to customers. Further, entries in respect of returns, both inward and outward, recorded in the financial books should be checked with corresponding entries in the Inventory Book. Also, the totals of the Inventory Book should be checked. Finally, the shortages observed on physical verification of inventory should be reconciled with the discrepancies observed on checking the books in the manner mentioned above. In the case of an industrial concern, issue of raw materials, stores and tools to the factory and receipts of manufactured goods in the godown also should be verified with relative source documents.

Defalcations of inventory, sometimes, also are committed by the management, by diverting a part of production and the consequent shortages in production being adjusted by inflating the wastage in production; similar defalcations of inventories and stores are covered up by inflating quantities issued for production. For detecting such shortages, the investigating accountant should take assistance of an engineer. For that he will be more conversant with factors which are responsible for shortage in production and thus will be able to correctly determine the extent to which the shortage in production has been inflated. In this regard, guidance can also be taken from past records showing the extent of wastage in production in the past. Similarly, he would be able to better judge whether the material issued for production was excessive and, if so to what extent. The per hour capacity of the machine and the time that it took to complete one cycle of production, also would show whether the issues have been larger than those required.

11.4.2 Indicators of Fraud

Several indications of possible frauds can be listed as follows :-

i.	Discrepancies in Accounting Records including non-recording or partial recording or incorrect recording or delayed recording of amounts, misclassifications, etc.
ii.	Conflicting or missing evidence including missing documents, altered documents, significant unexplained items in reconciliations, discrepancies between entity's records and confirmations received etc.

iii.	Unacceptable management responses such as – denial of access to records/facilities/employees, undue time pressure to resolve complex issues, unusual delays in providing requested information, denial for use of Computer Assisted Audit Techniques, unwillingness to address identified deficiencies in internal control etc.
iv.	Other indications such as – Accounting Policies in variance with Industry Norms, Frequent changes in accounting estimates etc.

The Fraud Diamond: Considering the Four Elements of Fraud: Many frauds, especially some of the multibillion-dollar ones, would not have occurred without the right person with the right capabilities in place. Opportunity opens the doorway to fraud, and incentive and rationalization can draw the person toward it. But the person must have the capability to recognize the open doorway as an opportunity and to take advantage of it by walking through, not just once, but time and time again. This give rise to the fourth element of fraud.

Fraud Diamond i.e. four elements of fraud is a theory which was established by David T. Wolfe and Dana R. Hermanson. Under this Wolfe and Hermanson classified the indicators of fraud into 4 categories

Fraud Diamond: Four Elements of Fraud
• **Incentive:** I want to, or have a need to, commit fraud.
• **Opportunity** : There is a weakness in the system that the right person could exploit. Fraud is possible.
• **Rationalization:** I have convinced myself that this fraudulent behavior is worth the risks.
• **Capability:** I have the necessary traits and abilities to be the right person to pull it off. I have recognized this particular fraud opportunity and can turn it into reality.

A pictorial depiction of the Fraud Diamond is as follows:

11.4.3 Responses to Fraud

SA 330 states the auditor's responses to assessed risks. It requires auditor to assign and supervise personnel taking into account of the knowledge, skill and ability of the individuals, evaluation of selection and application of accounting policies by the entity and incorporation of an element of unpredictability in the selection of the nature, timing and extent of audit procedure.

Response to the risks related to management override of controls includes Testing the appropriateness of journal entries and other adjustments made in preparation of the Financial Statements, review of accounting estimates for biases and also review the significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual.

Auditor need to assessed fraud risk factors for material misstatement or misappropriation of assets due to fraud, such as incentive / pressures, opportunities and attitudes /rationalizations.

The responses to fraud will include communications to management and with those charged with governance, communication to regulatory and enforcement authorities and appropriate documentation on his assessment of the risks of material misstatement.

Auditor's ability to detect fraud depends on factors such as –	
—	the skillfulness of the perpetrator
—	the frequency & extent of manipulation
—	the degree of collusion involved
—	the relative size of Individual amounts manipulated; and
—	the seniority of those individuals involved.

Detection of Fraud depends upon effectiveness of Audit Procedure. Detection risk, however, can only be reduced, not eliminated.

TEST YOUR UNDERSTANDING 2

A company has installed an Effluent treatment plant (ETP) in compliance with pollution control regulations of the state government. The authority structure in the company is fairly decentralized and top management of the company has given considerable leeway to different departments for meeting their manpower requirements in accordance with emerging and changing needs from time to time. Recently, the top management became concerned about the growing manpower expenditure in section maintaining and beautifying area around ETP. There is a system in the company where timecards are punched by all employees to mark attendance.

Suggest any one procedure you would perform as an investigator to bring out the facts.

11.5 Investigation on behalf of an Individual or Firm Proposing to Buy a Business

Scope of investigation - The objective of such an investigation is to collect such information as would enable the purchaser to decide whether it is worthwhile to buy the business and if so, for what amount. The investigation should proceed broadly on the same lines as for valuation of shares.

Additional matters which must receive the attention of the investigating accountant on which, if appropriate, information to the client should be given.

(A) In case of proprietary concerns or partnerships -

(i) Reasons for the sale of the business and the effect on turnover and profits that there would be on retirement of the present proprietor (or partners).

(ii) The length of lease under which the premises are held, the prospects of its renewal or extension.

(iii) The unexpired period of any patents owned by the vendors.

(iv) The age of the present managerial staff and the prospects of continuing in service under the new proprietorship and the possible liability, not already provided for that would arise as regards payment of pensions or gratuities in case of old and aged employees/ retrenched employees.

(v) If the bulk of sales are made to customers whose number is small, the profitability of the business would be greatly shaken on withdrawing their support. This would be an element of weakness which should be investigated as it might affect future profitability.

(vi) The valuation that could be placed on goodwill to determine whether that appearing in the book is less or more; if none is included to determine the amount that should be included, if at all.

(B) If the business belongs to a limited company -The vendors' interest in this case will be purchased by the acquisition of shares. On that account, the following additional matters would also require consideration:

(i) The authorised and issued capital of the company.

(ii) Whether there is any uncalled liability on the shares.

(iii) If the capital is divided into different classes of shares - the rights that are attached to each class.

(iv) Particulars of dividends paid in the past and the amounts thereof which are in arrear (on cumulative preference shares).

(v) If there are any mortgages/ charge created on the assets appearing in the company's books, a search should be made in the Register of Charges in the office of the Registrar of Companies.

(vi) The price at which the shares are being offered. If the company is a public company, the price will usually be in excess of market price quoted on the Stock Exchange, but in the case of unquoted shares particularly where the company whose shares are being acquired is a private company, a valuation will have to be placed on the shares for the purpose of purchase.

11.6 Investigation in connection with review of Profit/Financial Forecasts

There are many investigations which involve an examination of future profits like,

(1) Profit reports can be required as part of a general investigation into the purchase of a business or,

(2) By banks and financial institutions with regard to project cash flow and profitability statements for appraisal of loan applications submitted by the intending borrowers.

All forecasts depend, to a large extent, on the nature of the business with its numerous and substantial uncertainties. Therefore, such forecasts are not capable of verification by the reporting accountants in the same way as financial statements which present the results of a completed accounting period. Normally, such situations involve special review as these depart from the auditor's traditional role of expressing an opinion in relation to past events.

12. FORENSIC ACCOUNTING

The number of fraudulent activities and ambiguous financial activities have been accelerating all over the world. Consequently, businesses are exposed to risks of fraudulent activities. With all of the recent corporate accounting scandals at Parmalat, Xerox Corporation, and Satyam Computer Services, and all the high-profile corporate frauds at Enron, WorldCom, and HealthSouth followed by Bernie Madoff's colossal ponzi scheme, the media has made Forensic Accounting and Forensic Accounting into a growth industry.

Forensic Accounting has established itself as dynamic and strategic tool in combating corruption, financial crimes and frauds through investigations and resolving allegations of fraud and embezzlement. Thus, a new area, known as Forensic Accounting, was needed to detect the frauds in companies that suspected fraudulent transactions.

"Forensic" means "suitable for use in the court of law". Bologna said that it is the application of financial skills and investigative mentality to unresolved issues, conducted within the context of the rules of evidence. As an emerging discipline, it encompasses financial expertise, fraud knowledge and a sound knowledge and understanding of business reality and the working of legal system.

However, the definition of Forensic Accounting keeps on changing in response to the growing needs of corporations. Simply stated, Forensic Accounting includes the use of accounting, accounting and investigative skills to assist in legal matters.

Important Definitions:
Forensic: The word forensic comes from the Latin word forensis, meaning "of or before the forum." It is - - Relating to, used in, or appropriate for courts of law or for public discussion or argumentation. - Relating to the use of science or technology in the investigation and establishment of facts or evidence in a court of law.
Forensic Accounting: The integration of accounting, auditing and investigative skills yields the specialty known as Forensic Accounting. It is the study and interpretation of accounting evidence. It is 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.
Book definition: ***Forensic Accounting* by Hopwood, Leiner, and Young** • Forensic accounting is the application of investigative and analytical skills for the purpose of resolving financial issues in a manner that meets standards required by courts of law. • Forensic accountants apply special skills in accounting, auditing, finance, quantitative methods, certain areas of the law, research and investigative skills to collect, analyse and evaluate evidential matter and to interpret and communicate findings.
Red Flag: Red flags are indicators or warning of any impending danger or inappropriate behavior. Red flag does not necessarily indicate the existence of fraud however are indicators that caution needs to be exercised while investigating the situations. Red flags are classified in categories such as financial performance red flag, accounting system red flags, operational red flags and behavioral red flags.

Forensic Accounting 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 in addition, an audit may be conducted to determine negligence.

Example of Forensics

The Company received an anonymous handwritten letter through the mail containing serious death threats against the CEO and his family. The letter indicated to the fact that bodily harm may be inflicted on the Children of the CEO unless he took some specific action to send a specific amount of cash in currency notes within a specified time period in such a manner where the identity of the receiver was to remain unknown. The CEO immediately informed the police regarding who took the letter, and the envelope it came in, for “forensic analysis".

The lab undertaking the forensic work examined the paper used, the possibility of capturing some fingerprints on the letter and envelope, scrutinise the manner in which the writing was done, such as the ink used to find out the nature of the writing implement, deployed the expertise of a handwriting expert to decipher the possibility of the writer etc. The police also undertook an investigation of the possible suspects and collected various samples of handwritings of their suspects to allow the forensic experts to match the handwritings and shortlist the most likely suspect.

All the above-mentioned techniques deployed to analyse the only clue available (letter and envelope) are generally referred to as forensic work.

Example of Forensic Accounting

The Accounting Officer in the pharma company performs a regular reconciliation between the physical inventory counted in the factory and the inventory as calculated by the books and accounts. He takes the opening physical inventory as reconciled last month and adjusting for purchases and sales during the month along with any production wastage/shrinkage etc. he calculates the theoretical inventory at the close of the last day of the month. This time he noticed a large discrepancy and after double checking the figures could not understand why he had a large reconciliation variance.

To identify the reason for the variance, he undertook a review of the quantities of some of the large inventory items to see if he could identify the variance in kilogram weight terms. He noticed that some large expensive raw inventory items receipts during the month could neither be located in the storeroom or the factory production floor. He tried to trace these receipts to specific production runs to see if they had been used for making the medicines sold during the month. Finally, he reviewed the wastage records to see if these had been discarded due to quality control purposes. When he received no plausible explanation, he concluded that there is a serious possibility of pilferage of these expensive raw materials and asked the security head to investigate the matter during and after the time of receipt. This investigation led the security people to review the CCTV footage and records during delivery to identify a few instances of short delivery by the inward people.

This detailed analysis by the Accounting Officer was an example of some Forensic Accounting techniques to identify a case of accounting fraud.

How is a forensic accounting analysis different from an audit?

The general public believes that a financial auditor would detect a fraud if one were being perpetrated during the financial auditor's audit. The truth, however, is that the procedures for financial audits are designed to detect material misstatements, not immaterial frauds. While it is true that many of the financial statements and frauds could have, perhaps should have, been detected by financial auditors, the vast majority of frauds could not be detected with the use of financial audits. Reasons include the dependence of financial auditors on a sample and the auditors' reliance on examining the audit trail versus examining the events and activities behind the documents. The latter is simply resource prohibitive in terms of costs and time.

There are some basic differences today between the procedures of Forensic Accounting and those of financial auditors. In comparison, forensic accounting and audit differ in specific ways, as shown below:

Key elements of the **Statutory Audit** are presented here:

STATUTORY AUDIT

- IT'S A LEGAL MANDATE
- CONDUCTED ONLY BY A CHARTERED ACCOUNTANT
- EXPRESSION OF AN INDEPENDENT OPINION
- ON FINANCIAL STATEMENTS
- AS PER ICAI AUDITING STANDARDS

OBJECTIVE: TRUE AND FAIR PICTURE

FOCUS: VERY GENERAL – AN OVERALL REVIEW OF THE BOOKS OF ACCOUNT

APPROACH: CONTROL TESTS OF TRANSACTIONS AND SUBSTANTIVE TESTS OF BALANCES

TARGET: IDENTIFY MATERIAL MIS – STATEMENTS IN FINANCIAL STATEMENTS

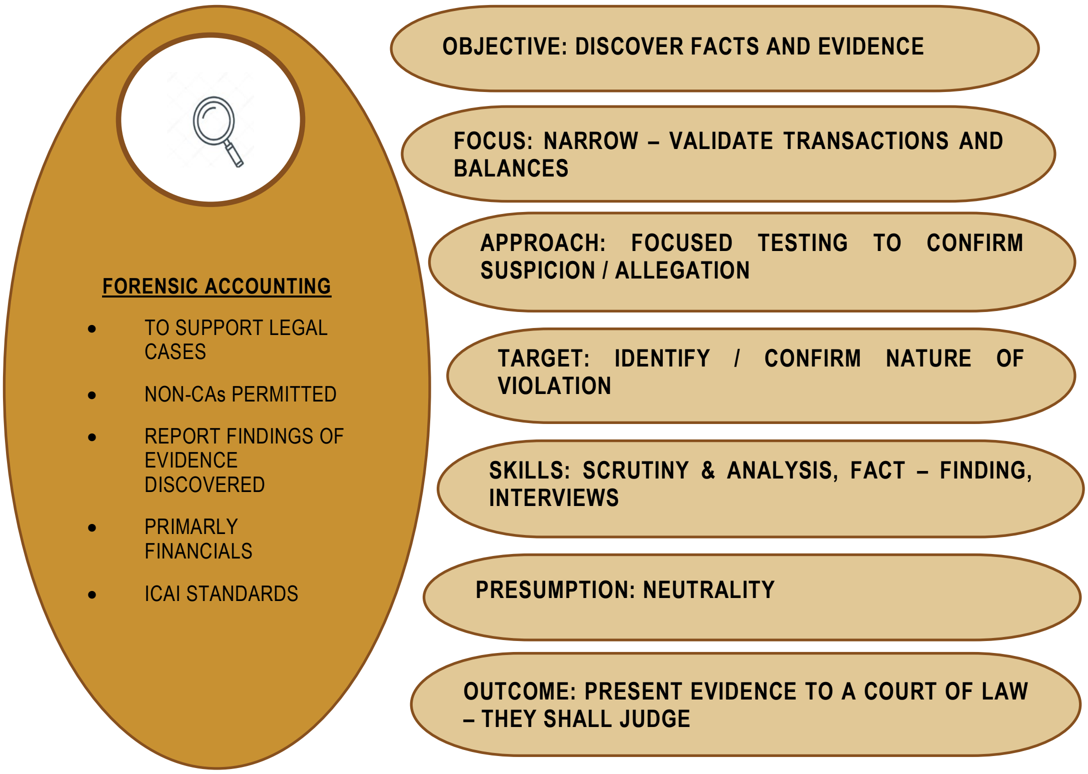
SKILLS: TESTING & CHECKING, ANALYSIS, INQUIRY & OBSERVATION

PRESUMPTION: PROFESSIONAL SKEPTICISM, DUE PROFESSIONAL CARE

OUTCOME: AUDIT REPORT OPINION (QUALIFICATION – SUBJECT TO/EXCEPT FOR)

This shows clearly how the statutory audit is a legal mandate and designed to provide an overall assurance to the shareholders of the true and fair nature of the annual financial statements primarily from a materiality perspective. Individual transactions and balances do not play a major role except in so far as they have a material impact on the overall financial statements. The Auditor has the overall responsibility to issue his independent opinion without any influence from anyone.

Key elements of Forensic Accounting are presented here:



This infographic shows how Forensic Accounting is a separate mandate altogether and designed primarily to provide support to legal cases. The Forensic professional does not conduct an audit using sample selection methodologies to perform substantive or compliance tests. The professional undertakes a scrutiny and detailed examination of all transactions and balances relevant to the mandate so that the evidence discovered is suitable for a court of law (i.e., in compliance with legal requirements) where it can be challenged through cross examination by the defending party. No audit report with any opinion is issued by the professional as his mandate is limited to present his findings to a superior authority (e.g., a judge) who will examine these from a legal point of view to establish whether the law has been violated or not.

Forensic Accounting	***In response to an event** ***Financial investigation** ***Finding used as evidence in court or to resolve disputes**
Audit	***Mandatory** ***Measures compliance with reporting standards** ***Obtain reasonable assurance that financial statements are free of material misstatement**

A Forensic Professional will often look for indications of fraud that are not subject to the scope of a financial statement audit. Forensic Accounting has **"Investigative mentality" however auditing is done with "professional scepticism". A Forensic Professional will often require more extensive corroboration. A Forensic Professional may focus more on seemingly immaterial transactions.**

Sr. No.	Particulars	Other Audits	Forensic Accounting
1.	Objectives	Express an opinion as to 'True & Fair' presentation	Whether fraud has actually taken place in books
2.	Techniques	Substantive & Compliance. Sample based	Investigative, substantive or in-depth checking
3.	Period	Normally for a particulars accounting period.	No such limitations
4.	Verification of stock, Estimation realisable value of assets, provisions, liability etc.	Relies on the management certificate/Management Representation	Independent/verification of suspected/selected items where misappropriation in suspected
5.	Off balance sheet items (like contracts etc.)	Used to vouch the arithmetic accuracy & compliance with procedures.	Regulatory & propriety of these transactions/contracts are examined.
6.	Adverse findings if any	Negative opinion or qualified opinion expressed with/without quantification	Legal determination of fraud impact and identification of perpetrators depending on scope.

13. FORENSIC PROFESSIONAL

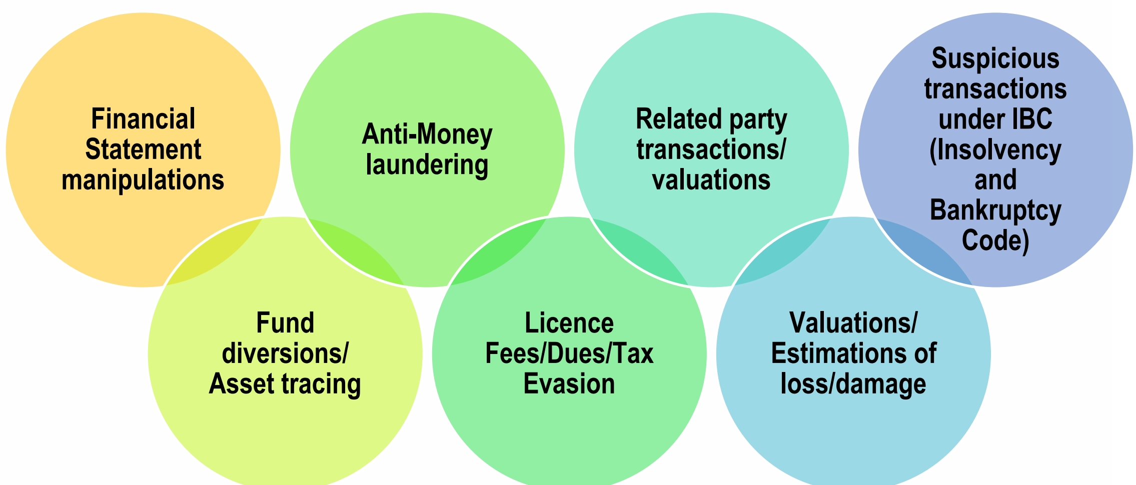
A Forensic Professional is often retained to analyze, interpret, summarize and present complex financial and business-related issues in a manner which is both understandable and properly supported. Forensic Professional are trained to look beyond the numbers and deal with the business reality of the situation.

A Forensic Professional must initially consider whether his/her firm has the necessary skills and experience to accept the work. Forensic Accounting is highly specialized, and the work requires detailed knowledge of fraud investigation techniques and the legal framework. Forensic Professional needs to have an understanding on various frauds that can be carried off and how evidence need to be collected.

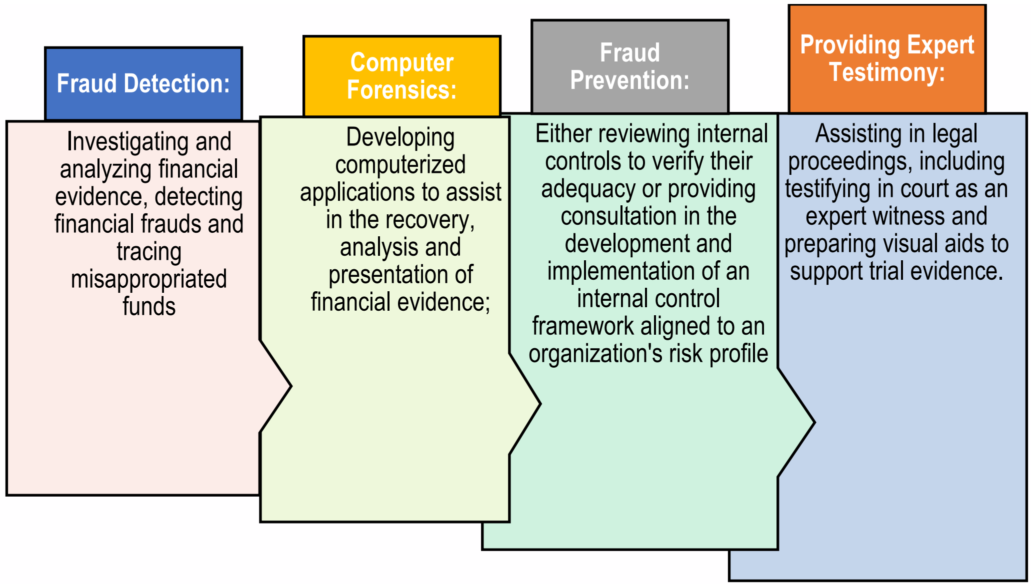
Forensic Professional can be engaged in public practice or employed by insurance companies, banks, police forces, government agencies and other organizations.

Forensic Accounting Services: An indicative list of services that can be provided by the Professional in this area are as follows:

- Financial Statement manipulations
- Fund diversions/Asset tracing
- Anti-Money laundering
- Licence Fees/Dues/Tax Evasion
- Related party transactions/valuations
- Valuations/Estimations of loss/damage
- Suspicious transactions under IBC (Insolvency and Bankruptcy Code)



A Forensic Professional is often involved in:



In order to properly perform these services a Forensic Professional must be familiar with legal concepts and procedures and have expertise in the use of IT tools and techniques that facilitate data recovery and analysis. In addition, a Forensic Professional must be able to identify substance over form when dealing with an issue.

TEST YOUR UNDERSTANDING 3

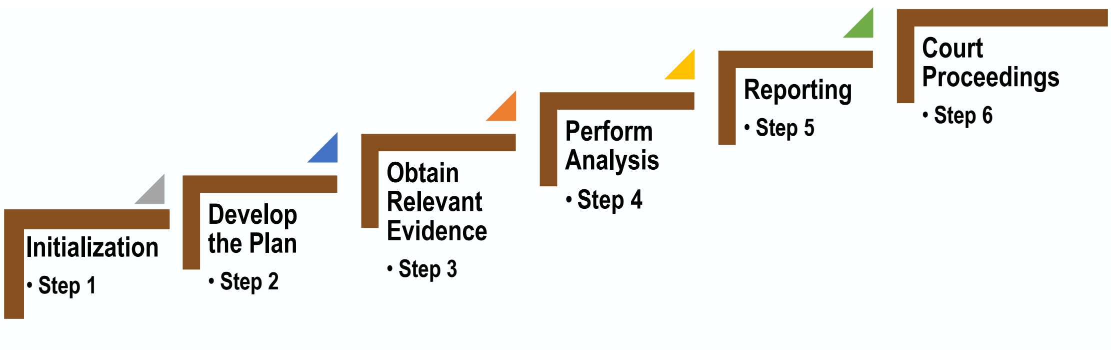
X Limited engaged in manufacturing of floor coverings has taken a Product Liability Insurance policy (PLI). Such a policy covers risk of liabilities for damages for bodily injury resulting from sale and distribution of floor coverings by vendors of X Limited's products. The policy is also subject to "claim series" clause. A Claims Series event is a series of two or more claims arising from one specific common cause which are attributable to the same fault in design or manufacture of products or to the supply of the same products showing the same defect. A claim series event is deemed to be one claim under the terms & conditions of PLI policy.

The company has been asked to shell out damages of ₹5 crore due to supply of faulty products to one of its vendors. The vendor had sold floor coverings to a 5-star hotel which has alleged that harmful chemicals used in dyeing of floor coverings have resulted in skin ailments to some of its guests.

Being in capacity of Forensic Professional appointed by insurance company, what special issues you would keep in mind while dealing with claims involving PLI policy covering such matters?

14. PROCESS OF FORENSIC ACCOUNTING

Each Forensic Accounting assignment is unique. Accordingly, the actual approach adopted and the procedures performed will be specific to it. However, in general, many Forensic Accounting assignments will include the steps detailed below.



Step 1. Initialization

It is vital to clarify and remove all doubts as to the real motive, purpose and utility of the assignment. It is helpful to meet the client to obtain an understanding of the important facts, players and issues at hand. A conflict check should be carried out as soon as the relevant parties are established. It is often useful to carry out a preliminary investigation prior to the development of a detailed plan of action. This will allow subsequent planning to be based upon a more complete understanding of the issues.

Step 2. Develop Plan

This plan will take into account the knowledge gained by meeting with the client and carrying out the initial investigation and will set out the objectives to be achieved and the methodology to be utilized to accomplish them.

Step 3. Obtain Relevant Evidence

Depending on the nature of the case, this may involve locating documents, economic information, assets, a person or company, another expert or proof of the occurrence of an event. In order to gather detailed evidence, the investigator must understand the specific type of fraud that has been carried out, and how the fraud has been committed. The evidence should be sufficient to ultimately prove the identity of the fraudster(s), the mechanics of the fraud scheme, and the amount of financial loss suffered. It is important that the investigating team is skilled in collecting evidence that can be used in a court case within the stipulated time period, and in keeping a clear chain of custody until the evidence is presented in court. If any evidence is inconclusive or there are gaps in the chain of custody, then the evidence may be challenged in court, or even become inadmissible. Investigators must be alert to documents being falsified, damaged or destroyed by the suspect(s).

Step 4. Perform the analysis

The actual analysis performed will be dependent upon the nature of the assignment and may involve:

- calculating economic damages;
- summarizing a large number of transactions;
- performing a tracing of assets;
- performing present value calculations utilizing appropriate discount rates;
- performing a regression or sensitivity analysis;
- utilizing a computerized application such as a spread sheet, data base or computer model; and
- utilizing charts and graphics to explain the analysis.

Step 5. Reporting

Issuing an report is the final step of a forensic accounting. Accountant / Investigators will include information detailing the fraudulent activity, if any has been found. The client will expect a report containing the findings of the investigation, including a summary of evidence, a conclusion as to the amount of loss suffered as a result of the fraud and to identify those involved in fraud. The report may include sections on the nature of the assignment, scope of the investigation, approach utilized, limitations of scope and findings and/or opinions. The report will include schedules and graphics necessary to properly support and explain the findings.

The report will also discuss how the fraudster set up the fraud scheme, and which controls, if any, were circumvented. It is also likely that the investigative team will recommend improvements to controls within the organization to prevent any similar frauds occurring in the future.

Step 6. Court proceedings

The investigation is likely to lead to legal proceedings against the suspect, and members of the investigative team will probably be involved in any resultant court case. The evidence gathered during the investigation will need to be presented at court, and team members may be called to court to describe the evidence they have gathered and to explain how the suspect was identified.

15. FORENSIC ACCOUNTING AND INVESTIGATION REPORT

This Forensic Accounting and Investigation Standard (FAIS or "Standard") 510 deals with the responsibility of the Professional to issue a written report to the stakeholders at the conclusion of the assignment.

Reporting results of the work procedures completed and the findings from those procedures, is the concluding part of the assignment. Since one engagement may include multiple assignments, multiple reports may have to be issued; one for each assignment.

1. **Written Report:** The Professional shall issue a written report which conveys the results of the assignment clearly and accurately. The findings reported shall be based on evidence gathered which are reliable and relevant. Thus, the Professional shall issue a written report which is precise and unambiguous.

2. **Report addressee and distribution:** The report shall be addressed to the Primary Stakeholders and shared with other stakeholder(s) if required or otherwise permissible

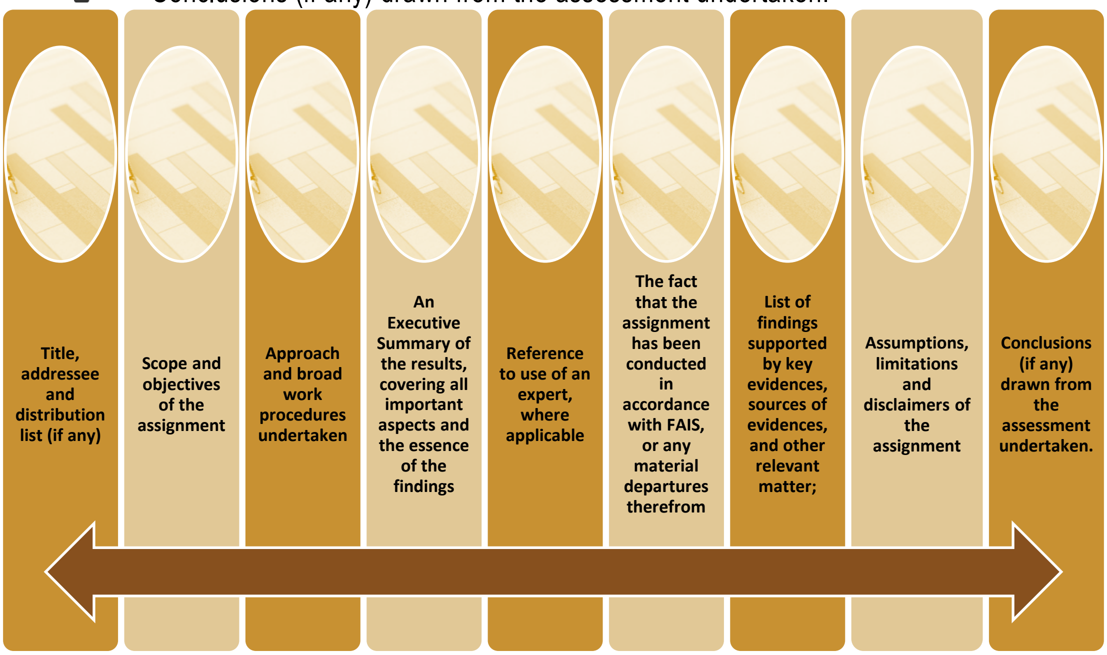
3. **Format or Content of Report:** While no fixed form or content of the report is mandated by this Standard, the report shall include certain key elements to enable the recipient to understand the purpose of the assignment, the extent and scope of work performed by the Professional, any limitations, assumptions or disclaimers, the facts and evidence gathered and the conclusions drawn.

   Where the form and content of the report is mandated by the stakeholders, or specified by the statutory or regulatory requirements, the Professional shall report in line with those requirements, while keeping in mind the key elements.

   Key Elements of the Report: The Professional shall consider the inclusion of the following key elements in the report (indicative list):

   - Title, addressee and distribution list (if any)
   - Scope and objectives of the assignment

- Approach and broad work procedures undertaken
- An Executive Summary of the results, covering all important aspects and the essence of the findings
- Reference to use of an expert, where applicable
- The fact that the assignment has been conducted in accordance with FAIS, or any material departures therefrom
- List of findings supported by key evidences, sources of evidences, and other relevant matter;
- Assumptions, limitations and disclaimers of the assignment
- Conclusions (if any) drawn from the assessment undertaken.



4. **Discussion of Draft report:** Where the mandate of the engagement requires a discussion of the findings with the subject party prior to finalisation, a summary of the responses received from them shall be included in the report. Further, the Principles of Natural Justice requires a discussion of the observations with the subject party. In some cases, this is done by the Primary Stakeholders through their own internal processes (e.g., disciplinary committee, show-cause notice, etc.). At times, the Professional is requested to incorporate the discussion of draft findings as part of the interview process with the subject. Where the engagement

mandate requires a discussion of the draft findings with the subject party, any response received from them shall be included in the written report issued by the Professional.

5. **Assumptions and Limitations:** The Professional shall list any relevant assumptions made during the assignment having a significant bearing on the subject matter. In addition, the Professional may encounter limitations that restrict the methodologies or procedures applied in carrying out the assignment. Such limitations can be in the form of lack of (or limited) management support, restricted (or denied) access to required records, information or people, due to any reason such as court orders, short timelines, etc. These disclaimers would be covered in the report as a key element of the report.

   The report shall not express an opinion or pass any judgement on the guilt or innocence. Determination of culpability is either a disciplinary process internal to the organization under review, or a judicial process depending on the specific situation under review. The report can, at best, highlight the circumstances and facts that may aid a stakeholder decision or further a civil or criminal investigation.

6. **Reporting Timelines:** The report shall be issued within reasonable time frame as per the engagement terms. The Professional may be required to provide interim reports as per the engagement terms which can be given to the extent practicable without compromising the progress of the investigation. Such interim reports are also subject to this Standard.

16. OVERVIEW OF FORENSIC ACCOUNTING AND INVESTIGATION STANDARDS (FAIS)

The Institute of Chartered Accountants of India (ICAI) was formed with many mandates, one of which places a responsibility of "Ensuring Standards of Performance of its Members". In keeping with this obligation, the ICAI has recently published a full set of standards in the area of forensic science. These are referred to as the "Forensic Accounting and Investigation Standards (FAIS for short). The FAIS are issued to ensure that the ICAI members deliver high quality output in the area of Forensic Accounting and Investigations.

The Framework Governing Forensic Accounting and Investigations (the "Framework") lays down the underlying principles and boundaries for undertaking such services. It aims to preserve and enhance the quality of practice of a member of the Institute of Chartered Accountants (ICAI) performing forensic accounting and investigation services. This Framework needs to be read in conjunction with the Preface to the Forensic Accounting and Investigation Standards (FAIS).

The main objectives of the Framework are to: 1 Provide an overall understanding of Forensic Accounting and Investigations and its key components; 2 Outline the manner in which these components come together in an inter-related cohesive manner when providing such services; 3 Maintain and improve the quality of forensic accounting and investigation services.

The Framework establishes the structure which governs the professions of Forensic Accounting and Investigations. It is based on the "Definition of forensic accounting and investigation" (as covered under para 3, above), and the Code of Ethics forms the foundation of the Framework. It comprises of four components inherent to the process of forensic accounting and investigations. These components implicitly form part of the FAIS, even though they may not be mentioned explicitly in the particular Standards. Hence, as explained in the Preface, they all are mandatory in nature, except the Guidance which is recommendatory.

The four key components (forming the pillars) of the Framework are:

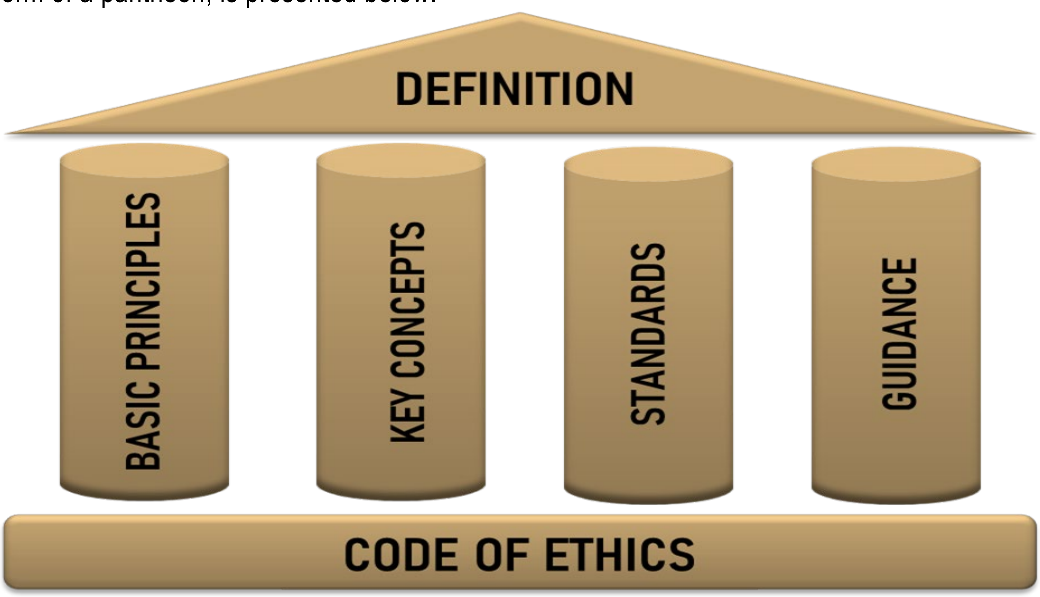
(i) Basic Principles of Forensic Accounting and Investigations.

(ii) Key Concepts.

(iii) Standards on Forensic Accounting and Investigations.

(iv) Guidance.

A pictorial depiction of the Framework Governing Forensic Accounting and Investigations, in the form of a pantheon, is presented below.



The Forensic Accounting and Investigation Standards (referred to as "FAIS" or the "Standards") at a broad level seek to provide:

(a) The Professionals with the minimum standards for undertaking forensic accounting and investigation (FAI) assignments;

(b) The Users of FAI services with an indication of the quality of service that can be expected from such engagements;

(c) The Regulators and Governmental agencies with an appreciation of what can be expected from FAI services; and

(d) To everyone, guidance on matters of implementation and related practical issues.

The Standards are intended to be principle-based, rather than rule based, thereby providing ample room for professional judgment when applying such principles to unique situations and under specific circumstances. The unique nature of forensic assignments would necessitate that the application of forensic accounting and investigative skills, together with the use of digital forensic tools, may vary depending on the nature of specific engagements.

If, for any reason, a member is unable to comply with any of the requirements of the FAIS, or if there is a conflict between the Standards and other mandates, such as a statutory or regulatory requirement, the FAI report (or such similar communication) should draw attention to the material departures therefrom along with appropriate explanation.

The FAIS, as and when issued, will be classified, and numbered in a series format, as follows:

Forensic Accounting and Investigation Standards (FAIS)
100 Series:: Standards on Key Concepts FAIS 110 : Nature of Engagement FAIS 120 : Fraud Risk FAIS 130 : Laws and Regulations FAIS 140 : Applying Hypotheses
200 Series: Standards on Engagement Management FAIS 210 : Engagement Objectives FAIS 220 : Engagement Acceptance and Appointment FAIS 230 : Using the Work of An Expert

FAIS 240 : Engaging with Agencies FAIS 250 : Communication with Stakeholders
300 Series: Standards on Executing Assignments FAIS 310 : Planning the Assignment FAIS 320 : Evidence and Documentation FAIS 330 : Conducting Work Procedures FAIS 340 : Conducting Interviews FAIS 350 : Review and Supervision FAIS 360 : Testifying Before a Competent Authority
400 Series: Standards on Specialised Areas FAIS 410 : Applying Data Analysis FAIS 420 : Evidence Gathering in Digital Domain FAIS 430 : Loans Or Borrowings
500 Series: Standards on Reporting FAIS 510 : Reporting Results
600 Series: Standards on Quality Control FAIS 610 : Quality Control

Key Takeaways

- Due Diligence implies a general duty to exercise care in any transaction. It is a measure of prudence activity, or dedication, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent person under the particular circumstance, not measured by any absolute standard but depends on the relative facts of the special case.

- Due Diligence may also require to be performed in cases of corporate restructuring, venture capital financing, lending, leveraged buyouts, public offerings, disinvestment, corporatisation, etc.

- Contents of a due diligence report vary with individual circumstances and the purpose of such exercise.

- Investigation implies a systematic and in-depth examination or inquiry to establish a fact or to evaluate a specific situation. It is the systematic and critical examination of facts, records and documents for a specific purpose.
- Investigation differs substantially from an audit assignment. Audit aims at collection of sufficient appropriate audit evidence to enable the auditor to form a judgement and express an opinion on the financial statements or other data under examination. An investigation, on the other hand, requires special in-depth examination of the particular records or transaction with the objective of establishing a part or happening or assessing a particular situation. The scope of audit is broad based and general in nature whereas investigation is narrow and specific.
- Investigation by Chartered Accountants can be statutory or non-statutory. Non-statutory investigations could include investigation of frauds or investigations in case of proposals to buy a business etc.
- Forensic accounting is the use of professional accounting skills in matters involving the possibility of a fraud, in order to collect relevant evidence and facts which could help support an expert view for potential or actual civil or criminal litigation. It is also called forensic accounting.
- Forensic accounting is different from audit of financial statements. A Forensic Professional will often look for indications of fraud that are not subject to the scope of a financial statement audit. Forensic accounting has investigative mentality" however auditing is done with "professional skepticism". A Forensic Professional will often require more extensive corroboration and may focus more on seemingly immaterial transactions.
- Services of forensic professionals may be used by banks, insurance companies, government agencies, courts and even by business community.
- Forensic Accounting and Investigation Standards (FAIS) aim to preserve and enhance the quality of practice of a member of the Institute of Chartered Accountants (ICAI) performing forensic accounting and investigation services.

TEST YOUR KNOWLEDGE

Theoretical Questions

1. *Sri Rajan is above 80 years old and wishes to sell his proprietary business of manufacture of specialty chemicals. Ceta Ltd. wants to buy the business and appoints you to carry out a due diligence audit to decide whether it would be worthwhile to acquire the business.*

   What procedures you would adopt before you could render any advice to Ceta Ltd.?

2. *An American Company engaged in the business of manufacturing and distribution of industrial gases, is interested in acquiring a listed Indian Company having a market share of more than 65% of the industrial gas business in India. It requests you to conduct a "Due Diligence" of this Indian Company and submit your Report. List out the contents of your Due Diligence Review Report that you will submit to your USA based Client.*

3. *KDK Bank Ltd., received an application from a pharmaceutical company for takeover of their outstanding term loans secured on its assets, availed from and outstanding with a nationalised bank. KDK Bank Ltd., requires you to make a due diligence audit in the areas of assets of pharmaceutical company especially with reference to valuation aspect of assets. State what may be your areas of analysis in order to ensure that the assets are not stated at overvalued amounts.*

4. *"Due diligence is different from audit" – Explain the difference between due diligence and audit.*

5. *PB Ltd. entered into a deal with SV Ltd. for buying its business of manufacturing wooden products/ goods. PB Ltd. has appointed your firm for conducting due diligence review and they want to know the cash generating abilities of SV Ltd. What points will you check in order to ensure that the manufacturing unit of SV Ltd. will be able to meet the cash requirements internally?*

6. *CA Sanjana is acting as Credit manager in branch of DFC Bank Limited. A company has approached the branch for a request to sanction credit facilities worth ₹10 crore for meeting usual business requirements. It is a prospective new client. She checks past history of the company, background of promoters & directors, shareholding pattern and nature of business.*

Assessment of financial results of past years and future projections is also undertaken. She also carries out SWOT analysis of the company.

Besides, assessment of net worth of directors is also undertaken. Status of CIBIL score and position of name of promoters/directors in RBI defaulter list is also verified.

She also makes discreet inquiries from few clients of the branch engaged in similar line of activity regarding credit worthiness of company, its promoters and directors.

Based on above-

(a) Identify activity being performed by CA Sanjana and discuss its nature.

(b) Would your answer be different if this activity was to be performed by a person not qualified as a Chartered Accountant? Can a non-CA perform such activity? State reason.

(c) Name any three other areas where identified activity can be undertaken.

7. *A nationalised bank received an application from an export company seeking sanction of a term loan to expand the existing sea food processing plant. In this connection, the General Manager, who is in charge of Advances, approaches you to conduct a thorough investigation of this limited company and submit a confidential report based on which he will decide whether to sanction this loan or not.*

   List out the points you will cover in your investigation before submitting your report to the General Manager.

8. *What are the important steps involved while conducting Investigation on behalf of an Incoming Partner?*

9. *Mr. Clean who proposes to buy the proprietary business of Mr. Perfect, engages you as investigating accountant. Specify the areas which you will cover in your investigation.*

10. *In a Company, it is suspected that there has been embezzlement in cash receipts. As an investigator, what are the areas that you would verify?*

11. *J Ltd. is interested in acquiring S Ltd. The valuation of S Ltd. is dependent on future maintainable sales. As the person entrusted to value S Ltd., what factors would you consider in assessing the future maintainable turnover?*

12. *MF Ltd., engaged in the manufacturing of various products in its factory, is concerned with shortage in production and there arose suspicion of inventory fraud. You are appointed by*

MF Ltd. To evaluate the options for verifying the process to reveal fraud and the corrective action to be taken. As an investigating accountant what will be your areas of verification and the procedure to be followed for verification of defalcation of inventory?

13. *In a Public Limited Company, it is suspected by the Management that there has been embezzlement in supplier's ledger. As an auditor of the Company, you have been asked to investigate the matter. What are the major areas that you would verify in this regard?*

14. *General objective of an audit is to find out whether the financial statements show true and fair view. On the other hand, investigation implies systematic, critical and special examination of the records of a business for a specific purpose.*

    In view of the above, you are required to brief out the difference between Audit and Investigation.

15. *Enumerate the steps to be undertaken in case of forensic accounting process.*

16. *Briefly discuss the key content of Forensic Accounting and Investigation Report.*

17. *ABC Ltd. is a listed company having turnover of ₹ 50 crores & plans expansion by installation of new machines at new building-having total additional project cost of ₹ 20 crore.*

Rupees (In crore)	***Purpose***
10.0	*- for Building*
8.5	*- for Machinery*
1.5	*- for Working Capital*
20 Crore	*Total*

Project gets implemented in 2022-23 and one of the accountants report to the Managing Director that some suspicious transactions are noticed in the purchase of building material. But the Management is confused as to whether they should get an audit or Forensic Accounting done for the same. Advise Management about the difference in forensic accounting and audit.

18. ***CA Rajpal is performing a forensic accounting engagement involving gathering of evidence in relation to suspected fraud of substantial amount in a company. He has been appointed under the terms of a contractual agreement with the company.***

The company operates in an electronic environment. While performing engagement, his team has gathered evidence from electronic records in Enterprise Resource Planning system (ERP), messages in company's e-mail system and also from system

logs and audit trails generated by company's computer systems. However, while doing so, the team has failed to take care of aspects such as keeping records of each person in team gathering relevant evidence, date and time of collection and storage of such evidence. What implications may it have on forensic accounting engagement as such?

19. *Mr. Rajat, while reviewing the anti-fraud controls for a construction company, found that the company has witnessed a few frauds in the past mainly in the nature of material theft from the sites and fake expense vouchers.*

    Mr. Rajat is evaluating options for verifying the process to reveal fraud and the corrective action to be taken in such cases. As an expert in fraud prevention, you have been asked to brief Mr. Rajat about the inventory fraud and verification procedure with respect to defalcation of inventory.

20. *Sid is a financial analyst working for a large corporation that is considering the acquisition of a mid-sized manufacturing company. The initial financial statements provided by the target company appear to be in order, showing profits and a solid asset base. However, his team is concerned about potential risks that may not be immediately visible in the financial documents provided.*

    Guide Sid on what specific aspects should be focused during due diligence to ensure that there are no hidden liabilities in this deal?

21. *Quality Ltd. is engaged in the business of manufacturing and distribution of various Ready to cook products like vegetables, Noodles etc. The government made certain changes in rules and regulations relating to this sector, consequently management decided to go for expansion. Management was looking for some financial investor who can fund some part of the proposed expansion. Mr. Aman is interested in the venture and appoints you to act as an advisor to the proposed investment in the business of Quality Ltd. You have to investigate the audited financial statements and ensure that the valuation of shares of the company on the basis of audited financial statements is appropriate. What process will be used for checking and can reliance be placed on the already audited statement of accounts?*

22. *Core Limited submitted a credit proposal XYZ Bank Limited for the sanction of a Term Loan of ₹ 150.00 crore required for procuring and installing a latest Plant and machinery for their upcoming project. Based on the application, XYZ Bank Limited approached CA P to investigate the profitability of the business for judging the accuracy of the schedule of repayment furnished by Core Limited, as well as the value*

of the security in the form of assets of the business already possessed and those which will be created out of the loan. Elucidate the steps that should be undertaken by CA P?

Answers to Test Your Understanding

1. As a part of due diligence exercise, he is performing SWOT analysis of borrower. He is making analysis of strengths, weaknesses, opportunities and threats (SWOT) pertaining to borrower. Features such as rise in sales, generation of cash profits and timely service of debts represent borrower strengths. Lack of well-paid qualified staff to deal effectively with its domestic and foreign customers is an area of weakness. Entering into export market presents an opportunity for borrowers and the presence of large number of competitors and demand slump in the US market reflect threats.

2. The attendance record of employees pertaining to that section can be analysed with regards to in and out time. Further, surprise visit to the site can be conducted to see the actual number of workers at a point of time. It may reveal ghost workers. Discrepancies in attendance records vis-à-vis actual number of workers present could reveal dummy workers. Such a visit would also give indication of actual work done in the area and give an inkling of productivity of employees.

3. (i) In claims involving product liability insurance policies, many documents are required from third parties. The third party may be unwilling to provide relevant documents to Forensic Professional concerning the very organization responsible for causing damages.

(ii) Independence of Forensic Professional become paramount in such types of assignments because it involves engagement with parties who are not directly claiming from insurance company. Forensic Professional needs to resist any pressure or interference in establishing the scope of the assignments or the manner in which the work is conducted and reported.

(iii) The company might be willing to negotiate it to salvage its reputation. It can lead to additional complexities.

(iv) Quantification of legal liability under the policy can prove to be a challenging task and it has to be determined in accordance with policy terms & conditions.

(v) Careful analysis of date of loss when first claim occurred in accordance with "claim series" clause and whether the same falls under the policy

Hints /Answers to Theoretical Questions

1. Refer Financial Due Diligence given in Para 3.

2. Refer Para 6.

3. Refer Over-Valued Assets Part given in Para 3.

4. Refer Para 1.

5. In order to ensure that the manufacturing unit of SV Ltd. will be able to meet the cash requirements internally, one is required to verify:

(a) Is the company able to honor its commitments to its trade payables, to the banks, to the government and other stakeholders?

(b) How well is the company able to convert its trade receivables and inventories?

(c) How well the Company deploys its funds?

(d) Are there any funds lying idle or is the company able to reap maximum benefits out of the available funds?

(e) What is the investment pattern of the company and are they easily realizable?

Refer Cash Flow in Para 3.

6. **(a)** The activity described in the situation is Due diligence. Due diligence is a measure of prudence activity, or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent person under the particular circumstance, not measured by any absolute standard but depending upon the relative facts of the case. It involves a careful study of financial and non-financial possibilities. It implies a general duty to take care in any transaction.

Due diligence is a process of investigation, performed by investors, into the details of a potential investment such as an examination of operations and management and the verification of material facts. It entails conducting inquiries for the purpose of timely, sufficient and accurate disclosure of all material statements/information or documents, which may influence the outcome of the transaction. Due diligence involves a careful study of the financial as well as non-financial possibilities for successful implementation of restructuring plans.

Due diligence involves an analysis carried out before acquiring a controlling interest in a company to determine that the conditions of the business conform with what has been presented about the target business. Also, due diligence can apply to recommendation for an investment or advancing a loan/credit.

(b) There would be no difference in answer if above activity was to be performed by a person who is not a Chartered Accountant. The activity would remain due diligence. Due diligence can be performed by any person. It is not necessary that due diligence can only be carried out by a Chartered Accountant. As due diligence involves exercise of prudence and general duty to take care in any transaction, it can be undertaken by any person.

(c) The areas where due diligence may be undertaken are: -

(i) Corporate restructuring

(ii) Venture capital financing

(iii) Public offerings

7. Refer Para 11.3.

8. Refer Para 11.1.

9. Refer Para 10 and 11.5.

10. Refer Cash Receipts embezzlement in Para 11.4.1.

11. In assessing the turnover which the business would be able to maintain in the future, the following factors should be taken into account:

(i) **Trend:** Whether in the past, sales have been increasing consistently or they have been fluctuating. A proper study of this phenomenon should be made.

(ii) **Marketability:** Is it possible to extend the sales into new markets or that these have been fully exploited? Product wise estimation should be made.

(iii) **Political and economic considerations:** Are the policies pursued by the Government likely to promote the extension of the market for goods to other countries? Whether the sales in the home market are likely to increase or decrease as a result of various emerging economic trends?

(iv) **Competition:** What is the likely effect on the business if other manufacturers enter the same field or if products which would sell in competition are placed on the market at cheaper price? Is the demand for competing products increasing? Is the company's share in the total trade constant or has it been fluctuating?

12. Refer Inventory Fraud in Para 11.4.1.

13. Refer Areas to be verified in case of embezzlement in supplier's ledger in Para 11.4.1.

14. Refer Para 7.1.

15. Refer Para 14.

16. Refer Para 15.

17. Refer Para 12.

18. ***In a forensic accounting engagement, professional undertakes a scrutiny and detailed examination of all transactions and balances relevant to the mandate so that evidence gathered is suitable in a Court of Law i.e. in compliance with legal requirements where it can be challenged through cross-examination by the defending party.***

It is important that team is skilled in collecting evidence that can be used in a court case keeping a clear chain of custody till evidence is presented in court. If there are gaps in chain of custody, then the evidence may be challenged in court or even become inadmissible.

In the given case, team has failed to keep record of matters such as persons gathering relevant evidence, date and time of collection and storage of evidence. Therefore, team has failed to maintain the chain of custody.

It can, therefore, defeat the objective of forensic accounting engagement as evidence may be challenged in Court of law by defending parties and may become inadmissible.

19. ***Refer Inventory Frauds Part given in Para 11.4.3.***

20. ***Refer hidden liabilities Part given in Para 3.***

21. ***In the instant case, Quality Ltd. is engaged in the business of manufacturing and distribution of various ready-to-cook products like vegetables, noodles etc. Further, management was looking for some financial investor to fund some part of the proposed expansion. Aman is interested in funding; therefore, he initiated investigation of audited financial statements to ensure the appropriateness of the valuation of the shares. For initiating the same it may be considered that if the investigation has been launched because of some doubt in the audited statement of account, no question of reliance on the audited statement of account arises. However, if the investigator has been requested to establish value of a business or a share or the amount of goodwill payable by an incoming partner, ordinarily the investigator would be entitled to put***

reliance on audited materials made available to him unless, in the course of his test verification, he finds the audit to have been carried on very casually or unless his terms of appointment clearly require to test everything afresh.

- *If the statements of account produced before the investigator were not audited by a qualified accountant, then of course there arises a natural duty to get the figures in the accounts properly checked and verified.*
- *However, when the accounts produced to the investigator have been specially prepared by a professional accountant, who knows or ought to have known that these were prepared for purposes of the investigation, he could accept them as correct relying on the principle of liability to third parties.*
- *It would be prudent to see first that such accounts were prepared with objectivity and that no bias has crept in to give advantage to the person on whose behalf these were prepared.*

22. Refer Para 11.3.