

Investigations and Due Diligence

Question 1

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

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

Answer

A due diligence audit on behalf of C Ltd. with a view to acquiring the business shall involve following steps:

- (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 have 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
- (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 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.

- (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. Generally taxes are levied both by the Central Government as well as by the State Government. Further taxes may be direct or indirect. Most of the tax laws require the enterprise to register itself with the government and it is important to check if all necessary registrations have been made. 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 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 the Indian context, the status of work force, staff and employees and their demands is a complex problem. 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.

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.

In addition to the above steps, the following further points have to be seen:

- (i) Reason for sale of business and the effect on turnover and profits due to the exist of the present proprietor.
- (ii) The length of the lease under which business has been operating.
- (iii) The unexpired period of patents if any held by the vendors.
- (iv) The age of managerial staff and prospects of their continuing in service in the new environment; the effect of trained managerial staff learning the organisation in

production/sales/administrative and the financial liability to pay terminal benefits/compensation, etc.

- (v) If bulk sales are to a few limited customers, the profitability should be discounted greatly, because any substantial withdrawal of customers might cause business crashes.
- (vi) A company with a sound financial structure can better withstand the stresses and strains of business. A low debt-equity ratio would indicate an ability to grow through debt financing without raising equity.
- (vii) The cash generated from operations; the need for redeployment of resources and funds needed for repayment of loans become major factors in determining growth potential.
- (viii) The valuation of goodwill if any should be on reasonable basis having regards to all factors mentioned above.

Question 2

An American Company engaged in the business of manufacturing and distribution of industrial gases, is interested in acquiring a listed Indian Company having a market share of more than 65% of the industrial gas business in India, request you to conduct a "Due Diligence" of this Indian Company and submit your Report. As due Diligence Auditor, what key areas you will cover in your review? List out the contents of your Due Diligence Review Report that you will submit to your USA based Client.

Answer

Due Diligence – Key Areas: The American company engaged in the business of manufacturing and distribution of industrial gases wishing to acquire a listed Indian company has commissioned the Due Diligence Audit to assess the strengths and weaknesses of this company. It is quite important for the acquirer to assess the proposal from different angles and specifically as per terms of the assignment and also see 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. In any case, it is quite important 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. Some of the significant key areas which shall be covered under the review are as under:

- (1) **Historical Background:** 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 have to be gone into, before verification of financial data in detail. An eye into the history of the company may reveal its turning points, survival strategies adopted from time to time, the market share enjoyed by 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 said company. This could, inter alia, include the nature of business(es), location of production facilities, warehouses, offices, products or services and markets.
- (2) **Significant Accounting Policies:** The accounting policies being followed by the company and the appropriateness thereof is another key area. The impact of the recent changes in the accounting policies in the recent past keeping in view its intention of offering itself for sale. The accountant has to look at the main effect of accounting policies on the overall profitability and their correctness. It is also quite important to ascertain significant accounting policies used by the company, that changes that have been made to the accounting policies in the recent past, the areas in which accounting policies followed by the company are different from those adopted by the acquiring enterprise and the effect of such differences. Finally, examine whether the financial statements of the company have been prepared in accordance with the governing statutory requirements.
- (3) **Review of Financial Statements:** An evaluation of the profit reported by the company would be largely based upon its operating results. Any extraordinary item of income or expense that might have affected the operating results would require close examination. It is advisable to compare the actual figures with the budgeted figures for the period under review and those of the previous accounting period. It is important that the trading results for the past four to five years are compared and the trend of normal operating profit arrived at. The normal operating profits should further be benchmarked against other similar companies. Besides the above, and based on the trend of operating results, the accountant has to advise the acquiring enterprise, through due diligence report, on the indicative valuation of the business. The exercise to evaluate the balance sheet of the 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.
- (4) **Cash Flow:** A review of historical cash flows and their pattern would reflect the cash generating abilities of the 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:

- (a) Whether the company is 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; and
 - (d) Whether any funds are lying idle or is the company able to reap maximum benefits out of the available funds.
- (5) **Financial Projections:** The projections for the next five years with detailed assumptions and workings and 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 company are unrealistic, the accountant should consider its impact on the overall valuation of the company.
- (6) **Human Resources:** In the Indian context, the status of work force, staff and employees is a complex problem. 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. The aspects whether all employee benefits like PF, Gratuity, ESI and superannuation have been properly paid/funded. The pay packages of the key employees will be thoroughly reviewed since this can be a crucial factor in future employee costs.
- (7) **Statutory Compliance:** This is one area that has to be examined in detail. It is important 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. The impact on such violations be quantified and assessed in respect of entity; financial status and even on its governing concern status.

Contents of a Due Diligence Report: Briefly, the contents of a due diligence report can be discussed under:

- ◆ Terms of reference and scope of verification
- ◆ Objective of due diligence
- ◆ Brief history of the company including shareholding pattern
- ◆ Assessment of management structure
- ◆ Assessment of financial liabilities with special emphasis on 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.
- ◆ Assessment of valuation of assets including comments on properties, terms of leases, lien and encumbrances including status of charges, liens, mortgages, assets and properties of the company.

- ◆ Assessment of operating results
- ◆ Assessment of taxation and statutory liabilities
- ◆ Assessment of possible liabilities on account of litigation and legal proceedings against the company and suggestion on ways and means including affidavits, indemnities, to be executed to cover unforeseen and undetected contingent liabilities.
- ◆ Assessment of net worth.
- ◆ Suggestions on various aspects to be taken care of before and after the proposed merger / acquisition.
- ◆ Status of franchises, license and patents.

Finally, an executive summary may be prepared highlighting the significant areas.

Question 3

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

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

Answer

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

- (i) The purpose for which the loan is required and the manner in which the borrower proposes to invest the amount of the loan.
- (ii) The schedule of repayment of loan submitted by the borrower, particularly the assumptions made therein as regards amounts of profits that will be earned in cash and the amount of cash that would be available for the repayment of loan to confirm that they are reasonable and valid in the circumstances of the case. Institutional lenders now-a-days rely more for 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 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.
- (j) **The impact on economic position of the company by economic, political and social changes** those are likely to take place during the period of loan.

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.

Question 4

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

Answer

Steps involved while conducting 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.

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

Question 5

Write a short note on - Audit and Investigation.

Answer

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. The object of auditing is to ensure that the financial statements are free and fair not misleading or unreliable. The merit of auditing lies in its ability to pronounce in general terms whether the accounts are basically reliable or not and in accordance with the legal requirements and regulations applicable to the particular audit. Audit is not based on suspicion unless circumstances exist to arouse suspicion 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 be 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.

Basis of Difference	Investigation	Audit
(i) Objective	An investigation aims at establishing a fact or a happening or at assessing a particular situation.	The main objective of an audit is to verify whether the financial statements display a true and fair view of the state of affairs and the working results of an entity.
(ii) Scope	The scope of investigation may be governed by statute or it may be non- statutory.	The scope of audit is wide and in case of statutory audit the scope of work is determined by the provisions of relevant law.
(iii) Periodicity	The work is not limited by rigid time frame. It may cover several years, as the outcome of the same is not certain.	The audit is carried on either quarterly, half-yearly or yearly.
(iv) Nature	Requires a detailed study and examination of facts and figures.	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.

Question 6

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.

Answer

Areas to covered in investigation as an investigating accountant:

- (a) 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:

- (b) **Profit and Loss Account:** To study the Profit and Loss Account of a concern and 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 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 centered 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 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.

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. 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.

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 under mentioned factors:

- (i) the amount required for the replacement of assets when these would become worn out or obsolete;
- (ii) the expenditure which will be necessary to replace obsolete machinery by more sophisticated machinery for manufacturing different types of goods for which there is demand.

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

- (i) **Trend:** Whether in the past sales have been increasing consistently or they have been fluctuating. A proper study of this phenomenon should be made.
- (ii) **Marketability:** Is it possible to extend the sales into new markets or that these have been fully exploited? Product wise estimation should be made.
- (iii) **Political and economic considerations:** Are the policies pursued by the Government likely to promote the extension of the market for goods to other countries? Whether the sales in the home market are likely to increase or decrease as a result of various emerging economic trends?

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

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

- (i) Has the ratio of 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.

Question 7

Your client is contemplating taking over a manufacturing concern and desires that in the course of due diligence review, you should look specifically for any hidden liabilities and overvalued assets.

State (in brief) the major areas you would examine for the above.

Answer

Major areas to examine in course of Due Diligence Review

'Due Diligence' is a term that is often heard in the corporate world these days in relation to corporate restructuring. The purpose of due diligence is to assist the purchaser or the investor in finding out all he can, reasonably 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.

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 the auditor should pay his attention to the following areas:

- ◆ 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.
- ◆ Contingent liabilities not shown in books.

Regularly Overvalued Assets:

The auditor shall have to specifically examine the following areas:

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

Question 8

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?

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 Sales mix:** 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 sales mix, more quantities of unprofitable products are sold, profits will be reduced in spite 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 Profit and Loss Account 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. In spite 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 9

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

Answer

The following areas need to be verified in this regard:

- (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.

Question 10

What are the areas in which Due Diligence can take place?

Answer

Areas in which Due Diligence can take place -

1. **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.
2. **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.
3. **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.
4. **Information systems due diligence:** It pertains to all computer systems and related matter of the entity.
5. **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.
6. **Environmental due diligence:** It is carried out in order to study the entity's environment, its flexibility and adaptiveness to the acquirer entity.
7. **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 11

Write short note on Frauds through supplier ledger.

Answer

Frauds through suppliers ledger: Fraud through supplies ledger could be made in any of the following ways, which the auditor has to take case of:

- (1) Adjusting fictitious as duplicate invoices as purchases in the accounts of suppliers and subsequently misappropriating the money when payments are made in respect of these invoices.
- (2) Suppressing credit notes issued by suppliers and withdrawing the corresponding amount not claimed by them.
- (3) Withdrawing amounts which remain unclaimed for more than the normal time limit for one reason or other by showing the same have been paid to the parties.
- (4) Accepting invoices at prices considerably highest than the market price and collecting the excess claim from the suppliers directly.

Question 12

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.

Answer

Due Diligence Exercise in case of Overvalued Assets: 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 overvalued assets are concerned, this shall form part of such a review. Normally, overvalued assets are not apparent from books of accounts and financial statements. Review of financial statements does involve examination from the view point of extraordinary items, analysis of significant deviations, etc. However, in order to reduce the risk of over valuation of assets, the auditor should pay his attention to the following areas:

Overvalued assets: The auditor shall have to specifically examine the following areas:

1. Uncollected/uncollectable receivables
2. Obsolete, slow non-moving inventories or inventories valued above NRV; huge inventories of packing materials etc. with the name of company.
3. Underused or obsolete Plant and Machinery and their spares; asset values which have been impaired due to sudden fall in market value etc.
4. 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
5. Litigated assets and property
6. Investments carried at cost though realizable value is much lower
7. Investments carrying a very low rate of income / return
8. Infertuous project expenditure/deferred revenue expenditure etc.
9. Group Company balances under reconciliation etc.
10. Intangibles of no value

Question 13

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?

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., stock, 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 14

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 ?

Answer

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?*