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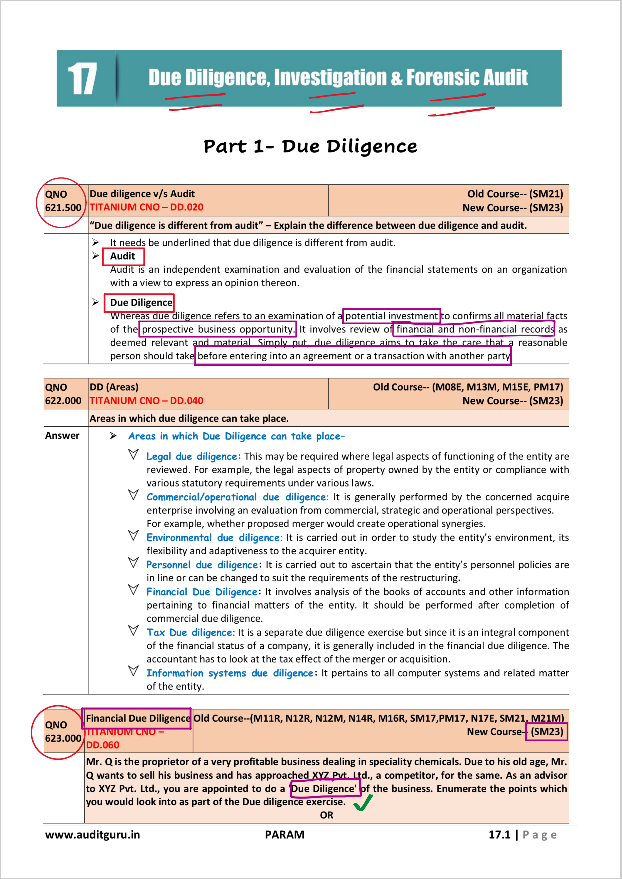


17 Due Diligence, Investigation & Forensic Audit

Part 1- Due Diligence

QNO		
QNO 621.500	**Due diligence v/s Audit** TITANIUM CNO – DD.020	**Old Course-- (SM21)** **New Course-- (SM23)**
	"Due diligence is different from audit" – Explain the difference between due diligence and audit.	

- It needs be underlined that due diligence is different from audit.
- **Audit**

  Audit is an independent examination and evaluation of the financial statements on an organization with a view to express an opinion thereon.
- **Due Diligence**

  Whereas due diligence refers to an examination of a potential investment to confirms all material facts of the prospective business opportunity. It involves review of financial and non-financial records as deemed relevant and material. Simply put, due diligence aims to take the care that a reasonable person should take before entering into an agreement or a transaction with another party.

QNO		
QNO 622.000	**DD (Areas)** TITANIUM CNO – DD.040	**Old Course-- (M08E, M13M, M15E, PM17)** **New Course-- (SM23)**
	Areas in which due diligence can take place.	

Answer

- Areas in which Due Diligence can take place-
  - **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.
  - **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.
  - **Environmental due diligence:** It is carried out in order to study the entity's environment, its flexibility and adaptiveness to the acquirer entity.
  - **Personnel due diligence:** It is carried out to ascertain that the entity's personnel policies are in line or can be changed to suit the requirements of the restructuring.
  - **Financial Due Diligence:** 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.
  - **Tax Due diligence:** It is a separate due diligence exercise but since it is an integral component of the financial status of a company, it is generally included in the financial due diligence. The accountant has to look at the tax effect of the merger or acquisition.
  - **Information systems due diligence:** It pertains to all computer systems and related matter of the entity.

QNO		
QNO 623.000	**Financial Due Diligence** TITANIUM CNO – DD.060	**Old Course--(M11R, N12R, N12M, N14R, M16R, SM17,PM17, N17E, SM21, M21M)** **New Course-- (SM23)**
	Mr. Q is the proprietor of a very profitable business dealing in speciality chemicals. Due to his old age, Mr. Q wants to sell his business and has approached XYZ Pvt. Ltd., a competitor, for the same. As an advisor to XYZ Pvt. Ltd., you are appointed to do a 'Due Diligence' of the business. Enumerate the points which you would look into as part of the Due diligence exercise. ✓ **OR**	

Sri Rajan is above 80 years old and wishes to sell his proprietary business of manufacture of specialty chemicals. Ceta Ltd. wants to buy the business and appoints you to carry out a due diligence audit to decide whether it would be worthwhile to acquire the business. What procedures you would adopt before you could render any advice to Ceta Ltd.?

OR

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

Answer Some of the significant key areas which shall be covered under the review are as under:

- **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.

- **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.

- **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.**

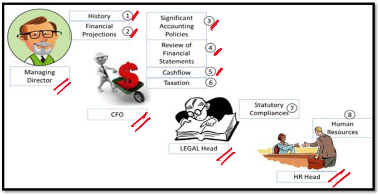
- **Review of Financial Statements:** An evaluation of the profit reported by the company would be largely based upon its operating results**. Any extraordinary item of income or expense that might have affected the operating results would require close examination.**

  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 recognized. **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.**

- **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:
  - Whether the company **is able to honour its commitments** to its trade payables, to the banks, to government and other stakeholders;
  - How well is the **company able to turn its trade receivables and inventories;**
  - How well does it **deploy its funds;** and
  - Whether any funds are **lying idle or is the company able to reap maximum benefits out of the available** funds.

- **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.

- **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 matches 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.



Author's Note

- If the question asks about due diligence but it is silent on which type of due diligence, then we have to assume and write answer considering financial due diligence.
- Question may also ask about any specific requirement such as the 3rd question which specifically asks for "What points will you check in order to ensure that company will be able to meet the cash requirements internally?", in such case such write the 5th para of the answer that deals with cash flow.
- If question is on due diligence on proprietary business then give answer for financial due diligence i.e QNO 623.000 and if it is on investigation of proprietary business answer as per QNO 643.050.

QNO 627.000	DD (Under / Over Valuation) TITANIUM CNO – DD.100	Old Course-(N05E, N10E, M12E, N13E, M15R, PM17, M17R, N17M, M18E, N19R, N20R, N20E, SM21, N21M, N22M) New Course- (SM23)

M Limited is going to acquire S Limited The purchase consideration has decided at Rs 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.

OR

Zeta Ltd is anticipating taking over a manufacturing concern and appoints you for due diligence review While reviewing, it requests you to look specifically for any hidden liabilities and overvalued assets State in brief the major areas you would examine for hidden liabilities and overvalued assets.

OR

Vita Ltd. is anticipating taking over a manufacturing concern and appoints you for due diligence review. While reviewing, it requests you to look specifically for any hidden liabilities. State in brief the major areas you would examine for hidden liabilities.

OR

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

Answer

- **Different Types**
  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.

- **Review of Financial Statements**
  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 viewpoint of extraordinary items, analysis of significant deviations, etc.

- **Hidden Liabilities**
  However, in order to investigate hidden liabilities, the auditor should pay his attention to the following areas
  - **Government**
    - The company may not show any **show cause notices** which have not matured into demands, as contingent liabilities. These may be material and important.
    - **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.
  - **Share Holders**
    - Agreement to buy back shares sold at a stated price.
  - **Financers**
    - 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.
  - **Subsidiaries**
    - 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.

- Employees
  - **Unfunded** gratuity/superannuation/leave salary liabilities; incorrect gratuity valuations.
  - Huge **labour claims under negotiation** when the labour wage agreement has already expired.
- Customer
  - Product and other **liability claims; warranty liabilities;** product returns/ discounts; liquidated damages for late deliveries etc. and all litigation.
- Other Third-Party Liabilities
  - Environmental problems/claims/third party claims.
  - Future lease liabilities.
  - Contingent liabilities not shown in books.

➢ Regularly Overvalued Assets

The auditor shall have to specifically examine the following areas:

- Fixed Assets
  - **Underused or obsolete** Plant and Machinery and their spares;
  - Asset values which have been **impaired due to sudden fall in market value etc**.
  - Litigated assets and property.
- Investments
  - Investments **carried at cost** though realizable value is much lower.
  - Investments carrying **a very low rate of income / return.**

- Inventory
  - **Obsolete,** slow non-moving inventories or inventories valued above NRV; **huge** inventories of packing materials etc. with name of company.
- Trade Receivables
  - Uncollected / uncollectable receivables.
  - Group Company balances under reconciliation etc.

Authors Note

Students are advices to see in the question what is asked, whether hidden liabilities or overvalued assets or both and then shall answer accordingly.

QNO 628.000	Due Diligence Report TITANIUM CNO – DD.160	Old Course -- (M07E, N08R, N15E, N16R, PM17, N17R, N18M, M19M, SM21, N21R) New Course-- (SM23)

A Japanese 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 a due diligence auditor:

(a) indicate the key areas you will cover in your review.

(b) list out the contents of your Due Diligence Review Report that you will submit to your Japan based Client.

Financial Due Diligence

Answer (a) Some of the significant key areas which shall be covered under the review are as under:

➢ 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.

➢ 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.

➢ 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.**

➢ 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 recognized. **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.**

- **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:
  - Whether the company **is able to honour its commitments** to its trade payables, to the banks, to government and other stakeholders;
  - How well is the **company able to turn its trade receivables and inventories;**
  - How well does it **deploy its funds**; and
  - Whether any funds **are lying idle or is the company able to reap maximum benefits out of the available** funds.
- **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.
- **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 matches 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.

(b)The contents of a due diligence report can be discussed under:

(Start of the Report)

- Terms of reference and scope of verification.
- Objective of due diligence.
- Brief history of the company including shareholding pattern.

(Legal DD Related)

- 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.
- Status of franchises, license and patents.

(Operational / Commercial DD Related)

- Assessment of operating results.

(Environment DD Related)

- Assessment on Environment Related Policies

(Personnel DD Related)

- Assessment of Management Structure.

(Financial DD Related)

- 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 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 net worth.

(TAX DD Related)

- Assessment of taxation and statutory liabilities.

(IT DD Related)

- Assessment of Information Technology

(Conclusion Related)

- Suggestions on various aspects to be taken care of before and after the proposed merger / acquisition.
- Finally, an executive summary may be prepared highlighting the significant areas.

QNO 628.500 **SWOT Analysis**
TITANIUM CNO -- Unique

New Course – (SM23)

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

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

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

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

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

Answer

SWOT Analysis: As part of due diligence exercise, he is performing SWOT analysis of borrower. He is making analysis of strengths, weaknesses, opportunities and threats (SWOT) pertaining to borrower.

Strengths: Features such as rise in sales, generation of cash profits and timely service of debts represent borrower strengths.

Weakness: Lack of well-paid qualified staff to deal effectively with its domestic and foreign customers is an area of weakness.

Opportunities: Entering into export market presents opportunity for borrower.

Threats: Presence of large number of competitors and demand slump in US market reflect threats.

Part 2- Investigation

QNO 625.000	Investigation (Incoming Partner) TITANIUM CNO – INTG.100	Old Course-- (N10R, M14R, SM17, PM17, M18M, SM21, M20M, M23M) New Course-- (SM23)

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

OR

Dalal, Banerji and Mallick are partners in a firm sharing profits and losses in the ratio 2:2:1. The partners have agreed to take Mr. Mistri as a partner with effect from 1st April 2018 as 1/4th partner.
What are the important steps involved while conducting investigation on behalf of Mr. Mistri, the incoming partner?

Answer

- Purpose: -
  - 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.
  - To ascertain whether the capital to be contributed by him would be safe and applied usefully.
- Areas to be covered: -
  - Reasons & History
    - Ascertain **reasons** for the offer of admission to a new partner should be ascertained and it should be determined whether the same synchronizes with the retirement of any senior partner whose association may have had considerable bearing on the firm's success.
    - Ascertainment of the **history of the firm**, since inception and growth of the firm.
  - Present Situation & Partnership Deed
    - Study the composition and **quality of key personnel employed** by the firm and any likelihood of their leaving the organization.
    - Assess **position of orders** at hand and the range and quality of clientele should be thoroughly examined, which the firm is presently operating.
    - Studies 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.
    - Examine 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.
  - Financial Statement Analysis
    - 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.
    - Ascertain manner of computation of **goodwill** on admission as also on retirement, if any
    - Scrutinize **terms of loan finance** to assess its usefulness and implication for the overall financial position.
    - Examine whether the **incomplete contracts** which will be transferred to the reconstituted firm will be a liability or a loss.
    - Scrutiny of the record of **profitability** of the firm's business over a suitable number of years.
    - 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.

QNO 632.000	Audit Vs Investigation TITANIUM CNO – INTG.020	Old Course- (N04E, N10R, N12M, PM17, M17R, N18E, N19R, SM21) New Course-- (SM23)

General objective of an audit is to find out whether the financial statements show true and fair view. On the other hand, investigation implies systematic, critical and special examination of the records of a business for a specific purpose. In view of the above, you are required to brief out the difference between Audit and Investigation.

Answer

- *Auditing*

  It involves examination of financial information contained in financial statements to **express an opinion** whether or not the same have been prepared properly. In essence, auditing involves independent examination of financial information prepared by the management of an entity.
- *Investigation*: -
  - It 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.

Basis	INVESTIGATION	AUDIT
➢ **Objective**	It aims at **establishing a fact or a happening or at assessing a particular situation**	To verify whether the financial statements **display a true and fair view** of the state of affairs and the working results of an entity.
➢ **Legal Requirement**	Voluntary, in some companies it may be ordered as per LAW	Mandatory for Companies. For others, it is voluntary
➢ **Who performs / Conducted by**	Any person, who may not be a Chartered Accountant.	**A Chartered Accountant** within the meaning of the Chartered Accountants Act 1949.
➢ **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.
➢ **Time Frame (Period Covered)**	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.
➢ **Nature of activities performed**	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
➢ **Application of accounting principles**	It is analytical in nature and requires a thorough mind, capable of observing, collecting and evaluating facts. There may not be any focus on accounting principles and disclosures.	Is governed by compliance with generally accepted accounting principles, audit procedures and disclosure requirements.
➢ **Evidence**	It seeks conclusive evidence	Audit is mainly concerned with prima- facie evidence (Persuasive Evidence).
➢ **Reporting**	The outcome is reported to the person(s) on whose behalf investigation is carried out. (No particular format)	The outcome is reported to the owners of the business Entity. (Format is generally fixed)
➢ **Inherent Limitations**	No inherent limitation owing to its nature of engagement.	Audit suffers from inherent Limitation.
➢ **Pre-Condition**	Its essence lies in going into the matter with some pre-conceived notion suited to the objective	Audit is not based on suspicion unless circumstances exist to arouse suspicion

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QNO 633.000	Embezzlement of Cash- Areas TITANIUM CNO – INTG.140	Old Course- (N07E, M09R, M12M,M16M, PM17, N17M, SM17, N18M SM21) New Course-- (SM23)

In a company, it is suspected that there has been embezzlement in cash receipts. The company appoints you as an investigator. What are the areas you would verify?

Answer

➢ *Cash Receipts:-*

- Showing a **larger cash discount** than actually allowed.
- Issuing a receipt to the payee for the full amount collected and **entering only a part of the amount on the counterfoil.**
- Adjusting a **fictitious credit in the account of a customer** for the value of goods returned.
- Adjusting **a cash sale as a 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.
- **Short debiting the customer's account** in the ledger with an intention to withdraw the difference when the full amount payable.
- **Under-casting the receipts** side of the Cash Book.
- **Over-casting the payment side** Cash Book.

QNO 635.000	Fraud (Supplier Ledger) TITANIUM CNO – INTG.140	Old Course- (N08E, M11E, N16M, PM17, N19E, SM21) New Course-- (SM23)

Write a short note on Frauds through supplier ledger.

OR

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

Answer

➢ *Supplier Ledger: -*

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

- The auditor should **verify the bought journal with reference to entries in the Goods Inward Book and the suppliers' invoices** to confirm that amounts credited to the accounts of suppliers were in respect of goods, which were duly received, and the suppliers' accounts had been credited correctly.
- The auditor **should request all the suppliers to furnish statements of their accounts** to see whether or not any **balance is outstanding or due so as to confirm that allowances and rebates given by them have been correctly adjusted**.

QNO 637.010	Investigate Frauds of Inventory defalcation TITANIUM CNO – INTG.140	Old Course- (M19R, N19M N19E, SM21) New Course-- (SM23)

Mr Sharma is reviewing the anti-fraud controls for a construction company. The company has witnessed a few frauds in the past mainly in the nature of material stolen from the sites and fake expense vouchers.
Mr. Sharma is evaluating options for verifying the process to reveal fraud and the corrective action to be taken in such cases. As an expert, you are required to brief Mr. Sharma about the inventory fraud and verification procedure with respect to defalcation of inventory?

Answer

- **Inventory frauds**- Inventory frauds are many and varied but here we are concerned with misappropriation of goods and their concealment.

Where:
- Goods Received
- Goods Store
- Goods Issue

Who
- Employee
- mgt

Conceal.
- Damaged Obsolete
- Issue for Production
- Inventory Records

Verify
- TOC
- Physical verification
- Engineer
- Data Analysis

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

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

  The determination of factors which have been responsible for the theft and the establishment of guilt would be difficult in the absence of:
  - a system of inventory control, and existence of detailed record of the movement of inventory, or
  - availability of sufficient data from which such a record can be constructed.

  The step in such an investigation is to establish the different items of inventory defalcated and their quantities by checking physically the quantities in inventory held and those shown by the Inventory Book.

  Defalcations of inventory, sometimes, also are committed by the management, by **diverting a part of production and the consequent shortages in production being adjusted by inflating the wastage in production**; similar defalcations of inventories and stores are covered up by **inflating quantities issued for production**. For detecting such shortages, the investigating accountant should take **assistance of an engineer**. For that he will be more conversant with factors which are responsible for shortage in production and thus will be able to correctly determine the extent to which the **shortage in production has been inflated.**

  In this regard, guidance can also be taken from **past records showing the extent of wastage in production in the past.** Similarly, he would be able to better judge whether the material issued for production was excessive and, if so to what extent.

  The per hour capacity of the machine and the time that it took to complete one cycle of production, also would show whether the issues have been larger than those required.

QNO 639.000	Investigation (Future Maintainable Turnover)- TITANIUM CNO – INTG.080	Old Course- (M13E, M16M, PM17, SM17, M18M, M19M, SM21, N22E) New Course-- (SM23)

H 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 sales?

Answer

- **Factors to be considered in Assessing Future Maintainable Sales:**
  In assessing the sales which the business would be able to maintain in the future, the following factors should be taken into account-

(Past)

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

(Present)

- **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?

- **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?

(Future)

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

QNO 641.000	Investigation (Sec 210) TITANIUM CNO – INTG.160	Old Course- (M15R, PM17, N18R, N18M)
	What will be your approach in investigation under Section 210 and 213 into the affairs of the company registered under Companies Act, 2013?	

Answer

➢ Approach in investigation under section 210 and 213 into the affairs of the Companies:

The general approach for investigation under Sections 210 and 213 of the Companies Act, 2013 is conditioned by the legal requirements in these regards. The affairs of the company may include everything such as goodwill, profit and loss, contracts, investments, assets, shareholding in subsidiaries, decision making, etc. Also, the specific circumstances mentioned in these sections like fraud, mismanagement, oppression of any shareholder etc. come within the term "affairs of the company."

Investigation under Sections 210 and 213 do not call for any special approach. Approach/Steps for pursuing the investigation are:

- **Clarity of Terms of Reference:**
  The approach to any investigation is determined on a consideration of the nature of the investigation and the terms of reference. However, the inspector should ensure that the terms of reference are clear, unambiguous and in writing. If he has any doubt about any item in the terms, he should obtain clarification in writing. It should also be, seen that the terms of reference are not too general, because that may frustrate the whole objective of the investigation; the scope of the investigation will become unwieldy and ill defined. An investigation order to investigate into the affairs of the company would be an instance at point. Therefore, the inspector should ask for reframing of the order specifying the exact matters to be investigated. He should also take into consideration the possible effect of limitations, if any, put in the terms of reference and should keep the Central Government informed in writing about their effect on the investigation.

- **Scope of Investigation:**
  The next point for consideration of the inspector would be the determination of the scope of the investigation on the basis of the terms of reference. At this stage, it may be useful for the inspector to go into the history of the company and its affiliates or associates. He should evaluate the terms of reference in sketching the scope of investigation; this will enable him to locate the limitation, if any, in the terms of reference, not clearly mentioned. For a purposeful investigation, he may need to stretch his inquiry into the books and records of allied and associated persons and concerns and may require to arm himself with the powers given under the Companies Act.
- **Period for investigation:**
  He should also have regard to the period over which the investigation should stretch. The evaluation of terms of reference and the consequential determination of the scope of investigation are the twin props on which the entire investigation would rest and, therefore, the inspector appointed under Sections 210 and 213 should devote careful attention to these.

- **Framing of Programme**:
  The next step is the investigator/inspector should frame his programme for investigation in a systematic manner. He should keep adequate working notes and papers with references and cross references in a proper and methodical way to aid him in the preparation of the report. The actual process of investigation would be essentially an evidence gathering procedure and, at every step, he should have regard to the procedures laid down in these sections regarding production of documents and evidence, examination on oath and seizure of documents. He should also keep his mind open to the revelations he comes across in the process of evidence collection and should assess whether the programme of investigation needs amendment or modification.

- **Using the work of Experts:**
  He should also consider whether assistance of other experts like engineers, lawyers, etc., is necessary in the interest of a comprehensive and full proof examination of the documents and information.

- **Legal requirements and investigation Report:**
  Only after he has completed the steps in the investigation programme and has marshalled all the information that he needed should he prepare his report. He, however, can also make interim report. The findings should be completed and exhaustive. Before he makes his final report he should obtain and keep on record the evidences relied upon by him. By the nature of things, such evidence should be as conclusive as possible depending on circumstances of the case. He should make his report in accordance with the provisions of the Companies Act, 2013.
  The general approach for investigations under Sections 210 and 213 should, therefore, be formulated having regard to the terms of reference, scope, the period, the programme and procedure of the investigation and the attending legal requirements specified above.

QNO 643.000	**Investigation of Borrower** TITANIUM CNO - INTG.120	**Old Course- (M12R, M13R, N15R, PM17, SM17, M18M, M18E, N18R, M20R, SM21)** **New Course-- (SM23)**

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

Answer

- **Purpose: -**
  - Reason for obtaining the loan
  - Determining of sources of repayment.
  - Availability of security, if borrower fails to repay.
- **Collection of Information: -**
  Investigator is required to collect the information with respect to;
  - **The financial standing and reputation** for business integrity enjoyed by directors and officers of the company.
  - **History of growth and development** of the company and its performance during the past 5 years.
  - **Authorization** under Memorandum or the Articles of Association to borrow money for the purpose for which the loan will be used.
  - **The purpose** for which the loan is required.
  - Manner in which the borrower **proposes to invest the amount of the loan.**
  - **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.
- **Examination of Financial Statements: -**
  - From the Statement of Profit and Loss for the previous five years, showing separately therein various items of income and expenses, the amounts of gross and net profits earned, and taxes paid annually during each of the five years.
  - The purpose is to ascertain strengths of profitability
- **Computation of relevant Ratios: -**
  - Equity to Fixed Assets.

  - Equity to Long Term Loans.
  - Sales to Fixed Assets.
  - Sales to Average Inventories held.
  - Sales to Book Debts.
  - Current Assets to Current Liabilities.
  - Quick Assets (the current assets that are readily realizable) to Quick Liabilities.
  - Return on Capital Employed.
- **Break-up of annual sales: -**
  Product-wise to show their trends.
- **Schedule of assets and liabilities: -**
  - **Assets: -**
    - To ensure their existence, ownership and proper valuation.
    - To examine whether assets have been adequately insured.
  - **Liabilities: -**

- To determine present and future obligations.
- To ensure completeness of recording.

QNO 643.020	Investigation of borrower-Special Focus on Assets & liabilities - Unique	Old Course-- (N20M)

A nationalized bank received an application from a Limited company seeking sanction of a term loan to expand its existing business. In this connection, the Loan Manager of the Bank approaches you to conduct a thorough investigation of the items of the Balance Sheet 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 major steps an investigating accountant would keep in mind while verifying assets and liabilities included in the Balance Sheet of the borrower company which has been furnished to the Bank.

➢ 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:

- **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.

- **Inventory –**
  The value of different types of inventories held (raw materials, work-in-progress and finished goods) and the basis on which these have been valued. Details as regards the nature and composition of finished goods should be disclosed. Slow moving or obsolete items should be separately stated along with the amounts of allowances, if any, made in their valuation. For assessing redundancy, the changes that have occurred in important items of inventory subsequent to the date of the Balance Sheet, either due to conversion into finished goods or sale, should be considered. If any inventory has been pledged as a security for a loan the amount of loan should be disclosed.

- **Trade Receivables, including bills receivable -** Their composition should be disclosed to indicate the nature of different types of debts that are outstanding for recovery; also whether the debts were being collected within the period of credit as well as the fact whether any debts are considered bad or doubtful and the provision if any, that has been made against them.
  Further, the total amount outstanding at the close of the period should be segregated as follows:
  - debts due in respect of which the period of credit has not expired;

  - debts due within six months; and
  - 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.

- **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.

- **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.

- **Provision of Taxation**–
  The previous years up to which taxes have been assessed should be ascertained. If provision for taxes not assessed appears in be inadequate, the fact should be stated along with the extent of the shortfall.

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

- **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.

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

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

Author's Note
In QNO 643.000 and 643.020 questions are similar but QNO 643.000 asks about investigation of borrower in general and QNO 643.020 focuses on investigation of assets and liabilities of borrower.

QNO 643.030	Investigation of Borrower (Due Diligence) TITANIUM CNO— Unique	Old Course – (M23M, M23R) New Course – (SM23)

CA. Rajul is acting as Credit manager in branch of DFC Bank Limited. A company has approached the branch for a request to sanction credit facilities worth `10 crore for meeting usual business requirements. It is a prospective new client. She checks past history of the company, background of promoters & directors, shareholding pattern and nature of business. Assessment of financial results of past years and future projections is also undertaken. She also carries out SWOT analysis of the company.

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

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

Based on above:

i. **Identify activity being performed by CA Rajul and discuss its nature.** ✓
ii. **Would your answer be different if this activity was to be performed by a person not qualified as a Chartered Accountant? Can a non-CA perform such activity? State reason.** ✓
iii. **Name any three other areas where identified activity can be undertaken.** ✓

Answer

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

Case Discussion

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

DD Definition

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

Other than CA

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

Areas

iii. The areas where due diligence may be undertaken are: -
1) Corporate restructuring. 2
2) Venture capital financing. 1
3) Public offerings. 3

QNO 643.050	Investigation (Propriety Business) – TITANIUM CNO— INTG.180	Old Course- (M04E, PM17, SM17, SM21) New Course-- (SM23)

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

➢ 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-

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

Author's Note
If question is on due diligence on proprietary business, then give answer for financial due diligence i.e QNO 623.000 and if it is on investigation of prop business answer as per QNO 643.050.

QNO 644.020	**Special issues in investigation** **TITANIUM CNO – INTG.060**	**Old Course- (N16M, M21E, N23R)**

Milk Ltd. is engaged in the business of manufacturing and distribution of various milk products like cheese, curd, paneer, etc. Government made certain changes in rules and regulations relating to this sector, consequently management decided to go for expansion. Management was looking for some financial investor, who can fund some part of the proposed expansion. Mr. X is interested in the venture and appoints you to act as an advisor to the proposed investment in the business of Milk Ltd. You have to investigate the audited financial statements and ensure that the valuation of shares of the company on the basis of audited financial statements is appropriate. What process will be used for checking and whether you can put reliance on already audited statement of accounts?

OR

You have been appointed to investigate the accounts of a company and informed that the accounts have already been audited. Discuss whether you can put reliance on such already audited statement of accounts for the purpose of investigation.

Answer

Process used for checking and reliance on already audited statement of accounts -
Following process may be carried out-

1. If the statements of account produced before the investigator were not audited by a qualified accountant, then of course there arises a natural duty to get the figures in the accounts properly checked and verified.

2. However, when the accounts produced to the investigator have been specially prepared by a professional accountant, who knows or ought to have known that these were prepared for purposes of the investigation, he could accept them as correct relying on the principle of liability to third parties.

3. Nevertheless, it would be prudent to see first that such accounts were prepared with objectivity and that no bias has crept in to give advantage to the person on whose behalf these were prepared.
Whether the investigator can put reliance on the already audited statement of account
- If the investigation has been launched because of some doubt in the audited statement of account, no question of reliance on the audited statement of account arises. However, if the investigator has been requested to establish value of a business or a share or the amount of goodwill payable by an incoming partner, ordinarily the investigator would be entitled to put reliance on audited materials made available to him unless, in the course of his test verification, he finds the audit to have been carried on very casually or unless his terms of appointment clearly require t o test everything afresh.

QNO 644.030	**Investigator taking assistance of expert** **TITANIUM CNO – INTG.060**	**Old Course-- (SM21)**

XYZ Ltd. has bought a land in Nagpur for setting up a manufacturing unit in the year 2018 at a price of Rs. 10 crores. In the year 2019, one of the directors of company raised suspicion on the price and transactions related to purchase of land. Therefore, an investigation was ordered by the management and PV Associates were appointed to investigate the matter and submit their report accordingly. PV Associates were of the view that they need to take an expert's opinion on the price of land. Whether PV Associates is authorized to take assistance of expert? If yes, what is the process they need to follow?

If PV Associates feels the necessity of obtaining views and opinions of experts in various fields to properly conduct the investigation, they are allowed to do so.
It would be therefore, proper for the investigator to get the written general consent of his client, to refer special matters for views of different experts at the beginning of investigation and he should settle the question of costs for obtaining the views and other related implications.

Author's Note:
ICAI has drafted big question, but relevant answer given is of 3 to 4 lines which is sufficient for 2 marks

question.

QNO 644.050 **Investigate economic and financial position** **Old Course – (N23M)**
TITANIUM CNO -- Unique

Namo Limited wants to acquire a unit of Sidha Limited. Namo Limited is uncertain about the future viability of the unit under consideration. You are appointed to investigate economic and financial position of the unit. What are the factors that you shall consider while studying the economic and financial position of the business?

Answer For studying the economic and financial position of the business, the following should be considered:

✓ ① (i) The adequacy or otherwise of fixed and working capital. Are these sufficient for the growth of the business?

✓ ③ (ii) What will be the trend of the sales and profits in the future? Establishing the trend of sales, product-wise and area-wise will ordinarily help in drawing a conclusion on whether the trend will be maintained in the future.

✓ ④ (iii) Whether the profit which the business could be expected to maintain in the future would yield an adequate return on the capital employed?

✓ ② (iv) Whether the business is operating at its 100 percent capacity or improvements can be made to reach at full productivity?

QNO 644.070 **Time Cards** **New Course – (SM23)**
TITANIUM CNO -- Unique

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

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

Answer

Achving

1A. Attendance Record Analysis: The attendance record of employees pertaining to that section can be analysed with regards to in and out time.

1B. Surprise Site Visits: Further, surprise visit to the site can be conducted to see the actual number of workers at a point of time.

Result

2A Revealing Ghost Workers: It may reveal ghost workers. Discrepancies in attendance records vis-à-vis actual number of workers present could reveal dummy workers.

2B. Productivity Indication: Such a visit would also give indication of actual work done in the area and give an inkling of productivity of employees.

Part 3- Forensic Audit

QNO 628.500 **Forensic Accountants Service – Areas** **Old Course-- (SM21, N22R)**
TITANIUM CNO – FA.040

What are the areas where the services of forensic accountants/ auditors are generally required?

Answer **The services rendered by the forensic accountants are in great demand in the following areas:**

Criminal Investigation:	• Matters relating to financial implications the services of the forensic accountants are availed of. The report of the accountants is considered in preparing and presentation as evidence.
Professional Negligence Cases :	• Professional negligence cases are taken up by the forensic accountants. Non-conformation to Generally Accepted Accounting Standards (GAAS) or noncompliance to auditing practices or ethical codes of any profession, Forensic Auditors are needed to measure the loss due to such professional negligence or shortage in services.
Arbitration service:	• Forensic accountants render arbitration and mediation services for the business community. Their expertise in data collection and evidence presentation makes them sought after in this specialized practice area.
Fraud Investigation And Risk / Control Reviews:	• Forensic accountants render such services both when called upon to investigate specific cases as well for a review of or for implementation of Internal Controls. Another area of significance is Risk Assessment and Risk Mitigation.
Settlement of insurance claims:	• Insurance companies engage forensic accountants to have an accurate assessment of claims to be settled. • In case of policyholders seek the help of a forensic accountant when they need to challenge the claim settlement as worked out by the insurance companies. A forensic accountant handles the claims relating to consequential loss policy, property loss due to various risks, fidelity insurance and other types of insurance claims.
Dispute settlement:	• Business firms engage forensic accountants to handle contract disputes, construction claims, product liability claims, infringement of patent and trade marks cases, liability arising from breach of contracts and so on.

QNO 629.000 **Forensic Accounting Vs Audit** TITANIUM CNO – FA.025

New Course-- (SM17, M18R, M18E, M22R,N22E)
New Course—(SM23)

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

OR

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

Project gets implemented in 2017-18 and one of the accountants points out to Managing Director that something wrong has happened in the purchase of building material. On hearing this, the management is planning to appoint Forensic Auditor. Advise management that how is a forensic accounting analysis is different from an audit.

OR

Explain how a Forensic Audit differs from an Assurance Engagement

OR

Forensic audit is unlike other audits Explain

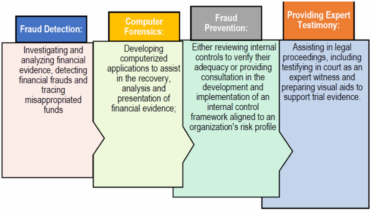
Answer **Difference between a forensic audit and financial audit**:

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

QNO 629.500	"Forensic" meaning and its need TITANIUM CNO – FA.040	Old Course-- (SM21)

What do you understand by the word "Forensic" and why the need for forensic audit arises?

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



Fraud Detection: Investigating and analyzing financial evidence, detecting financial frauds and tracing misappropriated funds

Computer Forensics: Developing computerized applications to assist in the recovery, analysis and presentation of financial evidence;

Fraud Prevention: Either reviewing internal controls to verify their adequacy or providing consultation in the development and implementation of an internal control framework aligned to an organization's risk profile

Providing Expert Testimony: Assisting in legal proceedings, including testifying in court as an expert witness and preparing visual aids to support trial evidence.

QNO 630.000	Forensic Audit Steps TITANIUM CNO – FA.060	Old Course-- (SM17, N18M, SM21, N21E,N23M) New Course-- (SM23)

Enumerate the steps to be undertaken in case of forensic audit process

OR

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

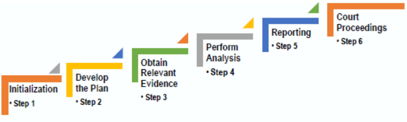
Rupees (In crore)	Purpose
10.0	- for Building
8.5	- for Machinery
1.5	- for Working Capital
20 Crore	

Project gets implemented in 2017-18 and one of the accountants points out to Managing Director that something wrong has happened in the purchase of building material.

On hearing this, the management is planning to appoint Forensic Auditor. Advise the Forensic Auditor about the steps to be undertaken in case of forensic audit process.

Answer

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



Step 1. – Initialization

- **Purpose**
  It is vital to clarify and remove all doubts as to the real motive, purpose and utility of the assignment.
- **Meet Client**
  It is helpful to meet the client to obtain an understanding of the important facts, players and issues at hand.
- **Conflict Check**
  A conflict check should be carried out as soon as the relevant parties are established. *(Whether it will affect other assignment of firm and vice versa)*

  - **Preliminary Investigation**
    It is often useful to carry out a preliminary investigation prior to the development of a detailed plan of action. This will allow subsequent planning to be based upon a more complete understanding of the issues.

- **Step 2. - Develop Plan**
  - **Set Objectives & Methodology**
    This plan will take into account the knowledge gained by meeting with the client and carrying out the initial investigation and will set out the objectives to be achieved and the methodology to be utilized to accomplish them.

- **Step 3. Obtain Relevant Evidence**
  - **Economic Information / Documents / Assets / Person / Expert / Company**

    Depending on the nature of the case, this may involve locating documents, economic information, assets, a person or company, another expert or proof of the occurrence of an event.

  - **Depends on Nature of Fraud**
    In order to gather detailed evidence, the investigator must understand the specific type of fraud that has been carried out, and how the fraud has been committed.

  - **Sufficient to Prove Identity of Fraudster / Mechanics of Fraud / Amount of Fraud / Clear Chain of Custody / Usable in Court**
    The evidence should be sufficient to ultimately prove the identity of the fraudster(s), the mechanics of the fraud scheme, and the amount of financial loss suffered. It is important that the investigating team is skilled in collecting evidence that can be used in a court case, and in keeping a clear chain of custody until the evidence is presented in court. If any evidence is inconclusive or there are gaps in the chain of custody, then the evidence may be challenged in court, or even become inadmissible. Investigators must be alert to documents being falsified, damaged or destroyed by the suspect(s).

- **Step 4.- Perform the analysis**
  The actual analysis performed will be dependent upon the nature of the assignment and may involve:
  - summarizing a large number of transactions
  - calculating economic damages;
  - performing present value calculations utilizing appropriate discount rates;
  - performing a regression or sensitivity analysis;
  - utilizing a computerized application such as a spread sheet, data base or computer model;
  - utilizing charts and graphics to explain the analysis.
  - performing a tracing of assets;

- **Step 5.- Reporting**
  Issuing an audit report is the final step of a fraud audit. Auditors will include information detailing the fraudulent activity, if any has been found. The client will expect a report containing the findings of the investigation, including a summary of evidence and a conclusion as to the amount of loss suffered as a result of the fraud.

  - **Sections in Report**
    The report may include sections on the nature of the assignment, scope of the investigation, approach utilized, limitations of scope and findings and/or opinions. The report will include schedules and graphics necessary to properly support and explain the findings.

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

  - **Facts should be the base and not mere Opinions**
    The forensic auditor should have active listening skills which will enable him to summarize the facts in the report. It should be kept in mind that the report should be based on the facts assimilated during the process and not on the opinion of the person writing the report.

- **Step 6. Court proceedings**
  The investigation is likely to lead to legal proceedings against the suspect, and members of the investigative team will probably be involved in any resultant court case. The evidence gathered during the investigation will need to be presented at court, and team members may be called to court to describe the evidence they have gathered and to explain how the suspect was identified.

QNO 630.100 **Forensic Audit Steps (Types of Analysis)** **Old Course-- (M19E)**
TITANIUM CNO – FA.060

You have been appointed as a forensic accountant in M/s Secure Ltd .to carryout various analysis as a part of your assignment to arrive at a % particular result. Specify the various analysis which might have to be carried out by you to arrive at your result.

- **Perform the analysis**
  The actual analysis performed will be dependent upon the nature of the assignment and may involve:
  - summarizing a large number of transactions;
  - calculating economic damages;
  - performing present value calculations utilizing appropriate discount rates
  - performing a regression or sensitivity analysis;
  - utilizing a computerized application such as a spread sheet, data base or computer model;
  - utilizing charts and graphics to explain the analysis.
  - performing a tracing of assets;

QNO 631.500 **Areas of Information (Content) of Forensic Audit Report** **Old Course-- (M21E)**
TITANIUM CNO – FA.080

M/s GSB Limited is into the business of construction for the past 25 years. Management of the Company came to know that building material sent to construction sites are of substandard quality whereas the payment released by the accounts department of the Company are on the higher sides. Forensic Auditor was asked to carry out detailed investigation. Forensic auditor completed his investigation and now preparing his report. What are the broad areas of information that needs to be incorporated in the report of forensic auditor?

Answer Broad areas of information to be incorporated in the report of Forensic auditor -
Issuing an audit report is the final step of a fraud audit. Auditors will include information detailing the fraudulent activity, if any has been found. The client will expect a report containing the findings of the investigation, including a summary of evidence, a conclusion as to the amount of loss suffered as a result of the fraud and to identify those involved in fraud.

The report may include sections on the nature of the assignment, scope of the investigation, approach utilized, limitations of scope and findings and/or opinions. The report will include schedules and graphics necessary to properly support and explain the findings.

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

The forensic auditor should have active listening skills which will enable him to summarize the facts in the report. It should be kept in mind that the report should be based on the facts assimilated during the process and not on the opinion of the person writing the report.

QNO 631.600 **Dealing with Claims involving PLI policy** **New Course -- (SM23)**
TITANIUM CNO -- Unique

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

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

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

Answer ② (i) In claims involving product liability insurance policies, many documents are required from third parties. The third party may be unwilling to provide relevant documents to forensic accountant concerning the very organization responsible for causing damages.

✓ ① (ii) Independence of forensic accountant become paramount in such types of assignments because it involves engagement with parties who are not directly claiming from insurance company. Forensic accountant needs to resist any pressure or interference in establishing the scope of the assignments or the manner in which the work is conducted and reported.

✓ ⑤ (iii) The company might be willing to negotiate it to salvage its reputation. It can lead to additional complexities.

✓ ④ (iv) Quantification of legal liability under the policy can prove to be a challenging task and it has to be determined in accordance with policy terms & conditions.

✓ ③ (v) Careful analysis of date of loss when first claim occurred in accordance with "claim series" clause and whether the same falls under the policy