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Investigation and Due Diligence

Question 1

What will be your approach in investigation under Section 235 and 237 into the affairs of the company registered under Companies Act, 1956? (4 Marks, May, 2014)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 2

M Limited is going to acquire S Limited. The purchase consideration has been decided at ₹ 4000 Crores. M Limited is worried about hidden liabilities or overvalued assets of S Limited and approached you to examine the same.

List out eight important transactions/items which you would like to investigate in the Due Diligence exercise. (4 Marks, November, 2013)

Or

Z Ltd is intending to acquire A Ltd. It hires B & Co., a firm of Chartered Accountants to conduct a due diligence. B & Co., wants to reduce the risk of over valuation of assets in its due diligence exercise. Kindly guide B & Co. (8 Marks, May, 2012)

Or

Your client is contemplating taking over a manufacturing concern and desires that in the course of due diligence review, you should specifically look for hidden liabilities and over valued assets, if any. State in brief the major areas you would examine for the above.

(5 Marks, November, 2010) (8 Marks, November, 2005)

Answer

Major Areas to Examine in Course of Due Diligence Review: Due diligence is an all pervasive exercise to review all important aspects like financial, legal, commercial, etc. before taking any final decision in the matter. As far as any hidden liabilities or overvalued assets are concerned, this shall form part of such a review of Financial Statements. Normally, cases of hidden liabilities and overvalued assets are not apparent from books of accounts and financial statements. Review of financial statements does not involve examination from the view point of extraordinary items, analysis of significant deviations, etc.

However, in order to investigate hidden liabilities or over-valued assets the auditor should pay his attention to the following areas:

Important transactions/ items which need to be investigated in the due diligence exercise are-

Items of Hidden Liabilities:

- The company may not show any show cause notices which have not matured into demands, as contingent liabilities. These may be material and important.
- The company may have given "Letters of Comfort" to 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.

Items of Over-Valued Assets:

- Uncollected/uncollectable receivables.
- Obsolete, slow non-moving inventories or inventories valued above NRV; huge inventories of packing materials etc. with name of company.
- Underused or obsolete Plant and Machinery and their spares; asset values which have been impaired due to sudden fall in market value etc.
- Assets carried at much more than current market value due to capitalization of expenditure/foreign exchange fluctuation, or capitalization of expenditure mainly in the nature of revenue.
- Litigated assets and property.
- Investments carried at cost though realizable value is much lower.
- Investments carrying a very low rate of income / return.

- Infructuous project expenditure/deferred revenue expenditure etc.
- Group Company balances under reconciliation etc.
- Intangibles of no value.

Question 3

J Ltd is interested in acquiring S Ltd. The valuation of S Ltd is dependent on future maintainable sales. As the person entrusted to value S Ltd what factors would you consider in assessing the future maintainable turnover? (4 Marks, May, 2013)

Answer

Factors to be Considered in Assessing Future Maintainable 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?

Question 4

You have been appointed to investigate a suspected embezzlement of cash receipts in a departmental store. What are the steps you would take in this regard?

(6 Marks, November, 2013)

Answer

Investigation of Suspected Embezzlement of Cash Receipts: While doing investigation of suspected embezzlement of cash receipts of a departmental store, we would like to take below mentioned steps-

(i) Before proceeding to investigate a suspected embezzlement, 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.

(ii) He should also examine the line of responsibility between the various members of the staff.

(iii) 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.

(iv) On the assumption that cash may have been diverted before being entered in the books, evidence as regards income received from different sources should be scrutinised, e.g., inventory, sales summaries, rental registers, correspondence with customers, advices of travelling salesmen and counterfoils or receipts.

(v) Carbon copies of receipts marked 'duplicate', should be scrutinised to confirm that they are in fact copies of receipts issued earlier.

(vi) 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.

(vii) 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.

(viii) 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.

(ix) All withdrawals from the bank should be checked by reference to corresponding entries in the bank pass book.

Question 5

What are the areas in which Due Diligence can take place ? *(5 Marks, May, 2008)*

Answer

Areas in which Due Diligence can take place:

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

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

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

(iv) Information systems due diligence: It pertains to all computer systems and related matter of the entity.

(v) Legal due diligence: This may be required where legal aspects of functioning of the entity are reviewed. For example, the legal aspects of property owned by the entity or compliance with various statutory requirements under various laws.

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

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

Question 6

What are the important aspects to be looked into a due diligence review of Cash flow?

(8 Marks, November, 2007)

Answer

Due Diligence Review of Cash Flow:

(i) Review the historical pattern of cash flows of the organization and look for change in trends.

(ii) See whether the company is able to meet its cash requirements from internal generations/accruals or does it seek outside sources from time to time.

(iii) Check whether the company honours its commitments to trade payables, Government and other stock holders.

(iv) Verify the ability of the company to turn its inventory into trade receivables i.e sale ability of its products.

(v) Ensure that the company follows up with trade receivables and that the trade receivables collection period is not very large.

(vi) Check the ability of the company to deploy its funds in profitable investment opportunities.

(vii) Look into the investment pattern of the company, whether they give maximum benefits to the company and are easily realizable.

Question 7

In a Company, it is suspected that there has been an embezzlement in cash receipts. As an investigator, what are the areas that you would verify? *(8 Marks, November, 2007)*

Answer

Embezzlement in Cash Receipts: The following areas need to be verified in this regard-

(i) Issuing a receipt for full amount collected, entering only a lesser 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 goods returned.

(iv) Cash sales entered as credit sales with debit to customer.

(v) Writing off a good debt as bad and irrecoverable to cover up misappropriation of amount collected.

(vi) Short-debiting customer's ledger account and withdrawing the difference on collection of full amount.

(vii) Under-casting the receipts side of cash book; carrying over a shorter total of the receipts from one page of the cash book to the next so as to cover up short banking misappropriated.

(viii) Over-casting the payment side of the cash book; over-carrying the total of the payments from one page of the cash book to the next so as to cover up misappropriation of a part of the amount withdrawn from the bank.

Question 8

Outline the contents of a due diligence report. *(8 Marks, May, 2007)*

Answer

Contents of a Due Diligence Report: The Contents of a due diligence report vary with individual cases but the following can be illustrative headings-

(i) Executive summary.

(ii) Introduction.

(iii) Background of target.

(iv) Objective of due diligence.

(v) Terms of reference and scope of verification.

(vi) Brief history of the company.

(vii) Summary on capital structure and group structure of company.

(viii) Shareholding pattern.

(ix) Observations on the review.

(x) Assessment of Management structure.

(xi) Assessment of financial liabilities.

(xii) Assessment of valuation of assets.

(xiii) Comments on properties, terms of leases, lien and encumbrances.

(xiv) Assessment of operating results.

(xv) Assessment of taxation and statutory liabilities.

(xvi) Assessment of possible liabilities on account of litigation.

(xvii) Assessment of net worth.

(xviii) Any liabilities not provided for in the books.

(xix) SWOT analysis comments on future projections.

(xx) Status on charges, liens, mortgages and assets of the company.

(xxi) Ways and means to cover unforeseen contingent liabilities.

(xxii) Aspects to be taken care of before/after merger.

(xxiii) Interlocking investments and financial obligations with group/associate companies amounts receivable subject to litigation.

Question 9

A company engaged in manufacturing of chemicals is consistently recording higher sales turnover, but declining net profits since the last 5 years. As an investigator appointed to find out the reasons for the same, what are the points you would verify? (8 Marks, May, 2006)

Answer

Decline in Net Profits Despite Increasing Sales: As per the facts that there has been consistently high turnover but declining net profits is an anomalous situation. It may be attributed to one or more following reasons requiring further investigation-

(i) Unfavourable Salesmix: Where the company sells different chemical products with different product margins, the product with the maximum PV ratio/margin should have a higher share in the total sales. If due to revision of salesmix, more quantities of unprofitable products are sold, profits will be reduced inspite of an increase in sales.

(ii) Negative Impact of Financial Leverage: Where the company does not have sufficient own funds (equity) but has a higher debt-equity ratio, the interest commitments will be higher. As the volume of its operation increases, higher debt and interest charges would result in lower profits.

(iii) Other Items Included in Sales: The figure of sales as per Statement of Profit and Loss may include incidental revenues, e.g., freight, excise duty, sales-tax, etc. where the amount of excise duty goes up considerably the total sales may show an increase which is not represented by a real increase in sales quantity/value.

(iv) High Administrative and Selling Expenses: Administrative and selling costs are generally period costs which are fixed in nature. Their increase is generally not proportional to sale increase. However, a reduction in profit could also be due to increase in administrative overheads and sales overheads at a rate higher than the rate of increase in sales.

(v) Cost-Price Relationship: If the increases in cost of raw materials and labour has not been compensated by a corresponding increase in the sales price this would also result in higher sales and declining profits. Inspite of same sales quantity, for the increasing cost of raw materials and other services, per unit values of the product has been increased which is however unmatched by the increase in cost.

(vi) Competitive Price: Where sales have been made at cut-throat prices in order to eliminate competition from the market, the profits would be in the declining trend in the short-run.

(vii) Additions to Fixed Assets: Where there are heavy additions to fixed assets and consequent depreciation charges in the initial years of additions, there may be reduction in profits in spite of increased sales.

Question 10

Write a short note on Audit vs. Investigation. *(4 Marks, November, 2004)*

Answer

Audit vs. Investigation: As Per SA 200 "Overall Objectives of the Independent Auditor and the conduct of an audit in accordance with standards on auditing". The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

For auditing on the other hand, the general objective is to find out whether the financial statements show true and fair view. The auditor seeks to report what he finds in the normal course of examination of the accounts adopting generally followed techniques unless circumstances call for a special probe. As per sub section 12 of section 143 of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure. Fraud, error, irregularity, whatever comes to the auditor's notice in the usual course of checking, are all looked into in depth and sometimes investigation results from the prima facie findings of the auditor.

Investigation implies systematic, critical and special examination of the records of a business for a specific purpose. The examination conducted under investigation is intensive as well as exhaustive so far as the activities or areas of accounting is concerned. Investigation requires a concentrated focus on the subject matter of inquiry and related matters. Often, investigations may spread over a period longer than one year and its scope may extend to inquiry beyond the books of accounts if the circumstances so require.

For example if fraud is suspected and an accountant is called upon to check the accounts to whether fraud really exists and if so, the amount involved, the character of the enquiry changes into investigation. Investigation may be undertaken in numerous areas of accounts, e.g., the extent of waste and loss, profitability, cost of production etc. It extends scope beyond books of accounts.

Etymologically, auditing and investigation are largely overlapping concepts because auditing is nothing but an investigation used in a broad sense. Both auditing and investigation are fact finding techniques but their basic nature and objectives differ as regards scope, frequency, basis, thrust, depth and conclusiveness. Audit and investigation differ in objectives and in their nature. Auditing is general while investigation is specific.

Question 11

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

(8 Marks, May, 2004)

Answer

Areas to be Covered in Investigation: Following are the areas which shall be covered under investigation while proposing to buy a proprietary business-

Studying the overall picture: The first and foremost important aspect in any business investigation is to have an overall picture of the position of the business which is being investigated before the details are gone into. 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. For studying the economic and financial position of the business, the following should be considered-

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

(ii) What will be the trend of the sales and profits in the future? The success of a business in the future would depend on the position enjoyed by it in the past in relation to its competitors. A business may be successful because it enjoys a monopoly. In such a case, the possibility of emergence of competition must be examined. This may be ascertained on the basis of the trend in market share of the product and the licensing policy followed by the government. 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?

From the accountant's view point, the following specific areas need to be looked into:

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

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.

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

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. 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.

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

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

Apart from the above areas, the other factors relating to the management, skilled labour, etc. may also be covered in the investigation.