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CA Final & CA Inter Audit

Abki Baar Audit Mei Exemption Paaar!



CA Ankush Chirimar
AIR 5,6,32

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Notes*

Brief about Author

- All India Ranker at all 3 levels of CA
- Scored 95 Marks in Audit - Highest marks in history of ICAI till Nov 23
- Articleship at KPMG, Mumbai in Statutory Audit Domain
- Industrial Training at DBS Bank

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Due Diligence, Investigation & Forensic Accounting

Due Diligence

<ul style="list-style-type: none"> • It is process of investigation, performed by investors, into details of potential investment like examination of operations & mgt & verification of material facts • It can be conducted by non-CA as well. E.g. - Bank granting loan, Corporate Restructuring, Venture Capital Financing & Public Offerings 	<p>Diff B/w Due Diligence & Audit</p> <ul style="list-style-type: none"> • Audit is independent examination of FS to express opinion • Due diligence is examination of potential investment to confirm all material facts of prospective business opportunity. It reviews financial & non-financial records
<p>Importance/Reasons of Due Diligence</p> <ul style="list-style-type: none"> • To confirm if business is what it appears to be • Identify potential 'deal killer' defects in target co. & avoid bad business transaction • To gain info for valuing assets & warranties & negotiating price concessions • To verify that transaction complies with investment/acquisition criteria 	<p>Classification of Due Diligence</p> <ul style="list-style-type: none"> • Commercial/Operational Due Diligence • Personnel Due Diligence • Tax Due Diligence • <u>Financial Due Diligence</u> - Unless its scope is wide enough to cover all aspects, it shall not be confused with overall due diligence. It commences only after price is agreed • Info System Due Diligence • Legal Due Diligence • Environmental Due Diligence
<p>Scope of Financial due diligence/Individual Areas of Verification</p> <ul style="list-style-type: none"> • Brief history of target co. & background of its promoter • Mgt & employees • Review of FS • Statutory Compliance • A/cing policies • <u>Cash flow</u> - Can co. meet its cash requirements internally, check - <ul style="list-style-type: none"> ○ Is co. able to honour its commitments to its trade payables, to banks, to government & other stakeholders? ○ How well is co. able to turn its trade receivables & inventories? ○ How well does it deploy its funds? ○ Are there any funds lying idle or is co. able to reap maximum benefits out of available funds? ○ What is investment pattern of co. & are they easily realisable? • Taxation 	<p>Hidden Liabilities</p> <ul style="list-style-type: none"> • Co. may not show any show cause notices, which have not matured into demands, as contingent liabilities • Co. may have given "Letters of Comfort" to banks, may not be disclosed in B/S as these are not "guarantees" • Tax liabilities under DT & IDT • Long pending sales tax assessments • Pending final assessments of customs duty • Future lease liabilities • Unresolved labour litigations • Agreement to buy back shares at stated price <p>Work Approach to Due Diligence/Assessing Business FV involves</p> <ul style="list-style-type: none"> • Assessing business 1st hand by site visit • Working through due diligence process with investor • Reviewing & reporting on FS of target co.

<ul style="list-style-type: none"> Financial Projection 	<ul style="list-style-type: none"> Helping prepare offer based on completion of due diligence
<p>Over-Valued Assets</p> <ul style="list-style-type: none"> Uncollected/uncollectable receivables Obsolete, slow non-moving inventories valued above NRV Litigated assets & property Underused or obsolete PPE impaired due to fall in market value Intangible assets of no value Investments carried at cost though realizable value is much lower Investments carrying very low rate of return 	<p>How to Conduct Due Diligence</p> <ul style="list-style-type: none"> Start with open mind. Identify trouble spots & ask for explanations Take risk mgt approach Get best team of people. Hire due diligence experts Get help in all areas to get 360-degree view Talk to customers, suppliers & employees Prepare comprehensive report detailing compliances & substantive risks

<p>Contents of Due Diligence Report</p>		
<ul style="list-style-type: none"> Executive Summary Introduction Background of Target co. Brief history of co. 	<ul style="list-style-type: none"> Objective of due diligence Terms of reference & scope of verification Assessment of financial liabilities Assessment of valuation of assets 	<ul style="list-style-type: none"> Assessment of net worth Assessment of operating results Assessment of taxation & statutory liabilities SWOT Analysis Comments on future projections

Investigation

It is **systematic & in-depth examination** to establish fact or to evaluate specific situation

Basis	Investigation	Audit
Objective	Establishing a fact or happening or assessing particular situation	Verify whether FS give true & fair view of state of affairs & financial results
Nature	Voluntary in nature. Requires detailed study & examination of facts	Mandatory for co. Involves tests checking to draw evidences for expressing opinion
Evidence	It seeks conclusive evidence	Mainly concerned with prima- facie evidence
Appointing Agency	Even 3rd party can appoint Investigator	Owner /shareholders of Co.
Reporting	To person for whom investigation is done	To owners of entity
Inherent Limitations	No inherent limitation owing to nature of engagement	Suffers from inherent limitation
Periodicity	Not limited by rigid time frame. May cover several years	Either quarterly, half-yearly or yearly basis
Observance of A/cing Principles	Analytical in nature & requires thorough mind to observe, collect & evaluate facts	Governed by compliance with GAAPs, audit procedures & disclosure requirements
Scope	Governed by statute or may be non-statutory	Wide and for statutory audit, determined by provisions of law

<p>Steps in Investigation</p> <ul style="list-style-type: none"> • Determination of objectives & scope of investigation • Formulation of investigation programme • Examination of records referring appropriate evidence • Analysis & interpretation of findings • Preparation of report & drawing conclusions <p>Important issues while preparing report</p> <ul style="list-style-type: none"> • Report shall not contain anything which is not relevant • Relevant facts & conclusions be linked with evidence • Report shall state nature, objective & scope of assignment • Report shall also state restrictions/limitations imposed by client • Bases & assumptions made shall be explicitly stated • Every word used shall be properly considered so that possibility of arriving at different meaning can be minimized • Report shall be in para form with headings • Opinion of investigator shall appear in final para of report 	<p>Special Issues in Investigations</p> <ul style="list-style-type: none"> • <u>Whether 100% or selective verification</u> - Depends on case. If cash defalcated - examine all cash vouchers. If checking profitability of concern - verify on selective basis • <u>If Investigator can rely audited FS</u> - If investigation due to doubt in audited FS - no reliance. If FS not audited by qualified CA - check & verify FS. In other cases, agree with client in writing • <u>If investigator requires assistance of expert</u> - He shall get written consent of client • <u>Investigation out of disputes & conflicting claims</u> - Investigator shall remain above disputes & be alert as info may be prejudiced. He shall keep interest of all parties in view • <u>Basis of opinion</u> - Investigator shall not issue speculative opinion. He shall restrict his opinion to established facts. If books & records are incomplete - not express opinion or qualify opinion with reasons • <u>Futuristic statements</u> - Even if appointing party is willing to obtain futuristic statement, investigator shall refuse to be futuristic. He may assume that trend will continue in arriving at present value of business • <u>Retaining working papers</u> - Investigator shall retain working papers. He shall take WR to give evidence in court of law to support his figures
<p>To study economic & financial position of business, consider</p> <ul style="list-style-type: none"> • Adequacy of fixed & working capital for growth of business? • What will be trend of sales & profits in future? • Whether profit expected in future will yield adequate return on capital? • Whether business is operating at 100% capacity or improvements are required? 	<p>In assessing future maintainable turnover, consider</p> <ul style="list-style-type: none"> • <u>Marketability</u> - Extend sales into new markets or fully exploited? • <u>Trend</u> - Sales are increasing consistently or fluctuating? • <u>Political & economic considerations</u> - Govt policies extending market to other countries? • <u>Competition</u> - Effect on business of products at cheaper price?
<p>In assessing value of Trade Receivables, consider</p> <ul style="list-style-type: none"> • Whether Provision for Bad Debts is made in years of sales instead of in year of writing off 	<p>In assessing working capital requirements in future, consider</p> <ul style="list-style-type: none"> • Has ratio of inventory to turnover increasing? • Are trade payables being paid promptly or there is backlog?

<ul style="list-style-type: none"> • Debts shall be classified according to their age • Length of credit period or excessive discounts allowed 	<ul style="list-style-type: none"> • What will be effect on inventory, trade receivables & payables, if turnover is increased or new products are introduced?
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Types of Investigation
Statutory - Discussed in SPOM Set A
Non-statutory - Discussed Below

<p>Investigation for Bank Giving Loan to Co.</p> <ul style="list-style-type: none"> • Purpose of loan & how borrower will invest amount of loan • Schedule of repayment of loan submitted by borrower • History of growth & development of co. during past 5 years • Financial standing & reputation for business integrity • Whether co. is authorised by MOA/AOA to borrow money for purpose specified • Whether loan was applied to other Bank & if so, reasons for rejection <p>Steps to investigate profitability of business for judging accuracy of schedule of repayment</p> <ul style="list-style-type: none"> • Prepare condensed income statement from P/L for last 5 years • Compute below ratios separately - <ul style="list-style-type: none"> ○ Sales to Average Inventories held ○ Sales to Fixed Assets ○ Sales to Book Debts ○ Equity to Fixed Assets ○ Equity to Long Term Loans ○ Current Assets to Current Liabilities ○ Quick Assets to Quick Liabilities ○ Return on Capital Employed • Enter in separate part of statement break-up of annual sales product-wise <p>Steps for verification of assets & liabilities of borrower co.</p> <ul style="list-style-type: none"> • Fixed assets • Inventory • <u>Trade Receivables</u> - segregated as - <ul style="list-style-type: none"> ○ Debts for which credit period has not expired ○ Debts due within 6 months 	<p>Investigation of Frauds</p> <p><u>Types of Frauds</u> - Fraudulent Financial Reporting, Mis-appropriation of Assets & Corruption</p> <p>Corporate Frauds</p> <ul style="list-style-type: none"> • Advance Sales Billing • Shell/Dummy Co. Schemes • Money-Laundering Activities <p>Fraud at Operational Level Employees</p> <ul style="list-style-type: none"> • Tampering of Cheques/ Drafts/ On-line payments/ receipts • Off Book Frauds • Cash Misappropriation • Teeming & Lading • Fraudulent Disbursements • Expense Reimbursement Schemes • Payroll Fraud • Commission Schemes <p>Indicators of Fraud</p> <ul style="list-style-type: none"> • Discrepancies in A/cing Records including incorrect/non-recording • Conflicting or missing evidence including missing/altered docs • Unacceptable mgt responses like denial of access, undue time pressure, unusual delays in providing info • Other indications like A/cing Policies in variance with Industry etc. <p>Fraud Diamond - 4 Elements of Fraud</p> <ul style="list-style-type: none"> • <u>Incentive</u> - I want to, or have need to, commit fraud • <u>Rationalization</u> - I have convinced myself that this fraudulent behaviour is worth risks • <u>Opportunity</u> - There is weakness in system that right person could exploit
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<ul style="list-style-type: none"> ○ Debts due but not recovered for over 6 months • Investments • Secured & Unsecured Loans • Provision of Taxation • Other Liabilities • Insurance • Contingent Liabilities 	<ul style="list-style-type: none"> • <u>Capability</u> - I have necessary abilities to be right person to pull it off <p>Factors affecting Auditor ability to detect fraud</p> <ul style="list-style-type: none"> • Seniority of individuals involved • Skilfulness of perpetrator • Degree of collusion involved • Frequency & extent of manipulation • Relative size of amounts manipulated <p>Read Forms of Money Embezzlement from ICAI SM Page No. 17.49</p>
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Investigation on behalf of Incoming Partner - Steps	
<ul style="list-style-type: none"> • History of inception & growth of firm • Knowledge about specialisation of firm • Study composition & quality of key personnel • Reasons for offer of admission to new partner should be ascertained • Study provisions of deed of partnership 	<ul style="list-style-type: none"> • Scrutiny of profitability of firm over years • Examination of asset & liability position • Appraisal of capital employed & rate of return • Manner of computation of goodwill on admission & retirement

Investigation for Person Proposing to Buy Business	
<p><u>For proprietorship or partnerships -</u></p> <ul style="list-style-type: none"> • Reasons for sale & effect on turnover & profits • If bulk sales are made to small number of customers, profitability will be shaken on withdrawing their support • Length of lease of premises, its renewal or extension • Unexpired period of patents owned by vendors • Valuation of goodwill to determine if that appearing in book is less or more • Age of present managerial staff & prospects of continuing service under new proprietorship 	<p><u>If business belongs to limited co. - Additional Matters</u></p> <ul style="list-style-type: none"> • Authorised & Issued capital of co. • If there is uncalled liability on shares • If capital is divided into diff classes - rights attached to each class • Particulars of dividends paid in past & in arrear • If there are mortgages on assets appearing in co.'s books • Price at which shares are being offered

Forensic Accounting

- Forensic means suitable for **use in court of law**
- Forensic A/cing - **Integration of a/cing, auditing & investigative** skills
- Red Flag - **Indicators of danger** or inappropriate behaviour

Basis	Other Audits	Forensic Accounting
Objectives	Express opinion on 'True & Fair' presentation	Whether fraud has actually occurred in books

Techniques	Substantive & Compliance. Sample based	Investigative, substantive or in-depth checking
Period	Normally for a particular a/cing period	No such limitations
Verification of stock, Estimation of realizable value of assets	Relies on Mgt certificate/ Mgt Representation	Verification of selected items where misappropriation is suspected
Off balance sheet items	Used to vouch arithmetic accuracy & compliance with procedures	Regulatory & propriety of these transactions are examined
Adverse findings	Negative/qualified opinion is expressed with/without quantification	Legal determination of fraud & identification of perpetrators depending on scope
List of Forensic A/cing Services <ul style="list-style-type: none"> • Fund diversions/Asset tracing • Related party transactions/valuations • Suspicious transactions under IBC • Anti-Money laundering • Licence Fees/Dues/Tax Evasion • Valuations/Estimations of loss/damage 		Forensic Professional is often involved in <ul style="list-style-type: none"> • Computer Forensics • Fraud Prevention • Fraud Detection • Providing Expert Testimony
Forensic A/cing Process <ol style="list-style-type: none"> 1. Initialization 2. Develop Plan 3. Obtain Relevant Evidence 4. <u>Perform analysis</u> - involves <ul style="list-style-type: none"> • Summarizing large number of transactions • Performing present value calculations using discount rates • Performing regression/sensitivity analysis • Performing tracing of assets • Calculating economic damages • Using computerized application like spread sheet • Using charts & graphics to explain analysis 5. Reporting 6. Court proceedings 		Format/Content/Elements of Report <ul style="list-style-type: none"> • Title, addressee & distribution list • Scope & objectives of assignment • Approach & broad procedures undertaken • Executive Summary of results • Reference to use of expert • Fact that assignment is conducted as per Forensic A/cing & Investigation Standard (FAIS) • List of findings supported by evidences & its sources • Assumptions, limitations & disclaimers of assignment • Conclusions drawn from assessment • Summary of responses received from entity over draft report
4 components of FAIS Framework are <ul style="list-style-type: none"> • Basic Principles of FAI • Key Concepts • Standards on FAI • Guidance <p>1st 3 are Mandatory</p>		FAIS seek to provide <ul style="list-style-type: none"> • Professionals with minimum standards for undertaking FAI • Users with expected quality of service • Regulators & Govt with what can be expected from FAI services • To everyone, guidance on implementation & practical issues • It is principle-based, rather than rule based