UNIT 3 : FORENSIC AUDIT

1. OVERVIEW

The number of fraudulent activities and ambiguous financial activities have been accelerating all over the world. Consequently, businesses are exposed to risks of fraudulent activities. With all of the recent corporate accounting scandals at Parmalat, Xerox Corporation, and Satyam Computer Services, and all the high profile corporate frauds at Enron, WorldCom, and HealthSouth followed by Bernie Madoff’s colossal ponzi scheme, the media has made Forensic Accounting and Forensic Auditing into a growth industry.

Forensic Auditing has established itself as dynamic and strategic tool in combating corruption, financial crimes and frauds through investigations and resolving allegations of fraud and embezzlement. Thus, a new area of auditing, known as Forensic Audit, was needed to detect the frauds in companies that suspected fraudulent transactions.

“Forensic” means “suitable for use in the court of law”. Bologna said that it is the application of financial skills and investigative mentality to unresolved issues, conducted within the context of the rules of evidence. As an emerging discipline, it encompasses financial expertise, fraud knowledge and a sound knowledge and understanding of business reality and the working of legal system.

However, the definition of Forensic Auditing keeps on changing in response to the growing needs of corporations. Simply stated, Forensic Auditing includes the use of accounting, auditing and investigative skills to assist in legal matters.

Important Definitions:

Forensic: The word forensic comes from the Latin word forensis, meaning "of or before the forum." It is -

Relating to, used in, or appropriate for courts of law or for public discussion or argumentation.

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Relating to the use of science or technology in the investigation and establishment of facts or evidence in a court of law.

**Forensic Accounting**: The integration of accounting, auditing and investigative skills yields the specialty known as Forensic Accounting. It is the study and interpretation of accounting evidence. It is the application of accounting methods to the tracking and collection of forensic evidence, usually for investigation and prosecution of criminal acts such as embezzlement or fraud.

Forensic Accounting can sometimes be referred to as Forensic Auditing.

**Forensic Investigation**: Also known as forensic audit is the examination of documents and the interviewing of people to extract evidence. Forensic Accounting examines individual or company financial records as an investigative measure that attempts to derive evidence suitable for use in litigation.

**Fraud Auditing**: In a fraud audit one searches for the point where the numbers and/or financial statements do mesh. It is a meticulous review of financial documents conducted when fraud is suspected. Some entities do them as a precaution to prevent fraud from happening and to catch it before the loss magnifies. A Fraud Audit however is not an Investigation. Fraud auditing is used to identify fraudulent transactions, not to figure out how they were created. Fraud auditors often go outside the books of accounts to find fraudulent transactions.

**Red Flag**: Red flags are sign or warning of any impending danger or inappropriate behavior. Red flag do not necessarily indicate the existence of fraud however are indicators that caution needs to be exercised while investigating the situations. Red flags are classified in categories such as financial performance red flag, accounting system red flags, operational red flags and behavioral red flags.

Forensic audit can be conducted in order to prosecute a party for fraud, embezzlement or other financial claims. In addition, an audit may be conducted to determine negligence in addition, an audit may be conducted to determine negligence.

### 2. AUDIT V/S. FORENSIC ACCOUNTING/FORENSIC AUDIT

**How is a forensic accounting analysis different from an audit?**

The general public believes that a financial auditor would detect a fraud if one were being perpetrated during the financial auditor's audit. The truth, however, is that the procedures for financial audits are designed to detect material misstatements, not immaterial frauds. While it is true that many of the financial statements and frauds could have, perhaps should have, been detected by financial auditors, the vast majority of frauds could not be detected with the use of financial audits. Reasons include the dependence of financial auditors on a sample and the auditors’ reliance on examining the audit trail versus examining the events’ and activities behind the documents. The latter is simply
resource prohibitive in terms of costs and time.

There are some basic differences today between the procedures of forensic auditors and those of financial auditors. In comparison, forensic accounting and audit differ in specific ways, as shown below:

A forensic accountant will often look for indications of fraud that are not subject to the scope of a financial statement audit.

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

A Forensic Auditor is often retained to analyze, interpret, summarize and present complex financial and business related issues in a manner which is both understandable and properly supported. Forensic Accountants are trained to look beyond the numbers and deal with the business reality of the situation.

A Forensic Auditor must initially consider whether his/her firm has the necessary skills and experience to accept the work. Forensic audits are highly specialized, and the work requires detailed knowledge of fraud investigation techniques and the legal framework.

Forensic Auditors can be engaged in public practice or employed by insurance companies, banks, police forces, government agencies and other organizations.

3.1 A Forensic Auditor is often involved in:

- **Fraud Detection:** Investigating and analyzing financial evidence, detecting financial frauds and tracing misappropriated funds
- **Computer Forensics:** Developing computerized applications to assist in the recovery, analysis and presentation of financial evidence
- **Fraud Prevention:** Either reviewing internal controls to verify their adequacy or providing consultation in the development and implementation of an internal control framework aligned to an organization’s risk profile
- **Providing Expert Testimony:** Assisting in legal proceedings, including testifying in court as an expert witness and preparing visual aids to support trial evidence.

In order to properly perform these services a Forensic Auditor must be familiar with legal concepts and procedures and have expertise in the use of IT tools and techniques that facilitate data recovery and analysis. In addition, a Forensic Auditor must be able to identify substance over form when dealing with an issue.
3.2 Who retains Forensic Auditors?

Lawyers  Courts and Business Community
Police Forces  Banks
Insurance Companies  Government Regulatory Bodies and Agencies

3.3 Importance of Forensic Auditors

They can resolve the matters by combining accounting knowledge & experience with respect to:

<table>
<thead>
<tr>
<th>Fraud Prevention</th>
<th>Fraud Detection</th>
<th>Risk Management</th>
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<tbody>
<tr>
<td>Filing requirements</td>
<td>Court systems</td>
<td>Investigative methodologies</td>
</tr>
<tr>
<td>Internal Controls Implementation and Review</td>
<td>Compliance and Regulatory Functions</td>
<td></td>
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<tr>
<td>Evidence Collection and Analysis</td>
<td>Assignments with regulatory agencies like SEBI, RBI, EOW etc.,</td>
<td></td>
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<tr>
<td>Professional body to provide expertise and literature in this fast growing field</td>
<td></td>
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<tr>
<td>Communicating with audiences from attorneys &amp; judges to victims &amp; suspects</td>
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3.4 Services rendered by Forensic Auditors

- Crafting questions to be posed
- Responding to questions posed
- Identifying documents to be requested and/or subpoenaed
- Identifying individuals to be most knowledgeable of facts
- Conducting research relevant to facts of the case
- Identifying and preserving key evidence
- Evaluating produced documentation and information for completeness
- Analyzing produced records and other information for facts
- Identifying alternative means to obtain key facts and information
- Providing questions for deposition and cross examination of fact and expert witnesses
The services rendered by the forensic accountants are in great demand in the following areas:

- **Criminal Investigation:**
  - Matters relating to financial implications the services of the forensic accountants are availed of. The report of the accountants is considered in preparing and presentation as evidence.

- **Professional Negligence Cases:**
  - Professional negligence cases are taken up by the forensic accountants. Non-conformance to Generally Accepted Accounting Standards (GAAS) or non-compliance to auditing practices or ethical codes of any profession they are needed to measure the loss due to such professional negligence or shortage in services.

- **Arbitration service:**
  - Forensic accountants render arbitration and mediation services for the business community. Their expertise in data collection and evidence presentation makes them sought after in this specialized practice area.

- **Fraud Investigation and Risk/Control Reviews:**
  - Forensic accountants render such services both when called upon to investigate specific cases as well for a review of or for implementation of Internal Controls. Another area of significance is Risk Assessment and Risk Mitigation.

- **Settlement of insurance claims:**
  - Insurance companies engage forensic accountants to have an accurate assessment of claims to be settled.
  - In case of policyholders seek the help of a forensic accountant when they need to challenge the claim settlement as worked out by the insurance companies. A forensic accountant handles the claims relating to consequential loss policy, property loss due to various risks, fidelity insurance and other types of insurance claims.

- **Dispute settlement:**
  - Business firms engage forensic accountants to handle contract disputes, construction claims, product liability claims, infringement of patent and trade marks cases, liability arising from breach of contracts and so on.
A forensic accountant should possess not only the broad knowledge of accounting principles, practice and standards but also the knowledge of insurance, banking civil and criminal law and human psychology.

A Forensic Auditor must be open to consider all alternatives, scrutinize the details and at the same time see the big picture. In addition, a Forensic Auditor must be able to listen effectively and communicate clearly and concisely in a timely manner.

### 4. PROCESS OF FORENSIC ACCOUNTING

Each Forensic Accounting assignment is unique. Accordingly, the actual approach adopted and the procedures performed will be specific to it. However, in general, many Forensic Accounting assignments will include the steps detailed below.
Step 1. Initialization

It is vital to clarify and remove all doubts as to the real motive, purpose and utility of the assignment. It is helpful to meet the client to obtain an understanding of the important facts, players and issues at hand. A conflict check should be carried out as soon as the relevant parties are established. It is often useful to carry out a preliminary investigation prior to the development of a detailed plan of action. This will allow subsequent planning to be based upon a more complete understanding of the issues.

Step 2. Develop Plan

This plan will take into account the knowledge gained by meeting with the client and carrying out the initial investigation and will set out the objectives to be achieved and the methodology to be utilized to accomplish them.

Step 3. Obtain Relevant Evidence

Depending on the nature of the case, this may involve locating documents, economic information, assets, a person or company, another expert or proof of the occurrence of an event. In order to gather detailed evidence, the investigator must understand the specific type of fraud that has been carried out, and how the fraud has been committed. The evidence should be sufficient to ultimately prove the identity of the fraudster(s), the mechanics of the fraud scheme, and the amount of financial loss suffered. It is important that the investigating team is skilled in collecting evidence that can be used in a court case, and in keeping a clear chain of custody until the evidence is presented in court. If any evidence is inconclusive or there are gaps in the chain of custody, then the evidence may be challenged in court, or even become inadmissible. Investigators must be alert to documents being falsified, damaged or destroyed by the suspect(s).

Step 4. Perform the analysis

The actual analysis performed will be dependent upon the nature of the assignment and may involve:

- calculating economic damages;
- summarizing a large number of transactions;
- performing a tracing of assets;
- performing present value calculations utilizing appropriate discount rates;
- performing a regression or sensitivity analysis;
- utilizing a computerized application such as a spread sheet, data base or computer model; and
- utilizing charts and graphics to explain the analysis.
Step 5. Reporting

Issuing an audit report is the final step of a fraud audit. Auditors will include information detailing the fraudulent activity, if any has been found. The client will expect a report containing the findings of the investigation, including a summary of evidence and a conclusion as to the amount of loss suffered as a result of the fraud. The report may include sections on the nature of the assignment, scope of the investigation, approach utilized, limitations of scope and findings and/or opinions. The report will include schedules and graphics necessary to properly support and explain the findings.

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

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

Step 6. Court proceedings

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

5. FORENSIC AUDIT TECHNIQUES
Detecting fraud is difficult, especially frauds involving material financial statement misstatements, which occur only in about 2 percent of all financial statements. Fraud is generally concealed and often occurs through collusion. Normally, the documents supporting omitted transactions are not kept in company files. False documentation is often created or legitimate documents are altered to support fictitious transactions. While fraud detection techniques will not identify all fraud, the use of sound techniques can increase the likelihood that misstatements or defalcations will be discovered on a timely basis.

Some of the techniques that a forensic auditor may use are listed below:

(I) **General Audit Techniques:**
- **Testing defenses:** A good initial forensic audit technique is to attempt to circumvent these defenses yourself. The weaknesses you find within the organizations control will most probably guide you down the sea path taken by suspected perpetrators. This technique requires you to attempt to put yourself in the shoes and think like your suspect.

(II) **Statistical & Mathematical Techniques:**
- **Trend Analysis:** Businesses have cycles and seasons much akin to nature itself. An expense or event within a business that would be analogous to a snowy day in the middle of summer is worth investigating. Careful review of your subject organization’s historical norms is necessary in order for you to be able to discern the outlier event should it arise within your investigation.
- **Ratio Analysis:** Another useful fraud detection technique is the calculation of data analysis ratios for key numeric fields. Like financial ratios that give indications of the financial health of a company, data analysis ratios report on the fraud health by identifying possible symptoms of fraud.

(III) **Technology based /Digital Forensics Techniques:** Every transaction leaves a digital footprint in today’s computer-driven society. Close scrutiny of relevant emails, accounting records, phone logs and target hard drives is a requisite facet of any modern forensic audit. Before taking steps such as obtaining data from email etc. the forensic auditor should take appropriate legal advice so that it doesn’t amount to invasion of privacy. Digital investigations can become quite complex and require support from trained digital investigators. However, many open-source digital forensics tools are now available to assist you in this phase of the investigation.

| Cross Drive Analysis | EnCase |
| Live Analysis | MD5 |
| Deleted Files | Tracking Log Files |
| Stochastic Forensics | PC System Log |
| Steganography | Free Log Tools |
(IV) Computer Assisted Auditing Techniques (CAATs): Changing patterns of businesses, regulatory framework, scarcity of resources at auditors’ disposal on one side and the ever increasing mountainous data on other hand is making audit a complex process. Use of CAATTs is, thus, indispensable to the Auditors and forensic auditors. Computer-assisted audit techniques (CAATs) or computer-assisted audit tools and techniques (CAATTs) are computer programs that the auditors use as part of the audit procedures to process data of audit significance contained in a client’s information systems, without depending on him.

(V) Generalised Audit Software (GAS): Generalized Audit Software (GAS) is a class of CAATs that allows auditors to undertake data extraction, querying, manipulation, summarization and analytical tasks. GAS focuses on the fully exploiting the data available in the entity’s application systems in the pursuit of audit objectives. GAS support auditors by allowing them to examine the entity’s data easily, flexibly, independently and interactively in data based auditing.

Using GAS, an auditor can formulate a range of alternative hypotheses for a particular potential misstatement in the subject matter and then test those hypotheses immediately. “What if” scenarios can be developed with the results and the auditors can examine the generated report rapidly. Currently, the latest versions of GAS include the Audit Command Language (ACL), Interactive Data Extraction and Analysis (IDEA) and Panaudit.

(VI) Common Software Tool (CST): Due to shortcomings of GASs, CSTs have become popular over a period. Spreadsheets (like MS Excel, Lotus, etc.), RDBMS (like MS Access, etc.) and Report writers (like Crystal reports, etc.) are few examples of CSTs. Their widespread acceptability is due to its instant availability and lower costs. While spreadsheets may be extremely easy to use due to its simplicity and versatility, other CSTs may need some practice.

Whether one uses GAS or CST, it is imperative that the auditor is aware about the manner and processes that have led to the data generation, the control environment revolving around the data and the source from where the data samples are imported into the GAS/CST.

(VII) Data Mining Techniques: It is a set of assisted techniques designed to automatically mine large volumes of data for new, hidden or unexpected information or patterns.

Data mining techniques are categorized in three ways: Discovery, Predictive modeling and Deviation and Link analysis. It discovers the usual knowledge or patterns in data, without a predefined idea or hypothesis about what the pattern may be, i.e. without any prior knowledge of fraud. It explains various affinities, association, trends and variations in the form of conditional logic.
(VIII) Laboratory Analysis of Physical and Electronic Evidences:

<table>
<thead>
<tr>
<th>Computer Forensics</th>
<th>Protection/Validation of Evidence</th>
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<tbody>
<tr>
<td>hard disk imaging</td>
<td>Federal Rules of Evidence</td>
</tr>
<tr>
<td>E-mail analysis</td>
<td>Chain of Custody</td>
</tr>
<tr>
<td>search for erased files</td>
<td>Altered &amp; Fictitious Documents</td>
</tr>
<tr>
<td>analyze use &amp; possible misuse</td>
<td>physical examination</td>
</tr>
<tr>
<td>computer software to analyze data</td>
<td>fingerprint analysis</td>
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<td>forgeries</td>
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<td></td>
<td>ink sampling</td>
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<td>document dating</td>
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6. FORENSIC AUDIT REPORT

A Report is a statement of collected & considered facts, so drawn up as to give clear and concise information to persons who are not already in possession of the full facts of the subject matter of the report.

The Forensic Audit Report is nothing but statements of observation gathered & considered while proving conclusive evidence. It is a medium through which an auditor expresses his opinion under audit. It is an important part of the audit as it provides the results of the audit conducted by the auditor.

Points to keep in mind while reporting:

<table>
<thead>
<tr>
<th>Clear thinking:</th>
<th>Yes</th>
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<tbody>
<tr>
<td>To whom the report is directed</td>
<td></td>
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<tr>
<td>Purpose and aim</td>
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<tr>
<td>Cool and calm thinking to have logical and coherent</td>
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<tr>
<td>presentation</td>
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<tr>
<td>Pattern of presentation</td>
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<table>
<thead>
<tr>
<th>Keep the reader uppermost in mind</th>
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<tbody>
<tr>
<td>Translate technical matters to layman's language</td>
<td></td>
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<tr>
<td>To visualize the reader's viewpoint</td>
<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Unbiased approach</th>
<th>Yes</th>
</tr>
</thead>
<tbody>
<tr>
<td>To mention the view point of the auditee</td>
<td></td>
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</table>
Impact of the report

✓ What be the probable reaction to reporting whether action or decision will follow in quickest possible time or to be treated as of academic interest only.

✓ To remember the universal saying - "don't jump to conclusions"

Facts and figures to be in proper sequences

The main factors to be considered for the various ways of presentations of written reports are:

Sample Table of Contents of a Forensic Audit Report may include the following:

1. EXECUTIVE SUMMARY
   1.0 Background
   1.1 Origin of the Audit
   1.2 Audit Objective
   1.3 Proposed Audit Outputs
   1.4 Audit Implementation Approach

2. RISK ANALYSIS
   2.1 Internal Environment Risk
       2.1.1 Financial Management
       2.1.2 Customers, Products and Competitors
       2.1.3 Information technology
       2.1.4 Business Process
       2.1.5 Human Resource Management
   2.2 External Environment Forces
       2.2.1 Influence of Economics and relevant Market
       2.2.2 Political and Legal Scenario
       2.2.3 Technology in the Sector
3. **AUDIT PROCESS**

3.1. Preliminary understanding of scope and incident coverage
   (i) Identification of all related data elements
   (ii) Preparation of a List of "persons of interest" for interview
   (iii) Obtain management approval for scope

3.2. Collect Evidence

3.3. Conduct Interviews

3.4. Analyze findings

3.5. Validate Inferences and conclusions

4. **EVIDENCE OF RISK EVENTS**

4.1 Conflicts of interest
4.2 Bribery
4.3 Extortion
4.4 Theft
4.5 Fraudulent transactions
4.6 Inventory frauds
4.7 Misuse of assets
4.8 Financial Statement frauds

5. **AUDIT RECOMMENDATIONS**

5.1 Logical Framework Approach
5.2 Preconditions and Risks

6. **GOVERNANCE ON RECOMMENDATION IMPLEMENTATION**

6.1 Stakeholders
6.2 Budget Considerations

**LIST OF ANNEXURES**

Annex 1: Members of the Interviews
Annex 2: Organization Chart of Auditee organization
Annex 3: Financial Performance (YYYY to YYYY)
Annex 4: Audit Recommendation Logical Framework
Annex 5: Analysis of Key Risk Events

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TEST YOUR KNOWLEDGE

Theoretical Questions

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

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

2. An American Company engaged in the business of manufacturing and distribution of industrial gases, is interested in acquiring a listed Indian Company having a market share of more than 65% of the industrial gas business in India. It requests you to conduct a “Due Diligence” of this Indian Company and submit your Report. List out the contents of your Due Diligence Review Report that you will submit to your USA based Client.

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

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

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

5. Mr. Clean who proposes to buy the proprietary business of Mr. Perfect, engages you as investigating accountant. Specify the areas which you will cover in your investigation.

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

7. J Ltd. is interested in acquiring S Ltd. The valuation of S Ltd. is dependent on future maintainable sales. As the person entrusted to value S Ltd., what factors would you consider in assessing the future maintainable turnover?

8. Briefly mentioned the forensic audit techniques name.

9. Forensic audit is unlike other audits. Explain

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

Multiple Choice Questions

1. IMIR Inc is a major technology, engineering, manufacturing and financial services conglomerate, with global operations having its registered office in US. The Company’s
manufacturing footprint extends across eight countries in addition to US. It has several international offices and a supply chain that extends around the globe.

HIN Private Limited is a medium-sized Fast Moving Electrical Goods (FMEG) company and is also involved in power distribution equipment manufacturing. This company is based in India and enjoys a good market share in a wide spectrum of products like Industrial & Domestic Circuit Protection Devices, Cables & Wires, Fans, Commercial and Industrial Applications.

IMIR Inc (Acquirer) is currently in talks to acquire HIN Pvt Ltd (Target). The initial price has been agreed for the acquisition of business based on net worth and profitability of the target company with an assumption that all contingent liabilities of the target impacting its future business have been considered. The acquirer appointed a firm to carry out the financial due diligence review of the target company and advised that the firm should strictly work as per the scope.

The firm during the course of its review found some showcause notices (which have not matured into demands) being issued against the target company. The firm also found that there could be a potential high value labour claim which may arise out of the negotiation which was ongoing between the target company and the labour union and the labour wage agreement was already expired.

The firm discussed all these matters with the management of the target company. The target company confirmed that these matters are under discussion and was confident that these matters would not result into any liability and hence it did not consider the same in the initial price. The firm after its discussion with the target reported these matters to the acquirer.

In the given situation, please suggest which one of the following should be correct?

(a) In the given case, the initial price between the target and the acquirer is already set which includes the impact of contingent liabilities. Hence the above mentioned matters relating to showcause notice and labour claim should be ignored by the firm.

(b) In the given case, the initial price between the target and the acquirer is already set which includes the impact of contingent liabilities. However, since these matters have not been considered by the target company in the initial price, it would be appropriate to consider the impact of matter related to labour claim as that may result in liability in future but the matter related to showcause notice should be ignored by the firm.

(c) In the given case, the firm has gone beyond its scope of financial due diligence review. Financial due diligence review covers review of trading results, assets and liabilities and accounting policies and practices of the target company. The management of the target company should talk to acquirer so that the acquirer can ask the firm to limit its work as per the scope agreed.
In the given case, even though the initial price between the target and the acquirer is already set but still the firm needs to look at any hidden liabilities which may arise in the two cases – show cause notices and labour claim. Accordingly, the firm has done the right thing by reporting these matters to the acquirer.

FTA Renewables S.p.A, is based in Europe and has operations in renewable energy. The company’s operations are spread out in many countries. The company is also looking for various acquisitions.

VAS Private Limited is a company based in Pune having operations into solar energy. The company’s management projected that its operations should increase significantly and it should become one of the largest companies in the sector in the next five years on the basis of the management plan. However, due to some unforeseen circumstances, the promoters of the company are looking to sell their business.

FTA Renewables S.p.A (acquirer) is interested in acquisition of VAS Private Ltd (target) and has started the discussions with the target company for the same.

The due diligence of the target company is in process and the reviewer has come up with following observations so far:

(i) The target company has certain balances with its related companies which are under reconciliation for long time.
(ii) The target company had certain demands in respect of taxation matters on which the court has given a stay.
(iii) The target company has some assets which are carried in its books at more than their current market value due to capitalization of foreign exchange loss as the same was permitted in Indian GAAP.
(iv) The target company had two properties which were under litigation.
(v) The target company had given guarantees which were not appearing the financial statements.

Reviewer needs your advise that which of the above mentioned observations should be reported by him to the acquirer?

(a) i, ii, iv and v.
(b) ii, iii, iv and v.
(c) i, ii, iii, iv and v.
(d) i, iii, iv and v.
3. ARA & Associates is a partnership firm and has been in existence for the last 15 years. The firm is engaged in consultancy business related to various areas and has built a good name for itself over the period.

Some of the clients of the firm are very old who have been continuing since its existence. The business of the firm has gone through various phases some of them were very bad. But currently the business is going very well and the firm is looking to expand its operations into different geographies. For this, the firm's management decided that some of its senior partners will move to new offices and new partners would be inducted.

A team of new partners is in discussion with the senior old partners regarding their joining the firm.

The new partners would be interested to know whether the terms offered to them are reasonable having regard to the nature of the business, profit records, capital distribution, personal capacity of the existing partners, socio-economic setting etc. and whether they would be able to derive continuing benefits in the shape of return of capital to be contributed and remuneration of services to be offered. In addition, they also want to ascertain whether the capital to be contributed by them would be safe and applied usefully or not.

For this purpose, an investigation of the business of the firm was set up on behalf of these new partners.

At the time of scrutiny of the record of profitability of the firm's business, the investigating accountant picked up records of last 4-5 years wherein he observed 2 years which were unusual because the profits during those 2 years were highly erratic and fluctuating. The investigating accountant, therefore, went into the profits of last 7-8 years to iron out the fluctuation. He also examined the provisions of the partnership deed particularly the composition of partners, their capital contribution, drawing rights, retirement benefits and goodwill. He also asked for details of jobs/contracts in hand and the range of current clientele of the firm for his examination. Some of these procedures of the investigating accountant were not found appropriate by the senior partners of the firm and they advised the investigating accountant not to go beyond his scope.

Please advise which of the above mentioned procedures of investigating accountant is/are not appropriate and what improvements/changes are required in his approach.

(a) The investigating accountant should not have asked for the records of the profits of last 7-8 years as that would be too much of the information for his review. Also the details of jobs/contracts in hand and the range of current clientele of the firm are confidential and hence does not get covered in his scope.

(b) After finding 2 years which were unusual because the profits during those 2 years were highly erratic and fluctuating, the investigating accountant should have reported the matter to the new partners instead of asking for more details related to the profits of
last 7-8 years. Also he is not required to examine the provisions of the partnership deed as these details would have already been discussed with the new partners and they would have checked that.

(c) The procedures of the investigating accountant looks completely reasonable considering his scope of work. Further, no changes are required in his work approach.

(d) At the outset, it can be said that investigation in the given case was not required. However, even if the new partners decided to carry out the investigation it should have been limited to mainly inquiry procedures by the investigating accountant. The investigating accountant could have also reviewed the manner of computation of goodwill which doesn't seem to have been performed on the basis of the above mentioned facts.

Case Study Based MCQs

Karma Ltd got incorporated in 1980’s as a private limited company and started its business into two segments – retail and construction. The two business activities were completely different but those were managed very well and the company grew significantly over a period of time. In year 2001, the company got converted into a public company and in 2008, the company also got listed on Bombay Stock Exchange.

The turnover of the company was increasing, however, the margins were not increasing as per the expectations of the management and the management analysed this aspect and realized that the margins were not so high in case of retail segment.

The company decided to focus more on construction business and include infrastructure in its line of business. This was also because of the fact that the government policies were favourable towards this sector. For this the company decided to sell its retail segment in 2015.

The new investor for the retail segment carried out a due-diligence of the business involving various aspects and the company sold this segment in January 2016.

Since the business of the company was infrastructure and it involved transactions with government officials also, the management suspected certain suspicious transactions for which it decided to carry out a forensic audit in the financial year 2016-17. Certain transactions were identified as per this audit on which the management worked and set up certain new processes and stringent controls so that the business can function in an efficient manner.

In the financial year ended 31 March 2019, an investigation was set up against the company which impacted the company significantly in terms of its reputation and business. The company lost some significant contracts during the process of investigation itself.
In the light of the above mentioned facts, you are required to comment on the following:

1. At the time of due diligence, the reviewer assessed the business feasibility also which included the assessment whether business would be more beneficial at its current location or not. The management of Karma Ltd did not understand this perspective. The management argued that the reviewer should not have this assessment as part of his scope as the company has been doing this business for many years at that location.
   
   (a) The contention of the management was correct.
   
   (b) Reviewer was correct as due diligence covers assessment of business feasibility as well.
   
   (c) Reviewer was correct as due diligence covers assessment of business feasibility as well, however, considering the company was doing this business for decades it should not have been carried out by the reviewer.
   
   (d) Management was correct, however, the same thing should have been discussed with the investor as part of the sale contract.

2. The due diligence reviewer was given audited financial statement of the company for his financial review. However, the reviewer asked for certain documents pertaining to the year which was already audited by the statutory auditors of the company and the management of the company declined this request.
   
   (a) The management is correct.
   
   (b) Reviewer can ask for documents even for the period for which audit is completed.
   
   (c) Reviewer can ask for documents for the period for which audit is completed but he cannot give any assessment on that. That can be given for his documentation purpose only as per the requirements of the auditing standards.
   
   (d) Reviewer cannot ask for documents for the period for which audit is completed. However, if the same document is required for further period for which audit is not completed, then the management should give him that document.

3. The company has various litigations going on including those related to matter of taxation. The company had taken consultations in respect of those litigations from some renowned legal/ tax consultants. The reviewer for due diligence reviewed these consultation documents and also asked for the documents related to these matters. Further he also suggested that the positions taken by the company in some matters was not correct.
   
   (a) The reviewer needs to have independent assessment of legal/ tax cases and any outcome needs to be discussed with the management.
   
   (b) The company can provide consultation documents but should not have provide any other document to the reviewer as those are confidential.
(c) The reviewer can review the consultation document but should ask for further details, if required.

(d) The company cannot provide documents of any other consultant to the reviewer. However, the documents related to cases can be shared with the reviewer.

4. During the forensic review, the reviewer observed certain points and the report for the same was shared with the management.

(a) The management should share these observations with the statutory auditor also if they have any bearing on the financials.

(b) The management should keep the forensic report very confidential and should report all these matters to the Reserve Bank of India (RBI).

(c) The management should keep the forensic report very confidential and should report all these matters to the National Highway Authority of India (NHAI).

(d) The management needs to assess the matters on its own and cannot get forensic audit in this manner.

5. At the time of investigation, the investigation officer asked for the information of financials for the last 5-7 years.

The management explained that there was no need for this investigation. Further the company has gone through the processes of due diligence and forensic audit in the past. Also the financial statements related to the period prior to investigation are audited and hence cannot be shared.

(a) Since the company went through audit process related to period prior to investigation, investigation should not have been set up.

(b) Since the company went through processes of due diligence in the past, investigation cannot be set up.

(c) Since the company went through processes of forensic audit in the past, investigation cannot be set up.

(d) The contention of the management is not correct.

Answers to Theoretical Questions

1. Refer Financial Due Diligence given in Para 4 of Unit 1.

2. Refer Para 7 of Unit 1.

3. Refer Para 6.4 of Unit 2.

4. Refer Para 6.2 of Unit 2.

5. Refer Para 5 of Unit 2.
6. Refer Para 5.5.1 of Unit 2.

7. 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?

8. Refer Para 5 of Unit 3.

9. Refer Para 2 of Unit 3.

10. Refer Para 4 of Unit 3.

**Answers to Multiple Choice Questions**

1. (d) 2. (c) 3. (c)

**Answers to Case Study Based MCQs**

1. (b) 2. (b) 3. (a) 4. (a) 5. (d)