

20. Investigation and Due Diligence

Important Point of this chapter

1.

Introduction

The term investigation implies a systematic and in-depth examination or inquiry to establish a fact or to evaluate a specific situation. The term investigation may be defined as an examination of books and records preliminary to financing or for any other specified purpose, sometimes differing in scope from the ordinary audit, thus investigation covers areas of financing decisions, investment decisions, fraud or profitability determination or cost determination etc.

Audit versus Investigation

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

(Detail difference in practice manual)

Steps in investigation

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

1. Determination of objectives and establishment of scope of investigation

- ✓ At the stage of acceptance of the assignment, the investigator should be absolutely clear about what is sought to be achieved by the investigation.
- ✓ The period which the investigation should cover should be clearly specified.
- ✓ The purpose of the investigation should be borne in mind while deterring the period which an investigation should cover.

2. Formulation of the investigation programmed

- ✓ The investigation programme should be drawn up having regard to the nature of the business, the structure of business, the instructions from the client embodying the objectives, the consequent scope and depth and the necessity to investigation into books and records belonging to others.
- ✓ In programming the verification, the investigator should concentrate on areas considered relevant rather than to undertake wide-ranging verification.
- ✓ Matters not found to have a bearing n the subject matter of investigation should be gradually and progressively eliminated. This procedure alone will enable an in-depth examination of the matters relevant to the investigation.

3. Collection of evidence

- ✓ Through examination, the investigator would be gathering relevant evidence connected with the matters to be investigated. In the course of examination of the documents and records, the investigator may require to obtain oral explanation from various personnel of the concerned business.
- ✓ He should examine if and if circumstances demand should try to obtain evidence that may have to be specifically procured.

4. Analysis and interpretation of findings

- ✓ Careful analysis and correlation of facts and figures should be necessary before the investigator can reach his conclusion. The conclusion should be well reasoned and backed by established facts and data.
- ✓ While interpreting the figures, the investigator must keep in mind various factors e.g. political and economic considerations, competition faced by the business, historical pattern of the data, nature of the business, etc.

5. Reporting of findings

- ✓ The nature of the report is governed mainly by two factors. First, the instruction given by the client as regards the special aspects of the business which are required to be investigated; and second, the findings of the investigating accountant.
- ✓ The important issues to be kept in mind by the investigator while preparing his report are as follows:
 - i. The report should not contain anything which is not relevant either to highlight the nature of the investigation or final outcome thereof.
 - ii. Every word or expression used should be properly considered so that the possibility of arriving at a different meaning or interpretation other than the one intended by the investigator can be minimized.
 - iii. Relevant factors and conclusions should be properly linked.
 - iv. Bases and assumptions should be explicitly stated. Reasonableness of the bases and assumptions should be well examined and care should be taken to see that none of the bases and assumptions can be considered to be in conflict with the objective of the investigation.
 - v. The report should clearly spell out the nature and objective of the assignment accepted its scope and limitation, if any.
 - vi. The report should be made in paragraph form with heading for the paragraphs.
 - vii. The report should also state restrictions and limitations, if any, imposed on the instructions given by the client.
 - viii. The opinion of the investigator should appear in the final paragraph of the report.

Special Issues in Investigation

- a. Whether an investigator is required to undertake a cent per cent verification approach or whether he can adopt selective verification.
 - ✓ The answer is depends on the exact circumstances of the case under investigation.
- b. Whether the investigator can put reliance on the already audited statement of account
 - ✓ Here also no dogmatic views are possible, if the investigation has been launched because of some doubt in the audited statement of account, no question of reliance on the audited statements of account arises.
 - ✓ If any other purpose than he can rely audited statement after due verification about audit procedure conducted and appointment of auditor is valid or not.
- c. Whether an investigation necessarily requires assistance of expert
 - ✓ If he require assistance than, proper for the investigator to get the written general consent of his client, to refer special matters for views of different experts; at the beginning it and he should settle the questions of costs for obtaining the views and other related implications.

- d. Investigation out of disputed and conflicting claims
 - ✓ It is needless to emphasis that the investigator should remain above disputes or conflicting claims and be alert to the possibilities of the information or documents made available to him to be prejudiced.
- e. Basis of opinion of an investor
 - ✓ The investigator should retrain from issuing speculative opinion. He should confine his opinion to the established facts and nothing more.
- f. Whether investigator can make futuristic statements
 - ✓ The investigator should refuse to be futuristic.
 - ✓ He may assume that the established trend in the business will continue in the near future, in the absence of any contrary evidence, in arriving at the present value of business. He however, should not project the trend into any future years to establish a value.
- g. Whether to retain working papers or not
 - ✓ Yes he can keep working paper for better opinion

Special aspects in connection with business investigation

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

a. Studying the overall picture

- ✓ In such a business investigation, it is of utmost importance first to have an overall picture of the position of the business which is being investigated before the details are gone into.
- ✓ Nature of business must be known for better investigation, i.e., whether business connected with manufacturing or only retailing.
- ✓ Apart from above preliminary examination, he should also study,
 - i. The character of the management
 - ii. The economic and political forces to which the business is subject; and
 - iii. The position he enjoys in trade.
- ✓ 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?
 - iii. Whether the profit which the business could be expected to maintain in the future would yield an adequate return on the capital employed?

b. Profit and loss account

- ✓ To study P & L of a concern, it is necessary to consider each item, included therein, in relation to the corresponding items in the P & L statement of the previous years. It is therefore, necessary that a summary, in a columnar form should be prepared of the balances included in the P & L statement of the business for a period of say 5 to 7 years.
- ✓ For preparing the summary attention should be paid to the following matters:
 - i. *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.
- Further check the customer list for verify whether large turnover with a few customer or small turnover with several customers.
- 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.

ii. Wage structures

- The method of computing wages and rates of wage should be examined.
- Another factor which is important to consider in this connection is relationship of the business with its workers. A business which 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 worker's unions.

iii. Depreciation

iv. Managerial remuneration

v. Exceptional and non-recurring items

vi. Repairs and maintenance

vii. 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.
- But if the same is fluctuation, there would be more demand on judgement of the accountant in selecting the period to be covered for estimation of profitability.

c. Balance sheet

- ✓ Fixed assets
- ✓ Investments
- ✓ Stock and work-in-progress
- ✓ Other liquid assets
- ✓ Idle assets
- ✓ Liabilities
- ✓ Taxation
- ✓ Capital

d. Interpretation of figures

- ✓ Fixed assets
 - 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

- i. Trend
- ii. Marketability
- iii. Political and economical condition
- iv. Competition
- ✓ Working capital
 - 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

Types of Investigation

Statutory	Non-Statutory
1. Investigation into the affairs of the company 2. Investigation of ownership of a company For this Section 235 to 251 of the companies act, 1956 is used.	1. On behalf of an incoming partner 2. For valuation of shares in private companies 3. On behalf of a bank proposing to advocate loan to a company 4. Investigation of frauds 5. On behalf of an individual or firm proposing to buy a business. 6. In connection with review of profit/financial forecast

A. Investigation into affairs of the company

For following situation, the CG may appoint one or more competent persons as inspector to investigate the affairs of a company.

1. According to section 235(1) the company fails to supply information or explanation to registrar.
 2. If in the opinion of the CG or that of CLB, national company law tribunal, there are circumstance suggesting:
 - a. That the business of the company is being conducted with intent to defraud its creditors, members or any other person
 - b. That the persons concerned with the formation and with management of company of its affairs have in connection herewith been guilty or fraud.
 - c. That the members of the company have not been given all information rating to commission and remuneration of manager.
- Investigation into the affairs of related companies and other - Section 239 of the companies act 1956 provides that an inspector can also with the prior approval of CG in appropriate cases, and if he thinks fir essential, investigate the affairs of the following corporate and other:
- a. Any other body corporate which is or has at any relevant time been the subsidiary of the company under investigation or holding company or subsidiary of its holding company or a holding company of its subsidiary.
 - b. Any other body corporate which is, or has at ay relent time been managed by any person as director or as manager, who is, or was, at the relevant time, the MD or the manager of the company.

- c. Any person who is or has at any relent time been the company's MD or manager.
- The objective of these investigations, fundamentally is to determine whether any provision of the act has been violated or there has been a breach of duty on the part of a director or an officer of the company resulting in a loss to shareholder or a class of them.
- **Inspector's Report:** U/s 241 of the companies Act, 1956, the inspector has to make interim and the final report to the CG.

Investigation for valuation of shares of a private company

- The **necessity** for valuation of shares of a private company arises, for under the companies Act, a private company must restrict the transfer of shares. In consequences, the shares of a private company do not have a free market in which the prices could be determined by interaction of the forces of supply and demand.
- The value can be calculated by the two method which are as follows:
 - ✓ Net worth basis
 - ✓ Yield basis

Investigation of frauds

The various situation in which money may be embezzled and the various forms that such frauds usually take include the following:

1. Cash receipts

The amount or amounts of receipts embezzled may be subsequently covered up by the perpetrator adopting one or other of the under mentioned devices:

- ✓ Issuing a receipt to the payee for the full amount collected and entering only a part of the amount on the counterfoil.
- ✓ Showing a larger cash discount than actually allowed
- ✓ Adjustment of a fictitious credit in the account of a customer for the value of goods returned by him.
- ✓ Adjusting a cash sale as credit sale, and raising a debit in the account of the customer
- ✓ Writing off a good debt as bad and irrecoverable to cover up the amount collected which has been misappropriated.
- ✓ 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.
- ✓ Under casting the receipts side of payment of the cash book or over-casting the payment side.

Steps to investigate such frauds:

- ✓ On the assumption that some of these may have been diverted before being entered in the books, evidence as regards income received from different sources should be scrutinised.
- ✓ In addition, by recalling pay-in-slips from bank the details of cash deposited on each day should be compared with those shown in cash-book.
- ✓ Cash sales should be vouched in detail.
- ✓ Temporary cash income should be compared with actual circumstances.
- ✓ 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.

2. Inflating cash payments

- ✓ Making double payment of an invoice or paying a false invoice.
- ✓ Paying personal expenses out of the business by falsifying details.
- ✓ Withdrawing unclaimed credit balances of customers or amounts falsely credited in the accounts of parties.
- ✓ Falsely adjusting a refund in the account of a customer and withdrawing the credit balance.
- ✓ Wrong totalling of the wage sheet and misappropriating the excess amount withdrawn from the bank for payment of wages.

Steps to investigate such fraud

- ✓ All the evidences as regards cash payments made including acknowledgement by parties for payment shown to have been made to them, should be carefully scrutinised.
- ✓ All payment made by bearer cheque should be examined.
- ✓ The system or recording of wages should be reviewed, especially as regards possible over-totalling of wage sheets, and entries in them of dummy work man.
- ✓ Confirmation should be obtained from partners or directors in respect of amounts shown to have been paid to them.

3. Frauds through suppliers' ledger

- ✓ Adjusting fictitious or duplicate invoices as purchases in the account of suppliers and subsequently misappropriating the amounts when payments are made to the suppliers in respect of these invoices.
- ✓ Suppressing the credit notes issued by suppliers and withdrawing the corresponding amounts not claimed by them.
- ✓ Withdrawing amounts unclaimed by suppliers, for one reason or another by showing that the same have been paid to them
- ✓ Accepting purchases invoices at prices considerably higher than their market prices and collecting the excess amount, paid in cash, from the suppliers

Steps to investigate such frauds

- ✓ Special attention should be paid to allowances adjusted on account of goods returned or difference in price or any other account as well as to amount written off as bad debts.
- ✓ Obtain confirmation of accounts from supplier.
- ✓ Reconciliation made if necessary.

4. Customer's ledger

- ✓ By the 'teeming and lading' method, i.e., misappropriating the amount collected from a customer and crediting his account by the amount paid by him only when an amount is subsequently collected from another customer; repeating this practice with several items collected and depositing back the amount or amounts so misappropriated before the close of the year.
- ✓ Misappropriating the amount collected from a customer and subsequently its charge as excess price charges.
- ✓ Crediting the amount received from a customer to the account of another customer and subsequently withdrawing the amount wrongly credited.

Steps to detect such fraud

- ✓ Special attention should be paid to allowances adjusted on account of goods returned or difference in price or any other account as well as to amount written off as bad debts.
- ✓ Obtain confirmation of accounts from supplier.
- ✓ Reconciliation made if necessary.

5. Stock Frauds

- ✓ Employees may simply remove goods from the premises
- ✓ Theft of goods may be concealed by writing of them off as damaged goods, etc.
- ✓ Stock records may be manipulated by employees who have committed theft so that book quantities tally with the actual quantities of stocks in hand.

Investigation on behalf of an individual or firm proposing to buy a business

Scope: the objective of such an investigation is to collect such information as would enable the purchaser to decide whether it is worth while to buy the business and is so, for what amount.

a. In cash of proprietary concerns or partnerships

- ✓ Reasons for sale of the business and effect on turnover and profits that there would be on retirement of the present owner.
- ✓ The length of lease under which the premises are held; the prospects of its renewal or extension.
- ✓ The unexpired period of patents owned by the vendors.
- ✓ The age of managerial staff.
- ✓ If the bulk sales are made to small number customers than profitability may be greatly shaken on withdrawing their support.
- ✓ The valuation that could be placed on goodwill to determine whether that appraising in the book is less or more; if none is included to determine the amount that should be included, if at all.

b. If the business belongs to a limited company

- ✓ The authorised and issued capital of the company.
- ✓ Whether there is any uncalled liability on the shares.
- ✓ If the capital is divided into different class of shares – the rights that are attached to each class.
- ✓ Particulars of dividends paid in the past and the amounts thereof which are in arrear.
- ✓ If there are any mortgages created on the assets appearing in the company's books, a search should be made in the register of the charges in the office of the ROC.
- ✓ The price at which the shares have been offered.

Due Diligence

Due diligence required to be performed in case of venture capital financing, lending, leveraged buyouts, public offerings, disinvestment, corporatisation etc.

Purpose

The purpose of DD is to assist the purchaser or the investor in finding out all he reasonably can about the business he is acquiring or investing in prior to completion of the transaction including its critical success factors as well as its strength and weaknesses.

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

- ✓ Commercial or operational due diligence
- ✓ Financial Due diligence
- ✓ Tax due diligence
- ✓ Information system due diligence
- ✓ Environmental due diligence
- ✓ Personnel due diligence
- ✓ Legal due diligence

Financial Due diligence

If a full fledged financial DD is conducted, it would include the following matters, in its scope:

- a. Brief history of the target and background of its promoter
- b. Accounting policies
- c. Review of financial statements
- d. Taxation
- e. Cash flow
- f. Financial projection
- g. Management and employees
- h. Statutory compliances

Contents of due diligence report

- a. Executive summary
- b. Introduction
- c. Background of target
- d. Objective of the due diligence
- e. Terms of reference and scope of verification
- f. Brief history of the company
- g. Share holding pattern
- h. Observation on the review
- i. Assessment of management structure
- j. Assessment of financial liabilities
- k. Assessment of valuation of assets
- l. Comments on properties, terms of leases, lien and encumbrances
- m. Assessment of operating results
- n. Assessment of taxation and statutory liabilities
- o. Assessment of possible liabilities in account of litigation and legal proceedings against the company.
- p. Assessment of net worth
- q. Interlocking investments and financial obligations with group/AE, amount receivables subject to litigation, any other likely liability which is not provided for in the books of account.
- r. SWOT analysis comment on future projections
- s. Status of charges, liens, mortgages, assets and properties of the company.
- t. Suggestion on ways and means including affidavits, indemnities, to be executed to cover unforeseen and undetected contingent liabilities.
- u. Suggestions on various aspects to be taken care of before and after the proposed merger/acquisition.