UNIT 2 : INVESTIGATION

1. OVERVIEW

The term investigation implies a systematic and in-depth examination or inquiry to establish a fact or to evaluate a specific situation. In other words, investigation means inquiry into facts”. Professional accountants are often required to investigate the accounts or the related matters and records of the enterprise. The term investigation may be defined as an examination of books and records preliminary to financing or for any other specified purpose, sometimes differing in scope from the ordinary audit. Thus, investigation covers areas of financing decisions, investment decisions, fraud or profitability determination or cost determination etc.

2. AUDIT VERSUS INVESTIGATION

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

The difference is tabulated below:

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

(iv) Nature
- Requires a detailed study and examination of facts and figures.
- Involves tests checking or sample technique to draw evidences for forming a judgement and expression of opinion.

(v) Inherent Limitations
- No inherent limitation owing to its nature of engagement.
- Audit suffers from inherent limitation.

(vi) Evidence
- It seeks conclusive evidence.
- Audit is mainly concerned with prima-facie evidence.

(vii) Observance of Accounting Principles
- It is analytical in nature and requires a thorough mind, capable of observing, collecting and evaluating facts.
- Is governed by compliance with generally accepted accounting principles, audit procedures and disclosure requirements.

(viii) Reporting
- The outcome is reported to the person(s) on whose behalf investigation is carried out.
- The outcome is reported to the owners of the business entity.

The approach to an investigation is different from that followed in an audit. An investigation involves a more detailed examination of the selected areas than what is required in an audit. An investigation seeks substantive and in some case even conclusive evidence as compared to audit which mainly relies on persuasive evidence.

An investigator does not accept a stated fact as correct until it is substantiated. An auditor, in the absence of suspicious circumstances, relies on stated facts or figures. An auditor has to see whether the method of valuation and other accounting policies have been properly made in the financial statements or not. An investigator, however, is not by accounting conventions, policies and disclosure requirements. An auditor does not suspect unless circumstances are there to arouse suspicion, while an investigator approaches the work with a frame of mind to suspect, verify and satisfy.

The auditor seeks to report what he finds in the normal course of examination of the accounts adopting generally followed techniques unless circumstances call for a special probe: fraud, error, irregularity, whatever comes to the auditor’s notice in the usual course of checking, are all looked into in depth and sometimes investigation results from the prima facie findings of the auditor.
3. STEPS IN INVESTIGATION

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

1. **Determination of objectives and establishment of scope of investigation.**
   
2. **Formulation of the investigation programme.**

   
3. **Examination and study of various records by reference to appropriate evidence.**

   
4. **Analysis, processing and interpretation of findings.**

   
5. **Preparation of report and drawing up of conclusions.**

   
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**Step 1: Determination of objectives and establishment of scope of investigation**

At the stage of acceptance of the assignment, the investigator should be absolutely clear about what is sought to be achieved by the investigation. If instructions from the client leave matters vague and non-specific, it would be proper for the investigator to have the matters discussed and obtain clearly written instructions covering the object and the scope of investigations and the issues incidental thereto.

The period which the investigation should cover should be clearly specified. The results of investigation are often seriously affected owing to change in circumstances which have occurred since it was contemplated, e.g., devaluation, import restrictions, starting of a new division, etc. Therefore, the purpose of the investigation should be borne in mind while determining the period which an investigation should cover.

**Step 2: Formulation of the investigation programme**

It is not possible to draw up one programme to serve different types of investigations which a professional accountant is called upon to carry out, for their scope and content have to be determined on a consideration of circumstances peculiar to each business or situation. The investigation programme should be drawn up having regard to the nature of the business, the structure of business, the instructions from the client embodying the objectives, the consequent scope and depth and the necessity to extend the investigation into books and records belonging to
others. The programme should also be flexible so that knowledge gained with the progress of work can be used to extend, reduce or modify the extent and areas of checking.

In programming the verification, the investigator should concentrate on areas considered relevant rather than to undertake a wide-ranging verification.

In case of an investigation on suspected payment of wages to ghost workers, the investigator should scan the areas having a bearing on the determination of wages and payments thereof. He should concentrate on time and job cards, appointment and termination of workers, attendance records, internal controls, internal checks, and preparation of wage sheets, withdrawal of money from bank for payment of wages and the actual disbursement of wages.

A conscious effort in investigation programming should be devoted to localise the enquiry into the relevant areas and, for that purpose, the initial wider base of inquiry should be gradually narrowed and fixed at a level that is meaningful. Matters not found to have a bearing on the subject matter of investigation should be gradually and progressively eliminated. This procedure alone will enable an in-depth examination of the matters relevant to the investigation.

**Step 3: Collection of Evidence**

Through examination, the investigator would be gathering relevant evidence connected with the matters to be investigated. In the course of examination of the documents and records, the investigator may require to obtain oral explanations from various personnel of the concerned business. In case his client is a person external to the business, it may be necessary for the investigator to get the matter formally agreed to by the business through the client. The investigator should look for the most convincing evidence; he should seek and examine all the available evidence and by a process of elimination and corroboration, should endeavour to reach at the truth of the matter. He, unlike the auditor, is not to restrict himself to *prima facie* evidence ordinarily available. He should examine it and if circumstances demand should try to obtain evidence that may have to be specifically procured.

In the matter of valuation of land, he should definitely have regard to the available evidence as per records of the business and records of any bid received for the land. In addition, he should have regard to the prices at which land was sold or purchased in the neighbourhood around the same time. This may require him to obtain evidence even by going to the land registration office. He may also call for the report of experts in land valuation.

**Step 4: Analysis and Interpretation of Findings**

Careful analysis and correlation of facts and figures will be necessary before the investigator can reach his conclusion. The conclusion should be well reasoned and backed by established facts and data. He must analyse the data objectively on the basis of evidence gathered by him and should not draw conclusions according to pre-conceived notions. While interpreting the figures, the investigator must keep in mind various factors e.g. the political and economic considerations, competition faced by the business, historical pattern of the data, nature of the business, etc.
Step 5: Reporting of findings

Like all other work of an accountant, an investigation results in a report. It is submitted and addressed to the party at whose instance the investigation has been carried out. The nature of the report is governed mainly by two factors. First, the instructions given by the client as regards the special aspects of the business which are required to be investigated; and second, the findings of the investigating accountant.

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<th>The important issues to be kept in mind by the investigator while preparing his report are as follows:</th>
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<td>(i) The report should not contain anything which is not relevant either to highlight the nature of the investigation or the final outcome thereof.</td>
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<td>(ii) Every word or expression used should be properly considered so that the possibility of arriving at a different meaning or interpretation other than the one intended by the investigator can be minimized.</td>
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<td>(iii) Relevant facts and conclusions should be properly linked.</td>
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<td>(iv) Bases and assumptions made should be explicitly stated. Reasonableness of the bases and assumptions made should be well examined and care should be taken to see that none of the bases and assumptions can be considered to be in conflict with the objective of the investigation. For example, in an investigation into over-stocking of raw materials, inventories and spares etc. it should not be assumed that the ordering levels indicated on bin cards provide fair guidance about acquisition of further materials. Also, since investigation is a fact finding assignment, assumptions should be made only when it is unavoidably necessary.</td>
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<td>(v) The report should clearly spell out the nature and objective of the assignment accepted its scope and limitations, if any.</td>
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<td>(vi) The report should be made in paragraph form with headings for the paragraphs. Any detailed data and figures supporting any finding may be given in Annexures.</td>
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<td>(vii) The report should also state restrictions or limitations, if any, imposed on the instructions given by the client. Preferably the reasons for placing such restrictions and their impact on the final result should also be stated.</td>
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<td>(viii) The opinion of the investigator should appear in the final paragraph of the report.</td>
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Due to non-availability of standardised procedure and lack of professional guidance, investigation calls for extreme care, caution and circumspection on the part of the investigator in exercising his judgement and discretion. Investigation often has a characteristic of very intimate and direct involvement of parties whose interest may be affected. Therefore, unlike auditing, chances of one or the other of the parties challenging the finding of the investigation are far greater.
4. SPECIAL ISSUES IN INVESTIGATIONS

Investigations broadly range between two extremes; on the one hand there are those in respect of which complete accounts, documents, records and other information are available, and on the other, those in respect of which little information, besides published accounts and statistical data, is available. Then again, investigation may cover the whole of accounting or may relate to only a part or parts of accounting as may be specified. Some more issues often arise in investigation. They are stated below:

(a) **Whether an investigator is required to undertake a cent per cent verification approach or whether he can adopt selective verification** - The answer to this question depends on the exact circumstances of the case under investigation. If the investigator has to establish the amount of cash defalcated by the cashier, he has probably no option but to carefully examine all the cash vouchers and related transactions. On the other hand, if he is to arrive at the profitability of a concern, he may verify constituent transactions on a selective basis taking extreme care to see that no material transaction that affects profit has remained concealed from his eyes. In investigation, it is always safer to go by statistically recognised sampling methods than to depend on the so-called “test checks” where circumstances permit selective verification.

(b) **Whether the investigator can put reliance on the already audited statement of account** - Here also no dogmatic views are possible. If the investigation has been launched because of some doubt in the audited statement of account, no question of reliance on the audited 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 to test everything afresh.

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It was held in the case of *Short & Compton v. Brackert (1904)* that an accountant, when making an investigation for an incoming partner, was entitled to assume that the figures appearing in the books were correct.

In another case, *Mead v. Ball Baker & Co. (1911)*, it was held that an accountant, when acting as an adviser to a proposed investor in a limited company, was not expected to check errors in stock sheets and the omission of liabilities.

These cases were decided long time ago. Therefore, much reliance cannot be placed on them. It is, therefore, desirable for the investigator to ascertain from the client, in advance, in writing, whether the audited statements of account produced to him should be taken as correct.
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. 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 settled in the famous Hedley Byrne's case. 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.

(c) **Whether an investigator necessarily requires assistance of expert** - Often an investigator may feel the necessity of obtaining views and opinions of experts in various fields to properly conduct the investigation. 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 it and he should settle the question of costs for obtaining the views and other related implications.

(d) **Investigation out of disputes and conflicting claims** - Cases for investigation sometimes arise out of disputes and conflicting claims. It is needless to emphasise that the investigator should remain above disputes or conflicting claims and be alert to the possibilities of the information or documents made available to him to be prejudiced. Even the client, overtly or covertly, may try to influence his reports. A seller of a business or controlling shares may request him to see that he gets the most favourable price. Similarly, if he is appointed by the buyer, he may be requested to deliberately depress the value. The investigator should keep him scrupulously professional and should keep the interest of all the involved parties in view. This is a challenging task and probably no other professional work offers this much of challenge. This work is exciting too and requires not only the best of skill but of a high degree of maturity and experience.

(e) **Basis of opinion of an investor** - The investigator should refrain from issuing speculative opinion. He should confine his opinion to the established facts and nothing more. If the facts, as conveyed through the books, records, papers and other evidence, are not capable of being properly established, he should not express an opinion or, if at all he expresses any opinion, he should qualify the opinion appropriately. This problem may particularly arise in cases where incomplete books and records are produced for investigation.

(f) **Whether an investigator can make futuristic statements** - The investigator should refuse to be futuristic. He may assume that the established trend in the business will continue in the near future, in the absence of any contrary evidence, in arriving at the present value of a business. He, however, should not project the trend into any future years to establish a value.

(g) **Whether to retain working papers or not** - Another important precaution is that the investigating accountant should retain, on his files full notes of the work carried out, copies
of schedules and all working papers, record of conversations and the like. Also, the working papers should link up the figures shown by the books of business with the final figures produced by the accountant. In the absence thereof, he would not be able to explain the figures when he is called upon to give evidence in a court of law to support his figures; for quite often the conclusions of the accountant are challenged by parties whose interest is adversely affected by his findings, for example, when the value of shares of a company taken over by the Government has been determined by him. This will also be of immense help to the investigator in correlating facts and events and later in drafting the report.

5. SPECIAL ASPECTS IN CONNECTION WITH BUSINESS INVESTIGATIONS

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

(a) Studying the overall picture - In such a business investigation, it is of utmost importance first to have an overall picture of the position of the business which is being investigated before the details are gone into. This is because figures are only symbols; and it is impossible to interpret them intelligently without knowledge of the background in which they have emerged.

For investigating the accounts of a group of companies, it would not be possible to know the manner in which the profits had emerged in the past unless a chart is prepared, showing the relationship of different companies comprising the group; whether as subsidiaries or not, the nature of transactions entered into by one unit in the group with another or others and the terms on which this has been done. 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. Apart from these preliminary enquiries, the investigating accountant should study:

(i) the character of management;
(ii) the economic and political forces to which the business is subject; and
(iii) the position it enjoys in trade.
At times, political or economic factors also may affect the fortunes of a business; for example, labour disturbances, changes in government policies in the matter of levy of excise and custom duties, imports, etc. It is, therefore necessary that the impact of all these factors should be studied and their effect on the business judged on a consideration of the profits in the past. For studying the economic and financial position of the business, the following should be considered:

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

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

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

(b) Statement of Profit and Loss - To study the Statement of Profit and Loss of a concern, it is necessary to 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.

In the foregoing summary, in the place of figures of opening and closing inventories, the figures of inventory consumed in different years should be entered. It should also be verified that the inventories have been valued on a consistent basis throughout the period under review. If there has been a change, the values of inventories should be adjusted. Further, in the summary, the gross profit ratios and the ratios showing the relationship between various items of expenses and sales should be entered. The trend of these ratios should be examined and, if there is a wide divergence in them, an explanation for the same should be sought. In the preparation of the summary attention should also be paid to the following matters:

Turnover - The figures of sales should be broken down between the various products sold to show variations in turnover of individual products from year to year. In this way, it would be possible to find out the products the sales of which have been increasing and those the sales of which have been falling.

By reference to the list of customers, in the Order Books, it should be ascertained whether the business has a very large turnover with a few customers or a small turnover with several customers.

The Order Books should also be examined to find out if fictitious sales have been entered in any year to boost up profits. If so, the figures of sales of the year or years should be adjusted.

If the business consists of activities which are dissimilar in operation, like manufacturing and agency, then apart from splitting the income between the two sources, expenses should also be apportioned between them to separately arrive at the figures of profit from each of the activities.
**Wage structure** - The method of computing wages and the rates of wages should be examined. On occasions a business may have to pay higher wages than those prevailing in other business in the same neighbourhood in pursuance of an industrial award. Another factor which is important to consider in this connection is the relationship of the business with its workers. A business which has suffered several industrial disputes, strikes, etc. and has had its working interrupted by them frequently cannot be expected to prosper unless a proper settlement is reached with workers' unions.

**Depreciation** - The charge on account of depreciation and maintenance of machinery and other assets included in the accounts of different years should be compared to verify that depreciation has been provided from year to year on a consistent basis and that it is adequate. Also, the necessary adjustment in the depreciation charge should be made if it is the practice of the company to write off the assets on a renewal basis.

Further, if assets have been revalued, it should be confirmed that depreciation on the increased valuation has been adjusted.

Generally, with age, the cost of maintenance of assets should increase. If it has not, the reason thereof should be ascertained.

In case of leasehold property, it should be ascertained whether an adequate provision has been made for the dilapidation charge which may be payable at the end of the lease.

Further, compliance of relevant AS should also be verified.

**Managerial Remuneration** - It should be verified that the remuneration payable to various members of managerial personnel is not excessive in relation to the profits of the business after taking into account the time devoted by each of them. However, it could also be that no or only a nominal remuneration has been charged in the accounts. In either case, an adjustment should be made to arrive at true profitability of the concern. Further, in case of company, requirement of relevant section of Companies Act, 2013 is to be seen. It has to be assured that calculation of profit for arriving at the remuneration is correct.

**Exceptional and non-recurring items** - It is customary to adjust exceptional items in the summary of Statement of Profit and Loss in order that they may not obscure the trend of the profits. In the matter of non-recurring items, it is necessary to remember that adjustments are to be made in respect of exceptional items which do not recur from year to year or can be considered exceptional having regard to their materiality or periodicity.

In this connection, it is worthwhile to examine the income tax assessment orders of the business to find out the items which have been treated as revenue but have been regarded by the taxing authority as inadmissible. Where the effect of these has been abnormal on the tax paid by the company from year to year, suitable adjustments should be made in the figures of taxes paid, as well as in the assets amounts. Likewise, adjustments should be made in respect of exceptional profits and losses.
Repairs and maintenance - It is one of the recurring expenses of a business. Occasionally it is noticed that this expenditure is unduly heavy in some of the years, while quite low in some others. Generally, companies, as a matter of routine undertake major repairs, overhauls and maintenance programme at an interval of 3 or 4 years while running repairs and maintenance continue in the usual manner which gives rise to fluctuating charges in the accounts unless periodic major expenses are treated as deferred expenditure.

Besides, due to wrong allocation of expenses between capital and revenue, repair charges may appear to be heavy or low. If fluctuating and abnormal charges for repairs is noticed, it would be the duty of the investigating accountant to scrutinise this head thoroughly to establish correct and normal charge for repairs.

Unusual year - A company’s record of profitability may show a trend of increasing or decreasing profit or loss or it may be highly erratic and fluctuating. Where a definite trend is discernible, the job of the investigating accountant is somewhat simplified. He can adopt recent years’ record of profitability as the basis for estimating future maintainable profit having regard to the inflationary state in the economy. But if the same is fluctuating, there would be more demand on judgement of the accountant in selecting the period to be covered for estimation of profitability. In such cases it may even be necessary to take into consideration results of past 9 to 10 years with a view to iron out the fluctuation. If, however, it is noticed that results of one or more years under scrutiny were materially vitiated by exceptional factors like a long term industrial dispute, natural calamities, fire, war, ravage etc., the investigating accountant should eliminate such year / years from consideration altogether since they do not reflect the results obtained through normal business.

(c) Balance Sheet - Fixed Assets - Fixed assets, usually, are shown in accounts at cost less depreciation but the accounts do not show the ages of different assets. It is desirable, therefore, to obtain age analysis of various items of fixed assets. Assets which are old or are obsolete would naturally have to be replaced. It should be seen that their values are not in excess of the value of service that they could be expected to render to the business during the balance period of their active life and the amount they would fetch on sale as scrap.

In addition, from a study of the maintenance expenses incurred from year to year, it should be judged whether the assets have been properly maintained. If not, it might be necessary to incur heavy expenditure on repairs to put them in a proper working order. In such a case, an allowance for this factor should be made in the value of assets. More particularly, it should be seen that if assets have been revalued, the increased depreciation charge has been adjusted against profit. Further, investigator has to assure whether assets whose recoverable amount is less than carrying amount are impaired and requirement of AS 28, “Impairment of Asset”, has been complied.

Investments -Investments should be broadly classified into long term investments and current investments. A current investment is by its nature readily realisable and is intended to be held for not more than one year. All other investments are long term investments.
Current investments are valued on the basis of lower of cost and fair value determined either on an individual investment basis or by category of investment but not on an overall basis.

Long-term investments are usually carried at cost. However, when there is a permanent decline in the value of long-term investments, the carrying amount should be reduced to recognise the decline. The carrying amount of long term investments is determined on an individual investment basis. Interest, dividends and rentals receivable in connection with investment are generally regarded as income. However in some cases, such receipts represent recovery of cost and should therefore be reduced from, the cost of investment (e.g. dividend out of pre-acquisition profits).

**Inventories** - It should be seen that inventories 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.

**Trade Receivables** - In assessing their value, the following should be taken into account:

(i) Whether bad debts have been adjusted in the years in which the relevant sales took place instead of in the year in which they have been written off. Normally, such an adjustment should be made but not when debts have had to be written off on account of a slump or a fall in international prices, during a period subsequent to the period in which sales had taken place.

(ii) The length of the credit period allowed throughout the period under investigation, to determine whether it has been necessary to increase continually the credit period in order to effect the sales. If it has been so, it would indicate that the demand for the goods manufactured by the concern in the market has been diminishing gradually.

(iii) Debts should be classified according to their age. This would disclose the character of the parties with whom the company trades and the amount of working capital that will be necessarily blocked on this account in the course of business.

**Other liquid assets** - It should be ascertained that the assets so described are readily realisable. Money with a bank in liquidation should be taken only to the extent guaranteed by Deposit Insurance Scheme.

**Idle assets** - On a scrutiny, it may appear that certain assets are remaining idle and are not being properly applied in the business. These may come from all sections of assets. 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. The company may hold large cash and bank balances, not warranted by the need of the business. Then again, there may be instances of obsolete and slow moving inventories of large value in the accounts of the company. It would be the duty of the investigating accountant to eliminate these idle assets, if any, after proper identification from the net worth of the business. However, proper value of these assets may be separately added to the value of the business.
Liabilities - The important matter to investigate in this regard is whether those are stated fully or understated or overstated. In other words, whether the profits of the business have been inflated by suppression of liabilities or there are any free reserves included in the liabilities. In either case, an adjustment would be necessary. Secondly, it should be ascertained that liabilities are not unduly large or are not outstanding for a long time, in such cases, it would be necessary to pay off some of them which would cause a drain on the liquid resources of the concern. The fact should be stated in the report.

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

Capital - In this regard, it is necessary to ascertain:

(i) Whether the capital is well balanced. This would not be the case if the amount of debentures and preference share capital are disproportionately large as compared to the equity capital, for this would be a handicap to the company in raising further equity capital, on favourable terms for financing the business or to pay off capital commitment. Further, when the capital is highly geared, it would affect the value of the equity capital;

(ii) That the amount of capital is reasonable compared to the value of fixed assets and the amount of working capital required. The terms associated with the issue of the capital should also be studied; restriction on transferability of shares usually depresses the value of share and of the business.

(d) Interpretation of figures - Fixed Assets - The amount of capital expenditure which would be necessary in the future for the continuation of the business, in its existing stage, should be assessed having regard to the under-mentioned factors:

(i) the amount required for the replacement of assets when these would become worn out or obsolete;

(ii) the expenditure which will be necessary to replace obsolete machinery by more sophisticated machinery for manufacturing different types of goods for which there is demand.

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

(i) Trend: Whether in the past sales have been increasing consistently or they have been fluctuating. A proper study of this phenomenon should be made.
(ii) **Marketability**: Is it possible to extend the sales into new markets or that these have been fully exploited? Product wise estimation should be made.

(iii) **Political and economic considerations**: Are the policies pursued by the Government likely to promote the extension of the market for goods to other countries? Whether the sales in the home market are likely to increase or decrease as a result of various emerging economic trends?

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

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

(i) Has the ratio of inventory to turnover been increasing and if so, is it a continuing or only a temporary trend?

(ii) Are the trade payables being paid promptly or is there a backlog which will have to be dealt with?

(iii) What will be the effect on inventory, trade receivables and trade payables, if the turnover is increased or if new products are introduced?

**Estimating Future Maintainable Profits** - Fluctuations in profits during the years under review should be examined after adjusting the profits for extraneous factors, if any, that had given rise to fluctuations to determine whether the factors responsible for the fluctuations were temporary or was likely to recur in future. A statement should be prepared showing separately the profits after depreciation earned in each of the years during the period under review, after making adjustments therein, if considered necessary, as regards factors which have been responsible for any extraordinary increase in profits. If the percentage of profits before taxation to capital has been stable or has been increasing, it would indicate that the business would continue to earn the same rate of profit as it has done in the past. If, on the other hand, the percentage has been falling, and there is no evidence that the factors responsible therefore have ceased to operate, investment of further capital in the business would not be commercially advisable.
6. TYPES OF INVESTIGATION

The different types of investigation that a chartered accountant is usually called upon to carry out are given hereunder:

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<th>Types of Investigation</th>
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<td><strong>Statutory</strong></td>
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<td>Investigation into the affairs of a company</td>
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<td>By inspector through an order of the Central Government (Section 210)</td>
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<tr>
<td>By Serious Fraud Investigation Office (Section 212)</td>
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<td>Other cases (Section 213)</td>
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<td>Investigation for valuation of shares in private companies</td>
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<td>Investigation in connection with review of profit/financial forecast</td>
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**Statutory** - By an inspector under Sections 210, 212, 213 and 216 of the Companies Act, 2013.

**Non-statutory** - These are listed as under:

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<tbody>
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</tbody>
</table>
6.1 Investigation under the Companies Act, 2013

Investigation under the Companies Act, 2013 may broadly be classified into:

(A) Investigation into the affairs of a company: This may further be divided into three parts:

1. Investigation into the affairs of a company by inspector through an order of the Central Government as envisaged under Section 210.
2. Investigation into the affairs of a company by Serious Fraud Investigation Office as prescribed under Section 212.
3. Investigation into the affairs of a company in other cases as provided under Section 213.

(1) Investigation into the affairs of a company as envisaged under Section 210:
Where the Central Government is of the opinion, that it is necessary to investigate into the affairs of a company-

(a) on the receipt of a report of the Registrar or inspector;
(b) on intimation of a special resolution passed by a company that the affairs of the company ought to be investigated; or
(c) in public interest,

it may order an investigation into the affairs of the company.

Further, where an order is passed by a court; or the Tribunal requiring investigation, the Central Government shall order an investigation into the affairs of that company.

For the above purposes, the Central Government would appoint one or more persons as inspectors to investigate into the affairs of the company and to report thereon in such manner as the Central Government may direct.

(2) Investigation into the affairs of a company by Serious Fraud Investigation Office under Section 212: The Central Government may, by an order, assign the investigation, into the affairs of the company, to the Serious Fraud Investigation Office, when it considers necessary to investigate into the affairs of the company, on receipt
of a report of the Registrar or inspector; or on intimation of a special resolution passed by a company; or in public interest; or on request from the Department of the Central Government, or a State Government.

Where the Central Government assign any case to the Serious Fraud Investigation Office for investigation under this Act, no other investigating agency of Central Government or any State Government shall proceed with investigation in such case. The Serious Fraud Investigation Office shall follow the manner and procedure as provided and submit its report to the Central Government. The Central Government may also direct to submit an interim report.

Where the report states that fraud has taken place in a company and due to such fraud any director, key managerial personnel, other officer of the company or any other person or entity, has taken undue advantage or benefit, whether in the form of any asset, property or cash or in any other manner, the Central Government may file an application before the Tribunal for appropriate orders with regard to disgorgement of such asset, property or cash and also for holding such director, key managerial personnel, other officer or any other person liable personally without any limitation of liability.

(3) Investigation into the affairs of a company in other cases as provided under Section 213: The Tribunal may order investigation into affairs of the company, on an application received by specified number of members and supported by such evidence; or on an application made to it by any other person or otherwise, if it is satisfied that there are circumstances like, the business of the company is being conducted with intent to defraud its creditors, or that the company was formed for any fraudulent or unlawful purpose, or the members of the company have not been given all the information with respect to its affairs, etc. The investigation may be ordered, after giving a reasonable opportunity of being heard to the parties concerned.

It may be noted that if after investigation it is proved that—

| (i) | the business of the company is being conducted with intent to defraud its creditors, members or any other persons or otherwise for a fraudulent or unlawful purpose, or that the company was formed for any fraudulent or unlawful purpose; or |
| (ii) | any person concerned in the formation of the company or the management of its affairs have in connection therewith been guilty of fraud, misfeasance or other misconduct, |

then, every officer of the company who is in default and the person or persons concerned in the formation of the company or the management of its affairs shall be punishable for fraud.
Who can be appointed as an Inspector - A firm, body corporate or other association cannot be appointed as an inspector. Thus, a firm of professional accountant cannot be appointed as inspector but an individual accountant can be so appointed.

Power of Inspector to conduct investigation into the affairs of related companies etc.- Section 219 of the Companies Act, 2013 provides that an inspector appointed under section 210 or section 212 or section 213 to investigate into the affairs of a company may also investigate, subject to approval of the Central Government, into the affairs of—

(a) any other body corporate which is, or has at any relevant time been the company’s subsidiary company or holding company, or a subsidiary company of its holding company;

(b) any other body corporate which is, or has at any relevant time been managed by any person as managing director or as manager, who is, or was, at the relevant time, the managing director or the manager of the company;

(c) any other body corporate whose Board of Directors comprises nominees of the company or is accustomed to act in accordance with the directions or instructions of the company or any of its directors; or

(d) any person who is or has at any relevant time been the company’s managing director or manager or employee.

It may be noted that he shall, subject to the prior approval of the Central Government, investigate into and report on the affairs of the other body corporate or of the managing director or manager, in so far as he considers that the results of his investigation are relevant to the investigation of the affairs of the company for which he is appointed.

The objective of these investigations, fundamentally, is to determine whether any provision of the Act has been violated or there has been a breach of duty on the part of a director or an officer of the company resulting in a loss to shareholders or a class of them. It has been held in the case *Narayanlal Bansilal v. Maneck Phiroze Mistry and another* (1960 comp. Cases, p. 62) that an investigation into the affairs of a company under the Companies Act was not a criminal proceeding. It was also held that the report of the inspector is just an expression of his opinion in the manner in which affairs of the company was conducted.

The term “affairs of a company” was considered in *R.V. Board of Trade Ex. parte St. Martin Preserving Company Ltd.* (1964 E.R. 561). It was held that it can cover investigations into all aspects of its business; its assets including goodwill, profits and losses, contracts and transactions, investments and rather property interests and control of subsidiary companies and transactions of a receiver and manager of a company.
PROCEDURE, POWERS ETC. OF INSPECTORS – Section 217 of the Companies Act, 2013 states the procedures, powers of the Inspectors as follows:

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<th>Description</th>
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<td>1</td>
<td>Duty of officers and employees of the company towards inspector: It shall be the duty of all officers and other employees and agents including the former officers, employees and agents of a company which is under investigation to preserve and to produce to an inspector or any person authorised by him, all books and papers relating to the company or the person; and to provide assistance in connection with the investigation which they are reasonably able to give.</td>
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<td>2</td>
<td>Inspector may ask information from any body corporate: The inspector may require any body corporate, other than a body corporate referred to in point(1), to furnish such information to, or produce such books and papers before him as he may consider necessary.</td>
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<td>3</td>
<td>Not to keep Books and Papers in custody for more than 180 days: The inspector shall not keep in his custody any books and papers produced for more than 180 days and return the same to those by whom the books and papers were produced. The inspector may call the books and papers again, if needed, for a further period of 180 days by an order in writing.</td>
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<td>4</td>
<td>Examine on oath: The inspector may examine on oath any of the persons referred above; and with the prior approval of the Central Government, any other person in relation to the affairs of the company, or other body corporate or person, as the case may be.</td>
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<td>5</td>
<td>Inspector to possess all the Powers of Civil Court: The inspector, being an officer of the Central Government, making an investigation shall have all the powers as are vested in a civil court under the Code of Civil Procedure, while trying a suit in respect of specified matters.</td>
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<td>6</td>
<td>Assistance of Officers of Government to Inspector: The officers of the Central Government, State Government, police or statutory authority shall provide necessary assistance to the inspector for the purpose of inspection, investigation etc.</td>
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<td>7</td>
<td>Evidence from place outside India: If in the course of an investigation into the affairs of the company, an application is made to the competent court in India by the inspector stating that evidence may be available in a country or place outside India, such court may issue a letter of request to a court or an authority in such country or place for seeking such evidence.</td>
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It may be noted that the letter of request shall be transmitted in such manner as the Central Government may specify in this behalf.

**INSPECTOR’S REPORT** - Under Section 223 of the Companies Act, 2013, an inspector shall, if so directed by the Central Government, submit interim reports to that Government, and on the conclusion of the investigation, shall submit a final report to the Central Government. Every report made shall be in writing or printed as directed by the Central Government. A copy of the report may be obtained by members, creditors or any other person whose interest is likely to be affected by making an application to the Central Government.

Section 224 of the Companies Act, 2013, deal with follow-up of the inspector’s report and gives power to the central government to launch prosecution; apply for winding up of the company etc.

**GENERAL APPROACH FOR INVESTIGATION** - The general approach for investigation under Sections 210, 212 and 213 of the Companies Act, 2013 is conditioned by the legal requirements in these regards. From the foregoing requirements of law, it is apparent that investigations under these requirements may encompass a wide field.

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:

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<th>(i) Clarity of Terms of Reference:</th>
<th>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 rephrasing 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.</th>
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(ii) **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.

(iii) **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.

(iv) **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.

(v) **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.

(vi) **Legal requirements and investigation Report**: Only after he has completed the steps in the investigation programme and has marshaled all the information that he needed should he prepare his report. He, however, can also make interim report as provided under Section 223 of the Companies Act. 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 section 223 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.
(B) INVESTIGATION OF OWNERSHIP OF A COMPANY: According to Section 216 of the Companies Act, 2013, where it appears to the Central Government that there is a reason so to do, it may appoint one or more inspectors to investigate and report on matters relating to the company, and its membership for the purpose of determining the true persons, who are or have been financially interested in the success or failure, whether real or apparent, of the company; or who are or have been able to control or to materially influence the policy of the company; or who have or had beneficial interest in shares of a company or who are or have been beneficial owners or significant beneficial owner of a company.

In case, if the Tribunal, in the course of any proceeding before it, directs by an order that the affairs of the company ought to be investigated as regards the membership of the company and other matters relating to the company discussed above, the Central Government shall appoint one or more inspectors.

While appointing an inspector, the Central Government may define the scope of the investigation as respects the matters or the period to which it is to extend. It may limit the investigation to matters connected with particular shares or debentures. Powers of inspectors shall extend to the investigation of any circumstances suggesting the existence of any arrangement or understanding.

Scope and extent of investigation - When a chartered accountant is appointed to carry out an investigation under any of the aforementioned provisions, the extent of enquiry, the objective of the investigation and the various matters referred to for investigation are specified in the order of investigation issued by the appointing authority.

On a consideration thereof, the investigating accountant should determine the areas of accounts which require investigation and the extent to which the enquiry is to be made as well as his general approach to the enquiry.

In case, if the allegation is that certain transactions have been entered into in contravention of the provisions of the Companies Act, the nature of transactions, the persons who were parties thereto, the amount or amounts involved and the circumstances under which these were entered into must be examined. If the contravention was deliberate and willful and was made with some ulterior motive, it would attract greater penalty as compared to the one which was inadvertent. The enquiry therefore should show the motive, if any, of the contravention. If the loss suffered by the company has given rise to a gain by a director and other managerial personnel or its associates, the manner in which the benefit has accrued and the amount thereof shall have to be investigated.

In case of a company having subsidiaries or where one or more directors are interested in one or more concerns, all the dealings with these concerns should be examined for these may have been entered into with the intention of transferring profit. Generally, all sales and purchases of goods and assets from directors and their associated concerns should be scrutinized since these also can be a vehicle of illicit transferring of profits.
Any breach of duty or abdication of responsibility for purposes of investigation would be material only if it has resulted in a loss to the company. In such a case, the factors responsible for the loss or losses, besides the amount thereof, shall have to be investigated. Negligence would be culpable only if it was in relation to a duty cast by the Act, Articles of Association or by a resolution of the shareholders or that of the Board of Directors.

Any negligence in the discharge of duty of a director or any other managerial personnel must be construed very broadly, for apart from being the agents of the company, they are trustees of its property. As such, it is their duty to safeguard the property of the company and protect the interest of the shareholders. It must be remembered, however, that it is not the duty of a director to attend to the business of a company continuously and, therefore, so long as the decisions of the Board at which the director was present were taken on a proper consideration of the evidence available and in the best interest of the company, he would not be responsible for any losses suffered by the company.

It may be necessary for an investigator to interrogate directors, officers, agents, and others concerned with matters under his enquiry. Before drawing up his brief in this regard as well as for framing his conclusions, he should, if necessary, take legal assistance. If the Investigating accountant is required to report on the efficiency of the management, he should be discreet in expressing his opinion. Usually, it is sufficient if he merely indicates the general limitations of the management. The inspector must ensure that the persons who figure in the investigation get the fullest opportunity to explain their action and conduct. However, the inspector cannot hold out any assurance to anybody except the assurance of fairness implicit in the job.

6.2 Investigation on behalf of an Incoming Partner

The general approach of the investigating accountant in this type of investigation would be more or less similar, irrespective of the nature of business of the firm-manufacturing, trading or rendering a service.

Primarily, an incoming partner would be interested to know whether the terms offered to him are reasonable having regard to the nature of the business, profit records, capital distribution, personal capability of the existing partners, socio-economic setting, etc., and whether he would be capable of deriving continuing benefit in the shape of return on capital to be contributed and remuneration for services to be rendered, which can be justified by the overall economic conditions prevailing and other considerations considering his own personality and achievements. In addition, he would be interested to ascertain whether the capital to be contributed by him would be safe and applied usefully.

Broadly, the steps involved are the following:

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<th>(a)</th>
<th>Ascertainment of the history of the inception and growth of the firm.</th>
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<tr>
<td>(b)</td>
<td>Study of the provisions of the deed of partnership, particularly for composition of partners, their capital contribution, drawing rights, retirement benefits, job allocation, financial management, goodwill, etc.</td>
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</table>
Scrutiny of the record of profitability of the firm’s business over a suitable number of years, with usual adjustments that are necessary in ascertaining the true record of business profits. Particular attention should, however, be paid to the nature of partners’ remuneration, which may be excessive or inadequate in relation to the nature and profitability of the business, qualification and expertise of the partners and such other factors as may be relevant.

Examination of the asset and liability position to determine the tangible asset backing for the partner’s investment, appraisal of the value of intangibles like goodwill, know how, patents, etc. impending liabilities including contingent liabilities and those for pending tax assessment. In case of firms rendering services, the question of tangible asset backing usually is not important, provided the firm’s profit record, business coverage and standing of the partners are of the acceptable order.

Position of orders at hand and the range and quality of clientele should be thoroughly examined, which the firm is presently operating.

Position and terms of loan finance would call for careful scrutiny to assess its usefulness and implication for the overall financial position; reason for its absence should be studied.

It would be interesting to study the composition and quality of key personnel employed by the firm and any likelihood of their leaving the organisation in the near future.

Various important contractual and legal obligations should be ascertained and their nature studied. It may be the case that the firm has standing agreement with the employees as regards salary and wages, bonus, gratuity and other incidental benefits. Full import of such standing agreements would be gauged before a final decision is reached.

Reasons for the offer of admission to a new partner should be ascertained and it should be determined whether the same synchronises with the retirement of any senior partner whose association may have had considerable bearing on the firm’s success.

Appraisal of the record of capital employed and the rate of return. It is necessary to have a comparison with alternative business avenues for investments and evaluation of possible results on a changed capital and organisation structure, if any, envisaged along with the admission of the partner.

It would be useful to have a firsthand knowledge about the specialisation, if any, attained by the firm in any of its activities.

Manner of computation of goodwill on admission as also on retirement, if any, should be ascertained.

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.

Whether the incomplete contracts which will be transferred to the reconstituted firm will be a liability or a loss.

It would always be worthwhile to remember that, in a partnership, personal considerations count predominantly over other considerations and assessment of standing of the firm, standing and reliability of other partners, their personal reputation and the goodwill enjoyed by the products/services are important.
On the basis of the broad frame of considerations as given above, the investigating accountant should devise his own considerations in each case which may be quite diverse. Additional considerations may come up in the case of service-rendering firms where profit and business record, goodwill of the firm and of individual partners would assume greater significance. Again, in the case of industrial firms, the network of customers, their scatter, size, etc., would be relevant for consideration.

6.3 Investigation for Valuation of Shares in Private Companies

The importance should be given on various purposes for which such a valuation is necessary, the different bases on which valuation is possible and the variety of economic factors, on a consideration whereof the price so determined needs to be adjusted.

The necessity for valuation of shares of a private company arises, for under the Companies Act, a private company must restrict the transfer of its shares. In consequence, the shares of a private company do not have a free market in which their prices could be determined by interaction of the forces of supply and demand.

In respect of equity shares, there are two main methods of valuation. According to the first method, value is determined on the basis of net worth of the company. The amount of net worth is divided by the number of shares comprising the equity capital to arrive at the value for one share. When this method is followed, goodwill of the business, based on the estimated future maintainable profit, is included among the assets to arrive at the amount of net worth. According to the second method, the average profit earned by the business during the preceding 5 to 7 years is computed. Afterwards, on the assumption that the same would continue to be earned in the future, the value of business is calculated by capitalising it at a reasonable rate of interest. If the rate assumed is high, the value of the business would be smaller. Correspondingly, it would be high if the rate of interest applied is low. A provision of the risk factor and restriction on transfers in the value of shares is made by varying the rate of interest applied. The rate of return that an investor expects to earn in a business of the type in which the company is engaged, is ascertained from the prices of the shares of companies engaged in a similar business quoted on the stock exchange.

The value of preference shares is estimated on the basis of the yield on preference shares of companies engaged in a similar trade or industry after making allowance for factors like restriction on transferability, average rate of earnings as compared to the rate of dividend, etc.

Special features -

Net worth basis

(a) Each asset should be revalued on taking into account its utility to the business as a going concern. The value of different assets, on a revaluation, may be either more or less in comparison to their book values.
The book value of safes and furniture in the case of a bank is usually much less as compared to their utility. On the other hand, the book value of intangible assets, e.g., leasehold rights, patents, goodwill, etc., in case of an industrial concern may be higher in comparison with the advantage which accrues to it from these assets. In both the cases, the assets should be revalued at their replacement cost i.e., the cost of similar assets at the prevailing market price, reduced by the amount of depreciation which they would have suffered, if they were in use during the period that the corresponding assets have been in use. But the cost adopted, in cash, should be the cost of the assets as were originally purchased or that of their substitutes considered more suitable in the circumstances of the case.

(b) The value of goodwill of a business is primarily dependent on its capacity to earn super-profit and the period over which these are expected to arise. The super profits that the business would earn in the future are estimated on the basis of profits earned in the past, after making an allowance therein for the continuation or otherwise of favourable factors, which in the past had enabled the business to earn super-profits. This is usually a difficult matter since, for the purpose, it is necessary to analyse the trend of economic, social and political forces which have an impact on the profitability of the business.

The installed capacity must be viewed against future national requirements on taking into account the government’s licensing policy. Again, government policies like controls over selling price or advantages of marketing through its own organisations will have to be considered since any change therein might seriously affect the profit structure. Therefore, to determine the impact of these factors, the accountant must have knowledge of the company’s working and experience of the business in general.

Yield basis

(a) The value of shares on yield basis is arrived at on the basis of present value of the right to receive dividends in the future. Since dividends can be paid only out of profits, in this case also, it is necessary to determine the amounts of profits which the company would be earning in future as well as the amounts thereof which would be distributed as dividend from year to year. In short, it is an exercise in projecting the trend to profits and predicting the policy that the company might follow in the matter of declaration of dividends.

(b) The rate at which the amount of dividends should be capitalised is decided on taking into account the risk that shareholders are taking in the matter of declaration of dividends being continued in future, assessed in the background of past history of the company, the amount of reserves the company possesses, both secret and those disclosed in its books, future prospects of the line of manufacture or trade in which the company is engaged and the impact of various social and political factors that are likely to emerge on the company’s profitability. Since the effect of these factors is reflected in the prices at which the shares of companies engaged in similar trades and businesses are quoted on the Stock Exchange, the investigating accountant should consider them. These would show to him the rate at which their dividends were being capitalised. He should adopt the average rate of return expected
by investors in the shares of such companies but it should be applied only after making due allowance for the factors peculiar to the case, such as restrictions on transfer of shares, majority holding, etc. In any valuation of shares, with the transfer of shares control is also to pass, a separate value should be ascertained for the control and added to the value otherwise obtained either on net worth basis or yield basis.

6.4 Investigation on behalf of a Bank Proposing to Advance Loan to a Company

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

| (i) | The purpose for which the loan is required and the manner in which the borrower proposes to invest the amount of the loan. |
| (ii) | The schedule of repayment of loan submitted by the borrower, particularly the assumptions made therein as regards amounts of profits that will be earned in cash and the amount of cash that would be available for the repayment of loan to confirm that they are reasonable and valid in the circumstances of the case. Institutional lenders now-a-days rely more for payment of loans on the reliability of annual profits and loss on the values of assets mortgaged to them. |
| (iii) | The financial standing and reputation for business integrity enjoyed by directors and officers of the company. |
| (iv) | Whether the company is authorised by the Memorandum or the Articles of Association to borrow money for the purpose for which the loan will be used. |
| (v) | The history of growth and development of the company and its performance during the past 5 years. |
| (vi) | How the economic position of the company would be affected by economic, political and social changes that are likely to take place during the period of loan. |

To investigate the profitability of the business for judging the accuracy of the schedule of repayment furnished by the borrower, as well as the value of the security in the form of assets of the business already possessed and those which will be created out of the loan, the investigating accountant should take the under-mentioned steps:

(a) Prepare a condensed income statement from the 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 amount of maintainable profits determined on the basis of foregoing statement should be increased by the amount by which these would increase on the investment of borrowed funds.
(b) Compute the under-mentioned ratios separately and then include them in the statement to show the trend as well as changes that have taken place in the financial position of the company:

(i) Sales to Average Inventories held.

(ii) Sales to Fixed Assets.

(iii) Equity to Fixed Assets.

(iv) Current Assets to Current Liabilities.

(v) Quick Assets (the current assets that are readily realisable) to Quick Liabilities.

(vi) Equity to Long Term Loans.

(vii) Sales to Book Debts.

(viii) Return on Capital Employed.

(c) Enter in a separate part of the statement the break-up of annual sales product-wise to show their trend.

**Steps involved in the verification of assets and liabilities included in the Balance Sheet of the borrower company which has been furnished to the Bank** - The investigating accountant should prepare schedules of assets and liabilities of the borrower and include in the particulars stated below:

(a) **Fixed assets** - A full description of each item, its gross value, the rate at which depreciation has been charged and the total depreciation written off. In case the rate at which depreciation has been adjusted is inadequate, the fact should be stated. In case any asset is encumbered, the amount of the charge and its nature should be disclosed. In case an asset has been revalued recently, the amount by which the value of the asset has been decreased or increased on revaluation should be stated along with the date of revaluation. If considered necessary, he may also comment on the revaluation and its basis.

(b) **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.

(c) **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:

<table>
<thead>
<tr>
<th>Type of Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>(i) debts due in respect of which the period of credit has not expired;</td>
</tr>
<tr>
<td>(ii) debts due within six months; and</td>
</tr>
<tr>
<td>(iii) debts due but not recovered for over six months.</td>
</tr>
</tbody>
</table>

If any debts are due from directors or other officers or employees of the company, the particulars thereof should be stated. Amounts due from subsidiary and affiliated concerns, as well as those considered abnormal should be disclosed. The recoveries out of various debts subsequent to the date of the Balance sheet should be stated.

(d) **Investments** - The schedule of investments should be prepared. It should disclose the date of purchase, cost and the nominal and market value of each investment. If any investment is pledged as security for a loan, full particulars of the loan should be given.

(e) **Secured Loans** - Debentures and other loans should be included together in a separate schedule. Against the debentures and each secured loan, the amounts outstanding for payments along with due dates of payment should be shown. In case any debentures have been issued as a collateral security, the fact should be stated. Particulars of assets pledged or those on which a charge has been created for re-payment of a liability should be disclosed.

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

(g) **Other Liabilities** - It should be stated whether all the liabilities, actual and contingent, are correctly disclosed. Also, an analysis according to ages of trade 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.

(h) **Insurance** - A schedule of insurance policies giving details of risks covered, the date of payment of last premiums and their value should be attached as an annexure to the statements of assets, together with a report as to whether or not the insurance-cover appears to be adequate, having regard to the value of assets.

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

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.
6.5 Investigation of Frauds

In the Companies Act, 2013 meaning of fraud has been considered in two specific sections viz. Section 143(10), where the SAs specified by the ICAI are deemed to be the auditing standards for purposes of the Act, which, inter alia, define fraud, and in Section 447, where punishment for fraud has been prescribed.

Fraud has been defined in paragraph 11(a) of SA 240, “The Auditor’s responsibilities Relating to Fraud in an Audit of Financial Statements” as ‘an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.’

In the context of stating the provisions for punishment for fraud, Section 447 of the Act has explained the term ‘fraud’ as “fraud in relation to affairs of a company or any body corporate, includes any act, omission, concealment of fact or abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss.”

This Section further explains the terms ‘wrongful gain’ and ‘wrongful loss’ to mean the gain by unlawful means of property to which the person gaining is not legally entitled; and the loss by unlawful means of property to which the person losing is legally entitled, respectively.

Note: Students are also advised to refer Chapter 5 of this study material given in Module I and Chapter 5 Fraud and the Responsibilities of the Auditor in this regard of Auditing and Assurance study material of Intermediate level for detailed provisions w.r.t to Fraud Reporting.

6.5.1 Types of Frauds

Frauds may broadly be categorized as –

<table>
<thead>
<tr>
<th>Fraudulent Financial Reporting –</th>
<th>Mis-appropriation of Assets –</th>
</tr>
</thead>
<tbody>
<tr>
<td>🚬 Alteration or falsification of records &amp; documents</td>
<td>🚬 Embezzlement of receipts in respect of written-off accounts</td>
</tr>
<tr>
<td>🚬 Misrepresentation in or intentional omission of events, transactions or information</td>
<td>🚬 Stealing physical assets or intellectual properties</td>
</tr>
<tr>
<td>🚬 Intentional misapplication of accounting principles</td>
<td>🚬 Introduction of fictitious vendors</td>
</tr>
<tr>
<td>🚬 Fictitious Journal Entries</td>
<td>🚬 Payment of factitious employees</td>
</tr>
<tr>
<td>🚬 Adjusting assumptions and changing Judgments</td>
<td>🚬 Using entities assets for personal use.</td>
</tr>
<tr>
<td>🚬 Omitting, advancing or delaying the recognition of events or transactions.</td>
<td></td>
</tr>
</tbody>
</table>
### DUE DILIGENCE, INVESTIGATION & FORENSIC AUDIT

<table>
<thead>
<tr>
<th>Fraudulent Entries</th>
<th>Sales Frauds</th>
<th>Collection Frauds</th>
<th>Expenses Frauds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Late entry</td>
<td>Price enhancement</td>
<td>Defalcation of contributions to charity funds</td>
<td>Entering ineligible discount</td>
</tr>
<tr>
<td>No entry</td>
<td>Omission to make receipt of sale of scrap</td>
<td>Crediting donation to loan accounts</td>
<td>Overcharging expenses</td>
</tr>
<tr>
<td>Part entry</td>
<td>Billing and sales reversals in amusement parks</td>
<td>• Food production yield ratio in hotels and suppression of Revenue</td>
<td>Falsification of documents</td>
</tr>
<tr>
<td></td>
<td>• Using or hiring assets of the company in lean period</td>
<td>• Using or hiring assets of the company in lean period</td>
<td>Untimely payment</td>
</tr>
<tr>
<td></td>
<td>• Inserting wrong entries to divert attention</td>
<td>• Omission in preparation of dispatch note for sale</td>
<td>Introduction of fictitious vendor</td>
</tr>
</tbody>
</table>

### Sales Frauds
- Price enhancement
- Omission to make receipt of sale of scrap
- Billing and sales reversals in amusement parks
- Food production yield ratio in hotels and suppression of Revenue
- Using or hiring assets of the company in lean period
- Omission in preparation of dispatch note for sale
- Sale of Assets recorded as Income

### Collection Frauds
- Defalcation of contributions to charity funds
- Crediting donation to loan accounts

### Expenses Frauds
- Entering ineligible discount
- Overcharging expenses
- Falsification of documents
- Untimely payment
- Introduction of fictitious vendor

### Payroll Frauds
- Extra number of employees
- Extra hours
- Calculation of net pay by transferring rounding off amount to personal account.
- Not deactivating the retired employees’ IDs

### Data Frauds
- Change in computer data
- Destroy, suppress or insert records
- Using open fields in computerized accounting system

### Technology related Frauds
- Employing hostile Software Programs or malware attacks
- Phishing mails
- Vishing – Voice Mail
- SMSishing - Text messages
- Whaling – Targeted phishing on high network individuals
- Card duplications
- Stealing confidential data

### Banking related Frauds
- Forged Signatures
- Cheque Frauds - Alteration in amounts, Alteration in account titles, Kite flying
- Cash lending during working hours
- Missing notes in bundles
- Use of same notes bundles by two branches
- Wrong posting in other accounts
- Misuse of sensitive stationery
- ATM transaction misuse
- Using PINs of debit card/credit card holder
- Advances - Car, Xerox Machine, inflated stock statements, inflated projections, forged/duplicate land documents, L/Cs

### Others
- Teaming and Lading
- Process houses mixing inferior quality material to sale good quality material
- Pilferage and theft in super markets
- Selling classified information,
- Withholding information from customer about free product schemes, discount and concession.
- Enhancement of performance
- Taking advantage of disaster or natural calamity.
- Trust FDs
- Fictitious journal entries to inflate expenses or income.
Frauds may be classified as defalcations involving misappropriation, either of money or that of goods, and manipulation of accounts not involving a defalcation. The detections of manipulations of accounts being one of the objects of an audit, for the detection of frauds perpetrated for misappropriating either money or goods, knowledge of the various circumstances under which these may be committed and that of different forms they take is essential. On this account, a brief description thereof at different level is given below:

1. **Fraud for Personal GainS**

   **Bribery:** Money, gift or other favours offered to procure (often illegal or dishonest) action or decision in favour of the giver. These are also relatable to contract fraud or procurement fraud and are, generally, out of books transactions. The auditor normally conducts a propriety audit over the veracity of the transactions and review of any undue favours to vendors.

2. **Corporate Frauds/ Irregularities**

   (i) **Advance Billing:** Advance billing is a situation where the company officials indulge in booking fictitious sales in anticipation of actual sales. This results in misrepresentation of revenue in the books thereby misleading financers and stakeholders. When the management treats borrowings from money lenders as customer advances in the books against sale orders or for adjusting bills receivables, the fraudulent act gets unnoticed for an extended period. This situation results in a death knell for the corporation as the company is dragged into an irredeemable debt trap.

   Use of Shell Company, false vendors, purchases of personal nature booked as official expenses enable falsification of accounts and diversion of funds for purposes other than an intended purpose. These could also be mechanism for employees or cartel of employees engaging in personal gain at the cost of the company. In the former incident this could be termed as management fraud.

   (ii) **Shell/ Dummy Company Schemes:** Generally, represents a fictitious company or a ‘paper company’ to transfer profits or funds from the main company. This could also involve fictitious bills (mostly for services rendered or consultancy charges that cannot be corroborated) which are used in the name of dummy companies diverting the funds taken from banks and financial institutions.

   The books could be falsified by wrong classification of expenses, inflating the expense claims, fictitious expenses or multiple reimbursements. A review of controls, normally, leads to the uncovering of expense booking that are prima facie not incurred.

   (iii) **Money Laundering Activities:** As per the Prevention of Money Laundering Act, 2002 whosoever directly or indirectly attempts to indulge or knowingly assists or knowingly is a party or is actually involved in any process or activity connected with the proceeds of crime and projecting it as untainted property shall be guilty of offence of money laundering."
The person indulging in money laundering looks for avenues with weak banking controls for converting illegal money into the banking system. Any excess credit in the bank accounts that does not belong to the customer or is parked for a temporary period should raise suspicion of such activities. This person indulging in money laundering activity looks for avenues to enter into ‘benami’ (could be called ‘proxy’ name lending) transactions. Companies with extensive cash handling and inadequate identification process of source of money or about the remitter are susceptible to money laundering activities.

3. Fraud at Operational Level Employees

(i) Tampering of Cheques/Drafts/On-line payments/receipts: Tampering of cheques, payee name being altered, or preparation of cheques without issue of the cheques to payee, etc., are methods that may also lead to falsification of accounts.

On-line payments generally are considered a transparent mechanism to prevent the above frauds. The ATM is a popular technological advancement that has inherent control gaps. For example, credit cards once swiped the transaction is put through in the system without the need for a signature of the payer. Similarly, unauthorised credits in bank accounts through ATMs are an immense source of threat to recipients including bribery allegations, unless they lodge a complaint with the bankers or the regulatory authorities in a prompt manner of such unauthorised credits to their accounts/or company bank accounts.

Care should be taken that the name of the payee in the payment transactions in books and cheque issued therein for payment is not fabricated to wrongly codify and book against an improper account head.

(ii) Off Book Frauds: In off book frauds, the fraud perpetrator misappropriates the cash before these are recorded in the books or before the sale is recorded in the books. These frauds are difficult to unearth as the cash or collection is taken off before the accounting entries are made in the books. This situation arises especially in unorganized markets and in rural economies where banking habits are relatively underdeveloped. These are difficult to establish due to absence of audit trails and are more prevalent in businesses that have extensive cash dealings. These are difficult to uncover as the means adopted could include printing of receipts/ bills outside the system.

The above fraudulent schemes can be established based on circumstantial evidence or validation through external sources such as, customer balance confirmations (where feasible) and customer copy of the receipts or other documents that are retained by them. These are also further supplemented by external evidence in the form of background checks and surveillance mechanism.
(iii) **Cash Misappropriation:** Cash is misappropriated after the accounting entries are already passed in the books. These are identified through surprise checks and through shortages in cash balances. These occur when there are delays in accounting of cash collections and there are no laid down cash flow controls. Unaccounted money in any form in an entity is a serious red flag in uncovering of irregularities. Improper daily fund monitoring mechanism is another factor that results in creating unauthorised float by employees in their personal account or in fictitious surrogate (proxy) entities by fraudsters.

(iv) **Teeming and Lading:** This is also achieved through cash deposits or cheques collected from customers being overlapped with the collections from subsequent customers and the amount collected is diverted to personal account. The ageing of receivables is not a constant, and, therefore, this makes the task of identifying the leakage of collections unless all the customer accounts are reconciled at a single point of time.

(v) **Fraudulent Disbursements:** Fraudulent disbursements or reimbursements take place either by issuing or submission of false bills, or personal expense bills being converted into official expenses bills. The other method that is resorted to by the perpetrator of fraud is to inflate the refunds due to a customer and skim the excess refunds.

(vi) **Expense Reimbursement Schemes:** These fraudulent schemes involve employees resorting to treating their personal expenses as incurred for business purpose and claiming reimbursement. In some cases, employees may get reimbursed by third parties (such as distributors) as well as by claiming these expenses from the company. Multiple expense claims based on duplicate bills or photostat copies.

(vii) **Payroll Fraud:** The payroll fraud could include payment to non-existent employees or in a contractual arrangement inflating of the manpower resources than those actually deployed while billing the client. It may also include showing higher pay than actual disbursement to employees/ workers, etc. The process would require a detailed review of statutory declarations/filings under various labour law statutes including disclosures in financial statements of retirement benefits such as P.F, Gratuity and Superannuation benefits from an evidence gathering perspective.

(viii) **Commission Schemes:** The salesman exaggerates the sales through fictitious billings to earn higher commission or alter the sales prices of the products sold from those stipulated by the company or share the sales volumes achieved with other employees to share higher commission. Commission schemes in mega deals backed by legal documents are often tools used to camouflage kickbacks. These are often difficult to uncover and would need to be supplemented by the monetary trails across entities and geographies.
Procedure for Investigation of Fraud: Before proceeding to investigate frauds of the type afore-mentioned, the investigating accountant should ascertain the exact duties of the person concerned who is suspected to have committed a fraud; his relationship to the general routine of the office, and the circumstances in which any known instances of defalcation have come to light. Such an enquiry would give a clue to promising avenues of investigation. Greater the authority of the individual suspected of a fraud, wider would be the field which would have to be covered by the investigation. At times, an accountant is called upon to investigate a suspected fraud, the details or the nature whereof is not known. In such a case, for localising the source of the fraud, the investigating accountant will have to study the financial and accounting structure of the organisation. As a first step, he should examine the line of responsibility between the various members of the staff. He should have a look at the system of internal control in operation for spotting out the weaknesses, if any, that may exist in it. Relying on the above study, he should direct his enquiry towards those aspects of the business where there has been excessive control in the hands of single persons, without any supervision by any other person or any other inherent weakness that may be in existence in the system.

Some of the situations in which money may be embezzled and the various forms that such frauds usually take place alongwith their investigation procedure include the following:

(a) Cash receipts - In cases like holding back cash sales, collections by travelling salesmen, V.P.P receipts, or casual receipts, e.g., sales of scrap, recoveries out of debts written off earlier, etc., the amount or amounts of receipts embezzled may be subsequently covered up by the perpetrator adopting one or other of the under-mentioned devices:

(i) Issuing a receipt to the payee for the full amount collected and entering only a part of the amount on the counterfoil.

(ii) Showing a larger cash discount than actually allowed.

(iii) Adjusting a fictitious credit in the account of a customer for the value of goods returned by him.

(iv) Adjusting a cash sale as a credit sale, and raising a debit in the account of the customer.

(v) Writing off a good debt as bad and irrecoverable to cover up the amount collected which has been misappropriated.

(vi) Short-debiting the customer’s account in the ledger with an intention to withdraw the difference when the full amount payable by him is collected.

(vii) Under-casting the receipts side of the Cash Book or over-casting the payment side; carrying over a shorter total of the receipts from one page of the Cash Book to the next or over-carrying the total of the payment from one page of the Cash Book to the
next with a view to covering up misappropriation; either short banking of cash collection or apart of the amount withdrawal from the bank.

**Verification of Cash Receipts:** On the assumption that some of these may have been diverted before being entered in the books, evidence as regards income received from different sources should be scrutinised, e.g., inventory, sales summaries, rental registers, correspondence with customers, advices of travelling salesmen and counterfoils or receipts. Carbon copies of receipts marked ‘duplicate’, should be scrutinised to confirm that they are in fact copies of receipts issued earlier. In addition, by recalling paying-in-slips from the bank the details of cash deposited on each day should be compared with those shown in the Cash Book. The record of sales of scrap of waste paper, that of collection of rents from labourers temporarily accommodated in the company’s quarters, that of refunds of amounts deposited with the electric supply co., and other Government authorities should be examined for finding out if any of these amounts have been misappropriated. Cash sales should be vouched in detail. Recoveries from customers and sundry parties should be checked with the copies of receipts issued to them; deductions made on account of cash discounts should be reviewed. All withdrawals from the bank should be checked by reference to corresponding entries in the bank pass book.

(b) **Inflating cash payment** -

(i) Making double payment of an invoice or paying a false invoice.

(ii) Paying personal expenses out of the business by falsifying details. e.g., showing betting losses as advertisement charges.

(iii) Withdrawing unclaimed credit balances of customers or amounts falsely credited in the accounts of parties.

(iv) Falsely adjusting a refund in the account of a customer and withdrawing the credit balance.

(v) Wrong totalling of the wage sheets and misappropriating the excess amount withdrawn from the bank for payment of wages.

**Verification of Cash Payments:** All the evidence as regards cash payments made, including acknowledgement by parties for payments shown to have been made to them, should be carefully scrutinised. In the case where a figure appears to have been erased or altered on the receipts issued by the party, on reference to the party concerned, the actual amount paid to him should be confirmed. The same procedure should be adopted in respect of amounts acknowledged on blank papers. All payments by bearer cheques should be examined. The system of recording of wages should be reviewed, specially as regards possible over-totalling of wage sheets, and entries in them of dummy workmen. The system of ordering and receiving goods should be reviewed so as to confirm that no payment has been made in respect of
supplies which have not been received. Confirmations should be obtained from partners or Directors in respect of amounts shown to have been paid to them.

The Petty Cash Book should be vouched and totaled. Special attention should be paid to payments made on account of salaries and wages; confirmation should be obtained from the management that all payments of such salaries and wages were made to persons who were actually in the service of the company. All the withdrawals from the bank should be checked by reference to entries in the bank’s pass book. All the bills receivable or payable should be checked by reference to the Bills Books.

(c) Frauds through suppliers’ ledger -

(i) 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.

(ii) Suppressing the Credit Notes issued by suppliers and withdrawing the corresponding amounts not claimed by them.

(iii) Withdrawing amounts unclaimed by suppliers, for one reason or another by showing that the same have been paid to them.

(iv) Accepting purchase invoices at prices considerably higher than their market prices and collecting the excess amount, paid in cash, from the suppliers.

Verification of balances in suppliers’ ledger - The Bought Journal should be vouched by 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. All the suppliers should be requested 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.

(d) Customers’ ledger -

(i) By the ‘teeming and lading’ method, i.e., misappropriating the amount collected from a customer and crediting his account by the amount paid by him only when an amount is subsequently collected from another customer; repeating this practice with several items collected and depositing back the amount or amounts so misappropriated before the close of the year.

(ii) Misappropriating the amount collected from a customer and subsequently adjusting his account by crediting the amount on account of allowance or a rebate for excess price charged.

(iii) Crediting the amount received from a customer to the account of another customer and subsequently withdrawing the amount wrongly credited.
Verification of balances in customers’ ledger: Special attention should be paid to allowances adjusted on account of goods returned or difference in price or on any other account as well as to amounts written off as bad debts. To confirm that the accounts of customers have been debited in respect of goods supplied to them, entries in the Order Book should be tested with those in the Sales Day Book where one is kept. The investigating accountant should obtain confirmation of customers in respect of the amounts standing in their accounts. Those of them who have no balance in their accounts should be requested to confirm the statement of their account (which should be sent to them) for ascertaining that the entries shown therein were genuine.

(e) Inventory frauds—Inventory frauds are many and varied but here we are concerned with misappropriation of goods and their concealment.

(i) Employees may simply remove goods from the premises.

(ii) Theft of goods may be concealed by writing them off as damaged goods, etc.

(iii) 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) a system of inventory control, and existence of detailed record of the movement of inventory, or (b) availability of sufficient data from which such a record can be constructed. The first 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.

Afterwards, all the receipts and issues of inventory recorded in the Inventory Book should be verified by reference to entries in the Goods Inward and Outward Registers and the documentary evidence as regards purchases and sales. This would reveal the particulars of inventory not received but paid for as well as that issued but not charged to customers. Further, entries in respect of returns, both inward and outward, recorded in the financial books should be checked with corresponding entries in the Inventory Book. Also, the totals of the Inventory Book should be checked. Finally, the shortages observed on physical verification of inventory should be reconciled with the discrepancies observed on checking the books in the manner mentioned above. In the case of an industrial concern, issue of raw materials,
stores and tools to the factory and receipts of manufactured goods in the godown also should be verified with relative source documents.

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.

6.5.2 Indicators of Fraud

Several indications of possible frauds can be listed as follows:

| i. | Discrepancies in Accounting Records including non-recording or partial recording or incorrect recording or delayed recording of amounts, misclassifications, etc. |
| ii. | Conflicting or missing evidence including missing documents, altered documents, significant unexplained items in reconciliations, discrepancies between entity’s records and confirmations received etc. |
| iii. | Unacceptable management responses such as – denial of access to records/facilities/employees, undue time pressure to resolve complex issues, unusual delays in providing requested information, denial for use of Computer Assisted Audit Techniques, unwillingness to address identified deficiencies in internal control etc. |
| iv. | Other indications such as – Accounting Policies in variance with Industry Norms, Frequent changes in accounting estimates etc. |

6.5.3 Responses to Fraud

SA 330 states the auditor’s responses to assessed risks. It requires auditor to assign and supervise personnel taking into account of the knowledge, skill and ability of the individuals, evaluation of selection and application of accounting policies by the entity and incorporation of an element of unpredictability in the selection of the nature, timing and extent of audit procedure.

Response to the risks related to management override of controls includes Testing the appropriateness of journal entries and other adjustments made in preparation of the Financial Statements, review of accounting estimates for biases and also review the significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual.
Auditor need to assess fraud risk factors for material misstatement or misappropriation of assets due to fraud, such as incentive / pressures, opportunities and attitudes / rationalizations.

The responses to fraud will include communications to management and with those charged with governance, communication to regulatory and enforcement authorities and appropriate documentation on his assessment of the risks of material misstatement.

<table>
<thead>
<tr>
<th>Auditor’s ability to detect fraud depends on factors such as –</th>
</tr>
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<tbody>
<tr>
<td>- the skillfulness of the perpetrator</td>
</tr>
<tr>
<td>- the frequency &amp; extent of manipulation</td>
</tr>
<tr>
<td>- the degree of collusion involved</td>
</tr>
<tr>
<td>- the relative size of Individual amounts manipulated; and</td>
</tr>
<tr>
<td>- the seniority of those individuals involved.</td>
</tr>
</tbody>
</table>

Detection of fraud depends upon effectiveness of Audit Procedure. Detection risk, however, can only be reduced, not eliminated.

6.6 Investigation on behalf of an Individual or Firm Proposing to Buy a Business

Scope of investigation - The objective of such an investigation is to collect such information as would enable the purchaser to decide whether it is worthwhile to buy the business and if so, for what amount. The investigation should proceed broadly on the same lines as for valuation of shares.

Additional matters which must receive the attention of the investigating accountant on which, if appropriate, information to the client should be given.

(A) In case of proprietary concerns or partnerships -

(i) Reasons for the sale of the business and the effect on turnover and profits that there would be on retirement of the present proprietor (or partners).

(ii) The length of lease under which the premises are held; the prospects of its renewal or extension.

(iii) The unexpired period of any patents owned by the vendors.

(iv) The age of the present managerial staff and the prospects of continuing in service under the new proprietorship and the possible liability, not already provided for that would arise as regards payment of pensions or gratuities in case of old and aged employees and those retrenched.

(v) If the bulk of sales are made to customers whose number is small, the profitability of the business would be greatly shaken on withdrawing their support. This would be an element of weakness which should be investigated as it might affect future profitability.
(vi) The valuation that could be placed on goodwill to determine whether that appearing in the book is less or more; if none is included to determine the amount that should be included, if at all.

(B) If the business belongs to a limited company - The vendors’ interest in this case will be purchased by the acquisition of shares. On that account, the following additional matters would also require consideration:

(i) The authorised and issued capital of the company.

(ii) Whether there is any uncalled liability on the shares.

(iii) If the capital is divided into different classes of shares - the rights that are attached to each class.

(iv) Particulars of dividends paid in the past and the amounts thereof which are in arrear (on cumulative preference shares).

(v) If there are any mortgages created on the assets appearing in the company’s books, a search should be made in the Register of Charges in the office of the Registrar of Companies.

(vi) The price at which the shares are being offered. If the company is a public company, the price will usually be in excess of market price quoted on the Stock Exchange, but in the case of unquoted shares particularly where the company whose shares are being acquired is a private company, a valuation will have to be placed on the shares for the purpose of purchase.

6.7 Investigation in connection with review of Profit/Financial Forecasts

There are many investigations which involve an examination of future profits. Profit reports can be required as part of a general investigation into the purchase of a business or by banks and financial institutions with regard to project cash flow and profitability statements for appraisal of loan applications submitted by the intending borrowers. All forecasts depend, to a large extent, on the nature of the business with its numerous and substantial uncertainties. Therefore, such forecasts are not capable of verification by the reporting accountants in the same way as financial statements which present the results of a completed accounting period. Normally, such situations involve special review as these depart from the auditor’s traditional role of expressing an opinion in relation to past events.