After studying this chapter, you will be able to:

- Know the concept of Due Diligence, Investigation and Forensic Audit.
- Differentiate between Audit and Investigation.
- Know the steps to be taken at the time of Investigation.
- Understand the purpose of Due diligence and content of its report
- Gain knowledge of Forensic Audit Techniques and content of its report.

CHAPTER OVERVIEW

Unit 1 : Due Diligence
- Purpose
- Classification
- Content of Due Diligence Report

Unit 2 : Investigation
- Steps in Investigation
- Special Issues in Investigations
- Audit V/s. Investigation

Unit 3 : Forensic Audit
- Meaning
- Fraud and Procedures
- Forensic Audit Techniques
1. OVERVIEW

Due Diligence is used to investigate and evaluate a business opportunity. It implies a general duty to exercise care in any transaction. Most legal definition of due diligence describe it as 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 measure by any absolute standard but depends on the relative facts of the special case.

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 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.

Due Diligence may also required to be performed in cases of corporate restructuring, venture capital financing, lending, leveraged buyouts, public offerings, disinvestment, corporatisation, etc. Sometimes, in a restructuring exercise, while the unit may remain within a group, it may pass from under the charge of one management team to that of another team. This situation also gives rise to the need for a due diligence review.

2. DIFFERENCE BETWEEN DUE DILIGENCE AND AUDIT

It needs be underlined that due diligence is different from audit. Audit is an independent examination and evaluation of the financial statements on an organization with a view to express an opinion thereon. Whereas, due diligence refers to an examination of a potential investment to confirms all

* Source: www.lyagency.co.ke

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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.

3. IMPORTANCE OF DUE DILIGENCE

When a business opportunity first arises, it continues throughout the talks, initial data collection and evaluation commence. Thorough detailed due diligence is typically conducted after the parties involved in a proposed transaction have agreed in principle that a deal should be pursued and after a preliminary understanding has been reached, but prior to the signing of a binding contract.

<table>
<thead>
<tr>
<th>Reasons for Due Diligence</th>
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<tbody>
<tr>
<td>To confirm that the business is what it appears to be;</td>
</tr>
<tr>
<td>To identify potential ‘deal killer’ defects in the target and avoid a bad business transaction;</td>
</tr>
<tr>
<td>To gain information that will be useful for valuing assets, defining representations and warranties, and/or negotiating price concessions; and</td>
</tr>
<tr>
<td>To verify that the transaction complies with investment or acquisition criteria.</td>
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</tbody>
</table>

4. CLASSIFICATION OF DUE-DILIGENCE

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

In addition, it may expose problems or potential problems that can be addressed in the price negotiations or by dealing suitable clauses in the contractual documentation, in particular, warranty and or indemnity provisions.

Due Diligence can be sub-classified into discipline-wise exercises in following manner:

(i) **Commercial/Operational Due Diligence:** It is generally performed by the concerned acquire enterprise involving an evaluation from commercial, strategic and operational perspectives. For example, whether proposed merger would create operational synergies.
(ii) **Financial Due Diligence**: It involves analysis of the books of accounts and other information pertaining to financial matters of the entity. It should be performed after completion of commercial due diligence.

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

(iv) **Information Systems Due Diligence**: It pertains to all computer systems and related matter of the entity.

(v) **Legal Due Diligence**: This may be required where legal aspects of functioning of the entity are reviewed.

The legal aspects of property owned by the entity or compliance with various statutory requirements under various laws.

(vi) **Environmental Due Diligence**: It is carried out in order to study the entity’s environment, its flexibility and adaptiveness to the acquirer entity.

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

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**Financial Due Diligence**

At times, the financial due diligence review is interpreted as complete due diligence review since it is supposed to ascertain the financial implications of all the other due diligence reviews. This is, however, not appropriate. The term ‘financial due diligence’ should be used with caution. Unless the scope of financial due diligence to be performed is wide enough to cover all the aspects, it should not be confused with overall due diligence review.

It can be understood from the foregoing that the role of financial due diligence commences after a price has been agreed for the business. The initial price and other decisions are taken on the basis of net worth as well as trend of profitability of the target company, with an assumption that all contingent liabilities that may impact the future of the business have been recorded. The principal objective of financial due diligence, therefore, is usually to look behind the veil of initial information provided by the company and to assess the benefits and costs of the proposed acquisition/merger by inquiring into all relevant aspects of the past, present and future of the business to be acquired/merged with.

In order to achieve its objective, the due diligence process can include any or all of the following objectives for individual areas of the verification:

- Brief description of the history of business
- The background of promoters
- Accounting policies and practices
If a full fledged financial due diligence is conducted, it would include the following matters, *inter alia*, in its scope:

| (a) Brief history of the target and background of its promoter; | (b) Accounting policies; |
| (c) Review of financial statements; | (d) Taxation; |
| (e) Cash flow; | (f) Financial Projection; |
| (g) Management and employees; | (h) Statutory Compliance. |

**Brief history of the target and background of its promoters** - The accountant should begin the financial due diligence review by looking into the history of the company and the background of the promoters.

The details of how the company was set up and who were the original promoters has to be gone into, before verification of financial data in detail. An eye into the history of the target may reveal its turning points, survival strategies adopted by the target from time to time, the market share enjoyed by the target and changes therein, product life cycle and adequacy of resources. It could also help the accountant in determining whether, in the past, any regulatory requirements have had an impact on the business of the target. Broadly, the accountant should make relevant enquiries about the history of target's business products, markets, suppliers, expenses, operations. This could, *inter alia*, include the following:

- **Nature of business(es)**
  - Example: Manufacturer, wholesaler, financial services, import/export.

- **Location of production facilities, warehouses, offices.**

- **Employment**
  - Example: By location, supply, wage levels, union contracts, pension commitments, government regulation.

- **Products or services and markets**
Major customers and contracts, terms of payment, profit margins, market share, competitors, exports, pricing policies, reputation of products, warranties, order book, trends, marketing strategy and objectives, manufacturing processes.

- History of the business with important suppliers of goods and services
  - Long-term contracts, stability of supply, terms of payment, imports, methods of delivery such as "just-in-time".
- Inventories
  - Locations, Quantities.
- Franchises, licenses, patents.
- Important expense categories.
- Research and development.
- Foreign currency assets, liabilities and transactions.
- Legislation and regulation that significantly affect the entity.
- Information systems.

(b) Accounting policies - The accountant should study the accounting policies being followed by the target and ascertain whether any accounting policy is inappropriate.

The accountant should also see the effects of the recent changes in the accounting policies. The target might have changed its accounting policies in the recent past keeping in view its intention of offering itself for sale.

The overall scope has to be based on the accounting policies adopted by the management. The accountant has to look at the main effect of accounting policies on the overall profitability and their correctness. It is reiterated that the accountant should mainly look at all material changes in Accounting Policies in the period subjected to review very carefully.

The accountant's report should include a summary of significant accounting policies used by the target, that changes that have been made to the accounting policies in the recent past, the areas in which accounting policies followed by the target are different from those adopted by the acquiring enterprise, the effect of such differences.

(c) Review of Financial Statements - Before commencing the review of each of the aspect covered by the financial statements, the accountant should examine whether the financial statements of the target have been prepared in accordance with the Statute governing the target, Framework for Preparation and Presentation of the Financial Statements and the relevant Accounting Standards. If not the accountant should record the deviations from the above and consider whether it warrant an inclusion in the final report on due diligence.
After having an overall view of the financial statements, as mentioned in the above paragraphs, the accountant should review the operating results of the target in great detail. It is important to make an evaluation of the profit reported by the target. The reason being that the price of the target would be largely based upon its operating results.

The accountant should consider the presence of an extraordinary item of income or expense that might have affected the operating results of the target.

It is advisable to compare the actual figures with the budgeted figures for the period under review and those of the previous accounting period. This comparison could lead the accountant to the reasons behind the variations. It is important that the trading results for the past four to five years are compared and the trend of normal operating profit arrived at.

The normal operating profits should further be benchmarked against other similar companies. Besides the above, and based on the trend of operating results, the accountant has to advise the acquiring enterprise, through due diligence report, on the indicative valuation of the business.

In the case of many enterprises, the valuation is mainly based on the value of net assets only. For valuation of immovable properties and plant, if required, the assistance of expert valuers could also be taken. The exercise to evaluate the balance sheet of the target company has to take into consideration the basis upon which assets have been valued and liabilities have been recognised. The net worth of the business has to be arrived at by taking into account the impact of over/under valuation of assets and liabilities. The accountant should pay particular attention to the valuation of intangible assets.

**The objective of the Due Diligence exercise will be to look specifically for any hidden liabilities or over-valued assets.**

<table>
<thead>
<tr>
<th>Hidden Liabilities:</th>
</tr>
</thead>
<tbody>
<tr>
<td>🔖 The company may not show any show cause notices which have not matured into demands, as contingent liabilities. These may be material and important.</td>
</tr>
<tr>
<td>🔖 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.</td>
</tr>
<tr>
<td>🔖 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.</td>
</tr>
<tr>
<td>🔖 Product and other liability claims; warranty liabilities; product returns/discounts; liquidated damages for late deliveries etc. and all litigation.</td>
</tr>
<tr>
<td>🔖 Tax liabilities under direct and indirect taxes.</td>
</tr>
<tr>
<td>🔖 Long pending sales tax assessments.</td>
</tr>
</tbody>
</table>
## Over-Valued Assets:

- Uncollected/uncollectable receivables.
- Obsolete, slow non-moving inventories or inventories valued above NRV; huge inventories of packing materials etc. with name of company.
- Underused or obsolete Plant and Machinery and their spares; asset values which have been impaired due to sudden fall in market value etc.
- Assets carried at much more than current market value due to capitalization of expenditure/foreign exchange fluctuation, or capitalization of expenditure mainly in the nature of revenue.
- Litigated assets and property.
- Investments carried at cost though realizable value is much lower.
- Investments carrying a very low rate of income / return.
- Infructuous project expenditure/deferred revenue expenditure etc.
- Group Company balances under reconciliation etc.
- Intangibles of no value.

### Taxation

- Tax due diligence is a separate due diligence exercise but since it is an integral component of the financial status of a company, it is generally included in the financial due diligence. It is important to check if the company is regular in paying various taxes to the Government. The accountant has to also look at the tax effects of the merger or acquisition.

### Cash Flow

- A review of historical cash flows and their pattern would reflect the cash generating abilities of the target company and should highlight the major trends. It is important to know if the company is able to meet its cash requirements through internal accruals or does it have to seek external help from time to time.

### It is necessary to check that:

- Is the company able to honour its commitments to its trade payables, to the banks, to
government and other stakeholders

(b) How well is the company able to turn its trade receivables and inventories
(c) How well does it deploy its funds
(d) Are there any funds lying idle or is the company able to reap maximum benefits out of the available funds?

(f) Financial Projections - The accountant should obtain from the target company the projections for the next five years with detailed assumptions and workings. He should ask the target to give projections on optimistic, pessimistic and most likely bases.

The accountant evaluates the appropriateness of assumption used in the preparation and presentation of financial projections. If, the accountant is of the opinion that as assumption used by the target is unrealistic, the accountant should consider its impact on the overall valuation of the company. He should offer his comments on all the assumption, highlighting those which, in his opinion are not inappropriate. In case he feels the projections provided by the target are not achievable or aggressive he has to mention this in his report. He should thoroughly check the arithmetic of the calculations made for financial projections.

(g) Management and Employees - In most of the companies which are available for take over the problem of excess work force is often witnessed. It is important to work out how much of the labour force has to be retained. It is also important to judge the job profile of the administrative and managerial staff to gauge which of these match the requirements of the new incumbents. Due to complex set of labour laws applicable to them, companies often have to face protracted litigation from its workforce and it is important to gauge the likely impact of such litigation.

It is important to see if all employee benefits like Provident Fund (P.F.), Employees State Insurance (E.S.I.), Gratuity, leave and Superannuation have been properly paid/provided for/funded. In case of un-funded Gratuity, an actuarial valuation of the liability has to be obtained from a reputed actuary.

The assumptions regarding increase in salaries, interest rate, retirement etc. have to be gone into to see if they are reasonable. It is also necessary to see if the basic salary/wage considered for the valuation is correct and includes all elements subject to payment of Gratuity. In the case of PF, ESI etc. the accountant has to see if all eligible employees have been covered.

It is very important to consider the pay packages of the key employees as this can be a crucial factor in future costs. One has to carefully look at Employees Stock Option Plans; deferred compensation plans; Economic Value Addition and other performance linked pay; sales incentives that have been promised etc. It is also important to identify the key employees who will not continue after the acquisition either because they are not willing to continue or because they are to be transferred to another company within the ‘group’ of the target company.

(h) Statutory Compliance - During a due diligence this is one aspect that has to be investigated in detail. It is important therefore, to make a list of laws that are applicable to the entity as well as to
make a checklist of compliance required from the company under those laws. If the company has not been regular in its legal compliance it could lead to punitive charges under the law. These may have to be quantified and factored into the financial results of the company.

5. WORK APPROACH TO DUE DILIGENCE

The purchase of business in many instances is the largest and most expensive assets purchase in life time and therefore some caution should be exercised through the due diligence process. Therefore, assessing the businesses fair value passes through.

Discovering the correct strategy is always challenging, and even more so during challenging economic circumstances. Each situation is unique. The variables are numerous, including factors such as company age, markets, geography, price levels, competitive dynamics, to name but a few. But when a company and its products are turned to match market needs and expectations—that is, the decision markers and influencers involved in purchase decision—exceptional changes in performance can occur. However, comprehensive model that describes this approach to the work is illustrated in the figure below:

![Six Dimensional Process Framework](image-url)

Figure : Six Dimensional Process Framework
6. HOW TO CONDUCT DUE DILIGENCE

Start with an open mind. Do not assume that anything wrong will be found and look for it. What needs to be done is to identify trouble spots and ask for explanations.

Get the best team of people. If you do not have a group of people inside your firm that can do the task (e.g. lack of staff, lack of people who know the new business because you are acquiring a business in an unrelated areas, etc.), there are due diligence experts that you can hire. When hiring such professionals, look for their experience record in the industry.

Get help in all areas like finance, tax accounting, legal, marketing, technology, and any others relevant to the assignment so that you get a 36-degree view of the acquisition candidate.

Talk to customers, suppliers, business partners, and employees are great resources.

Take a risk management approach. So, while you want to do your research, you also want to make sure that you do not antagonise the team of people of the target company by bogging them down with loads of questions.

Prepare a comprehensive report detailing the compliances and substantive risks/issues.

* Source: Mazars.sg

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7. CONTENTS OF A DUE DILIGENCE REPORT

The contents of a due diligence report will always vary with individual circumstances. Following headings are illustrative:

<table>
<thead>
<tr>
<th>Example of Headings of a Due Diligence Report</th>
</tr>
</thead>
<tbody>
<tr>
<td>♦ Executive Summary</td>
</tr>
<tr>
<td>♦ Introduction</td>
</tr>
<tr>
<td>♦ Background of Target</td>
</tr>
<tr>
<td>♦ Objective of due diligence</td>
</tr>
<tr>
<td>♦ Terms of reference and scope of verification</td>
</tr>
<tr>
<td>♦ Brief history of the company</td>
</tr>
<tr>
<td>♦ Share holding pattern</td>
</tr>
<tr>
<td>♦ Observations on the review</td>
</tr>
<tr>
<td>♦ Assessment of management structure</td>
</tr>
<tr>
<td>♦ Assessment of financial liabilities</td>
</tr>
<tr>
<td>♦ Assessment of valuation of assets</td>
</tr>
<tr>
<td>♦ Comments on properties, terms of leases, lien and encumbrances.</td>
</tr>
<tr>
<td>♦ Assessment of operating results</td>
</tr>
<tr>
<td>♦ Assessment of taxation and statutory liabilities</td>
</tr>
<tr>
<td>♦ Assessment of possible liabilities on account of litigation and legal proceedings against the company</td>
</tr>
<tr>
<td>♦ Assessment of net worth</td>
</tr>
<tr>
<td>♦ 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</td>
</tr>
<tr>
<td>♦ SWOT Analysis</td>
</tr>
<tr>
<td>♦ Comments on future projections</td>
</tr>
<tr>
<td>♦ Status of charges, liens, mortgages, assets and properties of the company</td>
</tr>
<tr>
<td>♦ Suggestion on ways and means including affidavits, indemnities, to be executed to cover unforeseen and undetected contingent liabilities</td>
</tr>
<tr>
<td>♦ Suggestions on various aspects to be taken care of before and after the proposed merger/acquisition.</td>
</tr>
</tbody>
</table>