

Investigations and Due Diligence

20.1 Introduction

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.

20.2 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.

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(iv) Nature	Requires a detailed study and examination of facts and figures.	Involves tests checking or sample technique to draw evidences for forming a judgement and expression of opinion.
(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) 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 case 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 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.

20.3 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:

- ◆ Determination of objectives and establishment of scope of investigation.
- ◆ Formulation of the investigation programme.
- ◆ Examination and study of various records by reference to appropriate evidence.
- ◆ Analysis, processing and interpretation of findings.
- ◆ Preparation of report and drawing up of conclusions.

Now let us study each of these steps in detail.

20.3.1 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 and the scope of investigations and the issues incidental thereto.

The period which the investigation should cover should be clearly specified. The results of investigation are often seriously affected owing to change 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.

20.3.2 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 the nature of the business, the structure of business, the instructions from the client embodying the objectives, the consequent scope and depth and the necessity to extend the investigation into books and records belonging to others. 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.

In programming the verification, the investigator should concentrate on areas considered relevant rather than to undertake a wide-ranging verification. For example, in 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 termination 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.

20.3.3 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

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procured. For example, 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.

20.3.4 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 and backed by established facts and 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.

20.3.5 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. First, the instructions given by the client as regards the special aspects of the business which are required to be investigated; and second, the findings of the investigating accountant. 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.
- (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, stocks 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.

20.4 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 transactions. 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 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.

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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 it 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 emphasise 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 appropriately. This problem may particularly arise in cases where incomplete books and records are produced for investigation.
- (f) **Whether an investigator can make futuristic statements** - 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, on his files full notes of the work carried out, copies of schedules and all working papers, record of conversations and the like. Also the working papers should link up the figures shown by the books of business with the final figures

produced by the accountant. 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.

20.5 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. For instance, 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. It may be noted here that Section 212 of the Companies Act, 1956 requires every holding company to furnish a statement along with its annual accounts showing certain financial and non-financial information in respect of its subsidiaries. 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. If the business is labour - intensive, its future profitability would be dependent on 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 trade.

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?

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- (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?

For finding answers to all these questions, the Profit and Loss Account and the Balance Sheets of the concern for the past several years should be examined.

(b) Profit and Loss Account - To study the Profit and Loss Account of a concern, it is necessary to consider each item, included therein, in relation to the corresponding items in the Profit and Loss Account of the previous years. It is therefore, necessary that a summary, in a columnar form, should be prepared of the balances included in the Profit and Loss Accounts 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 stocks, the figures of stock consumed in different years should be entered. It should also be verified that the stocks and work-in-progress have been valued on a consistent basis throughout the period under review. If there has been a change, the values of stocks 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. Further, 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 neighbourhood 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. 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 - 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. In this respect it may be noted that Para 26 of AS-6 'Depreciation Accounting' states that in case of revaluation of depreciable assets, the provision for depreciation should be based on the revalued amount and on the estimate of the remaining useful life of the assets. If the annual maintenance charge has been fluctuating from year to year, it may indicate that the plant or the building has not been regularly repaired. 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.

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 Companies Act, 1956 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 Profit and Loss Account 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 regarded by the taxing authority as inadmissible. 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.

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

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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, 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.

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 assets have been revalued, the increased depreciation charge has been adjusted against profit. Para 10 of the Guidance Note on 'Treatment of Reserve created on Revaluation of Fixed Assets' states that when a company has created revaluation reserve by revaluation of fixed assets and the company has charged the additional depreciation to Profit and Loss Account, it is possible to transfer an amount equivalent to accumulated additional depreciation from the revaluation reserve to Profit and Loss Account or General Reserve as the case may be. 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).

Stock and work-in-progress - It should be seen that stocks have been valued consistently and that the basis of valuation was such that the value placed on stocks did not include any element of profit. Also, there should be due allowance for damaged, obsolete and slow moving stocks.

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

- (i) Whether bad debts have been adjusted in the years in which the relevant sales took place instead of in the year in which they have been written off. Normally, such an adjustment should be made but not 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 throughout the period under investigation, to determine whether it has been necessary to increase continually the credit period in order to effect 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.

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 stocks 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

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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 amount of debentures and preference share capital are disproportionately large as compared to the equity capital, for this would be a handicap to 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 undermentioned 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 stock to turnover been increasing and if so, is it a continuing or only a temporary trend?

- (ii) Are the creditors being paid promptly or is there a backlog which will have to be dealt with?
- (iii) What will be the effect on stock, debtors and creditors, 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.

20.6 Types of Investigation

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

Statutory - As an inspector under Sections 235 to 251 of the Companies Act, 1956.

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.

20.6.1 Investigation under the Companies Act, 1956: Investigation under the Companies Act, 1956 may broadly be classified into:

(A) Investigation into the affairs of a company and (B) Investigation of ownership of a company.

(A) Investigation into the affairs of a company - In the following situations, the Central Government may appoint one or more competent persons as inspectors to investigate the affairs of a company and to report thereon in the manner directed by it:

- (i) If the registrar of the Companies makes a written report, under Section 234(6) of the Companies Act, 1956, to the Central Government that certain information or explanation are not supplied to him by the Company or that the books, documents or other

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information and explanations are not supplied to him disclose an unsatisfactory state of affairs or that they do not make a full and fair disclosures [Section 235 (1)].

- (ii) If in the opinion of the Central Government or that of Company law Board, National Company law Tribunal, there are circumstances suggesting:
 - (a) That the business of the company is being conducted with intent to defraud its creditors, members or any other persons or otherwise for a fraudulent or unlawful purpose, or in a manner oppressive of any of its members, or that the company was formed for any fraudulent or unlawful purpose;
 - (b) That the persons concerned with the formation of the Company, or the management of its affairs have in connection therewith been guilty of fraud, misfeasance or other misconduct towards the company or towards any of its members; or
 - (c) that the members of the company have not been given all the information with respect to its affairs they might reasonably expect, including information relating to the calculation of the commission payable to a managing director or the manager of the company [Section 237 (b)].
 - (d) In the case of *Barium Chemicals Ltd. V. Company Law Board'*, it was held that one of the circumstances mentioned above must exist before the Central Government can order an investigation. If it is shown that the circumstances do not exist or that they are such that it is impossible for anyone to form an opinion there from suggestive of the aforesaid things, the opinion is challengeable on the ground of non-application of mind or perversity or on the ground that it was formed on collateral grounds and was beyond the scope of the statute.

In the following situations, the Central Government has to appoint an inspector to investigate the affairs of the company:

- (i) Where the Tribunal orders such an investigation on an application made by the following:
 - (a) In the case of a Company having share capital, not less than 200 members or members holding not less than 1/10th of the total voting power [Section 235 (2) (a)].
 - (b) In case of a company not having share capital, not less than 1/5th in number of the members of the company [Section 235(2) (b)].

Section 236 provides that the application should be supported by evidence showing that the applicants have good reasons for requiring the investigation. The Central Government can also ask the applicants to give security up to ₹ 1,000.00 towards payment of the investigation

- (ii) Where the company by special resolution, or by Court order, declares that the affairs of the company ought to be investigated by an inspector appointed by the Central Government. [Section 237 (a)].

Section 238 provides that a firm, body corporate or other association cannot be appointed as an inspector. Thus, a firm of professional accountant cannot be appointed as inspector but an individual accountant can be so appointed.

Investigation into the affairs of related companies and other - Section 239 of the Companies Act, 1956 provides that an inspector appointed under Section 235 or 237 can also, with the prior approval of Central Government in appropriate cases, and if he thinks it essential, investigate the affairs of the following bodies corporate and others:

- (a) Any other body corporate which is or has at any relevant time been the subsidiary of the company under investigation or holding company or subsidiary of its holding company or a holding company of its subsidiary.
- (b) any other body corporate which is, or has at any relevant time been managed by any person as managing director or as manager, who is, or was, at the relevant time, the managing director or the manager of the company; or
- (c) Any other body corporate which is, or has at any relevant time been, managed by the company under investigation or whose board of directors comprises of nominees of the company under investigation or is accustomed to act in accordance with the directions or instructions of the said company or any of its director or of any company any of whose directorships is held by the employees or nominees of those having the control and management of the company under investigation.
- (d) any person who is or has at any relevant time been the company's managing director or manager.

The objective of these investigations, fundamentally, is to determine whether any provision of the Act has been violated or there has been a breach of duty on the part of a director or an officer of the company resulting in a loss to shareholders or a class of them. It has been held in the case *Narayanlal Bansilal v. Maneck Phiroze Mistry and another* (1960 comp. Cases, p. 62) that an investigation into the affairs of a company under the Companies Act was not a criminal proceeding. It was also held that the report of the inspector is just an expression of his opinion in the manner in which affairs of the company was conducted.

The term "affairs of a company" was considered in *R.V. Board of Trade Ex. parte St. Martin Preserving Company Ltd.* (1964 E.R. 561). It was held that it can cover investigations into all aspects of its business; its assets including goodwill, profits and losses, contracts and transactions, investments and rather property interests and control of subsidiary companies and transactions of a receiver and manager of a company.

In another case, *S.L. Verma v. Delhi Flour Mills Co. Ltd.* (1975, 45 company cases), it was held that to order investigation under Section 237, at least *prima facie* evidence should exist showing circumstances which would lead to the conclusion that an investigation was necessary. The simple fact that subsidiary company had not shown any profit would not justify an order for investigation.

Powers of the Inspector - Section 240 of the Companies Act, 1956, directs all officers, other employees and agents of the company or of the related bodies corporate under investigation

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to preserve and to produce all books and papers in their custody before the inspector. They are also required to give all reasonable assistance to the inspector in connection with the investigation. With the previous approval of the central government, the inspector may also ask any other body corporate to furnish such information or to produce such books and papers before him as are considered necessary for his investigation into the affairs of the company. The inspector may keep in his custody any such books or papers for six months. The inspector also has the power to examine on oath any officers, employees or agents of the company under investigation or of the other ' body corporate. .With the previous approval of the central government; he may also summon and examine any other person on oath. Penalties have been prescribed for persons who do not give information or books and papers to the inspector or who do not appear before the inspector when required to do so.

The expression "Officers" in the case of investigations includes the trustees for debenture holders. Similarly, the expression "agents" includes all persons acting or purporting to act on behalf of the company under investigation or the related bodies corporate or persons and includes the bankers, legal advisors and auditors. Further, the expression "officers and other employees and agents" includes both past and present officers, other employees and agents.

Section 240A gives powers to inspector, if he is so authorized by a First Class Magistrate, to seize the books and papers of the company under investigation or of any related body corporate or of the managing director or the manager of the company or other body corporate, if he has reasonable ground to believe that such books or papers may be destroyed, falsified, altered, mutilated or secreted. The Magistrate can, after considering the inspector's application on their behalf, authorize him to enter and search the places where such books and papers are kept and cease them, if considered necessary. The inspector can retain the ceased books and papers till the conclusion of the investigation. Before returning them, he can put appropriate identification marks on them.

Inspector's Report - Under Section 241 of the Companies Act, 1956, the inspector has to make interim (if so required) and the final report to the Central Government. The Central Government forwards a copy of the final report to the company and the related bodies corporate under investigation. Copies of the final report to the company are to be furnished by the central government to the applicants for investigation on a request being made in their behalf and to the court and the Tribunal in relevant cases. The central government may also publish the report and may furnish copies thereof to certain other persons.

Section 242 to Section 244 of the Companies Act, 1956, deal with follow -up of the inspector's report and gives power to the central government to launch prosecution or apply for winding up of the company or for an order under Section 397 or Section 398 or institute proceedings for recovery of damages regarding fraud or other misconduct or for recovery of the misapplied property. Section 245 provides that the expenses of investigation shall be defrayed by the central government in the first instance. However, it can recover the same from the persons specified in their behalf to the extent so specified. Section 246 provides that the inspector's report shall be admissible in any legal proceedings as evidence of the inspector's opinion on matters contained in the report.

General approach for investigation - The general approach for investigation under Sections 235 and 237 of the Companies Act, 1956 is conditioned by the legal requirements in these regards. From the foregoing requirements of law, it is apparent that investigations under these requirements may encompass a wide field. The affairs of the company may include everything such as goodwill, profit and loss, contracts, investments, assets, shareholding in subsidiaries, decision making, etc. Also the specific circumstances mentioned in these sections like fraud, mismanagement, oppression of any shareholder etc. come within the term "affairs of the company."

Investigation under Sections 235 and 237 do not call for any special approach. The approach to any investigation is determined on a consideration of the nature of the investigation and the terms of reference. However, the inspector should ensure that the terms of reference are clear, unambiguous and in writing. If he has any doubt about any item in the terms, he should obtain clarification in writing. It should also be seen that the terms of reference are not too general, because that may frustrate the whole objective of the investigation; the scope of the investigation will become unwieldy and ill defined. An investigation order to investigate into the affairs of the company would be an instance at point. Affairs would mean anything and everything that the company is involved in. The thrust and sharpness of the investigation would get diffused and blunted and important distortions in the company may be overlooked in the generalities of the scope. Therefore the inspector should ask for reframing of the order specifying the exact matters to be investigated. He should also take into consideration the possible effect of limitations, if any, put in the terms of reference and should keep the Central Government informed in writing about their effect on the investigation.

The next point for consideration of the inspector would be the determination of the scope of the investigation on the basis of the terms of reference. At this stage, it may be useful for the inspector to go into the history of the company and its affiliates or associates. He should evaluate the terms of reference in sketching the scope of investigation; this will enable him to locate the limitation, if any, in the terms of reference, not clearly mentioned. For a purposeful investigation, he may need to stretch his inquiry into the books and records of allied and associated persons and concerns and may require to arm himself with the powers given under Section 239 of the Companies Act. He should also have regard to the period over which the investigation should stretch. The evaluation of terms of reference and the consequential determination of the scope of investigation are the twin props on which the entire investigation would rest and, therefore, the inspector appointed under Sections 235 or 237 should devote careful attention to these. Thereafter, he should frame his programme for investigation in a systematic manner. He should keep adequate working notes and papers with references and cross references in a proper and methodical way to aid him in the preparation of the report. The actual process of investigation would be essentially an evidence gathering procedure and, at every step, he should have regard to the procedures laid down in these sections regarding production of documents and evidence, examination on oath and seizure of documents. He should also keep his mind open to the revelations he comes across in the process of evidence collection and should assess whether the programme of investigation needs amendment or modification. He should also consider whether assistance of other experts like engineers,

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lawyers, etc., is necessary in the interest of a comprehensive and fool proof examination of the documents and information.

Only after he has completed the steps in the investigation programme and has marshaled all the information that he needed should he prepare his report. He, however, can make interim report also as provided under Section 241 of the Companies Act. The findings should be completed and exhaustive. Before he makes his final report he should obtain and keep on record the evidences relied upon by him. By the nature of things, such evidence should be as conclusive as possible depending on circumstances of the case. He should make his report in accordance with the provisions of Section 241 of the Companies Act. However, the overriding consideration that he should at every stage of investigation and especially in the report framing stage bear is to remain fair and thoroughly unbiased.

The general approach for investigations under Sections 235 and 237 should, therefore, be formulated having regard to the terms of reference, scope, the period, the programme and procedure of the investigation and the attending legal requirements specified above.

(B) Investigation of ownership of a company - Section 247(l) enables the Central Government, if it thinks fit, to appoint inspector(s) to investigate and report on the membership of any company and other matters relating to the company, for the purpose of determining the true persons who are or have been financially interested in the success or failure, whether real or apparent, of the company or who are or have been able to control or materially influence the policy of the company. Also if the Tribunal declares by an order that the ownership of a company should be investigated, the Central Government shall appoint inspector(s) for the same purpose as mentioned in Section 247(l). Section 247(1A) without prejudice to its powers under this section, the Central Government shall appoint one or more inspectors under sub-section (1), if the [Tribunal], in the course of any proceedings before it, declares by an order that the affairs of the company ought to be investigated as regards the membership of the company and other matters relating to the company, for the purpose of determining the true persons –

- (a) who are or have been financially interested in the success or failure, whether real or apparent, of the company; or
- (b) who are or have been able to control or materially to influence the policy of the company.

While appointing an inspector under Section 247(l), the Central Government normally defines the scope of his investigation. The power of the investigator shall extend to the investigation of any circumstances suggesting the existence of any arrangement or understanding which, though not legally binding, is or was observed or is likely to be observed in practice and which is relevant for the purposes of his investigation. For the purposes of any investigation under Sections 247, 239, 240 and 241 shall apply with necessary modifications. However under Section 247, the Central Government is not bound to furnish the company under investigation or any other person with a copy of the inspector's report. But it has to keep with the Registrar of companies, a copy of the report or of those parts which may be divulged.

Section 250 of the Companies Act empowers the Tribunal, on a reference made to it by the Central Government in connection with any investigation under Sections 247, 248 or 249 or on

a complaint made by any person in this behalf, to impose restrictions upon issue and transfer of shares and debentures of a company under investigation. Such a restriction is valid for a period not exceeding three years. Section 250A provides that investigation proceeds initiated against a company will not be stopped even if the company has passed a special resolution for voluntary winding up or it has made an application for relief in cases of oppression or mismanagement.

Finally, Section 251 safeguards the legal advisers and bankers of a company under investigation from furnishing certain privileged communication in respect of the company or any information as to the affairs of any of the customers other than such company to the Central Government or Tribunal or the inspector.

Scope and extent of investigation - When a chartered accountant is appointed to carry out an investigation under any of the aforementioned provisions, the extent of enquiry, the objective of the investigation and the various matters referred to for investigation are specified in the order of investigation issued by the appointing authority. On a consideration thereof, the investigating accountant should determine the areas of accounts which require investigation and the extent to which the enquiry is to be made as well as his general approach to the enquiry. For example, if the allegation is that certain transactions have been entered into in contravention of the provisions of the Companies Act, the nature of transactions, the persons who were parties thereto, the amount or amounts involved and the circumstances under which these were entered into must be examined. If the contravention was deliberate and willful and was made with some ulterior motive, it would attract greater penalty as compared to the one which was inadvertent. The enquiry therefore should show the motive, if any, of the contravention. If the loss suffered by the company has given rise to a gain by a director and other managerial personnel or its associates, the manner in which the benefit has accrued and the amount thereof shall have to be investigated.

In case of a company having subsidiaries or where one or more directors are interested in one or more concerns, all the dealings with these concerns should be examined for these may have been entered into with the intention of transferring profit. Generally, all sales and purchases of goods and assets from directors and their associated concerns should be scrutinised since these also can be a vehicle of illicit transferring of profits.

Any breach of duty or abdication of responsibility for purposes of investigation would be material only if it has resulted in a loss to the company. In such a case, the factors responsible for the loss or losses, besides the amount thereof, shall have to be investigated. Negligence would be culpable only if it was in relation to a duty cast by the Act, Articles of Association or by a resolution of the shareholders or that of the Board of Directors.

Any negligence in the discharge of duty of a director or any other managerial personnel must be construed very broadly, for apart from being the agents of the company, they are trustees of its property. As such, it is their duty to safeguard the property of the company and protect the interest of the shareholders. It must be remembered, however, that it is not the duty of a director to attend to the business of a company continuously and, therefore, so long as the decisions of the Board at which the director was present were taken on a proper consideration

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of the evidence available and in the best interest of the company, he would not be responsible for any losses suffered by the company.

It may be necessary for an investigator to interrogate directors, officers, agents, and others concerned with matters under his enquiry. Before drawing up his brief in this regard as well as for framing his conclusions, he should, if necessary, take legal assistance. If the Investigating accountant is required to report on the efficiency of the management, he should be discreet in expressing his opinion. Usually, it is sufficient if he merely indicates the general limitations of the management. The inspector must ensure that the persons who figure in the investigation get the fullest opportunity to explain their action and conduct. However, the inspector can not hold out any assurance to anybody except the assurance of fairness implicit in the job.

It is necessary to note that according to the provisions contained in clause (b) of Sub-section (vi) of Section 240 of the Companies Act, auditors also are considered agents of the company. As such, they are expected to give to the inspector all assistance in connection with the investigation which they are in a reasonable position to give. They also can be required to produce their working papers and notes for examination by the investigator.

20.6.2 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 distribution, personal capability of the existing partners, socio-economic setting, etc., and whether he would be capable of deriving continuing benefit in the shape 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 for pending 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 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 import 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 first hand 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 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.

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

20.6.3 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, 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 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, 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 on 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. For example, 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. For instance, 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 in projecting the trend to 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. These would show to him 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.

20.6.4 Investigation on behalf of a bank 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 undermentioned 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.

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- (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 payment of loans on the reliability of annual profits and loss 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.

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 Profit and Loss Accounts 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 Stocks 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 item, 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) **Stock** - The value of different types of stocks 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 stock subsequent to the date of the Balance Sheet, either due to conversion into finished goods or sale, should be considered.

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

(c) **Sundry debtors, 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 Loans** - Debentures and other loans should be included together in a separate schedule. Against the debentures and each secured loan, the amounts outstanding for

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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.

- (f) **Provision of Taxation** - The previous years up to which taxes have been assessed should be ascertain. If provision for taxes not assessed appears in 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 creditors 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 those of machinery suppliers and the legal adviser, for example, 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.

Finally, the investigating accountant should ascertain whether any application for loan to another bank or any other party has been made. If so, the result thereof should be examined.

20.6.5 Investigation of frauds

Frauds are of two classes, viz. 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 is given below.

The various situations in which money may be embezzled and the various forms that such frauds usually take 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 undermentioned 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; 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 apart of the amount withdrawal from the bank.
- (b) Inflating cash payment -**
- (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.
- (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.
- (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

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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.
- (e) **Stock frauds** - Stock 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) Stock records may be manipulated by employees who have committed theft so that book quantities tally with the actual quantities of stocks in hand.

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, without any supervision by any other person or any other inherent weakness that may be in existence in the system.

Procedure for Investigation

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., stock, 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., and 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.

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 totalled. 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.

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 tested with those in the Sales Day Book where one 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.

Verification of balances in suppliers' ledger - The Bought 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.

Defalcation of stock - 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

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persons. Therefore, for their detection, the entire system of receipts, storage and despatch 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 stock control, and existence of detailed record of the movement of stock, 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 stock defalcated and their quantities by checking physically the quantities in stock held and those shown by the Stock Book.

Afterwards, all the receipts and issues of stock recorded in the Stock 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 stock 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 Stock Book. Also, the totals of the Stock Book should be checked. Finally, the shortages observed on physical verification of stock 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 stock, 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 stocks 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.

20.6.6 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 worth while 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 and those retrenched.
 - (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 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.

20.6.7 Investigation in connection with review of profit/financial forecasts: There are many investigations which involve an examination of future profits. Profit reports can be required as part of a general investigation into the purchase of a business or 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.

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Normally, such situations involve special review as these depart from the auditor's traditional role of expressing an opinion in relation to past events.

For quite a long time, professional accountants have been involved in the preparation or review of profit forecasts to be submitted by intending borrowers to banks and financial institutions. These institutions place a greater reliance on such statements if they are prepared or reviewed by chartered accountants. As a large number of chartered accountants are undertaking the preparation and review of profit and financial forecasts for submission to banks and financial institutions, the ICAI had issued a guidance note on this subject. The guidance note discussed various considerations and important matters to which the accountants should direct their attention in reviewing the forecasts. It also contained guidelines for preparation of the report. Pursuant to the growing implications in this arena, ICAI issued SAE 3400 on "Examination of Prospective Financial Information" to deal with the subject matter. Consequent upon to the issue of this Standard, the erstwhile Guidance Note stands withdrawn.

20.7 Due Diligence

'*Due Diligence*' is a term that is often heard in the corporate world these days in relation to corporate restructuring. The term '*corporate restructuring*' normally includes internal reconstruction, amalgamations, spin-offs, divestiture, mergers, joint ventures, split-off, etc. Certain corporate restructuring exercises are not within the group (also known as external corporate restructuring exercises), for example, a joint venture between two parties where one party hives off an existing unit or division into another company into which the joint venture partner then acquires an interest or has acquired an interest. These are all corporate restructuring exercises that involve more than one party. For such a corporate restructuring exercise to succeed, it must be planned properly. A key element in such an exercise, where it involves the acquisition of another entity, unit or assets of an entity, is the performance of a "due diligence" review. Due Diligence may also required to be performed in cases of venture capital financing, lending, leveraged buyouts, public offerings, disinvestment, coporatisation, 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.

Purpose of Due-Diligence - The purpose of due diligence is to assist the purchaser or the investor in finding out all he reasonably 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.

Due Diligence can be sub-classified into discipline-wise exercises be as follows:

- ◆ Commercial or Operational Due Diligence
- ◆ Financial Due Diligence

- ◆ Tax Due Diligence
- ◆ Information Systems Due Diligence
- ◆ Legal Due Diligence
- ◆ Environmental Due Diligence
- ◆ Personnel Due Diligence

20.7.1 Commercial or operational Due Diligence: Operational due diligence is generally performed by the concerned acquirer enterprise (due diligence may also be commissioned by the enterprise for the sale of its business or part of a business), and involves an evaluation from a commercial, strategic or operational perspective. For example, whether proposed merger would create operational synergies. On the other hand, financial due diligence review would be performed after the commercial valuation. Accordingly, while a preliminary review might be performed during initial stages of the restructuring exercise and may, in fact, be performed simultaneously with the commercial evaluation, at a later stage, financial due diligence may be performed on the books of account and other information directly pertaining to the financial matters of the entity. In addition, a legal due diligence may be required where legal aspects of functioning of the entities are reviewed; for example, the legal aspects of property owned by the entity or compliance with various statutory requirements under various laws. Like other due diligence exercises, environmental and personnel due diligence are also carried out in order to establish whether various propositions with regard to environment and personnel of the enterprise under review are appropriate.

20.7.2 Financial Due Diligence: At times, the financial due diligence review is interpreted as 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 after a price has been agreed for the business. The initial price and other decisions are taken on the basis of 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 of promoters
- ◆ Accounting policies and practices
- ◆ Management information systems

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- ◆ 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
- ◆ 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 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 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 may reveal its turning points, survival strategies adopted by the target from time to time, the market share enjoyed by the target 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. 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) (for example, manufacturer, wholesaler, financial services, import/export)
- ◆ Location of production facilities, warehouses, offices
- ◆ Employment (for example, by location, supply, wage levels, union contracts, pension commitments, government regulation)
- ◆ Products or services and markets (for example, 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 (for example, long-term contracts, stability of supply, terms of payment, imports, methods of delivery such as "just-in-time")
- ◆ Inventories (for example, 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 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 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 the main effect of accounting policies on the overall profitability and their correctness. It is reiterated that the accountant should mainly 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, that changes that have been made to the accounting policies in the recent past, the areas in which accounting policies followed by the target 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 have been prepared in accordance with the Statute governing the target, 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 in great detail. It is important to make an evaluation of the profit reported by the target. The reason being that the price of the target 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. 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

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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 assets only. For valuation of immovable properties and plant, if required, the assistance of expert valuers could also 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.

Certain examples of hidden liabilities are:

- ◆ 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 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 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.

Examples of over valued assets could be:

- ◆ 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.
- ◆ Intangibles 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 if a) Is the company able to honour its commitments to its creditors, to the banks, to government and other stakeholders b) How well is the company able to turn its debtors and stocks 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?

(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 to give projections on optimistic, pessimistic and most likely bases.

Ordinarily, it would be desirable that 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 is unrealistic, the accountant should consider its impact on the overall valuation of the company. He should offer his comments on all the assumption, highlighting those which, in his opinion are not inappropriate. In case he feels the projections provided by the target are not achievable or aggressive he has to mention this in his report. He should thoroughly check the arithmetic 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 match the requirements of the new incumbents. Due to 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.

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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 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 a due diligence this is one aspect that has to be investigated in detail. It is important therefore, to make a list of laws 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.

20.7.3 Contents of a Due Diligence Report: The contents of a due diligence report will always vary with individual circumstances. Following headings are illustrative:

- ◆ Executive Summary
- ◆ Introduction
- ◆ Background of Target
- ◆ 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.

CASE STUDIES

I. Excess Claim for Loss of Stocks

This is a case study of an investigation in respect of a major insurance claim where an investigator was appointed by surveyors for evaluation of stocks.

Introduction

An investigator (for that matter even an auditor, whether statutory, Internal, or Concurrent) has to be attentive to deficiencies or weaknesses in internal controls. Such deficiencies or weaknesses expose the client to possibilities of errors and frauds. The significant difference between the two is that errors are a result of either inefficiency or oversight, while frauds are the result of shrewd planning by the fraudster. Further, errors can be more easily located since they would have been inadvertently committed without any intention of concealment, while camouflaging of frauds would be deliberate and intelligent. Therefore, the investigator (or auditor) has to modify his approach in circumstances where fraud is suspected.

It is always advisable for an investigator (or auditor) to review all his findings objectively towards the completion of the assignment, just before finalizing his report. This would enable him to have an overview of all his observations. He must ask himself "Do all the facts and pieces of evidence fit in logically? Is there any indication of mismatching of facts? Do the data tie up with the current, circumstances? Is there any unusual or strange pattern?" A study of the findings is likely to give him a wealth of information. This exercise may reveal latent errors or frauds.

The following case study explains how an investigator was able to detect a major insurance fraud.

Facts of the case

ABC was a partnership firm trading in television sets. It stocked several models of television sets of various companies. The stocks were kept at a warehouse. After an outbreak of fire in the warehouse, ABC lodged a claim with the insurance company. The claim was for ₹ 200 lacs for about 1550 television sets. Stock records which were maintained at the warehouse included the following:

1. Goods Inward Notes
2. Delivery Challans.
3. No Charge Invoices for free replacements
4. Stock Ledger (ledger page for each model of television)

A parallel stock, ledger was maintained at the office also.

The insurance company sent an investigator to assess the claim of ABC. Since the warehouse was completely reduced to cinders, the only quantitative record available was the stock ledger at the office. The investigator went about his task meticulously. First he gathered all the routine information — list of books of account, purchase and sales procedures, levels of authorities in force, and list of suppliers and customers. He also documented, in brief, the nature of the business and the background of the owners. Since his focus was on the insurance claim. He concentrated his efforts on the examination of stock ledger, purchases and sales.

Investigator's approach and plan

The investigator conducted the investigation with two broad objectives in mind:

- (a) To assess the correctness of the quantities of the stock-on-hand as on the date of fire.
- (b) To satisfy himself that the valuation was fair and reasonable.

As regards (a), he adopted the following procedure:

- (i) He traced the opening balances from the last audited physical verification statement.
- (ii) He checked the castings of the stock ledger for all the quantities received and sold.
- (iii) He traced quantities of goods received from the Purchase Register and suppliers' challans (since GRNs were lost).
- (iv) He traced quantities of goods sold from the sale register.
- (v) He traced the free replacements from the Claims Register and obtained confirmations in writing from the partners that barring those shown in the register, there were no other free replacements.
- (vi) He listed damaged or defective stock on the basis of the Claims Register.
- (vii) He traced quantities of returns from both credit notes and debit notes into the stock register.
- (viii) He could not get any feedback from the storekeeper since the latter had been hospitalised after the fire and had subsequently gone back to his village.

As regards the findings, he had nothing unusual to report. Everything seemed to be correct. All the checks detailed above did not reveal any discrepancy.

As regards (b), the procedure was fairly simple since it was only a trading firm. The firm had adopted the FIFO basis of valuation and, therefore, the cost of stock was derived from the latest purchase bill. The insurance company was satisfied with this because, as per the policy, it had to reimburse the claimant at the 'replacement value'.

The investigator then decided to examine all the facts collectively before finalising his report.

Results and findings

Though he did not have any specific query, the following observations were unusual:

- ◆ The past audited physical verification statement as well as the earlier balance sheets of the firm disclosed stocks which were less than 50 % of the stocks value as on the date of the fire.
- ◆ Faxed orders-on-hand as on the date of fire did not even add up to 15 % of the stocks claimed to have been lost.
- ◆ Some of the purchases during the last few days before the fire were made without any advance being paid. In the past, by and large, purchases were made with 50% advance to suppliers. The payments were made after the date of fire.
- ◆ Suppliers' challans for the purchases stated above did not bear the usual godown keepers' signature.

All these facts led the investigator to believe that the stocks had been overstated in the claim. However, none of these observations were really sufficient for him to conclusively prove that stocks were overstated. He asked the firm for explanations which were given in respect of each of the above observations as follows:

- (a) The increase in the quantum of stocks was due to major sales drive which the firm was proposing to launch shortly. They had been negotiating a major order with a new client, which was in the process of finalisation.
- (b) A lot of verbal and telephonic orders were received as on the date of fire.
- (c) Due to growing competition, some of the suppliers were willing to favour the Firm by not insisting advance payments.
- (d) Due to heavy traffic, a large consignment of stocks came late at night when the usual warehouse keeper was not there and one of the partners had himself come and accepted the stocks.

Obviously, some concrete evidence was required to disprove the claim. The investigator decided to visit the warehouse to see if any more evidence was available. It was at the warehouse that he hit upon the solution to the problem of proving the absurdity of the claim. The dimensions of the warehouse apparently did not seem to practically permit more than 1000 television sets to fit in. He called for the layout of the warehouse and took the actual measurements of the smallest television set stocked by the firm. Even if these had been the only sets stocked by the firm, not more than 1200 sets could be fitted in the godown without even providing for space for human movement. Also, stacking norms permitted only 3 television boxes in a column, further restricting the number of sets, which could be stored. When these queries were raised, the firm accepted that there seemed to be an 'error' and reduced the claim unconditionally.

Lessons to be learnt

Dimensional limits of storage of assets can be the most important consideration in determination of an asset quantification. It is logical to presume that the inventory cannot be more than :

- (a) The physical limits of space available.
- (b) The permissible storage facility. The storage facility limits may not merely be on account of dimensions. For instance, stocks may be governed by stocking norms for safety or prevention of damage. To illustrate a godown having stacks of pressure cookers may have a height to accommodate 15 pressure cookers, but storage may not be permitted over 10 cookers cartons vertically since the cookers may not be able to withstand the weight of more than 9 cartons on top.
- (c) Legal constraints.
- (d) Certain items of plant and machinery may technically require certain open space or clear area surrounding it or on top thereby restricting the number of such assets in a given area.

Wherever the investigator (auditor) deems fit, he should obtain technical guidance on the storage and custody of the assets as per the plan and layout furnished by the client. This would give the investigator (auditor) the upper limit of the asset quantification with suitable.

Modifications and adjustments for stocks lying with third parties and third party stocks lying with the client.

The point that this case study highlights is that an effective investigation warrants all the examination and review procedures are adopted in harmony and objectively. The findings have to be viewed both individually and collectively and the results must ring true. Illogical trends, patterns or mismatches of facts are the significant pointers to the investigator or auditor, as the case may be. It is up to him to examine them and draw his conclusions appropriately.

II. Embezzlement of Cash

This is a case study where an investigator was appointed by an insurance company to assist the surveyors in investigating into a major insurance claim involving embezzlement of cash.

Introduction

Man has been known to exploit situations of crisis and disaster, because human, nature is frail and easily susceptible to temptation. Accordingly, an investigator needs to be alert to the increased probability of fraud in circumstances of disaster and crisis. The following is a case, which amply illustrates this point.

Facts of the case

A supermarket, having a very large turnover in cash sales of all kinds of items such as groceries, foodstuffs, sweets, chocolates, meat, and other related items, was severely looted during an outbreak of riots and was literally reduced to shambles. Foodstuffs, sweets, and other traded items were looted or strewn all over. The supermarket remained shut for a few days after the riots since the stocks and scraps could not be disposed of until permitted by the Police and the insurance company. A police complaint was filed but the stolen goods and cash could not be recovered. The insurance company

started making preparations for assessment of the claim. As per the standard approved procedure, insurance surveyors were appointed to assess the claim for:

Loss of stocks: ₹ 1.25 crores.

Loss of cash : ₹ 1.5 lacs. An amount of ₹ 8 lacs was left back in the cash box which had been forcibly broken open.

Investigator's approach and plan

The surveyors appointed a chartered accountant as an investigator to help them in evaluating the claim. The following procedures were performed by him:

- (a) Photographs and a video film of the site evidencing the actual damage were examined.
- (b) Copy of the police complaint was obtained and kept on record.
- (c) Books of account and stock records were asked for. It was explained that these were fully destroyed and found to be in a torn, damaged or mutilated condition in the inner accounts office which was also not spared by the rioters.
- (d) Monthly physical stock statements sent to the bank till the date of damage were also compared with the estimate of the claim to assess the reasonableness of the claim.
- (e) In respect of the 'A' category items (top 70% in value), investigator derived the quantities of items of closing stock using the last audited physical verification stock sheet as the starting point and adjusting subsequent receipts (from statements submitted by vendors) and issues (from statements submitted to sales tax consultant).
- (f) Both the cash on hand and the stocks were tested for 'goodness of fit' in the trends seen for the relevant periods. As far as the cash balance was concerned, it was actually estimated on the basis of the average daily balance for the previous year which seemed reasonable, considering that sales during the current period were at least 12% higher. Stock value was compared with the average stock value for the last three years and fitted reasonably it, the trend.
- (g) Routine statements were taken from the cashiers and the salesmen. Apparently, when the supermarket was opened the day after the riots the entire premises were found ransacked. The manager had designated the person in-charge to assess the damage in his individual department and report on its status after taking note of the physical condition and quantity of the inventory. On the basis of these reports, made informally initially, an estimate of the loss was made.

Results and findings

General symptoms did not seem to point out anything adverse or extraordinary. It seemed as if the claim was reasonable and acceptable under the circumstances. However, the investigator decided to probe further. He asked for routine, but essential information such as the list of books and records maintained and documents in use and the system of accounting in force. In addition to the analysis of historical data of cash, sales and stocks as above, the investigator even asked for assistance in gathering and preserving documents in whatever condition they appeared to be in and expressed a desire to examine each scrap of paper himself. The investigator, eventually, came across the proof. He

found some torn faxes dated three days subsequent to the date of the riots! Obviously, the rioters had not come back to damage the papers. It had to be someone else who would benefit from the destruction of papers. Moreover, it had to be someone who had been the first to visit the cash department immediately after the date of the riots. The cashier, on being confronted with the faxes, confessed that in order to take advantage of the situation, he had taken out the money and destroyed all the papers in the cashier's office to make it seem as if the cash box had also been broken open and looted. He admitted that there was indeed no damage in the inner account office. This also gave him an opportunity to cover up his earlier embezzlement by destroying all the records.

How then did the investigator guess that something was wrong when all other tests did not indicate so? Partly it was his experience. He had seen a case where an income tax assessee had deliberately taken advantage of a fire in his office to destroy certain records for avoiding disconcerting tax queries. He saw a similar opportunity here for a typical cash fraud. Secondly, it was unlikely that rioters would leave 8.5 lacs in the cash box and destroy each and every document in the office. The normal psychology of any human being would be to take off with money rather than go on rampage where no material gain was likely.

Lessons to be learnt

The case study highlights:

- (a) Disaster and crisis can provide unbelievable opportunity for perpetrating frauds, and
- (b) a fraud can be very easily camouflaged and it is very easy to fall into a trap of believing what one sees.

Thus, in situations of disaster and crisis, the investigator must not fall into the trap of believing and depending only on what is apparent, unless he has eliminated every other possibility. In such situations, he can effectively adopt the principle of 'mistrust the obvious'. He should leave no stone unturned and satisfy himself that all evidence is reliable and, if not, must clearly state in his report the extent of gap or insufficiency in the evidence. The management must be informed of all possible consequences of damage/ loss through such gaps in the evidence.

III. Misuse of a Discount Scheme

This is a case study highlighting the use of the technique of "Investigator's Bluff" to detect misuse of a discount scheme.

Introduction

Investigation goes beyond a mere exercise of examining books and records produced before an investigator. Application of skill and expertise by the investigator is essential to get meaningful and useful results. In this context, inspection, physical verification, or visit to place of manufacturing, trading, marketing or any other place of activity assumes immeasurable importance in collection and gathering of evidence. The following case study highlights the importance of inspection and use of the technique of "Investigator's Bluff".

Facts of the case

A trading concern, dealing in chocolates and sweets and having a chain of retail outlets in all the metro cities, decided to have an incentive scheme to induce shoppers to visit its shops again. The scheme required shoppers to make a purchase of more than ₹ 1,000 to entitle them to get a 10% discount coupon for their next visit. A placard was prominently displayed at each of the shops to advertise the discount scheme. Appropriate internal controls in the form of pre-numbered receipt books and discount coupons were also introduced.

Pursuant to the scheme, sales of all the metros, showed an upswing as expected, except in one city where even after the introduction of the discount scheme, the sales had not increased, though large values of discounts had been availed of the management was intrigued by this and appointed an investigator to look into the matter.

Investigator's approach and plan

The investigator's plan covered examination of the following:

- ◆ Sales
- ◆ Purchases
- ◆ Cash and bank transactions
- ◆ Salaries
- ◆ Journal entries
- ◆ Other books of account

Results and findings

The investigator did not notice anything untoward and the financial statements and the books of account seemed to be in order. The serial numbers controls, cash totals and cash registers appeared to be satisfactory. The investigator then decided to personally visit the concerned metro to look into the matter.

On a personal visit, the first thing he noticed was that the placard regarding the scheme was not displayed. Obviously, shoppers could have had no other way of knowing whether such a scheme was in force unless the cashier was, as a matter of routine, informing shoppers purchasing chocolates worth ₹ 1,000 or more, of the discount entitlement and furnishing discount coupons. He went through all the past discount coupons encashed by customers and found that most of the shoppers who had purchased chocolates and sweets over ₹ 1,000/- had purchased chocolates or sweets worth much more on their next visit. This perhaps was understandable, but even more intriguing was the fact that a lot of shoppers had visited the shop again on the same or the very next day to purchase chocolates. This was certainly unusual because normally chocolates are not 'stocked and a shopper would generally buy his required quantity on the first visit itself. This led the investigator to believe that the discounts claimed were not genuine. However, since the names and addresses of the shoppers were not available, proving any foul play was difficult.

The investigator decided to adopt "Investigator's bluff" technique. He decided to test the scheme by sending a decoy customer who purchased chocolates worth ₹ 2,500. As expected, the customer did not

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get the discount coupon. He was given a receipt of ₹ 2,500, numbered 20026. The spaces relating to information of discount coupon as well as the net payment amount were left blank in the receipt. At the end of the day, the cashier reported his total cash sales for the day and a statement of account coupons issued, which showed that discount coupon number 2113 had been issued against the receipt 20026. The investigator confronted the cashier about the discount coupon, who confessed that he had fraudulently retained the discount coupon himself, explained how he went about encashing such discount coupons, as follows

Step 1: Receipt say 20001 was issued to XYZ for ₹ 2,500/-

Step 2: Daily Cash Receipt and Discount Coupons Statement would disclose: A discount coupon say 2001 issued to the shopper XYZ against Receipt 20001, though the discount coupon 2001 was actually in possession of the cashier himself.

Step 3: When another customer making a purchase of ₹1,500/- did not ask for a cash receipt, the cashier would make out a receipt for ₹ 1,500/- with ₹ 150/- entered in the discount column, and attach coupon 2001 to that receipt as if that customer was XYZ who had returned to purchase chocolates again with the discount receipt 2001.

Step 4: The cashier would pocket ₹ 150/- and put ₹ 1,350/- In the cash box.

In this manner, he had siphoned off an average of almost ₹ 20,000 per week. This would never have come to light if the investigator had not visited the shop and learnt that the discount scheme, infact, had never been in operation at all. This explained why the sales at the concerned metro had not increased even after the introduction of the scheme.

Lessons to be learnt

Very often the conventional procedures applied by the investigator do disclose weaknesses in controls and anomalies in findings. However, these procedures may, at times, fail to discover or bring to light the actual damage done and the nature of deceit or trickery. It is, therefore, essential for an investigator to adopt effective fact-finding techniques to determine whether all policies and control procedures are being implemented or not. That is also why personal inspection, visits and 'walk-through tests' are very meaningful, and where situation so demands, an "investigator's bluff", as shown above, can be used.

IV. Duplicate Documentary Evidence used to Raise False Claims

This is a case study wherein duplicate documentary evidence used to support a payment was detected by an investigator.

Introduction

In spite of various controls in an organisation, it is difficult to rule out the possibility of a payment being made on the basis of a duplicate supporting evidence. It is not easy to lay down a plan applicable in all situations regarding the steps to be taken to prevent such payments. The following case study illustrates this point.

Facts of the case

A Company was spending several lacs of rupees on advertising through hoardings at prominent places in the city. The usual evidence of such an expenditure was in the form of:

- ◆ Agreement with the owner of the hoarding site, specifying the details of the size of the hoarding, the subject matter with a description of the hoarding, location, rate, and the period for which the hoarding was to be kept.
- ◆ Agreement regarding the maintenance of the hoarding, i.e., touching-up and cleaning periodically for removal of dust, erasures due to rain, etc.
- ◆ Photograph of the hoarding.
- ◆ Bill for rent charged by the owner of the site.
- ◆ Certification by an independent agency as regards verification and compliance of the terms and conditions of the agreement with the owner of the hoarding site.

Investigator's approach and plan

1. Compliance with agreement: The investigator verified the compliance of the terms of agreements, as per the checklist prepared by him.
2. Vouching of bills: The bill for rent charged by the site owner was checked to ensure that it was supported by a 'physical inspection report' and photographs.

Results and findings

At a first glance, the evidence stated above appeared to be sufficient. There was nothing in the inspection report to suggest any non-compliance of any of the terms of the agreement. However, one small detail in the photograph attached to the bill caught the investigator's attention. The photograph showed the hoarding next to a small poster of a film running at a particular cinema hall. He knew that particular cinema hall had been demolished well over a year ago. Just to satisfy himself, the investigator asked for the previous year's file and on examining it he found that the photographs of the hoardings attached were duplicates of those in the previous year. The investigator notified the management and suggested that a physical verification be carried out immediately to ascertain whether the hoarding was satisfactorily displayed at the site. An independent check was carried out and the results were startling. Not only had the company's hoarding been removed from its designated place on the date of verification, but its competitor was given the hoarding site for which the rent was being collected from the company. On making further inquiries with local residents, it was learnt that the hoarding of the company had been removed many months ago. The company took legal action against the owner of the hoarding site and the agency, which was responsible for carrying out the physical inspection.

Lessons to be learnt

It is necessary to minutely examine the evidence particularly where the investigator is dependent on another agency for physical inspection or verification. In this case though there was no real necessity for the investigator to call for the previous year's records, yet, on a suspicion as mentioned above, he called for the previous year's photographs and a comparison provided the clue as to the possibility of existence of a foul play. Keen examination of photographs revealed that they were identical and thus,

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the investigator decided to launch a further inquiry and on physical inspection at the site, the actual fraud came to light. Therefore, it is advisable that, in all areas requiring physical verification or inspection, the investigators must include in their checklist, comparison with previous periods' records. For example:

1. Physical verification of investments and comparison with investments which existed in the previous period will disclose bonus shares received or investments stolen or lost.
2. Stock verification statements compared with those related to previous period will indicate the comparative status of old, damaged, unserviceable and obsolete stocks.
3. Similar procedures will be applicable to all assets of the-client lying with third parties.
4. Physical verification or inspection is also likely to enable an investigator to verify the reasonableness and sanctity of expenses incurred.