Compendium of Generic Internal Audit Guides

(*As on January 1, 2015*)

Volume I

The Institute of Chartered Accountants of India

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Foreword

The business landscape has changed dramatically and the need to create greater transparency, establish sound corporate governance and understand risk exposure has never been greater. Internal audit is well positioned to help organizations adapt and even succeed in these unprecedented times. It is a key pillar in effective corporate governance and risk management, and is ultimately there to safeguard the sustainability of organizations.

The Institute has been working relentlessly to elevate the internal audit profession and to provide members with the support and resources they need to successfully meet each challenge. Strong technical knowledge and skills will help the internal auditors to meet stakeholder's expectations and be viewed as enablers of sustainable value. Internal Audit Standards Board of the Institute has over the years brought out high quality literature on internal audit, internal control and risk management for the guidance of the members. Apart from issuing Standards on Internal Audit, the Board has also issued a number of generic and industry specific guides. In 2013, the Board had issued "Compendium of Technical Guides on Internal Audit" which contained both generic and industry specific Guides. Considering the fact that number of guides have increased substantially, the Board has decided to issue two separate Compendiums, one for industry specific Guides and other for generic Guides on internal audit. This "Compendium of Generic Internal Audit Guides" is a one stop reference for all the generic guides issued by the Board till date.

I would like to congratulate CA. Charanjot Singh Nanda, Chairman, Internal Audit Standards Board and all the other members of the Board for their efforts in developing technical literature on internal audit.

I am sure that this Compendium would prove beneficial, as part of efforts of our members to deliver best in all their internal audit engagements.

January 13, 2015	**CA. K. Raghu**
New Delhi	President, ICAI

Preface

Accelerated changes in response to challenging economic and competitive market conditions over the past years have redefined organizational structures, business processes, and ultimately the risks. In this dynamic environment, internal audit's scope is expanding because the expectations that boards and management place on it are growing thereby demanding an increased focus on achieving balance between risk management and business performance. Internal auditors need to be more broad based and adopt a holistic approach to their planning and execution methodology in order to be effective business partners.

The Institute through Internal Audit Standards Board has been playing an important role in helping members to not only sharpen internal auditing knowledge and skills but also in moving towards being an important pillar of corporate governance framework. The Board has over the years brought out a number of generic and industry specific guides which provide detailed guidance to the members on various internal audit aspects. In 2011, the Board had issued "Compendium of Technical Guides on Internal Audit" which contained text of all the Industry Specific and Generic Guides issued by the Board till June, 2011 and further issued revised edition of the same in 2013.

With a view to enhance utility and optimize the size of the Compendium, the Board is bringing out separate Compendiums for Industry Specific Internal Audit Guides and Generic Internal Audit Guides. This *Compendium of Generic Internal Audit Guides (As on January 1, 2015)* is divided into two Volumes. The first volume contains Background Material on Due Diligence, Guide on Risk Based Internal Audit, Guide to Implementing Enterprise Risk Management, Study on Co-ordination of Internal Auditor with Functional Heads and Study on Investigative Audit, The second volume contains Guide on Environmental Audit, Data Analytics and Continuous Control Monitoring, Technical Guide on Social Audit, Technical Guide on Internal Audit of Intangible Assets and

Technical Guide on Internal Audit of Tendering Process. Further, it may be noted that the text of each of all these Guides have been published as a separate publication of the Institute.

I would like to express my gratitude to CA. K. Raghu, President, ICAI and CA. Manoj Fadnis, Vice President, ICAI for their continuous support and encouragement to the initiatives of the Board. I must also thank my colleagues from the Council at the Internal Audit Standards Board, *viz.*, CA. Shriniwas Yeshwant Joshi, Vice Chairman, IASB, CA. Rajkumar S. Adukia, CA. Prafulla Premsukh Chhajed, CA. Sanjeev K. Maheshwari, CA. Dhinal Ashvinbhai Shah, CA. Shiwaji Bhikaji Zaware, CA. V. Murali, CA. S. Santhanakrishnan, CA. Abhijit Bandyopadhyay, CA. Sanjiv Kumar Chaudhary, CA. Atul Kumar Gupta, CA. Naveen N.D. Gupta, Shri Manoj Kumar, Shri P. Sesh Kumar and Shri R.K. Jain for their vision and support. I also wish to place on record my gratitude for the co-opted members on the Board, *viz.*, CA. R. Balakrishnan, CA. N. S. Ayyanagoudar, CA. Sunil H. Talati, CA. J. Vedantha Ramanujam and CA. Milind Vijayvargia and special invitees, CA. Nagesh D. Pinge and CA. Hardik Chokshi for their invaluable guidance as also their dedication and support to various initiatives of the Board. I also wish to express my thanks to CA. Jyoti Singh, Secretary, Internal Audit Standards Board, CA. Arti Bansal, Asst. Secretary and CA. Pallavi Aggarwal, Management Trainee in giving final shape to the Compendium.

I am sure that having these Guides together at one place in the form of Compendium would make an easy reference for all the users.

January 13, 2015 — **CA. Charanjot Singh Nanda**
New Delhi — Chairman, IASB

Contents

Note : Detailed contents of each of these Guides is given at the beginning of the respective Guide.

G-1
BACKGROUND MATERIAL ON DUE DILIGENCE

Foreword

With the all round steady growth being witnessed by the Indian economy, dramatic restructuring of companies in the form of amalgamations, acquisitions, mergers and joint ventures has become common. It is in this context that assessing the potential risks of a proposed transaction by inquiring into all relevant aspects of the business to be ventured has become indispensable. Thus the importance of 'Due Diligence'.

The Institute on its part has been working quite proactively to help members sharpen their skill sets in all the emerging areas of professional relevance by way of technical literature as well as conferences, workshops etc. I am pleased to note that the Committee on Internal Audit* of the Institute is issuing this comprehensive background material on 'Due Diligence'.

I congratulate CA. Abhijit Bandyopadhyay, Chairman, Committee on Internal Audit and other Committee members on the issuance of this publication.

I am sure that this book will be of immense help to the members and other interested readers.

29th January, 2008 **CA. SUNIL H. TALATI**
New Delhi *President*, ICAI

* The Council at its 282nd meeting held on November 5,-7, 2008, has renamed the "Committee on Internal Audit" to "Internal Audit Standards Board (IASB)"

Preface

The Committee on Internal Audit has immense pleasure in placing before the members the background material on "Due Diligence".

Corporate acquisitions/mergers/takeovers have become a part of business strategy to grow rapidly and widely. Due Diligence is used to investigate and evaluate a business opportunity. It involves an analysis carried out before acquiring a controlling interest in a company. Irrespective of the nature of takeover, be it hostile or friendly, it is quite normal for the buyers to seek an independent due diligence report in respect of their target acquisitions. Here lies the scope of a professional to conduct due diligence process on behalf of their clients for proper evaluation of the vendor.

In light of this recent development, it is felt that the members require to be equipped to avail the emerging opportunity of undertaking due diligence exercise. Accordingly, to meet this purpose, the committee has brought out this Background Material on Due Diligence for assistance of the members. It is also aimed at being used as a background material for Training our members in this area which requires specialised skill.

Through this background material an attempt has been made to answer many of the queries that may be raised by the investigating Chartered Accountants. With a view to providing appropriate guidance in a manner that is easily understood by all the readers, this background material is divided into eight main chapters sequentially as Introduction to Due Diligence, Approach to Due Diligence, Due Diligence for Mergers & Acquisitions, Due Diligence for Venture Capital Investment, Due Diligence for Franchisee, Challenges and Risks Covered in Due Diligence Process, Work Approach for Due Diligence, and Summary. In addition, the material consists of Appendices containing Open House discussion- with sample questions and answers, Group Exercise, and Glossary of Salient Terms for better understanding of the readers.

I am extremely grateful to CA. Amitava Basu, for sparing time out of his professional and personal preoccupations and sharing his wealth of experience in the area of due diligence in the form of this Background Material. I am obliged to CA. Sunil H. Talati, our President and CA. Ved Jain, our Vice President for giving me this opportunity. I also wish to thank my colleagues in the Committee on Internal Audit, CA. Charanjot Singh Nanda, CA. Shanti Lal Daga, CA. Rajkumar S. Adukia, CA. Amarjit Chopra, CA. Sanjeev K. Maheshwari, CA. Mahesh P. Sarda, CA. Atul C. Bheda, CA J. Venkateswarlu, CA. Anuj Goyal, Shri Manoj K. Sarkar CA. Prashant S. Akkalkotkar, CA. Krishan Lal Bansal, CA. Vivek R. Joshi, CA. Shyam Lal Agarwal, CA. Brij Bhushan Gupta, CA. Anil Jain and CA. Satyavati Berera for their invaluable guidance and support in giving final shape to this Background Material. I would also like to place on record my sincere thanks to Mr. Vijay Kapur, CA. Puja Wadhera and the whole team of CIA secretariat for their untiring effort to bring out this publication.

I am confident that this Background Material will go a long way in helping the members understand the fundamental concepts of Due Diligence and sharpen their skill sets in this area.

CA. ABHIJIT BANDYOPADHYAY
Chairman
Committee on Internal Audit

28th January, 2008
Kolkata

Contents

Chapter 1

Introduction to Due Diligence

Introduction

A worldwide earthquake of activity is shaking the foundations of traditional business thinking. It is generating a tidal wave of economic as well as social growth and prosperity. Economic value and wealth creation has accelerated to unprecedented levels. Global capital market is expected to grow about 10 times in less than 10 years, unleashing undreamed of possibilities and solutions to longstanding problems. Though capital and trade have faced shifts around the world for centuries, certain powerful factors such as faster communication and decision-making, emerging global investors and financial markets, and converging consumer expectations across previously distinct regions have permanently altered the face and pace of economic activity.

Under these circumstances dramatic restructuring of companies in the form of amalgamations, acquisitions, mergers, and joint ventures has almost become a norm. New business structures through public-private partnerships, concession arrangements, etc. also have emerged. It is in this context that assessing the potential risks of a proposed transaction by inquiring into all relevant aspects of the past, present and predictable future of the business to be ventured has become quintessential. This exercise is referred to as 'Due Diligence'.

What is Due Diligence ?

Due diligence is used to investigate and evaluate a business opportunity. It implies a general duty to exercise care in any transaction. Most legal definitions of due diligence describe it as a measure of prudence activity, or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent person under the particular circumstance; not measured by any absolute standard but depends on the relative facts of the special case. In other words, making sure one gets what one thinks he/ she is paying for. Due diligence is a process of investigation, performed by investors, into the details of a potential investment such as an examination of operations and management and the verification of material facts. It entails conducting inquiries for the purposes of timely, sufficient and accurate disclosure of all material statements/information or documents, which may influence the outcome of the transaction. Due diligence involves an analysis carried out before acquiring a controlling interest in a company to determine that the conditions of the business conform with what has been presented about the target business. Also, due diligence can apply to recommendation for an investment or advancing a loan/credit.

Need for Due Diligence

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

- To confirm that the business is what it appears to be;
- To identify potential 'deal killer' defects in the target and avoid a bad business transaction;
- To gain information that will be useful for valuing assets, defining representations and warranties, and/or negotiating price concessions; and
- To verify that the transaction complies with investment or acquisition criteria.

Difference Between Due Diligence and Audit

It needs to be underlined that due diligence is different from audit. Audit is an independent examination and evaluation of the financial statements of an organization with a view to express an opinion thereon. Whereas, due diligence refers to an examination of a potential investment to confirms all material facts of the prospective business opportunity. It involves review of financial and non-financial records as deemed relevant and material. Simply put, due diligence aimsto take the care that a reasonable person should take before entering into an agreement or a transaction with another party.

Some Basics

The two questions that frequently arise in the context of due diligence for venturing into a target business are :

(1) What is expected from the due diligence process? (2) How can the confidential information be protected while still moving the process forward?

The answer to these questions may vary depending on a number of characteristicsof the acquiring company and the target business, that include size, maturity, process orientation, public or private, and competition for the deal. However, in general, the following are the common matters the due diligence process is expectedto cover:

a) General Corporate Matters

b) Financial, Accounting and Taxation

c) Technology and Intellectual Property

d) Product/Service Offerings

e) Operations

f) Sales and Marketing

g) Human Resources and Personnel

h) Legal and Regulatory.

For each of the items listed above, there is need for proper documentation and prioritisation. Also, it is important to see projections, reports and other documents actually used by the target company, as opposed to specially created projections and reports just for this process. Eventually, anything that could be material enough to affect the valuation of the business is to be carefully examined and considered. As it may not be possible to know what is material until the exercise proceeds, the initial due diligence list can be overly long with a number of items that may be irrelevant. This involves visiting the offices of the target company and speaking to most of the top management team.

Apart from due diligence from the buyer's side, there is also usually a requirement of similar exercise from the seller's side. This aspect covers three main items as discussed below:

a) Gauging the seriousness of the potential buyer:

   This involves evaluating the financial ability of the potential buyer to acquire and run the business:

   - Does the buyer have cash to make a cash deal?
   - Does the buyer already carry a large debt burden or has the ability to finance the deal?
   - In case of a public limited company is it feasible to consummate a stock deal?
   - Does the buyer have a clear and realistic plan on how the deal will be structured and financed?

b) Evaluating the means of initial contact:

   - Was it through a senior executive or board member or through a person with less authority?
   - If it is through an intermediary, how credible is the intermediary and is it formally representing the buyer?

Protecting Confidentiality of the Information

Staging the flow of confidential information based on the overall progress of the transaction is one of the best means of protection.

In other words, less sensitive information should be shared initially, and as the potential buyer progresses and shows seriousness; more sensitive information could be shared. It forces the potential buyer to earn the more sensitive information and limits the number of parties who see the confidential records.

The phasing of information flow could follow the pattern mentioned below:

- The first phase consists of information that are already in public domain.
- The next phase consists of information that is typically heavier on current and historical matters than on forward-looking projections. Quite a bit of confidential company information is disclosed at this stage, but very little thatis competitively sensitive.
- The third phase involves the most sensitive company information, including projections, customer information and any other information requested by the buyer deemed too sensitive to share earlier in the process.
- Finally, the accounting and legal due diligence is usually at the end of the process. This phase is last more for reasons of larger number of people involved and cost than for confidentiality reasons.

Warning Signs

Through out the process, it is essential for the target seller to continually evaluate the potential buyer. This can be achieved by focusing on aspects such as:

- *The Due Diligence Team* - size of the team, time spent by the team, compositionof the team for example, whether professionals such as investment bankers, lawyers and accountants have been deployed for the exercise.
- *Activities and Apparent Intention of the Team* - the seller should assess whether the buyer's team is apparently only fishing for information that is not critical to the deal but could be important to a competitor

- *Level of People Involved* - the seller should assess the level of people involved from the potential buyer's side. Typically, there is mostly management level involvement in the early process and more operational people and specialists come later.

Questions

Question 1.1

What does Due Diligence mean?

Question 1.2

What does Due Diligence require?

Question 1.3

How is Due Diligence conducted?

Question 1.4

How much Due Diligence needs to be conducted?

Question 1.5

Can Due Diligence efforts be overdone?

Question 1.6

How Much Time is allocated for Due Diligence Completion?

Question 1.7

How should tasks within the Due Diligence efforts be prioritised?

Question 1.8

How to maintain confidentiality during a Due Diligence engagement?

Question 1.9

Does Due Diligence ensure that a business transaction will be successful?

Chapter 2
Approach to Due Diligence

Due Diligence is the process whereby a potential investor accesses the target company's books and records to verify that all of the information provided thus far is true and accurate. Often, people think that due diligence is simply an exercise to verify the financial position of the company. While this is true to some extent, a proper and effective due diligence goes past the financials.

The Right Approach to Due Diligence

Is this the time to look for things that are wrong with the business? Is this the timeto strictly verify numbers? Is this the time to disprove what the investor has been told by the target company? While each of these approaches is somewhat valid none are absolute. While the investor would want to employ a part of each of these strategies, an effective due diligence is when one can really "check things out". This exercise is to be used to determine whether the future looks bright for the business and the industry. To do so, the investor must investigate far more than the financial aspect. Sure, the various financial statements will give the investor a picture of the past and perhaps a glimpse of the future but the past is over and done with. The investor must, therefore, thoroughly review the company's sales, marketing, employees, contracts, customers, competition, systems, suppliers, and legal and corporate issues. The investor wants to complete the due diligence exercise knowing exactly what one is getting into, what needs to be fixed, what the costs are to fix and if one is the right person to be at the helm to put the plans in place to make a great future for the business.

Due Diligence Period

Target companies normally try to negotiate the shortest due diligence period possible. However, it is impossible to understand a business in a short time. Even for the smallest of companies, an investor would ordinarily need no less than 20 working days. Since a proper investigation reaches farther than just financials the investor must negotiate for adequate time to accumulate the information. For this purpose, the target company should be clearly communicated all that would be investigated. It should also be made clear to the target company that if it truly wants the deal to move forward it must allow the potential investor adequate time to do the proper investigations.

Preparation

Preparation for due diligence begins the moment it is believed that the business may be worth pursuing. After the investor meets the target company's authorities the first time and believes that one may be interested one should begin to organise one's plan. The first step in this direction is preparing lists and noting areas and specific details related to the business that need further review. Once the investor gets closer to a decision to go for the deal detailed, "to do" lists need to be maintained, broken down for each aspect of the business (i.e. Financials, Employees, Sales, Contracts, etc.). The target company should be kept informed of when the investor anticipates beginning the due diligence. Lists of the materials needed from the target company should be first assembled and never the due diligence exercise should begin until the investor has received all of the supporting documents that one needs from the target company.

Getting the Target Company and its Staff to Cooperate

The target company must let its people know that they are to provide one with full access to all files and complete cooperation throughout the investor's investigation.

What if Surprises are Found

This should probably be titled: "What to do "WHEN" surprises are found" because this is likely to happen. On the contrary, if surprises are not found, it may imply that the examination has not been thorough enough. The Due Diligence team needs to deal with each on its own and make sure that each is thoroughly investigated so that the facts are foolproof. However, the exercise should not be bogged down with minor issues and these have to be taken as "part of the due diligence package". Unless something is found that cannot be resolved or is so detrimental that even if the target company significantly lowers the acquisition price, the potential buyer would still walk away from the deal, it is best to take all of these obstacles in stride. Do not publicise them; investigate them. A few issues do not mean that the business is bad. The items or issues must be appropriately weighed with reference to the impact against the future viability of the business. It should be remembered that the goal is to learn what the potential buyer would be getting into and what the future can be with the investor in charge. The option always exists for the investor to renegotiate once the investigation is completed. The investor will be in a much stronger position if one can go to the entrepreneur with very specific concerns, which require reevaluation and renegotiation. With this in mind, the findings should notbe discussed with anyone except the accountant or other advisors.

Applications

Most business managers routinely develop critical relationships with new suppliers and customers without much forethought. However, making assumptions about the integrity and ethical standards of the customers and suppliers can leave the business vulnerable. Businesses sometimes find themselves in difficult situations that could have been avoided had they conducted thorough background checks. For example, a "friend" might have been hired to run a new startup, not knowing that he had defrauded a former employer. The mistake of giving him sole signing authority on the startup's accounts may result in victimisation about six months later. Another example could be of an individual from another country claiming that he can broker a substantial financing for the potential buyer, who then engages his services. It is, however, subsequently learnt that this engagement is far beyond the scope of his experience and capability, and that there are some unsavory aspects to the people he represents.

Integrity Due Diligence therefore, is a process of gathering and analysing information to assess whether or not one wants to do business with a person or company. This intelligence will allow one to make informed decisions and can reduce or eliminate any number of possible risks.

There is a host of legal and ethical information available to help one protect oneself and the business. Most people think that checking references or "asking around" is enough. However, when someone provides with a reference, he usually nominates someone he has hand picked. To get a truly objective feedback a different and much deeper approach is needed to be taken. A comprehensive review could include areas such as:

- Civil litigation history - These records are available on a jurisdiction-by- jurisdiction basis, so knowing where to look is very important.
- Writs of execution - A writ is issued when a judgment has been issued in a civil trial but has not been paid. A writ may be the only evidence of an important case.
- Criminal records - An important check, but it should not stop there. Much of the fraudulent or unethical behaviour in business are civil matters that do not result in criminal prosecution or charges.
- Current charges - A criminal records check will indicate only prior convictions. It also needs to be known if there are any current charges that have not yet gone to court.
- Corporate affiliations - What are other associations? What is the nature of the involvement? What is the history and reputation of these businesses? Commercially available databases of corporate information can help, as can state and national level records.
- News media - A full range of media should be checked; from small local newspapers to the national dailies, as well as industry periodicals and international sources.

- Internet - The Internet has provided a publishing medium to the masses. Someone may have communicated information about the potential business partners that is not in the press but from which one might benefit.
- Credit reports - Available through credit-rating companies such as CRISIL, ICRA, etc. credit reports can provide a lot of useful information on companies and individuals. Personal credit reports are available only with signed consent, but this is not a requirement for obtaining a credit report on a company.
- Insolvency filings - Have the individuals ever filed for, or been petitioned into insolvency ? What were the circumstances?

When Should Integrity Due Diligence be Considered

When an investor is looking to enter a new business relationship, it should be considered important to conduct background checks. Examples include:

- Reviewing potential suppliers
- Entering into a licensing agreement
- Reviewing prospective joint venture partners
- Entering new markets
- Reviewing existing customers
- Reviewing potential merger or acquisition targets
- Reviewing individuals who wish to broker opportunities for investing company, including financing, property development, new markets, etc.

The time and money invested in integrity due diligence just might save the investor from a significant business risk.

Chapter 3

Due Diligence for Mergers & Acquisitions

Mergers, Acquisitions and Takeovers

Expansion either by entering a new market or through expansion in an existing market is becoming a common trend. In that context, Indian business houses are increasingly resorting to mergers and acquisition as a means to growth.

Mergers result in combination of two or more companies into one, wherein the all or all except one merging entities loose their identities. No fresh investment is made through this process. However, an exchange of shares takes place between the entities involved in such a process. Generally, the company that survives is the buyer, which retains its identity, and the seller company is extinguished.

A merger can also be defined as an amalgamation of all assets and liabilities of one company transferred to the transferee company in consideration of payment in the form of equity shares of the transferee company or the venture or cash or of a mix of above modes of payments.

An acquisition, on the other hand, is aimed at gaining a controlling interest in the share capital of the acquired company. It can be enforced through an agreement with the persons holding a majority interest in the company's management or through purchasing shares in the open market or purchasing new shares by private treaty or by making a take over offer to the general body of shareholders.

The takeover, which is essentially an acquisition, differs from the merger in its approach to business combination. In the process of takeover, the acquisitioning company decides the maximum price and form that is to be offered to the acquired and hence takes lesser time in completing the transaction than in mergers. In merger transactions, the consideration is paid for in shares whereas in a takeover, the consideration is in the form of cash. However, mergers and takeovers can be treated as similar process since in both cases at least one set of shareholders looses an executive control over a company, which they otherwise hold.

Mergers and acquisitions are prominent in the business world and due diligence is a vital aspect of that activity. Due diligence is used by Mergers and Acquisitions(M&A) professionals, to cover the data-gathering exercise which is a necessary precursor to any M&A deal.

Due diligence is undertaken by the buyer in an attempt to gain an understanding of the business that it is proposing to acquire (the target). It is also one of the key means by which the buyer seeks to gain information that it will use to negotiate the final price, a change in the terms of the deal, or both.

Price Negotiations

"Due diligence is an essential data-gathering exercise for any M&A deal."

Typically, the potential buyer will make an offer for the target company that is subject toa range of conditions, including due diligence. In spite of the fact that it always happens this way, the final price is more than likely going to be lower; and, that lowering is more than likely going to be the result of what is found in due diligence. There has hardly been a price negotiated upwards as a result of issues emerging from due diligence.

Strategic Secrecy

Traditionally, due diligence is a battleground. The seller wants to keep certain information away from the potential buyer until the latest possible moment. In particular, the seller will not want to disclose commercially sensitive information such as customer names and actual prices. This is more likely if the buyer is a trade competitor rather than an institutional buyer since trade competitors may pose as potential buyers just to gather valuable information from the seller. In any event, if the seller reveals too much too soon, it can kill the value of the deal.

Another aspect of this competitive issue is the problem of multiple disclosures in the course of a sale exercise. An important issue is if ten bidders see the same information, whether the value of that information gets diluted ten-fold. After the deal is done and the business is sold, in spite of the confidentiality agreements that will have been made between the seller and the (nine) other potential buyers, those potential buyers will not obviously be able to un-learn what they have learned. They will know things, which, although un-useable in any overt way because of the confidentiality agreements, might be used covertly or even inadvertently.

Be Prepared

Sellers should consider how much due diligence they should undertake before letting potential buyers anywhere near the target. The last thing the seller wants is a nasty surprise being discovered by a potential buyer as they sift through the due diligence material.

"Trade competitors often pose as potential buyers just to gather valuable information."

In fact, sellers should do more due diligence than buyers. The seller should know everything there is to know about the target company, the buyer should only get to know a limited range of things. The seller should control the information flow. That is only possible if it knows what information exists.

Caveat Emptor

Typically, buyer-side due diligence exercises are too broad and too unfocused on the real value issues underlying the proposed deal. That is, there is too much reliance on the volume of information that is requested and not enough consideration of the specific aspects of the business upon which the 'buy' decision is, was or will be based.

Due diligence exercises tend to focus on the past (not least because there is a mass of information on that). For example, how did the target company perform one, two, three, or even five or six years ago, what are the accounts like for those years? Further, some key issues, such as tax liability and other potential liability issues can be found in the historical paperwork. However, if the buyer is valuing the business on the basis of its future prospects, it should spend considerable time assessing whether the target company has the ability to deliver on those prospects.

Other aspects normally investigated into by the potential buyers are the conditionof the machinery and equipment, the state of the order book and current contracts, research and development activities of the seller, target-customer and target- supplier relations, There is a host of forward-looking information which should be looked at in great detail but which is often ignored or relegated to the ‘if we have time’ pile.

Discreet Disclosure

For the seller, due diligence is typically seen as a necessary evil. However, there is an alternative view. While accepting that, for the reasons given above, full disclosure is not wise, the seller should consider whether more disclosure, rather than less, is good for both price and potential liability.

At times, the seller may take a stand that though, during due diligence, the potential buyer may decide to walk away from the deal, the initial price offered cannot be changed. A seller can only take that confident stance if it has done its own due diligence. In addition, a buyer will only entertain that approach if it is allowedto undertake extensive and deep due diligence.

Things to Consider

Both the seller and the potential buyer should, therefore, think long and hard about due diligence. Sellers should consider the value and process implications of high quality, pre-sale due diligence. Identifying all the skeletons in the cupboards, as well as all the potential gold mines, will (in either case) have a positive effect on the negotiations.

Potential buyers, on the other hand, should identify the value in the deal, assess as to why the business is being sought. Whereas history of the business is important, far more so will be the ability of the business to perform in the future, in the hands of the buyer and to the standard expected and paid for. Due diligence should be directed towards those issues.

Sample Due Diligence Check List

At the beginning of the due diligence process, the following documents are normally requested :

- The latest business plan
- Product data sheets and literature
- Analysis of competitors
- Organisational chart
- Capitalisation structure and shareholder information
- Historical balance sheet cash flow and income statements since inception
- Forecast balance sheet, cash flow, and income statements (possibly up to 5 years)
- Current operating budgets compared to actual
- Detailed budget and revenue forecasts
- Tax filings
- Description of leases.

In carrying out due diligence exercise for merger and acquisition, the checks generally followed are provided in **Annexure 'A'** to this Chapter. Further in **Annexure 'B'** to this Chapter, a specimen checklist for preliminary legal due diligence is given, and **Annexure 'C**' contains specimen checklist for commercial due diligence.

Sample Due Diligence Report

Based on the checks carried out in accordance with the guidelines provided in the check list as set out in **Annexure 'A',** the advisor or the public accountant entrusted with the due diligence exercise is required to submit a report to the client, viz., the potential buyer. However, a specimen report of due diligence for a prospective investment is set out in **Annexure 'D'** to this Chapter.

Annexure - A

Sample Due Diligence Checklist

The following due diligence checklist is only a sample, and may differ from the actual list used during the deal process. Some of the information may not be relevant to every situation, and will not be required by the buyer.

A. Organisation of the Company

1. Describe the corporate or other structure of the legal entities that comprise the Company. Include any helpful diagrams or charts. Provide a list of the officers and directors of the Company and a brief description of their duties.

2. Long-form certificate of good standing and certificate of incorporation. Listing all documents on file with respect to the Company, and a copy of all documents listed therein.

3. Current by-laws of the Company (i.e., *Articles of Association*)

4. List of all jurisdictions in which the Company is qualified to do business and list of all other jurisdictions in which the Company owns or leases real property or maintains an office and a description of business in each such jurisdiction. Copies of the certificate of authority, good standing certificates and tax status certificates from all jurisdictions in which the Company is qualified to do business.

5. All minutes for meetings of the Company's board of directors, board committees and shareholders for the last five years, and all written actions or consents in lieu of meetings thereof.

6. List of all subsidiaries and other entities (including partnerships) in which the Company has an equity interest; organisational chart showing ownership of such entities; and any agreements relating to the Company's interest in any such entity.

B. Ownership and Control of the Company

1. Capitalisation of the Company, including all outstanding capital stock, convertible securities and similar instruments.

2. List of shareholders of the Company, setting forth class and number of shares held.

3. Copies of any voting agreements, shareholder agreements, proxies, transfer restriction agreements, rights of first offer or refusal, preemptive rights, registration agreements or other agreements regarding the ownership or control of the Company.

C. Assets and Operations

1. Annual financial statements with notes thereto for the past three fiscal years of the Company, and the latest interim financial statements since the end of the last fiscal year and product sales and cost of sales (including royalties) analysis for each product which is part of assets to be sold.

2. All current budgets and projections including projections for product sales and cost of sales.

3. Any auditor's (internal and external) letters and reports to management for the past five years (and management's responses thereto)

4. A detailed breakdown of the basis for the allowance for doubtful accounts.

5. Inventory valuation, including turnover rates and statistics, gross profit percentages and obsolescence analysis including inventory of each product, which is part of assets to be sold.

6. Letters to auditors from outside counsel.

7. Description of any real estate owned by the Company and copies of related deeds, surveys, title insurance policies (and all documents referred to therein), title opinions, certificates

of occupancy, easements, deeds of trust and mortgages.

8. Schedule of significant fixed assets, owned or used by the Company, including the identification of the person holding title to such assets and any material liens or restrictions on such assets.

9. Without duplication of separate intellectual property due diligence checklist from Section D below, schedule of all intangible assets (including customer lists and goodwill) and proprietary or intellectual properties owned or used in the Company, including a statement as to the entity holding title or right to such assets and any material liens or restrictions on such assets, include on and off balance sheet items.

D. Intellectual Property

List of all patents, trademarks, service marks and copyrights owned or used by the Company, all applications and copies thereof, search reports related thereto and information about any liens or other restrictions and agreements on or related to any of the foregoing.

E. Reports

1. Copies of any studies, appraisals, reports, analysis or memoranda within the last three years relating to the Company (i.e., competition, products, pricing, technological developments, software developments, etc.)

2. Current descriptions of the Company that may have been prepared for any purpose, including any brochures used in soliciting or advertising.

3. Descriptions of any customer quality awards, plant qualification/ certification distinctions, ISO certifications or other awards or certificates viewed by the Company as significant or reflective of superior performance.

4. Copies of any analyst or other market reports concerning the Company known to have been issued within the last three years.

5. Copies of any studies prepared by the Company regarding the Company's insurance currently in effect and self-insurance programme (*if any*), together with information on the claim and loss experience there under.

6. Any of the following documents filed by the Company or affiliates of the Company and which contain information concerning the Company: annual reports, and quarterly reports.

F. Compliance with Laws

1. Copies of all licences, permits, certificates, authorisations, registrations, concessions, approvals, exemptions from all governmental and other operating authorities any applications therefore, and a description of any pending contemplated or threatened changes in the foregoing.

2. A description of any pending or threatened proceedings or investigations before any court or any regulatory authority.

3. Describe any circumstance where the Company has been or may be accused of violating any law or failing to possess any material licence, permit or other authorisation. List all clarifications and notices from governmental or regulatory authorities.

4. Schedule of the latest dates of inspection of the Company's facilities by each regulatory authority that has inspected such facilities.

5. Description of the potential effect on the Company of any pending or proposed regulatory changes of which the Company is aware.

6. Copies of any information requests from, correspondence with, reports ofor to, filings with or other material information with respect to any regulatory bodies, which regulate a material portion of the Company's business. Limit response to the last five years unless an older document has a continuing impact on the Company.

7. Copies of all other studies, surveys, memoranda or other data on regulatory compliance including, spill control, environmental clean-up or environmental preventive or remedial matters, employee safety compliance, import and export licences, common carrier licences, problems, potential violations, expenditures, etc.

8. State whether any consent is necessary from any governmental authority to embark upon or consummate the proposed transaction.

9. Schedule of any significant import or export restrictions that relate to the Company's operations.

10. List of any export, import or customs permits or authorisations, certificates, registrations, concessions, exemptions, etc., that are required in order for the Company to conduct its business and copies of all approvals, etc., granted to the Company that are currently in effect or pending renewal.

11. Any correspondence with or complaints from third parties relating to the marketing, sales or promotion practices of the Company.

G. Environmental Matters

1. A list of facilities or other properties currently or formerly owned, leased, or operated by the Company and its predecessors, if any.

2. Reports of environmental audits or site assessments in the possession of the Company.

3. Copies of any inspection reports prepared by any governmental agency or insurance carrier in connection with environmental or workplace safety and health regulations relating to any such facilities or properties.

4. Copies of all environmental and workplace safety and health notices of violations, complaints, consent decrees, and other documents indicating non-compliance with environmental or

workplace safety and health laws or regulations, received by the Company from local, state, or central governmental authorities. If available, include documentation indicating how such situations were resolved.

5. Copies of any private party complaints, claims, lawsuits or other documents relating to potential environmental liability of the Company to private parties.

6. Listing of underground storage tanks currently or previously present at the properties and facilities listed in response to item 1 above, copies of permits, licences or registrations relating to such tanks, and documentation of underground storage tank removals and any associated remediation work.

7. Descriptions of any release of hazardous substances or petroleum known by the Company to have occurred at the properties and facilities listed in response to Item 1, if such release has not otherwise been described in the documents provided in response to Items 1-6 above.

8. Copies of any information requests, or other notices received by the Company relating to liability for hazardous substance releases at off-site facilities.

9. Copies of any notices or requests described in Item 8 above, relating to potential liability for hazardous substance releases at any properties or facilities described in response to Item 1.

10. Copies of material correspondence or other documents (including any relating to the Company's share of liability) with respect to any matters identified in response to Items 8 and 9.

11. Copies of any written analyses conducted by the Company or an outside consultant relating to future environmental activities (i.e., upgrades to control equipment, improvements in waste disposal practices, materials substitution) for which expenditure significant amount is either certain or reasonably anticipated within the next five years and an estimate of the costs associated with such activities.

12. Description of the workplace safety and health programmes currently in place for the Company's business, with particular emphasis on chemical handling practices.

H. Litigation

1. List of all litigation, arbitration and governmental proceedings relating to the Company to which the Company or any of its directors, officers or employees is or has been a party, or which is threatened against any of them, indicating the name of the court, agency or other body before whom pending, date instituted, amount involved, insurance coverage and current status. Also describe any similar matters which were material to the Company and which were adjudicated or settled in the last ten years.

2. Information as to any past or present governmental investigation of or proceeding involving the Company or the Company's directors, officers or employees.

3. Copies of any consent decrees, orders (including applicable injunctions) or similar documents to which the Company is a party, and a brief description of the circumstances surrounding such document.

4. Copies of all letters of counsel to independent public accountants concerning pending or threatened litigation.

5. Any reports or correspondence related to the infringement by theCompany or a third party of intellectual property rights.

I. Significant Contracts and Commitments

1. Contracts relating to any completed (during the past 10 years) or proposed reorganisation, acquisition, merger, or purchase or sale of substantial assets (including all agreements relating to the sale, proposed acquisitionor disposition of any and all divisions, subsidiaries or businesses) of or with respect to the Company.

2. All joint venture and partnership agreements to which the Company is a party.

3. All material agreements encumbering real or personal property owned by the Company including mortgages, pledges, security agreements or financing statements.

4. Copies of all real property leases relating to the Company (whether the Company is lessor or lessee), and all leasehold title insurance policies (*if any*).

5. Copies of all leases of personal property and fixtures relating to the Company (whether the Company is lessor or lessee), including, without limitation, all equipment rental agreements.

6. Guarantees or similar commitments by or on behalf of the Company, other than endorsements for collection in the ordinary course and consistent with past practice.

7. Indemnification contracts or arrangements insuring or indemnifying any director, officer, employee or agent against any liability incurred in such capacity.

8. Loan agreements, lines of credit, lease financing arrangements, installment purchases, etc., relating to the Company or its assets and copies of any security interests or other lines securing such obligations.

9. No-default certificates and similar documents delivered to lenders for the last five (or shorter period, if applicable) years evidencing compliance with financing agreements.

10. Documentation used internally for the last five years (or shorter time period, if applicable) to monitor compliance with financial covenants contained in financing agreements.

11. Any correspondence or documentation for the last five years (or shorter period, if applicable) relating to any defaults or potential defaults under financing agreements.

12. Contracts involving cooperation with other companies or restricting competition.

13. Contracts relating to other material business relationships, including:

    a) any current service, operation or maintenance contracts;

    b) any current contracts with customers;

    c) any current contracts for the purchase of fixed assets; and

    d) any franchise, distributor or agency contracts.

14. Without duplicating the intellectual property due diligence check list as outlined in **Section D** above, contracts involving licensing, know-how or technical assistance arrangements including contracts relating to any patent, trademark, service mark and copyright registrations or other proprietary rights used by the Company and any other agreement under which royalties are to be paid or received.

15. Description of any circumstances under which the Company may be required to repurchase or repossess assets or properties previously sold.

16. Data processing agreements relating to the Company.

17. Copies of any contract by which any broker or finder is entitled to a fee for facilitating the proposed transaction or any other transactions involving the Company or its properties or assets.

18. Management, service or support agreements relating to the Company, or any power of attorney with respect to any material assets or aspects of the Company.

19. List of significant vendor and service providers (if any) who, for whatever reason, expressly decline to do business with the Company.

20. Samples of all forms, including purchase orders, invoices, supply agreements, etc.

21. Any agreements or arrangements relating to any other transactions between the Company and any director, officer, shareholder or affiliate of the Company (collectively, “Related Persons”), including but not limited to:

    a) Contracts or understandings between the Company and any Related Person regarding the sharing of assets, liabilities, services, employee benefits, insurance, data processing, third-party consulting, professional services or intellectual property.

    b) Contracts or understandings between Related Persons and third parties who supply inventory or services through Related Persons to the Company.

    c) Contracts or understandings between the Company and any Related Person that contemplate favourable pricing or terms to such parties.

    d) Contracts or understandings between the Company and any Related Person regarding the use of hardware or software.

    e) Contracts or understandings regarding the maintenance of equipmentof any Related Person that is either sold, rented, leased or used by the Company.

    f) Description of the percentage of business done by the Company with Related Persons.

    g) Covenants not to compete and confidentiality agreements between the Company and a Related Person.

    h) List of all accounts receivable, loans and other obligations owing to or by the Company from or to a Related Person, together with any agreements relating thereto.

22. Copies of all insurance and indemnity policies and coverages carried by the Company including policies or coverages for products, properties, business risk, casualty and workers

compensation. A summary of all material claims for the last five years as well as aggregate claims experience data and studies.

23. List of any other agreements or group of related agreements with the same party or group of affiliated parties continuing over a period of more than six months from the date or dates thereof.

24. Copies of all supply agreements relating to the Company and a description of any supply arrangements.

25. Copies of all contracts relating to marketing and advertising.

26. Copies of all construction agreements and performance guarantees.

27. Copies of all secrecy, confidentiality and non-disclosure agreements.

28. Copies of all agreements related to the development or acquisition of technology.

29. Copies of all agreements outside the ordinary course of business.

30. Copies of all warranties offered by the Company with respect to its products or services.

31. List of all major contracts or understandings not otherwise previously disclosed under this section, indicating the material terms and parties.

32. For any contract listed in this Section state whether any party is in default or claimed to be in default.

33. For any contract listed in this Section state whether the contract requires the consent of any person to assign such contract or collaterally assign such contract to any lender.

Note: Remember to include all amendments, schedules, exhibits and side letters. Also include brief description of any oral contract listed in this Section.

J. Employees, Benefits and Contracts

1. Copies of the Company's employee benefit plans as most recently amended, including all pension, profit sharing, thrift, stock bonus, ESOPs, health and welfare plans (including retiree health), bonus, stock option plans, direct or deferred compensation plans and severance plans, together with the following documents:

   a) all applicable trust agreements for the foregoing plans;

   b) copies of all determination letters of tax authorities for the foregoing qualified plans;

   c) latest copies of all summary plan descriptions, including modifications, for the foregoing plans;

   d) latest actuarial evaluations with respect to the foregoing defined benefit plans; and

   e) schedule of fund assets and unfounded liabilities under applicable plans

2. Copies of all employment contracts, consulting agreements, severance agreements, independent contractor agreements, non-disclosure agreements and non-compete agreements relating to any employees of the Company.

3. Copies of any collective bargaining agreements and related plans and trusts relating to the Company (*if any*). Description of labour disputes relating to the Company within the last three years. List of current organisational efforts and projected schedule of future collective bargaining negotiations (*if any*).

4. Copies of all employee handbooks and policy manuals

5. The results of any formal employee surveys.

K. Tax Matters

1. Copies of returns for the three prior closed tax years and all open tax years for the Company together with a work paper therefore wherein each item is detailed and documented that reconciles net income as specified in the applicable financial statement with taxable income for the related period.
2. Audit and revenue agents reports for the Company; audit adjustments proposed by the Tax Authorities for any year of the Company or protests filed by the Company.
3. Settlement documents and correspondence for last six years involving the Company.
4. Agreements waiving statute of limitations or extending time involving the Company.
5. Description of accrued withholding taxes for the Company.

L. Miscellaneous

1. Information regarding any material contingent liabilities and material unasserted claims and information regarding any asserted or unasserted violation of any employee safety and environmental laws and any asserted or unasserted pollution clean-up liability.
2. List of the ten largest customers and suppliers for each product or service of the Company.
3. List of major competitors for each business segment or product line.
4. Any plan or arrangement filed or confirmed under the bankruptcy laws
5. A list of all officers, directors and shareholders of the Company.

6. All annual and interim reports to shareholders and any other communications with them.

7. Description of principal banking and credit relationships (excluding payroll matters), including the names of each bank or other financial institution, the nature, limit and current status of any outstanding indebtedness, loan or credit commitment and other financing arrangements.

8. Summary and description of all product, property, business risk, employee health, group life and key-man insurance.

9. Copies of any judgment or suit searches or filings related to the Company in different states conducted in the past three years.

10. Copies of all filings with the Securities Exchange Board of India or foreign security regulators or exchanges.

11. All other information material to the financial condition, business, assets, prospects or commercial relations of the Company.

Annexure - B

Preliminary Legal Due Diligence Checklist

Table of Contents

Legal Due Diligence Checklist and Preliminary Enquiries

Introduction

The following list sets out the information and documents which are initially required in order to conduct the legal due diligence in relation to the proposed subscription to new shares of [ABC] by XYZ (*the Investor*).

In this Checklist:

***Company* means ABC Limited;**

Promoter means the promoters of the Company; and

Subsidiaries means subsidiaries of the Company

In this checklist, the relevant questions have been placed on the left hand side of the page. The responses to the questions may be inserted in the response column on the right hand side of each question.

For ease of reference all questions should be answered, where appropriate in the negative. In the event any question requires a detailed response, the same may be separately annexed and referenced to the left of the concerned question. Wherever the response to any question includes any documents, these may be similarly annexed and referenced. Similarly, all answers and documents to which you refer should be clearly marked with the section and question to which they relate. Where you provide documents, please provide in your answer a brief identification (including identifying to which company the documents relate) where this is not clear from the heading of the document itself. Unless otherwise specified, please provide all information with reference to the Company as well as each Subsidiary.

Where the item requested does not exist or is otherwise inapplicable, please indicate so in the response column. Please also state the reason why it is inapplicable. If in doubt the questions should be answered according to the spirit of information requested rather than merely the letter and too much information rather than too little should be given. Where the same information and documents are to be supplied in response to two or more different questions, there is no need to repeat your response provided all necessary cross-references are made.

When any specific foreign law, legislation or practice is not referred to in this document and the Company or any Subsidiary operates or has operated in a foreign jurisdiction, each of the enquiries in this document shall apply to such company or companies in relation to its foreign activities and presence as if, where the context admits or requires, references to Indian law, practice and legislation were references to similar law practice or legislation applicable in the relevant foreign jurisdiction in which such activities are or were performed.

After completing the response to the questions on each page, please initial each page before forwarding the response to us.

Where documents are requested to be sent along with the response to this checklist, please provide copies rather than originals. Please arrange to have originals providedat the time of physical verification by us. Further, please ensure that a person so authorised by the Company certifies all copies of documents provided, as true copies. It would also be helpful if you would provide any documents requested in lever arch files with an index correlating to the numbering system used in this list.

Please ensure that all responses are, to the extent possible, complete. Further queries may need to be raised depending on the content of the replies.

During the course of, or subsequent to, the completion of this due diligence exercise, you may be requested to provide certificates as to the completeness and accuracy of the information provided. However, please note that the answers to questions raised in these enquiries or the certificates mentioned above would not comprise formal disclosures for the purposes of any representations or warranties sought by the investor in the legal documents. Any such formal disclosure will be required tobe made in the legal documents and such disclosures will be expected to be clear, concise, full and fair disclosures against the relevant warranties.

If you have any queries in connection with this due diligence checklist/questionnaire please contact XYZ at YYY Limited, Delhi at the telephone number or the e-mail addresses mentioned on the cover.

General Information

Sl. No.	Question	Response
1.1	Briefly describe the history of the Company and the Subsidiaries since their incorporation, including the details of the acquisition of the Subsidiaries by the Company.	
1.2	Briefly describe the business of the Company and the Subsidiaries, specifically detailing product and service lines.	
1.3	Please provide the full registered name of the Company and each Subsidiary	
1.4	Please provide the date of incorporation and the registration number of the Company and each Subsidiary.	

Corporate Organisation & Structure

Sl. No.	Question	Response
2.1	Please provide details (with a description of the nature and size of such interest) of any interest (including any partnerships, collaborations, associations of persons, sole proprietorships, joint ventures or other entities or interest groupings) held in any enterprise by any of the following: (i) Any Promoter of the Company; or (ii) Any company in a group of companies of which any Promoter is a part ("the Group"); or (iii) Any individuals [not covered under sub-clause (c) above] having a controlling interest in the Company or it Subsidiary or in the Group.	
2.2	Please provide a list of the following (if any): (i) Subsidiaries of the Company (as defined in section 4 of the Companies Act, 1956);	

	(ii) Companies under the same management as the Company (as defined in Section 370 (1-B) of the Companies Act); (iii) Other interests (including options) held by the Company or its Subsidiary or any of its directors in other companies or businesses (including joint ventures, partnerships, consortiums, or other profit sharing arrangements), stating percentage of total issued capital.	
2.3	Where the Group comprises more than two companies, please provide a structure chart of the Group companies.	
2.4	Please provide organisational and ownership charts or similar information relating to the Company and each Subsidiary.	
2.5	Please provide the following details of relationship between the Company, Promoters, its Subsidiaries and their promoters, affiliated companies, families and friends: ■ Details of cross shareholdings. ■ Details of trading relationship. ■ Details of shared facilities. ■ Details of financing arrangements. ■ Details of direct or indirect investments and the reason for each direct and indirect investment.	
2.6	Please supply copies (or details where unwritten) of agreements or other documentation relating to any joint venture, partnership, consortium or other profit sharing arrangement to which the Company or any Subsidiary is a party (including those with other companies in the Group or between the Company's shareholders).	

Sl. No.	Question	Response
2.7	The following details in respect of every undertaking in which the Company or any Subsidiary has a direct or indirect interest, if the book value of that interest represents at least 5% of the capital and reserves of the Company/ Subsidiary or if that interest accounts for at least 5% of the net profit or loss of the Company/ Subsidiary, and any other undertakings in which the Company or any Subsidiary has an interest which is liable to have a significant effect on the Company's/ Subsidiary's assets and liabilities, financial position or profits and losses: the name and address of the registered office; ▪ the field of activity; ▪ the proportion of capital held; ▪ the issued capital; ▪ any obligations or arrangements to make further investments or to disinvest; ▪ the reserves; ▪ the profit or loss arising out of ordinary activities, after tax, for the last financial year; ▪ the value at which the Company/Subsidiary shows the interest in its accounts; ▪ any amount of dividends received in the course of the last financial year in respect of shares held; ▪ any amount still held to be paid up or shares held; and ▪ the amounts of the debts owed to and by the Company/Subsidiary with regard to the undertakings.	

Management

Sl. No.	Question	Response
3.1	Please provide the following information in relation to the management of the Company and its Subsidiaries: (i) Names of the members of the board of directors and a brief summary of their experience and details of directorships held. (ii) Details of interests in shares, options, warrants, etc. issued to any of the directors or shareholders of the Company and/or the Subsidiaries. (iii) Details of any interests of directors and shareholders of the Company and / or its Subsidiaries or affiliates or relatives of any of the aforesaid in all transactions and contracts that were effected or entered into by the Company or its Subsidiary since incorporation. (iv) Details of any outstanding loans granted by the Company or its Subsidiary to any of the directors and also any guarantees provided by the Company or its Subsidiaries for their benefit. (v) Details of any non-arm‘s length transactions between directors and the Company or its Subsidiaries and any other company promoted by the promoters of the Company or its Subsidiaries and the Company or its Subsidiaries. (vi) Are there any restrictions upon the directors’ dealings in the Company and its Subsidiaries’ shares?	
3.2	Names of the secretary and other key officers of the Company and the Subsidiaries.	

Share Capital & Ownership

Sl. No.	Question	Response
4.1	Please provide particulars of share capital of the Company and the Subsidiaries, showing their authorised and issued and paid up capital, and details of number and classes of shares with their principal characteristics.	
4.2	In the case of the Company as well as each Subsidiary, please provide a summary of any events or transactions that have changed the amount of the issued capital of the concerned company since its incorporation.	
4.3	Please provide details of any issued capital still to be paid up (in respect of the Company as well as each Subsidiary), including statements of: ▪ The number or total nominal value; ▪ The types of shares not yet fully paid up, broken down (where applicable) according to the extent to which they have been paid up.	
4.4	Please detail any expected dilution effect of any exercises of conversion rights, options, warrants, etc.	
4.5	Provide Copies (or details here unwritten) of and agreements or documents connected to the Company or any Subsidiary relating to: ▪ Any agreement or commitment to create, issue or transfer shares (including loan capital and share options); ▪ Any rights of pre-emption; ▪ Any share conversion rights; ▪ Any share option or warrants; ▪ Share pledge or similar arrangements affecting the shares of the Company and the Subsidiaries; ▪ Any undertakings (e.g. non disposal undertakings) given by shareholders	

Sl. No.	Question	Response
	concerning the holding of shares in the Company and/or the Subsidiaries; ■ Any other rights to unissued share capital;put or call provisions; ■ Any hedges that the Company has taken out, against calls, conversions or exercises of options or warrants etc.	
4.6	Please provide a schedule of all shareholders with direct or indirect holdings in the Company and each Subsidiary showing number of shares held and stating whether held beneficially or otherwise. If any of the shareholders are individuals, please also provide details of any such individuals who may be under any disability, for example infants, bankrupts, or where probate or letters of administration are pending. Please also specify any such holdings, which the company knows are held directly, or indirectly by members of a family or other connected persons.	
4.7	Please list the names of the persons who, directly or indirectly, jointly or severally, exercise or could exercise control over the Company, including the particulars of the proportion of their voting capital. (Please include details of any lenders who hold charges over any shares in the Company).	
4.8	Trustee shareholders In the case of members of the Company or any Subsidiary who hold their shares on trust, please provide the following: ■ A copy of the relevant trust instrument; ■ Advice whether any of the trustees are resident outside India and, if so, their place ofresidence; ■ The date(s) on which the shares were transferred to the original trustees by the settler; ■ The full name and address of the settler; ■ If any such transfer was made within the last five years, please confirm that the settler,	

Sl. No.	Question	Response
	to the best of the vendor's knowledge, was not insolvent at the date of any transfer nor made insolvent as a result of it. Please also provide corroboration of this from the settler's professional advisers; ■ Please confirm that, to the best of the vendor's knowledge, the settler has not been adjudicated bankrupt since the date of the transfer(s); ■ Advice whether, to the best of the vendor's knowledge, any such transfer was intended either wholly or in part to defeat the settler's creditors.	
4.9	Please provide copies of any governmental or regulatory approvals obtained by the Company or any Subsidiary or available with the Company or any Subsidiary in relation to the acquisition or transfer of shares of the Company or any Subsidiary.	
4.10	Please provide copies of any court orders or other demerger or merger orders obtained by the Company and each Subsidiary in connection with the acquisition or disposal of any business.	

Secretarial & Regulatory

Sl. No.	Question	Response
5.1	Please provide copies of the following : (i) Certificate of Incorporation of the Company and its Subsidiaries (including any previous certificates of incorporation and amendments thereto, whether on account of change of name or otherwise). Certificate of commencement of business (if applicable) of the Company and each Subsidiary.	

Sl. No.	Question	Response
	Memorandum and Articles of Association of the Company and its Subsidiaries (incorporating any amendments) together with copies of all resolutions amending the Memorandum and Articles of Association and consents required by law to be annexed thereto.	
5.2	Please provide a confirmation from the Company and its Subsidiaries that all the business that it has carried out is in accordance with the Memorandum of Association and the object clause in the Memorandum of Association permits the Company/Subsidiary to carry on the business as is currently conducted.	
5.3	Please list the addresses of registered office and principal place of business (if different) of the Company and its Subsidiaries.	
5.4	Provide a brief description of all branches, agencies, places of business and establishment of the Company and its Subsidiaries, including a brief description of the business carries out and the number of personnel involved.	
5.5	Please provide the address at which the statutory registers and books are kept, and the address where our personnel, if required can view them.	
5.6	The Company and each Subsidiary are to confirm that all the statutory registers as required under the provisions of the Companies Act, 1956 are being maintained by the Company and the Subsidiary respectively and are unto date, including the following registers: ▪ Register of minutes of meetings of the Board of directors (and any committees of the Board) of the Company and each Subsidiary. ▪ Register of Minutes of Meetings of shareholders of the Company and each Subsidiary. ▪ Register of members and register of transfers(or equivalent) and other statutory	

Sl. No.	Question	Response
	registers(required to be maintained under the Companies Act, 1956) of the Company and each Subsidiary. ▪ Register of Charges (along with instruments of charges created by the Company and each Subsidiary). ▪ Register of Members. ▪ Register of Contracts, Companies and Firms in which directors are interested. ▪ Register of Directors, Managing Director, Manager and Secretary (along with contracts of terms of appointment of the Managing Director/ Manager). ▪ Register of Director's shareholdings. ▪ Register of Loans to Companies under the same management. ▪ Register of Investments. ▪ Register of Deposits accepted from the public.	
5.7	Meetings Please provide the address where our personnel can inspect minutes of meetings and agenda papers presented to the following bodies of the Company and each Subsidiary during the last 18 months: ▪ Shareholders ▪ Directors ▪ Directors' committees ▪ Management committees	
5.8	Reports: Please provide copies of all quarterly, annual and other periodical reports and other communications to the shareholders of the Company and each Subsidiary including the following: ▪ Annual Reports of the Company /Subsidiary for the last three years.	

Sl. No.	Question	Response
	▪ Copies of all circulars to shareholders and any other report or communication sent to shareholders of the Company/Subsidiary during the last three years. ▪ Any other information distributed to the shareholders of the Company/Subsidiary during the last five years.	
5.9	Please provide copies of any reports prepared during the last five (5) years or any other relevant reports on the Company or its Subsidiary, for example market research, accountant's report, environmental report.	
5.10	Copies of all prospectuses and placement memoranda relating to any securities offering by the Company or any Subsidiary during the last three years.	
5.11	Copies of any legal notices that have been published by or in respect of, the Company and each Subsidiary during the last three years.	
5.12	Copies of all agreements required to be filed with the registrar of Companies under any provision of the Companies Act 1956 (including sections 75,192).	
5.13	Copies of all documents filed at (i) Registrar of Companies and (ii) the Securities and Exchange Board of India within the last three] years.	
5.14	Copies of documents filed with the Registrar of Companies in relation to any amendment to the Articles of Association of the Company and its Subsidiaries.	
5.15	Please provide copies of all government or regulatory consents for the Company and its Subsidiaries including without limitation the following: ▪ Relating to the investment or proposed investment in other company. ▪ Shops and Establishment Act Registrations.	

Sl. No.	Question	Response
	▪ Professional Tax registrations/challans for last payments. ▪ Registrations under Service Tax rules and show cause notices in this regard. ▪ Compliance with the provisions of section 372 or 372A as applicable for loans, investment and guarantees.	
5.16	Copies of any necessary consents in relation to any loans or guarantees made by or given in favour of non-Indian parties, and copies of any related agreements and correspondence.	
5.17	Copies of documentation and correspondence relating to any governmental or regional incentives, subsidies or grants made available in relation to the Company and its Subsidiaries or aspect of their business.	
5.18	Please provide a full list, together with full copies of, all licences, permits or other authorisations issued to the Company and its Subsidiaries by any government agency and any related agreements and correspondence.	
5.19	Please provide copies of any documents filed with any relevant securities regulatory authority by the Company or any Subsidiary.	
5.20	A list of all performance bonds, guarantees or similar security arrangements entered into by or on behalf of the Company and its Subsidiaries in connection with any of the licences or authorisations held by them.	
5.21	Copies of any reports, notices or correspondence relating to any alleged violation, non-compliance or infringement by the Company and its Subsidiaries of any government regulation, licence, permit or other authorisation.	
5.22	Details of any determinations, declarations or directions given by any relevant regulatory authority, and of obligations or promises made by the Company or its Subsidiaries to such	

Sl. No.	Question	Response
	regulatory authorities, including the dates from which the concerned company is bound under each of these determinations, directions, obligations or promises.	
5.23	Please provide, in relation to the Company and the Subsidiaries: ■ Copies of any agreement or arrangement with any company (whether intended to be legally enforceable or not) relating to the prices or conditions for the sale of products or provision of services, or for the purchase of supplies (for example, cartels). ■ Copies of any agreements or details of any arrangements in force restricting the freedom of the company to provide and take goods and services. ■ Copies of any agreements registered under the Monopolies and Restrictive Trade Practices Act, 1969. ■ Copies of internal competition compliance programmes if any. ■ Copies of any undertakings or orders made to competition authorities nationally.	
5.24	Please provide confirmations that the Company and Promoters have authority to: ■ Undertake; and ■ Close this transaction.	
5.25	Please supply details of any governmental and other consents required for the implementation and closing of the transaction.	
	Listing	
5.26	Are the shares or other securities of the Company or any Subsidiary listed on any stock exchange in India or abroad?	
5.27	Please provide copies of the listing agreement as well as all correspondence in relation to the listing of such securities.	

Sl. No.	Question	Response
5.28	Has the listing of these securities been suspended for any reason at any time? If yes, please provide details thereof.	
5.29	Has there, at any time, been any actual or alleged violation of the terms of the listing agreement in relation to such securities?	
5.30	Are any approvals required from the relevant exchange(s) for any further issue of securities by the Company/Subsidiary.	

Financial Accounts

Sl. No.	Question	Response
6.1	Balance Sheets of the Company and each Subsidiary of the last three years duly certified by the Auditors.	
6.2	Please provide us with any management accounts and audited accounts prepared since last annual balance date.	
6.3	Please provide copies of all breakdowns, analysis, commentaries and reports prepared in relation to audited annual accounts and management accounts.	
6.4	Details of any actual or Contingent Liabilities of the Company/Subsidiary, whether as original contracting part to, as a guarantor of any party to, or their liability in respect of any freehold or leasehold property or license connected therewith. Please also complete Schedule II in respect of the Company and each Subsidiary.	
6.5	In respect of the Company and each Subsidiary, please provide a record of dividend payments during the last five years (including dividends per share, the number of shares entitled to the dividends at the times they are declared or paid, and the gross amount of the dividends paid).	

Sl. No.	Question	Response
6.6	Does the Company or any Subsidiary have a dividend policy? If yes, please provide a copy of the same.	
6.7	In relation to the Company and each Subsidiary, please provide a schedule of dividends declared relative to net profits.	

Banking Facilities/Borrowing from Third Parties, Financial Grants

Sl. No.	Question	Response
7.1	Please provide: *Accounts* ■ Names and branch addresses of all banks and financial institutions with whom the Company and Subsidiaries hold accounts (including all current, deposit and trust accounts) ■ Titles and numbers of each account. ■ Copies of all existing direct debits, standing orders or similar instructions. ■ Current balance of each account. ■ Copies of latest statement for each account. ■ Copies of mandates for each account.	
7.2	*Borrowing* Please provide details of all borrowing by the Company and each Subsidiary, whether under term loan or overdraft facilities, bonds, loan stock issues, bills of exchange, commercial paper or similar instruments (including share capital redeemable within 10 years of issue), acceptance credit, documentary credit or bill discounting facilities, interest rate swaps, currency swaps, financial options, financial contracts or other similar instruments and finance leases any other	

Sl. No.	Question	Response
	forms of debts financing (e.g. receivables, financing or factoring arrangements). This should include inter-group borrowings and loans from directors, employees or shareholders. Without limitation to the above, please provide: A schedule of loan capital and other financing showing maturities, interest rates, any security, and whether committed or uncommitted. (See Schedule I). Copies of all agreements relating to any borrowings by the Company and Subsidiaries and details of all existing or anticipated breaches of the terms of such agreements by the Company/ Subsidiary together with copies of all extant notices, demands or other communications from the relevant lender to the Company/ Subsidiary. Particulars and (where applicable) copies of all mortgages, debentures (whether convertible or not), debenture trust deeds, instruments by way of security charges, pledges, liens, encumbrances, conditional sale or other title retention or trust arrangements, deeds of postponement, preferential rights or other agreements or arrangements the effect of which is to create a security over the assets or any part thereof of the Company or Subsidiaries, together with copies of all extant notices, demands or other communications from the beneficiary of the relevant security to the Company or Subsidiaries. Schedule of loan capital and other financing showing maturities, interest rates, any security, and whether committed or uncommitted. Details of the Company's and the Subsidiaries' contingent liabilities. Details of lenders' rights to convert loans into equity in any circumstances.	

Sl. No.	Question	Response
	Confirmation that the Company and Subsidiaries are in compliance with their loan agreements, credit facilities, debt securities and loan capital. Details of any issued loan stock/preference capital. Details of all balances outstanding. Copies (or details where unwritten) of any default notices served on the Company and Subsidiaries together with details of any non- compliance with the borrowing and security documentation referred to above. Confirmation whether it is intended that any borrowings will be repaid before completion of this transaction. Confirmation that the current level of banking facilities generally is adequate for the Company's working capital purposes for the next 12 months. Details of amounts outstanding. Highlighting covenants or events of default restricting : ▪ Future borrowings; ▪ Negative pledges; ▪ Issue of equity; ▪ Change of control; and ▪ Change of management.	
7.3	Financial Grants or other Assistance Please provide copies of documentation for (or details where unwritten of) financial grants or other assistance from a governmental or other body by the Company or any Subsidiary.	
7.4	Guarantees, Indemnities, Letters of Credit Please provide copies of: ▪ Any guarantees, sureties, indemnities or	

Sl. No.	Question	Response
	counter-indemnities (including Letters of Comfort, extant notices, demands or other communications from such third parties) given by the Company or Subsidiary in respect of the obligations of another party (including shareholders ofthe Company or Subsidiary). ■ Guarantee given by Promoters ■ Bank Guarantees for the obligations of the Company/Subsidiary ■ Any bond executed by the Company/ Subsidiary for its obligations ■ Any guarantees, sureties and indemnities provided by any third party in respect of the obligations of the Company/Subsidiary together with any security documentation. All letters of credit issued in favour of third parties on application of the Company/ Subsidiary.	
7.5	Confirmation that the Statutory Auditors have not commented on the compliance of mandatory accounting standards in terms of section 211(3C) ofthe Companies Act, 1956.	
7.6	Details of all loans made to or by the Company, including all loans and indebtedness to directors, officers, employees or shareholders of any ofthe Company and each Subsidiary or any other companies in which any such director, employee or shareholder is interested, together with copies of all loan documentation. Loan/Guarantee to/in favour of Directors; Loan/Guarantee to/in favour of Employees; Loan/Guarantee to/in favour of connectedconcern or person	
7.7	Copies of all hire purchase or instalment purchase agreements, finance leases, letters of credit, performance and other bonds and similar	

Taxation covered by Accounting Due Diligence Employment Matters

Sl. No.	Question	Response
8.1	Please provide details of organisation charts for employees of the Company and its Subsidiaries, including a list of key personnel as well as details of the number of full-time and part-time employees and whether these employees are permanent or temporary. Please also provide us with the following details for each such company: ■ Total number of employees; ■ Average numbers employed and changes therein over the last three financial years (if such changes are material) ■ Management Structure, organisation chart and responsibilities/authorities of key personnel.	
8.2	Copies of all employment and golden parachute agreements, consultancy agreements, and all agreements with present or former employees in respect of confidentiality, non-competition or indemnities for the Company and each Subsidiary. Please also provide: ■ Details of compensation structure ■ Standard Employment Agreement ■ Service Agreement with Directors ■ Non-compete and confidentiality agreement ■ Letters of confirmation ■ In case of contract labour, copies of contracts executed with contractors and terms and conditions on which labour is taken of contact basis.	
8.3	Copies of all share option, share incentive, profit sharing or similar arrangements for employees ofthe Company and the Subsidiaries, including copies ofthe ESOP Plan.	

Sl. No.	Question	Response
8.4	Details of the pension, provident or life assurance schemes operated by the Company or its Subsidiaries or in which they participate. Employees' Provident Fund Miscellaneous Provisions Act, 1952. Group Insurance.	
8.5	Details of any other benefits provided by the Company and or its Subsidiaries to their respective employees. Health and other benefits. Voluntary retirement schemes. Redundancy policies. Retrenchment schemes ofthe company Terms and conditions on which employees hold shares in the company (if any)	
8.6	All employment booklets, manuals or other literature regarding terms and conditions of employment generally furnished to employees, including details of grievance and disciplinary procedures, normal working hours, guaranteed pay, health and safety procedures and policy, and sick pay. (for the Company and each Subsidiary)	
8.7	All union and collective bargaining agreements and all other agreements with employee representatives, and minutes of meetings with any of such bodies. (for the Company and each Subsidiary)	
8.8	Details of any industrial action or disputes within the last three years (or such shorter period for companies incorporated for less than three years).(for the Company and each Subsidiary)	
8.9	Details of wrongful, unreasonable or unfair dismissal or race, sex, age, disability, religious or other discrimination claims within the last five years and related correspondence. (for the Company and each Subsidiary).	

Property

Sl. No.	Question	Response
9.1	Please provide details of all freehold property owned or occupied by the Company and its Subsidiaries. If freehold property occupied by the concerned company is not owned by it, details of the ownership and the terms upon which the property is occupied.	
	Type of interest (freehold, leasehold or other);	
	Tenure of interest;	
	Type of activity conducted at the property;	
	Details of encumbrances on the properties of the Company and or its Subsidiaries, if any;	
	Details of any dispute relating to the properties.	
9.2	Please also detail all leasehold property occupied by the Company and or its Subsidiaries, including term, rent and any other material provisions.	
	Details of tenanted premises in possession ofthe Company and or its Subsidiaries and rent receipts in respect of such tenanted premises.	
	Escalation clause	
	Termination clause	
	Extension clause	
	Stamp duty and registration	
	Revenue records and municipal tax paid receipts	
9.3	Please provide details of all licences to occupy property held by the Company and or its Subsidiaries, including copies of all concerned documents.	
9.4	Please provide details of any leases, tenancies or licences to occupy granted by the Company and or its Subsidiaries, including term, rent and any other material terms together with copies of all concerned documents.	
9.5	Please provide copies of any appraisal or valuation reports or surveys on any material	

Sl. No.	Question	Response
	properties owned or occupied by the Company or a Subsidiary.	
9.6	Please provide a schedule of all material plant, machinery and equipment, motor vehicles and other tangible assets and movable property used by the Company and each Subsidiary, indicating the ownership and nature thereof and the material terms of any financial lease or security agreement pursuant or subject to which the same may be leased or owned. These must include (by way of illustration). All plant and machinery required for the purpose of manufacture of the Products Computer and accessories (whether outright purchase of hire purchase, lease etc.). Vehicles (whether outright purchase of hire purchase, lease etc.). Office equipment (whether outright purchase of hire purchase, lease etc.). Documents underlying the abovementioned assets.	

Business and Operational Matters

Sl. No.	Question	Response
10.1	Identify the critical technologies used or to be used by the Company and the Subsidiaries in their respective businesses (Technologies) including, but not limited to: ▪ Software; ▪ Hardware; ▪ Integrated Circuitry; ▪ Any technologies that are under development.	
10.2	Confirm as to whether the choice to use any of these particular Technologies by the Company or	

Sl. No.	Question	Response
	its Subsidiaries has limited the future direction of such company's business in any way.	
10.3	Provide copies of any agreements or, if no agreement exists, provide details of any arrangement that the Company or its Subsidiaries has entered into with any suppliers of equipment and/or infrastructure that includes any exclusivity arrangements.	
10.4	Provide details of the source of the rights of the Company and the Subsidiaries to use each of the Technologies i.e. in relation to each of the Technologies advise if it was purchased, leased, licensed, developed internally or developed externally and assigned or licensed to the Company or its Subsidiaries.	
10.5	For purchased Technology - please supply the relevant purchase agreements (and any amending or supplemental documentation).	
10.6	For leased Technology - please supply the relevant lease (or hire purchase) agreements (and any amending or supplemental documentation).	
10.7	For licensed Technology (usually software) - please supply the relevant licence agreements (and any amending or supplemental documentation).	
10.8	For Technology developed externally or internally by a contractor (i.e. not an employee of the Company/Subsidiary) - please supply the relevant development agreements (and any amending or supplemental documentation).	
10.9	To the extent available (and not provided in response to the foregoing questions above) - please supply the following agreements (and any amending or supplemental documentation) between the Company or its Subsidiaries and any third party: (i) technical services agreements;	

Sl. No.	Question	Response
	(ii) agreements, memoranda of understanding, letters or intent or otherwise for manufacture, supply, purchase or lease of any critical equipment; (iii) licences for critical software or other technology; (iv) technology development agreements; (v) framework agreements; (vi) technical consultancy agreements,as well as any amendment agreement, side letter or a description of a verbal understanding for amendment of any of the foregoing agreements.	
10.10	Please supply all maintenance, repair, support, training and other consultancy services agreements in relation to the Technologies.	
10.11	Please advise as to what extent other value-added services have been planned and/or implemented by the Company or its Subsidiaries and whether the Technologies required for these services are in place.	
10.12	To what extent do the Company and Subsidiaries market their services and to what extent do they use distributors or re-sellers?	
10.13	Provide a list of the major (i.e. more than 5% of goods or services supplied in any six month period) suppliers (identifying product or service) of the Company and each Subsidiary.	
10.14	A schedule of all material plant, machinery and equipment, motor vehicles and other tangible assets used by the Company and the Subsidiaries, indicating the ownership and nature thereof and the material terms of any financial lease or security agreement pursuant or subject to which the same may be leased or owned. Computer and accessories (whether outright purchase of hire purchase, lease *etc).*	

Sl. No.	Question	Response
	Vehicles (whether outright purchase of hire purchase, lease *etc).* Office equipment (whether outright purchase of hire purchase, lease *etc).* Documents underlying the abovementioned assets.	

Contracts

Sl. No.	Question	Response
11.1	Copies of all material contracts to which the Company or any Subsidiary is or was a party relating to the acquisition or sales of shares or businesses, joint ventures, partnership or investments in other entities, or reorganisations including the following agreements: ■ Share purchase agreement ■ Subscription Agreement ■ Assignment Agreement ■ Slump Sale agreement ■ Shareholders Agreement ■ Joint Venture Agreement ■ Accquisition Agreement	
11.2	Copies of all licence, distribution, franchise, agency, research and development, marketing, consulting and management contracts granted to or by or entered into by the Company or any Subsidiary and all other contracts: ■ Material to the business of any company; or ■ Containing long-term, unusual or onerous provisions; or ■ Containing exclusivity, non-competition or confidentiality provisions; or ■ Where change of shareholding could give	

Sl. No.	Question	Response
	grounds for termination or is otherwise relevant,(to the extent not otherwise covered above).	
11.3	Details of breaches of any contracts by the Company or any Subsidiary whether outstanding or in the past including the following: ■ Breach of contract with a customer; ■ Breach of contract with a supplier; ■ Breach of contract with a licens or	
11.4	Please provide details and documentation of any outstanding quotation or tender for a major contract made to or submitted by the Company or any Subsidiary as well as any incomplete project or assignment.	
11.5	Copies of all contracts with directors or officers of the Company and the Subsidiaries or the companies' shareholders or with any affiliate.	
11.6	Copies of all agreements of the Company and Subsidiaries with governments and government agencies, including, without limitation. Software Technology Part of India. Local Authorities. Special arrangement for any facility for the business of company.	
11.7	A brief outline, in respect of each type of trading activity, ofthe method by which the Company and its Subsidiaries documents its arrangements with customers i.e., Standard Terms of Supply; Does the company supply customers on a standard supply order form? If so, please provide a copy. Approximately what percentage of customers would this form apply to? Does this form contain all terms and conditions of purchase when used or does a standard set of	

Sl. No.	Question	Response
	conditions, an order acknowledgement form, sales brochure or other document also contain some ofthe terms and conditions?	
	Customers' Terms of Purchase;	
	Do some customers use their own purchase order form or other documentation?	
	Approximately what percentage of customers would use their own form?	
	In respect of each Company and Subsidiary, please list any major customers, i.e. those accounting for more than five per cent of sales and provide copies of documentation with them.	
11.8	Long Term Contracts: In respect of the Company and each Subsidiary:	
	Please provide copies of any contracts with customers having duration of more than six months.	
	Please provide copies of any power of attorney or similar authority granted by Company and Subsidiaries to a third party, or granted to the Company or Subsidiary by a third party.	
	Non-Compliance with Agreements/Change Of Control.	
11.9	Please provide details of any non-compliance by either the Company/Subsidiary or the other party in respect of any agreement (whether written or unwritten) entered into by the Company/ Subsidiary.	
11.10	Please provide a list of any agreements or arrangements, which are subject to termination or variation, require prior consent or notification, or are contravened or otherwise affected by the transfer of shares in the Company or any Subsidiary.	

Intellectual Property

Sl. No.	Question	Response
12.1	Please provide a schedule of all patents, trademarks, service marks, trade names, copyrights, know-how and registered designs owned by or licensed to or by or used by the Company or any Subsidiary and all other intellectual property of the Company and all Subsidiaries, and copies of all relevant registrations, applications, consents, licences and sub-licences.	
12.2	Details of software licence royalties to be paid by the Company or any Subsidiary to the licensor(past, present and future payments)	
12.3	Trademark registration of the logo, name etc of the Company/Subsidiaries.	
12.4	A list of authors, contributors, independent contractors and employees involved in the development of the Company and the Subsidiaries' intellectual property, and copies of any related employment, commissioning or development agreements and related records and correspondence.	
12.5	In respect of the Company and its Subsidiaries, a list of all proprietary products not protected by patents or registered copyrights, trademarks, etc. and steps taken to ensure their secrecy.	
12.6	Details of any opposition proceedings, petitions or challenges to any of the Company's and the Subsidiaries' intellectual property.	
12.7	Details of any infringement or alleged infringement of the intellectual property rights of any Company or Subsidiary, or of any such rights of others by any Company or Subsidiary, and related correspondence and documentation.	
12.8	All assignments of intellectual property rights by or to the Company or any Subsidiary.	
12.9	All technical assistance, know-how and similar	

Sl. No.	Question	Response
	agreements relating to the Company and the Subsidiary.	
12.10	Details of all software and hardware used by the Company and the Subsidiaries, indicating the licensor/owner of any software used and details of any royalties or continuing payments required to be made for the use of any software.	
12.11	Details of all contracts taken out by the Company and the Subsidiaries relating to the maintenance of computer hardware and software.	
12.12	Details of the security and backup arrangements put in place by the Company and Subsidiaries to protect the information maintained by computer and to retrieve information in the event of a computer system shutdown, and of the type and range of information stored by computer.	
12.13	Details of any governmental or data protection related licences held by the Company or any Subsidiary regarding the storage, transmission or usage of computer-held information.	
12.14	Details of arrangements relating to the source codes of any software developed, owned or used by the Company and Subsidiaries, and of records relating to its creation.	
12.15	Ownership of Intellectual property arising of the product development by the Company or Subsidiaries.	
12.16	Details of all trademark searches or other research on trademarks or other designations which are the same or similar to marks or designations used by the Company or any Subsidiary.	
12.17	Details of any material known or suspected problems with the computer systems of the Company or Subsidiaries (e.g. viruses, defects in functioning and material bugs) and details of assessment procedures undertaken to assess such computer systems.	

Sl. No.	Question	Response
	Security breaches System shutdown	
12.18	Provide a full list of Internet domain names registered in the name of the Company or any Subsidiary or used in the course of the their businesses including: Key domain names: name registration Negative registration (Whether registered in the name of individuals instead of the company)	

Legal Proceedings, Disputes and Investigations

Sl. No.	Question	Response
13.1	Please provide details of all pending or threatened or anticipated claims, litigation, arbitration proceedings, or governmental investigations and proceedings (domestic or foreign), including parties, damages and other remedies sought, nature of action, details of any actual or potential breaches of contract (all kinds of contracts including those detailed in the Financial, Business and operation matters, Intellectual property, and other sections) or infringement of rights by or against the Company and all Subsidiaries including the following: Disputes with customers. Disputes with third parties. Disputes with suppliers. Disputes relating to intellectual property infringement. Disputes relating to recoveries. Disputes with Employees of the company	

Sl. No.	Question	Response
	Disputes with Income tax, Customs, and other authorities. Others.	
13.2	Please furnish copies of all pleadings and other material documents relating to material litigation, arbitration and governmental proceedings in connection with the Company and Subsidiaries.	
13.3	Please attach a schedule of all orders, writs, decrees, injunctions, judgements, awards or rulings (including consent decrees and judgements) by any court, arbitration panel or governmental agency affecting the Company or any Subsidiary.	
13.4	Please provide copies of all correspondence relating to any threatened governmental investigation or alleged violation of law or regulation by the Company or any Subsidiary.	

Insurance Policies

Sl. No.	Question	Response
14.1	Please provide details of all material insurance policies taken out by or on behalf of the Company and all Subsidiaries and also furnish copies of all contracts, policies and certificates of insurance including the following : Fire Theft Burglary Professional liability Key employee	
14.2	Please provide copies of any reports or correspondence regarding the adequacy of any insurance coverage, reservation of rights or denial of liability or coverage under any such policies.	

Sl. No.	Question	Response
14.3	Please provide confirmations from the Company and its Subsidiaries as to the adequacy of such company's insurance.	
14.4	Please detail the Company's and the Subsidiaries' claims records, rejections and provide copies of related reports and correspondence.	
14.5	Please complete Schedule III for the Company and each Subsidiary.	

Environmental Matters

Sl. No.	Question	Response
15.1	Please provide copies of all internal and external reports concerning environmental matters relating to current or former properties of the Company and its Subsidiaries.	
15.2	Please furnish copies of all permits relating to environmental matters and of any statements or reports by the Company and its Subsidiaries to any governmental, central or local department of environmental regulation or any similar body.	
15.3	Please provide copies of all approvals and permissions obtained by the Company or any Subsidiary under: The Environmental Protection Act; Air (Prevention and Control of Pollution) Act, 1981; Water (Prevention and Control of Pollution) Act, 1974.	
15.4	Please furnish copies of all notices, complaints, suits or similar documents sent to, received by or served upon any of the Company or Subsidiaries by any governmental, central or local department of environmental regulation or any similar governmental, central or local regulatory body, authority or agency.	
15.5	Please provide us with all correspondence, reports and other details pertaining to the notices, complaints, suits, etc mentioned at [16.4] above.	

Product/Service Liabilities

Sl. No.	Question	Response
16.1	Please provide a brief outline of the method by which the Company and each Subsidiary documents its product/service warranties or guarantees given to customers (if any). Please provide copies of the documentation used, including any warranty cards issued.	
16.2	Have there been any product/service warranty claims against the Company or any Subsidiary in the past? If so, please provide details, including present status.	
16.3	Is the Company or any Subsidiary indemnified for any product/service warranties or guarantees by any of its suppliers? If so, please provide details, including copies of the agreements with such suppliers.	

Impending Legislative Changes

Sl. No.	Question	Response
17.1	Are you aware of any impending legislative changes, which might affect the Company, or any Subsidiary? If so, please provide details of the legislation as well as the possible impact upon the Company or the Subsidiary.	

Compliance with Special Industry Sector Legislation

Sl. No.	Question	Response
18.1	Are any of the products manufactured by the Company reserved for the small-scale sector as per the Industrial Policy?	

SCHEDULE ONE

Finance[1]

Date of Issue/Facility[2]	**Amount**
Long-term	
Committed[3]	
Drawn	
Undrawn	
Uncommitted[4]	
Drawn	
Undrawn	
Short-term	
Committed[3]	
Drawn	
Undrawn	
Uncommitted[4]	
Drawn	
Undrawn	

1. Include all forms of debt financing (e.g. loan facilities, issues of bonds, receivables financing, factoring arrangements).
2. Please provide details of the term to run for each facility or loan.
3. Where the issuer has already received the funds or the issuer has an enforceable right to draw the funds, subject onlyto fulfilling conditions, which it is able to fulfill.
4. Date on which the underlying claim will be released (e.g. the debt guaranteed will be repaid).

SCHEDULE TWO

Contingent Liabilities[1]

Brief Description[2]	Amount[3]	Expiry Date[4]

1. Include all contingent liabilities (e.g. guarantee).
2. Nature (e.g. "guarantee"), identity of beneficiary (e.g. "in favour of XYZ Bank") and identity of person incurring the underlying obligation (e.g. the person guaranteed).
3. Maximum amount of the possible claim.
4. Facilities where either the issuer has received the funds, but the lender can require payment on demand, or where the issuer has no contractual right to drawn the funds.

SCHEDULE THREE

Insurance

Name of Insurer	Property Insured	First loss	% of value Insure

Annexure C

Specimen Check List for Commercial Due Diligence

Please prepare a folder containing the information requested below. This checklist is to be placed at the top of the folder and should indicate against each question either an explanation or the reference number of the document in the folder that supports the explanation or both. In case a question is not applicable please indicate as such. All documents in the folder should be numbered and the folder should be indexed.

1. General

i. List of companies/ firms which are a part of the business group to which the target company belongs.

ii. Brief note on the history of the company being invested in, including reference to its foundation and expansion.

iii. Brief note on present business and activities, including list of business locations; please provide details for separate product/ service verticals embedded solutions, infrastructure for power and software solutions.

iv. Any recent reports on the company's activities prepared internally or by outside consultants (such as analyst reports, information memorandum, valuation reports etc.).

v. Copies of any literature prepared by the company illustrating its products, operations, history etc.

vi. Any agreements or documents recording arrangements between shareholders of the company.

vii. A list of all licenses and registrations held by the company specifying number, validity period, purpose, granting authority and other relevant details. Copies of the same may also be enclosed.

viii. Minutes of meetings of the board of directors, shareholders and audit/operational committees since incorporation.

ix. Brief note on the internal control environment in the division.

x. Details of bankers, lawyers, consultants and other professional advisers.

xi. Transactions/ agreements with affiliates and related parties especially with respect to prices, payment terms, etc.

xii. All statutory registers and returns filed required to be maintained/ filed under the Companies Act.

xiii. Details of intellectual property rights (including trademarks & brands)held by the company, if any.

xiv. Note on planning and control systems prevalent in the organisation including controls over non financial systems such as production planning, quality control, inventory management, sales etc.

xv. Details of statutory records maintained under the Companies Act and other applicable statutes.

xvi. Transaction documents (agreements) for any prior acquisitions done by the company or investments in the company.

2. Financial Statements information for the year ended March 31, 200_, March 31, 200_ and for the nine months ended December 31, 200_.

i. Audited/ un-audited financial statements of the Company along with its reconciliation with management accounts for the year ended March 31,200_, March 31, 200_ and for the nine months ended December 31, 200_.

ii. Chart of accounts.

iii. Accounting policy at present, in particular with respect to income/ sales recognition, research and development, exceptional and extraordinary items, acquisition and disposal of assets, differentiating between capital expenditure & repairs and maintenance, valuation of fixed assets, capitalisation of interest, inventory/ stock valuation, transfer pricing, preliminary expenses.

iv. Details of changes in accounting policies over last 5 years.

v. Closing audit working files prepared by the Company, as appropriate.

vi. Trail Balance, schedules and groupings supporting the financial statements for the year ended March 31, 200_, March 31, 200_ and for the nine months ended December 31, 200_.

vii. Audit management letters for the period under review.

viii. Internal audit reports for the period under review.

ix. Budgets, comparison with actuals and explanation for variances for last two accounting periods i.e. FYO-, FYO- and YTDO-. Specifically revenue forecast versus. actuals, expenditure forecast versus. actuals and manpower budget versus. actual headcount.

x. Cash flow statements for the year ended March 31, 200_, March 31, 200_ and for the nine months ended December 31, 200_.

3. Management Accounts

i. Copies of monthly management accounts since April 200_ till date.

ii. Breakdown of above by vertical (separately identifying financials for embedded solutions, infrastructure for power and software solutions).

iii. Reconciliation of management accounts to statutory accounts for the year ended March 31, 200_, March 31, 200_ and for the nine months ended December 31, 200_.

iv. Trading Results.

4. Revenues

i. Split of revenue:

- Customer wise
- Product wise/ Service Wise
- Substation Controllers
- Distribution Transformer Monitoring System
- Theft Detection Device
- Intelligent Automatic Meter Reading
- General Automatic Meter Reading
- Spot Billing Machine
- Computerised Online Data Logging System
- Energy Audit Services
- Micro RTU
- Vertical wise
- Embedded Solutions
- Infrastructure for Power
- Software Solutions
- Geography wise and target industry sector
- Rural electrification
- Transmission
- Oil & gas
- Technology, and
- Exports.

ii. Historic product/ service wise contributions earned and gross margin. Also provide details of direct costs. Details of profitability for top 5 customers.

iii. Comparison of revenue and contribution reflected in the financial statements with the Management Information System ('MIS') and budgets; analysis of reasons for variance.

iv. Average realisations by product/service in last three years for the customers.

v. Details of the basis for revenue recognition for all the contracts with customers.

vi. Details of deferred revenues year ended March 31, 200_, March 31, 200_ and for the nine months ended December 31, 200_ and bookings carried forward to the next year and the next period.

vii. Details on marketing and pricing strategies of the Company; average realisation per hour per contract/ agreement for each key customer/ product/ service of the Company.

viii. Revenue per headcount, together with details of employee productivity (*monthly data*) for the historic period.

ix. Discount structures and credit terms for major customers; historic average realization per headcount/service for that customer.

x. Details of customer agreements terms, value, rates, penalties, Service Level Agreements, committed headcount and volume and bearing of training costs. Also provide details of revenue by nature of billing cycle, frequency of billing, milestone based or man hours per month basis/ transaction.

xi. Product wise/ service wise/ customer wise status of contracts under negotiation and details of the progress in the same.

xii. Details of customer acquisitions in the last two years ended March 31, 200_, March 31, 200_ and for the nine months ended December 31, 200_.

xiii. Details of customer attrition rate, clients acquired from competitors and clients lost to competitors along with the reasons for the same over the past for the year ended March 31, 200_, March 31, 200_ and for the nine months ended December 31, 200_.

xiv. What has been the increase in the size of operation for the existing clients?

xv. Details of other income.

xvi. Details of exceptional and extraordinary income items.

xvii. Pricing movements for the defined historical period together with the nature of movement; pricing differences between clients and reasons for the same; pricing band service wise/ product wise, if any.

xviii. Budget/ Actual analysis of product/ service-wise and customer wise sales and analysis of the reasons for variations.

xix. Revenue sharing arrangements and transfer pricing amongst the Divisions, *if any,* as per the terms of the respective contracts.

xx. Comparison of revenue and contribution reflected in the financial statements with the Management Information System (MIS) and budgets.

5. Customers and Marketing

i. Write up on selling and distribution methods (systems and procedures followed, *etc*), factors affecting prices, margins, periods of peak and low revenue, *etc*.

ii. Details on marketing and pricing strategies of the Company.

iii. Details of various components of freight, tax and other costs from factory sales point to the sale point of the customer.

iv. Discount structures and credit terms for major customers; historic average price realisations.

v. Average price realisation (monthly) per unit for each product of the Company in the last two years i.e., March 31, 200_, March 31, 200_ and for the nine months ended December 31, 200_.

vi. List of all significant marketing agreements and contracts with customers.

vii. List of major customers for individual products along with details of geographic segments sales (*domestic and export*) for March 31, 200_, March 31, 200_ and for the nine months ended December 31, 200_.

viii. Pricing policy for sale to related parties.

ix. List of any claims/ disputes with or complaints from customers giving amounts and background.

x. Details of all returns by customers with reasons for year ended March 31,200_, March 31, 200_ and for the nine months ended December 31, 200_.

xi. List of all competitors, company market share (present and anticipated), etc.

xii. Status of order book as on December 31, 200_.

6. Suppliers

i. Purchase policies and procedures.

ii. List of major suppliers in the period ended March 31, 200_, March 31,200_ and for the nine months ended December 31, 200_ showing nature of purchase, quantity purchased and amount of purchases.

iii. Pricing policy for purchases from related companies.

iv. List of all significant contracts with the suppliers.

v. Details of purchase at forward prices and forward purchase, *if any*.

vi. List of any claims/ disputes with suppliers giving amounts and background.

7. Purchases and Consumption Costs

i. Material expenditure with the respective supply contracts.

ii. Consumption costs for individual products, details of actual consumption with standard.

iii. Details of the power and fuel cost with respect to unit rates and consumption patterns in the last three years.

8. Expenditure

i. Details of average headcount cost per customer/ service.

ii. Details of average direct cost per customer/ service.

iii. Direct costs for individual services detailing all components of costs.

iv. Details of cost structure, breaking it into fixed costs and variable costs.

v. Personnel cost including perquisites and retirement benefits.

vi. Details of incentive/ commission policy for sales and other of the Company and details of the cost during the historical period.

vii. Payment of royalty/ technical know-how fees, if any, along with the terms of the respective agreements.

viii. Details of repairs, rent, stores and spares consumed, carriage and freight, finished goods handling expenses, other expenses, etc.

ix. Details of the inventory write-offs in the last three years.

x. Details of provision for bad and doubtful debts in the last three years.

xi. Administrative and other expenses including professional, legal fees, other expenses.

xii. Details of the selling and marketing costs.

xiii. Basis for allocation of common costs and support expenses.

xiv. Details of financial costs including interest, lease rent and hire charges.

xv. Details of payment of royalty/ technical know-how fees along with terms of respective agreements.

xvi. Details of provision for bad and doubtful debts in the last three years.

xvii. Balance sheet (Details required as on March 31, 200_, March 31, 200_ and for the nine months ended December 31, 200_, unless otherwise specified).

9. Fixed Assets

i. Summary showing principal categories of assets at last year end and most recent accounting date showing cost, accumulated depreciation, net book value and depreciation charge for the period.

ii. Details of valuation/ revaluation of fixed assets, *if any*.

iii. Details of charges or lien created against any fixed assets through guarantees or loan arrangements.

iv. Details of insurance policies and coverage of fixed assets.

v. Details of capital work in progress, *if any*.

vi. Contracts for pending capital commitments at last year-end and most recent date - contracted for and authorised but not contracted.

vii. Copies of leasehold agreements (lease and sub-leases) and tenancy rights, title deeds and other agreements giving amounts and terms involved (renewal options for the lease period).

viii. Fixed assets ledger/ register and supporting documents for fixed assets.

ix. Physical verification reports and its periodicity.

x. Procedure for authorising and procurement of capital expenditure.

xi. Accounting policy for capitalisation of financial costs and details of capitalisation of financial costs.

xii. Terms and accounting practice for leased/ hired assets; details of financing arrangements and payments thereof and details of future commitments, if any.

xiii. Useful life of assets and depreciation computation.

xiv. Details of sale of fixed assets and policy for determining prices.

xv. List of obsolete and idle equipment with cost and net book value attached.

xvi. List of fully depreciated assets.

xvii. Details of any restriction on the use or sale of any asset.

xviii. Foreign exchange fluctuation and accounting thereof.

xix. List of all properties owned or operated that are connected to the business with details of their book values, usage, title/ lease and rent details.

10. Inventories

i. Details of inventory/ stock as on March 31, 200_, March 31, 200_ and December 31, 200_.

ii. Inventory details and classification into raw material, work in process, finished goods and stores and spares.

iii. Quantitative reconciliation of opening stock, purchases, sales and wastage, etc., for FY O_, FY O_ and YTD O_.

iv. Inventory valuation workings and its basis. Details of overhead and other costs included in stock values.

v. Age wise details of inventory as on March 31, 200_ and March 31, 200_.

vi. Provisioning policy of inventory and details of provision against inventory as on March 31, 200_ and on December 31, 200_.

vii. Procedure for identification of slow moving and obsolete/ unusable inventories.

viii. Treatment of goods in transit and material at third location and details in respect thereof as on March 31, 200_, March 31, 200_ and December 31, 200_.

11. Receivables

i. Party-wise break-up of Sundry Debtors with confirmation and reconciliation statements as on March 31, 200_, March 31, 200_ and December 31, 200_.

ii. Ageing details of Debtors as on March 31, 200_, March 31, 200_ and December 31, 200_.

iii. Details of subsequent receipts with supporting documents.

iv. Details of credit terms as per the respective contracts and other supporting documents with details of changes in the credit terms, *if any*.

v. Details of provisions for doubtful debts/ written off debts and movement in provisions since incorporation.

vi. Details of subsequent receipts with supporting documents.

vii. Details of dispute in payment/ claims filed by customer.

viii. Details of actual collections period versus contractual credit period for receivables outstanding.

ix. Details of write off of bad debts over the last three years ended on March 31, 0- or later financial period as being followed.

x. Nature and details of transactions with related Company and accounts ledger of these receivables.

12. Loans & Advances and Other Current Assets

i. Details of Advances recoverable in cash or in kind or value to be received with supporting documents as on March 31, 200_, March 31, 200_ and December 31, 200_. Reasons for advancement, ageing, existence and adequacy of contracts and reasonableness of terms and conditions of each receivable.

ii. Details of deposits with Public Bodies and others prepaid expenses with supporting documents and balance confirmations. Review of the terms of the deposits, ageing and subsequent clearances thereof.

iii. Details of Fixed Deposits held for disposal and interest accrued on investments & deposits.

iv. Details of provision for doubtful advances, *if any*.

v. Details of amounts due from staff and officers and their subsequent clearances.

vi. Details of other receivables on account including reason for advancement, ageing, existence and adequacy of contracts and reasonableness of terms and conditions of each receivable.

vii. Nature and details of transactions with related company and accounts ledger of these receivables.

13. Cash and Bank Balances

i. List of bank balances and bank accounts as on March 31, 200_, March 31, 200_ and December 31, 200_.

ii. Bank reconciliation statements and confirmations as on March 31, 200_and December 31, 200_.

iii. Details of the fixed deposit amount providing the date of deposit, interest rates, *etc*.

14. Miscellaneous Expenditure to the Extent Not Written-off

Details of accumulated amortization and net book value as on, March 31, 200_, March 31, 200_ and December 31, 200_.

15. Creditors and Accrued Expenses

i. List of trade creditors at March 31, 200_, March 31, 200_ and December 31, 200_.

ii. Ageing details of trade creditors along with supply contracts (including the terms of payments) and subsequent payments.

iii. Contracts with the Vendors.

iv. Creditors balance confirmation certificates and reconciliation statements as at March 31, 200_, March 31, 200_ and December 31, 200_ or any other latest date.

v. Details of accruals with supporting documents and subsequent clearances.

vi. Details of off Balance Sheet Liabilities (such as leases).

vii. Details of advances received with aging details, subsequent clearances, etc.

viii. Basis of accruals of expenses and other liabilities.

ix. Details of provisions against claims, *if any*.

x. Hedging policy, *if any* and details of purchase commitments as on date of financial statements.

xi. Detailed listing of overdue payables.

xii. Details of any penalties/ interest levied on overdue payments, *if any*.

xiii. Purchase policies and procedures for all operational (ex: content) and administrative purchases (miscellaneous purchases).

xiv. List of major suppliers in the period showing nature of contract and value of purchases.

xv. Pricing policy for purchases from related companies.

xvi. List of any claims/ disputes with suppliers, background and current status of the same.

xvii. Any redundancy or liability clauses against the key suppliers like transportation, food, Server and Switch maintenance vendors etc.

16. Amounts Due to Related Parties

Nature and details of related company dues and account listing of these dues since the incorporation of the Company

17. Secured and Unsecured Loans

i. Details & terms of working capital loans & other financing from banks & other parties with their respective repayment schedule. Review of the outstanding amounts at March 31, 200_, March 31, 200_ and December 31, 200_, current interest rates, period, loan covenants.

ii. Provide details of default in repayment of loans and interest in the historic period, *if any*.

iii. Bank facility letters for encumbrances on assets.

iv. Details of outstanding amounts, current interest rates, period, loan covenants.

v. Details of any corporate/ personal guarantee extended.

vi. Confirmation from the Bank on the amount outstanding and interest accrued thereon.

vii. Details of the sales tax deferral scheme, *if any*.

18. Reserves

i. Provide details of all the reserves at the historic balance sheet dates for the historical period. Provide the terms for the statutory reserves.

ii. For all reserves, provide details regarding (i) purpose of reserve, (ii) period reserves were originally established, and (iii) all movements to the reserve (i.e., roll forward payments against, reversals, transfers, and reclassifications) for each period during the historical period.

19. Contingencies

i. Significant contracts, correspondence with solicitors, tax offices, shareholders register.

ii. Details of claims against the Company not acknowledged as debt.

iii. Details of outstanding bank guarantees and bill discounted.

iv. List of charges, pledges, etc., over assets of group.

v. Details of capital commitments, non-cancelable operating lease and other commitments and contingencies.

vi. Details of litigation disputes against the company, promoters and group concerns on the company.

vii. List & details of any existing and potential lawsuits/ claims - cause, amounts involved, latest provisions, etc.

viii. Disputes/ claims with respect to employees, ex-employees, customers, vendors, etc.

ix. Details of any regulatory claims against the Company.

x. Confirmation from the lawyers about the list of legal issues and current status of the same.

xi. List of any claims/ disputes with or complaints from customers giving amounts and background.

20. Secretarial Records

i. Minutes of Board of Directors and Shareholders meetings.

ii. Shareholders register.

iii. Register of Directors and Contracts in which Directors are interested.

21. Human Resources

i. Organization structure and reporting relationships as on March 31, 200_ and on March 31, 200_.

ii. Number of employees, grade-wise in each of the vertical and by department.

iii. Details of time management system, together with details of employee productivity over the historic period.

iv. List of directors, officers, senior staff (considered key to the business) showing position, name, age, length of service, skills, salary benefits, etc.

v. HR systems prevalent in the organization, including performance appraisal systems.

vi. Level-wise headcount movement, i.e., month-wise number of employees joining and leaving the organisation in the last two years, by department/ function. Also provide us with an average replacement time and cost of replacement.

vii. Employee contracts, service agreements.

viii. Details of employee union activities and note explaining significant Union activities since incorporation.

ix. Details of any wages/ bonus, etc., agreements signed with the employee unions.

x. Staff movement, i.e., month-wise number of employees joining and leaving the organisation in the last two years.

xi. Details of key employees who have left the Company in the past two years.

xii. Is manpower hired from third parties? If so, agreements with these parties.

xiii. List of all labor disputes pending as on March 31, 200_ and on December 31, 200_.

xiv. Employee Provident Fund registration certificate, sample monthly remittance challans,

xv. annual returns and correspondence with the relevant authorities.

xvi. Details of accrual of various retirement liabilities *viz.* leave encashment, gratuity, etc., as on March 31, 200_ and on December 31, 200_. Please also specify how the various retirement benefit liabilities are funded.

xvii. Actuary certificate for the retirements benefits as on December 31, 200_.

xviii. Number of employees education wise at the agent and management level.

xix. The details of the training calendar for the year ended March 31, 200_,March 31, 200_ and the nine months ended December 31, 200_.

xx. Ratio of full time employed/contracted headcount year ended March 31,200_, March 31, 200_ and the nine months ended December 31, 200_.

xxi. Training cost/headcount

22. Forecast

Details of the forecast for FY 200_ (reflecting actuals YTD) and FY 200_ along with detailed assumption on growth assumed in product/service/customer sales, prices, product-wise sales and margins, customers, geographical sales, sales and marketing costs, customer returns, raw material mix-quantity and prices, other administrative costs, interest cost, etc.

Others

23. Technology

i. Note on the Information technology and the overall control environmentof the Company.

ii. Details of software used for staffing & scheduling, planning and any other key softwares used for the year ended March 31, 200_, March 31, 200_ and the nine months ended December 31, 200_and what is the efficiency of the scheduling for the top 5 customers.

iii. Are there any knowledge management software being used for the operations & their details.

iv. How many licenses are available for different software being used*?

v. Do you have any documented and implemented Disaster Recovery and Business Continuity plan.

vi. When was last BCP/ DRP test performed and details of the same.

24. Infrastructure

i. What has been the build up of capacity over the last for the last two years i.e., for the year ended March 31, 200_, March 31, 200_ and the nine months ended December 31, 200_.

ii. What % is the un-utilised capacity?

25. Taxes

Direct Taxes

Summary Information

i. Year-wise summary chart for income tax and wealth tax for past five years, detailing the following:

ii. Current assessment/ litigation status.

iii. Key disallowances/ issues raised by the authorities.

iv. Amount of demands raised by the authorities and paid by the Company.

v. Level of settlement of dispute (i.e. CIT (A)/ ITAT/ HC/ SC).

vi. Taxable profit/ carried forward loss for the year and set off in future years.

vii. Status of brought forward losses/ allowances, if any.

26. Information for Review Period

i. Copies of Return, computation of income, transfer pricing report (along with transfer pricing study) for three preceding years.

ii. Copies of tax audit report and other annexure for the latest three assessment years.

iii. Copies of intimations, assessment orders, submissions made, appellate orders etc for all open years.

iv. Details of tax benefits claimed by the Company.

v. Year-wise details of amount appearing under the heads ‘provision for tax’and ‘advance tax’ as at March 31, 200_ and December 31, 200_.

vi. Provisional computation of tax liability for the Financial Year 2000-, based on which the Company has paid advance tax installments.

vii. Computation of amount appearing as deferred tax asset/ liability as at December 31, 200_ and March 31, 200_.

viii. Copies of legal opinions, *if any*, obtained by the Company.

ix. Copies of wealth tax returns (along with all annexure) filed by the Company for three preceding years.

27. Indirect Taxes

Service Tax

Status of compliance and assessment

i. Statement of domestic revenue streams and whether service tax charged. Verticals can provide details and sub-divisions thereof or chart on reasoned positions adopted regarding applicability of service tax.

ii. ST-3 and credit returns filed.

iii. Details of payments to foreign service providers for services rendered in India.

iv. Details of payments to road transporters.

v. Details of all payments made to and services received from all foreign service providers.

vi. Any audit objections received by the company after excise/ service tax audit?

vii. Agreements for services utilized and rendered by the company.

Customs

i. List of goods, which are generally imported along with tariff classification and rate of duty.

ii. Bills of Entry for all imports assessed provisionally.

iii. Licenses granted (for import).

iv. Licenses granted (under Duty Exemption Scheme).

v. Status on discharge of export obligation and related documentation.

vi. Status on discharge of legal undertaking/ bonds.

vii. Status of show cause notices ("SCN") issued; submissions made, adjudication thereon and appeals.

viii. Agreements pertaining to import of know how, technology, drawings, designs, etc.

ix. Legal opinions obtained, *if any*.

Excise Duty

i. Status of compliance and assessment.

ii. Registration certificates.

iii. Show cause notices, submissions made, adjudication orders and appeals.

iv. Registers maintained for excise purposes including returns and credit returns.

v. Documentation in support of credit and refund claims in relation to input duties/ taxes.

vi. Outsourced job works/ relevant agreements for the same.

vii. Exemptions claimed in the review period and those that are currently valid.

viii. Legal opinions obtained, if any.

Sales Tax/ VAT

i. Status of compliance and assessment.

ii. Assessment orders for last 3 assessed years (for CST, local sales tax).

iii. Returns filed during the last one-year.

iv. Details of incentives claimed and periodical reports filed, *if any*.

v. Details of declaration form pending receipt.

vi. Classification determination order, *if any*.

vii. Copies of all distribution agreement.

viii. SCNs, communications from the sales tax authorities.

ix. Appeal petitions/ applications.

x. Application for any sales tax exemption, along with related documentation.

xi. Legal opinions obtained, *if any*.

Annexure D

This specimen report attempts to cover venture finance, investment and a amalgam type transaction and it should not be construed as one intended for only merger & acquisition due diligence. The instructor may use this specimen report to explain the different aspects that a due diligence findings cover and its style of writing.

Sample Due Diligence Report for a Prospective Investment

This report is for the limited usage of the private party that commissioned it, and remains the property of the author. This report and it's information is not for distribution, dissemination, or publication in any form or manner, including excerpts, quotations, summarisation, or paraphrasing, whether written, verbal, or otherwise. This may not be used by anyone, including the party that commissionedit, to persuade or dissuade other prospective investors.

1. Economics

In our limited review, we found some items of concern as reported in this section. These may or may not be indicative of problems, and should probably be followed-up with questions to the Company for clarification. We can pursue this further if desired.

- Evidence of high-end marker - The Plan devotes considerable space to the general prevalence in the country of problems, but shows essentially no data regarding the particular market for people who can afford to pay Rs._____ to Rs._____ (or more) out of personal funds to deal with it in a luxury setting. The presumed existence of such a sub-market is the cornerstoneof the whole Plan. This target market may well exist to the point that four dozen such people can be found every month or two, for years to come, but no evidenceis presented.
- Inadequate budget to provide deluxe environment - People that are paying this price range may expect private rooms,

and better food and more personal attention than what is presently included in the Plan. People are to sleep two toa room, food is budgeted at about Rs._____ per month per person, and the professional staff is budgeted at about ________________ professional (__________, etc.) for each five guests. Taking into account the 24/7 nature of the situation, the 1-to-5 ratio is actually even worse, at this would imply each guest would get about 1 hour per 24-hour day of individual attention, and actually less when further taking into account that some of the professionals' time will be spent in group activities, and thus unavailable for individual attention. Similarly, the Plan appears to provide for very few kitchen staff and housekeepers, especially in light of the 24/7 setting and the high-end clientele. There appears to be no budget for a ___________, and a fulltime one would only allow an average of less than one hour per week per patient. It is the nature of most such start-up plans (i.e., for a new business model) to not anticipate all costs, and thus it would be both reasonable and prudent that a non-trivial allowance should also be provided for "Unanticipated Other Costs" (perhaps about 15% of the total of identified costs). These budgeting issues suggest lower profitability than what is indicated in the Plan, or worse, forthcoming client dissatisfaction with the experience, or, perhapsalack of business/operational/management experience (and/or attention to detail) on the part of the founders.

- Significant omissions in the budget, or extra fees to the clients - The Plan states that " all treatment services" as well as "outside functions" are included in the very large fee. The Plan describes a significant roster of "Adjunct Services" which will be available (e.g., services, management,______-feedback, conditioning, _______, treatment, services, etc.), all to be provided by outside contractors. There does not appear to be any funds in the budget to cover this, which would likely be a significant cost. The alternative, of charging extra for these items, would not appear to fit well with the high-priced "all inclusive" portrayal.

- Treatment pricing is twice as high - The Plan seems inconsistent as to the average cost per patient, variously citing full term price of Rs.______, a monthly fee of Rs._____ "an average length of stay of two months" (i.e., Rs._____), and Rs._____ per month in the P&L spreadsheet. Additionally, as above, will there be potentially substantial extra fees charged?

- Plan details for equipment and furnishings not provided - Perhaps it has been done and simply not included, but we see no list of major assets required, and associated costs of procurement, nor any estimate of the total funds budgeted. For example, the facility is in effect going to be operating a small restaurant, if it is to include all meals for 48 or so people (plus staff?), three times a day (plus late-night snacks available for the "deluxe" environment?), seven days a week.

- Financial results for the ramp-up years - The spreadsheet that we examined was not labeled as to what year it represented (i.e., the first year, or the fourth year, etc.), but showed the client load already at essentially full capacity. The economics of the ramp-up years were not shown in our copy; these years could possibly be more problematic in terms of cash flow.

- Higher density per building - The property is reported as acres with existing homes, which are described as capable of housing 6 clients each. The Plan then provides for an additional homes to be built on the property, which implies they would have to house ten clients each to reach planned capacity; this larger group size is not mentioned.

- Competitive advantage - Being "first to market" (as stated in the Plan as a key competitive advantage) in this particular situation does not infer much in the way of lasting competitive advantage, as far as we can tell. Likewise, the Plan statement that their services … can not be duplicated" rings rather hollow. There is a strong market and few providers, these may not matter. We have not spent time to search for possibly pre-existing high-end competitors; this can be pursued if desired.

2. Usage of Stock Sale Proceeds

In our limited review, we found items of very substantial concern in this section, which we believe should be clarified in writing with the Company prior to any investment.

- Document contradictions - There were two documents provided ("Confidential Private Placement Memorandum; Rs. 10,000,000; _______, Inc.; Equity Shares" and "________; Confidential Document; Contact ___________; ________, Inc."), and these two documents at times appear to contradict each other, including with regard to the usage of share sale proceeds. It is our lay interpretation that the Private Placement Memorandum would be the definitive legally binding language; if this issue is a concern, an attorney should be consulted for a professional legal opinion on this issue (which we cannot and do not provide). For the sake of brevity, our comments with regard to the usage of proceeds apply primarily to the Private Placement Memorandum ("PPM") document.

- Half of the proceeds to be raised are targeted to go to what is effectively the apparent anticipated cost of raising the funds. - This "half" also may well be the "first half", i.e., if the full Rs.10 Million is not raised, the first funds (or perhaps even the first Rs. 5 Million) may go to these ends, leaving even less than half of what is ultimately raised for the business. This would appear excessive, and dangerous to the integrity of the stock investment from the investor's perspective. Of the other half, a significant piece is slated for overhead, analysis, and other "soft" costs; only Rs.4.2 Million of the Rs.10 Million is specifically slated for real estate costs, construction, and asset/equipment requisition. The PPM also states, with respect to the Rs.5 Million that is earmarked for the cost of raising funds, and all other categories, that "any unused sums in any of the above categories may be retained by the Company for any purposes … including … payments to the principals for management fees." It is our interpretation, which may be incorrect, that the PPM states, in effect. That substantial amounts of the

Offering may be paid directly to the principals, in unspecified ways, with no defined oversight or scrutiny.

- It is not all clear that the funds earmarked from this stock issuance will be used to purchase any property - The footnote that explains what the "Real Estate Costs" are does not mention the purchase of any property; rather, it says that this Rs.4 Million is "Reserved for the pre-payment and continuing of leases …". It further mentions "leasehold improvement for space renovations including architectural drawings and consultation." This would appear to b a somewhat cryptic reference to the only lease mentioned, which is the presently leased _____, 000 square foot office space, which is not part of the residential property being considered for purchase. The PPM further states "The Company plans to use the capital provided by this Offering for advertising and marketing, accounts payable or other working capital and general corporate purposes that management determines are in the best interest of the Company." We can find no place in the PPM where it indicates planned usage of the funds for acquisition of the real estate and facilities, which acquisition is the supposed cornerstone of the Plan. Additionally, it states "Management is not restricted in the application of the funds as provided in this Memorandum under the caption 'Use of Proceeds'." This is close to a "blank check." In our view, the charitable interpretation of these facts is that the PPM document is poorly written. We regard this as a substantial "red flag."

- Stock investment could be at substantial risk if inadequate funds are raised in Offering - The Offering is being conducted on a "best efforts, no minimum basis," stating that "There is no minimum amount of proceeds that must be raised before the Company may use the Proceeds of this Offering, … The Company will have broad discretion in the use of these funds. In yet another area it states "Whereas the total amount of the offering may not be raised, there is substantial risk that if the total amount is not raised there may not be sufficient capital to complete any of the projects contemplated. To that extent, the investor may lose all of the investment." While it can certainly be claimed that this is "just legal boilerplate," consider two things: 1) subscriptions such as this can be, and often are, structured such that if a certain threshold amount is not raised, then all the funds get returned; this PPM is very pointedly not that way; and, 2) the Company specifically states in the PPM that "The Company has not been represented by legal counsel in connection with the preparation of this Offering". .... so who then wanted the deal structured this way, and that language included? If there is inadequate funding raised to accomplish the Plan objectives, the Company is under no obligation to return any funds to stockholders, and from all apparent writings, it would appear that the Company has no intention to return funds under such a scenario. This also plays in to a concern raised in Section 3 below.

3. Ownership, Control, Accountability and Investment Exit

In our limited review, we found items of very substantial concern in this section.

- Present ownership and control: At present, the majority of the Company's stockis reported by the Company to be owned by_____(35.1%), _______(19.2%), and______(10.6%), collectively 64.9%, with the next largest holder reported at7.4%. We have absolutely no further information on any of these people, including even what their first names are. They are not listed as Officers. The Board of Directors is not identified, and we do not know if it has even been established at this point. We do not have access at this time to the Articles of Incorporation, or the Bylaws, which could be critical. The PPM states that"certain provisions of the Company's Certificate of Incorporation and Bylaws and of law may delay, defer, or prevent a change of control of the Company and may adversely affect the voting and other rights of the holders of Common Stock."

- Control by presently subscribing shareholders: The Offering is for 10.0 million shares, and it states that there are presently only 0.2 million outstanding, and further, that the Company is authorised to issue a total of 25.0 million shares of equity stock, and that the Board can issue the remaining 14.8 million additional shares (subject to law) without stockholder approval. The bolders of these new shares (which could, or may have to be, issued at a vastly lower price) could then control the majority of the Company's stock. There is no mention that we saw in the PPM of any election of Directors shortly after the subscription for the present stock. The PPM states, "The Investors shall not be entitled to receive a copy of the list of Investors." It appears to us as a distinct possibility that unless someone (or a group of parties that knows each other before hand) subscribes to more than half of the current Offering, that the subscribers to the Offering may have absolutely no method of influencing the Board, even if 90% of the shareholders felt the same way.

- Accountability: near absolute power of the unidentified Board - The PPM states that if the Company has inadequate funds to carry on it's business, that it may issue more shares in a attempt to raise additional funds. The new shares may be of the same, or a different, "series" of stock. Further, the PPM states that the Board of Directors has the authority, without stockholder approval (subject to ____________ law), to alter the rights, privileges, and voting of the shares outstanding (including those being offered in the PPM), and may apparently do so differently by series (e.g., to give the second series different rights than the first series). Lastly, the PPM states "the Board of Directors may authorize and issue Preferred Stock with voting or conversion rights that adversely affect the voting power or other rights of the holders of the Common Stock. In addition, the issuance of the Preference Shares may have the effect of deferring or preventing a change of control in the Company." This appears to be unconstrained by any stockholder vote. Our lay interpretation of this is that the common shareholders do not effectively control the Board here; this is not a legal opinion, and an attorney may not agree with out assessment. We see the combination of the items above as a substantive red flag.

- Insulation of the Board: The PPM states "The Company's Certificate of Incorporation and Bylaws contains provisions that limit the liability of directors ... and provides for indemnification of officers and directors under certain circumstances. Such provisions may discourage stockholders from bringing a lawsuit against directors for breaches of fiduciary duty and may also have the effect of reducing the likelihood of derivative litigation against directors and officers even though such action, if successful, might otherwise have benefited the Company's shareholders. In addition, a stockholder's investment in the Company may be adversely affected to the extent that costsof settlement and damage awards against the Company's officers and directors are paid by the Company pursuant to such provisions." This kind of provision is not all that uncommon, and is sometimes used by bonafide companies to discourage frivolous lawsuits and to entire good people to serveas officers and directors; however, in conjunction with everything else here, itis worrisome. The PPM also states, "Investors shall not have the right to receive copies of any federal, state or local income tax or information returns.... Investors shall not have access to the books and records of the Company." Again, this may actually be not uncommon, but in our case, no independent outside auditors have been named, nor has there been any mention that some such chartered accountant firm shall be found; only annual reports are committed to (none quarterly, and nothing as to being audited).

- Investment: Substantial restrictions apply with respect to any sale of an investor's stock. Dividends are not assured, even if the Company is profitable. Prospective distributions to investors are not clearly defined. This is not necessary uncommon.

4. Founders, Officers, Principals

In our limited review, this section came up largely neutral. There are a couple of things that would be problematic if they are truly associated with the Principals; we can pursue this further if desired.

- Same level of comfort established - In the time allocated for this section, we did not find any conclusive evidence that any of the principals identified have problematic records. It should be noted that this is not always easy to find, and we did not, for example, spend the time yet to check non-current records. We have not done through background checks. We have, however, done enough probing to give us some degree of comfort with respect to the principals. We spent a fair amount of time looking and coming up with nothing, which in general is a good indication. If through background checks are desired, please let us know.

- _____________appears to be bona fide. The proposed Chief Officer. ______, is shown on the website of ________, as the _______Director of the Centre, where it states that he "has more than 10 years of experience in _________________" and that he "received his _degree from the University of __________, ___________School and has practiced_____________for 15 years," among other things.

- No certain information found on other - There was no definitive information of nay sort (positive or negative) found regarding______(the proposed CEO), or ______(the President), state corporation records show Mr. ______ as the only listed officer, holding positions of President, Treasurer, and Secretary, and listing a _________________ address from him. We likewise found nothing on the two or three largest present shareholders; their last names are somewhat common, and only their first initial is listed (a with no indication of where they reside), so it is not likely that anything conclusive would be found on these names, even if it certainly exists. We have no indication at this point if these shareholders are insiders or exert any real control or influence.

- Potential problem areas - There were several pieces of non-conclusive information, which may well be coincidences that do not pertain to the principals; however, if they did actually pertain, it would be of significance, and troubling. These can be investigated further if desired. They includes two of the companies listed in the experience portion of Mr. _____'s bio-data (where he was alternately the_____manager and the CEO) are not listed with complete names (i.e. "ABCD" and "T.S.G."); there is (or was) a company called "PMFG" of PQRS City, California that has had troubles with the SEBI; likewise there is a "TSG" that has also had troubles with the SEBI. It would be prudent to simply clarify the complete names of the companies that Mr._________worked for. Additionally, there appears to be another, different, ________on the west coast in the same field; there is _____________, Advanced __________Care" website, with a different educational and professional background; the site also has a photo, at www. _____________. com. We did not call to check Mr._____________'s prior employment claims.

- Corporate identity - The Company was incorporated Sept. ____200____. The Company has a website domain name reserved at www. ____________. com (with no functioning website yet). There are at least two previously existing organisations with similar names.: the at the University of is sometimes referred to as the _______________. There is a in _____, _______(which may be near _________).

- Officer's stock-The present officers appear to own no company stock at present, although there are ________ shares variously described as either"reserved for management" or "owned by officers and directors" (although there are only_________shares listed as having been issued to date, and none of these shares are ascribed to any of the listed officers).

- Company's Officers and Directors may beneficially own a significant portion of the outstanding equity Shares of the Company."

- Officers' compensation - There is conflicting information regarding the proposed compensation of the officers. The

PPM states that "All compensationto the Company's Executives will be in the form of stock and/or stock options for the foreseeable future." On the same page it also says "Officers and Directors are expected to draw limited salaries after this Offering has been successful." Note that it is generally not common that directors would immediately receive salaries in the initial stages of a start-up, and that the identities of the Directors has not been provided, nor has anything been established with regard to elections of Directors; so who then are the Directors loyal to? The shareholders,or the people that pay (and determine) their salaries? The PPM further states, "For the most part, these persons control, and will continue to control, their levels of executive compensation in future years, which may be significantly higher…" The spreadsheet attached to the other document (not the PPM), shows Mr. ________ with a Rs. ______ per year salary, and a bonus (not necessarily all to him) to be paid of another Rs.______. While talent should be paid well, andif this is successful such compensation may not be at all out of line, this comes across to us as being handled in a less than forthright manner. Nothing is shown with regard to compensation plans for Mr. ______, who is the only officer listed in_______corporate records, and who is President and Treasurer, and is not listed as a shareholder in the PPM. Mr. ________is presumably not doing this for charity, and the complete lack of any disclosure regarding his financial ties addsto the overall problematic lone here.

5. Summary Conclusion

We believe that either this has been inadvertently poorly written and structured, or else it is a rip-off. It is difficult to tell which, even if it is not inadvertent, it is likely that some of the principals may be entirely innocent, such as Dr. ________ who may have been talked into joining this, and may not be involved in or knowledgeable about the structuring, financial, and business issues. In either case, we would not be comfortable recommending it unless certain aspects of the Offering were changed, and some additional disclosure was made. There are some important issues here (as well as a number of possibly not so important ones). Some of the key ones may largely be legalistic “technicalities,” but they could absolutely be deadly to an investor, and they are in cumulative total, “out-of-line.” If they are not intended, they should be changed.

The investor is, in effect, depending entirely upon the goodwill of the Board of Directors in order to not be screwed, and the Board is neither identified nor is near- term elections plainly provided-for. Important items to consider include:

- This Company has been set-up to largely bypass the normal accountability and checks-and-balances. Perhaps they do not intend to utilise that capability; are you comfortable in counting on that?
- It does not appear that they are bound to use any of the proceeds raised to actually acquire the necessary real estate.
- It appears that if the Offering is less than fully subscribed, then there is significant possibility that the subscribers will lose their entire investment.
- It appears that a huge portion of proceeds raised will be paid to people raising the money, and very possibly to the founders.
- Additionally, there are potentially significant documents not disclosed, and the budgeting appears amateurish.

Chapter 4
Due Diligence for Venture Capital Investment

Background

Before making any investment, the goal as venture capitalist is to understand virtually every aspect of the target company, the experience and capabilities of the management team, the business plan, the nature of its operations, its products and/or services, the methods by which sales are made, the market for the products and/or services, the competitive landscape, and other factors that may affect the outcome of the investment. While due diligence exercise is viewed by many as mundane and irritating tasks, the process enables venture capitalist to address areas of concern andis an important tool in determining a fair pre-investment valuation, and may help to avoid significant and otherwise unexpected liability following the investment.

For venture capitalist, the due diligence process is a means of identifying and becoming comfortable with the risks to which the capital would be exposed. The due diligence process for venture capitalist involves an assessment of both the microeconomic and macroeconomic factors that can affect the earnings growth of the target company. The due diligence process also includes a review of the corporate and legal records, including the documentation supporting any previous issuances of the company's securities.

Microeconomic Analysis

These are the factors within management's control and include a careful assessment of the management team, the business model, the value proposition, the distribution strategy, the intellectual property, the financial strategy and capital requirements, and the legal structure and records of the company.

Macroeconomic Analysis

These factors are generally outside of management's direct control and include a review of such areas as market size and expected growth potential, the perception of the company and its products by its suppliers and customers, the competitive situation and product differentiation, and government and regulatory influences.

Over the years, an extensive due diligence questionnaire have been developed and fine-tuned which is usually provided to prospective companies at the inception of the due diligence process.

Due diligence, itself, is both a quantitative and qualitative process. The due diligence process commences only after the venture capitalist has spent sufficient time with a prospective company to become convinced that spending the additional time and energy required will be a worthwhile endeavor.

Perhaps, the most critical aspect of the entire process is the close interaction between the venture capitalist and the management team of the company being considered for investing in throughout the due diligence process. In the process of getting better acquainted with the management team, it is important to discern whether the management team is appropriately experienced and committed to the business, as measured through the team's behavior as well as their response to queries.

While some of the findings of the due diligence process do little other than to confirm the initial "gut feelings" of the venture capitalist, there are some areas that are best described as "show stoppers." Show stoppers include determining that the target company has a flawed business plan, is managed by a group of convicted felons, has technology that does not work, or products that cannot be sold. However, there are other, less obvious issues that may arise in the due diligence process to cause a venture capitalist to break off discussions with a company.

One such problem is the inadvertent violation of provisions of the regulations of Securities Exchange Board of India (SEBI) that occurred when the target company was raising prior rounds of capital. Unfortunately, this is a frequent *faux pas* committed by many early-stage companies that raised their initial capital from family, friends, and casual acquaintances without proper documentation. In this instance, the company and an unsuspecting investor could find a significant portionof the proceeds of new financing being used to fund the repurchase of securities from disgruntled existing investors who may successfully sue for rescission of an earlier and improperly documented securities offering.

For instance, it might be agreed on a preliminary term sheet, subject to the satisfactory completion of due diligence. The due diligence exercise could establish a pre-investment valuation of the company significantly lower than the two previous investment rounds. Individual investors, many of whom were not accredited investors, might have funded both of those financings. Additionally, it could be determined during the due diligence process that there were numerous failures to fully comply with the provisions of SEBI Regulations. Because the proposed financing could be extremely dilutive to the existing common stockholders, there might be considerable consternation among the investors in the prior rounds. Ultimately, it could be concluded that the only cure for the SEBI violations would be for the company to initiate a rescission offer to repurchase any securities that the earlier investors wanted to sell back to the company; the price of the rescission offer would have to be at the price those investors paid for the stock they had purchased. It would be possible that most, if not all, of those investors would tender their shares and recover their original investment. The cost of completing the rescission offer would have consumed a significant portion of the proposed investment and increasing the proposed investment would have adversely affected the economics of an investmentin the company. Ultimately, it drives the decision not to proceed with an investment in the company.

Pending litigation can be another issue that can bring the investment discussions to an abrupt halt. Not being able to determine how a court or a jury may rule in a patent infringement suit is generally not a risk that a venture capitalist is willing to assume.

To summarise, if the due diligence process confirms an investors' initial instincts, nothing untoward arises during the review process, and the additional time spent between the venture capitalist and the management team results in a positive working relationship, the result is likely to be successful closure of an investment in the company. Additionally, a detailed due diligence process usually results in a more informed investor who can help management in the value-creation process from inception rather than spending time following the initial investment trying to understand the business and the challenges faced by the management team.

Due Diligence Check List

Typically, due diligence for venture capital financing covers examination of the following:

Corporate Books & Records

a) Charter and By-Laws

b) Minutes of Meetings

c) Recent Records of Officers and Directors

d) List of Shareholders

e) Company Registrations

f) Reports to Shareholders

Financial Information

a) Financial Statements

b) Taxation Matters

c) Indebtedness

d) Contingent Liabilities

Employee Matters

a) Organisational Information

b) Agreements

c) Benefit Plans

Legal Matters

a) Regulatory Compliance

b) Litigation

Contracts, Agreements and Other Arrangements

Proprietary Rights

a) Licences

b) Royalty Arrangement

c) Infringements, if any, on these rights

Plant, Property & Equipment

a) Real Property/Assets

b) Encumbrances, if any

c) Description of Facilities

Insurance

a) Assets

b) Employees

c) Directors

d) Loss of Profit

e) Transit Goods

Sales & Marketing

a) Description of Market and Share

b) Customer Identification and Profile

c) Potential Market

d) Sales Policy

Others

a) Company's Information Management System

b) Future Business Plan

c) Press Releases

Chapter 5
Due Diligence for Franchisee Arrangement

Franchising is a popular method of doing business and the chances for success are greater than those of independent business owners. To ensure survival some basic but vital steps should be followed. Essentially, conducting due diligence is essential. The fundamental factors for this due diligence are:

- *Know the Market*. Once the picture of what can be afforded and the type of franchise concept is clear, investigate the demand for that particular product or service in the proposed assigned area. Just because one type of business worksin one region does not mean it will work in the community where it is proposed to open the franchise. Some things to consider are the level of competition in the target market and whether a concept has only seasonal marketability.
- *Comparison Shop*. Even if the heart is set on one company, it never hurts to lookat other opportunities to make sure the investor is signing on with the best concept for the skills and interests. One way to do this is by attending a franchise tradeshow and/or using a franchise consultant who will enter the criteria into a database and then present companies that match the investor's parameters. There are numerous web sites that allow to see a snapshot of several concepts at once. It is a good strategy to talk to existing franchisees of the franchise companyin which the investor is interested.
- *Study the Franchisor's Offering.* No contract should be signed or any payment made until the opportunity to investigate the franchisor's offering is obtained. All earnings statements should be substantiated. The franchisor should be requested to disclose important information about the franchise system such as the past earnings, franchise agreement terminations, number of outlets are in operation, etc. Because investing in

a franchise involves a substantial investment, it is imperative to consider having a legal review of all documents and franchise agreement, as well as have a financial review of the franchisor's earnings claims.

- Find out the *training and support* (technical, administrative, training, etc.) that the franchisor provides. One of the advantages of buying a franchise is that the franchisor provides intensive training on how to run the business and offers some kind of ongoing support.

- *Talking to existing franchisees.* This is an important step because they can give honest feedback and substantiation of what the franchisor tells. They can be requested to share their experiences and advice, if any. Following is an illustrative set of questions that can be used to gather useful information from the franchisees:

  - Why did you select this particular franchise system over others in the same type of business?

  - What line of work were you in prior to purchasing a franchise?

  - Were you content with the initial training and support you paid for and were promised?

  - Did the training only cover the operating system or did the training prepare you to compete with other businesses providing similar products or services?

  - Did you encounter any problems with the franchisor, the site, or establishing your business and how did the franchisor respond to problems?

  - How would you describe your overall franchisor/ franchisee relationship?

  - What are your thoughts on this industry, the products and/or services available, and what trends do you see happening for the future?

- Do you have any issues or concerns with the franchise agreement? Were there any clauses that stuck out over others that may impact your relationship with the franchisor?

- How has the franchisor responded to your calls for support about business operations or any other general questions you may have had?

- Are you pleased with the quality of ongoing support, mentorship, and advertising campaigns provided by the franchisor?

- Has the franchisor responded to any of your own ideas about improving the franchise system?

- Are there any other franchisees or former franchisees you recommend contact?

If the individual is a former franchisee:

- Why did you leave the franchise system?

- Did the franchisor cooperate in helping you sell your franchise?

- If there was a termination or non-renewal, did the franchisor explain why and provide a reasonable opportunity for you to cure the problem?

- Would you consider buying a franchise from a different franchisor?

Further, the following guidelines help to make a diligent assessment of the franchise system.

Popularity of the Franchise System

If investment is proposed in a new franchise system (one that has been in operation for less than five years or has less than twenty outlets) it is important to consider that the business that is being bought may not be that well known yet to give an the edge over the competition. Buying into a new concept does not mean that it is necessarily making a bad investment; it just means that at the onset, one may not gain the same advantages as those built into a mature franchise concept such as consumer brand awareness.

Franchisor's Management Team and History

It is important to know who the key players are in the franchisor's management team. One may not get access to their resumes but their work experience should be enquired into and more importantly, their franchising experience. Information should also be gathered about aspects such as their membership in certain other organisations, their past track record, any lawsuits or pending convictions against them.

Financial Strength of the Company

If the franchisor is growing the franchise system with the influx of new franchisees and has no working capital or investment backing, this may be a sign of trouble. A review of the financial statements of the company, the financial stability of the franchiser's system can be assessed. Without this financial security, a franchisor cannot sustain operations and worse yet, cannot possibly expand.

Growth of Demand for the Franchised Concept

An easy way to address this question is to do a concept search on many of the franchise directories available online. Market research and review of trade magazines or journals is also useful in this regard. If the concept has been in operation for many years but it is one of few in the marketplace, this may be an indication that it is not a fad. On the contrary, if the concept is extremely unique, it might not have acceptability among public.

Trademark and Brand Protection

The franchisor's trademark is the most important level of protection that makes the concept uniquely distinguished from others in the industry or marketplace. A franchise system could have a number of “marks” such as logos, names, slogans, products, designs or a combination of these.

Franchisor’s System for Choosing Franchisees

The franchisor should have a proper system in place for selecting candidates. The primary considerations in allotting/ granting frachiseeship should be examined. The franchisor should not be motivated to sign on franchisees simply because they are lining up to buy franchises. To be granted a franchise means a franchisor’s investment in the franchisee.

Operational Outlets and Stores

A schedule that lists the names and locations of franchises that have closed over a certain time frame and the stores that have changed hands as well should be prepared. The reasons for the closures should also be determined. A franchise closure has more negative impact than one changing hands but both needs to be explored. Too many closures and/or terminations can signify an underlying problemor issue regarding the franchisor’s reputation.

Chapter 6

Challenges and Risks Covered in Due Diligence Process

The Value of Due Diligence

Prior to engaging in any business relationship, knowledge of the respective company and individuals must be based on facts, not perception. Due diligence findings have to provide conclusive, documented legal information about the target company's litigation history, credit history, business formation and a host of other pertinent information. In this litigious society it is common to identify pending civil litigation not previously revealed, including discrimination, monopolistic practices, and intellectual property lawsuits.

Acquisition due diligence assesses the risks and opportunities of a proposed transaction. It helps to reduce the risk of post-transaction unpleasant surprises. Itis vital that the results of any due diligence process are relevant to the transaction including:

- Valuation of the target and therefore the purchase price
- Sale and purchase agreement (e.g. accounting definitions, accounting and tax warranties and indemnities, etc)
- Integration plan (e.g. deal synergies).

There are a range of circumstances in which companies can benefit from externally provided acquisition due diligence, *viz.*,

- Where any organisation is considering an acquisition, merger or joint venture.
- Where the organisation or deal manager has limited experience in undertaking due diligence.
- Where existing advisers face a conflict of interest, or are not well placed to undertake the necessary due diligence.

- Where the required due diligence demands technical capabilities and commercial experience beyond the organisation's internal resources.

Doing business in emerging markets requires an acute understanding of the unique risks present and an ability to mitigate those risks. Without such an understandingor ability, any business, is exposed to a variety of threats to their operations, assets and profit line.

Having an effective risk management or security programme in place allows a business to protect its bottom line and maintain competitive advantage. The business environments in these markets are all very different, each having its own unique characteristics.

Different Markets, Different Challenges

Each country and its market have different features and therefore different challenges. For example:

- Unfamiliar customs, cultures and languages make understanding and controlling risk difficult.
- Complex regulations, a different legal system and priorities create barriers to enforcement.
- Political and economic change, business closures, rising unemployment and grey markets can create hostile environments.
- Obscured conflicts of interest, intricate personal networks, all make forging business relationships difficult.

Different Challenges, Different Risks

These challenges give rise to various risks that need to be searched and examined during the due diligence process. The risks, generally, entail:

- Revenue losses from counterfeit goods, trademark infringements and grey market activity

- Theft of proprietary information and industrial espionage
- Collusion, corruption and fraud
- Loss or damage to physical assets
- Physical threats to employees and their families
- Damage to business reputation from unethical business practices or local contractors and business partners.

Effectively addressing these risks requires any business to possess an acute understanding of the various ethnic, cultural, socio-political and economic factors affecting the business environment.

Culture Aspect

During the due diligence process, especially in case of merger and acquisition, it is equally important to pay attention to what is called call human due diligence. Under "human due diligence," understanding the culture of the organisation, the roles that individuals play, and the capabilities and attitudes of the people are grouped. During the due diligence process, focus requires to be given on identifying key employees to be retained. The new organisation will need the right talent and an integrated, consistent leadership voice to make the merger successful. But when it comes to how to factor in the two cultures into a new organisation, leaders need to identify something more substantive than "decision making styles" to better understand the role of culture in making or breaking the merger. Therefore, a critical element of the due diligence process is an assessment of how well each company is doing in executing key management practices that have been proven to be linked to bottom line results. One company may be stronger in some practices than the other. When working with companies who are looking to merge or acquire the other, it is important to know how the two companies measure up individually in executing these management practices. This assessment tells where the gaps might be that the leaders will need to address before, during, and after the merger. Otherwise it may be merely looking at what is called "culture" and find out only later that it was more window dressing than substantive business concerns.

This exercise can give both companies a clear picture of how well each of them is doing in four critical areas that reflect both an external and internal focus:

- Adaptability
- Mission
- Consistency
- Involvement.

It is a matter of concern in a merger that indicates that neither organisation has a particularly strong ability to adapt to market changes and customer needs(Adaptability) than how similar are the dress codes or benefits packages. Not to say that the merger should be abandoned but instead such an assessment will present the post-merger challenges and risks more clearly and concretely to the decision makers. This makes for a more robust due diligence, focused on the key management practices that will ultimately determine the success of the merger and, more importantly, bottom line business results. Otherwise, the two companies run the risk of falling into the trap of assuming the acquiring company or larger company's culture will be the culture of the new company. This could end up perpetuating, or even exacerbating, the deficient management practices in the new company. Better to find out where each company stands during the due diligence process by asking up front the people who see the company's culture from the inside looking out. No matter how challenging a merger or acquisition can be to the executives in charge, it is that much more complicated in the trenches. All the more reason to concentrate on assessing and understanding the culture from grass roots perspective. Otherwise, leaders retained will squander their talent by assuming culture means one thing when it really means another.

Employee Screening

Security risks to companies are both internal and external. Loss prevention begins internally, with the employee or business partner, only following that, does it deal with the non-employee and external factors. Hiring employees is one of the most critical business decisions a company makes. Recruiting new staff members on the basis of personal recommendations and appearance is not enough. Experience has taught many businesses that if they had objectively and comprehensively screened candidates prior to employment, many malpractices such as conflict of interest, industrial espionage, theft of proprietary information, contravention of business compliance issues, business fraud might have been avoided.

Employment screening is an essential process to safeguard any business from hiring persons who are either unqualified or of questionable integrity. Screening applicants through pre- and post-hire enquiries is loss prevention in its purest sense. This should not be restricted to employees, as the future problems that choosing an unsuitable business partner or vendor may create, should not be underestimated. To address this issue is due diligence and companies are encouraged to approach suitable professionals who specialise in this and related services, with wide network. This places them in an excellent position to screen emerging market-based applicants who may have studied or resided overseas or worked at companies that are incorporated or headquartered outside of India.

The extent of screening is determined by the seniority or sensitivity of the position to be filled; this also applies to joint venture partners or vendors when checking companies. Screening both existing and new employees at all levels is important. Even the lowest level of employee might have access to proprietary information and processes that are critical to the efficient running of the company. Companies should also consider screening personnel being either relocated to or promoted into areas where they will have additional responsibilities.

The overall objective of employee screening is to “protect” a company against hiring personnel who exaggerate or make false claims about their qualifications, work experience and personal background or, identify weaknesses or withheld information that is relevant to employment such as previous criminal convictions or misconduct.

There should, however, be a balance between the risks involved *vis-a-vis* cost of employee screening. Further, though complexity and budget will vary from company to company, initial outlay can assist in reducing potential for large losses.

It is a recognised fact that the soul of any organisation is its people and the company's performance improves by providing care and attention to personnel selection. It is recommended that with any programme embarked upon, screeningor background checks must be adapted to job level or size of company to be checked. Selection of an individual or company must be on an objective basis, not a subjective criteria and uniformity of processing is vital if the programme is to succeed, otherwise the programme will be piecemeal and vulnerabilities exist.

For the purpose of due diligence, it is strongly encouraged to contact industry leaders in security who can also be consulted on risk management, commercial enquiries, information security, personal protective services, and many other specialist fields offering premier security consultancy services for a systematic approach to asset protection.

Environment Risk Coverage

Environmental, health and safety (EHS) due diligence is the best way to avoid unforeseen environmental liabilities with new acquisitions.

When carrying out real estate acquisitions, divestitures or stock transactions getting clarity on the environmental, occupational, public health and safety regulations that could influence the investment can be an ordeal. That is why it is imperative to conduct a thorough EHS due diligence assessment before buying a facility or property. EHS due diligence assessment includes the necessary on-site and desk studies for identifying potential environmental liabilities associated with the acquisition, leasing and/or divestiture of real properties. Typically, EHS due diligence is used to determine whether:

- The facility has or will be able to obtain the right permits to do what it is doing or planning to do
- The permits will remain valid
- There are any constraints on permit renewal
- The facility has implemented the proper systems to ensure compliance
- The equipment used on site is safe
- The facility has a proper safety track record, etc.

EHS due diligence assessment analyses and outlines the legal ramifications to help ensure the acquisitioning company or the investor will not be exposed to liability.

Site Contamination, Liabilities and Hidden Costs

Investing in a new business overseas is always a challenge. Focusing on limiting the risk of acquiring contaminated site liabilities may sometimes overshadow the main purpose of the investment - running a viable and sustainable business that meets high environmental and occupational health and safety standards. Therefore, this part of due diligence combines EHS risk assessment and regulatory compliance verification.

Following are just a few examples of issues that companies frequently overlook during a transaction:

- The absence of an air emission permit.
- The upcoming expiration of a fire safety certificate.
- The obsolescence or non-compliance of electrical installations or working equipment.
- The lack of emergency exits or restrictions on the import or use of an essential raw material.

Further, inspections and analysis, include:

- Subsurface sampling and analysis to confirm the presence or absence of contamination or other problems from soil, surface water and groundwater.
- Building integrity.
- Machinery conformity.

In many countries, these issues can result in significant delays in the start-up of operations. They may also require extensive additional investments to limit the risk of prosecution and other employer liabilities.

Information Technology Security

Majority of the organisations today utilise computer systems for delivery and support of their business. Rapid advances in technology have resulted in deployment of new information technology (IT) systems. Adequate controls are not typically enforced in these systems resulting in higher risks and vulnerabilities. Concern over security, availability and integrity of IT systems is receiving increased attention.

Reviewing key IT components to help ensure the integrity and accuracy of information contained therein is of paramount importance to all areas of business and industry. A comprehensive technical review of the computing environment includes:

- Operating systems
- Network & Connectivity
- Vulnerability reviews of business applications
- Databases
- Change Management
- Governance
- Risk management

- Helpdesk services
- Disaster Recovery Plan & Business Continuity Planning.

The assessment methodology should cover the following aspects:

- Aligning business and local statutory requirements/mandates
- Performing risk assessment and identify potential risk areas
- Prioritising and categorise these issues
- Possible Action plan to remediate potential risk areas.

Conclusion

In sum, in addition to the traditional financial, legal and technical matters, the challenges cited above emerging with change in business environment and globalisation are significant factors that a comprehensive due diligence is required address.

Chapter 7

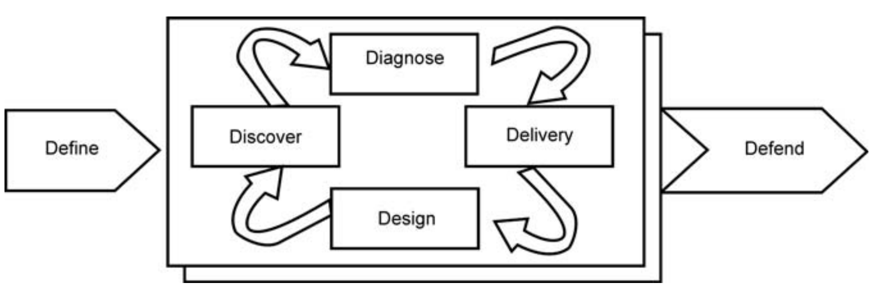
Work Approach to Due Diligence

Work Approach to Due Diligence

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

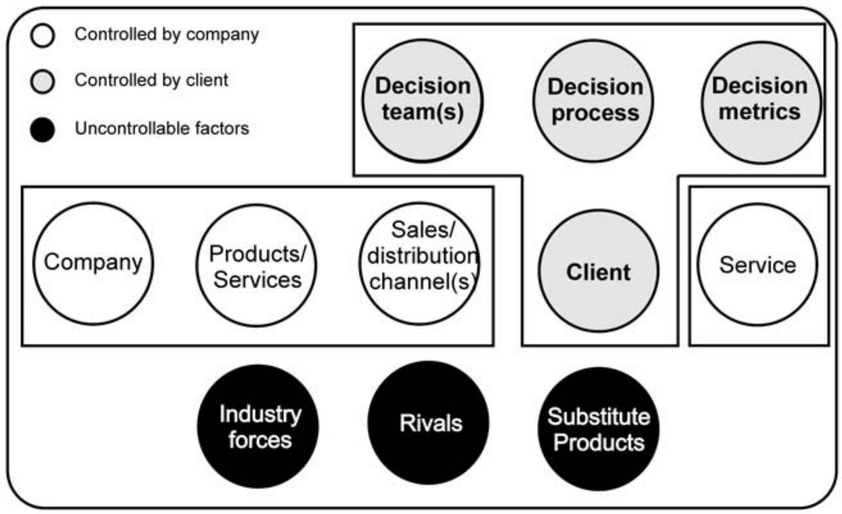
- Reviewing and reporting on the financials submitted by the target company.
- Assessing the business first hand by a site visit (if applicable).
- Working through the due diligence process with the acquisitioning company or investor by defining the key areas.
- Helping prepare an offer based on completion of due diligence.

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



Six Dimensional Process Framework

The approach as illustrated in the figure above is further expanded below to clarify the work stages.



Value Chain Framework

It needs to make sure that no hidden time bombs are ticking away in the business proposed to be acquired. The process kicks off when both the buyer and the seller sign a letter of intent, or term sheet, which sets the starting purchase price for a deal. By signing the letter, the seller agrees to open up the target company to a top-to-bottom examination by the buyer and adjust the sale price based on the findings of due diligence. Here is what to keep in mind:

a. **It is about managing risk.** Double-check financials, tax returns, patents, and customer lists, and make sure the company does not face a lawsuit or criminal investigation. Extra caution needs to be exercised if the company has never undergone an audit from an outside accounting firm. The company's customers can also be quite informative. The seller can be requested for a list of the most favoured clients and these customers can be called up.

b. **Prioritise the people.** Background checks on the company's key officers should be undertaken.

c. **Carry out the checks** as listed in Annexure 'A' of Chapter 3 with reference to documents and third part verification, as appropriate.

d. **Prepare to fix the price**. The investor can and should use any flaws that the due diligence uncovers to negotiate down the sale price. Due diligence is "a chance to get a better deal."

How to Conduct Due Diligence

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

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

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

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

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

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

Examples of Different Approaches

By and large, approach to due diligence exercise follows a common line. However, there are methodologies which different practitioners have developed to adequately cover the salient aspects of due diligence for various types of transactions. A vignette of these different approaches is provided in Annexure ‘E’ of this Chapter.

Valuation

Business valuation is another important task in the due diligence exercise. There are many reasons to know the value of the business- if it is considered to buy a business, a merger or outright sale. Whatever the reason for needing to know this information, trying to come up with a valid figure can be a major effort and challenge.

A realistic business valuation requires more then merely looking at last year’s financial statement. A valuation requires a thorough analysis of several years of the business operation and an opinion about the future outlook of the industry, the economy and how the subject company will compete.

There are many hard-to-measure intangibles that are a factor in the value of a business. It is not simply a process of adding up the numbers from a variety of reports. Business valuation has been called an art, rather than a science. Estimatesof a business’ value by various experts can vary as much as 30 percent.

Not only is there no consistency in methods used, but also there is also no consistency in naming the methods. Each method has a variety of names. The important factor in any valuation is that the method used is relevant to your type of business, providing a valid and supportable value.

This wide variety of methods available can be a confusing array to choose from. That is why a professional is often helpful. There are plenty of pros and cons for each method - and there seem to always be new valuation methods being touted.

Make certain a clear explanation of the valuation method is provided and justified. The current business owner needs to understand the possible valuation methods to be able to clearly defend the price of their business. For a buyer or investor, the reasoning behind the pricing is critical for evaluating the personal risk involved. Of critical importance to all parties is a sense of honesty in the method used.

While there is no such thing as absolute truth in business valuation, confidence in the eventual number is based on the integrity of the underlying process. To assure that integrity, many valuation professionals use more than one method, computing a weighted average to arrive at their final number. Following are some common valuation methods.

Adjusted Book Value

It is one of the least controversial valuation methods. It is based on the assets and liabilities of the business.

Asset Valuation

This method is often used for retail and manufacturing businesses because they have a lot of physical assets in inventory. Usually it is based on inventory and improvements that have been made to the physical space used by the business. Discretionary cash from the adjusted income statement can also be included in the valuation.

Capitalisation of Income Valuation

This approach is frequently used by service organisations because it places the greatest value on intangibles while giving no credit for physical assets. Capitalisation

is defined as the Return on Investment that is expected. In nutshell, one ranks a lists of variables with a score of 0-5 based on how strong the business is in each of those variables. The scores are averaged for a capitalisation rate, which is used as multiplication factor of the discretionary income to arrive at the business' value.

Capitalised Earning Approach

This method is based on the rate of return in earnings that the investor expects. For no risk investments, an investor would expect eight percent. Small businesses usually are expected to have a rate of return of 25 percent. Consequently, if the business has expected earnings of say, Rs.50, 000, its value might be estimated at Rs.200, 000 (200,000 * 0.25 = 50,000).

Cash Flow Method

This approach is based on how much of a loan one could get based on the cash flow of the business. The cash flow is adjusted for amortization, depreciation, and equipment replacement, then the loan amount calculated with traditional loan business calculations. The amount of the loan is the value of the business.

Cost to Create Approach (Leapfrog Start Up)

This approach is used when the buyer wants to buy an already functioning business to save start up time and costs. The buyer estimates what it would have cost to do the startup less what is missing in this business plus a premium for the saved time.

Debt Assumption Method

This method usually gives the highest price. It is based on how much debt a business could have and still operate; using cash flow to pay the debt.

Discounted Cash Flow

This method is based on the assumption that a rupee received today is worth more than one received in the future. It discounts the business's projected earnings to adjust for real growth, inflation and risk.

Excess Earning Method

This method is similar to the Capitalised Earning Approach, but return on assets is separated from other earnings, which are interpreted as the "excess" earnings you generate. Usually return on assets is estimated from an industry average.

Multiple of Earnings

One of the most common methods used for valuing a business, in this method a multiple of the cash flow of the business is used to calculate its value.

Multiplier or Market Valuation

This method uses an industry average sales figure from recent business sales in comparable businesses as a multiplier. For instance, the industry multiplier for an ad agency might be 75, which is multiplied by annual gross sales to arrive at the value of the business.

Owner Benefit Valuation

Under this method value of business is computed by multiplying 2.2727 times the owner benefit.

Rule of Thumb Methods

This is quick and dirty methods based on industry averages that help give a starting point for the valuation. While not popular with financial analysts, this is an easy way to get a ballpark on what your business might be worth. Many industry organisations provide rule of thumb methods for businesses in their industry.

Tangible Assets (Balance Sheet) Method

This method is often used for businesses that are losing money. The value of the business is based essentially on what the current assets of the business are worth.

Value of Specific Intangible Assets

This method is useful when there are specific intangible assets that come with a business that are highly valuable to the buyer.

For example, a customer base would be valuable to an insurance or advertising agency. The value of the business is based on how much it would have cost the buyer to generate this intangible asset themselves.

Sales Agreement

The sales agreement is the key document in buying the business assets or the stockof a corporation. It is important to make sure the agreement is accurate and contains all of the terms of the purchase. It would be a good idea to have a lawyer review this document. It is in this agreement that everything should be defined that the buyer intent to purchase of the business, assets, customer lists, intellectual property and goodwill.

The following is a checklist of items that should be addressed in the agreement:

- Names of Seller, Buyer and Business
- Background information
- Assets being sold
- Purchase price and Allocation of Assets
- Covenant Not to Compete
- Any adjustments to be made
- The Terms of the Agreement and payment terms
- List of inventory included in the sale
- Any representation and warranties of the seller
- Any representation and warranties of the buyer
- Determination as to the access to any business information
- Determination as to the running of the business prior to

closing

- Contingencies
- Possibilities of having the seller continue as a consultant
- Fee - including brokers fees
- Date of closing.

Due Diligence Team

A due diligence team needs multi-discipline expertise. Finance and accounts and legal specialists are the core to be adequately supported by market analyst, environmental expert, human resource specialist and the requisite technology specialist. Hence, it is an association or consortium approach that fits the bill for this exercise. Accordingly, the lead manager for the due diligence exercise has to arrange and organise this team. However, it may be mentioned that the description of the team given should not be taken as sacrosanct as this depends on the type and nature of due diligence. For example, in case of franchisee, finance and legal experts together with a market analyst may be sufficient.

Annexure - E

OUTLINE OF APPROACHES FOLLOWED BY DIFFERENT DUE DILIGENCE PRACTITIONERS FOR VARIOUS NEEDS OF THEIR CLIENTS

I. Approach to Acquisition of Overseas Company

XYZ was engaged by two investment firms (“Client Firms”) to perform financial and operational due diligence on a Chinese manufacturer based in Zhejiang Province, China. The Client Firms were in negotiations to acquire a company to which the Chinese manufacturer was a key exclusive supplier. The Client Firms wanted to better understand the Chinese manufacturer’s financial controls, performance, and operations in order to decide whether to make the investment and at what valuation. XYZ immediately deployed a team to meet with senior management of the Chinese company and to assess the company’s operations and manufacturing capabilities. It carried out

Financial Due Diligence - XYZ addressed issues relating to the company’s accounting system, financial performance, transfer pricing, payables to suppliers, royalty payments to the current owner, etc.

Operational Due Diligence - XYZ assessed the effects of changes in raw materials pricing on the business, existing equipment and capital expenditure requirements, worker satisfaction, management quality, potential effects of sales increase on operations, etc.

XYZ’s due diligence addressed the key questions and concerns of the Client Firms and gave them the confidence to move forward and close the transaction on the best terms.

(Source: AuBridge Partners, LLC, USA)

II. Approach to Enter a New Market

XYZ advised a leading industrial chains manufacturer on selling its products into the China market. The following steps were taken in helping the Client enter the China market:

- Market Research: XYZ conducted an in-depth research on the China market for the Client's products and identified the largest buyer of these specialty chains in China.
- Relationship Building: XYZ visited the potential customer to better understand its product specifications and to establish confidence and interest in cooperating with the Client. XYZ then hosted a meeting in China between the Client and Chinese customer to further build a good relationship between the two parties.
- Production Due Diligence: XYZ arranged a visit by the Chinese customer to the Client's factory to assess its products and production capabilities.
- Contract Negotiations: XYZ negotiated and finalized the sales contract between the Client and the Chinese customer.

XYZ helped the Client develop a distribution channel in the fastest growing market in the world for its products, despite a relatively late start as compared to its competitors. By selling to one of the largest accounts in China, the Client moved to greatly strengthen its global competitive position.

(Source: AuBridge Partners, LLC, USA)

III. Approach to Identify Manufacturing Partners

The XYZ team was engaged by a major building products and services company to identify potential Chinese manufacturing partners to serve in an OEM capacity. The Client has over 30 years of flooring experience and installations in over 30,000 new housing starts per year. The Client is one of the leading experts in the field of wood flooring and wants to leverage that knowledge into developing and marketing a "best of breed" wood-flooring offering. In January 2005, the XYZ team was retained to develop and implement the Client's product development strategy in China.

The methodology followed was:

Phase 1

The XYZ team first conducted an in-depth analysis of the China wood flooring industry by attending trade shows, visiting domestic point of sales, and speaking with current distributors of Chinese flooring products. Then pre-qualified potential partners were based on the Client's requirements for management style and capabilities and then conducted on-site due diligence and inspections of machinery, materials, production process, QA, and above all, people.

Phase 2

After working with the Client to identify the top manufacturer, XYZ team facilitated all discussions and negotiations between the Client and the Chinese manufacturer throughout the product development stage. This was the first experience working with a foreign company for both the Client and the manufacturer; thus, it was crucial that differences in language, customs, and business practices were properly managed. Over the course of 6 months, 8 new wood flooring lines were developed and approved to the satisfaction of the Client.

Phase 3

(Actually initiated in the middle of Phase 2) The XYZ team negotiated, on behalf of the Client, an Exclusive Supply Agreement for the Northern Regional territory valued at over Rs.500 million over the next 6 years. The XYZ team was able to balance the manufacturer's immediate needs for cash flow with the Client's goal of investing gradually.

The XYZ team has developed a cross-border supply chain for products within the fastest growing wood flooring category by bridging an up-and-coming Chinese wood manufacturer with the right skills and technologies with a leading wood flooring expert who has established distribution channels and marketing know-how.

(Source: AuBridge Partners, LLC, USA)

IV. Approach to Acquisition of Competitor's Retail NetworkThe Issue

The client company was considering the acquisition of a competitor's network of 10depots and 350 petrol retail stations, spread across five countries in East Africa. ABC was engaged to provide the financial due diligence when it was realised that no one was overseeing environmental, health and safety issues.

The Approach

From the project base in New Delhi, ABC:

- Managed an environmental, health and safety and physical asset due diligence of the network. This began with visits to five data rooms, one in each of the target's operating territories, to review available HSE-related information.
- Worked with the client company to modify one of its network site risk assessment tools, making it relevant to the deal context.
- Then applied this tool to the target network.
- Mobilised, during a four-week period, five teams to undertake site visits to over 100 destinations.
- Simultaneously managed the sub-contracting and delivery of intrusive investigations at 20 of the sites to investigate the presence of suspected contamination. This work formed the basis of statistically robust estimates of the level of contamination-related financial liability likely to be associated with the target's network.

The Outcome

The results included the following:

- Identification of a likely Rs.100 million of contamination-related liability in a report produced in time for price negotiations between the client and the target;

- Providing further client support with direct visual evidence of site contamination to counter the target's claims that its sites were essentially clean. ABC understood that these contributions materially affected the sale price in favour of the client company.

The work also equipped the client company with an action plan to effect early improvements to the network, by identifying sites where contamination clean-up was necessary and where early asset replacement, principally underground storage tanks, would avoid future contamination and product loss.

(Source: PwC, UK)

V. Approach to Due Diligence

When PQR handles the detailed analysis and, if necessary, management of difficult situations, credit issues are resolved before they threaten the survival of a company. Increasingly, stakeholders seek the help to ensure their own analysis is comprehensive and validated by an independent source and to build consensus for strategies that maximise value.

PQR's approach is disciplined, predictable, proven and effective. Once PQR has a clear understanding of the engagement and the desired outcome, the issues behind severe business problems are identified and financial models are used to integrate income statement, balance sheet and cash flow projections.

Using the experience, analysis and expertise, PQR developed a realistic plan of action that includes restructuring debt and identification of opportunities to rationalise operations or refocus the business. PQR gains the confidence of company management, which increases their willingness to modify their plan and its implementation. Throughout the process, PQR maintains an active and open dialogue with creditors and company management to build consensus and make sure all parties have a clear understanding of the facts.

When a company is in crisis, the one asset almost as scarce as cash is time. And a response that respects the value of both - in the form of knowledge, experience and a proven methodology - makes the difference between failure and recovery.With each engagement, PQR works quickly to identify problems, then Analyse, Stabilise, Advocate, Implement and Improve - each process laying the foundation for the next. Using this focused approach as a tool, PQR is able to weigh the variables and make difficult and time-sensitive decisions with confidence.

Analyse

PQR constructs a detailed, comprehensive analysis that examines fixed and variable costs, product line and operating unit performance, operating expense structure, asset performance and operational and financial restructuring options.

Stabilise

Establishing trust and confidence, PQR works with management, lenders and other creditors to prevent any actions that could threaten stability and endanger the recovery process.

Advocate

PQR is the catalyst for understanding and accepting the course of action embodied in the recovery plan. Good communication and cooperation among all constituencies are vital for moving the plan forward.

Implement

Marshaling the internal and external resources required to solve operating and financial problems, PQR motivates all levels of management, labour, creditors and shareholders to work toward successful recovery.

Improve

PQR develops and institutes process and performance improvements that increase profits, enhance corporate value and bring the enterprise to a new level of competitiveness - even excellence. Based on the overall approach described above, PQR undertakes financial and operational review and assesses business/ turnaround strategy as indicated below.

Financial and Operational Review

PQR reviews a company's historical financial performance against its financial projections to develop an assessment of the business plan and its risks. The operations are reviewed to assess potential areas for improvement and capabilities to achieve the projected financial performance. PQR assesses potential cash needs and profitability, at the level of detail that provides the clearest support for the desired results.

Business/Turnaround Strategy Assessment

Drawing on the knowledge of the needs of lenders, creditors and investors, PQR uses a straightforward, predictable process to deliver results.

PQR determines the outcome through examination of how achievable the proposed turnaround strategy or business plan is in relation to current market conditions and other operational issues.

PQR evaluates management's ability to implement the proposed strategy and plan.

PQR investigates into the interests and the position of other stakeholders(creditors, suppliers, minority shareholders, key employees and customers) todetermine potential risks in achieving the proposed plan.

Also, PQR identifies changes to the strategy and its implementation, as well as its proposed capital structure that would minimise execution risks in achieving the desired outcome.

Chapter 8

(Source: Corporate Revitalization Partners, LLC, and USA).

Summary

Due diligence is the process of obtaining sufficient reliable information about the proposed acquisition to help to uncover any fact, circumstance or set of conditions that would have a reasonable likelihood of influencing the offer or decision to acquire the business.

The internally-generated information obtained during the due diligence process will help to:

- Verify seller representations
- Assist in the determination of value (assets and liabilities)
- Uncover problems, issues and concerns (current and future)
- Gain a better understanding of the business and industry, key customers, trends and regulatory requirements
- Evaluate management and key employees.

The externally generated information will focus on:

- Public information regarding the company, its principals and key employees, key customers
- Market research to gain a better understanding of the dynamics of the marketplace.

Many buyers of small businesses do not conduct any due diligence or conduct an insufficient amount of this examination because they feel the amount of the purchase price does not justify their time and effort, as well as, the cost of the professionals they might engage. Some buyers feel they lack the knowledge of howto conduct a due diligence investigation. They are not sure about what to look for or where to look.

If the buyer is not sure how to effectively conduct a due diligence investigation, it is advisable that he seeks help of experts in the field. The cost of the investigation should be balanced against the total risk exposure, both now and in the future. Just because the purchase price is small or the seller is offering lucrative terms does not mean that the risk exposure cannot be large. An undiscovered contingent or pending liability could wipe out the total investment not to mention the psychological suffering it can cause. A legal remedy could be costly and time- consuming.

The nature, scope and timing of the due diligence investigation will depend on many factors. Among the more prominent factors are the price of the deal, the perceived risk, the urgency of consummating the deal (buyer or seller) and the cooperation of the seller.

Before getting bogged down in the detail of the due diligence investigation a preliminary investigation should be conducted that would focus on:

- Getting a comfort feeling about those significant factors that make the opportunity attractive to the buyer or investor
- The business practices, values and reputation of the company to be acquired are consistent with the acquisitioning company's approach to doing business
- Changing a company's way of doing business or trying to improve its reputation can be time consuming and costly
- An indication of price and terms (the following can all be used as a preliminary guideline before engaging in a more sophisticated valuation)
- Industry "rule of thumb" - basic return on investment calculations (price/earnings)
- Cash flow.

Once this preliminary investigation is completed the next step will be to decide whether or not the deal is worth pursuing.

Final tips for conducting a successful due diligence investigation are:

- Professional judgment and experience is critical.
- If you are lacking in certain areas get help.
- Use a questionnaire to help guide the investigation.
- Document the findings of the investigation.
- Be aware of how the nature of the information impacts - its reliability, internal versus external, how and from whom it is obtained, is it independently verifiable
- Be on the lookout for inconsistencies in verbal representations or information that are either individually or cumulatively material.
- Ask open-ended questions rather than asking for the confirmation of a fact, and ask a question that leads you to the same answer.
- Remember that in many instances past behavior can be a good predictor of future performance; this can be crucial in evaluating management's and employee's values, practices and performance.

Due diligence may not and probably will not uncover fraud or a conspiracy to commit fraud. The seller should always be required to sign a representation letter prior to closing the deal.

POSITIVE - confirming all the representations the seller has made

NEGATIVE - no known facts or circumstances that would affect the decision to buy the company under the terms and conditions agreed upon.

Also, it is important to note that from the seller's side, it is necessary to enquire into the buyer's financial strength, business practices, and market reputation and over and above the sincerity of intention to acquire or invest. This is called for so as to ensure that the efforts for the deal do not go in vain for any deficiencies of the buyer that was not known earlier. Moreover, it provides the seller an idea of whether the business that is build up does not go to hands of those that are not competent to carry on the business or the intention for acquisition is totally different. Besides, from the employees' perspective, it facilitates to assess the change contemplated following the acquisition or merger.

Appendix-I

Open House Discussion with Sample Questions and Answers

Introduction

The analysis of financial statements is important for many reasons, and for those people who routinely check the pulse of their companies; many of these reasons are obvious. But when the analysis relates to the acquisition of, or investment in, a new business, most investors will agree that numbers alone are entirely inadequate.

Financial statements provide thumbnail sketches of a business and its history, supplying a few clues and insights into the company's present, and may possibly offer a reasonable guess about its near-term future. But general and specific conditions and events relating to the business's future, and the ramifications of past events and conditions, will determine its eventual success or failure. Using only past results to forecast the future is folly.

Financial statements do not tell about some of the most critical factors that impact businesses, such as management competence and continuity, market trends, production capability, quality, potential litigation, employee turnover, the status of supplier contracts and a host of other items. These "non-financial" factors, more often than not, determine the future structure and viability of a company. For this reason, potential investors must care fully study these factors during the due diligence phase, before a final agreement is reached.

Planning Due Diligence

Due diligence is one of the procedures that is used to study, investigate and evaluate a business opportunity. It normally occurs after the parties to a deal have decided the deal is financially feasible and after a preliminary understanding has been reached (or appears reachable), but before a binding contract is signed.

The term came into common business usage during the 1980s. While the term is new, the activity itself is not. Studying and investigating before buying and investing is as old as trading itself. While the term was originally used in the context of studying a potential acquisition or merger, it has been broadened to cover the study of almost all business transactions, including the issuance of securities and private placements, real estate sales, appraisals and commercial lending.

Due diligence can be accomplished successfully if it is preceded by careful planning. Such planning includes the assessment of available resources, theestimation of risk, selection of management, the recognition of the consequences of failure, the identification of possible obstacles to the deal, the definition of the deal's scope—all of which lead to the crucial decisions essential to produce the results one wants to achieve. All of these major planning elements are essential and must be included in the planning process. Establishing clear objectives is of highest priority. To proceed without them would be like setting out on a trip to an unknown destination.

The objectives and results one hopes to attain must be equated with the number of people and the amount of money one has. The scope of the due diligence is also influenced by other resources one has and by the level of risk one will accept. There will always be some risk, but how much there actually is should be carefully assessed.

Conducting Due Diligence

Investors must be objective, able to maintain an open mind and avoid premature conclusions and yet react quickly to significant adverse information. There is no point in continuing a due diligence programme once defects of a"deal killer" magnitude arise. The most common evidence of a biased mind-set at one extreme is to be awed by a management that seems all virtuous, rarely makes bad decisions, is highly efficient and has total concern for the employees and shareholders. If prominent people or celebrities are involved in the business or promoting the transaction, due diligence investigators should be even more wary and not attribute to the business virtues that do not exist.

An opportunity to acquire a long-coveted business can place blinders on the potential investor. It can be equally erroneous to start with an assumption that the management is evil, solely-concerned with short-term personal enrichment and has survived in spite of itself. A Pollyanna view of looking only at the positive aspects of a business is as much indicative of a closed mind as exclusively concentrating on defects, characterised by the attitude of, “We are going to find out what is wrong with it.”

An objective approach free from ill-conceived prejudices, one that quantifies defects, can result in a rational evaluation of the business. Those involvedin due diligence soon learn that more often than not what first appears to be a major problem or defect can be explained. Or there maybe solutions under way and the problem is of lesser magnitude than first believed. An alarming first impression should only dictate that more studyis necessary before conclusions are drawn. However, when critical problems arise, or the full dimensions of others known or suspected are revealed, the investor should reassess his/her position and might even want to suspend further due diligence.

Constructing the Checklist

Once an investor decides to seriously consider a business opportunity, a list of information and documents that eventually may be required should be compiled. It should contain all essential data yet avoid the superfluous. Such a large quantity of information on so many subjects is needed that an effort must be made to circumvent matters of little importance or those that are irrelevant. Superfluous data will overburden, confuse, delay and distract analysts already confronted with a voluminous amount of data.

Overly burdensome demands for information could jeopardise the potential transaction by antagonizing a seller or whoever provides the data. As a result, the belief that the more information one has about a business, the more likely a shrewd investment decision will result, is not always true. The objective of data collection is to obtain enough information to make an informed business decision. No precise definition exists as to what is sufficient," but the following questions can help develop the questionnaire:

- Is the information necessary to understand the business?
- Is it necessary for negotiations and to write the contracts to conclude the deal?
- If the information is not requested now, will it be needed at a later date?
- Could mistakes be avoided by obtaining the information?
- Is the information necessary to affect a smooth transition and for those managing the investment to be effective?
- Since it's impossible to predict which subject or document will prove to be of great importance, it is better to include a subject than to delete it.

A due diligence checklist is a memory crutch on a grand scale; it records answers and identifies what is missing.

Due Diligence from a Legal Perspective

"Due diligence" will be involved in almost every type of business transaction and all business persons, including the professionals representing them or otherwise involved in the transaction, should be interested and concerned about conducting proper due diligence. Proper due diligence rewards a cautious person and increases the opportunity to avoid a problem situation. Failure to conduct proper due diligence could lead to other implications, such as liability to third parties or criminal liability. Attorneys, accountants, broker/ dealers, appraisers and other professionals may also find themselves being sued by their clients or by third parties asserting the failure to have conducted proper due diligence.

By being alert to the need for due diligence and focusing on the proper issues at the beginning of any transaction, a person can avoid a bad business transaction or unwanted liability. For example, early due diligencein a business acquisition may alert the purchaser to the need to structure the transaction in such a way as to avoid unassumed liabilities. Proper due diligence may also serve as a legal defence to third-party claims aftera transaction closes. Finally, part of the due diligence process in many transactions includes the drafting of contracts and other documents (suchas acquisition agreements and loan documents) that contain appropriate representations and warranties that elicit information and identify and address the transaction's risks. The information obtained from proper due diligence will also be critical to negotiating the terms of a business deal.

Business Description and Basic Information

The business description and basic information enumerated in the checklist constitutes the core reports, documents and data necessary to commence due diligence investigations. Financial reports are important, but at this stage additional information on the organisation's structure and the participants is essential. A primary objective of due diligence is to verify, analyse and distill basic information initially accepted at face value. After all, it was this temporary acceptance that spurred some interest or type of agreement to justify the cost of proceeding. It should be an adequate framework within which to plan the due diligence programme.

An overview of the business gained from the basic information enables an investorto plan the due diligence. Planning will be impossible without some general knowledge of the business, its structure and names and responsibilities of the participants. Without this information, the programme's scope cannot be estimated, assignments made or realistic time schedules developed. Requests for data will be misdirected or irrelevant and result in excessive expense, and needlessly antagonise those interrogated. An objective always should be expeditious completion, something that can only be achieved with intelligent preparation. At this stage, the majority of the basic information for planning the entire due diligence process is probably in the investor's possession.

During the analysis, one should record the time period of the study and the dates and source of documents and information received. Since any business is a moving target, the study is little more than a photograph of a specific time in its history. Business investments usually take considerable time, even when all goes well. The parties may also find agreement impossible or may agree to delay negotiations.

Critical Early Questions

The responses to questions or topics in the checklist and the initial questions the checklist should provide an investor with a comprehensive but not complete understanding of the business.

The ramifications and costs of due diligence require that priority be given to questions, data and analysis most likely to affect an investor's final decision. The answers and analysis may inspire greater interest in the investment's potential, trigger in-depth studies of problem areas or constitute "deal killers" that cause the investor to back out.

Top priority must be given to a dispassionate evaluation of management, since the success or failure of any business is primarily a function of management. The evaluation should include key executives who have managed or had a major influence on the business during the past five years. They are responsible for the business's current condition. However, the most important executives requiring intense evaluation are those responsible today and in the future. The investor should devote the time necessary and use whatever proven techniques are available to reach valid conclusions. Simultaneously, replacements for existing or anticipated management vacancies must be identified and evaluated.

Management evaluations are both objective and subjective. Announced terminations to retire or take other positions, serious health problems, education and the performance of the business managed are objective factors. Actual results and identifiable accomplishments are of paramount importance. Personality characteristics, management skills, creativity, leadership ability and a myriad of other traits involve subjective evaluations.

Capital Structure and Ownership

A basic part of any due diligence programme is to determine how the business is legally and financially structured and who owns each unit. An investor must know what he is buying, whom he is buying it from and who makes the key decisions. This should be confirmed for each legal entity under consideration, including subsidiaries, joint ventures, partnerships and other business entities. The legal structures may be simple and uncomplicated or complex with multiple classes of securities and debt instruments, each of which has its own rights and obligations. Ownership may be obvious or intricate, difficult to determine and in some cases mysterious.

There are two appropriate, revealing follow-up questions relative to structure and ownership issues: why and/or how. Insight can be gained by probing to learn the factors, rationale or chance events that led to current conditions. For example, why is this a corporation rather than a limited partnership? Why are 20 million equity sharesof stock authorised and only 1 million issued? Why were preferential rights granted to the share holders? How many shares were acquired for the employee stock ownership plan (ESOP) and why not more or less? By asking such “how” or “why” follow-up questions, the investigator will pursue information in greater depth.

Questions on the legal structure, ownership and control should come early in the due diligence process, since serious issues may emerge requiring resolutions beforea deal can proceed. A buy-sell agreement may emerge. A major shareholder may notbe committed to the deal. Conversion rights could exist that make the transaction impractical.

For every business, documents describing the legal structure should exist and must be located and reviewed.

Management

Management built the business, operates the business today, and will manage the business in the future. These simple truths should be foremost in the mind of any investor. Due diligence activity relative to management consists primarily of identification of executives and professionals in positions of substantial responsibility, determining their total compensation and associated expenses and, most importantly, evaluating their competence and potential. Current and anticipated vacancies must also be identified.

Management is usually viewed as a group or team, but any study will focus on individual members and team vacancies. The future role for each member of the current team will require decisions after review of their responsibilities, estimates of potential and, not to be overlooked, and the individual's wishes. No due diligence should be considered complete or adequate without personal interviews.

Identification of key management members is a critical first step, but not always a simple one. Officers may not be key employees and key employees may not be officers, because job titles can be misleading. Some companies have both a chairman of the board and a president with either one Chief Executive Officer or the other's job poorly defined. Some businesses have few officers, while in others, such as financial institutions; there may be a large number. Key employees who are not officers, such as managers of important divisions, may have greater responsibility than all officers other than the president. There may be executives with officers' titles who are not formally elected officers, such as division presidents. Compensation may not always indicate importance to the business, since shareholdings, age, former positions and relationships influence compensation. Formal job descriptions cannot be relied upon to learn the true nature of an executive's job. The diversity is so great among businesses that all factors must be considered to sort out the management team.

Products and Services

Comprehensive due diligence requires gauging the importance of products and services to the business. Public perceptions and initial impressions often deviate from reality because many businesses are best known for activity representing only a small fraction of their total business. Extensive promotion of new products thought to have great potential catches the public eye but today may have minimal revenues or serious quality problems. A business may have a famous name, but the products or services that brought the name into prominence may have long since been replaced. Use of trade names and private label manufacturing contributes to misconceptions. Actual amounts and proportions of sales revenues and operating profits for each product line within a business may prove to be a surprise.

Product line operating income is rarely in direct proportion to sales revenues. What constitutes a product line or category of service will be defined by the business, its organisational structure and its accounting system. The more detailed the breakdown by product segment, the more valuable the information to an investor. However, the existing accounting system that tends to track the organisational structure will largely determine the product breakdown possible. In many businesses this is sales revenue without calculation of separate operating profits. At some point the cost of calculating profits for each small segment of a business, plus the uncertainty caused by the subjective nature of overhead allocations, discourages detailed accounting. The result can be highly profitable or very unprofitable product lines or product line segments concealed in a broad financial report. An investor will likely have to accept whatever product or service break downs are contained in the financial statement.

R&D and Technology

Research and Development (R&D) is usually defined as: "Research and development arising from laboratory or experimental procedures. It includes the cost of developing, or improving a product, a formula, an invention,a plant process, an experimental or pilot model, or something similar. It also includes the cost of any research or experimental work carried on for the organisation by someone else (such as research institute, foundation, engineering company or similar contractor).

However, the terms R&D, research, development and design may have working definitions that vary from business to business. An understanding of how management defines the terms will avoid confusion during the due diligence study.

To evaluate the R&D effort, the historical and forecast costs should be equated with results, both actual and anticipated. “Results” are commercially profitable products or services. Projected costs to complete R&D projects in progress and the quantity and quality of proposals for new R&D projects should be part of the study. Evaluation may be difficult and require a team of technical, marketing and financial people to ask pertinent questions and comprehend the responses.

R&D, by its very nature, represents the hopes and commitments of individuals and the business with the stakes very high. Since success or failure of R&D projects can easily influence careers, it is understandable that overly optimistic comments may abound from those involved. Identify early the accounts in the financial statements recording R&D expenses.

Real Estate and Facilities

There are four general categories of real estate due diligence subjects: description and location, environmental, financial issues relative to costs and values and operational involving adequacy and continued availability. Unfortunately, opportunities for erroneous, misleading or withheld information, often totally unintentional, regularly occur to confuse or mislead an investor. Book values may have little relationship to true market value, which may in turn have little correlation with appraised values, whether tax, contemporary or anecdotal estimates. Known or unknown title defects may exist. Old photographs or descriptions may describe younger days rather than present conditions.

Facilities may be underutilised, creating unwanted expenses, or be inefficiently crowded, necessitating a costly relocation or expansion. Additionally, leases may expire, forcing an unwanted move, or long-term leases may be a burden or of debatable value.

A visit to each facility and review of ownership or lease documents is highly desirable. Visits confirm prior information; provide information on maintenance upkeep, general condition of facilities, housekeeping, safety, type of neighborhood, appearance of employees and level of utilisation. Leases, deeds, title insurance, contracts for leasehold improvements and other documents relating to real estate must be located and reviewed for defects and unusual provisions, and to verify basic information.

One business's real estate activity may be static with few past changes and none anticipated. But for others, there are constant requirements to sell existing and/or lease or build new space. Due diligence should not only identify the activity but evaluate the causes or need for each sale or new facility. The causes may reveal or confirm information about the business previously unknown or only suspected. The importance of any real estate for sale is a function of the size of the sale in relation to the business's size.

Markets, Competition and Customers

Due diligence must define markets, competition and customers. They are typical of many nebulous and imprecise terms brandished about in business that create confusion and misunderstanding. The "market" for a specific business may be proscribed by geographical, pricing, service or other limiting factors. "Competitors" include not only today's competition but also those who could enter the market in the future. Pricing changes, influenced by transportation costs or other forms of overhead, could generate new competitors. Investors also must determine how many "customers" are one time, not repeat, buyers and decide whether potential customers, those with a need but no financial resources, should be defined in the market.

Gauging the size of a business's potential market should not be hard. Management will have some facts, estimates, opinions and possibly even detailed information. Trade publications are an excellent source of data for only the cost of a subscription, and various government agencies, security analysts, industry associations, utilities, chambers of commerce, Yellow Pages, economic development agencies and private research groups can produce market studies. Many of the publications and studies will identify both competitors and customers, and the quantity of such reports available usually makes it unnecessary to commission expensive market studies. Reviewing customer lists and identifying individuals and businesses similar to those being served can ascertain exactly who the market's customers are. For some businesses it is possible to identify all existing and potential customers and accurately determine the total market.

Census and demographic data will be helpful in identifying trends and market size.

It is absolutely essential for investors to understand markets, both their size and their customers, to understand a business. Without such information an investor cannot evaluate the present marketing scheme or estimate the business's potential.

Marketing

Marketing is a term used to describe a broad range of activities associated with the sale of a business's products and services. Sales planning and strategy, pricing, staffing, distribution, financing and advertising are all major functions that fall under the general category of marketing. A financial review of marketing in which marketing or selling expense is solely equated to results in the form of sales will be inadequate. However, an overall review of marketing activity without equating cost to results will be equally frivolous.

Understanding and evaluating a marketing programme is both an objective and subjective task in which all factors need to be considered to produce a balanced judgment. Since marketing is an activity for which there may be more than one approach, differences of opinion are common and they complicate evaluations. It is easy to be enthusiastic or critical of what has or has not been accomplished, but no one knows with certainty what sales might have resulted with a different approach.

The level of marketing expense is a fundamental management decision. Whether the programme is adequately, under- or over funded are questions managements continually ponder and are basic to due diligence. There are other important questions: If the business sold more, could it finance, produce and deliver more? How can marketing be improved? Is the present programme adequate or merely a good foundation upon which to build? A business must establish a system for customers or clients to obtain information and enter into contracts or place orders. This may be as simple as a customer talking with a sole proprietor or as complex as an international sales programme involving multiple methods of distribution and hundreds of individuals. The investor should learn how the selling of the business's products or services is accomplished.

Pricing

Due diligence objectives are to analyse all factors affecting pricing, the existence of improprieties and hidden liabilities and, most important, to gather sufficient information to decide if pricing is maximising profits. Pricing directly affects profitability; so pricing improvements may be one of the quickest ways to increase profits.

An investor should understand the pricing philosophy, the method of setting prices and the factors influencing prices. Pricing improprieties and errors are an unpleasant reality that occurs with sufficient frequency that their possible existence cannot be ignored. For each product or service line, pricing should be reviewed separately, because variations can occur regardless of broad corporate policies. Formal pricing policies may clearly set forth the overall pricing philosophy used in setting prices. Such policies tend to be guidelines from which deviations are not permitted without the approval of a senior executive. If written policies exist, copies should be requested. While policies typically are unwritten, they usually are understood within the business. Whether written or unwritten, the pricing approach and policies are as basic information as the business's name and address.

Regardless of pricing philosophy, policies and management statements, it is important to understand and verify precisely how prices are established. There maybe large variations between policy and reality. Understanding the nuances can be achieved by obtaining current price lists, recently accepted quotations, or prices marked on merchandise, and then questioning in detail how the prices originated. Were they a fixed percent over cost or based on competition? What was believed tobe the most a customer would pay? Were prices simply pulled out of the air? After determining how actual prices are established, a comparison can be made between prices received and those on price lists or quotations.

Advertising and Public Relations

Except for businesses with substantial advertising and public relations expenditures, most investors limit the due diligence efforts on these activities. Dealkilling problems and perils are improbable, but knowledge of the functions willbe useful in planning a transition if acquisition occurs. Since the functions are not precisely defined and do overlap, it is usually wise to study both simultaneously.

Wide variances exist between industries and businesses within industries in the extent and use of advertising and public relations. For smaller businesses, expenditures are minimal, but as businesses grow or try to grow, advertising and public relations become more prevalent. In medium-sized businesses, both advertising and public relations often are combined. In larger businesses, advertising and public relations tend to eventually separate into independent functions.

Advertising is primarily concerned with promoting the sale of products and services, preparing literature, brochures, advertisements and buying media time or space, while public relations seeks publicity through news releases, lobbying and events. Public relations are more concerned with promoting the overall image of the business, government relations, its securities and often its key executives. Public relations informs the public of what the business wants the public to know and tries to cast in the best light whatever it wishes the public to know.

Budgets for the current year and actual expenditures for the last fiscal year indicate the extent of the advertising and public relations programmes and may identify projects and programmes. Information on specific activities and programmes can then be requested for evaluation. Any measures that the business may have of its advertising effectiveness should also be requested. A list of employees and their specific functions will clarify responsibilities.

Purchasing

Purchasing decisions spur broad due diligence questions. Is the function well managed with adequate controls? Does it have the authority and status to be effective? Does it contribute to business success with aggressive buying and by providing a source of intelligence for the entire business? Or is it simply a neglected arm and possibly a centre of conflict of interest and corruption? The importance and stature of purchasing may be evident in the existence of procedural controls and the placement of purchasing executives at senior levels. Regardless of its status, purchasing should be closely reviewed during due diligence, as every rupees saved in purchasing becomes a rupee of pretax income.

The role and impact of purchasing may be large and not limited to selection and evaluation of suppliers, negotiations, placing and expediting orders. It can be a conduit of information to the organisation on what is available from suppliers. It also can identify supply alternatives and be a valuable source of intelligence on competitors, industry trends and practices. Purchasing establishes controls so orders are precisely written and entered into the financial reporting system. Purchasing monitors and, when necessary, pressures suppliers to meet delivery dates and grant price concessions.

Purchasing does have a dark side because of the opportunities and temptations for personal enrichment. Few employees are entrusted with the business's money like those in purchasing and no other function has the breadth of opportunity for dishonesty. It ranges from the secretary buying personal items from the petty cash fund, to a clerk typing fictitious invoices, to the chief executive officer receiving kickbacks. Entertainment, gifts, kickbacks, conflicts of interest and fictitious purchases can and do happen. Due diligence investigators should be alert to any indication of misplaced trust.

Human Resources

A thorough knowledge of employees, employee costs, employee relations and commitments to current and former employees is an essential part of any due diligence programme.

An investor should know the total number of employees as well as the number in each category and at each location. This information provides another measure of the size and importance of each segment of the business. Careful attention shouldbe given to defining the employment relationship for all individuals providing regular services to the business, including those on a contractual basis. Seasonal factors must also be considered when applicable.

The number of job openings, the length of time each has been open and the circumstances creating the vacancies and any recruiting problems should be reviewed. It might be that no one is available to fill the positions, that compensation is too low, working conditions unsatisfactory, the job specifications unreasonably high, or the business is ineffective at recruiting. Basic questions for an investor are whether a shortage of employees at any level is adversely affecting the business and what corrective measures are possible. If personnel are not available locally, could they be recruited from other areas? Is subcontracting a partial solution? If the condition does not improve, must relocation be considered? Is the shortage temporary or has it been a chronic problem? Is it possible to quantify how seriously the business has been hurt by the shortages?

Management vacancies and the recruiting and selection methods deserve special attention. The philosophy and attitude of the board of directors and chief executive officer may be reflected in the selection procedures.

Employee Compensation and Benefits

Employee compensation and benefits, for most businesses, constitute a substantial expense that is burdensome but not crushing. However, for some the costs are so great they cannot remain viable without change. In others, unless wages and benefits are increased to attract and hold employees, the business cannot grow or survive. Due diligence should review actual compensation and benefits and causative factors such as competition, affordability, government regulations, customs, employee demands, levels necessary to recruit and retain employees and industry standards. Knowledge of these key factors is particularly important if the investment results in a merger necessitating the integration of operations and work forces. Care should be given to understand and evaluate both current and future costs, because present benefits and commitments for future benefits may not be reflected in financial statements. The lack of disclosure and understanding of future benefit costs is one of the most important areas for due diligence investigation. While reviewing the financial implications, investigators should be alert for compliance with central and state laws and regulations governing benefit plans.

If retirement plans exist, what are their costs and the method and adequacy of funding? What current contributions are required under the plans and are these being made on a timely basis? There is a strong trend away from defined benefit pension plans, but thousands exist with large liabilities. “Unfunded past service liability” is the amount not paid into a fund actuarially adequate to pay for promised future benefits. The unfunded past service liability can be of such magnitude that a business’s ability to ever fund the benefits may be in question. Investigate to learn if these liabilities are fully disclosed in the financial statements and whether practical measures can be taken to fund or reduce the liability.

Corporate Culture

Business deals all too frequently fail because differences in corporate cultures prevent the parties from understanding, accepting, reconciling or compromising. Unfortunately, cultural clashes are usually less a barrier to completing a deal thanto success after the deal closes, because investors tend to minimise or ignore differences during due diligence.

Cultural factors may exist because of chance but more likely because individuals in power are convinced they are the right things for the business. The factors become deeply ingrained and difficult to modify. Naive beliefs that cultural differences are interesting but insignificant or can easily be changed have caused many investorsto regret the day of their involvement. Cultural clashes are most severe when a business is acquired with a very different culture from the investor, who promptly attempts to revise practices to conform to his convictions or methods. However, if cultural practices have been clearly detrimental to the business, such as oppressive management styles, dishonest or rapacious marketing, excessive political activity and discriminatory employee selection practices, their elimination may have a liberation effect highly beneficial to the business.

Business culture is composed of numerous factors, both obvious and subtle, that have varying degrees of importance. Importance is partially a function of how long a practice has been in existence and if entrenched, fully accepted and expected to continue. Practices and conditions are far more significant when carried to extremes, as would be an authoritarian structure where all decisions are made by the chief executive officer, or a work force that is nearly all one religion or race. Common components of business culture are level of centralisation of authority; relative independence of business units; management approach to employee relations including paternalism, fads, compensation and dress codes; community involvement and the likes.

Legal

Most due diligence issues could conceivably be categorised under the heading “legal” because they directly relate to the compliance or non-compliance with laws. Of particular concern to any investor is whether the business is involved in litigation, and whether as a defendant or as a plaintiff. Similarly, an investor will need to know if the business is under investigation by any governmental agency, if it is subject to fines or penalties, or whether the government, has prohibited it by court order, or by agreement, from engaging in any activities. In addition, the investor will want to probe whether the business’s operations meet all legal and regulatory requirements.

An investor does not want to invest in a company that, shortly after closing, will be fined millions of rupees by a government agency or subject to a court verdict. In fashioning legal questions, the investor will find helpful the assistance of a lawyer to ensure that all aspects of the business’s operations are adequately investigated. As with other due diligence questions, legal questions should be coordinated with the representations and warranties in the transaction document. In addition, although these questions may be termed “legal” in nature, the investor’s financial and operational people, as well as the lawyers, should carefully review the results.

At the heart of the legal due diligence is a review of pending or prospective litigation. The investor will want to review any lawsuits involving the business. Not only might the business be liable for the underlying claim, but also even if the claim is without merit, the business will incur litigation costs. The lawsuits or claims may also indicate a foreboding trend in the business or its industry. The investor should, at a minimum, request the name of the case; the court where the suit is filed; a description of the general nature of the case; the amount sought; the status of the case; and the likely outcome.

Information Systems

Most information obtained during a due diligence review of a business’s information systems will be utilised after the investment is completed rather than to decide whether to invest. This will be particularly true if integration of the business’s and the investor’s systems is contemplated.

Knowledge of the present state of the systems is essential to decide what further additions or improvements are needed and economically justified. However, there are a few broad questions that could affect the investment decision. Are the systems compatible with the investor’s? Can the software licences be readily transferred to a new owner? Are the present systems inadequate or obsolete and in need of large capital expenditures? Specific questions regarding the nature, effectiveness, costsof systems, compatibility of systems, proper licensing and future programmes should help answer the broad questions for an investor.

Information systems include communications of all types. While computer technology changes at a rapid rate, the entire field of communications is changing equally fast. Whatever is the state of the art in both technologies, all agree today's technology will soon be obsolete and therefore will complicate any due diligence evaluation.

The first step is to find out what hardware and software is used, what systems they support and what information are provided. An inventory of all systems, records and reports provided through the use of computers and associated electronic equipment will indicate the end product. A second inventory of all hardware, computers, peripherals and software will indicate the type of equipment and software used to provide the systems and reports in the first inventory. The inventories should indicate which systems are being revised or scheduled to be replaced and if any hardware is considered to be surplus either now or in the near future.

Budgeting and Planning

Planning consists of studies, recommendations and decisions as to what products, services and industries the business should be in and what direction it should take. Planning involves establishing an overall philosophy, plan and objectives for the business, while in budgeting, pro forma financial statements are created to forecast, monitor and control existing business units. The financial statements normally reflect anticipated revenues, expense levels and approved capital expenditures. Most budgets have monthly financial statements for the first year and then quarterly or longer periods for future years.

In large corporations, planning and budgeting tend to be segregated into two distinct functions. In medium-size businesses, planning and budgeting often merge, with the chief executive officer or chief finance officer assuming more of the planning function with budgeting folded into the responsibility of the controller or some other financial executive. In small businesses, neither function may formally exist, with planning remaining in the head of an owner consumed with day-to-day operations, and budgeting considered unnecessary.

A primary due diligence should target copies of existing budgets and plans. No documents other than financial statements will be more informative. A comparison of prior years to actual results will provide insight into management's competence, failures, successes and changes in direction. The latest budgets and plans will indicate current thinking and management's views of the prospects for the business. There is little uniformity among businesses and great variation exists in both format and content of plans and budgets. Both become molded to the needs of a business and the preferences or whims of those in charge. They tend to increase in size and scope each year as executives not only see areas to improve and new subjects to cover, but learn from prior failures or overlooked problem areas.

Insurance

Professional assistance is usually necessary to adequately evaluate a business's insurance coverage. For most investors, the professional will be the insurance broker providing their existing insurance, but other consultants free of conflicts of interest can be employed. It is a relatively simple matter to gather the policies, secure premium and other related information, but to fully understand the policies' terms, coverage and common risks not covered is another matter. Most businessmen have a general knowledge of the policies and costs but very limited information on specific terms, at least until a disputed claim occurs.

Evaluation of the adequacy of any insurance coverage is no longer complete with just a study comparing probable risks to the terms of the contracts. The practices of the carriers and their financial capability to pay must also be considered. Carriers are private companies and, as in any industry, there are a few who are disreputable, engage in sharp practice and have limited or no financial ability to pay losses. Even some of the larger, better-known carriers have experienced substantial losses from poor investments, underwriting or both. The well-publicised financial problems of Lloyds of London, the large number of carriers that have failed, and the shortcomings of regulatory agencies should be a warning, in every due diligence evaluation, that review of the contracts is not enough. There are several companies involved in rating insurance companies that can be a quick reference and starting point. If the business has a significant outstanding but unpaid claim, carrier evaluation will take on immediate importance. All insurance in effect is described in a contract between the carrier and the insured, and one should assume that if there is no contract or policy, there is likely to be no insurance.

Environmental Issues

A public awareness of environmental hazards has resulted in broad, complex legislation, vigorous enforcement, endless litigation and horror stories in which investors found themselves owners of environmental liabilities that often exceeded their original investment. Today, few investments involving real estate or manufacturing are completed without an extensive review of environmental risks and negotiations to establish responsibility for remedial costs of any hazards that may exist—known or unknown. While no statistics are available, anecdotal evidence indicates that more deals upon which preliminary agreements were reached were eventually terminated over environmental issues than any other. An even larger category is failed deals that never reached the preliminary agreement stage because investors learned of environmental problems.

Due diligence of environmental issues is difficult because of their complexity, nebulous and untested legislation, unreasonable and ill-considered regulations, conflicting and changing regulations, changing technology, difficulty in securing estimates of the cost of remedial measures, difficulty of proving what does not exist.

When environmental issues arise, expert opinions may be necessary to evaluate the risks. Environmental engineers evaluate the nature and extent of the problem. A lawyer specialising in environmental law may be needed. Direct meetings with regulatory agencies may be advisable. All of these activities can become time-consuming, expensive and often discouraging because of the difficulty of securing precise answers, and differing opinions from the experts.

Debt and Banking

Debt is an extraordinarily broad term that describes financial obligations that must be identified and fully understood during the due diligence study. Debt and all its conditions have variations limited only by human imagination. Timing and terms of repayment, collateral, penalties for default, guarantees and various covenants can result in debt obligations that are extremely onerous or impossible to repay and others in which the debtor can largely repay at his discretion. Due diligence of debt requires studyingthe details of the actual financial instruments. The tedious fine print cannot be ignored.

An initial step is to identify all indebtedness of the business. Debts may be owed to banks and other financial institutions, shareholders, officers, security holders, individuals, a government and anything or anyone who can be defined as a legal entity. Supporting each debt should be documentation describing the terms and conditions of the indebtedness. Since such documents are often revised or amended, care must be taken to have the complete and latest documentation.

An investor will find it helpful to develop a list summarising all debt, its terms and conditions for use in evaluating the business and planning the programme. At a minimum, the list should include the amount owed, name of lender, repayment schedule, rate of interest, restrictions on use of funds, borrowing base, collateral, prepayment provisions and guarantees. A summary list does not reduce the need to study the individual loan documents. For most businessmen, the detailed study will be a task for their attorneys and accountants.

Any bank or financial institution with which there has been or is a business relationship will have an opinion regarding the business and its management. The nature of the relationship and the opinion of the institution will largely determine the future relationship.

Investments and Cash Management

Investments are extremely variable in their nature and require separate study. An investment may have a market value higher or lower than that recorded or its original cost. Restrictions on liquidity either by contract terms, government regulations or the market's ability to absorb the investment can affect the value. The value of an investment may be instantly discernible, as would be the case with government securities, or extremely difficult to determine, as would be the case with unregistered securities in a private company that was losing money. Some investments have no present market value and cannot be sold, but there remains the possibility that value would return at some future date and under the right circumstances. The due diligence objectives for each investment are to determine present value, quality and liquidity.

Businesses invest surplus cash in nearly every manner imaginable. Each investment should be reviewed, along with the decisions and policies that led to the investment. The investor should understand the rationale for the policies, how they were developed, and how investments were selected. Also to be determined is who makes the investment decisions and what have been the results. Investors should review the business's plans for using the invested funds and determine whether any investments were improper or insider deals. Additionally, the investor will want to review the financial instruments and documentation to confirm each investment.

Loans to shareholders and executives are usually insider transactions for the benefit of the borrower and as such those investments need careful review early in the due diligence process. Their most common purposes are a means of extra compensation, a method of financing stock purchases, financing for personal residences or other executive perquisites.

Taxes

Taxes may be an unpleasant cost of doing business. They contribute nothing directly to the success of a business but indirectly make the business possible, since only the most primitive of trading could occur in the absence of government. The task during due diligence is to identify tax obligations, evaluate how well they are being met, review their impact upon competitiveness and learn the status of any disputes. Sufficient information should be gathered to determine if excessive taxes have been paid and what steps may be taken to reduce the overall tax burden without violating any laws. Businessmen can readily gather the basic information on taxes and identify obvious problem areas and subjects for further study. However, taxes may be complex, and a professional tax expert may be required to evaluate a business's tax situation. If tax savings are a possibility, an expert usually will be required. Possibly several experts will be needed because of their tendency to specialise. An expert on income tax may know little of local ad valorem taxes or state taxes and their administration, and the reverse can definitely be true. Foreign taxes require experts on a country-by-country basis and the best will most likely reside in the country involved.

The first step in the due diligence study of taxes is to identify the tax reports required. Some will be of much greater importance (such as income tax returns) than others, but any of the taxing authorities has the power to take legal action against the business for failure to file required reports and pay taxes. The legal action may be slow in coming but one can assume it will eventually happen.

A summary of activity relative to each taxing authority will help to understand the effect of taxes upon the business. Identifying the actual amounts paid or due enables a rational determination of the taxes' impact upon profits and the business's competitive position.

General Accounting Questions

There are a number of subjects, questions and issues that apply to the accounting functions and systems in an overall or general way that are not specific to a particular account such as receivables or payables. Since a major part of the due diligence process consists of understanding the financial statements, background and supplemental information are essential to comprehend and verify the statements or determine the facts.

The reliability of the financial statements should be repeatedly questioned during the due diligence investigation. Few mistakes in investing are more common than to automatically assume the financial statements are accurate in all respects. There are at least three categories of financial statements: monthly or interim reports, annual reports and reports that are part of tax returns.

Public companies must submit reports containing financial statements to SEBI. Interim monthly or quarterly reports are not audited except in public companies, where auditors priorto publication may review quarterly reports.

Monthly reports are the least reliable and tend to be used more for internal operating purposes than as a basis for investment decisions. Annual reports may or may not be audited and if audited still may not be adequate. Certainly, the audited accounts have a high degree of reliability.

Accounting Policies

A business's accounting policies and practices can have an extreme effect on the profit or loss recorded in the financial statements. In many cases a recorded profit could just as easily have been a loss with different accounting policies, or the reverse could be true. What appears to be a remarkable turnaround from losses to profitability may be due to accounting policy changes rather than brilliant management. Frequently, large one-time losses are better explained as reversionsto more conservative accounting policies or recognition of losses more properly attributed to prior years. A business's accounting policies may be precisely written and elucidated by management, but some tests are always necessary to confirm that actual practices are consistent with policies. Not all executives are willing to admit their practice is to inflate or depress income. In the due diligence process, it is important to determine the accounting approach, policies applied and if a pattern of accounting practices is used to accomplish an objective. If any practice is discoveredto either inflate or deflate income, it is highly probable a pattern of similar practices exist. An example is that a business slow to write down obsolete inventory will alsobe likely to delay recognition of bad debts.

Cash

The cash account is first on the balance sheet and first in concealed characteristics. Many investors' enthusiasm for a business has been enhanced by the presence of a large cash balance only to discover later that much of the cash is gone or inaccessible.

Conversely, investors have disparaged businesses because of a low or negative cash position only to belatedly learn the condition was temporary. Large cash balances can reflect a very temporary condition, bad management or failure to make short-term investments or funds the business is obligated to keep in cash form. A balance sheet is a financial snapshot of the business that captures the cash position on a particular day. Few accounts are subject to change so rapidly and they should be viewed accordingly during due diligence. The cash account is something of a way station for cash after it is received and before it is sent to pay creditors and investors or to be invested. When reviewing cash, there are three other accounts that should be looked at simultaneously:

- Short-term investments, where surplus cash is temporarily placed
- Receivables, from which cash is received
- And current liabilities, where cash goes.

The amounts in these accounts have to be considered and trends identified to fully understand the overall cash account .The business may have cash in bank accounts but all or part may be restricted and cannot be spent. Compensating balances are funds required by a bank to be left in a non-interest-bearing account as part of the price the bank charges for a loan.

Accounts Receivable

A broad study of receivables provides an insight into numerous aspects of a business. Not only is the value of this major asset quantified, but from receivables customers can be identified, the proportion of revenues coming from geographical areas or customers can be determined, knowledge of customer relations can be gained and business problems identified through the existence of disputes.

Certain critical areas of accounting (receivables, inventory, accrued liabilities and income recognition) require intense scrutiny during due diligence because of the possibility of highly discretionary management polices, controversial entries, improprieties and disputes over value. Of these, receivables are easiest to verify and evaluate. Asking the questions in the checklist, coupled with direct confirmation of individual receivables, may give an investor comfort to proceed, information to negotiate adequate guarantees or convincing evidence to forget the entire investment.

Trade receivables are amounts owed to the business from the sale of products or services. Other receivables that may be included in one all-encompassing receivables account could be from the sale of patents, assets, licensing or royalty fees and other non-trade transactions. Notes receivable can be for anything but most commonly are slow-pay receivables converted into long-term loans to key shareholders and executives who may or may not repay on schedule.

An overview of receivables is possible by classifying the individual receivables into categories defined by the length of time a receivable has been outstanding or unpaid. This practice is called "aging" and an important internal accounting report for most businesses compiled at least monthly are a receivables aging report. An aging report can identify the overdue amounts and individual receivables overdue but it will not identify new receivable that may become overdue.

Inventory

Inventory presents a difficult due diligence challenge because it may be under- or overvalued and the chances of knowing its precise value are remote. The final value will be based on information prepared by accountants and used by the parties to reach an agreement incorporating a value they can accept. Even when management strives for realistic inventory values, the actual values may remain unknown until future sales occur. Management's intent upon manipulating financial statements find inventory an area of extreme opportunity, and it is one of the most frequently used means to inflate or reduce income.

Questioning management and reviewing reports and financial statements are important but should only supplement actual counts and physical inspection of the inventory and inventory records. Verification of the inventory both in count and price is essential and preferably observed by independent auditors. The overall statistics, trends and other information are vital to the study but will not provide sufficient data for comfort in the absence of on-site inspections. Inventory may conveniently be in one location, numerous locations, in transit or on consignment and so complicate the task of verification. Knowledge of its location is not only essential for verification but for studies conducted as to the cost of maintaining inventory at specific locations and the impact of the inventory level on sales. A business's total inventory is important to know, but the information of greatest value is the inventory by product line. The amount of capital committed to maintaining an inventory for a product line is a key element in evaluating profitability or lack thereof.

The number of inventory turns is a measure of how well a business is being managed in relation to others in the industry.

Fixed and Other Assets

Assets other than current assets may be the business's most important and valuable property. Facilities, production equipment, office and systems equipment are all critical components without which the business could not function. Major tangible assets should be identified along with their value as reported on the financial statements, their estimated market value and importance to the business. Intangible assets are those primarily visible only on the balance sheet, such as goodwill, capitalised expense, customer lists and trademarks. Intangible assets may have great value or even be undervalued, but many are worthless. Determining the origin of each intangible asset is helpful to estimate current value.

Fixed assets may appear on a balance sheet as several line items or an all-in-one general category of "property, plant and equipment" (PP&E). Regardless of how broadly described, this is a reasonable starting place. Using the balance sheet summary, the due diligence investigator can request the records supporting the individual components. They should disclose the original cost as well as the amount of depreciation taken and that remaining. A review of the financial records coupled with visual inspection of the assets is an essential part of due diligence.

A perfectly managed business will have accurate, up-to-date records identifying each fixed asset, its original cost and the depreciation taken to date. However, fixed- asset records often are poorly maintained, dated and do not accurately reflect the actual assets. Significant assets may have been acquired but not recorded and others sold, scrapped or discarded and not removed from the records. If physical inventories of assets are infrequent or never made, that permits the perpetuation of recording errors.

Liabilities

Due diligence requires verification of liabilities both listed and not listed on the balance sheet. To achieve a level of comfort the investor must gain adequate knowledge of the business's liabilities. Since unknown liabilities can emerge after the investment is consummated, the due diligence investigation should reduce this concern to a reasonable and acceptable business risk. It is virtually impossible to prove there are no other liabilities, but it is possible to reach a point where further concern or fears would border on the irrational. Just as identification of liabilities is important, investors should be wary of overemphasis on liabilities and what is wrong with a business rather than its attributes.

Unrecorded liabilities are those that should have been recorded or those in which a probable, undetermined liability exists. Inability to determine the precise amount of a liability is sometimes used as an unacceptable excuse to record no liability at all. A listof all unrecorded liabilities, actual and probable, should be developed for the investorto gain a complete picture. Common areas to search for unrecorded liabilities are litigation, non-capitalised leases, product guarantees, loan guarantees, service guarantees, self-insurance, purchase contracts, employment contracts, severance benefits, pensions and health insurance. These areas are by no means inclusive and each industry may have its own special types of liabilities. Once identified, investors need to determine whether liabilities are valid, estimate when cash outlays will be required and determine probable best or worst case exposure.

Backlog and Income Recognition

Making sales, recording orders and maintaining a backlog are basic activities that commence a sequence eventually resulting in a profit or loss reported on the business's income statement. The level of reported income largely determines the tenure of executives and so produces pressures to perform that should continually be kept in mind during due diligence. Lack of profits will eventually cause failure, the loss of the owner's investment and jobs. A profitability influence the market price of shares, spurs hopes to sell more shares and creates opportunities to exercise options and enjoy bonuses. Budgeted profits, earnings projection, growth targets and unbroken recordsof increased earnings have often caused managements to engage in dubious practices. The demands for performance are so strong that executives may take regrettable actions that should be ferreted out during due diligence.

Many businesses receive orders for products or services to be shipped or provided at a later date. The cumulative total of all unfilled orders is the "backlog" and is an important indicator of near-term business activity. In manufacturing, construction, contract services and hundreds of other types of businesses, executives watch the backlog closely to plan business activities. Comparisons of the present backlog to prior years and current trends in the backlog will give an investor the single best indication of what is happening to the business and the level of business to expect in the near future.

The amount of gross profit in the backlog is a far better indicator of future pre-tax income than the total level of backlog. In fact, total backlog and trends can be extremely misleading without gross profit data. Low-profit work may have been taken to make the backlog appear good or in the belief that increased pre-tax profits could result from a larger volume of business with a lower margin of profit.

Cost of Sales, Selling and Administrative Expenses

Due diligence should involve gathering sufficient data to analyse and understand the costs and expenses incurred by the business. While the term “costs” usually applies to production-related activities and “expense” to so-called non-production activities such as selling and administrative charges, there is no difference. Hundred rupees of wage cost paid to a production machine operator eventually has the same effect upon the business’s income statement as ten rupees of expense paid as part of the chairperson’s compensation. Executives who are zealous in “cost” cutting but largely oblivious of “expenses” often ignore this obvious fact.

Financial income statements will provide basic information in summary form and are the proper starting points to evaluate overall costs. Most contain separate information on costs of sales, selling expense and general and administrative expense. From the summary information trends should be discernible, but more specific information must be sought on the composition of each category and any significant shifts in the percentage of the components within a category. As an example in cost of sales, wage costs may be declining and material costs increasing with no net effect. In selling expenses, a large increase in support staff or a shift to telemarketing may be occurring, but selling costs as a percent of total sales may be declining. Trends are of great importance to identify the favourable accomplishments of the business as well as alert an investor to emerging problems. Gross profit is the profit calculated by subtracting cost of sales from revenues. Theyare profits before selling, general overhead charges and administrative expense(SG&A) and are primarily determined by two factors—prices received and cost of sales. Higher prices will increase gross profit and lowering of cost of sales will have the same effect.

Inter-company Transactions

Multiple business units with common ownership or control have evolved to accommodate diversity and growth, spread risk, facilitate management and maintain financial controls. Unfortunately, inter-company transactions can be a source of controversy, complex or misleading financial reports and, in extreme cases, an opportunity for deception. Inter-company transactions have been a favourite playground for those wishing to manipulate the books.

Whenever there are multiple business units controlled, owned or influenced by a common entity, the relationships must be clearly defined from both an operational and a financial perspective. Is the relationship with the parent one of tight or loose control? Do the individual units conduct business between themselves and how are such transactions recorded in the financial statements? Do policies, methods and approach to recording inter-company transactions reflect a desire to accurately record income or losses by each business unit? Are policies designed to benefit the business as a whole rather than individual unit? If statements are audited, consolidating income and balance sheets should indicate inter-company transactions.

Inter-company sales are the sales of products and services from one business unit to another. Some businesses negotiate inter-company sales between units on an arm's length basis without influence of the parent. Products and services purchased maybe paid for by cheque. The other extreme is when all inter-company transactions are controlled by detailed policies and only accounting entries are made to record the transactions without cash changing hands.

The investor should identify inter-company sales and learn the policies and practices influencing pricing and accounting for the transactions. Each line item on the financial statements involved must be identified.

Investment Questions and Issues

There still remain due diligence questions relative to participants in the proposed transaction and the business's value. All professionals, organisations and government agencies that may influence or can affect the investment decisions should be identified. Data useful in estimating the relative value of the business should be reviewed. Information on the business that may have been previously overlooked should be sought, even if it involves locating third parties whose approval must be secured before the investment can close.

Third-party approvals are those required from individuals, businesses, institutions and government agencies that are neither the buyer, seller nor investor. In some cases the third party must approve the entire transaction and in others only one segment. A search for such parties and an evaluation of the time, procedures, difficulty and strategy for securing their approvals should commence early in the due diligence process. The type and structure of an investment will affect the approvals required. If the investment is a purchase of selected assets and liabilities of a going business, approval may be required of lenders and creditors, and to transfer all contracts in effect and government permits. Contracts include leases, customer orders, purchase orders and licenses. In stock acquisitions approvals may be required from lenders, government anti-trust regulators and licensors.

Consultants provide highly specialised skills for projects of relatively short duration where it will be impossible or impractical to employ full time employees. They provide businesses with knowledge and skills often unavailable by any other means. Consultants are not employees and are considerably more expensive, often commanding large fees. The investor should identify the problems for which consultants were hired to solve and compare their costs with the results.

Appendix-II

Group Exercise

Q. How to start the due diligence exercise?

Q. What to read in the Sales/Purchase Agreement?

- Is this a purchase of stock or net assets?
- What is the approximate value of the transaction?
- Will the seller provide indemnification to the buyer for self-insured or uninsured liabilities?

Hint

Before getting started, the due diligence investigator should gain an understandingof the overall situation and the time-line. For example, if the proposed transactionis being conducted as an auction, you may have to get by with the documents in the data room. After the buyer has signed a letter of intent, you should insist on getting whatever reasonable information you think you will need.

Five Process-Planning Items

1. Sign a confidentiality agreement.
2. Obtain the index of the documents in the data room.
3. Make sure you know what your scope will be. (Who is doing the Employee benefits, environmental compliance, etc?)
4. Compile the names and contact information of those with who you will be Dealing (buy-out firm partners and associates, heads of risk management and employee benefits at the company, and your client's lawyer, etc.
5. Decide if you will need to visit the business to be acquired to observe operations and conduct interviews.

Q. What to learn from the Information Memorandum and other available information about the company?

- In what business (es) is the company?
- What are its products/services?
- Where are its plants and offices located?
- How many does it employ and what are the occupational classifications?
- What were the revenues and EBITDA over the past three years?
- What is projected for the rest of this and next year?
- What are the approximate values of the raw materials, inventory, plant and equipment on the balance sheet?
- Who are the company's major customers and suppliers?
- Are there any disclosures in regarding to legal compliance, enforcement or tort litigation?

Hint

Look for potential deal-breakers, such as businesses claim and product liability legacy issues. If necessary, search the internet for information about the company, its competitors and the industry. Other red flags to look for are unique exposures that may require special types of examination.

If a purchase of assets and the seller will be retaining the liabilities for workers compensation and other liability claims incurred prior to the sale, carefully read the indemnification provision in the purchase agreement to see if there are any rupees amount or time limits.

Appendix-III

Glossary of Salient Terms

1. Acquisition

Assuming ownership of another business. The acquisition can be made through a direct purchase or through a merger agreement that involves the exchange of assets.

2. Merger

A full joining together of two previously separate corporations. A true mergerin the legal sense occurs when both businesses dissolve and fold their assets and liabilities into a newly created third entity. This entails the creation of a new corporation.

3. Joint Venture

Two or more businesses joining together under a contractual agreement to conduct a specific business enterprise with both parties sharing profits and losses. The venture is for one specific project only, rather than for a continuing business relationship as in a strategic alliance.

4. Strategic Alliance

A Strategic Alliance is a partnership between businesses in which you combine efforts in a business effort. The joint effort can involve anything from getting a better price for goods by buying in bulk together to seeking business together with each of you providing part of the product. The basic idea behind strategic alliances is to minimise risk while maximizing your leverage in the marketplace.

5. Appraisal

An estimate of the worth or value of something on the open market. The term is also used for the report that describes how the estimation and conclusion of value was made.

6. Business Valuation

An estimate of the worth of a business entity and its assets.

7. Buying a Business

For many entrepreneurs the idea of starting a business from scratch may seem overwhelming. For them, buying an existing business or a franchise is often a viable alternative.

8. Adjust Purchase Price

This will take care of prorated items such as rent, utilities and inventory up to the time of closing.

Review documents required to be provided by the seller. This will provide a corporate resolution approving the sale, evidence that a corporation is in good standing, any tax releases that may be been promised by the seller. Check with the department of corporate affairs.

9. Security Agreements

These documents may be necessary if the purchase is going to be self financed. A Security Agreement lists the assets that will be used for security as a promise for payment of the loan.

10. Lease

If it is agreed to assume an existing lease, it is required to execute the assumption. Make sure that the landlords' concurrence to assumption of the lease. Instead there may be a new negotiated lease with the landlord instead of assuming the existing lease.

11. Patents, Trademarks and Copyrights

May need to execute the necessary forms of part of the transaction.

12. Franchise

May have to execute franchise documents if the purchase of the business is a franchise.

13. Closing or Settlement Sheet

The closing or settlement sheet will list all financial aspects of the transaction. Everything listed on the settlement should have been negotiated prior to the closing so there should be no surprises.

14. Covenant Not to Compete

It is a good idea to have the seller execute this agreement. This will help add to the success of the operation of the business without any interference from the previous owner.

Answers to Questions in Chapter One

Response 1.1

The legal side of due diligence is not as exciting and interesting necessarily as the financial end, and how well the buyers can actually model where the business is headed. It is a lot more important than making sure the contracts say what you think they do, although that is an important part what is asked for to be done. It is one aspect.

In simple terms, due diligence is doing the homework on a deal. Of course, it can create reasons not to do the deal, or it can show some hair on the deal, potentially influencing the deal terms. Generally speaking, it is doing the homework, whether it is on the legal side, on personal, on financial, on software, on technology and others. It runs the gamut of doing the homework on the deal before it is closed.

Due diligence could be finding something wrong that does not make the deal or that makes to renegotiate a price, but for someone who does it well, it may be finding value that allows to outbid someone else who has not done the proper homework.

Response 1.2

Normally, Due diligence requires the following:

(a) Examination of documentation and litigation issues, preliminary and in the review of the financial books, operations and technology to assess the way business is run, possibility of cost savings in operations and means to improve the working capital structure.

(b) Due diligence also involves background checks on people and it is usually based on bad experiences in the past.

(c) Due diligence entails the buyer's core competency in judging the business targeted and critically important is judging the management.

(d) Due diligence should endeavor to find out "what else?" It is not sufficient to stopat such as that it is possible to fill in the product line or to say it is possible to move into the plant. The upside comes on the operating company's standpoint.

Response 1.3

The parties conducting due diligence generally create a checklist of needed information. Management of the target company prepares some of the information. Financial statements, business plans and other documents are reviewed. In addition, interviews and site visits are conducted. Finally, thorough research is conducted with external sources including customers, suppliers, industry experts, trade organisations, market research firms, and others.

Response 1.4

There is no correct answer to this question. The amount of due diligence conductedis based on many factors, including prior experiences, the size of the transaction, the likelihood of closing a transaction, tolerance for risk, time constraints, cost factors, and resource availability. It is impossible to learn everything about a business but it is important to learn enough such that could lower the risks to the appropriate level and make good, informed business decisions.

Response 1.5

Yes. Too much due diligence can offend a target company to the point where it could walk away from a deal. It can also result in "analysis paralysis" that prevents from completing a transaction or provides time for a better competing offer to emerge. Accordingly, it is important that due diligence be prioritised and executed expeditiously. A sensible level of trust concerning lesser issues must balance appropriate investigation and verification into the most important issues.

Response 1.6

Time allocated for completion can vary widely with each situation. Many preliminary agreements define the time frames in which due diligence would be conducted. Time schedules through the closing of a transaction are typically tight parties should ensure that adequate time is allocated to due diligence.

Response 1.7

Every transaction would have different due diligence priorities. For example, if the main reason for acquiring a company is to get access to a new product it is developing to accelerate buyer's own time to market, then the highest priority task is to ensure that the product is near completion, that there are no major obstacles to completion, and that the end product would meet the buyer's business objectives. In another transaction, the highest priority might be to ensure that a major lawsuit is going to be resolved to the buyer's satisfaction.

Response 1.8

Certain activities conducted during due diligence could breach confidentiality that a transaction is being contemplated. For example, contacting a customer to assess the satisfaction with the target company's products might result in a rumor spreading that the company is up for sale. Accordingly, to maintain confidentiality, often customers may be contacted under the guise of being a prospective customer, journalist, or industry analyst.

Response 1.9

A well run due diligence programme could not guarantee that a business transaction would be successful. It can only improve the odds. Risk could not be totally eliminated through due diligence and success could never be guaranteed.

G-2
GUIDE ON RISK-BASED INTERNAL AUDIT

Foreword

With a dynamic entrepreneurial environment, which is changing and probably becoming more difficult to cope with every passing day, and the steeply rising expectations of the stakeholders in these entrepreneurial ventures, keeping pace and more often than not surpassing the changes in the entrepreneurial environment has everybody involved in running that venture on their toes. In that scenario, chartered accountants have a critical role to play whether at the forefront or at the back office.

But to be able to play an instrumental role in the sustained growth and meaningful development of a business, an Industry, the economy and the society, it is essential that we keep our knowledge base and skill sets at their sharpest best. The biggest challenge today, however, is not just keeping abreast with the existing technical knowledge and skills, but to imbibe such as are able to help us pre-empt the changes in the business environment and the stakeholders' expectations and adapt to the same. Whereas, the Institute is committed to that concern, and brings out a number of technical publications, organizes various dedicated conferences, seminars, workshops. At this juncture, I would also urge the members to come forward and actively participate in development of the technical literature and share their invaluable treasure of knowledge and experience with their professional colleagues.In addition to the above, it is equally essential that the members also remain alert to relevant developments at the global front. That, with the spread and penetration of technology to even the most interior parts of the country, I feel, should not be a difficult task, what is necessary is the commitment and zeal in our hearts.Only when we are able to embed that commitment and zeal in our hearts, would we be *partners in national building* in real sense of the word.

New Delhi
2nd November, 2007

CA. SUNIL H. TALATI
President, ICAI

Preface

Traditionally, the main focus of the internal audit was confined to the controls and processes relating to financial transactions. Even in certain entities, internal audit was more used as review and inspection. With the passage of time and combined with the growth of organisations, the managements view internal audit as a significant resource in evaluating entire operations and achieve more effectiveness in day to day activities. In today's era of globalisation, the emergence of new models of governing the enterprises, a subtle shift towards controls and strategic decisionmaking, identification and assessment of risk has become one focal point. In recent times, the risk-based internal audit is being viewed by the management as an important tool to assess the management of the risks that are barriers to the objectives and success of the organization. Risk-based internal audit involves the assessment of the risks' maturity level, expressing opinion on adequacy of the policies and processes established by the management to manage the risks. Risk-based internal audit mainly report on the risk management that includes identification, evaluation, control and monitoring of the risk. A risk-based internal audit mainly focuses on the objectives rather than looking at the controls and transactions. This demands the internal auditor to have the skills to provide broad level of the assurance to the management.

Keeping this in mind, the Committee on Internal Audit is issuing this Guide on Risk-based Internal Audit as a part of series of the publications on Internal Audit. This guide would help the members of the Institute as well as others to understand not only the concept of the risk-based internal audit but also the methodology of the same.

This Guide is divided into six chapters with a view to provide the guidance regarding the risk-based internal audit to all the readers. Chapter 1, Introduction, would help the readers to understand the concept of the risk-based internal audit. Chapter 2, Risk

Management, deals with aspects such as understanding risk, basic concepts of risk management, enterprise wide risk management, risk maturity of an organisation. Chapter 3, Using Risk-based Internal Audit Methodology, covers the building blocks of RBIA, stages in RBIA and a case study. Chapter 4, The Internal Audit Process explains the phases of the internal audit process. Chapter 5, Some Pitfalls and The Way Ahead describes the prospective picture of the RBIA. The Guide also contains the Exhibits and Appendices illustrating complex subjects in a simplified manner for easy understanding of the readers.

I am grateful to CA. Deepak Wadhawan, convenor of the study group and its members, CA. R. N. Joshi, CA. Neville Dumasia, CA. Pankaj Sahai, CA. Shrikant Sarpotdar and CA. Swapnil Kabra for squeezing the time to prepare the draft of the Guide.

I am also thankful to CA. Sunil H. Talati, President, ICAI and CA. Ved Kumar Jain, Vice President, ICAI for their continuous support. I also wish to thank all the members of the Committee, CA. Charanjot Singh Nanda, (Vice Chairman), CA. Rajkumar S. Adukia, CA. Atul Chunilal Bheda, CA. Sanjeev Krishnagopal Maheshwari, CA. Mahesh Pansukhlal Sarda, CA. Shanti Lal Daga, CA. J. Venkateswarlu, CA. Anuj Goyal, CA. Amarjit Chopra, Shri Manoj K. Sarkar, CA. Prashant S. Akkalkotkar, CA. Shyam Lal Agarwal, CA. Vivek R. Joshi, CA. Krishan Lal Bansal, CA. Satyavati Berera, CA. Brij Bhushan Gupta, CA. Anil Jain for their valuable support.

I am sure that this Guide would help the readers in learning techniques and methodologies that would boost their skills to divert the audit process to risk based approach.

A. ABHIJIT BANDYOPADHYAY
Chairman
Committee on Internal Audit

5th November, 2007
Kolkata

Contents

Chapter 1

Introduction

Background

1.1 During recent years, managements are increasingly getting risk focused. Expectations from internal auditors are hence shifting from providing an assurance on the adequacy and effectiveness of internal controls to an assurance on whether risks are being managed within acceptable limits as laid down by the Board of Directors. This shift in assurance from a control based focus to a risk based focus requires that the internal audit activity be carried out by an experienced multidisciplinary team using risk-based internal audit (RBIA) methodology.

1.2 The objective of this Guide is to provide guidance to the members of the Institute, as to the concepts and steps involved in risk-based internal audit (RBIA) methodology.

Internal Audit - Definition, Objectives and Scope

1.3 Preface to the Standards on Internal Audit, issued by the Institute of Chartered Accountants of India defines the term "internal audit" as:

"Internal audit is an independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system."

1.4 To achieve the objectives of appraising and suggesting improvements in the overall governance mechanism of the organisation, internal auditors have been carrying out assurance and consulting activities in the following areas:

a. Internal policy compliance.

b. Regulatory policy compliance.

c. Process improvement.

d. Training and development.

Assurance and consulting activities undertaken by internal auditors in the above four areas have normally taken the shape of the following activities:

- Examination and evaluation of the adequacy and effectiveness of the internal control system.
- Undertaking risk assessments in focus areas, either as a consulting activity or as an input to the internal audit plan.
- Review of financial information system, Management Information System (MIS) and the underlying technology platform that delivers this electronic data.
- Review of the accuracy and reliability of accounting records and financial reports.
- Review of safeguarding of assets.
- Appraisal of the economy and efficiency of activities in operational areas.
- Carrying out process improvement activities through business process audits.
- Carrying out performance reviews of functions through operational audits.
- Review of the systems established to ensure compliance with legal and regulatory requirements, code(s) of conduct and the implementation review of policies and procedures.

- Testing the reliability and timeliness of legal compliance.
- Using the internal audit department as a training ground for developing finance and accounts managers.

Need for Internal Audit and the "Expectation Gap"

1.5 In spite of the above activities and the mission - critical area of corporate governance that it operates in, the internal audit function has been historically viewed as stable and beneficial but not necessarily essential for the organization. Internal audit has traditionally drawn its importance from the legal and regulatory framework in which the entity operates and it is likely that in some organizations it still owes its existence to it. Of late, many legislations across the world have reiterated the importance of sound and effective internal audit function as part of effective internal control framework (for example, the Sarbanes Oxley Act of 2002, London Stock Exchange Combined Code, backed up by the Turnbull Committee guidance, etc.). The Indian requirement is in Clause 49 of the listing agreement. Also The Companies Auditors Report Order 2003 provides for the statutory auditor to comment on internal audit function of listed companies and other companies having paid capital of more than Rs. 50 lakh or average annual turnover more than Rs. 5 crore for last 3 consecutive financial years thereby making Internal audit a tacit mandatory requirement in such companies.

1.6 The lower status of *"beneficial but not necessarily essential"* in the organization can only be attributable to an *"expectation gap"* between what the internal auditors are delivering as assurance/ consulting and what the management expects out of an essential function.

1.7 Management's focus is to meet the overall corporate objective and those in the business plan. The business environment is increasingly throwing up newer challenges and opportunities with globalization, disruptive technologies and rules being continuously rewritten. New risks are hence coming up frequently. Focus on internal controls does not give the organization an assurance on whether all the significant risks which can impact the objectives of the organization are within acceptable levels as defined by the Board. Focus on risks and providing consulting and assurance services around a continuously updated *"risk register"* is probably the first step towards delivering to the management in accordance with their expectation and reducing the *"expectation gap"*.

Introduction to Risk-based Internal Audit

1.8 The objective of RBIA[1] is to provide independent assurance to the Board that:

- The risk management processes which management has put in place within the organisation (covering all risk management processes at corporate, divisional, business unit, business process level, etc.) are operating as intended.
- These risk management processes are of sound design.
- The responses which management has made to risks which they wish to treat are both adequate and effective in reducing those risks to a level acceptable to the Board.
- And a sound framework of controls is in place to sufficiently mitigate those risks which management wishes to treat.

1.9 Hence the internal audit report is on the management of significant risks of the organization and the assurance is on these risks being managed within the acceptable limits as laid down by the Board of Directors.

To give this assurance the internal auditor would carry out:

- *a process audit on risk management processes at all levels of the organization, viz., corporate, divisional, business unit, business process level, etc.,* put in place by line management so as to assess the adequacy of their design and compliance.

1 Position Statement on RBIA issued by the Institute of Internal Auditors - UK and Ireland

- *a transactional audit on the significant risks* so as to assess whether the risk response puts the risk within acceptable limits.

By doing so, the RBIA methodology links the internal audit activity to an organisation's overall risk management framework. At the risk register level, the link between management of risks and its audit is done by adding the audit procedure, and other relevant audit information against each risk. This set of documents is known as the risk and audit universe (RAU). *(Refer to Exhibit 6).*

Comparison with Traditional Internal Audit

1.10 RBIA is not different from internal audit. It represents internal auditing using a risk-based methodology. Under the traditional internal audit approach, the internal auditors are required to confirm that the controls are operating effectively. Internal auditors then make recommendations where the controls are not effective. Although traditional internal audit concentrates on riskier areas of the organisation, its approach is based on its own assessment of risk. RBIA bases itself on the underlying fact that the organisation's management is responsible for risk management across the organisation. It audits the risk management processes built by the management and if found reliable bases its audit efforts around management's assessment of risk. RBIA hence ensures that the audit resources are utilised towards assessing the management of most significant risks. RBIA approach has greater involvement of organisation's managementas many risks being dealt with are very significant to the organisation. RBIA may involve audit of new areas in the organisation that internal auditors had not covered before. RBIA does not necessarily change the auditing techniquesto be used. However, the audit tests and techniques under RBIA focus on ensuring the effectiveness of controls which treat risks. Neither are the tests specially designed to detect incorrect and fraudulent transactions, nor does it deploy resources on insignificant risks.

1.11 Internal auditors while following the RBIA methodology may also notice the following subtle differences during the assignment:

- Shift of focus from reviewing controls to reviewing risk.
- Extensive preparation required on understanding the macro economics of the industry, the positioning of the organization, its objectives, strategies and processes.
- Significant coverage of risks which are externally driven.
- Increased dependence on risk management documentation which links objectives, processes, risks, controls, and people.
- For organizations at a lower risk maturity level, performing both consulting and assurance activities.
- Redundancy of structured audit programs as individual risks are listed in the audit plan.
- Heightened management participation during all phases of the audit.
- Management pressure for an experienced multidisciplinary team whose members are first business managers and then internal auditors.

Before discussing the process of RBIA in detail, it is important to understand 'risks' and 'risk management'.

Chapter 2

Risk Management

A. Understanding Risk

Meaning of Risk

2.1 Organisations exist for a purpose. Whereas the private sector strives to enhance shareholder value, the Government and Not for Profit Organizations have a main purpose of delivering service or other benefits in public interest.

2.2 Achievement of organisational objectives is surrounded by uncertainties which both poses threats to and offers opportunity for increasing success. Changing circumstances, such as rising interest rates, can be an opportunity for an organization with surplus cash and a risk for a borrower. Hence these circumstances need to be seen with reference to the organisation's objective:

- When used in the broad sense, risks are those uncertainties of outcome, whether a opportunity or threat, arising out of actions and events.
- When defined narrowly, risks are those uncertainties which impede the achievement of the objective.

In this Guide, the term "risk" is used in the narrow sense.

Risk Attributes-Their Measurement and Risk Score

2.3 All risks have two attributes, *viz.*

- Likelihood of risk occurrence.
- Risk consequence.

2.4 To facilitate understanding and usability in decision making of risk, comparison helps. To enable comparison a risk score is used. By measuring the two risk attributes a risk score can be derived for that risk. This risk score is meant for comparison between a cut off point normally the *'risk appetite'* or comparing to other risks thereby filtering for *'significant risks'*.

2.5 The measurement of the likelihood of risk is normally against five levels on a scale of 5, *viz.*

- Remote (score 1).
- Unlikely (score 2).
- Possible (score 3).
- Likely (score 4).
- Almost certain (score 5).

Exhibit 1 contains details of the measurement yardstick for likelihood of risk.

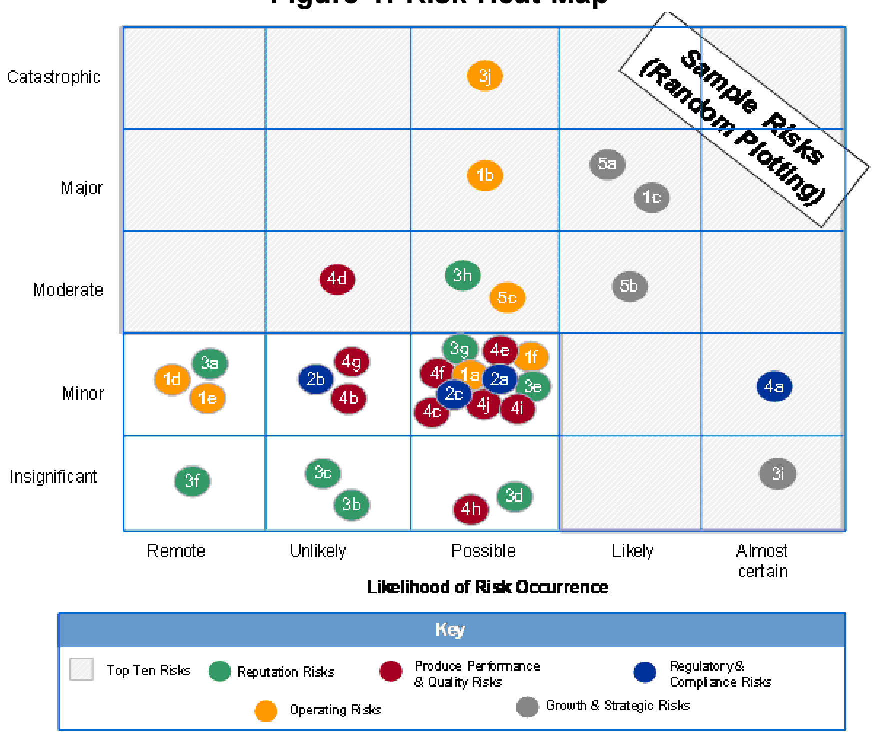
2.6 Risk consequences can also be against five levels on a scale of 5, *viz.*

- Insignificant (score 1).
- Minor (score 2).
- Moderate (score 3).
- Major (score 4).
- Catastrophic (score 5).

Appendix 1 contains details of the measurement yardstick for risk consequences. A risk with the lowest level of likelihood, i.e., remote (score 1) can nevertheless have the highest level of consequences, i.e., catastrophic (score 5). This can be explained by way of an example: The likelihood of floods causing damage to the distribution network of an electricity distribution company can be 'remote' but the consequences of damage can be 'catastrophic'. In such a scenario existence of a contingency plan becomes important.

2.7 Risk score for that risk is a numeric multiple of the likelihood of the risk and the risk consequences. As an example the Board may have a risk appetite of 12 and any risk with a score above 12 becomes significant risk and to be includedin the audit plan. For a better understanding, risk score can be plotted on a chart as below which is known as a *"risk heat map"*.

Figure 1: Risk Heat Map



Business Risk

2.8 Business risks impede the achievement of the organisation's goals and objectives and have been explained in detail in this chapter.

Audit Risk

2.9 Audit risk relates mainly to the internal and external audit efforts to achieve its objectives, i.e., provide effective, timely and efficient assurance to the Board. Audit risk has traditionally been seen strictly as the risk of incorrect audit conclusions. Contemporary views however include big-picture audit risks; specifically, that the internal audit function is not doing the right things or working in the best ways.

2.10 Even from internal auditing perspective, an organization with well established risk management processes decreases audit risk. Where the organization has a formal enterprise-wide risk management program (ERM) in place, the internal auditor would assess it for design adequacy and compliance to decide whether to rely on the risk register and where found reliable then focus on auditing the risk responses to significant risks. By relying on significant risks as determined by management, internal auditing becomes more efficient.

Classification of Business Risk

2.11 Business risks are of a diverse nature. For example, risks can be classified as internal and external risks; controllable and uncontrollable risks, etc. These classifications help in risk identification and a better understanding of the interplay between the risks themselves and between objectives, strategies, processes, risks and controls during risk assessment.

Business Risks: Internal and External

2.12 Internal risks arise from events taking place within the business enterprise. Such risks arise during the ordinary course of a business. These risks can be forecasted and the probability of their occurrence can be determined. Hence, they can be controlled by management significantly. Internal factors giving rise to such risks include:

- *Human factors* as strikes and lock-outs by trade unions; negligence and dishonesty of an employee; accidents or deaths in the factory, etc.

- T*echnological factors* unforeseen changes in the techniques of production or distribution resulting into technological obsolescence, etc.

- *Physical factors* as fire in the factory, damages to goods in transit, etc.

2.13 External risks arise due to events occurring outside the business organisation. Such events are generally beyond the control of the management. Hence, determining the likelihood of the resulting risks cannot be done with accuracy.External factors giving rise to such risks include:

- *Economic factors* as price fluctuations, changes in consumer preferences, inflation, etc.
- *Natural factors* as natural calamities such as earthquake, flood, cyclone, etc.
- *Political factors* as fall or change in the Government resulting into changes in government policies and regulations, communal violence or riots, hostilities with the neighboring countries, etc.

Business Risks: Controllable and Non-controllable

2.14 Controllable risks arise from the events taking place within the business enterprise. Such risks arise during the ordinary course of business. These risks can be forecasted and the probability of their occurrence can be determined. Hence, they can be controlled by management to an appreciable extent (e.g., risks of fire, storms, etc.). Controllable risks need not necessarily be prevented, but the financial loss can be minimised (e.g., insurance cover can be purchased to recover the financial loss due to fire).

2.15 Uncontrollable risks however, are those that would have a detrimental financial impact but cannot be controlled. Some uncontrollable risks that are common to many businesses include:

- Recessionary economy.
- New competitor locating nearby.
- New technology.

Each business faces risks that are unique to that business. Businesses should consider these carefully and briefly describe what steps would be taken if an uncontrollable risk actually happens to the business (contingency plan). For example, if the risk of a recession would severely affect the company, management may consider what products or services could be offered that would not be as sensitive to a recessionary economy.

Risk Categories by COSO

2.16 The COSO framework categories risks as Operations, Financial Reporting, and Compliance. This categorization is illustrated below:

- *Efficiency and effectiveness of operations*-e.g., the company does not meet strategic objectives, the process does not operate efficiently, customers are not satisfied with services received, etc.
- *Financial Reporting*-e.g., the absence of a key financial control causes a material error in the financial statements.
- *Compliance with laws and regulations*-e.g., the company is in violation of applicable regulatory requirements.

B. Basic Concepts of Risk Management

Risk Capacity

2.17 Risk capacity shows how much risk the organization can absorb.

Risk Appetite

2.18 Risk appetite shows how much risk the management is willing to accept.

Risk Response

2.19 The purpose of assessing and addressing risks is to constrain them to a tolerable level within the risk appetite of the organization.

Response to risks can be of the following types:

Tolerate:

The exposure may be tolerable without any further action being taken. Even if it is not tolerable, ability to do anything about some risks may be limited, or the cost of taking any action may be disproportionate to the potential benefit gained.

In these cases, the response may be to tolerate the existing level of risk. This option, of course, may be supplemented by contingency planning for handling the impact that will arise if the risk is realized.

Transfer:

For some risks the best response may be to transfer them. This might be done by conventional insurance or by paying a third party to take the risk.

This option is particularly good for mitigating financial risks or risks to assets. The transfer of risks may be considered to either reduce the exposure of the organization or because some other organization is more capable of effectively managing the risk. It is important to note that some risks are not (fully) transferable in particular, it is generally not possible to transfer reputation risk even if the delivery of a service is contracted out.

Terminate:

Some risks can only be treatable, or containable to acceptable levels, by terminating the activity itself. This option can be particularly important in project management if it becomes clear that the projected cost-benefit relationship is in jeopardy as the cost of treating the risk does not make the activity viable. For example, land acquisition for a project whose feasibility is based on that particular land may be risky and the cost of treating it in termsof legal fees is so high, that it may be better to terminate the project.

Treat:

By far, a large number of risks will be addressed in this way. The purpose of treatment is that whilst continuing with the activity giving rise to the risk, action (internal control) is taken to constrain the risk to an acceptable level.

Inherent Risk and Residual Risk

2.20 Inherent risk is the level of risk assuming no internal controls, while residual risk is the level of risk after considering the impact of internal controls. Example the risk of 'over/ understatement of revenue' without considering any internal controls indicates inherent risk. The above risk when considered with internal controls in place (say, monthly reconciliation of revenue and follow up, correction of discrepancies, etc.) indicate residual risk.

2.21 The objective of internal controls is to reduce the inherent risk and keep the residual risk within the organization's risk appetite. The gap between the inherent risk and residual risk shows the strength of the control and is known as the control score.

Entity Risk Assessment and Business Process Risk Assessment

2.22 Entity risk is the assessment of strategic risks. Organizational objectives and strategies are delivered through business processes; hence business process risk assessment is the preferred way to carry out the exercise.

Significant Risk

2.23 Significant risk is a term used by internal auditors where in their assessment the risk is significant enough to include it in the audit plan. Usually these risks in their inherent state have a risk score higher than the risk appetite for that risk.

Risk Register

2.24 Risk register is a record of risk, risk assessments; risk mitigation and action plans prepared by the responsible parties that help support the overall ERM and controls disclosures reporting process.

2.25 Risk register is continuously updated and has columns for risk, causes, consequences, ownership, inherent risk score, controls, residual risk score, process, action for further mitigation, action owner, due date, etc.

C. ERM - Enterprise Wide Risk Management

ERM and Risk Appetite of the Board

2.26 Enterprise Risk Management (ERM) is defined as a process, affected by an entity's board of directors, management, and other personal, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.[2]

2.27 ERM includes the following activities:

- Determining the risk appetite.
- Establishing an appropriate internal environment, including a risk management policy and framework.
- Identifying potential threats to the achievement of its objectives and assessing the risk, i.e., the impact and likelihood of the threat occurring.
- Undertaking control and other response activities.
- Communicating information on risks in a consistent manner at all levels in the organization.
- Centrally monitoring and coordinating the risk management processes and the outcomes, and
- Providing assurance on the effectiveness with which risks are managed.

2 Defined by COSO (Committee of Sponsoring Organisations of Treadway Commission)

2.28 The term *'risk appetite'* used in the above definition refers to the extent of risk that the Board is willing to take to pursue the objectives. Risk appetite settingis done at different levels, *viz.* for the organization at the entity level, process level, and different risk groups and for individual key risks. Risk appetite provides a standard against which a risk can be compared and where the riskis above the risk appetite, it is considered a threat to the reasonable assurance that the objective will be achieved.

2.29 While risk appetite is to be set lower than the risk capacity; however, with an aggressive Board, the risk appetite can be higher than the risk capacity. For example, the Board may decide on utilizing the cash flow for operational purposes in the short term for earmarked funds meant for payment of quarterly installment of taxes. This could result in default of payment on due date and hence becomes a significant risk which needs to be covered by the internal auditor and reported upon even though the risk may be within the risk appetite. However, in the normal course, internal auditors are expected to take the risk appetite as a given and evaluating the risk appetite is out of audit scope. Internal auditors can, however, do a consulting activity of assisting the Board in fixing the risk appetite and its documentation.

2.30 ERM is a new approach in the ways organizations are assessing, managing and communicating business risks. By assisting organizations climb up on the risk maturity scale, ERM makes a major contribution towards helping an organization manage risks to achieve its objectives. ERM helps an organization become a risk managed business. A fundamental question that emerges is how should the internal audit effectively audit the risk management processes that are being developed. Risk Based internal audit methodology provides an answer by providing assurance to the management and the Board on the effectiveness of risk management processes.

ERM as a part of Clause 49 Compliance

2.31 As per Clause 49 of the listing agreement, Board disclosures are to be made on whether the following is being carried out on risk management.

"The company shall lay down procedures to inform Board members about the risk assessment and minimization procedures. These procedures shall be periodically reviewed to ensure that executive management controls risk through a proper defined framework".

2.32 To implement the requirements of the above clause, organizations tend to introduce certain risk management processes and identify strategic risks mainly to fulfill compliance requirements. Over a period of time as management begin realizing the advantages of assessing risks through an enterprise wide structured, consistent and continuous process, it normally introduces ERM in a full fledged way as a strategic management tool.

2.33 An ERM policy is first put in place which defines the guiding principles showing responsibility of line management for ERM and the broad activities covered by the risk management processes. A risk management framework to implement the ERM policy is then finalized showing the activities which need to be carried out and how they are to be carried out under three processes, *viz.*

- Risk assessment.
- Risk management.
- Risk communication.

Implementation is facilitated by a risk manager or the internal auditor as a consulting assignment. Subsequently risk based internal audit is carried out

D. Risk Maturity of an Organization

Importance of Risk Maturity

2.34 RBIA provides an assurance on the effectiveness of risk management processes. The specific approach to be adopted during internal audit using RBIA methodology depends upon the internal auditor's assessment of the organisation's risk maturity. Risk maturity has levels which reflect the extentto which an organization understands its risks and has implemented ERM.

2.35 Some organizations especially those in a fast growth mode have an organizational culture which promotes operational mangers to remain at the risk naïve/ risk aware level. This means that the line managers are not expected to identify risks and if they do, it is confined to their personal knowledge or within their functional team. The internal control environment may be well defined but again it is to be operated by the staff management(such as the accounts manager), the logic being that line managers need to spend maximum time in operations and not be defocused by unnecessary paper work or issues other than their operations. In this mindset, coordinating activities and problem solving is considered as operations while risk assessment and management is considered a staff function. This model works well in a supply side market wherein the organization sells whatever it produces but flounders in a competitive and dynamic market wherein new risks arise periodically and the staff management who are not market facing are not fast enough to incorporate new controls to address these risks.

2.36 A risk naïve/risk aware organization in today's dynamic environment exhibits inefficiencies as a continuous long list of pending issues at all times with the line manager or even mundane issues as goods received but unreconciled with Purchase Orders, delayed supplier payments resulting in line managers chasing accounts department for release of payment, etc., wherein the root cause is usually a risk which has not been addressed. In a risk aware organization, the silo approach culture wherein the manager tracks and addresses new risks related to his department only rather than in the business process usually throws up big losses arising out of customer dissatisfaction or failure of an enterprise wide activity such as implementing ERP.

2.37 The audit strategy depends upon the organization's risk maturity. Organizations at low risk maturity levels may require internal auditors to consult by promoting and advising on identification of and response to risks. For organisations with high risk maturity, the internal auditor would need to concentrate more on carrying out process audits of the risk management processes and especially reviewing the risk assessment process wherein the inherent risk (untreated) are identified, estimated (scored) and evaluated (compared with risk appetite).

Risk Maturity Levels

2.38 The following aspects in the organisation indicate its risk maturity. Internal auditors should refer to the same for concluding on the organisation's risk maturity:

- Business objectives are defined and communicated.
- Risk appetite is defined and communicated across the organisation.
- Control environment is strong. Including the tone from the top.
- Adequate processes exist for the assessment, management and communication of risks.

A suggested score card to assess risk maturity is given in Appendix 2.

2.39 To determine the level of risk maturity the internal auditors need to undertake the following activities:

- Meet the senior management to understand the organisation's risk management policy and risk framework along with management's assessment on the level of implementation.
- Assemble the available information and documentation such as
- Organization's objectives:
    - Processes for risk assessment (identification, estimation and evaluation).
    - Definition of risk appetite.
    - Process of risk management, *viz.*, consideration of risks and associated controls in decision making process (example, in project evaluation).

- Process of communication on the working of risk management through monitoring controls, MIS reports, etc.

- Documentation on risks as risk register.

- Interview and discuss with managers as to their understanding of the risk management processes and their response to risks in their operations.

2.40 The table given below shows the levels of risk maturity.

Table 1: Key Characteristics at Different Levels of Risk Maturity

Risk Maturity	Key Characterstics
Risk Naive	No formal approach developed for risk management
Risk Aware	Scattered silo based approach to risk management. Risks identified within functions and not across processes. Also risks not communicated across enterprise.
Risk Defined	Strategy and policy in place and communicated. Risk appetite defined.
Risk Managed	Enterprise wide approach to risk management developed and communicated. Risk register in place.
Risk enabled	Risk management and internal control fully embedded into operations. Organization in readiness to convert market uncertainties into opportunities.

2.41 The internal audit approach is determined by the level of risk maturity identified above.

A. Risk Aware and Risk Naive

No risk register will be available in this type of organisation. As a consulting assignment, internal audit may be asked (in conjunction with management) to determine the work required to implement a risk framework which fulfils the requirements of the Board.

In such an organization, the focus of internal audit is necessarily on the controls. As same extent of risk assessment is in progress, some information on risks is available. The level of assurance on the controls would be higher if the internal auditor uses the key risks agreed with management to formulate the audit plan. The audit approach in this case would revolve around:

- Using the available information on risks during the planning stage for individual audits (discussed further in Chapter 4).
- Where management does not understand risks, conducting management training and risk facilitation workshops.

Despite a mention of the term "risks", the internal audit, as mentioned earlier, would provide assurance only on controls and not on the management of risks. Accordingly, the audit methodology is a modification of the traditional audit process and not RBIA. Also, care should be taken that as internal auditors are not primarily responsible for risk management, they should not determine risks without management involvement.

B. Risk Defined

In this type of organization, the understanding of risk management is patchy and the list of risks may not have been compiled into a complete risk register. As a consulting activity, internal audit in this case, would facilitate the compilation of a complete risk register from the list of risks already compiled by the managers. In areas where risk management is well defined, the internal auditor may use RBIA.

C. Risk Enabled and Risk Managed

This type of organisation represents a high level of understanding on the management of risk. A complete list of risks (risk register) is available for audit planning and the internal audit work would emphasize on whether risk management processes are working properly, responses to key risks and on the monitoring of controls.

Chapter 3

Using the Risk-based Internal Audit (RBIA) Methodology

A. Building Blocks of RBIA

Future Direction of Internal Auditing

3.1 As its primary activity, internal auditing is heading towards promoting risk management in an organisation, periodically assessing risk maturity and for reasonably risk matured organizations (thereby auditable under RBIA methodology), giving an assurance on the adequacy and effectiveness in managing risks that threaten the achievement of the defined objectives. The measuring yardstick for managing risks is the risk appetite as laid down by the Board.

Audit is of Management of Risk and not of Risk

3.2 *Management estimates of inherent risks are out of scope*: The internal auditor should comment on whether the process laid down for risk assessment (risk identification, estimation and evaluation) is adequate and has been followed. A competent management will, however, not encourage the internal auditor to give assurance on management estimates, example whether risks have been correctly identified, whether inherent risk scores are accurate, etc. Usually the more strategic the risk, lesser would be the tolerance to the internal auditor's opinions on risk management estimates. On the other hand, there are everyday examples of catastrophic risks. Also, there could be error indicators, example, in a known flood prone area the risk on account of flooding has not been taken in the risk register.

It may happen that the laid down risk processes were followed but there were errors in risk related management estimates. In such situations, the internal auditor should as a general practice, accept the management's inherent risk score as a given. Only where there are error indicators on risks, the audit report should bring out these error indicators and based on the likely severity of impact on the organisation, follow up with a letter to the Audit Committee.

3.3 *Control score is auditable*: The difference between the two scores of a particular risk (*viz.*, inherent score and residual score) is the score of the risk response *viz.*, control score. An internal auditor being a domain expert on controls is expected to review the control score and comment whether in his assessment the residual risk score is higher from management's estimate, especially where the residual risk score exceeds the risk appetite.

3.4 *Risk maturity level is the reference point*: As explained earlier, the risk maturity level reflects the organisation's understanding of its risks and the extent to which formal enterprise wide risk management is in place. The risk maturity level, hence, reflects the risk management environment and the tone on risks in the organisation. It is, therefore, a reference point for the internal auditor to base his activities.

Key Reporting Areas on Management of Risks

3.5 Following from the above, it can be deduced that the internal audit reports should include the following:

- Assessment of the risk maturity levels, both at the organizational and assignment level.
- Opinion on whether the laid down risk management policies and framework are being followed.
- Opinion on whether the laid down risk assessment processes are adequate and being followed.
- Report on whether there are error indicators relating to management estimates on risks.
- Assessment on control scores and an opinion on the residual score of risks in the audit plan.

Assurance Requirements of the Board and Risk Appetite Should Always be Documented

3.6 The Board, through the Audit committee, may convey assurance requirements of HIGH, MEDIUM, and LOW for different areas. For example, non-compliance of certain labour laws can result in penal action against the directors. Hence, the assurance requirement will always be HIGH for such risk. Assurance requirements have a direct impact on the coverage, *viz.* audit plan, and hence needs to be documented and clearly understood.

3.7 Risk appetite can be different for the organization as a whole, for business units/ divisions, for a group of risks and for specific risks. Rarely Board puts a risk score for its risk appetite. However, without a quantified risk appetite, there is no benchmark to compare risks. In such a case, a consulting assignment to document the risk appetite may be the starting point.

Audit Strategy is Based on the Risk Maturity

3.8 Audit strategy under RBIA methodology has two elements, *viz.*

- Subject matter of the internal auditor's assurance
  - *Controls or risk management.*
- Nature of consulting services that the auditor plans to perform on risk management.
  - *Promoting, guiding and facilitating (PGF) or need based improvement* (NBI).

3.9 As there is both an assurance and consulting activity in the audit strategy, it implies that there is a threshold level of risk maturity in an organisation, below which it is not possible to do an internal audit using RBIA methodology. For example, at the risk naïve and risk aware level, the internal auditor givesa traditional assurance on controls and provides consulting services in the nature of promoting, guiding and facilitating (PGF) risk management. Based on the risk maturity the audit and consulting strategy (known commonly as the audit strategy) is determined. The audit strategy for different risk maturity levels[3] are as under:

Table 2 : Audit Strategy for Different Levels of Risk Maturity

Area	Risk Naive	Risk Aware	Risk Defined	Risk Managed	Risk Enabled
Risk maturity report on enterprise wide risk management processes (RMP)	NO FORMAL RMP	POOR RMP	RMP DEFICIENCIES	RMP MANAGED ORGANISATION	RMP ENABLED ORGANISATION
Consulting objectives in risk management (RM)	To promote, guide, facilitate RM(PGF)	To promote, guide, facilitate RM (PGF)	To embed RM	To improve RM	Need based improvement (NBI)
Audit plan based on	Traditional audit plan (TAP)	Traditional audit plan (TAP)	Management view on risk (RBIA) and supplement with TAP	Management view on risk drives audit plan (RBIA)	Management view on risk drives audit plan (RBIA)
Assurance on	Control processes	Control processes	RMP and control processes	RMP	RMP

Selecting Individual Risks to Audit

3.10 The audit focus is to assess the control score of individual risks which have been selected. The internal auditor can adopt an inclusive approach to select the individual risks to be audited, *viz.*,

- Using the risk register, list the significant risks i.e., where the inherent score is above the risk appetite.
- Include risks where the management's assurance requirement is high.
- Include inherent risks appearing just within the risk appetite in key business processes, i.e., those processes that are associated with and manage a strategic risk of the organizational objectives.

3 "An Approach to implementing Risk based Internal Auditing" issued by The Institute of Internal Auditors UK and Ireland.

- Include those inherent risks which are within the risk appetite but have a high score on one of the two parameters *viz.* likelihood or significance.
- Include risks with a large control score.
- Include risks based on information resulting from the organization's external audits and regulatory examinations.

Deciding the Frequency of Coverage

3.11 The frequency with which a risk would be covered in the internal audit depends upon aspects such as:

- Board's assurance requirement on that risk *viz.* high, medium, low.
- Whether one of the two risk components (likelihood/ consequences) of that individual risk is on an extreme (high/ low).
- Whether controls put the risk below the risk appetite.

Including the Risks into an Audit Assignment and the Importance ofSelecting the Right Auditable Unit

3.12 As an auditing technique, risks are always analysed within a business process. Risks within a section of a business process are bunched logically into audit groups. For, example, risks in order booking of gold (See Exhibit 6C). Audit groups are then scheduled for internal audit. Audit groups are allocatedto the internal auditor based on the latter's proficiency and availability.

3.13 In the case of a large business, an auditable unit can be different entity levels such as corporate office, division, business unit, a location, subsidiary, etc. The following situations may arise in such cases:

- Usually there are audit teams at different locations and hence a preference is given to location as an auditable unit.

- Usually business process as an auditable unit should be the logical choice not only because risks can be logically bunched into audit groups, but that business processes exist to fulfill organizational objectives and strategy, thereby the correct interpretation on the management of risks for strategic objectives can be arrived at. This may cut across locations and could prove to be a challenge for the internal audit function. For, example, order fulfillment process for any product as cold rolled sheets or ribbed cotton fabric would involve looking at risks in processes as order booking, input inventory management, manufacturing management, finished goods inventory management and dispatches. In such cases, the internal auditor would give an assurance on the management of risks relating to fulfilling orders for that product. This assurance would be more valuable to management than separate internal audit reports on order booking, inventory, manufacturing, etc., which are not even product specific.

B. Stages in RBIA

3.14 Risk-based internal audit comprises of three stages, *viz.*,

- Assessing risk maturity.
- Preparing periodic audit plan.
- Conducting individual assurance audit assignments and reporting to appropriate levels.

Stage 1: Assessing Risk Maturity

The objective of assessing risk maturity is to decide which audit strategy to apply. Following steps are involved in this stage:

i. Understanding the risk maturity through discussions and documents.

ii. Concluding on the risk maturity.

iii. Submitting report to the audit committee on risk maturity; and

iv. Deciding on the audit strategy.

Stage 2: Preparing Periodic Audit Plan

The objective of the periodic plan is to decide on which risk management processes (at different organizational entity levels) and which risk responses to audit and make a plan for carrying out individual audits. This stage normally involves the following:

i. Identifying risk responses and risk management processes on which objective assurance is required.

ii. Categorising and prioritising the risk.

iii. Linking risks to audit assignments.

iv. Preparing the periodic audit plan.

v. Allocating resources; and

vi. Completing the risk and audit universe.

Stage 3: Conducting Individual Assurance Audit Assignments and Reporting to Appropriate Levels

The objective of this stage is to execute the individual audit in a manner where the audit risk is least and to convey the findings on the risk responses and the risk management processes under audit to different levels of management. This stage comprises the following activities:

i. Assessing the assignment level risk maturity and reconfirming the assignment scope.

ii. Carrying out audit procedures on monitoring controls, control score of individual risks and compliance of laid down risk management processes by:

- discussing and observing monitoring of controls.

- collecting audit evidence through verification, walk through, Re-performance, etc., and, documenting the results of the audit work.

iii. Assessing management's evaluation of residual risks and concluding on responses and risk management processes covered by assignment and

iv. Reporting and feedback on action taken.

C. Case Study

ABC Bullion Trading Company

3.15 ABC Bullion Trading Company (ABC) has nation wide branches which sell gold to registered customers. ABC is consignment agents of a global bullion company, and the Principal delivers gold directly to the branch. Prior to taking delivery, customers make advance payments of the full amount. Remittances made to the Principal are usually the day after the gold sale date and any loss/ gain in foreign exchange is debited/ credited to the customer. There is a gold procedure manual whose workflow (sequence of activities) and internal controls are automated in a software application known as the Gold Management System (GMS). Head office has real time access to branch transactions as the GMS is online. Because of the high value of transactions and high inherent risk of physical loss, and the Board's assurance requirement being HIGH, the management wants the branch internal auditors to cover gold transactions in a comprehensive way. The internal auditor has the option to use any audit methodology.

3.16 During the third quarter of the year, in one of the branches, an auditor observed discrepancies between the locker register balance and the GMS. After a thorough study, management took a view that while no gold was stolen, gold was being unofficially loaned to certain customers. Other practices also favoring certain customer at the cost of the company also came to light. Management came to the view that the branch manager was unaware of these wrongdoings. The branch manager, with a formidable reputation of being control focused, personally did physical verification at the end of every fortnight and tallied the balance with the GMS. It was also observed that there were no discrepancies on those days when he had done the physical verification. The branch manager was admitted that he was not aware of such risks. The management has become wary and wants to know from the internal auditors of other branches on the quality of their assurance.

The Agra Branch

3.17 Agra branch being small, has only one officer trained on GMS. All customers and their employees are personally known to branch staff. During the year, the officer went on two weeks leave. As the branch manager did not know how to use GMS he made manual entries while carrying out transactions. On his return the officer regularized the transactions by passing entries in the GMS and took receipt signatures from the customers once again for the gold delivered on the print out of the electronic delivery note (EDN).

Internal Audit using Traditional Internal Audit Methodology

3.18 The internal auditors have been around for many years and do an in-depth audit during every quarterly visit. They have so far not found any significant observations in their sample depth check. One of their reports did mention that GMS was not used for a fortnight, as the concerned officer had been on leave. Fifty per cent of the audit sample for that quarter included transactions during that period and no discrepancies were observed. The only audit recommendation made was that the other branch staffs be also trained to use GMS.

3.19 In response to the management's year end query, the internal auditors replied that their assurance was based on their sample size and hence be treated as a limited assurance on the compliance of internal controls. However, they agreed with the management's concern and were willing to do an assignmentto rule out the possibility of unofficial loans to customers and other irregularities.

The procedures involved cross reconciliations including a quantitative reconciliation of gold for the year.

Internal Audit using RBIA Methodology

Stage 1: Assessing Risk Maturity of the Organization

3.20 The internal auditor at the Agra branch started the assignment by asking for the risk maturity assessment done by the internal auditors at the corporate office of ABC and informed that no such assessment was done or required. The branch internal auditor then approached the CFO for his views on the risk management in the company. The CFO replied saying that as per the requirements of Clause 49 of the listing agreement, a risk management committee had been constituted two years ago which met every quarter. A risk management policy had been laid down by this committee and in every meeting, the strategic risks were reviewed and the status reported to the Board through the Audit Committee. With respect to bullion, a reference was made to the Gold Procedure Manual which describes at length the work flow and related internal controls. Also that GMS has a 'no deviation' compliance level status throughout the company as the risk appetite on bullion was zero. The bullion department at the corporate office plans, co-ordinates and monitors bullion activities to ensure that the targets in the business plan are met. It has an oversight cell on branches which also reviews MIS reports.

3.21 The branch internal auditor wrote back that he had visited the branch, had obtained an overall understanding of the GMS and the controls therein, which, he thought, were impressive. However, he wanted to know whether the risks that these controls aimed to remove were identified, assessed, documented and updated periodically. Based on dialogue with the concerned persons, the branch internal auditor observed that there was no enterprise wide continuous, consistent, structured activity relating to risks, but an occasional discussion on risks followed by a letter to that particular branch. He concluded that the organizational risk maturity was risk aware and submitted this assessment to the Audit committee through the CFO. He recommended that:

- A risk management framework be put in place to implement the risk management policy. This framework (guidelines) would help all managers carry out risk identification, assessment and its response.
- The documentation should result in a risk register.
- Regarding internal audit reports, the branch internal auditor concluded that while he would give an assurance on the compliance of internal controls as per the Gold Procedure Manual and comment on the usage of the GMS, he could not comply with:
  - the HIGH assurance requirement of the Board as there were too many transactions during the year and as per the traditional audit methodology he could at best give a reasonable assurance on controls
  - Nor could he give an assurance that all the significant risks were being managed within the appetite level, i.e., zero, as his audit procedures could not be extended to risks as there was no risk register.

3.22 At the next Audit Committee this report was taken up. The general view of the Directors was that as assurance requirement of the Board was HIGH, an audit report on whether the risks were being properly managed was more relevant than an assurance on whether controls were being followed. Accordingly, the branch internal auditor was requested to undertake a consulting assignment to guide and facilitate the branch management on risk identification, assessment and response, which was to be completed latest by the end of the second quarter.

Stage 2: Drawing up the Periodic Audit Plan

3.23 For the first two quarters, the branch internal auditor continued to carry out the traditional audit aimed at giving an assurance on controls as per the Gold Procedure Manual. At the beginning of the third quarter, the branch internal auditor reassessed the organization's risk maturity, concluded it as being as risk defined and that RBIA methodology could now be used. The Board's assurance requirements remained HIGH and risk appetite as zero; hence the branch internal auditor had no choice but to include risk responses to all risks(in the risk register) in his audit plan for the last two quarters. He grouped the risks into logical audit groups and allocated appropriate staff. As he was facilitating risk identification, he was well aware of the risk assessment process and its compliance. Hence, he ignored reviewing this aspect. The audit procedures used were to assess risk responses and conclude on the residual risk score (which had to be zero).

Stage 3: Conducting Individual Audits

3.24 During the course of internal audit, instance of non usage of GMS for a fortnight came to the notice of the branch internal auditor. As the GMS is online a comment was made on the weakness in monitoring controls at the Head office. The weakness being non usage of Electronic Delivery Note (EDN)a key control and non usage of GMS had not been brought out by the internal control system. The internal auditor's observation on a weak monitoring control was accepted, and the subsequent action by corporate office was to set up a monitoring control whereby an e-mail was automatically generated from the system listing the names of the branches where no EDN was cut the previous day. Another action was that a pool of staff at the corporate office were trained on GMS and deputed to branches for short durations as temporary staff whenever the concerned officer was on leave.

Response to Management's Year end Query

3.25 The Agra branch management had not identified unofficial gold loans to customers as a risk. The risk register was updated to include this risk, its response, etc., and the branch manager started an internal exercise for the year to check for any such irregularities. In response to the management's year end query, the branch internal auditors confirmed that risk of illegal gold loan to customers was not recognized as a risk by the Agra branch management, and hence, the response to this was not covered in their internal audit. They accepted this as an audit risk. However, the branch internal auditor asserted that they had given assurance from third quarter onwards on the management of significant risks (as per the risk register) within the tolerance level of zero, which stands as before.

Which Assurance is more Useful to the Board-A Comparison

3.26 On bullion, the Board had a zero risk appetite. The Board would value that internal auditor who can give an assurance on whether the risks are being managed within the zero risk appetite and also is transparent on where his assurance will have an audit risk.

3.27 Following is a comparison of the two internal audit methodologies at the Agra branch.

Table 3: Comparison of the Two Methodologies

Details	Audit under Traditional Methodology	Audit under RBIA (by Branch Internal Auditor)
Does the branch management feel responsible for thinking about risks that could impede its objectives?	×	√
Does branch management automatically assume responsibility for verifying that there were no unofficial gold loans for the year gone by?	×	√
Does the internal auditor form an opinion on the reliabilityof the process used by management to identify and assess risks?	×	√
Does the internal auditor give a direct assurance on whether the risks are being managed within zero risk appetite?	×	√

3.28 Using RBIA, the branch internal auditor is able to give a direct assurance on whether risks are within the zero appetite level or not. Also, they are able to comment on whether the branch management is assessing risks and takes responsibility for managing their risks or not?

3.29 Using the traditional audit methodology, the earlier internal auditor is unableto give a direct assurance on whether the risks at Agra branch are within the zero appetite level or not. Because it is expected that the internal auditors will do an assignment on quantitative reconciliation, it implies that the responsibility of internal controls is not really with the branch management.In that case, the branch management would not be thinking on the new risks in a structured way.

3.30 In the above situation, the internal auditor using RBIA methodology is definitely more useful to the Board.

Chapter 4
The Internal Audit Process

The Internal Audit Process

4.1 Internal audit has a planning and execution process through which RBIA methodology is delivered in a consistent manner. It delivers assurance on the management of risks. In the planning process the output is the yearly audit plan, while internal audit reports and tracking outstanding issues with the management is the deliverable in the execution process.

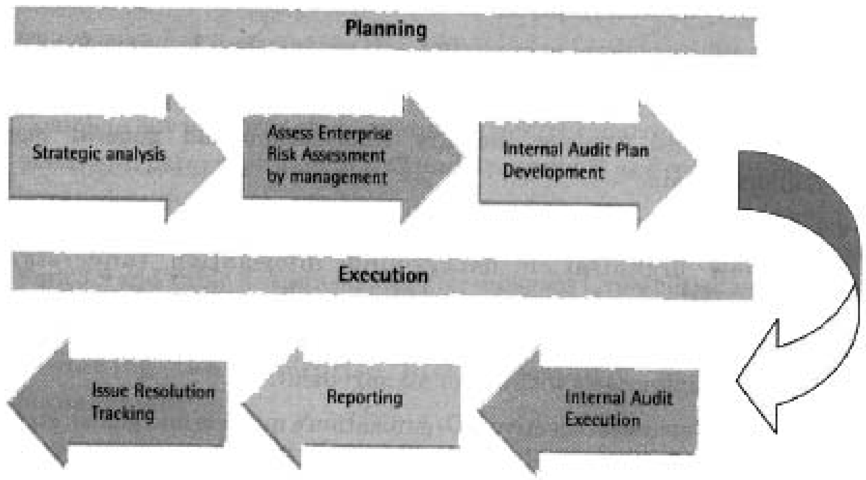
4.2 The planning process starts with the internal auditor becoming acquainted with the business and the industry in which the entity operates. This is a preparatory activity by the auditor to enable him:

- to assess risk maturity which determines whether to give an assurance using RBIA, and
- to review risk assessment done by management and conclude whether to rely or no to rely on the risk register, and

concludes with identifying auditable units, putting significant risks into audit groups, scheduling the audits, allocating auditors and presenting the yearly audit plan to the audit committee.

4.3 The execution process starts with executing individual internal audits followed with reporting the audit issues and finally keeping a track on management's implementation of accepted issues. Following is a diagrammatic representation of the process of RBIA.

Figure 2: The Risk-based Internal Audit Process



Planning Process

Phase 1: Strategic Analysis

4.4 In this phase the internal auditor identifies the strategic objectives and understands as to how the organisation reacts to challenges. This equips the internal auditor to carry out the risk maturity review and the review of the management's risk assessment.

4.5 Strategic analysis provides a high-level understanding of the organisation's business and the external forces that affect it. The purpose of undertaking such an analysis is that it leads to identification of strategic objectives and understanding of how the organisation reacts to challenges that threaten the attainment of these objectives. The output of this analysis and the information gathered will facilitate understanding of how business risks are linked to the overall objectives of the organization. This knowledge is used at the risk assessment phase. Strategic analysis is performed using the following information:

- Information on the organisation-Organisation charts, company vision, goals, objectives, strategies, challenges, business plans, and management reports.

- Industry data and reports.

4.6 The following activities are performed during strategic analysis:

- Review and analyse industry information and general business information
- (surveys, industry statistics, publications, etc.).
- Review organisation background information (understanding organisation and operating environment by review of annual report, organisation chart, strategic plans, etc.).
- Conduct interviews with senior management.
- Identify business objectives (Organisation's mission and goals), strategies (how the organisation plans to achieve its missions and goals) and business processes (activities designed to produce a specific output).
- Document the understanding of the business including strategic objectives, key strategies for achieving these objectives, external forces that can threaten the achievement of these objectives and structures and processes to manage such risks.
- Confirm understanding of business objectives, strategies, key risks and process map with the management.
- Periodically update the strategic analysis and take into account the changing circumstances, new management strategies, new risks, etc.

Phase 2: Enterprise Risk Assessment

4.7 In this phase, the internal auditor determines the entity level risk maturity as per the RBIA methodology to arrive at the audit approach and reviews the enterprise risk assessment process by management to conclude whether to rely or not to rely on the risk register. Based on the audit approach and the reliability of the risk register, the internal auditor identifies

the significant risks which are to be audited and need to be taken into the yearly audit plan. The activities undertaken by the internal auditor in this phase are as follows:

A. Assessing the Entity Level Risk Maturity of the Organisation and Finalising Audit Approach

The objective of undertaking this activity is to implement Stage 1. The steps involved in this activity are as follows:

Complete out the three stage approach (referred to in to paragraph 3.14 read along with paragraph 2.35 to 2.42 and Appendix 1) and conclude on the entity level risk maturity.

Based on the entity level risk maturity finalise the audit approach (refer toPara 3.9 and Table 2: *Audit strategy for different levels of risk maturity.*)

B. Reviewing the Enterprise Risk Assessment as Carried out by Management

Under traditional audit, the internal auditor carries out the enterprise risk assessment along with management to arrive at significant risks to be included in the audit plan. However, under RBIA, the assumption is that risk assessment is the responsibility of the management. Hence, the internal auditor evaluates the management's risk assessment to conclude whether to *rely* or *not to rely* on the risk register.

Table 4: Objectives of Enterprise Risk Assessment under Different Audit Methodologies

Methodology	Objective of Enterprise Risk Management
Traditional Internal Audit	Carry out the risk assessment along with management to identify significant risks to be included in the audit plan.
RBIA	Review the management's risk assessment to decide whether to rely on the risk register. If the risk assessment is reliable and complied with, the internal auditor lists those inherent risks in the risk register which are above the risk appetite as significant risks to include in the audit plan. Where the risk register is not reliable the auditor does not proceed further on the audit under RBIA methodology.

4.8 Prior to preparing the internal audit plan, it is necessary to understanding as to how those risks to which the organisation is exposed have been assessed.to is necessary. Risk Assessment has three processes *viz.* risk identification, risk estimation and risk evaluation.

4.9 Risk Assessment can be defined as the *"overall process of risk analysis and risk evaluation"*. Risk assessment has also been defined as *"identification and analysis of relevant risks to achievement of the objectives, forming a basis for determining how the risks should be managed"*[4].

4.10 As discussed earlier, there are two categories of risks to which any organisation is exposed to *viz.* external risks and internal risk. No standardized quantitative and/ or qualitative model available to assess both these kinds of risks. This is because even though industry risks to which anorganisation is exposed, may remain constant, the impact that risk would have on each organisation in that Industry differs from one to another. A mix of quantitative and qualitative methods is normally used in risk assessment process.

4 Defined by Committee of Sponsoring Organisations (COSO) of the Treadway Commission.

4.11 An illustrative model process for identifying, estimating and evaluating risks are given in Appendix 1. Under RBIA, the internal auditor compares the organisation's risk assessment process (usually mentioned in the risk framework) with that of the model process to form a view on the design. The next step is to test check, compliance with this process. Based on this, the internal auditor concludes whether to *rely* or *not to rely* on the risk register.

Phase 3: Internal Audit Plan Development

4.12 In this phase, the activity involves putting the significant risks which have been identified during the enterprise risk assessment phase into audit groups, listing out the requests for consulting (internal audit projects) made by management, preparing an internal audit calendar, allocating resources (internal auditors), collating and submitting to the Audit Committee the yearly audit plan for approval. While the yearly audit plan is updated continuously for new risks, quarterly audit plans are frozen and acted upon.

The objective of this phase is to implement the requirements of Stage 2.

Activities Partly Done in Phase 2 of the Internal Audit Process

4.13 The activity in developing an internal audit plan for an entity starts with finalizing the audit strategy which, as mentioned earlier, is derived from the auditor's assessment of the entity's risk maturity.

The next step is to decide whether to *rely* or *not to rely* on the risk register based on the enterprise risk assessment done by management.

4.14 As for different areas of the organization, risk maturity and reliability of the risk register may be different, hence, the objective would be to assess for different areas and business processes the type of assurance that can be given(traditional or RBIA) and internal audit projects (consulting assignments).

Further Activities to Develop a Periodic Internal Audit Plan under RBIA Would Include:

4.15 i. Listing the individual risks to be audited (refer to Para 3.10).

ii. Determining the periodicity (refer to Para 3.11).

iii. Deciding upon auditable units (refer to Para 3.12).

iv. Allocating resources (do limitation management where required).

v. Determining the internal audit plan and obtaining approval of AuditCommittee.

vi. Continuously updating the risk and audit universe (say, on a quarterly basis).

An Alternative Approach to Identifying Risks to be Audited

4.16 Another way to determine significant risks is the exclusion method, using the risk register. Out of the above, those risks for which internal audit is not possible or necessary, are removed. Nature of such risks include, risks within the risk appetite, risks that are to be tolerated as they cannot be brought within the risk appetite (other than where contingency plans are required), risks which are examined by third parties (example, external auditors, quality control), satisfactory results in previous internal audit (after considering changes in the concerned area). The remaining risks shall form the basis of the internal audit plan. These are those on which assurance is required. Also, those risks which may be within the risk appetite but have a high inherent risk score are normally included in the audit plan. Some organisations may need internal audits based on criteria other than risk, such as legal mandate, specific management requests. Business process is the default auditable unit under RBIA and information in the risk and audit universe (RAU) helps in developing an internal audit plan.

4.17 Business process is the *default auditable unit* under RBIA. Key business processes should be included in the internal audit plan. Other processes are also identified for inclusion.

4.18 Individual risks are listed in the risk register and business process to which the risk belongs is mentioned against that risk. Risks relating to a particular activity in a process are put into an *"audit group"*. All the audit related information such as resources allocated, yearly audit plan, issues, issues tracking, etc., end up being entered in separate columns or tables against each risk. Information on risks, processes and audits are now linked across tables. Hence, a resultant database is created and known as the risk and audit universe (RAU). The RAU helps in determining the individual risks to be examined and the audits linked to them. Extracting data from the RAU is the common way to develop an internal audit plan.

Determining and Allocating Resources-limitation Management

4.19 The duration required to complete an internal audit *vis a vis* that the required to complete all audits is estimated and compared with available resources to determine if limitations exist that may hinder the execution of the plan. Management of limitation is done to optimize the resource allocation.

Developing an Internal Audit Plan and Obtain Approval of the Audit Committee

4.20 Proposed internal audit plan should be developed (extracted) from the risk and audit universe (RAU). The proposed internal audit plan should be presented to the Audit Committee for consideration and adoption. It is often useful to highlight to the Audit Committee the risk areas/ business processesthat have been identified to be covered under RBIA, traditional audit andwhere consulting is suggested and also those which are not being covered with reasons therefor. This information enables the Audit Committee and executive management to make informed decisions on the internal audit coverage and in constructive changes to the internal audit plan.

Updating the Risk and Audit Universe (RAU)

4.21 Such update should be done regularly, say, at least every three months, based on management's reassessment of risks and conclusions from audits during the period. The impact on the audit plan should then be considered. It may be necessary to add audits where new, significant risks have been identified and remove those where risks have been reduced.

Phase 4: Internal Audit Execution

4.22 **In this phase, the internal auditor prepares the internal audit program, detailing the audit procedures to be carried out, carries out the audit procedures, discusses the observations with the auditee and prepares the audit issues.**

The objective of this phase is to implement Stage 3. During the internal audit execution process the following activities are conducted:

Reassessing the Audit Scope

4.23 The internal auditor, by this phase, becomes knowledge able of the organization and its management of risks through the following activities he has undertaken:

- strategic analysis an understanding would have been developed of the objectives, strategies, risks, responses and the overall process map of the organisation.
- entity level risk maturity review an understanding of the organisation's risk environment which may be different for areas/ business processes.
- review of the management's risk assessment the reliability of the risk register.

4.24 Before starting any individual audit, the auditor does a diagnostic check specific to that area/business process to see whether the audit scope remains the same or needs to be modified. This diagnostic check includes:

- ***Assignment Level Risk Maturity***

  The internal auditor reassesses the assignment risk maturity to reassess the audit scope.

- ***Business Process Analysis***

  Through a business process review the internal auditor gains a detailed understanding of that particular process under audit and assesses the risks therein and may result in a scope change. This understanding is carried out through interviews and discussions with process owners or control owners. The process understanding should be documented in narrative or through flowcharts and confirmed by the process/ control owners.

Preparing the Internal Audit Program

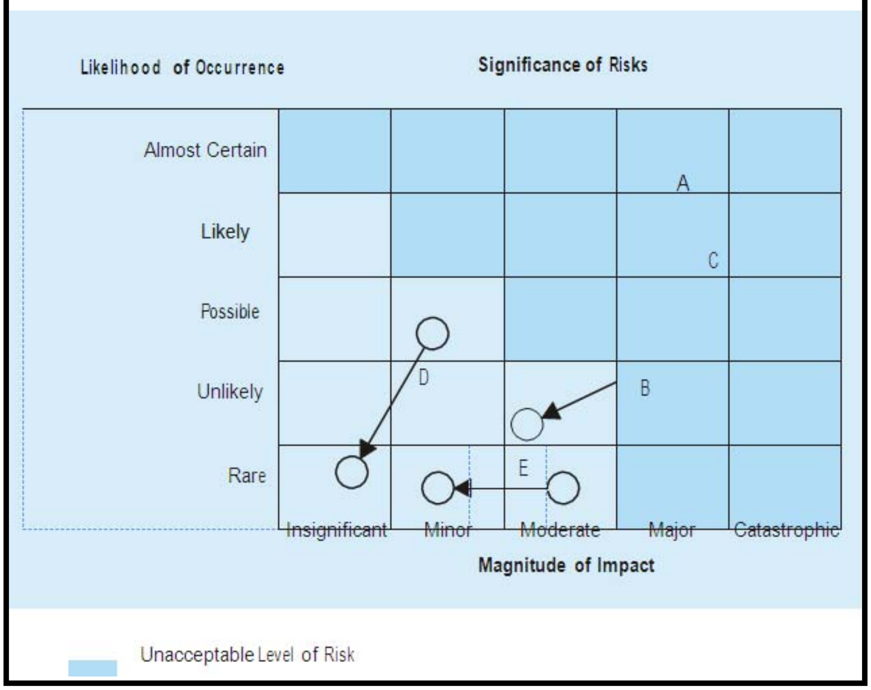
4.25 The internal audit program consists of two sections, *viz.,*

- Where the internal auditor is testing risk management in business processes, the internal audit program will consist of audit procedures to test design and compliance as observing, enquiring, process walkthroughs, depth checks, reviewing monitoring controls, etc.
- Where the internal auditor is testing for the adequacy of the response to risks, the audit procedures to test the internal controls would include verification, recomputation, etc. Prior to that, assessing whether the type of response, such as treat, transfer, tolerate are adequate.

4.26 Usage of the process - risk matrix to determine the areas of emphasis in an audit. Information gained from a number of sources, including strategic analysis, enterprise risk assessment, business process analysis, etc., assist in driving the areas of emphasis in an internal audit program. This is further refined through a process-risk matrix. As illustrated below the process-matrix helps in understanding the interplay of inherent risks, residual risks, risk appetite, importance of controls, etc.

Table 5: Process Risk Matrix with Inherent and Residual Risk

(Cumulative risks of a business process shown in their inherent and residual state and the length of the arrow shows the control score/importance of controls).



4.27 This tool can be used either for processes under audit or individual risks in a process. In the above table, business processes under audit are being studied.

- The controls that govern process B move the risks from an unacceptable to an acceptable level. Therefore, testing these controls to determine the effectiveness of the control design is the way forward.
- Process A shows an example of where the residual risks of the process continue to be beyond the risk appetite. This

point to the need for either re-evaluation of internal control design or review of the risk response (treat).

4.28 Internal audit procedures on business process audit do not change under RBIA *viz.*,

- Tests of design are associated with internal control design and may be primarily performed during business process analysis. Three types of observations may arize, *viz.*, the process is under-controlled, over- controlled, or inadequately controlled.

- Tests of effectiveness confirm whether key internal controls identified during business process analysis are in existence and are operating as intended.

There may be regulatory compliance issues that also require testing. These issues should be noted in the internal audit program.

4.29 Document evidence, report observations (issues) and update risk register.

- Audit evidence can be physical, documentary, or analytical. The type and source of test evidence obtained and used to complete testing should be documented in the working papers. Each test procedure should link back to the specific scope of internal audit.

- Based on the results of internal audit procedures, observations noted should be documented. Decision is then taken on which observations shall be carried through to the draft report.

- During testing it may be found that while management's view was that internal controls were well designed, it did not address the risk as intended. In this case, management may need to reassess the level of residual risk actually delivered by the internal control and respond accordingly. Risk register should be updated based on necessary changes in assessment of risks and response to it.

Phase 5: Reporting

4.30 In this phase, the internal auditor communicates the audit issues at different levels of management, obtains the management reply on the proposed action to be taken.

Objective

4.31 The primary objective of reporting is to effectively communicate the results of the internal audit work, thereby helping drive the changes that contribute to the achievement of organizational objectives. Reporting occurs through formal documentation and respective meetings with the process owners, senior management, audit committee and other stakeholders of the audit process.

Reporting Levels

4.32 Strategic-level reports are prepared to communicate the results of work performed to the most senior levels within the organization.

The audience for the process-level reports includes many of the organisation's senior management as well as executive management. Similar to strategic- level reporting, the outputs generated from the process-level activities need to be developed with significant organisation participation and acceptance. In addition to the outputs derived from the process analysis work, as applicable, individual audit reports are also covered.

Internal Audit Report

4.33 The following structure can be used as a basis for internal audit reports. The reporting format used is agreed with the organisation preferably at the inception of audit work.

4.34 *Executive Summary:* An Executive Summary is usually no more than three to four pages with a target audience of senior executives and the audit committee. The summary should focus on outlining the key issues in the report, which will allow the reader to quickly focus on the issues that require immediate attention. *(Refer to Exhibit 7 for a sample report)*

4.35 *Issues:* The purpose of this section is to list the issues to be resolved together with how, when, and by whom they will be resolved. This section would include the issue classification, a brief description, and risk to the organisation, recommendations for resolution, and a management response.

4.36 When applied thoroughly, risk-based internal audit methodology assists in identifying areas of unacceptable residual risk. For departments or subsidiaries within the organisation and auditable processes within that organization, RBIA will provide management with sufficient information to allow them to better optimise and more effectively manage strategic and process risks.

Reporting to Audit Committee

4.37 The internal audit function ultimately reports and is accountable to the Audit Committee. Prior to meeting the audit committee, internal auditors may prepare internal audit reports for the projects performed during the audit cycle and distribute them to the members of the audit committee and other concerned parties. This distribution allows the Committee to effectively examine and consider the issues when provided with sufficient lead time prior to the Audit Committee meeting.

Phase 6: Issue Resolution Tracking

4.38 **In this phase, the internal auditor tracks the progress of action on the issues where management action was agreed upon.**

Throughout the conduct of internal audit, issues are identified and reported, and ultimately action plans to resolve these issues are agreed to by management. If these action plans are not implemented, the organisation's risk exposure is not sufficiently mitigated and the value of the internal audit function is less likely to be realised. The follow-up process monitors the progress of agreed-upon management action plans and reports this progress to senior management and the audit committee. This phase involves a process to assess management's progress against the agreed-upon action plan and whether these actions were performed adequately and timely.

Following activities are involved in issue resolution tracking:

Determining the Approach

4.39 The audit committee and senior management must support the follow-up process and be willing to intervene in the process when a follow-up action is not being implemented. The method and timing of follow-up and roles and responsibilities should be formally agreed upon with the organisation.

Assessing Issue Resolution Activities and Comparing with Agreed Action Plans

4.40 Internal audit should determine whether corrective action was taken and is achieving the desired results, or whether the senior management or the Board has assumed the risk of not implementing the agreed-upon corrective action.In the event that a corrective action has not been taken, written confirmation from management stating that senior management or the Board has assumed the risk of not implementing the agreed-upon corrective action should be taken.

To effectively perform these tasks, following activities need to be coordinated:

- Determining which findings should be followed up.
- Confirming that the reported management response actually occurred.
- Evaluating the reasonableness of management response.

These activities can be performed in conjunction with a scheduled internal audit as per the internal audit plan or as a separate, discrete review. It is important to assess the status of these action plans and the related internal audit test work, as they may affect audits in the current plan.

Reporting

4.41 An issues tracking (or follow-up) report (illustrating the current status of the agreed-upon management action plans) is compiled by the internal auditors. This report allows the Audit Committee and senior management to assess the status of improvements between each audit reporting period. This report may also cover internal auditor's assessment of the effectiveness with which agreed upon action plans are implemented by management.

Chapter 5

Some Pitfalls and the Way Ahead

Pitfalls During the Assignment

5.1 Some difficult situations which the internal auditor may come across during the course of the assignment are discussed in the following paragraphs.

Lack of Support from Process Owners/ Key Management Personnel

5.2 Internal auditors quite often face instances of lack of support from process owners. Operational personnel tend consider internal audit as avoidable work as they have different priorities. They may not want to be questioned on the way they manage risks. To minimise such situations, it helps to have the support of those decision makers who are responsible for establishing sound internal controls and an internal audit environment in the organisation. The Chief Internal Auditor may find it useful to promote RBIA and the value it brings to these decision makers with respect to their compliance objectives.

Lack of Proper Communication to the Auditee

5.3 Another common pitfall during internal audit is that the only information the auditee has is the date of the by the internal visit, name of the internal auditors and copies of earlier reports. It is assumed that the internal audit will be carried out similarly as in the earlier period. This lack of information may result in low cooperation from the auditee. To avoid such scenarios the internal auditor should ensure that:

- Terms of reference and scope of the internal audit are discussed with the responsible management.
- Auditee is informed of the proceedings prior to the field visit.

- Internal auditors are known to be fair in their approach, preparing balanced-view audit reports by including auditee's replies.

Delegation of Internal Audit Planning to Field Audit Team

5.4 It is not an uncommon practice in a multilocational organization for the field audit team to send the audit plan to the principal internal auditor at the head office for approval. This may not be a good practice. At times the internal auditor at field level get caught up in complying with the internal audit manual, completing checklists, meeting personal targets, etc., at the cost of bringing value in the reports. For example, he may not focus on high risk areasor areas which are of importance to management- as risks in critical processes, risks with large control scores, etc., Audit planning hence plays a crucial roleto the effectiveness of RBIA. Audit planning cannot therefore be delegated and should be undertaken only by the senior audit team even if it sits at the headoffice.

Misplaced Focus on Risk Scores

5.5 This is common when significant effort has been put in by the organisation during the risk scoring activity at the time of preparation of the risk register. Because of the time constraint the organization may start putting undue reliance on risk scores while for the auditor these scores are indicative and a way to identify significant risks. The internal auditor uses qualitative information to finalise the risks to be considered in the audit plan. Also, at times, he may leave out certain significant risks as they are covered by other auditors. In the above situation, it is important to communicate this aspect so that there is no loss of credibility of the coverage in the internal audit plan.

Other Significant Factors

5.6 RBIA cannot be carried out without interacting extensively with management. Interviewing skills and managing risk workshops are a prerequisite. The internal auditor may need to curb his enthusiasm during these activities and not overstep his role. Also, for both these activities preparation is required, *viz.*

- It is always easier to interview managers if an agenda is circulated in advance. Also, it helps if the discussion is open and the internal auditor avoids trying to direct it. Lastly, the minutes of the interview should also be circulated.
- For risk workshops also, the agenda should be circulated in advance and should be kept simple. Short workshops prove more useful, example, five objectives and 100 minute duration. Using a board or a flip chart for participants to present their view is a standard norm. Minutes should be circulated by the internal auditor within reasonable time. The internal auditor should restrict his role as a facilitator and use the inputs in his audit planning/ fieldwork documentation.

5.7 Internet facilitates the internal audit activity, especially in organizations which are multi locational. Some forward looking organizations already have an internal audit portal as part of their web site. These portals are password protected and contain self assessment questionnaires, working papers, internal audit plan, internal audit reports, issue tracker, etc. It is also possible to conduct an audit under guidance of a senior auditor who is at a different geographical location. Internal auditor need to have strong skills in using web based environment.

The Way Ahead

5.8 Benefits to the management to follow a Risk based internal audit approach in internal auditing are now fairly obvious. Once internal audits based on RBIA is implemented in organizations, the positioning of the internal audit function should improve dramatically.

5.9 The current situation in India is that as RBIA audit approach is in the introduction stage, the skill of the practioner on how he conducts the initial activities in introducing RBIA approach is critical to the acceptance by management. In this regard, following suggestions may be useful:

- Assist the client to develop a risk register and see that it is updated regularly.
- Hold workshops, interviews so that the thinking process also includes risks.
- Assist in preparing a Risk and Audit Universe (RAU).
- Assist the Audit Committee fix the risk appetite by periodically making presentations on:
  - the key risks and the suggested response.
  - the risk assessment processes.
  - risk scores.

Once there is a acceptance by the Audit Committee, it is likely that RBIAwould get introduced within the organisation.

Exhibit 1

Measurement Yardstick for Likelihood of Risk

Likelihood of Risk Occurrence		
Level	**Description**	**Ranking Criteria**
1	Remote	Event may only occur in exceptional circumstances
2	Unlikely	Event could occur in rare circumstances
3	Possible	Event could occur at some time
4	Likely	Event could occur in most circumstances
5	Almost certain	Event is expected to occur in most circumstances

Exhibit 2

Measurement Yardstick for Risk Consequences*

Risk Consequence					
Level	**Descr1iption**	**Ranking Criteria**	**Impact**	**Resulting in**	**Illustrations**
1	Insignificant	• < Rs. 50 lakh impact on profitability • No impact on market share • No impact on reputation	Low	Causes minor inconvenience without impacting the achievement of objectives	• No potential impact on market shar • No impact on brand value • Issues would be delegated to junior management and staff to resolve
2	Minor	• Rs. 50 lakh Rs. 2 crore impact on profitability • Consequences can be absorbed under normal operating conditions • Potential impact on market share • Potential impact on reputation	Low to Moderate	Causes inconvenience without impacting the achievement of objectives	• Consequences can be absorbed under normal operating conditions • There is a potential impact on market share and brand values • Issues will be delegated to middle management for resolution
3	Moderate	• > Rs. 2 crore to Rs. 5 crore impact on profitability • There is some impact on market share • There is some impact on reputation	Moderate	Preventing organisation from achieving some of it's objective for limited period	• Market share and/or brand value will be effected in the short-term • The event will require senior and middle management intervantion
4.	Major	• > Rs. 5 crore to Rs. 10 crore impact on profitability • Market share will be affected in the shor term • Reputation is affected in the short term	Moderate to High	Preventing organisation from achieving majority of it's objective for a long time	• Serious diminution in brand value and market share with adverse publicity. • Key alliances are threatened • Events and problems will require Board and senior management attention
5.	Catastrophic	• > Rs. 10 crore impact on profitability • Serious diminution in reputation • Sustained loss of market share	High	Closing down of organisation/operation or significant part for a long time	• Loss of key alliances • Sustained, serious loss in market share

* The amounts (figures) given in this Exhibit are for illustrative purposes only and are not intended to serve as benchmarks.

Exhibit 3

Measurement Yardstick for Risk Score

Likelihood of Risk	Consequences of Risk				
	Insignificant (1)	Minor (2)	Moderate (3)	Major (4)	Catastrophic (5)
Almost Certain (5)	5 × 1 = 5	5 × 2 = 10	5 × 3 = 15	5 × 4 = 20	5 × 5 = 25
Almost Certain (4)	4 × 1 = 4	4 × 2 = 8	4 × 3 = 12	4 × 4 = 16	4 × 5 = 20
Almost Certain (3)	3 × 1 = 3	3 × 2 = 6	3 × 3 = 9	3 × 4 = 12	3 × 5 = 15
Almost Certain (2)	2 × 1 = 2	2 × 2 = 4	2 × 3 = 6	2 × 4 = 8	2 × 5 = 10
Almost Certain (1)	1 × 1 = 1	1 × 2 = 2	1 × 3 = 3	1 × 4 = 4	1 × 5 = 5

LEGEND

- Risks which require immediate attention
- Risks which should be monitored and brought down to green
- Risks which do not require action

Exhibit 4

Illustrative Risk Heat Map

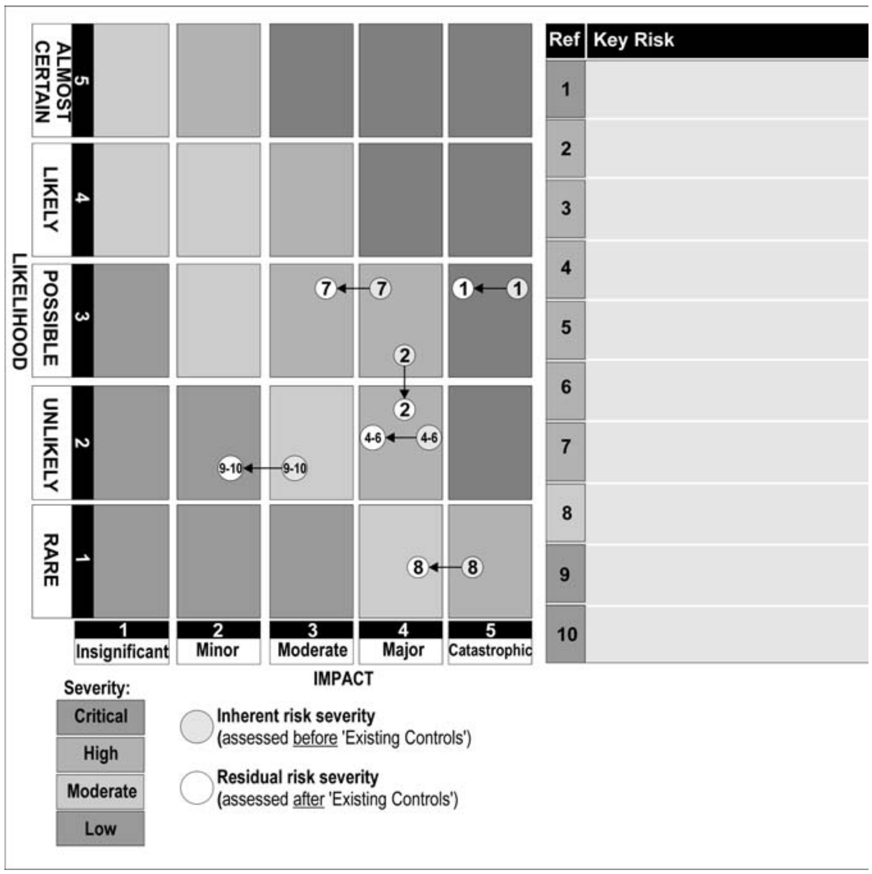


Exhibit 5

Illustrative Risk Register (Part A, B, C)

Part A: Summarised Risk Register

Auditable Unit: Bullion **ABC Bullion Trading Company**

Process: Gold Sale **Summarized Risk Register**

Sub Process: Order Booking[5] **Serial No of Risk 121-128**

Process Objectives	Critical Success Factors	Failure Rate
Sell gold on behalf of Principal at no financial and physical risk to our company	Order booking should consider future risks and treat them at this stage itself	Number of times gold delivery process initiated on the basis of manual instructions i.e., prior to first using GMS software for order booking

Risks which Threaten Objectives	Likelihood	Impact	Controls
Inadequate training provided to employees on the significance of gold procedure manual and its compliance	Possible	Major	New employees receive training as part of orientation process. Existing employees eceive periodic compliance training.
At times no trained person on GMS at a branch	Almost certain	Major	Head office maintains a roster of trained persons on GMS who can be deputed for short durations to branches

5 As per the Gold procedure manual, when gold is sold on cash basis, the rate is the spot rate. When sold on loan basis the transaction has to be completed and paid for within 21 days of delivery of gold. The bank guarantee submitted should be 110% of the spot rate on loan date. During the loan period the price fixing day is at the choice of the buyer. However once price is fixed the full payment must be credited in the company's bank account on that day itself otherwise bank guarantee is to be invoked the next day.

At times, no action on monitoring reports	Likely	Major	Alerts sent to multiple officers
New risks crystalising without the branch being aware	Possible	Moder-ate	Quarterly review for updating of risk register

Part B: Risk Register Showing Inherent Score of Risk

S.No. of Risk	Process	Sub Process (Level 1)	Sub process (Level 2)	Process Owner	Risk	Risk consequence	Gross Risk Assessment[6]		
							Impact	Likehood	Overall
121	Gold sale	Order booking	Gold to be said for cash	Bullion Officer	Novice buyer of gold bars	Messy dealings and time westage of staff as company does not sell less than a gold bar	2 (minor)	4 (likely)	8 (moderate)
122	-do-	-do-	-do-	-do-	Gold rate fluctuates during the day and the rate forced may not be accepted by Principal	Disagreements with Principal which may result in financial loss and reputation risk	4 (minor)	4 (likely)	16 (catastrophic)
123	-do-	-do-	Gold to be sold on loan basis (delivered now, rate fixed later on, payment need when, rate fixed)	Branch Manager	Buyer may later on defalut or delay payment	Financial loss to company	4 (minor)	4 (likely)	16 (catastrophic)
124	-do-	-do-	-do-	-do-	Buyer may later on dispute the spot rate fixed	Financial loss to company	4 (minor)	4 (likely)	16 (catastrophic)
125	-do-	-do-	-do-	-do-	Back Guarantee (BG) expires before receipt of payment from buyer	Financial exposure which may manifest as risk on 123 and 124	4 (minor)	4 (likely)	16 (catastrophic)
126	-do-	-do-	-do-	-do-	BG lower than current spot rate	Financial exposure which may manifest as risk no 123 and 124	2 (minor)	4 (likely)	16 (catastrophic)
127	-do-	-do-	-do-	-do-	BG defective /misplaced	Financial exposure which may manifest as risk no 123 and 124	4 (minor)	4 (likely)	16 (catastrophic)
128	Gold sale	Order booking	All	-do-	Occasional deviation by staff on compliance of gold procedure manual	Financial exposure which may manifest as risks mentioned above	4 (minor)	4 (likely)	16 (catastrophic)

6 Assessing the impact and likelihood of risks has been covered in section on risk estimation below.

Part C: Risk Register Showing Residual Score of Risk

S.No. of Risk	Process	Sub Process (Level 1)	Sub process (Level 2)	Risk	Control	Residual Risk Assessment[7]		
						Impact	Likehood	Overall
121	Gold sale	Order booking	Gold to be said for cash	Novice buyer of gold bars	Order booking by only registered customers	2 (Minor)	0	0
122	-do-	-do-	-do-	Gold rate fluctuates during the day and the rate fixed may not be accepted by Principal	Rate fixed by Principal and Rate fixing serial no (RFX) is mentioned in the remittances	4 (Major)	0	0
123	-do-	-do-	Gold to be sold on loan basis (delivered now, rate fixed later on, payment recd when rate fixed	Buyer may later on default or delay payment	Bank Guarantee of 110%	0	2 Unlikely	0
124	-do-	-do-	-do-	Buyer may later on dispute the spot rate fixed	BG invoked	0	2 Unlikely	0
125	-do-	-do-	-do-	Bank Guarantee (BG) expires before receipt	Daily monitoring report generated where BG is less of payment from buyer than 105% of the closing spot rate for the day. This report is circulated at Branch and Corporate office	4 Major	1 Unlikely	4 Low
126	-do-	-do-	-do-	BG lower than current sport rate	If BG has not yet been invoked thenimmediately invoked	4 Major	1 Unlikely	4 Low
127	-do-	-do-	-do-	BG defective/ misplaced	All BG on company's format and kept at safe	4 Major	1 Unlikely	2 Low
128 .	Gold sale	Order Booking	ALL	Occasional deviation by staff on compliance of gold procedure manual (GPM)	All transactions through a software, viz. Gold management system which has inbuilt internal controls as per GPM	4 Major	0	0

7 Assessing the impact and likelihood of risks has been covered in section on risk estimation below.

Exhibit 6A

List of Information in a Risk and Audit Universe Database (RAU)

The risk and audit universe would typically contain the following information against each risk:

A. RAU - Risk Planning file

Relevant extracts from the risk register (inherent risk details)

1. Process
2. Sub process
3. Risk
4. Gross risk assessment
    - Impact
    - Likelihood
    - Overall score
5. Process owner
6. Risk consequence
7. Adjusted inherent score
8. Control score
9. Last audit
    - Opinion
    - Year
10. Audit Group.

RAU Transaction File for the Year 2007-08

11. Risk

12. Audit group
13. Next audit
    - Date
    - Man days
    - Auditor
    - Status
    - Risk opinion
    - Audit report number.

RAU Issue Tracker File

14. Risk
15. Audit Group
16. Year 2006-07
    - Opinion
    - Tracking status
17. Year 2007-08
    - Opinion
    - Tracking status.

Resource Plan (Q1 of 2007-08)

(For each resource)

18. Auditor
19. Risk
20. Audit group
21. Audit
22. Man days
    - Budget
    - Revised
23. Running calendar.

Exhibit 6B

RAU - Audit Procedures for Risks

S.No. of Risk	Sub Process (Level 1)	Sub process (Level 2)	Risk	Control	Residual Risk Assessment[7]		
					Impact	Likehood	Overall
121	Gold to be sold for cash	Novice buyer of gold bars	Order booking by only registered customers	Test GMS to set whether the software takes transactions for unregistered users	8	0	8
122	-do-	Gold rate fluctuates during the day and the rate fixed may not be accepted by Principle	Rate fixed by Principal and Rate fixing serial no (RFX) is mentioned in the remittances	Using CAAT see that against all transactions there is a RFR in GSM. Vouch RFR against the related e-mail/fax/letter recd from Principal.	16	0	16
123	Gold to be sold on loan basis (delivered now, rate fixed later on, payment recd when rate fixed)	Buyer may later on default or delay payment	Bank Guarantee of 110% taken and invoked	Using CAAT is all cases where the transaction has gone beyond 21 days and the BG has not been ivoked.Vouch these cases.	16	0	16
124	-do-	Buyer may later on dispute the spot rate fixed	BG to be invoked	Using CAAT list all cases where the payment made by the buyer is a rate differentfrom RFR. Vouch for reasons.	16	4	12
125	-do-	Bank Guarantee (BG) expires before receipt of payment from buyer	Daily monitoring report listing BG's expiring within3 days. This report is circulated Branch and Corporate office through e-mail	1. Using CAAT list all cases where BG has expired prior to receipt of payment. Vouch it. 2. Using test pack, create such cases to see whether the case is included in the e-mail.	16	4	12
126	-do-	BG lower than current spot rate	Daily monitoring report generated where BG's is less than 105% of the closing spot rate for the day. If BG has not yet been involked then immediately invoked	1. Using CAAT list all cases where BG has expired prior to receipt of payment. Vouch it. 2. Using test pack, create such cases to see whether the case is included in the e-mail.	16	4	12
127	-do-	BG defective /misplaced	All BIG on company's formate and kept at safe	Using CAAT obtain a list of all BG. Examine the BGs.	16	2	14
128	All	Occasional deviation by staff on compliance of gold procedure manual (GPM)	All transactions through a software, viz. gold management system (GMS) which has inbuilt internal controls as per GPM	Verify buyer's sign for receipt of gold on electronic delivery challan (EDN)	16	0	16

Exhibit 6C

RAU- Transaction File for the Year 2007-08

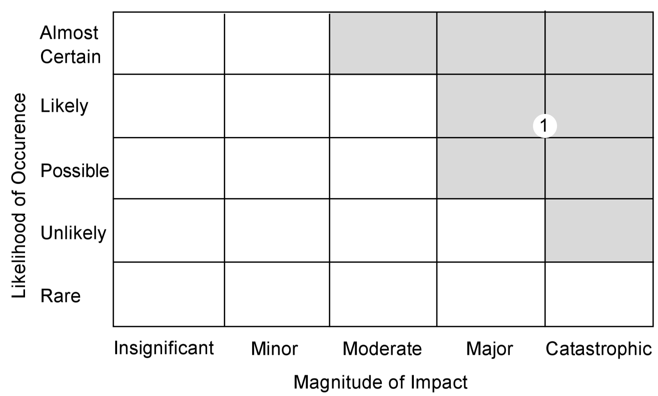
S.No. of Risk	Sub Process (Level 2)	Risk	Control	Score			Audit Procedure	2007-08				
				Interent Risk	Residual Risk	Control		Audit group	Coverage	Auditor Level	Report Date	2006 Opinion
127	Order booking-gold sold on loan basis	BG defective/ misplaced	All BG on company's format and kept at safe	16	2	14	Using CAAT obtain a list of all BG. Examine the Bgs.	B14	All Branches	Senior Manager (adult)	Jan 08	Green
128	All	Occasional deviation by staff on compliance of gold procedure manual (GPM)	All transactions through a software, viz. gold management system (GMS) which has inbuild internal controls as per GPM	16	0	16	Verify buyer's sign for receipt of cold on electronic delivery challan (EDN)	B14	do	do	Jan 08	Red

Exhibit 7

Internal Audit Report - Executive Summary

AGRA BRANCH – GOLD BULLION TRANSACTIONS				
	OBSERVATION	**Period**	**SIGNIFICANCE**	**PROCESS**
1	Electronic Delivery Note not used	03/2007-08	**KEY CONTROL FAILURE**	**GMS**

Risk Map – Audit Issues and Recommendation



Above Risk Appetite

AUDIT ISSUE

GMS was not in use for a fortnight as the only trained person, viz the Bullion officer was on leave. GMS is a risk response to all risks in the gold order fulfillment process as by using GMS all the internal controls automated have necessarily to be followed for each transaction. The Electronic Delivery note (EDN) is a key control as it implies that the transaction has been done through GMS.

AUDIT RECOMMENDATION

As the GMS is online, monitoring of the usage of this control be done whereby an e-mail is automatically generated and received the next day by AGM (Bullion) at Corporate office mentioning the branches where there was no EDN raised the previous day. AGM should enquiry the reasons and take suitable action. Also Corporate office should find a solution whereby there is always a trained person on GMS at branch.

Appendix I

Model Process for Assessing and Evaluating Risks

Steps in Risk Assessment

1. Activities in risk assessment can be put in three processes, *viz.*

   - Risk identification.
   - Risk estimation.
   - Risk evaluation.

Risk Assessment Tools

2. Following are some of the popular analytical methods used during risk assessment:

   - Market survey.
   - Dependency modeling.
   - SWOT (Strength, Weakness, Opportunity and Threat) analysis.
   - Event tree analysis.
   - BPEST (Business, Political, Economical, Social and Technological) analysis.
   - Fault tree analysis (Root Cause Analysis).
   - FMEA (Failure Mode and Effect Analysis).

Risk Identification

3. This is the start point for all risk assessment initiatives. As mentioned earlier all organizations are exposed to varieties

of threats and uncertainties which impact the objectives for which they have been established. It is essential that the risk identification process be planned and activities within streamlined. This process should ideally cover all risks and scenarios to which an organization is exposed to during the normal course of its business and also the various business activities which are a source of these risks.

4. Some of the business activities, which are a source of risk, are:

   - **Strategic** - These concern the long-term strategic objectives of the organization. They can be affected by capital availability, sovereign and political risks, legal and regulatory changes, reputation and changes in the physical environment.

   - **Operational** - These concern the day-to-day issues that the organization is confronted with as it strives to deliver it strategic objectives.

   - **Financial** - These concern the effective management and control of the finances of the organization and are affected by external factors such as availability of credit, foreign exchange rates, interest rate movement and other market exposures.

   - **Human Resources and Knowledge Management** - These concern the effective management and control of the knowledge resources, the production, protection and communication thereof. External risks include the unauthorized use or abuse of intellectual property. Internal risk could be loss of key staff.

   - **Compliance** - These concern issues as health and safety, environmental, trade regulations, consumer protection, data protection, employment practices and regulatory issues.

   - **Fraud** - All large organizations are exposed to fraud risks. Also various regulatory requirement as Clause

49 require organizations to have sound fraud control mechanisms in place

5. What is the best way to identify these risks? Whether it should be identified by people within the organization? Or external resources who specialize in these areas? Or a blend of both internal and external specialists? Who are the best resources internally to perform risk identification?Once again there is no standard practice or guideline which is followed. This decision would depend upon the management, expertise of internal resources, etc. Generally Internal Auditors are considered to be the appropriate personnel to facilitate this activity. Ownership of identifying the risks correctly remains with line management.During risk identification care should be taken to identify 'inherent/gross' risk. Rather than concentrating on 'residual/ net' risk. If this is not done the organization will not know what its exposure will be should controls fail. Knowledge on the inherent risk also allows better consideration of whether there is over-control in place if the inherent risk is within the risk appetite, resources may not need to be expended on controlling that risk. Knowledge about both 'inherent' and 'net' risk is important because the extent to which the risk needs to be addressed is informed by the inherent risk whereas the adequacy of the means chosen to address the risk can only be considered when the residual risk has been assessed.

Risk Identification Methods

6. To identify risks one of the following methods are used:

   - Surveys.
   - Interviews.
   - Workshops.

7. Following is the illustrative list of questions which could be used for surveys/interviews/ workshops:

   - From your perspective, what are your key business and/ or your area objectives?

- What are some of the significant internal and external risks faced by the organization in the achievement of the business and area objectives?
- From your perspective what is the likelihood of the risk occurring?
- From your perspective what is the consequence of the risk?
- What are some of the measurable performance targets and key performance indicators (KPIs) that can be linked to monitoring/mitigating the risks identified? (For example Budget to actual, ratings performance ranking).
- What is the frequency of measuring these KPIs?
- What other actions are taken to mitigate/ manage the risks identified?
- What is the frequency of these actions?
- Who is responsible for monitoring these risks?

Industry Risk Models

8. In addition to these generally used methodologies, industry-sector wise risk model can also be used. Generally these models are developed by professional organisations. Industry-sector model is helpful in identifying dynamic risks to which an organization is exposed to.

Which Method to Use ?

9. What is the most effective method or whether a combination of these methods should be used? This depends on various factors including the organizational culture, time available to complete risk identification, etc. Normally this comes with experience to the risk practioner.

Typical Risk Areas

10. Identification of the risks associated with business activities and decision making may be strategic/ tactical, project/ operational. It is important to incorporate risk management at the conceptual stage of projects as well as throughout the life of a specific project.

11. During identification of internal risks it would be important to consider aspects as organizational structure, locations, objectives of the organization, key business processes and functions, strategic partners, outsourced service providers, etc.

12. During identification of external risks the political, economic, social and regulatory aspects in which the organization is functioning needs to be considered. Since identifying external risks is a complex activity generally organizations utilize forecasts and current events/ scenarios. Because of its complexity organization can utilize specialized external sources in this area.

13. An illustrative listing of areas in an organization where risk arises is given below:

Governance	Finance	Operational	Preparedness	Integrity
Authority	Funding	Quality	Morale	Management fraud
Leadership	Financial instruments	Customer service	Workplace environment	Employee fraud
Performance	Financial reporting	Pricing	Confidentiality	Illegal acts
Corporate direction and strategy	Foreign exchange/ currency	Obsolescence	Communication flow	Unauthorized use
Incentives	Cash flow	Sourcing	Communication infrastructure	Unauthorized
	Investment evaluation	Product development	Change acceptance	

	Treasury	Product failure	Change readiness	
	Payroll	Business interruption	Challenge	
	Debtor/creditor management	Contingency Planning	Ethics	

Compliance Technology	**Environment**	**Human**	**Resources**	**Reputation**
Health and safety	Seasonality	Competencies	Brand	Reliability
Environment	Globalization	Recruitment	Reputation	Management information systems
Copyright and trademarks	Competition	Retention	Intellectual property	Access/ availability
Contractual liability	E-commerce	Performance measurement	Stakeholder perception	IT security
Taxation	Share price	Leadership development		
Data protection	Strategic uncertainty	Succession planning		

Risk Estimation (or Risk Measurement/ Risk Scoring)

14. Risk estimation can be defined as 'assessing the impact of the risk on the organisation.' During risk estimation the following should be kept in mind:

    - Difference between, inherent and residual risk needs to be established.
    - Ensure that there is a clear process methodology on risk estimation so that both likelihood and impact are considered for each risk.

- Record the estimation of risk in a way which facilitates monitoring and the identification of risk priorities.

15. As discussed earlier all organizations are exposed to various categories and nature of risks, and quantitative methodology may not be sufficient and relevant to complete risk estimation. Hence qualitative characteristics and judgment, knowledge of the management on the organization needs to be utilized (example in the case of reputation risk - a subjective view is all that is possible). Hence risk evaluation is more of an art, than science.

16. Risk estimation can be quantitative, semi-quantitative or qualitative in termsof the probability of occurrence and the possible consequence. The use of a well designed structure is necessary to ensure comprehensive risk identification, estimation and evaluation process. Different organizations will find their own measures of consequence and probability that will suit their needs best. For example many organizations find that assessing consequence and probability as high, medium or low is quite adequate for their needs and can be presented as a 3x3 matrix. Other organizations find that assessing consequence and probability using a 5x5 matrix gives them a better evaluation. If clear quantitative evaluation can be applied to the particular risk - "5x5" matrices are often used, with impact on a scale of "insignificant/ minor/ moderate/ major/ catastrophic" and likelihood on a scale of "rare/ unlikely/ possible/likely/ almost certain".

    Illustrations for measuring probability of occurrence and magnitude of impactof risk (5x5 criteria) are in Exhibit 1 and 2. Also refer to Para 2.4-2.8.

Risk Evaluation

17 When the risk estimation process for each risk has been completed, it is necessary to compare the estimated risks against risk criteria (i.e., risk appetite) which the organisation has established. The risk criteria may include associated costs and benefits, legal requirements, socioeconomic and

environmental factors, concerns of stakeholders, etc. Risk evaluation therefore, is used to make decisions about the significance of risks to the organization and whether each specific risk should be accepted or treated.

18. A common method of evaluation is to use a 'risk heat map'. The 'risk score' of a risk is the multiple of 'likelihood score' and 'significance score' which is adjusted by the qualitatitive assessment of the management. (Refer to Exhibit3 for risk score). The risk heat map has likelihood of risks and impact of risksas the two axis and individual risks are plotted on it based on their risk score. Further a "traffic light" approach is used to show the risk, where green signifies do not require action, those which are amber should be monitored and managed down to green if possible, and those which are red require immediate action (refer to Exhibit 4 for risk heat map).

Usage of Risk Scores

19. From the management's perspective when it is reviewing the risk register for CEO/ CFO reporting purposes and giving a disclosure in the Annual accounts on the internal controls, it is not the inherent risk score but the residual risk score which is important; as management wants to assess whether the residual risk is regarded as tolerable, or how far the exposure is away from tolerability.

20. From the internal auditor's perspective it is the inherent risk score which is important as the internal auditor is to give an assurance on the design and adequacy of risk identification process as part of his overall assurance on the risk management process.

Appendix II

Score Card for Assessing Risk Maturity

A. Check list for Assessing Risk Maturity[8]

Risk maturity is the degree to which the organisation understands its risk and has implemented ERM.

a. Understanding on Objectives and their Associated Risks

1. The organisation's objectives are documented and understood.
2. Management has been trained to understand as to what risks are and their responsibilities for them.

b. Installation and Usage of Risk Management within theOrganization

3. Process have been defined to determine risks and these have been followed.
4. A scoring system for assessing risks has been defined.
5. All risks have been assessed in accordance with the defined scoring system.
6. Response to the risks have been selected and implemented.
7. The risk appetite has been defined using the scoring system.
8. Risks have been allocated to specific job titles in the risk register.
9. Management have set up monitoring controls on processes, responses and action plans.

8 Based on An approach to implementing Risk Based Internal Auditing, IIA, UK and Ireland

10. Risks are regularly reviewed by the organization and the risk register updated.

11. Management report risks to Directors where responses have not managed risks the risks to a level acceptable to the Board.

12. All significantly new projects/ products are routinely assessed for risks.

c. Assessment on Managers Understanding and Usage of Risk Management

13. Responsibility for determination, assessment and management of risks is included in job description.

14. Managers provide assurance on the effectiveness of their risk management.

15. Managers are assessed on their risk management performance.

B. Suggested Scoring and its Interpretation

Score

0	-	No
1	-	Yes, Incomplete/ Possibly
2	-	Yes.

Conclusion on Risk Maturity

0 - 7	:	Risk Naïve
8 - 14	:	Risk aware
15 - 20	:	Risk defined
21 - 25	:	Risk managed
26 and above	:	Risk enabled.

G-3
GUIDE TO IMPLEMENTING ENTERPRISE RISK MANAGEMENT

Foreword

The concepts of risk and risk management are core of enterprises. An Enterprise Risk Management (ERM) system anticipates how an enterprise could be affected by a particular risk. ERM, in a contemporary entrepreneurial venture, is all pervasive, cutting across management levels and functional/departmental lines. Besides, ERM is equally important, not withstanding the nature, type, sector or commercial/philanthropic objectives of the entity. Members of the Institute have a valuable role to play, in both in helping entities to design and implement ERM framework and as internal auditors, in assessing the efficiency in functioning of that framework.

The Institute of Chartered Accountants of India, in its role as the regulator of the profession of chartered accountancy in India, has also been working proactively to keep its members well informed and abreast of the various technical intricacies involved in performing the attest function. I am happy to note that as another step in this direction, the Internal Audit Standards Board of the Institute has brought out the Guide to Implementing Enterprise Risk Management.

I wish to place my appreciation to CA. Abhijit Bandyopadhyay, Chairman, Internal Audit Standards Board for bringing out this Guide to Implementing Enterprise Risk Management. I am pleased to note that the range of topics is broad and carefully chosen for its applicability to practice.

I am sure the Guide would provide the readers the essential analytical foundations of risk management and would be another benchmark as the technical literature brought out by the Institute.

17th December, 2008 — **CA. Ved Jain**
New Delhi — *President*, ICAI

Preface

The primary objective of the Internal Audit Standards Board when it was established in 2004 was to enable the members to provide more effective and efficient value added services related to this field to the Industry and others and help them systematise and strengthen their governance process by systematising and strengthening their control and risk management process.

Developing internationally benchmarked technical literature is integral to the achievement of the above objective. In that line, the Board has, on the one hand, brought out a number of Standards on Internal Audit, codifying the best practices in the area of internal audit, on the other, it has also been bringing out generic as well as industry specific guides on various contemporary issues in the area of internal audit.

Enterprise risk management (ERM) is a concept which has come up in a significant way for the modern business enterprises. Managements have realized that even with huge human, physical and capital resources at their disposal, survival and growth of an organisation cannot be ensured if the latter does not have an adequate and formal system to identify and manage its risks. With the growing volatility and uncertainty in the operating environment for organisations, enterprise risk management is emerging as an area critical to effective decision making and resource planning. Organisations today are therefore, deploying considerable amounts of resources in understanding, establishing and ensuring effective working of an ERM system. The current economic scenario has only reiterated the need for an ERM system that can withstand the test of time.

This Guide to Implementing ERM has been written with the primary objective of helping the readers understand the essentials of implementing an ERM system in an organisation. It provides, in a simple manner, a step by step guidance to implementing ERM framework as also the issues that would be faced during implementation. At this juncture, I am grateful to CA. Deepak Wadhawan, New Delhi, CA. Neville Dumasia, CA. Anothony Crasto and CA. Chandrashekhar Mantha for squeezing time out of their professional and personal preoccupations to share their years of experience, knowledge and expertise in the area of enterprise risk management in the form of this Guide. I am also grateful to CA. RN Joshi, CA. Shrikant Sarpotdar, CA Pankaj Sahai, CA. Nikhil Kochhar and other professionals who have provided their invaluable suggestions to give this Guide a final shape. I also wish to thank CA. Ved Jain, President and CA. Uttam P Aggarwal, Vice President, ICAI for their continuous support and encouragement to the initiatives of the Board. I must also thank my colleagues from the Council at the Internal Audit Standards Board, *viz*., CA. Bhavna G Doshi, Vice Chairperson, CA. Sunil H Talati, CA. Mahesh P Sarda, CA. Shanti Lal Daga, CA. K P Khandelwal, CA. Manoj Fadnis, CA. Anuj Goyal, CA. Amarjit Chopra, Shri Manoj K Sarkar, Shri A K Awasthi, Dr. Pritam Singh and Shri O P Vaish for their vision and support. I also wish to place on records my gratitude for the co-opted members on the Board, *viz*., CA. Paratha Sarathi De, CA. N K Aneja, CA. Charanjit S Attra, CA. Nagesh D Pinge as also special invitees on the Board, *viz*., CA. Harinderjit Singh (my Council colleague), CA. Deepak Wadhawan, CA. Manu Chadha, CA. Santosh Nair and CA. Amit Roy for their devotion in terms of time as well as views and opinions to the cause of the professional and the national development. I also wish to place on record the efforts put in by CA. Puja Wadhera, Secretary, Internal Audit Standards Board and CA. Arti Agarwal, Executive Officer, in finalising the Guide.

I am sure that the readers would find this Guide immensely useful. I eagerly look forward to the feedback of the readers on the Guide.

CA. Abhijit Bandyopadhyay
15th December, 2008 *Chairman,*
Kolkata Internal Audit Standards Board

Contents

Risk	Risks are those uncertainties which impede the achievement of the objective.
Risk Capacity	Risk capacity is the quantum of risk that an organisation can absorb without affecting its business objectives.
Risk Appetite	Risk appetite is the level of risk which an organisation is willing to accept.
Risk Response	Risk response is the measures that an organisation takes to ensure that the overall risk levels within the organisation are within its risk appetite.
Inherent Risk	Inherent risk is the quantum of risk without considering the existing controls within the organisation to mitigate that risk.
Residual Risk	Residual risk is the quantum of risk after considering the existing controls within the organisation to mitigate that risk.
Internal Risk	Internal risks arise from the events taking place within the business enterprise. Such risks arise during the ordinary course of a business.
External Risk	External risks arise due to the events triggered in the environment outside the business organisation.
Controllable Risk	Controllable risks are those risks where the management is able to implement measures either to prevent those risks or minimize their impact.

Non-Controllable Risk	Non-Controllable risks are those risks which the management may not be able to anticipate effectively and will need to resort to detective measures or procedures post the risks has occurred to minimize their impact.
Enterprise Risk Management	A process, effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risks to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives – COSO Enterprise Risk Management – Integrated Framework, 2004.
Residual Risk	Residual risk is the quantum of risk after considering the existing controls within the organisation to mitigate that risk.
Risk Quantification	Risk quantification involves assigning an economic value to the risk based on its likelihood and impact.
Risk Events	Events which negatively impact the organization's objectives.
Opportunities	Events which could positively impact the organisation in achieving its objectives.
Risk Assessment	Risk assessment is a process of classifying and prioritization of risks based on their impact and likelihood.
Controls	Controls are activities which ensure that the risk response is implemented for the identified risks.
Residual Risk Portfolio	Residual risk portfolio is an inventory of risks after considering the existing mitigating controls.

Chapter 1

Introduction

1.1 Rapid and continuous change in the business environment is encouraging management to increasingly become more risk focused. Global extraordinary events as the financial meltdown has further enhanced the need for companies either to strengthen their risk management procedures or implement a robust framework to consolidate their fragmented risk management activities.

1.2 Business planning and annual budgeting process is a key tool for management to operationalise its vision and goals. The business planning process has matured significantly over the last two decades. Earlier, planning meant taking out a yearly business plan based on usually a percentage change from the previous year. Increasing competition since the 1990s has resulted in business plans being based more on the outcome of a strategy and less on working on the previous year's spreadsheets. Late 1990's saw a strong correlation between current market price (CMP) of shares and management's performance in meeting their quarterly forecasts. This necessitated managing risks more effectively in shorter time spans of a quarter instead of six months or a year as earlier. The importance of bringing qualitative improvements in quarterly plans and carrying out tactical measures to meet them has also become an important agenda in the short run. Leading companies are now considering risk management as an integral element of the annual budgeting process wherein costs (e.g., capital expenditure, increase in operational costs, insurance costs, etc.) to manage risks effectively are adequately estimated and planned for.

Table 1: Basis of Making the Yearly Business Plan

Period	*Driver of plan*	*Basis of the plan*
1980's	Business- as usual	New targets were prepared by making a percentage change to last year's figures.
1990's onwards	Competition	Outcome of strategy meetings drove targets in the new business plan.
2010's (projected)	Events arising out of the business environment	Anticipated risks that threaten objectives have started playing a crucial role in framing strategies.

1.3 One of the ways entities managed risks in shorter duration of time has been to create a risk management culture at different levels of the entity. The higher the level of risk maturity of an entity, the better prepared it is to either convert market uncertainties into opportunities or implement the measures to reduce their exposures. The aim of a robust Enterprise Risk Management (ERM) framework is to help the organisations manage their risks effectively, reduce the possibilities of any surprises with large exposures and continuously enhance the maturity levels. ERM is evolving more as an important strategic tool for management in turbulent market environment.

1.4 The objective of this Guide is to provide guidance on implementing an Enterprise Risk Management (ERM) Framework.

Chapter 2
Risk Management

Understanding Risk and Its Assessment

Meaning of Risk

2.1 Entities exist for a purpose. For private sector, the purpose is to enhance shareholder value. Government or not-for-profit organizations may have the main purpose of delivering service or other benefits in public interest.

2.2 Achievement of organisational objectives is surrounded by the uncertainties which pose threats to and offer the opportunity for increasing success. Changing circumstances, such as rising interest rates, can be an opportunity for an entity with surplus cash but a risk for a borrower. Hence, these circumstances need to be seen with reference to the organisation's objectives:

- When used in the broad sense, risks are those uncertainties of outcome, whether an opportunity or threat, arising out of actions and events.
- When defined narrowly, risks are those uncertainties which impede the achievement of the objective.

2.3 In this Guide, 'risk' is used in the narrow sense.

Classification of Business Risks

2.4 Business risks impede the achievement of the organisation's goals and objectives. In order to make an inventory of risks, *viz.* the risk register, it is important to understand the broad classification of risks. For example, risks can be classified into various categories such as internal and external risks; controllable and uncontrollable risks, etc.

2.5 Classifications helps in a better understanding of the interplay between the risks themselves and between objectives, strategies, processes, risks and controls during risk assessment.

Internal and External Risks

2.6 Internal risks arise from events taking place within the business enterprise. Such risks arise during the ordinary course of a business. Risks of this nature can be effectively controlled/ managed through implementing processes/ controls within the organisation. Management is able to exert a significant influence in managing these risks. Examples of internal factors giving rise to such risks include:

- *Human factors* such as strikes and lock-outs by trade unions; negligence and dishonesty of an employee; accidents or deaths in the factory, etc.
- *Technological factors* such as unforeseen changes in the techniques of production or distribution resulting into technological obsolescence, etc.
- *Physical factors* such as fire in the factory, damages to goods in transit, etc.

2.7 External risks arise due to the events triggered in the environment outside the business organisation. Such events are generally beyond the control of the management. Hence, determining the likelihood of the resulting risks cannot be done with accuracy. Examples of external factors giving rise to such risks include:

- *Economic factors* such as price fluctuations, changes in consumer preferences, inflation, etc.
- *Natural factors* such as natural calamities such as an earthquake, flood, cyclone, etc.
- *Political factors* such as the fall or change in the Government resulting into changes in government policies and regulations, communal violence or riots, hostilities with the neighboring countries, etc.

Controllable and Non-Controllable Risks

2.8 Controllable risks arise from the events taking place within the business enterprise. Such risks arise during the ordinary course of business. These risks can be forecasted and the probability of their occurrence can be determined. Hence, they can be controlled by the management to an appreciable extent (e.g., risks of fire, storms, etc.,). Controllable risks need not necessarily be prevented, but the financial loss can be minimised (e.g., insurance cover can be purchased to recover the financial loss due to fire).

2.9 Uncontrollable risks, however, are those that would have a detrimental financial impact but cannot be controlled. Some uncontrollable risks that are common to many businesses include:

- Recessionary economy
- New competitor locating nearby
- New technology

Each organisation faces risks that are unique to its line of business. Organisation should consider these carefully and briefly describe what steps would be taken if an uncontrollable risk actually happens to the business (contingency plan). For example, if the risk of a recession would severely affect the company, the management may consider what products or services could be offered that would not be as sensitive to a recessionary economy.

Table 2: Typical Pattern of Risks in an Entity

	Controllable	*Uncontrollable*
Internal risks	**Maximum number of risks**	
External risks		**Maximum number of risks**

Risk Quantification Method - Attributes, Measurement and Risk Score

2.10 All risks are measured on two attributes i.e.,

- Likelihood of risk occurrence
- Risk consequence

All risks need to be evaluated at two levels, i.e., Inherent Risk Level and Residual Risk Level.

2.11 To facilitate an understanding and usability in decision making of the risk, comparison helps. To enable comparison a risk score is used. By measuring the two risk attributes, a risk score can be derived for that risk. However, care should be taken to avoid misplaced focus on numbers. Risk score is meant for comparison between a cut off point, normally, the 'risk appetite'' or comparing to other risks, thereby, filtering for 'significant risks'.

2.12 The measurement of the likelihood of the risk is normally on a scale of five, *viz.*

- Remote (score 1)
- Unlikely (score 2)
- Possible (score 3)
- Likely (score 4)
- Almost certain (score 5)

Exhibit 1: Measurement Yardstick for the Likelihood of Risk

Likelihood of Risk Occurrence		
Level	***Description***	***Ranking Criteria***
1	Remote	Event may only occur in exceptional circumstances
2	Unlikely	Event could occur in rare circumstances
3	Possible	Event could occur at some time
4	Likely	Event could occur in most circumstances
5	Almost certain	Event is expected to occur in most circumstances

2.13 Risk consequences can also similarly be measured on a scale of five, *viz.*

- Insignificant (score 1)
- Minor (score 2)
- Moderate (score 3)
- Major (score 4)
- Catastrophic (score 5)

Exhibit 2: Measurement Yardstick for Risk Consequences

Risk Consequence		
Level	***Description***	***Ranking Criteria***
1	Insignificant	• ₹ 50 lakhs impact on profitability • No impact on market share • No impact on reputation
2	Minor	• ₹ 50 lakhs ₹ 2 crores impact on profitability • Consequences can be absorbed under normal operating conditions • Potential impact on market share • Potential impact on reputation

Level	***Description***	***Ranking Criteria***
3	Moderate	• ₹ 2 crores to Rs 5 crores impact on profitability • There is some impact on market share • There is some impact on reputation
4	Major	• ₹ 5 crores to Rs 10 crores impact on profitability • Market share will be affected in the short term • Reputation is affected in the short term
5	Catastrophic	• ₹ 10 crores impact on profitability • Serious diminution in reputation • Sustained loss of market share

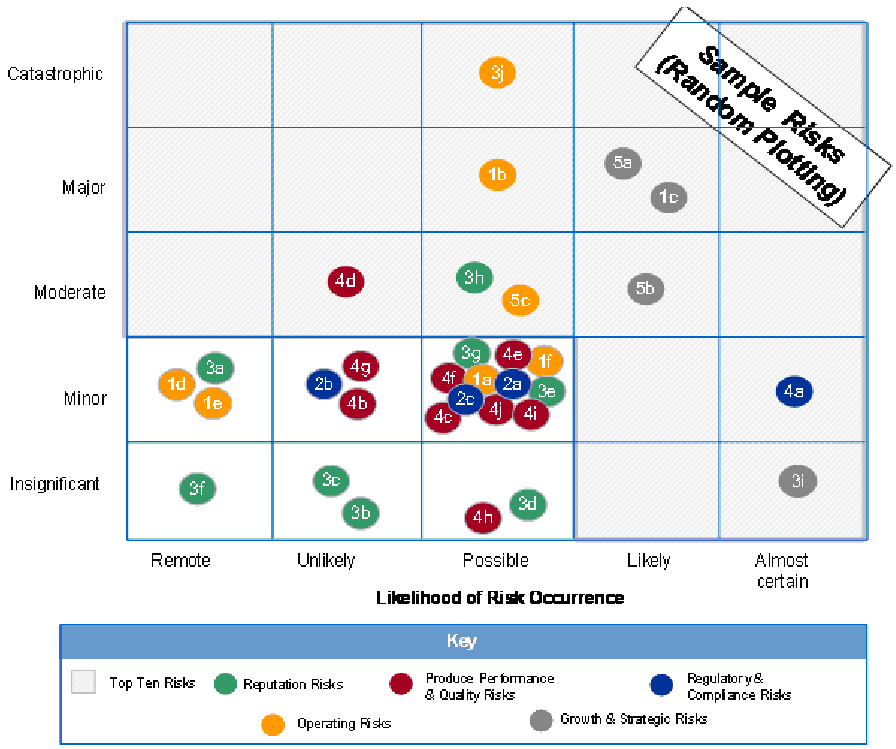
Level	**Description**	**Impact**	**Resulting in**	**Illustrations**
1	Insignificant	Low	Causes minor inconvenience without impacting the achievement of objectives	• No potential impact on market share • No impact on brand value • Issues would be delegated to junior management and staff to resolve
2	Minor	Low to Mod-erate	Causes inconvenience without impacting the achievement of objectives	• Consequences can be absorbed under normal operating conditions • There is a potential impact on market share and brand values • Issues will be delegated to middle management for resolution
3	Moderate	Mod-erate	Preventing the organisation from achieving some of it's objective for limited period	• Market share and/or brand value will be affected in the short term • The event will require senior and middle management intervention

Level	Description	Impact	Resulting in	Illustrations
4	Major	Mod-erate to High	Preventing the organisation from achieving majority of it's objective for a long time	• Serious diminution in brand value and market share with adverse publicity • Key alliances are threatened
5	Catastrophic	High	Closing down of the organisation / operation or significant part for a long time	• Events and problems will require Board and senior management attention • Loss of key alliances • Sustained, serious loss in market share

A risk with the lowest level of likelihood – i.e., remote (score 1) can nevertheless have the highest level of consequences – i.e., catastrophic (score 5). This can be explained by way of an example. The likelihood of floods causing a damage to the distribution network of an electricity distribution company can be 'remote' but the consequences of the damage can be catastrophic. In such a scenario, the existence of a contingency plan becomes important.

Risk score for that risk is a numeric multiple of the likelihood of the risk and the risk consequences. As an example, the Board may have a risk appetite of 12 and any risk with a score above 12 becomes a significant risk for which a risk response is required. For a better understanding, risk score can be plotted on a chart as below which is known as a *"risk heat map".*

Figure 1: Risk Prioritisation Map



Basic Concepts of Risk Management

Risk Capacity

2.14 Risk capacity shows how much risk the organisation can absorb.

Risk Appetite

2.15 Risk appetite shows how much risk the management is willing to accept.

Risk Response

2.16 The purpose of assessing and addressing risks is:

- To constrain them to a tolerable level within the risk appetite of the organisation (i.e., how much risk the management is ready to accept).
- To give a response to risks (i.e., aspects of addressing risks).

2.17 Risk response can be of the following types:

Avoid	Exiting the activities giving rise to risk. Risk avoidance may involve exiting a product line, declining expansion to a new geographical market, or selling a division.
Reduce	Action is taken to reduce the risk likelihood or impact, or both. This, typically, involves any of a myriad of everyday business decisions.
Share/Transfer	Reducing the risk likelihood or impact by transferring or, otherwise, sharing a portion of the risk. Common techniques include purchasing insurance cover, outsourcing activities, engaging in hedging transactions.
Accept	No action is taken to affect the risk likelihood or impact. This is mainly in cases where the risk implications are lower than the Company's risk appetite levels.

Inherent Risk and Residual Risk

2.18 Inherent risk is the level of risk, assuming no internal controls, while residual risk is the level of risk after considering the impact of internal controls. E.g., the risk of 'over/ understatement of revenue' without considering any internal controls indicates an inherent risk. The above risk when considered with internal controls in place (say, monthly reconciliation of revenue and follow up, correction of discrepancies, etc.) indicates a residual risk.

Control Score

2.19 The objective of internal controls is to reduce the inherent risk and keep the residual risk within the organization's risk appetite. The gap between the inherent risk and residual risk shows the strength of the control and is known as the control score.

Risk Register

2.20 Risk register is a detailed record of each risk.

2.21 Typically, a risk register contains information in columns which shows against each risk - the process and sub process that individual risk belongs to, the risk score before and after controls are applied, which controls to apply, name of the process owner, etc.

Risk Maturity of an Organization

Importance of Risk Maturity and the Four Questions

2.22 A matured outlook to risk facilitates quality business decisions. To take a matured view, there is a need to know against objectives:

- What events can trigger what risks?
- What is the risk score (likelihood and magnitude) of the risk?
- How does the risk score measure against the risk appetite?
- What should the risk response be?

Most of us at an individual level do not follow the above four questions in a formal and structured way. However, after setbacks we form a pattern of action which works for us and we do this by subconsciously figuring out the answers to the above four questions.

2.23 Certain entrepreneurial driven entities, especially, those which are highly successful in a relatively short span appear to have an extraordinary risk appetite and risk capacity. They seem to work on a very high residual risk and are seen as risk takers. Case histories point out that sustainable success has mainly come to those entities where the risk maturity is at the *risk enabled level,* *i.e., the entity in a readiness position to convert market uncertainties into opportunities.*

2.24 The way entities have an outlook to managing risks defines their level of risk maturity.

2.25 Some organizations, especially, those in the fast growth mode have an organizational culture which promotes operational mangers to remain at the risk naïve/risk aware maturity level. Following are the typical characteristics:

- Line managers are not expected to identify risks and if they do it is confined to their personal knowledge or within their functional team.
- Control environment may be well defined but again it is to be operated by the staff management (as the Accounts Manager). The logic being that line management as Marketing or Production managers need to spend the maximum time in operations and not defocused on unnecessary paper work or issues other than their operations.

In this mindset, coordinating activities and problem solving is considered as operations while risk assessment and management is considered a staff function. This model works well in a supply side market but not in a dynamically changing competitive market wherein new risks arise periodically and the staff management who are not market facing are not fast enough to incorporate new controls to address these risks.

Risk Maturity Levels

2.26 Following aspects in the organisation indicate its risk maturity:

- Business objectives are defined and communicated;
- Risk appetite is defined and communicated across the organisation;
- Control environment is strong, including the tone at the top; and

- Adequate processes exist for the assessment, management and communication of risks.

A model score card to assess risk maturity is given in **Appendix 1.**

2.27 The table given below shows the levels of risk maturity.

Table 3: Key Characteristics at Different Levels of Risk Maturity

Risk Maturity	Key Characteristics
Risk Naïve	No formal approach is developed for risk management.
Risk Aware	Risks are identified within functions and not across processes. Also risks are not communicated across enterprise. Also known as '*silos based approach to managing risks.'*
Risk Defined	Risk strategy, policy and framework in place and communicated. Risk appetite is defined. Risks start getting viewed across processes. Enterprise wide approach to risk management being developed.
Risk Managed	Enterprise wide approach to risk management is implemented and communicated. Risk register is in place. Also known as *'satisfactory implementation of ERM* stage'.
Risk Enabled	Risk management and internal control are fully embedded into operations. Entity is in readiness position to convert market uncertainties into opportunities.

A. Risk Enabled and Risk Managed:

This entity represents a high level of understanding on the management of risk.

B. Risk Defined:

Approach to risk identification is within functions and not across end-to-end processes. Risk register is incomplete.

C. Risk Aware and Risk Naïve:

Risks are either not identified or each person maintains his/her risk within personal knowledge.

Risk Management as Part of Clause 49 Compliance and Later as a Strategic Management Tool

2.28 As per Clause 49 of the Listing Agreement, disclosures to the Board are to be made on whether the following is being carried out on risk management.

"The company shall lay down procedures to inform Board members about the risk assessment and minimization procedures. These procedures shall be, periodically, reviewed to ensure that the executive management controls risk through a proper defined framework".

2.29 To comply with the requirements of the above clause, organizations tend to introduce certain risk management processes and identify strategic risks mainly to fulfill compliance requirements. Over a period of time, as the management realises the advantages of improving the level of risk maturity within the organization, it reassesses risks through an enterprise wide structured, consistent and continuous process and implements risk management in a full fledged way as a strategic management initiative.

2.30 This methodology is known as Enterprise Risk Management or ERM. First, an ERM policy is put in place which defines the guiding principles showing the responsibility of line management for ERM and the broad activities covered by the risk management processes. A risk management framework to implement the ERM policy is, then, finalized showing the activities which need to be carried out and how they are to be carried out under three processes, *viz.*

- Risk assessment
- Risk management

- Risk communication

A model risk assessment process is given in **Appendix 2**.

Implementation is facilitated by a risk manager or the internal auditor as a consulting assignment. Subsequently, risk-based internal audit is carried out.

2.31 ERM includes the following activities:

- Establishing an appropriate internal environment, including a risk management policy and framework;
- Defining risk appetite;
- Identifying potential threats to the achievement of its objectives and assessing the risk i.e., the impact and likelihood of the threat occurring;
- Undertaking control and other response activities;
- Communicating information on risks in a consistent manner at all levels in the organization;
- Centrally monitoring and coordinating the risk management processes and the outcomes, and
- Providing an assurance on the effectiveness with which risks are managed.

Need for Clarity on the Risk Appetite of the Board

2.33 Determining the risk appetite for the organisation is central to the ERM methodology. *Risk appetite* refers to the extent of the risk that the organsations are willing to take to pursue the objectives. Risk appetite setting is done at different levels, *viz.,* for the organisation at the entity level, process level, different risk groups and for individual key risks. Risk appetite provides a standard against which a risk can be compared and where the risk is above the risk appetite. It is considered a threat to the reasonable assurance that the objective will be achieved. The risk appetite is a key fundamental of the ERM methodology and needs to be approved by the Board of Directors.

Chapter 3
Implementing COSO* ERM

Introduction to COSO's ERM

Definition of Enterprise Risk Management

3.1 *"Enterprise Risk Management is a process, effected by an entity's Board of Directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risks to be within its risk appetite, to provide a reasonable assurance regarding the achievement of entity objectives"*. – COSO Enterprise Risk Management – Integrated Framework, 2004.

3.2 As per the COSO definition, e nterprise risk management encompasses:

- **Aligning risk appetite and strategy**. The management considers the entity's risk appetite in evaluating strategic alternatives, setting related objectives, and developing mechanisms to manage related risks.
- **Enhancing risk response decisions**. Enterprise risk management provides the rigor to identify and select among alternative risk responses—risk avoidance, reduction, sharing, and acceptance.

* Comprising the professional associations listed below, the Committee of Sponsoring Organizations (COSO) is a voluntary private-sector organization:
- American Accounting Association
- American Institute of Certified Public Accountants
- Financial Executives International
- Institute of Management Accountants
- The Institute of Internal Auditors

COSO is dedicated to guiding the executive management and governance entities toward the establishment of more effective, efficient, and ethical business operations on a global basis. It sponsors and disseminates frameworks and guidance based on in-depth research, analysis, and best practices.

- **Reducing operational surprises and losses.** Entities gain an enhanced capability to identify potential events and establish responses, reducing surprises and associated costs or losses.

- **Identifying and managing multiple and return cross-enterprise risks.** Every enterprise faces a myriad of risks affecting different parts of the organization, and enterprise risk management facilitates an effective response to the interrelated impacts and integrated responses to multiple risks.

- **Seizing opportunities.** By considering a full range of potential events, management is positioned to identify and proactively realize opportunities.

- **Improving deployment of capital.** Obtaining a robust risk information allows management to effectively assess overall capital needs and enhance capital allocation.

3.3 The COSO definition is an advanced framework for ERM; however, each organisation may adopt a framework suitable to its need and gradually move from a risk naive to the risk enabled level.

The Approach is at an Enterprise-wide Level and not at a Departmental/Function Level

3.4 Enterprise wide means an elimination of functional, departmental or cultural barriers so that a truly holistic, integrated, proactive, and process oriented approach is taken to manage all key business risks and opportunities – not just financial risks. Further, an entity-wide approach also assists the management in consolidating all the fragmented risk initiatives various departments and channelise resources effectively to manage the most important risks. This new risk management is a shift from the old process of managing risk. The transformation is depicted as below:

3.5 COSO ERM is always implemented across an entity and covers the entire spectrum of business organizations, i.e., subsidiary, business unit, division, etc.

Benefits of Enterprise Risk Management

3.6 ERM when implemented in a right manner can yield substantial benefits to an organization. Companies which are considered to be well governed get a premium both by rating agencies and shareholders. Some primary benefits include:

- Better-informed decisions
- Greater management consensus
- Increased management accountability
- Smoother governance practices
- Ability to meet strategic goals
- Better communication to Board
- Reduced earnings volatility

- Increased profitability
- Use risk as a competitive tool
- Accurate risk-adjusted pricing

Source: 'Beyond Compliance – The Future of Risk Management', The Conference Board (Jan 2005).

In addition, ERM helps to reduce the level of surprises which impact organizational goals. Organizations who implement ERM define a risk appetite which they are able to operate effectively and take more informed and appropriate decisions.

Why COSO ERM

3.7 Organisations are becoming more and more aware of the need and importance of implementing an enterprise risk management framework. The challenge in implementing ERM is applying the theory in practice since, COSO framework is the most widely accepted framework for ERM, in this guide we try to break down and analyze the COSO components of ERM to facilitate practical implementation.

Before Getting Started

3.8 In any ERM, before starting the implementation there are certain important infrastructural requirements to be put in place, without which the implementation may not be successful. These are as follows:

- Creating an awareness amongst the Board and senior management about the need and requirement of ERM. This is important to set the tone at the top.
- It is also important to understand the extent of ERM implementation required. There are various levels at which ERM could be implemented e.g., Low (naïve) to High (enabled). Hence, it is necessary to set the expectations right at the beginning by defining expectations.
- An organisation may have an existing risk management

framework, so it is necessary to highlight the changes from the existing approach. Further, the organisation should be open enough to admit the shortcomings of the existing process and appreciate the need for a more integrated and detailed approach towards risk management.

- Creating an adequate project sponsorship, requisite fund allocation for various activities to ensure that the objectives are met. The project funding would determine the extent of implementation.
- Define the project organisation and ensuring the involvement of various executive levels across the organisation starting from the Board of Directors to the lower levels of management. The number and extent of the involvement at each level would vary with every organization.

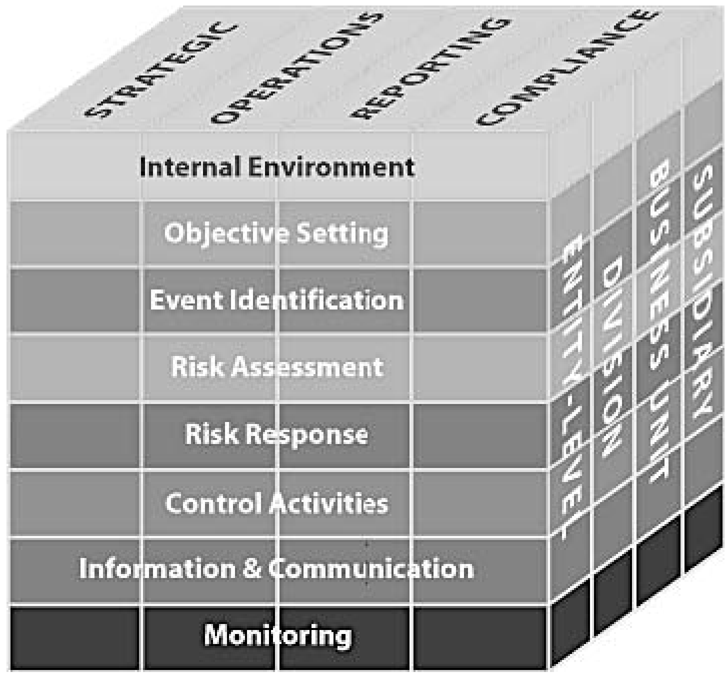
Above all, each organisation must understand that it is unique and has its own inherent complexities, industry culture, organizational cultures which it needs to respond. Thus, the ERM approach to be followed needs to be customized to suit each company. In this guide, we try to generalize the implementation steps.

COSO ERM Implementation

Components of ERM Implementation

3.9 Having established that the implementation has to be across an entity, the components to be implemented are:

- Preparing the internal environment
- Objective setting
- Event identification
- Risk assessment
- Risk response
- Control activities
- Information and communication
- Monitoring.



Source: COSO Integrated Framework

Step 1: Preparing the Internal Environment

3.10 The first step is to prepare the internal environment of an organisation for the ERM implementation. This would involve the preparedness of the organisation from the Board to the junior management level for the ERM. The organisation would also define its risk management philosophy and risk appetite during this stage. Any organisation aiming at an ERM needs to set the right ethical culture within the organization, this includes establishing a code of conduct, and whistle blower policy to ensure an appropriate ethical culture within the organisation which is a premise for risk management. Once the internal environment is set up, the organisation would then define the ERM project structure, assign the project responsibility and authority.

3.11 Key output of this stage are:

- Risk Management Philosophy
- Risk Management Survey and its outcomes

- Code of Conduct
- Project Structure

3.12 Guidance to preparing the internal environment is given in **Appendix 3**.

Step 2: Objective Setting

3.13 Once the internal environment of an organisation is ready for the ERM initiative, the next step is to set the objectives. The ERM requires that the organisation's mission, its strategic objectives, derived objectives be aligned. Further, the derived objectives should also reflect that they are in line with the overall organizational objective. The strategic objectives thus translate into operational, reporting and compliance objectives. Such an alignment facilitates further steps of event identification, risk assessment and mitigation in an ERM implementation process. Another important aspect is defining an organisation's risk appetite at an overall level and even at the sub unit levels. The risk appetite defines the extent of risks that an organisation is prepared to accept. Based on the risk appetite, the organisation then defines the risk tolerance levels.

3.14 Key output of this stage are:

- Linkage of mission-strategic objectives-derived objectives
- Defining strategies by using risk management techniques
- Defining overall risk appetite for various business activities
- Defining risk tolerances for sub activities in line with the overall risk appetite for the business activities.

3.15 Guidance on Objective setting is given in **Appendix 4**.

Step 3: Event Identification

3.16 The next step in an ERM implementation is the identification of the events which may affect the entity positively or negatively in achieving its objectives. Such events can be classified as risks and opportunities, depending on their impact. An organisation should also consider the interdependencies of events on the organisation as whole. An event, individually, may not affect an organization, however together with other events, it might increase the impact. These events are also termed as risks.

3.17 There are various techniques for the identification of events, e.g., interviews, questionnaires, workshops, etc. Some of these techniques are discussed in detail in this Guide.

3.18 Key outputs of this stage are:

- Interviews, workshop for event identification
- Linkage of events to objectives
- Event inventory for further actions

3.19 Guidance on Event Identification is given in **Appendix 5**.

Step 4: Risk Assessment

3.20 Once events/risks are identified, the next step is assessing the risks in terms of their impact on the objectives and the likelihood of such an impact. This is done by assigning qualitative and quantitative values to each risk event and its likelihood. All risk events need to be first evaluated on an inherent basis (considering their impact assuming that there is no remediation or response mechanism). These risks should then also be assessed after consideration of the available response mechanism to assess their residual risk. Such assessment would facilitate in risk ranking and subsequent prioritization for remediation.

3.21 Guidance on Risk Assessment is given in **Appendices 2** and **6**.

Step 5: Risk Response

3.22 The next step to risk assessment is developing a response to the risks identified in earlier stages. Management needs to evaluate each risk based on its gross risk (identified earlier) and develop or identify existing response mechanism to ensure that the net/residual risk (after considering the response) is within the risk tolerance levels of the organization. Management should also perform a cost benefit evaluation of the risk response, since all responses may not be suitable in a particular scenario and response needs to be customized to each organization. Response to the risk can be as follows:

1) Avoid

2) Reduce

3) Share

4) Accept.

3.23 Key output at this stage are:

- Risk Response for risks identified
- Risk portfolio after considering the residual risk

3.24 Guidance on risk assessment is given in **Appendix 7**.

Step 6: Control Activities

3.25 Risk response is the starting point of risk mitigation; however risks can be mitigated only when the response is implemented. Similarly, responses across the organisation at various levels should also be implemented. Controls are activities which ensure that the risk response is implemented for the identified risks. Thus, each of the risk response would have a control activity to support the risk response. Control activities include activities like reviews, approvals, authorizations, schedule of authority, policies, procedures, segregation of duty, safeguarding of assets and key performance indicators.

3.26 Guidance on Control Activities is given in **Appendix 8**.

Actioning the Balance Components of COSO ERM

Information and Communication

3.27 The first seven stages of the COSO framework are sequential. However, information and communication flow has to be smooth and efficient throughout all other phases. A successful ERM implementation requires that right information is captured in the right amount of detail across all levels of the organization. Management needs to develop efficient information flows within and outside the organization. Further, obtaining the right information is just one aspect, the most important part is to effectively communicate the information throughout the organisation from top to bottom and otherwise. Each individual within an organisation needs to understand his roles and responsibilities in the implementation. Further, there should be adequate escalation mechanisms. Communication also involves communication with various stakeholders within and outside the organisation (e.g., suppliers, customers, regulators, etc).

3.28 The following should be ensured while establishing information and communication flows within an organization:

- Information should be captured at various points within an organisation.
- Information should also be obtained from external sources (internet, subscribed databases, research agencies, external consultants, newsletters, industry forums, etc).
- Information obtained should have adequate detail, must be relevant, structured, accessible, usable and accurate.
- Information repositories should be created at various levels for retrieving the data as per need.
- Systems need to be developed which provide the required data for all risk management purposes.
- Management information systems should ensure that performance indicators for all activities within the organisation are captured accurately for a review and monitoring of activities.

- Degree of sophistication and usage of technology should commensurate the organization's need, maturity and capability.

Communication

3.29 The organisation needs to ensure that communication systems are established throughout the organization. There are various means by which communication systems can be established, some of them are:

- Intranet and intranet databases
- Emails
- Communiqués
- Discussion Forums
- Corporate newsletters
- Meetings among risk management teams, executive and line functions
- Resource database for enterprise risk management
- Anonymous emails for reporting incidents

At any point, effective communication is imperative since each and every individual within the organisation should be aware of his roles and responsibilities in managing business and managing risks.

Monitoring Activities

3.30 Once the ERM implementation is underway, the next step is to ensure that there is adequate monitoring of the activities, to ensure that the risk response mechanisms and control activities are ensuring that the objectives are achieved. Monitoring mechanisms need to be instituted internally and at periodic intervals by way of external assessments. External assessments would provide an assurance that the internal monitoring is working effectively. In addition to monitoring mechanisms, there should also be adequate escalation of significant issues to middle, senior management and Board of Directors.

3.31 Most common monitoring mechanisms include:

- Periodic operational performance monitoring against targets
- Monitoring of key performance indicators
- Monitoring of critical success factors for projects and new businesses
- Embedded controls which escalate deviations as a trigger for adequate corrective actions

3.32 Most common evaluation mechanisms include:

Internal Evaluations

- Management Information Systems
- Self Assessment Questionnaires
- Internal Control Assessment

External Evaluations

- Internal audit reviews
- Cross functional team reviews
- External consultant reviews
- Project audit reviews

3.33 Essentials for effective monitoring include:

- Pre-determine the methodology for evaluations
- Ensure adequate documentation with respect to ERM (e.g. The model implemented, the ERM organisation structure, roles and responsibilities, risk framework, risk registers, control framework, self assessment questionnaires, etc).

Chapter 4
Implementation Issues

Implementing ERM

4.1 Based on the understanding mentioned herein, the ERM implementation activities could be summarized as follows:

Board Level Activities

4.2 The Board level activities include:

- Provide ERM education at the Board level.
- Establish buy out at the Board level for risk appetite and risk strategy.
- Develop the "ownership" of risk management oversight by the Board.
- Review the risk report of the enterprise.

Management Level Activities

4.3 The Management activities include:

- Create a high level risk strategy (policy) aligned with business objectives.
- Create a risk management organizational structure and ensure clear reporting lines.
- Develop and assign the responsibilities for risk management.
- Communicate Board vision, strategy, policy, responsibilities and reporting lines to all employees.

Establish a Common Risk Culture

4.4 These include:

- Using a common risk language and concepts.
- Communicating about the risk using appropriate channels and technology.
- Developing training programs for risk management.
- Identifying and training "*risk officers*".
- Providing success stories and identifying quick wins.
- Aligning risk management techniques with the company culture.
- Developing a knowledge sharing system.

Embed Risk Activities Into Ongoing Business Processes

4.5 These include:

- Aligning and integrating risk management process within business processes.
- Embedding real time controls related to the risk into digital systems as appropriate.
- Developing continuous improvement processes related to the risk.

Measure and Monitor Risk

4.6 These include:

- Identifying key performance indicators and critical success factors related to the risk.
- Establishing success measures for risk strategy and activities.

- Providing a periodic process for measuring the risk/return.
- Identifying and implementing monitoring processes and methods of feed back.

Guide for Identifying and Assessing a Risk from an ERM Perspective

4.7 At various places in this Guide, identifying and assessing risks have been mentioned. However, these activities although sounding straight forward and simple, are the most difficult aspects of an ERM implementation. Identification and assessment of risks needs to be comprehensive and all aspects need to be considered while performing these activities. For a better understanding of these activities, certain aspects that need to be considered while performing risk identification and assessment have been discussed below.

4.8 Risks can be categorized into the following broad categories:

(i) Strategic Risk

(ii) Operational Risk

(iii) Reputation Risk

(iv) Financial Reporting

(v) Regulatory or Contractual Risk

(vi) Financial Risk

(vii) Information Risk

(viii) New Risks not identified or categorized erstwhile

4.9 One needs to identify a certain set of questions while identifying and assessing the above risks. Some indicative questions are as follows:

Strategic Risk

- Are critical strategies appropriate to enable the organisation to meet its objectives?

- What are the risks inherent in those strategies and how might the organisation identify, quantify, and manage these risks?
- How much risk is the organisation willing to take?
- What risks result from e-business developments?

Operational Risk

- What are the risks inherent in the processes that have been chosen to implement the strategies?
- How does the organisation identify, quantify and manage these risks given its appetite for risk? How does it adapt its activities as strategies and processes change?

Reputation Risk

- What are the risks inherent to brand and reputation inherent in how the organisation executes its strategies?

Financial Reporting

- What are the key risks which if not managed effectively will lead to an incorrect reporting of financial results/performance and disclosures to stakeholders?

Regulatory or Contractual Risk

- What risks are related to the compliance with regulations or contractual arrangements- not just those which are financially based?

Financial Risk

- Have operating processes put financial resources at undue risk?
- Has the organisation incurred an unreasonable liability to support operating processes?

- Has the organisation succeeded in meeting measurable business objectives?

Information Risk

- Is our data/ information/knowledge reliable, relevant and timely?
- Are our information systems reliable?
- Do our security systems reflect our e-business strategy?

New Risks

- These might include the risks from new competitors, emerging business models, recession risks, relationship risks, outsourcing risks, political risks, financial risk disasters (rogue traders), and other crisis and disasters risks.

Approach to Risk Management by Organizations (Centralized vs. Decentralized)

4.10 ERM could be implemented in an organisation using both centralized or a decentralized approach. This would depend on the nature and preferences of each organization. There is no prescribed method for ERM and organizations may select any of the approach or even a hybrid version of both the approaches. Some important aspects in respect of centralized and decentralized risk management have been discussed below.

Centralized Risk Management

- Focus on the risks that affect the achievement of key corporate objectives and strategies and significantly affect most if not all functions and processes (e.g., reputation). These risks are referred to as enterprise wide risks.
- Accountability for these enterprise wide risks is with the CEO, risk committee and the Board of Directors.
- Responsibility for these risks may be dispersed throughout the organisation.

- Risks which require specialized skill sets which are not available at division levels or those which require partnering or contracting at the corporate level are also handled centrally.

Decentralised Risk Management

- Decentralized management pushes the risk management activities to those who live with it on a day to day basis.
- Such an approach is more suited for the risks at the division or process level, such risks are significant for the division/ process but may not significantly affect the organisation's ability to achieve its overall objectives.

4.11 Certain organisations are now embedding a hybrid version of the above approaches and using centralised approach for entity wide risks and decentralised for the division or process level risks. In this manner they incorporate the best features of both the approaches.

Sustaining ERM and Continuous Improvement Processes

4.12 Once a certain degree of assurance of the adequate functioning of the ERM program is achieved, organizations should focus on sustaining ERM and continuous improvement opportunities. The following mechanisms could be used for this purpose:

Benchmarking

4.13 Organisations should continuously focus on Benchmarking ERM programs with the best in the class companies and align the best practices across related entities.

Knowledge Management

4.14 Organisations should develop effective communication channels within and outside the organisation to ensure a smooth flow of information at all levels within the organisation. This facilitates knowledge sharing of the risks and opportunities within the organization.

Risk Management Triggers

4.15 Focus on developing a robust ERM management information system which will highlight key risk exposures to the senior management in case and key risk indicators e.g., increased levels of credit exposures, increased cost of capital, etc., are breached or on the occurrence of certain triggers e.g., high volatility in foreign exchange rates, sharp increase or decrease in commodity prices, etc.

Organization Learning

4.16 Creating an awareness and educating the employees throughout the organisation about risk management inculcates a risk culture within an organization. This would then be beneficial for the smooth implementation and absorption of the entities risk strategy, policy and processes throughout the organization. This would also help the alignment of processes and technology in line with the ERM plan. Learning and awareness should be ensured in the following areas:

- Linking risk management with business operations.
- The existing risk management organisation and infrastructure.
- Risk strategies and policies.
- Risk language and risk assessment process.
- Objectivity in self assessment.
- Risk quantification methods used by the company.
- Escalation protocols across the organization.

4.17 Such an emphasis on the continuous improvement of risk strategies, policies and processes would result in:

- Continuous improvement and knowledge transfer.
- Enhancing capabilities even in cases where the people, processes and technology change.
- Development of a risk management process independent of the people and philosophies.
- Avoidance of subjectivity due to personal perception and the organisation would speak the organization's language and not the individual's language with respect to ERM.

This would result in a continuously evolving ERM program which would be in line with the dynamics of the changing business environment within and outside the organisation.

Chapter 5
Case Studies

After understanding the process of ERM implementation within organizations, in this section, how some of the leading Indian companies have approached ERM is discussed. This would help in understanding the practices followed by select companies who have already recognized the value of ERM and have embedded ERM in their operations. In this Guide, three detailed case studies of large companies in the IT sector which have matured in their ERM practices are discussed. In addition, four brief case studies are also discussed wherein the risk management framework/ practices implemented by companies in other industries are highlighted.

Case Study-1

An IT Company Having Operations in Various Countries

Risk Management Objectives

- The Enterprise Risk Management (ERM) program is aimed at meeting stakeholder expectations and avoiding surprises which affect the business adversely.
- Risk management practices are used for achieving competitive advantage.

Risk Management Approach

- To ensure that the overall risk exposure is within the risk appetite of the organisation.
- Perform a cost benefit analysis of risk responses to ensure that the best alternative is implemented.

Risk Management Methodology

- Escalation mechanisms have been developed within the organisation to identify the significant risk for taking necessary actions.

- The company conducts a risk survey and obtains the inputs from key stakeholders.
- Responsibility is attached to individuals within the organisation for risks and their mitigation.
- Risks, risk mitigation and controls are tracked to ensure that the overall exposure is within the requirements.
- Risks are periodically reported to the risk council and risk management committee for their review and insights.

Risk Organization

Level	*Role*
Board of Directors	Oversees risk management performed by the Executive Management
Risk Management Committee	Comprises completely of Independent Directors Oversees risk management on behalf of the Board Makes recommendations on the risk management program
Risk Council	Comprises the CEO, COO and CFO Formulates risk management guidelines and policies Reviews enterprise risks periodically, initiates action and reviews progress
Office of Risk Management	Comprises a network of risk managers from all businesses and support groups across the group, and is led by the Chief Risk Officer (CRO) Facilitates the execution of risk management in the enterprise as mandated by the Risk Council
Unit Heads	Manage their functions as per risk management philosophy Manage risks at the unit level, in consultation with the Risk Council
Operational Management	Implement ascribed risk actions Provide a feedback on the efficacy of risk management and warnings for early detection of risk events

Classification of Risks

The company classifies the risk under the following broad categories:

- Strategy risks
- Sector risks
- Human Resources risks
- Business Risks
- Regulatory risks

Key Risk Management Activities

- Company conducted a risk perception survey to prioritize risks to integrate risks with a strategic planning.
- Risks were refined by key stakeholders and the Risk Council members.
- The company has implemented advanced risk quantification techniques to identify risk mitigation and reporting alternatives.
- The company interacted with global companies to identify the best in the class risk management practices.

Case Study-2

An IT Group Operating in Various Countries and also Involved in Non-IT Business

Risk Management Objectives

- Customer oriented
- Employee oriented
- Risk Optimization
- Enhanced Governance

Risk Management Approach

- The company uses a participative approach wherein various stakeholders are trained to implement control activities for their processes.
- The company has implemented certain system based tools to monitor control activities.
- The company aims at creating an awareness on risk management within the organisation.
- Risk optimisation and monitoring mechanisms are highly valued.
- Risk management is a tool to provide an assurance on compliance levels within the organisation and good governing practices.

Risk Management Methodology

- Follow an integrated approach to optimise risks and identifying opportunities.
- The following phases are involved:
  1) Risk Identification
  2) Risk assessment
  3) Risk Quantification
  4) Risk mitigation, and
  5) Ongoing monitoring of business risks.
- The company focuses on risk management as an ongoing activity to identify:
  1) Worst case scenarios
  2) Likelihood of the worst case scenario
  3) Steps to mitigate such a scenario.

- The company identifies top 10 events which affect the organization.

Steps Followed	*Activities at each step*
Risk Summary	• Discussions with risk owners • Analysis of external factors
Risk Rating	• Rate risks on Probability & Impact
Risk mitigation	• Evaluate mitigation plans • Identifying responsibility
Major risks at Business unit level	• Business Unit heads prioritise the risks at the business unit level
Major risks at Corporate level	• Consolidate Business Unit level risks to arrive at an aggregate corporate exposure • Consider risk interdependencies to arrive at top key risks
Monitoring Mechanism	• Report mitigation plan status and net risk exposure on a periodic basis at appropriate levels

Risk Organization

- The company has adapted a decentralized approach for risk management and hence risks are managed across levels at each business unit, function level.
- The Chief Risk office is the project leader and the risk management assists the business unit heads to identify key risks.
- Risk officers are appointed at local unit levels to manage risks pertaining to the unit.
- Respective functions are responsible for identifying, devising mitigation plans and to monitor them on an ongoing basis.

Risk Management Activities

- Projects are subjected to risk management.
- Reporting mechanisms are installed which identify the events which affect business objectives.
- The company invited experts for conducting a seminar from the industry to discuss risk management practices and pitfalls in implementation.
- Awareness on risks management is created through workshops and training programs and has developed a web based tool in this regards.
- An employee survey was conducted to identify the risks across various business units, subsidiaries. Risks identified were assessed for the impact and likelihood.

Case Study -3

An IT Company with Global Operations

The framework is broadly aligned to the COSO framework.

Risk Management Objective

- Investor Satisfaction
- Customer Satisfaction
- Employee Satisfaction

Risk Management Methodology

- The Enterprise Risk Management is carried out at four levels, namely, (i) Project Level, (ii) Business unit Level, (iii) Unit Level and (iv) Company Level.
- The net risks at each of these levels are aggregated to the next level.

- A detailed ERM Policy Manual which details the risks is accessible to all stakeholders.
- The risk identification is based on a survey conducted across the entity.
- Key elements in the ERM Process are risk assessment, risk management and risk monitoring.
  - **Risk Assessment:** The heads at each level identify the events at project, business and unit level. Risk exposure is assessed on a scale of 1-5, 1 being the low risk and 5 being high risk determining their inherent and likelihood of occurrence.
  - **Risk Management:** The risk management strategy considers the risk appetite of the company. Response strategies are developed for identified risks.
  - **Risk Monitoring:** Risk response strategy is tracked at the Project, Unit, and Company level for resolution. An automated tool is put in place for an effective monitoring of the ERM process at all levels. Each business unit is given a risk rating to monitor its performance.

Risk Organization

- The ERM team consists of the heads of Finance, Corporate governance function, legal function, Information technology and quality.
- The Board of Directors periodically reviews the ERM framework and its effectiveness.

ERM step	*Performed by*
Risk Assessment	• Project level • Business unit • Corporate team
Risk Management	• Project heads

	• Business Unit heads • Corporate heads
Risk Monitoring	• Project heads and business unit heads • Board of Directors

Risk Categories

All the risks are classified under four categories as follows:

- Hazard Risks - Fire, Earthquake, other natural perils, etc.
- Financial Risks - Liquidity, inflation, currency fluctuations, etc.
- Operational Risk - HR management, compliances, project management, etc.
- Strategic Risk - Competition, market conditions, political environment, etc.

This classification forms the basis for the identification, monitoring and reporting of the risks.

Case Study - 4

An Indian Pharmaceutical Multinational Company

This company consulted external advisors for developing a basic ERM framework. Key highlights of its ERM initiative are as follows.

Risk Management Methodology

It comprises of three phases:

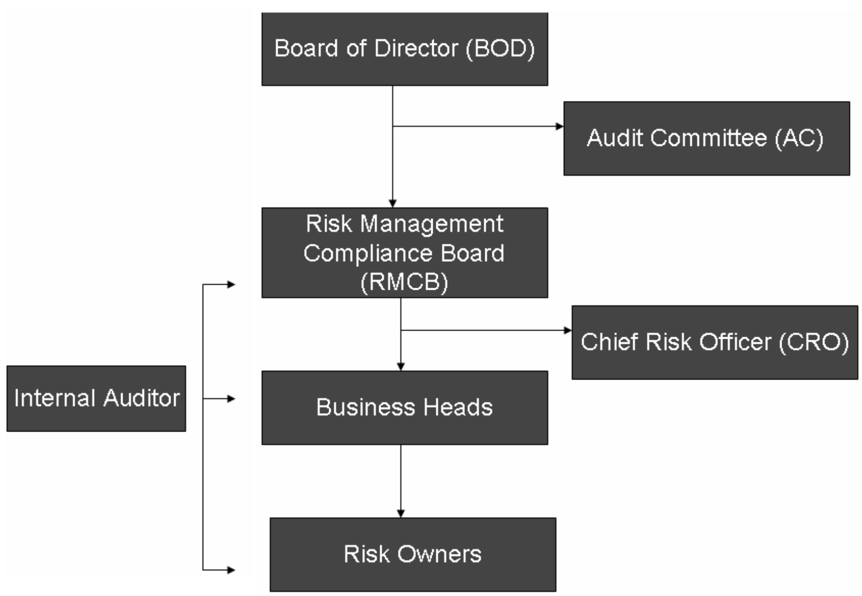
- ***Assess***: Identify, classify risks, rate risks and develop a risk inventory.
- ***Enhance***: Prioritize the risks based on workshops, perform root cause analysis and develop mitigation plans.

- ***Monitor***: Devise an organisation framework; maintain the framework on a continuous basis.

Risk Organization

Level	*Roles and Responsibilities*
Board of Directors through Audit Committee	• Performs oversight role • Monitors risk management activities.
Business Unit Heads	• Monitor risks on an ongoing basis within the risk management framework. • Provide regular updates to the audit committee through the risk officer.
Functional Heads	• Perform risk management activities while managing business activities.

Risk Organization Structure – Sample



Case Study-5

A Metals and Mining Group

Risk Management Approach

- Risk Management policies are documented and used effectively and embed risk management in business operations.

Risk Management Methodology

- A system is in place wherein risk owners at all levels and within all subsidiaries are actively involved in risk identification.
- Responsibility of risks is assigned at a senior level within the group.
- Periodic updates are made to risk quantification in terms of its likelihood and impact.
- Business unit heads maintain and update the risk inventory on a regular basis.

Risk Organization

- The internal audit function coordinates the risk management initiative and this function provides periodic updates to the Audit Committee. The Board of Directors has delegated its duties to the internal audit function.
- Operating performance is reviewed on a monthly basis by the senior management wherein risk management related issues are also highlighted.
- Key business decisions are taken only after an appropriate risk analysis.

Case Study - 6

A Chemicals Manufacturing Company of a Large Group

Risk Management Methodology

- ERM process includes the risk identification, risk assessment, creating risk response and an ongoing monitoring.
- Risk management is embedded in the organisation's planning process. It is used as a tool in taking strategic and business decisions. Risks and opportunities are managed to achieve business goals.
- The residual risk and mitigation plan of the organisation is periodically assessed by the senior management.
- Board of Directors and Audit Committee perform an oversight role and monitor activities on a periodic basis.
- Benchmarking process is carried out by the company to ensure that its internal audit and risk management processes are in line with global practices.
- The company has implemented a detailed control and self assessment model which operates on an ongoing basis.

Case Study - 7

A Large Banking Company Operating in Various Countries

Risk Management Approach

- Risks and opportunities are managed in such a manner that the company provides the maximum value to the shareholder. Risk management is an integral part of managing the business.

- The company aims at streamlining and structuring the risk management activities and monitors them on an ongoing basis.
- Organizational activities are well documented and assessed against global practices on an ongoing basis.

Risk Organization

- The company has dedicated groups for various categories of risk. These risk management groups assess, manage and mitigate specific risks allocated to them and thus ensure an enterprise wide risk management
- These risk management groups also monitor the adherence to regulatory compliances and internal authorization requirements.
- Independence is ensured since these groups are only involved in risk monitoring and are devoid of business responsibilities.
- General risk groups are further classified into specific risks groups to ensure that risk management is linked to competencies.
- Various risk functions report to the Audit committee.
- Each risk management group/sub-group develops risk management policies, identifies risks, quantifies them and develops action plans to manage these risks.

Appendix 1

Score Card for Assessing Risk Maturity

I. Check list for assessing risk maturity[1]		
Risk maturity is the degree to which the organisation understands its risk and has implemented ERM.		
S.No.	**Checklist**	**Score**
A. Understanding on objectives and their associated risks		
1	The organisation's objectives are documented and understood.	
2	Management has been trained to understand as to what risks are and their responsibilities for them.	
B. Installation and usage of risk management within the organisation		
3	Process have been defined to determine risks and these have been followed.	
4	A scoring system for assessing risks has been defined.	
5	All risks have been assessed in accordance with the defined scoring system.	
6	Response to the risks have been selected and implemented.	
7	The risk appetite has been defined using the scoring system.	
8	Risks have been allocated to specific job titles in the risk register.	
9	Management has set up monitoring controls on processes, responses and action plans.	
10	Risks are regularly reviewed by the organisation and the risk register updated.	

[1] Based on An approach to Implementing Risk Based Internal Auditing, IIA, UK & Ireland.

11	Management reports risks to Directors where responses have not managed the risks to a level acceptable to the Board.	
12	All significantly new projects/products are routinely assessed for risks.	
C. Assessment on managers understanding and usage of risk management		
13	Responsibility for determination, assessment and management of risks is included in job description.	
14	Managers provide an assurance on the effectiveness of their risk management.	
15	Managers are assessed on their risk management performance.	

II. Suggested scoring and its interpretation

	Score	
	0- No	
	1- Yes, Incomplete/ Possibly	
	2- Yes	
	Conclusion on Risk maturity	
	0-7 : Risk Naïve	
	8-14: Risk aware	
	15 -20: Risk defined	
	21- 25: Risk managed	
	26 and above: Risk enabled	

Appendix 2

Model Process for Assessing and Evaluating Risks

Steps in Risk Assessment

1. Activities in risk assessment can be put in three processes, *viz.*

- Risk identification
- Risk estimation
- Risk evaluation

Risk Assessment Tools

2. Following are some of the popular analytical methods used during risk assessment:

- Market survey
- Dependency Modeling
- SWOT (Strength, Weakness, Opportunity and Threat) analysis
- Event tree analysis
- BPEST (Business, Political, Economical, Social and Technological) analysis
- Fault tree analysis (Root cause analysis)
- FMEA (Failure Mode and Effect Analysis)

Risk Identification

3. This is the starting point for all risk assessment initiatives. As mentioned earlier, all organizations are exposed to varieties of

threats and uncertainties which impact the objectives for which they have been established. It is essential that the risk identification process be planned and activities within streamlined. This process should ideally cover all risks and scenarios to which an organisation is exposed to during the normal course of its business and also the various business activities which are a source of these risks.

4. Some of the business activities, which are a source of risk, are:

- **Strategic -** These concern the long-term strategic objectives of the organisation. They can be affected by the capital availability, sovereign and political risks, legal and regulatory changes, reputation and changes in the physical environment.

- **Operational** - These concern the day-to-day issues that the organisation is confronted with as it strives to deliver its strategic objectives.

- **Financial** - These concern the effective management and control of the finances of the organisation and are affected by external factors such as the availability of credit, foreign exchange rates, interest rate movement and other market exposures.

- **Human resources and knowledge management** - These concern the effective management and control of the knowledge resources, the production, protection and communication thereof. External risks include the unauthorised use or abuse of intellectual property. Internal risk could be the loss of key staff.

- **Compliance** - These concern issues as health and safety, environmental, trade regulations, consumer protection, data protection, employment practices and regulatory issues.

- **Fraud** - All large organizations are exposed to fraud risks. Also, various regulatory requirement as Clause 49 require organizations to have sound fraud control mechanisms in place.

5. What is the best way to identify these risks? Whether it should be identified by the people within the organisation? Or

external resources who specialize in these areas? Or a blend of both internal and external specialists? Who are the best resources internally to perform the risk identification?

Once again, there is no standard practice or guideline which is followed. This decision would depend upon the management, expertise of internal resources, etc. Generally, Internal Auditors are considered to be the appropriate personnel to facilitate this activity. The ownership of identifying the risks correctly remains with line management.

During the risk identification, care should be taken to identify 'inherent/gross' risk rather than concentrating on 'residual/net' risk. If this is not done, the organisation will not know what its exposure will be should controls fail. Knowledge on the inherent risk also allows a better consideration of whether there is over-control in place – if the inherent risk is within the risk appetite, resources may not need to be expended on controlling that risk. Knowledge about both 'inherent' and 'net' risk is important because the extent to which the risk needs to be addressed is informed by the inherent risk whereas the adequacy of the means chosen to address the risk can only be considered when the residual risk has been assessed.

Risk Identification Methods

1. To identify risks one of the following methods are used:

    - Surveys
    - Interviews
    - Workshops

2. Following is the illustrative list of questions which could be used for surveys/interviews/ workshops:

- From your perspective, what are your key business and/or your area objectives?
- What are some of the significant internal and external risks faced by the organisation in the achievement of the business and area objectives?

- From your perspective what is the likelihood of the risk occurring?
- From your perspective what is the consequence of the risk?
- What are some of the measurable performance targets and key performance indicators (KPIs) that can be linked to monitoring/ mitigating the risks identified? (For example, Budget to actual, ratings performance ranking).
- What is the frequency of measuring these KPIs?
- What other actions are taken to mitigate/manage the risks identified?
- What is the frequency of these actions?
- Who is responsible for monitoring these risks?

Industry risk models

3. In addition to these generally used methodologies, an Industry-sector wise risk model can also be used. Generally, these models are developed by professional organizations. The Industry-sector model is helpful in identifying dynamic risks to which an organisation is exposed to.

Which method to use

4. What is the most effective method or whether a combination of these methods should be used? This depends on various factors including the organizational culture, time available to complete risk identification, etc. Normally, this comes with an experience to the risk practitioner.

Typical risk areas

5. Identification of the risks associated with business activities and decision making may be strategic/tactical and/or project/ operational. It is important to incorporate risk management at the

conceptual stage of projects as well as throughout the life of a specific project.

6. During identification of internal risks, it would be important to consider aspects as organizational structure, locations, objectives of the organization, key business processes and functions, strategic partners, outsourced service providers, etc.

7. During the identification of external risks, the political, economic, social and regulatory aspects in which the organisation is functioning needs to be considered. Since identifying external risks is a complex activity, generally organizations utilize forecasts and current events/scenarios. Because of its complexity, the organisation can utilize specialized external sources in this area.

8. An illustrative listing of the areas in an organisation where the risk arises is given below:

GOVERNANCE	FINANCE	OPERATIONAL	PREPAREDNESS	INTEGRITY
Authority	Funding	Quality	Morale	Management fraud
Leadership	Financial instruments	Customer service	Workplace environment	Employee fraud
Performance	Financial reporting	Pricing	Confidentiality	Illegal acts
Corporate direction and strategy	Foreign exchange/ currency	Obsolescence	Communication flow	Unauthorized use
Incentives	Cash flow	Sourcing	Communication infrastructure	
	Investment evaluation	Product development	Change acceptance	
	Treasury	Product failure	Change readiness	
	Payroll	Business interruption	Challenge	
	Debtor/creditor management	Contingency Planning	Ethics	

COMPLIANCE	ENVIRON-MENT	HUMAN RESOURCES	REPUTATION	TECHNO-LOGY
Health & safety	Seasonality	Competencies	Brand	Reliability
Environment	Globalization	Recruitment	Reputation	Management information systems
Copyright and trademarks	Competition	Retention	Intellectual property	Access / availability
Contractual liability	E-commerce	Performance measurement	Stakeholder perception	IT security
Taxation	Share price	Leadership development		
Data protection	Strategic uncertainty	Succession planning		

Risk Estimation (or risk measurement/ risk scoring)

9. Risk estimation can be defined as 'assessing the impact of the risk on the organization.' During the risk estimation, the following should be kept in mind:

- Difference between, inherent and residual risk needs to be established.
- Ensure that there is a clear process methodology on the risk estimation so that both the likelihood and impact are considered for each risk.
- Record the estimation of the risk in a way which facilitates the monitoring and identification of risk priorities.

10. As discussed earlier, all organizations are exposed to various categories and nature of risks, and quantitative methodology may not be sufficient and relevant to complete risk estimation. Hence, qualitative characteristics and judgment, knowledge of the management on the organisation needs to be utilized (e.g. in the case of reputation risk - a subjective view is all that is possible). Hence, risk evaluation is more of an art, than science.

11. Risk estimation can be quantitative, semi-quantitative or qualitative in terms of the probability of occurrence and the possible consequence. The use of a well designed structure is necessary to ensure a comprehensive risk identification, estimation and evaluation process. Different organizations will find their own measures of consequence and probability that will suit their needs best. For example, many organizations find that assessing the consequence and probability as high, medium or low is adequate for their needs and can be presented as a 3 x 3 matrix. Other organizations find that assessing the consequence and probability using a 5 x 5 matrix gives them a better evaluation. If clear quantitative evaluation can be applied to the particular risk - “5x5” matrices are often used, with the impact on a scale of “insignificant / minor / moderate/ major/ catastrophic” and the likelihood on a scale of “rare / unlikely / possible / likely / almost certain”.

Illustrations for measuring the probability of occurrence and magnitude of impact of the risk (5x5 criteria) are in *Exhibit 1 and 2*. Also refer *Chapter 2* of the Guide.

Risk Evaluation

12. When the risk estimation process for each risk has been completed, it is necessary to compare the estimated risks against risk criteria (i.e. risk appetite) which the organisation has established. The risk criteria may include associated costs and benefits, legal requirements, socioeconomic and environmental factors, concerns of stakeholders, etc. Risk evaluation, therefore, is used to make decisions about the significance of risks to the organisation and whether each specific risk should be accepted or treated.

13. A common method of evaluation is to use a *‘risk heat map’*. The *‘risk score’* of a risk is the multiple of *‘likelihood score’* and *‘significance score’* which is adjusted by the qualitative assessment of the management. (Refer to Exhibit 3 for risk score). The risk heat map has the likelihood of risks and impact of risks as the two axis and individual risks are plotted on it based on their risk score. Further, a *“traffic light”* approach is used to show the risk, where green signifies *do not require action*, those which are amber *should*

be monitored and managed down to green if possible, and those which are red *require immediate action* (refer to Exhibit 4 for risk heat map).

Usage of Risk Scores

14. From the management's perspective when it is reviewing the risk register for CEO/ CFO reporting purposes and giving a disclosure in the Annual accounts on the internal controls, it is not the *inherent risk score* but the *residual risk score* which is important; as the management wants to assess whether the residual risk is regarded as tolerable, or how far the exposure is away from tolerability.

15. From the internal auditor's perspective, it is the *inherent risk score* which is important as the internal auditor is to give an assurance on the design and adequacy of the risk identification process as a part of his overall assurance on the risk management process.

Appendix 3

Preparing the Internal Environment

A. Key Activities to Prepare the Internal Environment are:

- Assessing and developing a risk management philosophy.
- Assessing the compliance to the risk management philosophy.
- Developing a code of conduct within the organization.
- Developing an infrastructure for the training on ethical behavior and ethical communication within the organization, e.g., hotlines, whistle blower mechanisms, escalation policies, etc.
- Assigning project roles and responsibilities to frame the project organization.

B. Carrying out the key Activities for Preparing the Internal Environment to Implement ERM

(A) Develop a risk management philosophy

While philosophy may vary with each company, a typically risk management philosophy would cover the following aspects:

- The organization's belief in risk management.
- How risk management is embedded in the organizations strategic decisions?
- How risk management is percolated in operational decisions?

Risk management philosophy is best adopted when it is also a part of various policies and procedures. The organisation can also adopt risk management as an operational indicator to assess performance. As an illustrative we mention below a sample risk management philosophy.

Your organisation believes in a risk based approach towards business activities. The organisation ensures that all facets of risks are considered while framing its strategy and it expects that risks are considered while making operational decisions within the organization. We believe that such an approach would allow us to make more rational decisions, make more informed decisions which would benefit all the stakeholders. Such a philosophy would also help us assign the responsibility for our decisions and strengthen the monitoring process within our organization. In line with the above philosophy, the management and staff is expected to confirm to the following: • Consider strategic, operational, compliance and reporting risks in decision-making. • Ensure that risk management begins at business unit level and is integrated to the overall organisation wide risk definition. • Be open to the adoption of risk management as a way of functioning as against compliance. • Work towards developing a competent risk management framework which is best in the class. • Be committed to developing a comprehensive risk portfolio and develop an adequate mitigation plan. • Absorb the ownership and responsibility for risk pertaining to one's activities.

(B) Assessing Compliance to Risk Philosophy

Assessing the compliance to risk philosophy is important to confirm that the internal environment is ready for the ERM implementation.

The most accepted methodology for such an assessment is risk survey within an organisation on a periodic basis. This should also evaluate the current level of compliance and as against the desired level. This would facilitate the gap analysis and subsequent mitigation. Such a survey may cover the following aspects:

Strategy

1) Strategic alignment – Is risk management aligned with the strategy?

2) Are the objectives of the company clearly communicated within the organisation?

3) Is the organisation culture aligned to risk management?

Policy

1) Are various policies in place and is risk management an integral part of various policies?

2) Is the organisation aware of such policy aspects?

3) What is the general level of compliance within the organisation?

Structure

1) What is the organisation's commitment to competency?

2) Are the people aware of the risk management philosophy of the organisation?

3) Is risk management given importance at various levels within the organisation?

Process

1) Is there an adequate information flow within the organisation across departments to ensure that risk management is comprehensive or are processes aligned to risk management?

2) Is there an adequate knowledge management within the organisation to ensure a successful risk management?

3) Are people accountable for risks and responsible for considering risks in making decisions?

Analytics

1) Is risk management linked to performance?

2) Are risks adequately identified and quantified?

3) Is the risk appetite defined?

Systems

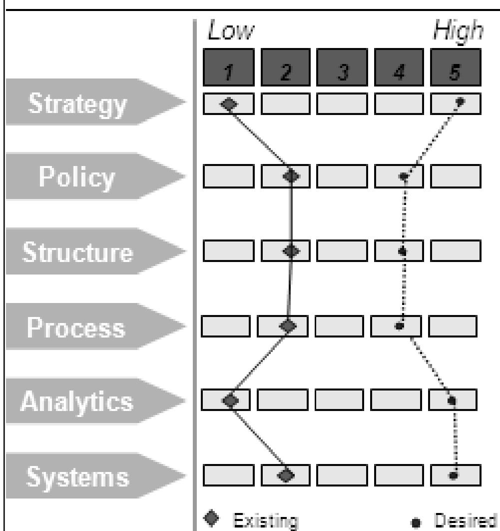
1) Do the systems support risk based decision making?

2) Is the organisation structure conducive to risk management and is the risk management structure in place?

3) Is there adequate infrastructure available for risk management activities?

Illustrative

Dimension	As-Is Assessment	Comment



Strategy
There is limited evidence of a definition of the risk appetite or the risk philosophy. The risk appetite needs to be specified in 'capital at risk terms based on the target rating / confidence level. The Board of Directors' risk philosophy needs to be communicated across the organization.

Structure
The responsibilities of the risk management function (e.g. independent risk oversight, measurement standards, limits, risk reporting) need to be clearly articulated

(C) Developing a code of conduct

Ethical values and culture within the organisation are important for a successful ERM implementation, since they:

- Determine the organization's openness to accepting the existence of a risk and the need for its mitigation.
- Establish the open channels of communication within an organization.
- Affix the responsibility on the pattern of behavior within an organization.
- Determine organization's responsibility towards various compliances and its commitment towards performing ethical activities.

A code of conduct may cover the entity's approach towards to following aspects:

- Purpose of the code of conduct and importance of ethics
- Applicability of the code of conduct
- Result of non compliance
- Relationship with stakeholders
- Disclosure, Reporting and resolution of conflicts
- Policy of gifts and entertainment
- Protection of assets
- Maintenance of confidentiality
- Public responsibility of the organization
- Legal compliance
- Corporate social responsibility
- Whistle blower policy – which covers escalation, treatment of violations and resolution, etc.

(D) ERM project Structure

Enterprise wide risk management would be successful when organizations are geared up for the implementation. This would include the support and involvement of the Board, Senior Management and Executive management. As ERM evolves, specialized roles are considered appropriate. In addition, the following specific responsibilities also devolve:

Board of Directors

- Develop a risk culture across the organization.
- Sponsor the ERM program.
- Oversight functions for evaluating the ERM implementation success.
- Facilitate the implementation by monitoring the project at each stage.

Risk Committee

- Act as an oversight for overall risk management initiatives.
- Ensure each stage in the ERM implementation is carried out effectively in line with the objectives.

Chief Risk Officer

- Manages the ERM project along with the risk management team.
- Provides periodic updates to the risk committee and The Board.

Business Unit heads

- Assume the overall responsibility for the risk identification, assessment and mitigation.

Functional heads

- Identify, assess and manage risks for individual processes.

It should be remembered that the above responsibilities should not conflict with other Board functions and responsibilities. The underlying principle being to ensure that the structure is conducive to the degree of implementation within the organization.

Appendix 4

Objective Setting

A. Key Activities to Objective Setting

- Define risk management process linkages with strategic objectives of the organisation and the mission of the company.
- Define the risk appetite for the organisation related to the strategic objectives.
- Define the risk tolerance levels in business decisions within the overall risk appetite of the organisation.

B. Carrying out the Key Activities to Objective Setting

a) Linking risk management to objectives

An illustration is provided below:

Mission	To be the leaders in providing telecommunication services in the country, thereby facilitating the society in which we exist.
Strategic Objectives	• To maintain an annual return on capital employed of 15%. • To grow the customer base by 40% within three years through increasing the network management capacity by 60% during this period.
Strategies	• Develop the network infrastructure in new areas that match our target customer demographics. • Acquire smaller service providers to obtain their existing subscriber base.
Networking services unit Objectives	• Acquire a minimum of 25 new terminals in second tier cities and new formed telecom circles.

	• Identify 5 potential target service providers in second tier cities. • Enhance existing network capabilities by 30% to support additional customer base.
Human Resources Objectives	• Recruit a senior manager in the networking department. • Annual turnover of customer services staff below 18%. • Recruit and train 175 customer service staff in the coming year.

Once the above linkage is determined, risks/events are identified which may affect in achieving the objectives. For e.g., in the above illustration the risks that could probably impact are as follows:

- Strategic
  - Increase in competition
  - Increase in Taxes affecting outlays and hence returns
- Operational
  - Requisite approvals for new terminals may not be obtained.
  - New targets acquisition may not be possible.
  - Attrition rate beyond the norms.
  - Lack of the availability of man power.

Thus, the risk assessment and risk response would then be linked to the strategic and operational goals of the organisation.

(b) Define risk appetite and risk tolerance

Risk Appetite

Once the objectives are defined as above, the organisation needs to define its overall risk appetite. The risk appetite is, normally, defined in terms of a measurable parameter e.g., total cash loss, exposure as a percentage of the capital invested, percentage of net profit, minimum rate of returns, etc. Defining risk appetite would include defining the following:

1) Extent of risk acceptable in a new business selection.
2) Minimum rate of return in new ventures.
3) Degree of importance towards various type of risks namely, Strategic, Operational, Compliance, Reporting.
4) Acceptable exposure in uncertain ventures.
5) Categories of the risk which would be unacceptable to the organization.

Risk Tolerance

After defining the risk appetite of the organization, it also needs to define the risk tolerance which is the degree to which non conformance to risk levels is acceptable to ensure that the overall exposure is within the risk appetite of the organization. For e.g., the overall risk appetite for the organisation is 20% of the capital investment of ₹ 300 Crores. There are three business units A, B and C with the investment of ₹ 100 Crore each. Suppose, the risk exposure for each of them is ₹ 8 Crores, ₹ 25 Crores and ₹ 25 Crores. Thus, the risk tolerance for the business units B and C is 5% (excess over the acceptable level of 20%). At 5% tolerance although the business units individually may exceed the risk appetite levels, at an organisation level, the total risk exposure is within its risk appetite (₹ 58 Crores which is less than ₹ 60 Crores (@20% of capital investment)). However, the entity would continue to monitor the non compliance to tolerance levels in units B and C to identify and mitigate the risks due to which the risks have exceed the unit tolerance levels.

Appendix 5

Event Identification

A. Key Activities to Event Identification

- Identify events which may affect the objectives.
- Use various techniques for event identification.
- Prepare an inventory of events.
- Categorize similar events in one category for a holistic assessment.
- Evaluate interdependencies in events.

B. Carrying Out the Key Activities to Objective Setting

(a) Identify the events affecting objectives

There are various techniques used to identify events, some of these are discussed in this Guide. However, it is important to link the events to the objectives for an effective event identification, some examples are given below:

Objective- Production capacity utilization should be at 95% of the planned capacity.

Events/Risk - Machine down time resulting in a lesser utilization of plant capacity.

- Delivery schedules of raw material not adhered to ensure a continuous production.

It is important to associate an event to an objective and then to a business/ sub unit or a department.

(b) Ensure the effective use of techniques for event identification

Some sample techniques which could be used:

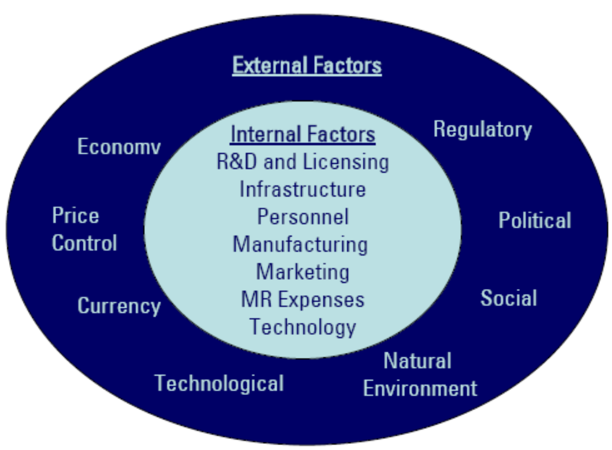
- Interviews
- Surveys
- Questionnaires
- Facilitated workshops

In all the above techniques the answers to following questions need to be obtained:

- Which objectives would be affected by the event?
- What is the degree to which the event would have an impact?
- What is the company's tolerance to that impact?
- Is the event resulting in a risk or opportunity?
- Is the event related to other events or are there other events affecting the given objective?

Event/Risk identification depends on many factors and all need to be taken into account. An illustrative list of the factors affecting the event identification in a pharmaceutical company is mentioned below:

Illustrative



An organisation can also develop certain trigger systems which would help in an event identification on an ongoing basis.

- Deviations from acceptable norms
- Deviations from acceptable key performance indicators
- Trend analysis of the event likelihood and impact

(c) Prepare event inventory

- Identify the events across various processes, business units.
- Categorize the events based on the business unit, process, sub process, division, department, risk category (Strategic, Operational, Compliance/ Regulatory, Reporting/Monitoring).
- Ensure similar events are grouped under one category.
- Evaluate the interdependencies of events to assess the impact of each event.

A sample risk/event inventory is given below:

Process	**Sub Process**	**Division**	**Department**	**Risk Category**	**Risk Owner**	**Risk Description**
Revenue	Billing	Health Care	Finance	Operational	XXX	Incorrect Billing
Treasury	Hedging	Health Care	Treasury	Strategic	XXX	Decrease in Dollar rate
Human Resources	Recruitment	Health Care	Human Resources	Strategic	XXX	Attrition
Legal	Legal	Health Care	Legal and compliance	Regulatory	XXX	Delays in obtaining statutory clearances

Appendix 6

Risk Assessment

A. Key Activities to Risk Assessment

- Evaluate each risk in terms of its likelihood of occurrence and impact.
- Use various qualitative and quantitative techniques for assessing risks.
- Prepare a risk map by plotting various risks in terms of their likelihood and impact.
- Prioritize risks to develop response mechanism.

B. Carrying out the Key Activities in Risk Assessment

a) Evaluate risk in terms of likelihood and impact

One of the most accepted risk assessment practices is conducting risk assessment workshops. The risks identified in the earlier stages are discussed in this workshop and risks are rated based on their likelihood and impact. Each risk needs to be evaluated on two criteria :

1) Likelihood - could be classified as –
   - Remote
   - Unlikely
   - Moderate
   - Likely
   - Almost Certain
2) Impact – could be classified as
   - Insignificant
   - Minor
   - Moderate
   - Major
   - Catastrophic

At this stage, risks would be assessed on an inherent basis, i.e., without considering the existing controls within the organization. There could be various criteria based on which the above classification could be made. An illustration is given below for further understanding:

Impact and probability descriptions are defined and agreed to with . Probabilities can alternatively be expressed in percentage probabilities to occur or periods of time in which an event might occur.

Impact	
Insignificant	• No potential impact on shareholder value • No impact on reputation
Minor	• There is a potential impact on shareholder value and reputation • Potential for regulatory criticism
Moderate	• Regulatory non compliance requiring board non compliance • Rs.100 to Rs 300 million impact on profitability
Major	• Rs. 300 to 500 million impact on profitability • Serious diminution in reputation and shareholder value with adverse publicity
Catastrophic	• > Rs 500 million impact on profitability • Loss of key alliances

Probability of Occurrence	
Almost certain	Event is expected to occur in most circumstances
Likely	Event will probably occur in most circumstances
Moderate	Event should occur at some time
Unlikely	Event could occur at some time
Remote	Event may only occur in exceptional circumstances

Assess the Impact and Probability of Each Risk Event (Illustrative scales)

It is critical to clearly define the Risk Rating Criteria by specific process groups to have better appreciation of relativity and criticality around the gamut of risks

(b) Prepare a risk assessment inventory

Once the risks are assessed for likelihood and impact in the workshop, gross risk is calculated for each risk. The risks could then be plotted on a graph. Such a graph (risk map) would depict the risk profile of the organization. The following illustration would make it easier.

Risk Assessment

Particulars	Average Gross Impact (A)	Average Gross Likelihood (B)	Average Gross Risk (A*B)
Talent Retention.	4	4	16
Increasing Competition	4	3	12
Lack of robust insider trading control framework	3	3	9
Weak IT security controls	3	2	6
Opportunity Loss of sale in stock out situations	2	2	4
Non compliance with regulatory and legal statues.	2	1	2

There are various, methods available for performing risk quantification. The method mentioned above is the most commonly used method. Companies depending on their need and maturity adopt methods like sensitivity analysis, stress testing, cash exposure criteria, etc for arriving at the gross risk. Further, risks are to be identified and assessed for all business units, locations, and the organisation as a whole. This would ensure that the risk identification and assessment is comprehensive.

Risk quantification is dependent on the likelihood and impact. Further, some risks can be quantified while others cannot be quantified. In such a scenario, in some cases, qualitative techniques are used for risk quantification while quantitative techniques are used in others. For example, Qualitative Techniques would be used when:

- Data analysis for quantification is not cost beneficial.
- Reliable data for analysis is not readily available.
- Risks are of a nature which cannot be quantified.

Quantitative Techniques are used when:

- Adequate and relevant data is available.
- Increase degree of accuracy is required for decision making.
- Qualitative aspects need to be substantiated.

In companies with an advanced level of ERM in place, the methods used for risk quantification for strategic risks is generally as follows: (In the order of most valued method)

- Key Risk Indicators
- Individual self assessments
- Scenario Analysis
- Risk Mapping using impact and frequency
- Facilitated group self assessments
- Economic Value Added
- Value at Risk
- Industry Benchmarks/Loss experience
- Statistical Analysis/Probabilistic modeling

(c) Perform risk categorization and prioritizing

Prioritizing and categorizing risks into manageable groups is the most critical aspect of the risk identification. The relevance, probability, impact of risks have to be agreed upon with the risk owners. Risk could be categorized as follows:

Based on Timing

- Short Term – Non achievement of yearly budgets.

- Medium Term – Attrition levels not maintained below desired level in the next three years.
- Long Term – Non achievement of targeted market share in the next five years.

Based on Nature

- Environment Risk (Regulations, Laws, Technology, Shareholder expectations, Availability of capital, Market trends, etc).
- Process Risk (Lack of alignment of business activities in line with business objectives, operational inefficiency, Frauds, misappropriation, employee retention, etc).
- Information for decision making risk (Inaccurate, out dated, irrelevant data used for business decisions).

Appendix 7

Risk Response

A. Key Activities to Risk Response

- Identify the response to risks identified.
- Evaluate each response in terms of cost and benefit by identifying cost and benefit of each option (i.e., Avoid, Reduce, Share/ Transfer and Accept).
- Select the most efficient option and identify the net/residual risk portfolio after considering the responses to various risks.
- Ensure that the residual risk is within the risk tolerance limits of the organization/ business unit.

B. Carrying Out Key Activities to Risk Response

a) Identify risk responses

Various risk response mechanisms could be classified as mentioned in the below diagram

Avoid	Exiting the activities giving rise to risk. Risk avoidance may involve exiting a product line, declining expansion to a new geographical market, or selling a division.
Reduce	Action is taken to reduce risk likelihood or impact, or both. This typically involves any of a myriad of everyday business decisions.
Share/Transfer	Reducing risk likelihood or impact by transferring or otherwise sharing a portion of the risk. Common techniques include purchasing insurance cover, outsourcing activities, engaging in hedging transactions.
Accept	No action is taken to affect risk likelihood or impact. This is mainly in cases where the risk implications are lower than the Company's risk appetite levels.

b) Evaluate risk response

Each risk response should be evaluated in terms of costs and benefits. An illustration is given below:

Case:

A large retail chain is dependent on a single supplier for the supply of toys. However, due to production bottlenecks with the supplier, many times there is a non adherence to supply requirements by the toy manufacturer. The non adherence is to the extent of 15% of the required supply quantities. This results in an inadequate supply for meeting the demand for the toys. The retail chain wants to ensure that it meets 90% of the demand for the toys. The related risk to this objective is – Dependency on a single vendor for supply of toys. As a response to this risk the following options are available:

Avoid - Avoid dependency on a single vendor, terminate his contract and develop new vendors.

Accept – Accept the non adherence to supply quantities by the existing vendor and procure the balance quantities from other vendors for meeting the demand.

Transfer – Negotiate with the supplier and obtain the commitment of minimum quantities and include penalty clauses for non adherence.

Reduce – Monitor the performance of the supplier on a periodic basis to ensure that production is at desired levels to ensure timely changes to the procurement plan. Use more sophisticated demand forecasting methods to ensure that the gap between supply and demand is forecasted on a more accurate basis.

Each of the above options has costs and benefits attached to them. One needs to tabulate the cost and benefits to identify the most efficient response.

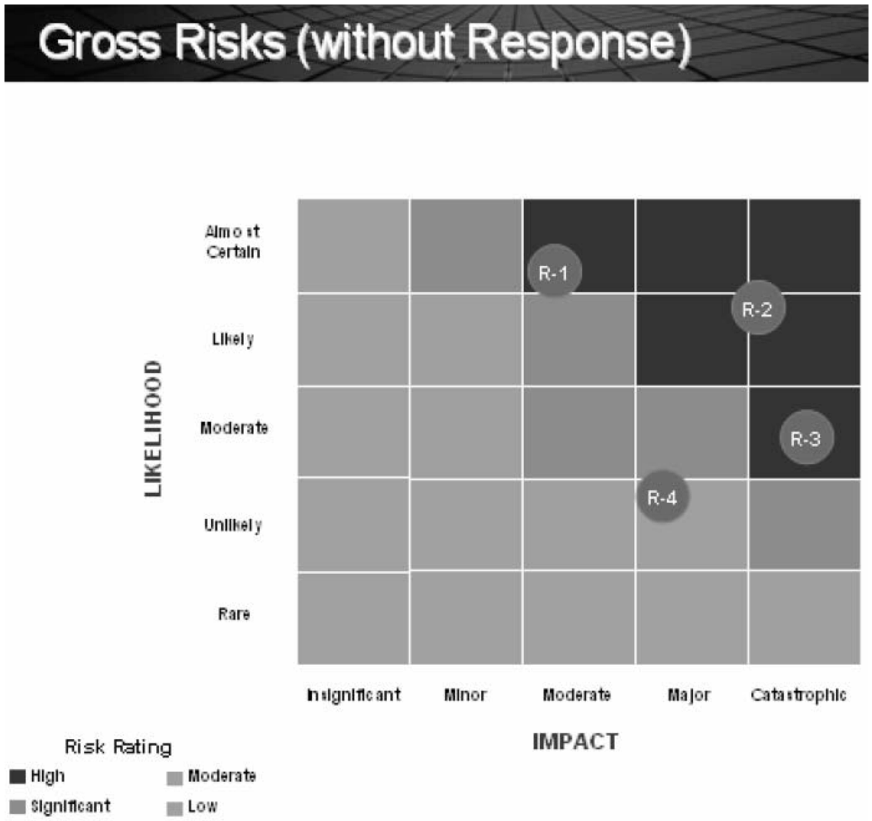
Response		Cost	Description	Benefits
A	Accept	₹ 50,000	Commercial department efforts required to identify additional suppliers, and additional logistics costs, ₹ 50,000	Management predicts it can sell an additional 3% to customers, bringing demand adherence up to 88% Effect on EBIT: increase of ₹ 250,000
B	Avoid	₹ 150,000	Unit price increased by 1.5% due to new suppliers charging premium price	Efforts allow meeting of 93% of the demand Effect on EBIT: increase of ₹ 600,000
			₹ 20,000 in increased salary costs for personnel required to identify, and sustain new vendors	
			₹ 80,000 in increased outbound logistics costs due to a larger number of suppliers	
			₹ 50,000 in legal fees to negotiate and finalize new agreements	
C	Transfer	₹ 25,000	Unit price increases 3% due to an increased pressure on supplier for meeting demand and penalty clause inclusion	New contract allows to meet 95% of the market demand Effect on EBIT: increase of ₹ 275,000
			₹ 25,000 in legal fees to negotiate and revise contract agreement	

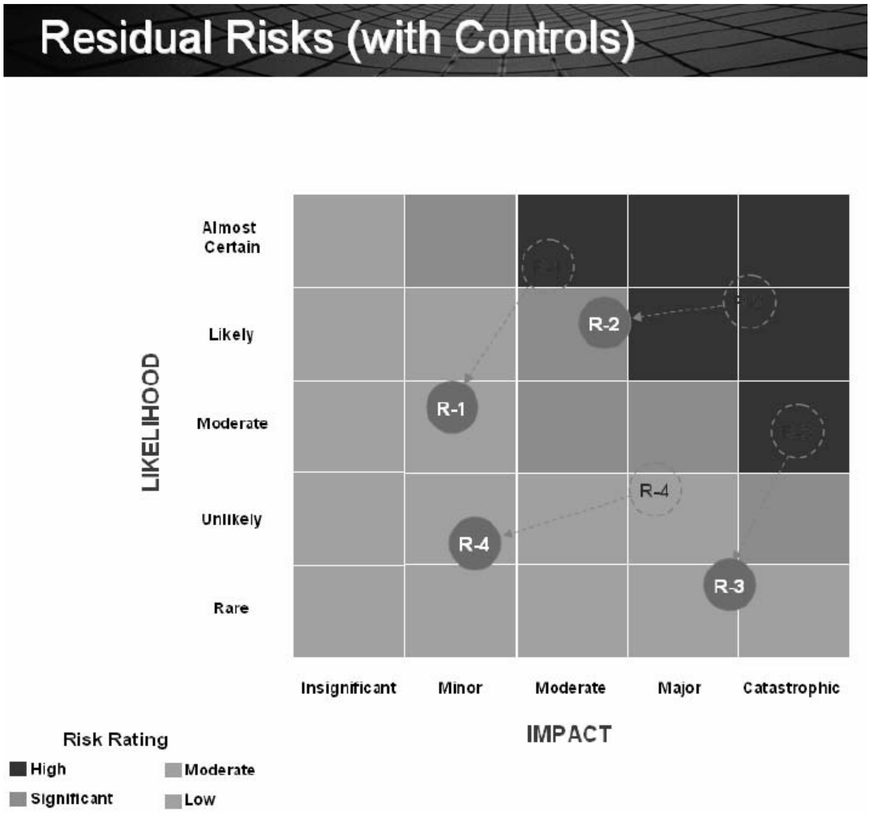
D	Reduce	₹ 150,000	Average unit price drops 1% due to suppliers asking for premium price for small quantities ₹ 150,000 for increased forecasting, analysis and monitoring of vendor performance on regular basis	Demand utilization possible up to 97% Effect on EBIT: increase of ₹ 370,000

Thus, based on the above evaluation, it could be observed that the response to this risk is the most efficient if the risk is avoided.

(c) Prepare residual risk portfolio

Once risk responses are identified, for each risk identified, the company then needs to identify the residual risk profile. This would facilitate in ensuring that the risks are within the tolerance limits defined in the initial stages. Once the risk response for each risk is identified, the likelihood and the impact needs to be reassessed taking in to consideration the response identified for each risk (Accept, Avoid, Share, Transfer). The scenario would appear as mentioned below:


Gross Risks (without Response)
LIKELIHOOD
Almost Certain
Likely
Moderate
Unlikely
Rare
R-1
R-2
R-3
R-4
Insignificant
Minor
Moderate
Major
Catastrophic
IMPACT
Risk Rating
High
Moderate
Significant
Low


Residual Risks (with Controls)
LIKELIHOOD
Almost Certain
Likely
Moderate
Unlikely
Rare
R-1
R-2
R-3
R-4
R-4
Insignificant
Minor
Moderate
Major
Catastrophic
IMPACT
Risk Rating
High
Moderate
Significant
Low

The risk portfolio would look as mentioned below:

Particulars	**Gross Risk**	**Residual Impact**	**Type of Response**	**Residual Likelihood**	**Residual Risk**	**Strength of response**
Talent Retention.	16	3	Reduce	4	12	4
Increasing Competition	12	3	Accept	3	9	3
Lack of a robust insider trading control framework	9	2	Reduce	3	6	3
Weak IT security controls	6	2	Reduce	2	4	2
Opportunity Loss of sale in stock out situations	4	2	Avoid	1	2	2
Non compliance with regulatory and legal statues.	2	1	Accept	1	1	1

Appendix 8

Control Activities

A. Key activities to Control Activities

- Perform a root cause analysis for the failure of risk response.
- Identify control activities for various risks responses.
- Evaluate the control activities in terms of cost and benefits.
- Implement the control activities for risk responses.

B. How to carry out key activities to Control Activities

a) Perform a root cause analysis for the failure of risk responses and identify control activities.

The following example would help understand the process of a root cause analysis for the failure of risk response and identification of control activities.

Root Causes	Key Controls	Action Plan	Key Performance Indicators
• Not hiring enough resources	• Identifying and hiring competent personnel	• Evaluation of employee morale to be carried out by external agencies	• Number of vacancies
• High Attrition	• Identifying employee needs and satisfying them to retail talent	• Identification of top performers/ successors and identification and satisfaction of their needs • Benchmarking current pay scales with industry	• Attrition Rate
• Absence of robust performance evaluation system	• Installing a structured performance evaluation and career progression plans		
• Non – application of KPIs	• Ensuring that KPIs are enforced and monitored on a periodic basis		
• Absence of a structured feedback mechanism	• Installing a 360 degree feedback mechanism		
• Absences of successors/ succession planning	Identifying and training /grooming successors		
• Integration of persons from various organizations			
• Non - availability of skilled resources			

G-4
STUDY ON CO-ORDINATION OF INTERNAL AUDITOR WITH FUNCTIONAL HEADS

Foreword

The forces shaping our world today are immense, complex, surprising and challenging. More than ever, our prosperity — as organizations, societies and individuals — depends on the extent to which we can adapt to these forces and deploy them to our advantage. In these challenging times if internal audit is to demonstrate value then it must begin with a fresh look at the organisation's internal audit strategy and a reassessment of its own processes. A forward looking approach demands that the internal auditors should recognize the need to redefine the function's value proposition and seek to increase its value by learning to operate more efficiently, intelligently, and quickly.

I am happy to note that Internal Audit Standards Board of the Institute is issuing this "Study on Co-ordination of Internal Auditor with Functional Heads" that throws light on crucial aspects, essential for working of successful internal audit departments, for meeting the evolving needs and expectations of their key stakeholders. At this juncture, I congratulate CA. Rajkumar S. Adukia, Chairman, Internal Audit Standards Board and other members of the Board for bringing out this innovative publication which guides the internal auditors to be well positioned and to demonstrate their function's real value.

I am sure that the members and other interested readers would benefit from this contemporary publication.

December 16, 2010 **CA. Amarjit Chopra**
New Delhi *President, ICAI*

Preface

In today's challenging times, organisations need professionals who generate results by being both technically strong and having great interpersonal skills. This is also a pre-requisite for internal auditors who should not only be well-equipped with traditional audit skills, but also acquire professional skills needed most as internal auditing moves forward as competitive and dynamic profession.

Internal audit function must be the catalyst for constructive changes in the organisation. Internal auditor should strive to be the partner to the organisation's various functions and instrumental to their success. To achieve this, it is necessary to approach internal audit with series of discussion with various functional heads about purpose, objectives and success factors. Internal auditor's role should be viewed as a partner and trusted advisor for functional heads as well as for the Board of Directors and Audit Committee.

The Internal Audit Standards Board has brought out "Study on Coordination of Internal Auditor with Functional Heads" with a view to provide guidance on the way co-ordination and co-operation between internal auditor and functional heads can be achieved while respecting distinctive functions and professional requirements of both. The Study provides an overview of the essential qualities an internal auditor must possess for effective co-ordination and discusses various basic tenets of internal audit which should not be compromised in the co-ordination process. It also provides an insight about various types of hurdles an internal auditor faces in the co-ordination process and the methodology to overcome these constraints with case studies.

At this juncture, I am grateful to CA. K.S. Sundara Raman and his study group members *viz*. Shri Kannan Rajagopalan, Shri Sridharan Sadagopan, Shri Shyamal Budhdev, Shri Sumit Mantri and Shri Pinaki Saha, for sharing their experience and knowledge with us and preparing the draft of the Study.

I also wish to thank CA. Amarjit Chopra, President and CA. G. Ramaswamy, Vice President for their continuous support and encouragement to the initiatives of the Board. I must also thank my colleagues from the Council at the Internal Audit Standards Board, *viz.,* CA. Naveen N. D. Gupta, CA. Nilesh Vikamsey, CA. Atul C. Bheda, CA. K. Raghu, CA. J. Venkateswarlu, CA. Abhijit Bandyopadhyay, CA. Ravindra Holani, CA. Charanjot Singh Nanda, Ms. Usha Sankar, Shri Prithvi Haldea and Shri Sidharth Birla for their vision and support. I also wish to place on record my gratitude for the co-opted members on the Board, *viz.,* CA. Sushil Gupta, CA. Smita Satish Gune, CA. Nagesh Dinkar Pinge, CA. Sumant Chadha and CA. Deepak Wadhawan for their devotion in terms of time as well as views and opinions to the cause of the professional development. I also appreciate efforts put in by CA. Jyoti Singh, Secretary, Internal Audit Standards Board and her team of officers, *viz.,* CA. Arti Aggarwal and CA. Gurpreet Singh, Senior Executive Officers, for their inputs in giving final shape to the publication.

I am confident that this publication would achieve its objective by helping the internal auditors conduct effective internal audit through refining their techniques and methodologies to maintain balanced relationship with the functional heads.

December 28, 2010
Mumbai

CA. Rajkumar S. Adukia
Chairman
Internal Audit Standards Board

Contents

Chapter 1

Role of Internal Audit

1.1 "*Preface to the Standards on Internal Audit*", issued by the Institute of Chartered Accountants of India defines "Internal Audit" as follows:

> "*Internal Audit is an independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system. Internal audit, therefore, provides assurance that there is transparency in reporting, as a part of good governance*".

The above definition amply reflects the current thinking as to what is an internal audit and highlights its important facets. Internal audit is a management function, thus, it has the high-level objective of serving management's needs through constructive recommendations in areas such as, internal control, risk, utilization of resources, compliance with laws, management information system, etc. Thus, internal audit's role should be a dynamic one, continually changing to meet the needs of the organization.

1.2 Internal audit activity is an essential component of the governance mechanism of the Board of Directors and Senior Management. Internal auditor furnishes analysis, appraisals, recommendations, counsel and information concerning the activities reviewed. Internal auditor can suggest ways of reducing costs, enhancing revenues, and improving profits.

Internal auditor's role encompasses close co-ordination of various functions of the organization and provides assurance to the Board, Audit Committee and Senior Management on risk management and the strength of corporate governance. They contribute in the organisation's need for sustained success and growth. A dedicated, independent and effective internal audit activity assists both functional management and the governing management (e.g., the

Board, Audit Committee) in fulfilling their responsibilities by bringing a systematic and disciplined approach in assessing the effectiveness of the design and execution of the system of internal controls and risk management processes.

1.3 The value addition role will be effective only if Internal auditor's co-ordination with the process owners of various functions is done more objectively.

The Internal auditor has a larger responsibility towards Audit Committee as they rely on the Internal auditor as an objective source of information on what is going on within the organization. Hence, the Internal auditor has to ensure that all his findings are accurate and fully backed up with responses of concerned Functional Heads.

1.4 Internal audit is a highly interactive process which is aimed to help organizations accomplish their objectives. Internal audit is not, in anyway, a desk research activity. Essentially, their role is based on review, analysis and conclusions culminating from their co-ordination with Functional Heads.

Effective co-ordination with Functional Heads enables the Internal auditor in meeting the Management Expectation of providing independent and objective assurance to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.

1.5 Internal auditor helps Audit Committee by:

(i) Conducting an objective evaluation of risk management and internal control systems;

(ii) Conducting a systematic analysis of business processes and associated control:

i. Being a source of information on frauds/ other irregularities;

ii. Conducting a review of operational and financial performance;

iii. Making recommendations on effective and efficient use of resources; and

iv. Making an assessment of accomplishment of corporate goals and objectives.

1.6 Internal audit head has to report its findings to the Audit Committee highlighting any deficiencies that have been detected, and the Audit Committee also has to enquire in depth from the Internal auditor about any complex issues involved. There should an open flow of communication and information between the Internal auditor, Audit Committee and Statutory auditor. This helps to avoid mistakes and miscommunications and also considerably improves the work quality of the auditors.

1.7 Co-ordination of internal audit efforts involves the following:

(i) Periodic meetings with Audit Committee and Statutory auditors regarding the company's internal audit universe, scope of the areas proposed to be covered, risk assessment updates, audit plans and the internal audit annual schedule.

(ii) Periodic meetings between Internal audit head, Audit Committee and Statutory auditors with respect to statutory audit schedule, coverage and the desired level of direct or indirect assistance required and available. This also includes coverage through internal audit of concerns raised by statutory auditors.

(iii) Access to statutory auditors of internal control documentation and reports. Common understanding of audit techniques, methods, audit approach and terminology to effectively co-ordinate work and rely on the work of one another.

(iv) Communication regarding announcements when audits are scheduled to begin and the specific audit objectives that have been established.

(v) Exchange of audit reports and management letters through the Audit Committee.

(vi) Exchange of information to be reported to the Company's Audit Committee to affect a mutual understanding of audit issues and to present a consolidated view of audit efforts.

Chapter 2
Areas of Co-ordination

2.1 Internal auditors have to interact with functional heads of various functions and the following are some important areas of co-ordination:

(i) Procurement (Revenue and CAPEX)

Revenue procurement has well governed internal control procedures, policies on authorisation and budgetary controls. On the other hand, in CAPEX procurement value of commitment is very high and it is cleared by the top management. In many well established corporates, capital budgets are approved by the Board of Directors. Since, the CAPEX goes to the highest level of approval; the process followed will be extensively detailed, and technically justified to present a schedule of commitment and completion. All issues related to CAPEX procurement should preferably be addressed to the top management for effective communication. However, revenue related issues may be discussed and closed with lead buyers.

(ii) Material Management

Material Management, broadly, includes correct classification and management of inventory at optimum level so as to avoid carrying cost of inventory as well as stock out of critical items, with a view to ensure effective utilisation of inventory. It is essential that recommendations for minimizing inventory cost like, Just in Time Inventory, Vendor Managed Inventory (VMI), etc., should be discussed with the top management at site. Internal auditors need to include in their communication to the management the benefits to the organisation by making these policy changes, and also the implications of not making these changes. However, routine inventory related issues on preservation, binning, etc., can be taken up with the Materials Head.

(iii) Accounts Receivable

Issues on Accounts Receivable may arise out of many sub-functions like, Banking and Collection; Credit/ Debit Notes consequent of allowing discounts and rebate; Credit Management, etc. These are usually handled by separate functional heads. Each such issue need to be identified and properly linked to the respective sub-functions and co-ordinated with them for getting proper response so that processes relating to these are understood before raising audit issues. This will not only avoid making any wrong conclusions on audit findings but also will make the process owners accountable for audit responses to make corrective or preventive actions, if recommended by the Internal auditors.

(iv) Treasury and Banking

Internal auditor needs to make a clear distinction between CAPEX funding and Working Capital Fund Management. CAPEX funding comes mainly from corporate objectives of investments in various projects and any issues relating to such activities can be addressed at appropriate decision making level in functional hierarchy instead of Fund Manager level. Internal auditor should have technical understanding of FOREX so that he can effectively communicate with the FOREX department.

(v) Insurance

Insurance involves two separate segments, *viz.*, coverage of insurable assets (risks) and the premium. For issues relating to the coverage of a particular risk, the Internal auditor needs to discuss and co-ordinate with the technical Functional Heads as this is a policy decision by the Management. However, issues relating to correctness of premium computation and inclusion of assets should be discussed with the concerned operational level heads.

(vi) Production

Process knowledge and critical observation on input and output analysis will be of great advantage in communication with the Production Head.

(vii) Plant Maintenance

Issues arising out of transaction recording of routine maintenance can be discussed with the Operation head but issues like, buy or repair, deferment of preventive maintenance, etc. should be discussed with the top management at site for getting the correct response.

(viii) Health, Safety and Environment

Effective implementation of Health, Safety and Environment (HSE) policy is critical from both statutory compliance and corporate social responsibility view point. Since this function is mostly guided by the company policy, the Internal auditor needs to interact with the top management.

(ix) Human Resources

Human Resources head guides and manages the overall Human Resources policies and programs for the entire company. Since this function is mostly guided by the Company policy, the Internal auditor needs to interact with the top management.

2.2 Strong knowledge of statute, good interpretation skills and well updated information on recent circulars/ notifications/ case laws will help in co-ordinating with functional heads in the following areas:

- Export and Import
- Indirect Taxation
- Direct Taxation

- Secretarial
- Legal Services.

2.3 Other than areas listed above, an Internal auditor has also to co-ordinate skillfully and competently with various Functional heads in the following areas also:

- Accounts Payable
- Accounts
- Security Services
- Logistics and Supply Chain Management
- Project
- Asset Management
- Administration
- Payroll and Retirement Benefits
- Information Technology
- Marketing & Sales
- Customer Care
- Corporate Communications/ Public Relations.

Co-ordination efforts of Internal auditor for different functions demand relevant knowledge and skill sets to command respect and acceptance. In addition, Internal auditor's overall understanding of inter-functional linkages help in his discussion with different Functional heads on communicating the wider implication of the audit findings.

Chapter 3

Essential Qualities for Effective Co-ordination

3.1 In order to effectively discharge professional responsibilities, the Internal auditor needs to focus on many different skills in three major areas – general technical knowledge, audit process knowledge and professional skills. Standard on Internal Audit (SIA) 2, "*Basic Principles Governing Internal Audit*" lays down following with respect to skills and competence of internal auditor:

> "*7.* ***The internal auditor should either have or obtain such skills and competence, acquired through general education, technical knowledge obtained through study and formal courses, as are necessary for the purpose of discharging his responsibilities.***
>
> *8. The internal auditor also has a continuing responsibility to maintain professional knowledge and skills at a level required to ensure that the client or employer receives the advantage of competent professional service based on the latest developments in the profession, the economy, the relevant industry and legislation.*"

3.2 The essential qualities that an internal auditor is required to have for effective co-ordination with functional heads are as follows:

(i) Knowledge

Internal auditor should have a comprehensive and multi-faceted knowledge of various areas like, operations, systems, processes, audit standards, regulatory and statutory provisions, etc. Internal auditor needs to update himself on developments in regulatory pronouncements, technology and new audit tools and procedures. Tools and technologies implemented by internal auditor typically support work papers, audit planning, reporting, report writing, tracking findings through remediation and knowledge sharing.

(ii) Business Understanding

The demanding timelines for management's reporting imposes severe pressure on internal auditor to complete the internal audit process, without compromising the quality, at the shortest time. Hence, his grasp and understanding of business processes has to be sharp and quick. An internal auditor must develop a strong understanding of the organisation. Levels of experience, training and education help the internal auditor to assess business situations for better evaluation. He should obtain the required knowledge at the commencement of the engagement and as the internal audit progresses, the information should be assessed, enhanced, updated, refined and validated as he obtains more knowledge about the entity's business. Further, in case of continuing engagements, the internal auditor should update and re-evaluate information gathered previously including identification of any significant changes that have taken place in the operations, control environment, technology and strategic processes since the last internal audit.

Internal auditor can use the information obtained from understanding of business in following areas:

- Assessing risks and identifying key focus areas.
- Planning and performing the internal audit effectively and efficiently.
- Evaluating audit evidence.
- Providing better quality of service to the client.

(iii) Professionalism

As internal auditor is viewed as an internal consultant to the management, he should exercise high degree of professionalism in his interaction with all levels of process owners.

(iv) Excellent Communication Skills

The communication skills, both written and oral, play a paramount role in their relationship with the operating and executive management. Many a times improper communication by the internal auditor creates disharmony, anguish and conflict with the operating process owners and the functional heads. Besides, this improper communication may also tend to mislead the management on complex issues. The golden rule for successful communication is that the sender and the receiver understand the same information.

(v) Perspective Reporting

Any functional head would appreciate Audit Reports that are presented in right perspective, besides being timely, factual, accurate and complete. While writing the report it is necessary that each observation be constructed in such a manner that it represents the true facts of the issue, its financial or other impact, the causes for the situation and also the recommendations to rectify it.

Within the management, there are different levels, and so the audit report has to be designed to suit the interest, needs and requirements of different levels of the management. All the levels need to know as to what is happening in the areas of their concern and internal audit report can serve as one of the vehicles of information. However, the degree of detail required by each level will be different and the internal auditor should take care of the same while drafting the report.

(vi) Effective Presentation Skills

An internal auditor should have effective presentation skills which involve selecting major issues that warrant functional head's attention and presenting the same in a lucid and easy to understand manner.

In addition, internal auditor's analytical ability and good interpersonal relationship makes the co-ordination with functional heads more rewarding.

Chapter 4

Co-ordination – Not a Compromise to Tenets of Internal Audit

4.1 In the zeal of cordial relationship, internal auditor should not lose sight of the basic tenets of internal audit. The basic tenets of internal audit as stipulated in Standards on Internal Audit, issued by the Institute, reinforce the importance of the principles with reference to co-ordination aspect and some such important aspects have been discussed in below paragraphs.

4.2 The following paragraphs of SIA 2 "*Basic Principles Governing Internal Audit*" guide the internal auditor on crucial aspects:

> ***"Integrity, Objectivity and Independence***
>
> 4. ***The internal auditor should be straight-forward, honest and sincere in his approach to his professional work.*** *He must be fair and must not allow prejudice or bias to override his objectivity.* ***He should maintain an impartial attitude. He should not only be independent in fact but also appear to be independent. The internal auditor should not, therefore, to the extent possible, undertake activities, which are or might appear to be incompatible with his independence and objectivity.*** *For example, to avoid any conflict of interest, the internal auditor should not review an activity for which he was previously responsible. It is also expected from the management to take steps necessary for providing an environment conducive to enable the internal auditor to discharge his responsibilities independently and also report his findings without any management interference. For example, in case of a listed company, the internal auditor may be required to report directly to those charged with governance, such as the Audit Committee instead of the Chief Executive Officer or the Chief Financial Officer.* ***The internal auditor should***

immediately bring any actual or apparent conflict of interest to the attention of the appropriate level of management so that necessary corrective action may be taken.

Confidentiality

5. ***The internal auditor should maintain the confidentiality of the information acquired in the course of his work and should not disclose any such information to a third party, including the employees of the entity, without the specific authority of the management/ client unless there is a legal or a professional responsibility to do so.*** *The internal auditor, therefore, needs to ensure that there are well laid out policies and controls to protect confidentiality of the information.*

Due Professional Care, Skills and Competence

6. ***The internal auditor should exercise due professional care, competence and diligence expected of him while carrying out the internal audit****. Due professional care signifies that the internal auditor exercise reasonable care in carrying out the work entrusted to him in terms of deciding on aspects such as the extent of work required to achieve the objectives of the engagement, relative complexity and materiality of the matters subjected to internal audit, assessment of risk management, control and governance processes and cost benefit analysis. Due professional care, however, neither implies nor guarantees infallibility, nor does it require the internal auditor to travel beyond the scope of his engagement.”*

4.3 Due to the very nature of internal audit function, it has a serious potential of creating behavioral issues within an entity. Recognizing this, SIA 4, “*Reporting*”, issued by the Institute of Chartered Accountants of India, requires that ***to facilitate effective communication and ensure that the recommendations presented in the final report are practical from the point of view of implementation, the internal auditor should discuss***

the draft with the entity's management prior to issuing the final report.

4.4 According to SIA 4, ***the different stages of communication and discussion should be as under:***

(i) ***Discussion Draft – At the conclusion of fieldwork, the internal auditor should draft the report after thoroughly reviewing his working papers. The discussion draft so prepared should also be carefully reviewed before it is presented to the entity's management for auditee's comments. This discussion draft should be submitted to the entity's management for review before the exit meeting.***

(ii) ***Exit Meeting – The internal auditor should discuss with the management of the entity regarding his findings, observations, recommendations, and text of the discussion draft. At this meeting, the entity's management should comment on the draft and the internal audit team should work to achieve consensus and reach an agreement on the internal audit findings.***

(iii) ***Formal Draft – The internal auditor should then prepare a formal draft, taking into account any revision or modification resulting from the exit meeting and other discussions. When the changes have been reviewed by the internal auditor and the entity management, the final report should be issued.***

(iv) ***Final Report – The internal auditor should submit the final report to the appointing authority or such members of management, as directed. The Final Report should include an executive summary clearly indicating the highlights of the internal audit findings, key issues and observations of concern, significant control lapses, failures and weaknesses in the systems or processes. The periodicity of the Report should be as agreed in the***

scope of the internal audit engagement. The internal audit should mention in the Report, the dates of discussion draft, exit meeting, Formal Draft and Final Report.

Chapter 5

Co-ordination Aspects in Various Types of Internal Audit

Operational Audit

5.1 Operational audit examines the use of resources to determine if resources are being used in the most effective and efficient manner to fulfill the organization's mission and objectives. It involves measuring the operations and processes of any entity against established operational standards and suggesting ways and means to improve adherence to standards. The most difficult co-ordination in this type of audit is dealing in technical issues with technical experts. Their pre-conceived notion of internal auditor having financial background lacking technical knowledge warrants a more convincing skill on the impact of the findings. Internal auditor has to drive home the point that everything has financial implication. He should, therefore, demonstrate the commercial/ financial implication in his conclusions.

Financial Audit

5.2 Financial audit reviews accounting and financial transactions to determine if commitments, authorizations, receipt and disbursement of funds are properly and accurately recorded and reported. Further, coverage of non-financial matters is limited to only those aspects that provide additional information to stakeholders who are mainly interested in the financial status of the entity. It is conducted keeping in mind the objective of issuing an opinion on the state of financial affairs. This type of audit also determines if there are sufficient controls over case and other assets and that adequate process controls exist over the acquisition and use of resources. It should be noted that any findings on transaction audit should be factual and not opinion based. All factual based audit exceptions will always be accepted by functional heads.

Compliance Audit

5.3 Compliance audit determines if the organization is complying with applicable laws, regulations, policies and procedures. Compliance audit entails:

- Gathering information about all applicable laws, regulations, and other compliance requirements.
- Understanding limitations of auditing in detecting deviations and non-compliance.
- Assessing the risk that significant illegal acts could occur.

5.4 Internal auditor would design and perform procedures based on risk assessment that would provide reasonable assurance of detecting significant deviations. Interpretation skills of internal auditor play an important role in co-ordination with functional heads of compliance and regulatory department. Unbiased interpretation of statutes, rules and regulations will help functional heads in appreciating the compliance requirement better. Any non-compliance, if reported with its implications to the functional head makes communication effective.

5.5 In order to obtain a general understanding of such a legal and regulatory framework, and how the organization complies with that framework, the internal auditor may, for example:

- Use the internal auditor's existing understanding of the entity's industry, regulatory and other external factors;
- Update the understanding of those laws and regulations that directly determine the reported amounts and disclosures in the financial statements;
- Inquire of management as to other laws or regulations that may be expected to have a significant effect on the operations of the entity;

- Inquire of management concerning the entity's policies and procedures regarding compliance with laws and regulations as well as ethical issues within the entity; and
- Inquire of management regarding the policies and procedures adopted for identifying, evaluating and accounting for litigation claims.

Information Systems (IS) Audit

5.6 Information Systems Audit reviews the internal control environment of automated information processing systems and how people use these systems. This audit usually evaluates system input, output; processing controls; backup and recovery plans; system security; and computer facilities. These audits may review existing, as well as, developing systems. Information System Audit is also known as Automated Data Processing (ADP) Audit or Computer Audit. Internal auditor should obtain an understanding of the systems, processes, control environment, risk-response activities and internal control systems and should also obtain an understanding of the significance and complexity of the IT activities.

5.7 Information System reviews include the following:

- Review of existing or new systems, before and after implementation, to ensure their security and that they meet the needs of users.
- Project management reviews to ensure controls are in place to mitigate project risks or to identify the strengths and improvements required for future projects.
- Organizational or operational reviews to ensure that the organization's goals and objectives will be achieved.
- Specific technology reviews to ensure security and controls are in place.

Internal auditor's communication with functional head of IS department should focus on deviations to organisation's policies and procedures. Internal auditor should effectively persuade the functional head on the importance of alignment to organization's objectives to systems and software policies.

Investigative Audit

5.8 Investigative assignments scrutinize allegations of wrongdoing or breaches of standards of conduct. Allegations may be internal or external to the organization and may examine the records of individuals, organizations and firms with agreements between them and the organization. While a financial audit samples the financial system and verifies that the sampled transactions add up according to basic accounting principles, an investigative audit goes deeper into the financial infrastructure investigating the bookkeeping, the transactions, the payments and the entities behind them, questioning their correctness validity and legality and exposing the truth behind the numbers.

5.9 Reasons for conducting investigation are as follows:

- internal theft
- misappropriation of assets
- conflicts of interest

Co-ordination for this audit is usually at the highest level in the organization like, with Senior Management. Investigative audits differ from other audits because they are, normally, conducted without first notifying the personnel who may be affected by the findings.

Management Audit

5.10 Management audit focuses on results, evaluating the effectiveness and suitability of controls by challenging underlying rules, procedures and methods. Management audits, which are, generally, performed in-house, are compliance audits plus cause-and-effect analysis. When performed correctly, they are potentially the most useful of the evaluation methods, because they result in change.

Since Management audit aims to bring in change management, change in processes and highlights revenue enhancement and cost optimisation, care should be taken that the co-ordination is done more professionally and the exercise is carried out diligently without offending process owner's conviction on the existing process.

Chapter 6

Importance of Communication/ Co-ordination with Functional Heads

6.1 Maintaining a balanced relationship with the functional heads is the most crucial and challenging task for the internal auditor. For internal audit to be effective, the communication with the executive management has to be constructive. The relationship has to be based on mutual confidence but it should not be too friendly. Findings should not be treated as deficiencies but as practices that can be improved by the process owners.

6.2 Traditionally, internal auditor is the least preferred customer since it is seen as a fault finding machinery reporting on errors and mistakes. Functional head becomes very defensive in their interaction with internal auditor and justifies their actions to resist internal audit's observations.

6.3 In this dynamic business environment, function of internal audit is not restricted to doing post facto transactional audit/ processes and issuing a report on what went wrong. In the present context, internal auditor assumes his role as an internal consultant to various functions and assists the organization in:

(i) Identifying all risks inherent to that function.

(ii) Managing risk by optimizing processes.

(iii) Developing simple work flow for processes.

(iv) Suggesting steps to improve and make corrections.

In this new role, the internal auditor has to co-ordinate with the functional heads for their risk management. The most important aspect of it is how efficiently and effectively the internal auditor is able to interact with the functional heads.

Chapter 7

Traditional and Modern Approach of Co-ordination with Functional Heads

Traditional Approach

7.1 Traditionally, the process of co-ordination with the functional heads includes the following:

(i) Discussion of audit scope with the functional heads and taking his/ her inputs for making it comprehensive.

(ii) Issuing query sheets based on the initial observation of transactions/ processes.

(iii) Validating replies given for each query.

(iv) Issuing draft report to the functional heads based on response given for all queries.

(v) Discussion of draft report with the functional heads to understand each others perspective.

(vi) Release of final report to the management.

7.2 This approach is more impersonal and non-collaborative. This always leaves an impression on the minds of the functional heads that the whole approach is not appreciative of the good work done by the function but only highlights faults. They also carry a strong belief that the internal audit is not appreciating the constraints which the auditee faces while carrying out day-to-day operations of the organisations. Many a times, postmortem audit gives a different view on hindsight. These lacunas in traditional approach necessitate embarking on to modern approach which has been discussed in paragraphs given below.

Modern Approach

7.3 Both the internal audit and the functional heads work towards the common objective of saving cost, implementing better controls and preventing revenue leakages. Internal audit is involved in Root Cause Analysis (RCA) of the problem and helps the functional heads in mitigating the same. Moreover, the internal auditor is also required to interface with other cross functional process owners to help in streamlining the processes in an integrated and seamless manner.

7.4 Modern approach of co-ordination with the functional heads is detailed as below:

(i) Understanding the broad processes of the function.

(ii) Proactive discussion of critical processes with the functional heads and identifying risks associated with these processes.

(iii) Understanding system controls and manual checks exercised by the department in managing the above risks.

(iv) Defining audit scope based on the above discussions and understandings.

(v) Conduct transactional and process audit based on the scope.

(vi) RCA of exceptions which may be because of input or internal processes of the function.

(vii) Recommend process improvement through system controls/ manual checks to the functional head if exception is due to internal processes.

(viii) Discuss processes of other function with the respective functional head if exception is because of input given by that function and suggest ways to streamline it.

(ix) Measure and provide facts with all analysis to substantiate impact of finding.

(x) Constructive discussion of draft audit report with the functional heads and structure auditee reply into – cause, corrective action, preventive action and target date.

(xi) Release audit report to all the stakeholders.

(xii) Follow-up for compliance till the issue is resolved.

Chapter 8

Hurdles of Co-ordination and Methodology to Overcome

8.1 The major constraints in the co-ordination process between the internal auditor and the functional head and the methodology/ requisite to overcome these constraints have been discussed in the following paragraphs. Different types of situations like, over cautious and defensive approach of the process owner, reservation on technical expertise of auditor, non-supportive stand, resistance to changes recommended by internal audit have been discussed with the help of case studies.

Over Cautious and Defensive Approach of the Process Owner

8.2 Many a times an over cautious functional head builds a fence around him fearing audit exposures, lapses and weaknesses. This makes the co-ordination and communication of the internal auditor with the functional head difficult.

Methodology to Overcome

8.3 If the observation is factually correct and the problem genuinely requires resolution, the functional head has to be made aware of his action towards solution. This will sound more as his achievement than as a lapse which is being reported by the internal auditor. This is because management always looks forward to a solution provider than to a person who reports only problem. The most important part of internal audit is to convince the functional head on audit observation. More often, the functional head is of the mindset that he or his department has done nothing wrong.

8.4 In this case, the requirement for winning strategy for successful co-ordination is as follows:

(i) Provide facts with all analysis to substantiate impact of findings.

(ii) Give detailed explanation of lacuna in the existing system.

(iii) Draw attention to better control practices within the organization and of other organizations in the industry.

(iv) Highlight the potential revenue loss that may occur to the organization, if current system is not strengthened soon.

(v) Project the internal audit findings to the management with corrective action plan of the process owner.

(vi) Once the new system is in force, provide the review results along with the process owners and project the same to the management as adoption of best practice.

(vii) Internal auditor has to explain all dimensions of the observation. He may also bring to the notice of the functional head that specified process executed by the department may be right on stand alone basis but is not best from over all organisation's perspective.

(viii) The next big step is to structure auditee response so that the management gets assurance on closure of audit issue. If auditee response is structured into cause, corrective action and preventive action then resolution process becomes clear to all. Target date gives definite timeline to close the issue.

8.5 The following illustrative case studies clarify the situation discussed in above paragraphs:

(i) Case Study 1

Company X was manufacturer of PVC. The finished product is in powder form and is sold in standard packaging of 25 kg bags. The bags are filled through an automated packing line and the quantity filled in bags is controlled through an online check weigher installed in the packaging line itself. In addition, tolerance limits were fixed for short/ excess filling in terms of number of grams per 25 kg bag.

During the process review, the internal auditor carried out weighment of bags on a standalone weighing scale, selecting adequate sample and observed that in a large percentage of bags comprised in the sample, the actual quantity filled far exceeded the defined tolerance limits, i.e., 50 gms per 25 kg. On being presented with the findings, the functional head's response was more of defensive nature, bringing out that firstly that this was only a statistical aberration and then stated that any such excess giveaways would get detected through other compensatory controls (manual) available like, random weighment of bags in a stand alone mode.

The internal auditor then co-ordinated with the commercial head and the warehouse in charge and took larger samples for study and validation of quantity bagged. In addition, the samples were taken at different points of time. In all cases the results were consistent with the initial findings. By extrapolating the findings for over one year period, the quantity giveaways and cost implications (factoring both negative and positive variations) were demonstrated to the functional head, along with live instances where the compensatory controls had failed to detect excess giveaways.

These findings were accepted by the functional head. Accordingly, system based control *viz.*, installation of check weighers in the conveyer, after filling level in the load cell, was introduced. This has resulted in to:

(i) Reduction of dependency to manual checking.

(ii) Increased accuracy level, since all bags are weighed after filling in load cell.

(iii) Reduction of labour in the filling and weighing section in the plant.

(ii) Case Study 2

Company Y was in the business of manufacturing polyester fibre. The finished product was wound in bobbins having standard weights. In case the weight of the bobbin is different from the standard size, the bobbin was downgraded to a lower grade (grade B) even though it conformed to all other quality parameters of prime grade material. In addition, there was no visibility of the reasons for classification as lower grade in the system. Internal auditor suggested introducing an intermediate grade for prime grade material wound in bobbins having non-standard weights.

This suggestion was initially rejected on the ground that almost the entire quantity manufactured was for the export market and non-standard material (in case the weight of the bobbin is different from the standard size) was not acceptable to customers. Internal auditor coordinated with marketing personnel, who concurred that it was possible to get a higher realization for prime grade material wound in non-standard sized than grade B. This suggestion was then accepted by the functional head and a new grade was introduced with the higher price than the B grade material.

Reservation on Technical Expertise of Internal Auditor

8.6 Functional heads who have a stronger knowledge of their processes of systems and expertise in their field always believe that the internal auditor lacks technical skill and knowledge to understand and analyse the technical aspects of the process.

Methodology to Overcome

8.7 A good understanding of business processes of functions that are taken up for internal audit helps the communication with functional head more effective. This also makes the enquiry process effective, i.e., asking pertinent question, in an appropriate manner.

The following may be considered by the internal auditor in such a situation:

(i) Internal auditor should always analyze issues from the outcome or end result of a control/ system lapse rather than procedural lapse in all cases of technical functions. This approach gives a better visibility and acceptance in the co-ordination process. Any functional head will appreciate the audit concern better if it is not sounded too procedural and bureaucratic.

(ii) Understand the broad processes and acquaint with controls, governing policies, Standard Operating Procedures (SOPs), Management directives, etc.

(iii) In most of the cases, the internal auditor who has better understanding of the processes commands more respect from the functional head while dealing with complex audit issues.

8.8 The following case studies give examples of situation discussed above:

(i) Case Study 1

Company Z was a multi-location/ multi-plant manufacturing company. All the processes, *viz.*, manufacturing, plant maintenance, materials management and finance were integrated by deployment of an ERP Package.

The ERP system provided a functionality to create a purchase requisition for engineering spares through the Plant Maintenance Module. However, on detailed study of the Plant Maintenance Module and the built in controls, the internal auditor observed that certain monitoring controls such as, linking of spares with particular equipment, were not configured in the system. The internal auditor demonstrated with data that the probability of an unlinked spare becoming a non-moving/ surplus inventory was much higher than spares which were linked to particular equipment in the system.

The internal audit findings were accepted by the management and necessary system based controls were configured in the ERP Package.

(ii) Case Study 2

Company C started a Special Grade Fibre Manufacturing Plant for the first time in the country using imported technology. The products did not meet the quality parameters and were not accepted by the market, hence, the plant was closed down. The fiber intermediaries were left unused and not disposed for many years along with the imported chemicals and catalyst purchased for the manufacture of this product.

Internal auditors pointed out the situation with the suggestion that:

(i) the intermediary product may have market for fibre manufacturer and, therefore, classify as special product and dispose off,

(ii) the purchase orders for chemicals and catalyst should have the buy back clause so that the failed chemicals will be re-exported to the supplier at the pre-determined prices.

The process owners did not want to make any attempt to dispose off the intermediaries and the unutilised chemicals catalyst, stating that these materials do not have ready market. On follow-ups and persuasion with Research and Development Team of the company, it was established that the intermediaries can be sold to fibre manufacturers by sending sample and explaining the properties of the intermediaries. The foreign vendors who supplied the chemical and catalyst were given the left over chemicals sample and re-exported at 75% price of the original price.

(iii) Case Study 3

Company D manufactured polyester fibres. In manufacture of one grade of fibres, the company used old PET Bottles as a raw material. The PET bottles were procured in bulk and payment was made on the basis of weight stated in the invoice.

On review of weight bridge data, the internal auditor observed major difference between the invoice weight and actual weight of material delivered. The process owners explained that the weight difference was on account of the moisture content in the material, which varies over time and evaporates during transit. The internal auditor highlighted the weight difference together with the annualized financial implication to the management and insisted for fixing a tolerance limit of moisture content and to fix variable price based on the moisture content. The findings of the internal auditor were accepted by the management and tolerance limits for moisture was defined in the Purchase Order, and lower price was fixed in the Purchase Order for the product exceeding the tolerance limit.

(iv) Case Study 4

Y Company was involved in the manufacturing of chemicals for which certain outsourced rental tools were used. These rental tools consisted of a large number of small items/ parts which were to be assembled before being put to use and this whole activity used to take a few hours. The rental tool was then at the time of usage lowered into the manufacturing process. As per the finalized contract, whenever the rental tools were actually used in the manufacturing process, “operating rate” was payable and for the other period “rental rate” was payable which was lower than the “operating rate”. The contractor used to charge “operating rate” for the time spent on assembling the tool.

Internal auditor brought out this issue to the functional head. Initially, it was brushed aside by the functional head stating that unless the tool is prepared/ assembled, it cannot be used. Secondly, it was an important activity forming part of the operations and, hence, the operating rate certified was correct. Internal auditor agreed with the functional head’s views that assembling activity was an integral and important part of the operations but “operating rate” was not payable as this was not an “operating activity” in line with the contract terms. Internal auditor also pointed out that such similar instances of the peer group companies which were being audited and had similar contracts. The functional head discussed the issue with the Procurement and Contracts team who concurred with the internal auditors' views. Accordingly, the excess payment made for the time certified for assembling the tool was recovered.

Non-supportive Stand

8.9 In many organizations, there exists a strong tendency of auditees delaying the internal audit process as long as possible. This is more due to non-assigning of priority to internal audit function with reference to their operational target. This leaves the internal auditor very little time to collect, assimilate, analyse and conclude.

Methodology to Overcome

8.10 The following are some important aspects which would help the internal auditor in such a situation:

(i) Every function has some processes which are either having high financial impact and/ or are vital for the operations of the organisation. A collaborative approach with the functional head in flagging such critical processes by the internal auditor aids in his effort of "buying in" the auditee on the purpose and gain.

(ii) Active participation by the internal auditor in discussing critical processes with the functional head brings sincerity in audit approach. This helps the internal auditor in presenting himself as a partner to business rather than fault finding reporter. Once this new role is understood, the functional head opens to audit and seeks internal auditor's guidance on control issues raised by the audit.

(iii) Internal auditor should persuade functional head to take corrective action within reasonable time. Functional head should be made to believe that taking corrective action is his achievement and not a closure of an audit issue.

(iv) The end game is to see complete resolution of the issue. Internal auditor has to communicate periodically with the functional head to monitor compliance status. Once the target date given by the auditee expires, internal auditor must verify whether the issue is resolved or not.

(v) Management is interested in comprehensive closure of issue. If auditee faces any bottleneck in resolving the issue, internal auditor may help him in closing the issue.

8.11 The following case studies illustrate certain situations which internal auditor may have to resolve:

(i) Case Study 1

A company B was involved in manufacturing and selling of "paints". As per the routine procedure, physical verification of finished products was taken by the internal auditors in the mid of March so that the final report can be submitted before the year end. If any discrepancy is noticed it can be suitably adjusted in the books to give the correct financial statements.

During the physical verification, certain discrepancies were noticed by the internal auditor and a draft report was submitted to the concerned functional head stating the differences noticed in the various ranges of the paint. On seeing the draft report, the functional head told his deputy to look into it and come back on the queries after completing his routine job. The deputy, therefore, gave last priority to the draft report.

Internal auditor after 7 days of the issue of draft called upon the functional head to have a meeting so as to close out the report. Functional head during the telephonic discussion stated, "I have a lot of priority work to attend, for me sales is the most important activity. If we do not achieve our target the company is going to be under trouble and I do not want to inform the top management that I have been busy replying the Internal Audit Report. Any way what you are going to inform me has already happened isn't it? Audit is merely a post mortem job."

After patiently hearing the functional head's views the internal auditor replied, "Very true Sir, sales has to be accorded top priority, but if you come to know after taking the order that the actual stock is less you will not be able to honour your commitment and the customer will lose faith in you. Hence, I request you to look at the actual stock figures and report". The auditor had broken the barrier and got the ears of the functional head. Internal auditor further went on "also certain big paint cans have started getting disfigured due to excessive heat at the warehouse. These cans may not be acceptable to the customers and the company might lose its reputation of selling old paint stock". This was the last straw on the functional head, his tone mellowed down completely and he immediately understood the importance of the physical verification process and the draft report. He immediately gave a suitable priority to the draft report and ensured its closure at the earliest.

(ii) Case Study 2

Company S was involved in production and selling of large number of perishable confectionary items. The process plants would send the finished products to the warehouse on the basis of the requirement sent by the marketing offices located at the various regional capitals. Quarterly Physical verification of all the warehouses (cold & dry) was undertaken by the internal auditors along with the warehouse in charge.

Internal auditor in order to ensure that all the boxes were counted used to make a coloured mark on the counted cartons. During one of the verification exercise the auditors noticed that a few of the boxes had the earlier coloured ticks also. Though, the Material count tallied and the internal auditors were satisfied with the physical verification, at the time of preparing the report one of the junior inquisitively informed this matter to their senior auditor. The senior auditor in order to confirm his doubt requested the junior to accompany him to the warehouse and show him the lot. During the re-verification of the stocks and comparing with the other lots it was noticed by the auditor that the old lot lying had a different MRP than the new lots. Further, they also noted that the expiry date of the old lot was fast approaching.

Internal auditor immediately issued an "interim report" to the Marketing Manager stating the facts of the old lot, and added that if immediate corrective actions were not taken, not only the stocks would become stale but would also have to be thrown out/ destroyed at an additional cost with a lot of statutory formalities being eatable item. Functional head appreciated the findings of the auditor, as "partner" to business rather than fault finding reporter and immediately took the necessary corrective action.

Resistance to Changes Recommended by Internal Audit

8.12 The functional heads are generally averse to internal auditor's recommendation as they are always comfortable with simple and flexible processes. This may lead to resistance to changes recommended by the internal auditor in his report.

Methodology to Overcome

8.13 The following aspects may be kept in mind by the internal auditor while dealing with such a situation:

(i) Internal auditor should take efforts to demonstrate the trade off between simplicity and rigid controls. Risk associated with critical processes lies in its execution. Internal auditor should deliberate on the need and relevance of built-in system controls. Internal auditor should also properly articulate the risks associated with flexible processes and the benefit of stringent controls which acts as effective risk cover.

(ii) Internal auditor should discuss efficacy of manual controls vis-à-vis system controls. He must understand from functional heads compensating checks to strengthen the process. He may discuss with functional heads whether these manual checks are in line with management policies and whether these manual checks can be substituted with system controls.

8.14 The following case study gives an example of the abovementioned situation:

Case Study

E Ltd was a manufacturing company. All functions including production processes and plant maintenance were configured in the ERP System. As per the design of the Plant Maintenance Module, all engineering spares must be drawn against Plant Maintenance Orders (PMO). In addition, the system provided a functionality whereby excess spares drawn could be returned against the same Plant Maintenance Order. These functionalities had been provided to determine the actual cost for each maintenance job.

On detailed review of the system, the internal auditor observed the following weaknesses in the module:

(i) There was no system lock to ensure that same materials which were originally drawn are returned back. This means that it was possible to return materials not originally drawn against the PMO.

(ii) It was possible to return materials in excess of the quantities drawn against the PMO.

As a result large number of cases was observed where the material was being drawn and returned against different PMOs. Hence, it was not possible to accurately determine the quantity of maintenance spares required for each job as well as the cost of the job. These findings were accepted by the management as result of which system locks were introduced in the system. An additional benefit which resulted from the system was the timely return of maintenance spares to stores.

Differing Views of Functional Heads on the Relevance of Audit Scope

8.15 Many a times the functional heads do not accept the relevance of audit scope as it is not in line with his view point. This situatioin may cause hindrance to the internal auditor in carrying out effective internal audit.

Methodology to Overcome

8.16 The following aspects would help the internal auditor to overcome such a situation:

(i) Internal auditor should walk through the major processes in general and critical processes in particular. This exercise will enable the internal auditor to convince the functional head on the comprehensiveness and relevance of the internal audit scope.

(ii) Internal audit scope must reflect cognizance of functional head's views. If the functional head can relate his department's process to audit scope then acceptance of internal audit recommendations is instantaneous.

8.17 The following case study reflects the abovementioned situation:

Case Study

Internal auditor carried out a physical verification of Fixed Deposit Receipts on a surprise basis and tallied it with the Ledger balance. Finding no discrepancy the auditor submitted an assurance report.

Finance head expressed the view that since this exercise was always carried out by the statutory auditors at the end of the year, this was a redundant exercise. Internal auditor explained that the physical verification was done on a surprise basis to test that the controls are in place for custody of the Fixed Deposit Receipts and traceability rather than as a mere physical verification exercise. Since the controls were found to be in place an assurance report was issued by the internal auditor.

Confrontation on Prioritizing Audit Schedule

8.18 The Functional Head, generally, prefers to postpone / defer audit schedules in view of his routine work pressures. This would lead to delay in completion of internal audit and as a result delay in timely issuance of internal audit report.

Methodology to Overcome

8.19 The following points would be helpful to internal auditor in dealing with such a situation:

(i) Internal Auditor should go with clear management mandate to complete the audit within the agreed timelines. He should clearly communicate that there is no preferential concession permitted by the management for the auditees to choose their priorities on matters of audit.

(ii) Internal auditor should discuss priorities and periodicity based on risk with functional heads. Complete coverage of audit scope in phased manner for both transactions and processes is essential to give assurance to management about working of the department.

(iii) Internal auditor must inform auditee that his department is subject to surprise checks during the course of audit. If relevance of such surprise checks is explained properly to the functional head then he will appreciate its importance.

8.20 The following case study illustrates a situation of confrontation on prioritizing internal audit schedule:

Case Study

The auditee initially deferred the internal audit under the pretext of being busy with the month end closing activities. Internal auditor convinced the auditee that the queries would be discussed after the month end activities. Further, if any major issues are surfaced during this audit, all necessary rectification entries can be carried out which will thereby ensure the quality of the financial statements.

Reluctance on Evaluating the Audit Issues

8.21 In some situations, the functional head may not merit the audit issues in the right perspective and finds it immaterial and of insignificant consequence.

Methodology to Overcome

8.22 Internal auditor should cautiously deal with the abovementioned situation and take care of the following aspects:

(i) The modern approach is to facilitate functional head in resolving the issue rather than pointing out mistakes. This can be done by carrying out Root Cause Analysis (RCA) of the issue. It is a class of problem solving methods aimed at identifying the root causes of problems or incidents. RCA is considered to be an iterative process, and viewed as a tool of continuous improvement.

(ii) Internal auditor should communicate clearly whether root cause is because of internal process weakness or because of input provided by the other department.

8.23 The following case study shows the abovementioned challenge faced by the internal auditor:

Case Study

While carrying out an internal audit of stores inventory of a manufacturing unit, the internal auditor observed that a substantial inventory comprised of surplus and obsolete spares. The initial observation was submitted to the materials department, who stated that the materials were procured at the instance of maintenance department.

On further analysis and discussion with the operating personnel, the internal auditor observed that most of the obsolete inventory comprised of spares which were not linked in the Plant Maintenance System with specific items of equipment through a Bill of Mateiral (BOM). Since the association of the spares was not visible the same were never used.

The results were accepted by the management and an organizational level exercised for updating the equipment Bill of Material was undertaken. After complete updation of BoMs substantial reduction in unwanted procurements and surplus/ obsolete inventory was achieved.

Lack of Visibility of Best Practices

8.24 The functional head, generally, presumes that the process undertaken at his units are best while internal auditors may provide certain benchmark parameters for evaluation. The three main barriers to adoption of a best practice are a lack of knowledge about current best practices, lack of motivation to make changes involved in their adoption and a lack of knowledge and skills required to do so.

Methodology to Overcome

8.25 The following aspects would help the internal auditor in dealing with such a situation:

(i) Having exposure to a large number of companies, internal auditor has the visibility of various processes. He can suggest benchmark practices of system controls and manual checks in mitigating process weaknesses.

(ii) Discussion on benchmark practices with functional head should suit to organisational operational convenience. A well evaluated and properly demonstrated actionable recommendation is easily accepted by the functional head.

8.26 The following case studies describe such a situation and also provide a correct solution to the internal auditor:

(i) Case Study 1

Internal auditor evaluated various commercial terms and conditions of the Procurement Orders and Contracts at the auditee unit with the peers in the industry. They also evaluated the commercial terms and conditions for similar contracts at other sites of the auditee's company.

In one of the case, while auditing the scrap disposal process, the internal auditor observed that all metal scrap was mixed together and was sold under one category *viz.*, metal scrap. The practice was contradictory to the practice followed in other companies whereby the metal scrap was segregated into SS/Bearing Scrap/ MS, etc, and then sold at differential rates based on categories. The realization by segregation far exceeded the realization in case of mixed scrap.

Internal auditor not only demonstrated/ brought out the strong points of the peers/ leaders in the industry but also suggested the ways and means of improving the terms in light of the best practices and country scenario. The scrap segregation and disposal procedure was immediately accepted and the same led to significantly higher realizations.

(ii) Case Study 2

A leading company "S" was into steel production business. The company had large number of plants at various geographical locations.

Internal auditor was assigned the job of ensuring that there were no revenue leakages and the payments at all the plants were made as per the Purchase/ Work Order terms and conditions. While reviewing the payments, the internal auditor noticed that the terms and conditions were quite different from one plant to another. Internal auditor came up with an innovative idea, "let me make a small report comparing the various terms and conditions followed at the specific plant vis-à-vis other plants and also the best practices followed in the industry also".

Internal auditor made the draft comparative statement and submitted it to the functional head for his review and comments. Functional head boasted, "I bet, Mr Internal auditor, we should be the best in the Industry, not only in India but also internationally. If it was not so, do you think the company would have hired me? I have been in this industry for last 30 years and I know ins and outs of this business".

Internal auditor smiled, trying to guess what would happen after seeing the report. The Functional head started reading the report which covered the following major points:

(a) Advance Bank Guarantee and percentage of the contract value

(b) Delivery period – Lead time

(c) Freight terms

(d) Other Warranties and Guarantees

(e) Performance Bank Guarantee terms and percentage of the contract value

(f) Payment terms. (15/ 30/ 45/ 60 days)

(g) Liquidated damages

(h) Liability in case of termination of contract

(i) Repair charges for damaged equipment

(j) Restocking charges in case of chemicals

(k) Rates and Price Validity.

As the Functional head went on reading the report his face went from white to red knowing what peers at the other units were doing and how far they were lagging behind the leaders in the industry.

On reading the full draft report his outlook towards the Internal auditor changed. He not only praised the Internal auditor for his efforts but also requested him to revisit his plant with such findings in other areas as well, which will help him in proving to the top management that their unit is the best.

Conflict Arising due to Weak Interface Linkages between Process Owners

8.27 At times, the functional heads work in an island approach and often miss out discussion/ deliberation on the interdependent processes for optimization. It is necessary that process owners work together to eliminate constraints and identify additional opportunities for improvement.

The process owners can evaluate each process by answering these process questions:

- What:
    - is there to do?
    - is being done?
    - should be done?
    - can be done?
    - constraints keep us from doing it?
- Who:
    - does this job?
    - should do this job?

  - o knows how to do it?
  - o should know how to do it?
- Where:
  - o is this job done?
  - o should it be done?
  - o can it be done?
- When:
  - o is this job done?
  - o should it be done?
  - o can it be done?

Methodology to Overcome

8.28 Internal auditor should take care of the following aspects in such a situation:

(i) Sometimes, the issue arises because of internal process weakness of other function. Proactively, internal auditor should involve in discussion with all interdependent functional heads in bringing clarity on the need for streamlining the process.

(ii) Many a times, problem lies in communication gap between two departments. Internal auditor may help in setting co-ordination between various departments. Since he is unbiased, acceptance of his view by respective departments and management is greater.

8.29 The following case studies describe situations of conflict between process owners:

(i) Case Study 1

Company XYZ is engaged in the manufacture of various grades of polymer. There are certain chemicals which are specific to a particular grade only and the composition of chemical changes with the change in the grade.

In one of the instance, direct charge material procured but remained unconsumed due to change in production plan. The reason being the breakdown of communication between the Business Group and the Procurement Department. While the production plan was dynamically changed as per change in the Business Plan, the same was not communicated on time to the Procurement Group resulting in receipt of material which will never be used in the near future. This thereby resulted into negative contribution for the alternate grade which was planned to be produced in place of the original grade, as the inventory built up of chemical for the original grade had significant financial implication.

A proper internal control system of Plant Changes and the Order Management System would have stopped the unwanted delivery or an agreeable deferred procurement plan with the vendor. Internal auditor brought this fact to the notice of business/ production/ procurement department and gave recommendation to streamline the process of communication of change in sales/ production plan.

(ii) Case Study 2

As per the procurement practice followed at XYZ Company, the yearly requirement of major direct charge chemicals was anticipated based on the Annual Production plan. Procurement action was initiated by the Central Procurement Department based on the yearly requirement submitted by the Production Department. The deliveries of the chemical used to be staggered over the period of production on monthly/ quarterly/ as is required basis.

In an instance, change in quantity of chemical requirement due to change in the production schedule as per change in Business Plan was not timely communicated to Central Procurement Department which had agreed for aggressive shipment schedule at a higher cost for a long lead time material. The material was thereafter received and was in stock for more than 12 months.

Internal auditor advised on the process improvement which was made standard operating procedure for control effectiveness. Thus, any change in the production plan by the Marketing Group, is now submitted concurrently to the Procurement Department along with the Production Department. Also, the procurement department now verifies the stock on monthly basis for proper deferment of supplies in case of excess stocked chemicals.

Discomfort on Findings which are based on Apprehensions

8.30 Functional heads never appreciate opinionated observations based on certain hypothetical assumptions. An assumption is a statement or condition which is presumed or assumed to be true and from which a conclusion can be drawn. A hypothetical condition is an assumption made contrary to fact, but which is assumed for the purpose of discussion, analysis, or formulation of opininons.

Methodology to Overcome

8.31 Internal auditor's findings based on apprehensions annoys functional heads. If findings are based on facts and provided with complete analysis, then functional heads would appreciate the dimension given in the report. Generally, internal audit remarks based on exaggerated apprehensions are met with hostile counters. Proper knowledge of process saves the Internal auditor from such embarrassing encounters. It also saves from embarrassment in pointing non-issue as observation. Moreover, this helps internal auditors in taking right approach to audit.

8.32 The following case studies describe situations mentioned above:

(i) Case Study 1

Report on delay in counterparty confirmation for closed forex transactions is immaterial to functional head. If internal auditor demonstrates the risk associated with it by giving examples of financial losses happened else where because of this control lapses then only functional head will appreciate internal auditor's point and strengthen counterparty confirmation process of front office and its monitoring process by back office.

(ii) Case Study 2

Internal auditor pointed out that equipments (cranes) are hired by the various sites, in spite of the fact that many such company owned equipments (cranes) are lying idle at one of the other site, after completion of a major capex at that site. This led to payment of rental charges which otherwise would have been avoided.

Internal auditor made a cost comparison and pointed out the effective cost savings which can be achieved by using own equipments. Also, the methodology and the authority level for approval in case of hired equipments (cranes) was reframed to allow hiring only if crane movements from one site to other is non-commercially viable, i.e., hiring only up to a particular amount for a job was introduced. The Functional Head appreciated and implemented his suggestion.

Chapter 9
Conclusion

9.1 When the internal auditor addresses the operational efficiency objectives articulating his methods for identifying and evaluating the redundant activities, process constraints, etc., the co-ordination will naturally be effective. Using risk based and value-for-money approach, the internal auditors' "Constructive Tone" helps the functional heads to focus on control exceptions and process irregularities. This approach significantly changes the internal auditor's image from a simple **"Fault-finder"** to an useful **"Internal Consultant".**

9.2 To summarize, the benefits of the modern approach detailed in earlier chapter achieves the following:

(i) Achieve cordial relationship with functional heads.

(ii) Instill confidence that internal audit is constructive internal support service instead of fault finding department.

(iii) Greater assurance to management that internal audit and functional heads work together to enhance controls, resolve deficiencies and optimize processes.

(iv) Functional heads institutionalize control systems in their areas based on the constructive process of internal audit.

9.3 It is expected that using the techniques and skills presented in this study, internal audit professionals will confidently leverage their position to carry out their tasks with high professional pride. The ultimate effect of effective co-ordination would be converting the most skeptical auditees into a staunch advocate of controls by making them realise **"controls are everybody's business".**

9.4 To conclude, this Study would achieve its purpose when Functional Head accepts that –

"The value of Internal Audit is undeniable and …….. the value they add is unmistakable".

G-5
STUDY ON
INVESTIGATIVE AUDIT

Foreword

Global challenges of growing menace in the form of frauds and white-collar crime in all types of trades and business practices intensifies the need for a system in place for their prevention and detection. Organizations these days are so focused in protecting themselves from the criminals outside that they seriously fail to spot the weakness inside it.

"There are two big forces at work, external and internal. We have very little control over external forces such as tornadoes, earthquakes, floods, disasters, illness, and pain. What really matters is the internal force. How do I respond to those disasters? Over that I have complete control" - Leo Buscaglia, author and motivational speaker.

Fraud investigations are generally conducted to determine existing internal control weaknesses, identify the fraud vulnerability areas and assist in risk management in determining the amount of loss and finally assist the investigated entity offering them recommendations on the corrective measures to prevent subsequent occurrences.

Formulating appropriate strategies for the prevention and detection of fraud, planning and execution of fraud investigations requires both academic and professional expertise. Formulating anti corruption methodologies and integrity checks that improve financial security is need of the hour.

It gives me immense pleasure in presenting this book on "Study of Investigative Audit" that attempts to share with the reader various facets of an investigative process at a basic level.

I appreciate the efforts of convenor of the Study Group CA R Srivatsan and his team members and the Chairman of the Internal Audit Standard Board CA Rajkumar S Adukia and other members of the Board for bringing out this reference material on Investigative Audits.

I am sure the members practicing investigative audit will appreciate the contribution of this reference material.

February 9, 2011 **CA. Amarjit Chopra**
New Delhi *President*, ICAI

Preface

The three fundamental changes in the business environment that significantly impacted the modern organisations are technological advances, globalisation of economy and convergence in the financial and capital markets. In the absence of right controls this dynamic business environment creates ideal scenario for the wrongdoers to exploit the weaknesses prevalent in the system, for their personal gains, based on inherent risks. At the same time past experience shows that frauds tend to grow exponentially over the period, if not detected on time. In this scenario, prevention through meaningful controls and early detection by professionals with right mind-set, professional expertise and pro-active fraud risk management strategy could save fortunes for the establishments.

The Internal Audit Standards Board has decided to bring out this "Study on Investigative Audits" with an aim to provide the readers with an understanding of various facets of an investigative process at a basic level. It covers in detail topics such as, types of fraudulent act, accountability for fraud detection, corporate fraud control plan, investigative tools and techniques, diagnosing fraud behaviour, external/ in-house investigations, pre-requisite of a good investigation, managing investigative assignments, interview process, investigation report, legal action, investigative audit and allied services, market scenario for investigative work, and way forward. An attempt has been made to provide practical approach to the subject matter through case studies. It may be mentioned that the information shared in this publication should be used in an appropriate manner on a case-to-case basis by using professional judgment. Readers should seek appropriate legal guidance and ensure adequate safeguards while conducting these types of assignments.

At this juncture, I wish to place on record my deep gratitude to the convenor of the Study Group CA R Srivatsan and other members of the study group *viz*., Shri Thomas Karithanam, Shri J. Kannan,

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I am hopeful that this publication would prove as a useful reference material to the members for carrying out investigative audits.

January 13, 2011
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CA. Rajkumar S. Adukia
Chairman
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Contents

Chapter 1

Introduction

Chapter Summary

The introductory chapter provides an insight into various facets of fraud risk and provides an overview of the contents in the book. An attempt has been made to avoid technical jargons making the contents understandable to the readers. The management perceptions about fraud risk and the specific exclusions from this book are elaborated. The book is meant for Chartered Accountants to strengthen their role as chief financial officers, internal auditors, chief investigating officers, statutory auditors or representing senior management positions in an organisation.

1.1 A Chartered Accountant in accordance with his professional knowledge base is able to be an efficient co-ordinator in the conduct of investigative assignments and is ably supported by analytical skills, working knowledge in process evaluation and requisite documentation, especially for investigation involving financial crimes. He is, therefore, at an advantage to play the role of a strategist in carrying out investigations. While this study is meant to supplement the role of practicing Chartered Accountants, it would also be an eye opener to the management on how they can engage the services of Chartered Accountants.

1.2 Aspirations, goals, stretch targets, execution excellence and sustained growth are prerequisites for any growing organization. Chartered Accountants do play a major role in strengthening risk assessment process, in capability assessment through performance reviews, ensuring value added services, customer focus and support to management in ensuirng effective corporate governance that are of significant importance to most professionally managed organizations. An effective governance mechanism encompasses integrity in dealings which also needs to be well ingrained in the organizational core values. All of us know and believe that business integrity is a fundamental need to achieve all these requirements. The biggest challenge for any Chief Executive Officer (CEO) or the Chief Financial Officer (CFO) is to ensure and demonstrate that business integrity issues are paramount to the functioning of their organization.

1.3 While it takes ages to build a business empire, it takes but a few mistakes to bring down the same.One can learn innumerable lessons on how successful corporations decay and very few are lucky to have a resurgence. For this reason, the tone at the top of the management hierarchy on sound value system is of prime importance and the same has to percolate down to the entire organisation. 'Integrity' is a virtue that is to be maintained, irrespective of the size of an organization. To this end, the management defines its core values through a code of conduct for its employees.

1.4 In times of recession or downturn in economy, it becomes difficult to achieve set targets of performance and that can create a conflict in the minds of financial executives to take decisions that are detrimental to them and the organization they represent. Since there is a thin line that divides a genuine mistake from a fraud, it becomes difficult for management to identify the real intent of such actions. The thumb rule is to ascertain whether there is a deception and whether the same has caused damage to the organisation, irrespective, of gains to the person practicing such deception. Chartered Accountants with their understanding of the functioning of the organisation are in a advantageous role in addressing this dilemma of the management.

1.5 Can an organization be insulated from risk of fraud? At best steps could be taken to mitigate the risk of fraud by strengthening controls and where such risks are inherent to the business environment, ensure a mechanism of timely compilation and reporting of such incidents and ensure corrective steps. There is always a need for this caution in managing the risk of fraud before, during and after the event has occurred. A fraudulent activity may not necessarily be a single event and, therefore, there are chances that an alert management is in a position to notice the leads that are available to identify suspected frauds before extensive damage is done to the organization. The diagnostic review for assessing vulnerabilities to fraud is a step towards deterrence of fraud.

1.6 From a management perspective, any remedial control measure arising out of diagnostic/ internal audit reviews should be subjected to a cost benefit analysis and at times management may be constrained to carry the risk of fraud, on cost considerations. The inclusion of preventive or detective controls would depend on the cost of introducing such controls vis-à-vis the impact analysis of the fraud risk.

1.7 There is a general reluctance in establishing an in-house investigation department considering the impact it has on the morale of the employees and a perceptible negative influence in the minds of the employees towards the internal audit team. The advantage of an in-house investigative team is cost effectiveness; information remains internal to the organization safeguarding the market image. However, for reasons mentioned above, there is a greater tendency to outsource the investigative assignments as there is a greater independence and acceptance of results of investigations carried out by outsourced firms *vis-à-vis* in-house internal audit teams. Irrespective of whether the investigation is conducted by in-house teams or outsourced firms, there is a greater responsibility in these assignments in respecting the dignity of the employees and ensuring utmost caution in dealing with matters relating to investigative assignments.

1.8 Both for the management and the internal audit fraternity it is important to ensure service differentiation between internal audit function and investigative assignments. When does one realize that the internal audit gets into the nature of an investigative type of assignment? There is a thin dividing line between mistake and fraud. In internal audit assignments to confirm whether a fraudulent act has occurred the auditor should consider whether there is an element of deception, whether the damages arising to the organisation as a result of the wrongful act is determinable, whether sufficient evidence or trail exists that suggest the involvement of persons to the happening of such wrongful act. The basic requirement of such a situation where internal audit may take the form an investigative assignment is to seek a referendum from the Chief Audit Executive or a designated authority.

1.9 It is the fundamental principle of any investigation that the methodology used for investigation to surface the truth cannot be fraudulent. In any investigative assignment, the rights available under the law of the land must be respected and, therefore, a Chartered Accountant conducting such investigations must ensure that methods used do not circumvent any legal requirement or infringe on the rights of other persons.

As a matter of principle, the ability of the firms in conducting investigation is of paramount importance in awarding an investigative assignment. Similarly, it is essential that the private investigators accept assignments for which they have the domain expertise.

1.10 The principles that apply to the conducting of business efficiently and ethically in a social environment also apply to managing of investigative assignments. Apart from the effectiveness of internal controls, both the management representatives and the investigating authorities must understand the social, political, cultural and legal environment in which the assignments are handled. The planning of any investigation also involves being aware of the local customs, practices and power centres in a given work environment. These factors do influence the outcome of any investigation. In investigative assignments though technically the Chartered Accountant would be in a position to gather evidence or reach a conclusive result, he/ she should be sufficiently aware of the control environment. He/ she should exercise diligence to safeguard his/ her interest and interest of the client on whose behalf such investigation is conducted in presenting the findings and evidence gathered. These are important factors that may be relevant to the investigative process. These depend on the prevailing situations and circumstances in which the alleged irregularities have occurred, the profile of the alleged perpetrator(s) and the way the investigation progresses.

1.11 This study attempts to share with the reader various facets of an investigative process at a basic level. Readers are requested to use their discretion on a case-to-case basis and use the information in an appropriate manner by adapting and/ or limiting the initiatives to be taken in the conduct of their assignment. The readers may take an independent view on legal advice in managing these kinds of assignments. The term investigation has been used in this publication with reference to investigation of frauds of financial nature.

1.12 The use of specialised software (licensed), proprietary methods and use of gadgets (including specifications), report formats and questionnaires, proprietary methodology of investigative firms are excluded from the purview of this publication. Similarly, investigation in public sector, government offices, the quasi government bodies and vigilance cell in banks and financial institutions, etc. are excluded from the scope of this publication. At times, investigative assignments may go beyond books of account and involve activities such as, background checks, gathering of business intelligence, shadowing of targetted individuals etc, that would be beyond the domain expertise of Chartered Accountants and, therefore, involve the support of specialists. This study also addresses the need for caution where Chartered Accountants engage services of specialists during investigation.

Readers may also refer to other publications of ICAI, other information that are accessible in the public domain for further enriching their knowledge on the subject. Appropriate references are given at the end of this publication.

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Chapter 2

Types of Fraudulent Act

Chapter Summary

A Chartered Accountant conducting financial investigation assignments should be familiar with fundamental concepts with reference to what constitutes a financial fraud. The connotations on wrongful practices may vary across organisations. For the purpose, the knowledge of internal processes, policies, procedures and documentation requirements are a prerogative in the conduct of investigations. Similarly, the Chartered Accountant should be familiar with the laws of the state in which investigations are conducted, that would enable him to seek expert opinion from legal counsel on whether based on facts any wrongful act has been committed, before a report is submitted to the client. Such expert legal opinion would enable the Chartered Accountant to exercise caution at each stage of the investigation process to prevent him from getting entrapped in controversies with legal ramifications, that may result in deviation from the core object of the investigation.

This chapter elucidates the type of fraudulent acts and the common types of frauds in a corporate entity.

Fraud

2.1 Fraud is defined in Standard on Internal Audit (SIA) 11, "*Consideration of Fraud in an Internal Audit*" as *an intentional act by one or more individuals among management, those charged with governance, or third parties, involving the use of deception to obtain unjust or illegal advantage. A fraud could take form of misstatement of an information (financial or otherwise) or misappropriation of the assets of the entity.*

The following are, essentially, the components in a fraudulent activity:

- A dishonest intention
- Use of deception
- Personal advantage or loss to a third person
- Generally results in financial/asset loss to an organization and may involve financial misstatements.

2.2 A common example of a fraudulent activity is availing of multiple loan transactions with several financial institutions by gross misrepresentations against the same asset. The value of the asset financed or income of the applicant is misstated to increase the eligibility norms, or make up for no down payment resulting in generation of cash proceeds for the perpetrator of fraud, profiting him at the cost of the company (entity).

2.3 Fraudulent activities are likely to be committed through the use of several mediums including cleverly drafted policy document to cover up follies, entering into fabricated agreements, usurping undue power in the guise of structured delegation, interpretation of conflict of interest in normal business dealings, misrepresentation of documents, photographs, use of pre-printed stationery such as, letter heads etc, mails, telegrams, telephone, and internet (computer crime and internet fraud). The difficulty of checking the identity and legitimacy online, the ease with which hackers can divert browsers to dishonest sites and steal credit card details, the international dimensions of the web and ease with which users can hide their location, all contribute to making internet fraud the fastest growing area of fraud.

2.4 A false document made wholly or in part by forgery is designated “a forged document”. Finger print analysis are assigned to specialists who are persons having requisite qualification as recognised by the Government. As of now, there are no private institutions in India who are entitled to offer qualifications in this field.

Further, the certification by a handwriting expert is not considered conclusive evidence and, generally, has to be backed by circumstantial evidence. At best such certificate can be construed only as supporting evidence in the eyes of law. The statement of a handwriting expert as witness may be admissible in litigation but not considered sufficient to prove a case. To solicit the services of a handwriting expert, the investigator may probably be able to identify the appropriate person through the offices of the ' Government examiner of Questioned Documents' (located at Shimla, Kolkata, Hyderabad, Delhi under the aegis of the ' Central Fingerprint Bureau').

Fraud for Personal Gain

Bribery

2.5 Money, gift or other favours offered to procure (often illegal or dishonest) action or decision in favour of the giver. Many organizations have laid down strict rules of not paying/ receiving bribes and employees are forewarned of disciplinary action in the event of deviations. These are also relatable to contract fraud or procurement fraud and are, generally, out of books transactions. The internal auditor normally conducts a propriety audit over the veracity of the transactions and review of any undue favours to vendors.

Conflict of Interest

2.6 There are circumstances wherein the officials are in a position of trust and in discharge of their duties face a competing professional or personal interest. Such conflicting interest results in impartial discharge of his/ her duties. A conflict of interest can create an appearance of impropriety that can undermine the confidence in that person or in his professional abilities. Thus, conflict of interest may arise from family interests, in which a spouse, child, or other close relative is engaged in a competing business or where goods or services are purchased from such a relative or a firm controlled by a relative. For this reason, many employment applications ask if one is related to a current employee or insist on self declarations.

2.7 The following are some ways to remove mitigate conflict of interest:

- Avoidance of conflicting roles
- Disclosure of conflict
- Abstain from decisions involving role conflicts
- Third party evaluations
- Code of ethics.

(i) Avoidance of Conflict

The best way to handle conflicts of interests is to avoid them entirely. For example, Under Section 226 of the Companies Act, 1956, a person holding any security (instrument carrying voting rights) of a client company is disqualified to be a statutory auditor.

(ii) Disclosure

Certain professionals are required either by rules related to their professional organization, or by statute, to disclose an actual or potential conflict of interests. In some instances, the failure to provide full disclosure is a crime.

(iii) Abstention

Those with a conflict of interests are expected to abstain themselves from decisions where such a conflict exists. The imperative for recusal varies depending upon the circumstance and profession, either as common sense ethics, codified ethics, or by statute.

(iv) Third-party Evaluations

Third-party evaluations can also be used as proof that transactions were, in fact, fair (“arm’s-length”). For example, a corporation that leases an office building that is owned by the Chief Executive Officer (CEO) might get an independent evaluation showing what the market rate is for such leases in the locale, to address the conflict of interests that exists between the fiduciary duty of the CEO (to the stockholders) and the personal interest of that CEO (to maximize the income that the CEO gets from owning that office building).

(v) Codes of Ethics

Generally, codes of ethics forbid conflicts of interests. Often, however, the specifics can be controversial. Codes of ethics help to minimize problems with conflicts of interests because they can spell out the extent to which such conflicts should be avoided, and what the parties should do where such conflicts are permitted by a code of ethics (disclosure, recusal, etc.). Thus, professionals cannot claim that they were unaware that their improper behavior was unethical. As importantly, the threat of disciplinary action helps to minimize unacceptable conflicts or improper acts when a conflict is unavoidable. However, a code of ethics cannot cover all situations, and would need appropriate interpretations and monitoring mechanism.

Corporate Frauds/ Irregularities

Advance Billing

2.8 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.

2.9 In public companies, improprieties in disclosure requirements or "window dressing" involving inflated revenues or costs can amount to fraud and investigations are typically launched by government oversight agencies, such as the Securities and Exchange Board of India, Office of the Comptroller and Auditor General of India, Central Vigilance Commission, and Central Bureau of Investigation, etc.

2.10 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 what is intended for. 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.

Shell/ Dummy Company Schemes

2.11 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. Such a shell company could be floated by employees too to siphon off funds from their legitimate company. The perpetrator could be preparing the payment vouchers or in some cases may be authorised to approve cheques. This could also include procurement of goods such as, for project work that is routed through a shell company to enable diversion of profits.

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.

Money Laundering Activities

2.12 Section 3 of the Prevention of Money Laundering Act, 2002 defines offence of money laundering as under:

"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."

2.13 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 belongs 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 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.

Anti-Money Laundering Measures

2.14 The financial institutions are generally required to monitor, investigate and report transactions (up to a defined limit) of a suspicious nature to the financial intelligence unit of the central bank in the respective country. For example, a bank must perform due diligence by having proof of a customer's identity and ensure that the use, source and destination of funds do not involve money laundering.

Fraud at Operational Level by Employees

Tampering of Cheques

2.15 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. The name of the payee in the cheque issued for payment could be fabricated to wrongly codify and book against an improper account head. This is difficult to uncover unless balance confirmations are obtained from the vendors.

2.16 A person draws cheque fraudulently in his name or converts a cheque drawn on a third party to his advantage. This could have been done through forgery in signature of the drawer, or misuse of blank cheques (could be even signed cheques or post dated cheques) retained at the back office of the company providing easy access to the perpetrator of the fraud, improper retention of cancelled or time barred cheques, forged endorsement, altering the name of the payee, involve concealed cheque schemes or authorised maker schemes, etc. These cheques could either be drawn or altered favouring the perpetrator of fraud or use for cash withdrawal, or to an accomplice later on sharing the amount misappropriated or in the name of a fictitious entity or a person who could be influenced to part with the amount at a later date.

2.17 Absence or lack of control in preparing the bank reconciliation statements results in employees resorting to wrong coding of cheques to inactive accounts. The person preparing the bank reconciliation statement should preferably be different from the person printing and issuing the cheques. A lack of control in this area can lead to fraudulent encashment or issue of multiple cheques that can be covered up by the 'subject' through an improper accounting process.

Off Book Frauds – Skimming

2.18 In skimming 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 under developed. The process gaps allow an employee to divert the cash collected to his personal account under the pretext of safeguarding of organization's cash.

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. For example, in a trading business of used cars, where the employee or the franchisee outlet manages to sell the car without inward stock and notifying or recording the sales in the books and diverts the amount collected from the customer to his personal account. Such a practice is called skimming.

2.19 The above 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. Such misrepresentations are noticeable in non-government organizations and by unscrupulous agents who collect the donations from gullible donors and have embezzled the amount for their personal use through the use of unauthorised receipts that are never accounted in the books.

Sales could also be understated through offering of heavy discounts, subventions or commissions that are netted off before recording the sale in the books. This is another form of scheme where employees convert the difference between sale amount and notional discount offered into off book diversion of income for personal gain. Contrary to the above, the booking of purchases without accounting for vendor rebates is another form of off-book diversion of funds.

Cash Larceny

2.20 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. In cash intensive business these are covered through adequate insurance cover to ensure that claims are lodged once theft of cash is reported. This can also be noticed through altered or forged cash deposit pay-in-slips.

The cash/ collection shortage is also covered up by declaring and accounting the shortage as cash/ cheque in transit. Thus, taking advantage of the communication gap that existed between the central office and remote locations regarding accountability in use of fund transfers. Another form of larceny is pilferage of cheques/ drafts that are in transit and endorsing it in personal name. This carries more risk where companies retain post dated cheques for fund transfers and do not ensure timely independent bank reconciliation statement. Any lack of segregation of duties in preparation of bank reconciliation statement will increase vulnerabilities to fraudulent act.

Teeming and Lading (also known as Lapping)

2.21 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.

Fraudulent Disbursements

2.22 Fraudulent disbursements or reimbursements take place either by issuing or submission of false bills, or personal expense bills being converted into official expenses bills.

Cash shortages are adjusted through false disbursal entries tallying the cash balance in the cash register. These are also called fraudulent register disbursements that may either involve excessive refunds or void sales. The excessive refunds could be by declaring false sales returns. This will result in excessive inventory that will be reflected during physical inventory verification. Alternatively, the customer is not issued a receipt post sale and when the customer leaves the counter, the sale is reversed in the books.

The amount collected is misappropriated. This anomaly surfaces through shortage in physical stock, and the perpetrator of fraud may either resort to destruction of registers or corruption of data or adjusting stock records where he has access in the system. Generally, these frauds are very evident where inventory verification is not done for substantial periods. 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.

Expense Reimbursement Schemes

2.23 These fraudulent schemes involve employees resorting to treating their personal expenses as incurred for business purpose and claiming reimbursement. For example, buying stationery for school kids and claiming it from the employer, travels bills claims that are subsequently cancelled without notifying the company, claiming medical or gift expenses that were not incurred or employees travelling together in a single cab but indulging in multiple claims individually, etc. In some cases, employees may get reimbursed by third parties such as, dealers as well as by claiming these expenses from the company. Multiple expense claims based on duplicate bills or photostat copies. These types of frauds are, generally, of lesser magnitude in terms of damages and are managed through in-house investigations.

Payroll Fraud

2.24 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 disbursment to employees/ workers, etc.

Commission Schemes

2.25 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.

Chapter 3

Accountability for Fraud Detection

Chapter Summary

The chapter assesses the role of management, internal auditor and statutory auditor in managing risk of fraud with reference to Standard on Internal Audit (SIA) 11, Clause 49 and CARO requirements.

3.1 The Board of Directors govern the company operations through their management representatives namely, the Chief Executive Officer and the Chief Financial Officer. This brings to focus striking the right balance between empowering them and ensuring a monitoring mechanism in meeting the responsibility towards stakeholders. However, there are no formal guidelines on the extent of documentation that would be sufficient in drafting of minutes in important meetings where crucial decisions are taken. Except for resolutions passed at the board meetings, the deliberations get under the smokes screen to the detriment of the the stakeholders. Such documentation gaps are noticeable in the event of major scandals that surface, but reflections over the past do not bring in much succour to companies inflicted with fraudulent activities since damage is already done and court litigations go on endlessly due to deficiencies in this basic documentation requirements. It is in these circumstances that the internal audit though seen as a subservient function is expected to fill the gap through its role as a 'watch dog' instead of being a blood hound. The internal audit function analysis the control gap for the management to ensure a voluntary check up on key controls and leakages, if any, in their operations through reporting to the audit committees. The internal audit findings, therefore, provide sufficient leads for the management to pursue further investigations.

3.2 The management of any organisation, generally, has a pragmatic approach towards managing risk of fraud. When the business operations are at a nascent stage, there is either less fund allocation or lesser importance attached to addressing fraud risk or on strengthening of internal controls. Once the business volumes get scaled up there is a sense of overconfidence resulting in management overlooking the control gaps till a major fraudulent act is uncovered. In the initial stages of such incidents, fraudulent activities are either downplayed as insignificant considering the overall operation of the company or these are categorised as inherent risk in the business model of the company. Another reason for complacency is that fraudulent activities that are uncovered always relate to a past period and so least importance is given to such past occurrences. It is in these circumstances that an effective audit process with adequate independence and reporting to highest authority is desirable.

3.3 Foremost the management stands answerable to the stakeholders for business performance, and as a result the internal audit recommendations with reference to strengthening of internal controls tend to get lesser importance in comparison to larger business objectives. Sometimes when observations that are of a serious nature are conveyed to senior management in confidentiality may seldom get officially recorded. In this scenario, the internal audit process tends to lose its independence especially where the reporting structure is interfered with by the Chief executive officer or the Chief financial officer of the company, without a direct reporting to audit committee or chairman of the company.

3.4 The audit process may also be hampered due to restrictions placed by the senior management on direct access to accounting data, IT system or use of audit tools citing information security or insider trading regulations. Further, considering that it is the responsibilities of management in ensuring a robust risk management and governance process, the internal audit function tends to be a limited function in assessing the state of internal controls and process gaps without any larger responsibility.

3.5 The primary responsibility for prevention and detection of frauds is that of the management of the entity. The internal auditor should, however, help the management fulfil its responsibilities relating to fraud prevention and detection. Thus, accountability on detection of fraud is with the management. They may engage the services of internal auditors as facilitators. Similarly, the role of statutory auditors on matters relating to reporting on fraudulent is defined under Standard on Auditing (SA) 240 "*The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*". The reporting requirements as a result are largely dependent on management perspective of the spate of internal controls wherein they are expected to declare the maintaining of ethical business standards and disclose irregularities and action thereon. This calls for greater role of internal auditors in confidence building measures on the state of internal controls in the organisation.

Role of Management

3.6 As per Standard on Internal Audit (SIA) 11, "*Consideration of Fraud in an Internal Audit*".

(i) *The control environment sets the tone at the top in an entity and greatly impacts the effectiveness of internal controls. It includes the following:*

- *The policies and procedures established by the management to communicate and enforce the culture of integrity and ethical values in the entity.*
- *management's commitment to competence.*
- *management's philosophy and operating style.*
- *organizational structure.*
- *assignment of authority and responsibility.*
- *human resources policies and practices.*

(ii) *The entity's risk assessment process includes the policies and procedures adopted by the management to identify risks*

that can affect the achievement of the objectives of the entity and to distinguish risks from opportunities. In the context of prevention of frauds, the entity's risk assessment process would include the policies and procedures of the management to identify and assess the risk of frauds, including the possibility of fraudulent financial reporting and misappropriation of assets.

(iii) The information system and communication refers to the policies and procedures established by the management to identify, capture and communicate relevant information to the concerned persons in the entity to enable them to make timely and effective decisions and discharge their responsibilities efficiently. In the context of frauds, such policies and procedures could take form of whistleblower policies and mechanisms, ethics help lines and counseling, training of employees, etc.

(iv) The control activities refer to the policies and procedures established by the management to ensure that the risks identified are responded to as per the policy or the specific decision of the management, as the case may be. In the context of frauds, the control activities include actions taken by management to prevent or detect and correct the frauds or breach of internal controls.

(v) Monitoring refers to continuous supervision and assessment of the internal controls to identify instances of any actual or possible breaches therein and to take corrective action on a timely basis.

3.7 Paragraph 6 of the Standard on Internal Audit (SIA) 2, *"Basic Principles Governing Internal Audit"*, states as follows:

"The internal auditor should exercise due professional care, competence and diligence expected of him while carrying out the internal audit. *Due professional care signifies that the internal auditor exercises reasonable care in carrying out the work entrusted to him in terms of deciding on aspects such as the extent of work required to achieve the objectives of the engagement, relative complexity and materiality of the matters subjected to internal audit,* *assessment of risk management, control and governance processes and cost benefit analysis. Due professional care, however, neither implies nor guarantees infallibility, nor does it require the internal auditor to travel beyond the scope of his engagement."*

3.8 An internal auditor should, therefore, use his knowledge and skills to reasonably enable him to identify indicators of frauds. However, the internal auditor cannot be expected to possess the expertise of a person with specialized knowledge and skills in detecting and investigating frauds.

A fraud normally occurs in situations where there is an incentive or a pressure to commit fraud, an opportunity to commit fraud or a rationalization for committing fraud. Although, normally, an internal auditor is not expected to possess skills and knowledge of a person expert in detecting and investigating frauds, he should, however, have reasonable knowledge of factors that might increase the risk of opportunities for frauds in an entity and exercise reasonable care and professional skepticism while carrying out internal audit. In addition, the understanding of the design and implementation of the internal controls in an entity would also help the internal auditor to assess the risk of frauds.

3.9 The following paragraphs discuss the approach of the internal auditor regarding this:

(i) The internal auditor should obtain an understanding of the various aspects of the control environment and evaluate the same as to the operating effectiveness.

(ii) The internal auditor should obtain an understanding of the policies and procedures adopted by the management to identify risks that can affect the achievement of the objectives of the entity and to distinguish risks from opportunities and evaluate the effectiveness of these policies and procedures. In the context of prevention of frauds, the internal auditor should specifically evaluate the policies and procedures established by the management to identify and assess the risk of frauds, including the possibility of fraudulent financial reporting and misappropriation of assets.

(iii) The internal auditor should assess the operating effectiveness of the policies and procedures established by the management to identify, capture and communicate relevant information to the concerned persons in the entity to enable them to make timely and effective decisions and discharge their responsibilities efficiently.

(iv) The internal auditor should assess whether the controls implemented by the management to ensure that the risks identified are responded to as per the policy or the specific decision of the management, as the case may be, are in fact working effectively and whether they are effective in prevention or timely detection and correction of the frauds or breach of internal controls.

(v) The internal auditor should evaluate the mechanism in place for supervision and assessment of the internal controls to identify instances of any actual or possible breaches therein and to take corrective action on a timely basis.

(vi) The internal auditor should carefully review and assess the conclusions drawn from the audit evidence obtained, as the basis for his findings contained in his report and suggest remedial action. However, in case the internal auditor comes across any actual or suspected fraud or any other misappropriation of assets, he should immediately bring the same to the attention of the management.

(vii) The internal auditor should document fraud risk factors identified as being present during the internal auditor's assessment process and document the internal auditor's response to any other factors. If during the performance of the internal audit fraud risk factors are identified that cause the internal auditor to believe that additional internal audit procedures are necessary, the internal auditor should document the same.

3.10 It is important for both the management and the internal audit fraternity to ensure service differentiation between internal audits and investigative assignments. While the skill sets required in executing these assignments may be similar, the objective and scope of coverage in these assignments may vary and, therefore, there is a need for greater understanding between the management and the internal auditors for any further action on any matter arising out of the audit observations.

3.11 The scope of review in an internal audit is, generally, restricted to what is reported in the books of account; while in an investigation the scope of review may extend beyond the books of account. Internal audit may be a trigger to commence an investigation. The following are some major differences between internal audit and investigation:

Internal Audit	Investigation
• Audits are planned in advance.	• Investigations are, generally, in response to events or occurrences.
• Materiality in reporting facts is a dominant factor.	• Gathering of evidence is a more dominant factor. Materiality may not be relevant.
• Primarily governed by statute.	• Governed by specific mandate as decided by management.
• References are to basic working paper documentation.	• In addition to working papers, there could be an element of background checks to corroborate evidence/ facts.
• Role of reviewing operations, recommending improvements or review costs to determine these are reasonable.	• Traditional role in investigation is to search for civil/ criminal/ ethical violations.

3.12 Auditors and Investigators vary in terms of need for training needs, work approach and deliverables. The mode of conducting interviews in an internal audit differs from that of an investigation. A toolkit used in an investigation may not be used in a normal internal audit assignment. e.g., voice recorders, bugs, cameras or other visual representations, etc. The mode of communicating their work activities and results can vary between an audit and an investigation assignment.

Benefits of Co-ordinated Effort between Audit and Investigation

3.13 Generally, auditors and investigating officers review different aspects of an organisation's operation, contracts and entitlements. Considerable research and time is often devoted to gathering information about the subject. By sharing this knowledge between audit and investigative staffs means averting or minimising duplication in effort and preventing loss of time. Sharing of knowledge can improve the quality of both audit and investigation assignment. Information about past irregularities can and should be used to update audit or investigative approaches thereby assuring that similar irregularities are not overlooked in future audits and investigations. There are occasions where audit and investigative engagements need special expertise. Auditors can and commonly do provide financial auditing expertise to investigating staff in various types of white-collar crime inquiries. Similarly, investigating officers can be of assistance to auditors in tracking down business relationships which may be essential to the audit, such as determining whether there is common control or ownership among companies which potentially results in inter-company transfers with excess profits or bid rigging or result in diversion of funds.

3.14 The top Management must project a positive and co-operative attitude, at the office and in the field. Communications at all levels should be mandated with Audit and Investigating officers knowing each other's role through regular meetings. Co-operation is not just top down: it has to be a bottom up as well. Individual auditors and investigating officers must share information about their work. There should be consensus about referrals, the timing and circumstances of advising their counterparts of new developments, and once an investigation or audit is initiated consideration must be given as to how and when to provide feedback as to it's progress among the designated officials.

3.15 There should be appropriate recognition and credit to deserving team members. If an auditor sees major accolades going to individuals who develop cases on major findings because of a referral they made, while they receive no credit at all, hard feelings and disagreements will occur and thereafter the co-operation is gone. Conversely, appropriate recognition will stimulate co-operation and get people to actively participate in such assignments.

The commercial officer in a company had acquired clout in the local unit due to his proximity to the plant head. Having won the confidence of his boss, he formed a network of important people in the locality and also with other employees in the plant as an 'honest person' reaching out to people when they most need him. Under the influence of outside elements he started indulging in unethical practices on a small scale. As his confidence grew, his greed overtook his needs and he started indulging in activities clandestinely, which were not in the best interests of the company. This was evident from disgruntled employees within the plant and also from the control gaps highlighted by the internal auditors. As a management representative what would be an important step in ascertaining the facts in this matter?

Based on the internal audit findings, the investigating officer could easily diagnose the problem. He could accordingly plan his strategy by seeking the list of active and non-active contracts, and was able to use the information available in the internal audit report regarding the key findings arising out of ledger scrutiny of billings and payments schedules, ascertaining the level of activities at the plant, the terms of contractual engagement and most importantly the reason for some of the contractors being discontinued. An interaction with the internal auditor would also be useful in defining the objective, scope of coverage and time targets within which the investigative assignments could be completed.

3.16 An internal auditor was apprehensive of certain irregularities relating to the lifestyle of the 'auditee' vis-à-vis his income levels. However, he considered this beyond the his scope of review and, therefore, highlighted his concerns to the management. The Chartered Accountant was called in and the scrutiny of the internal records with the external background checks revealed that the suspect had amassed wealth that was disproportionate to his income, through inappropriate means.

In an internal audit of the payroll function, an auditor stumbled upon falsification of wage records by the management with a view to evade taxes and non-payment of statutory dues. The scope of audit was restricted up to this point by resorting to review of the swipe card entries, review of work station level labour records, and gate records. Any attempt in gathering external evidence to highlight non-existent employees may involve physical inspection, background checks outside the office premises, residence checks, neighbour checks, interviews with fellow employees, etc., and so. the later part can be termed as investigative in nature.

3.17 During the audit of a treasury function, physical verification of the key security documents revealed that certain term deposit certificates were not traceable. The auditor pointed out the lacunae in the verification process and highlighted the matter to the management. The matter was referred for investigation and it was noticed that these certificates were pledged and borrowings were adjusted against receivables in the books to tide over the rising level of receivables.

An Information Technology (IT) company in its first year of it's operation wanted to project a healthy result. The company had a sub-entity created abroad and the entity was used as a front end company to build up a healthy balance sheet. The internal auditors were required to complete the audit based on the documents and declarations submitted by local management. The auditors had to rely on the contracts signed between the two companies and the fund flow from such entities. The internal auditor had to limit the audit review to the photostat copies of the documents and soft entries in the system of the operations between the main company and the 'front' company. The existence of the ultimate customer was questionable and not verifiable by the internal auditor as the audit of the 'front company' was not within the purview of internal audit engagement'. To maintain confidentiality, the auditor had to return back the supporting documents and contracts to the management to safeguard customer specific information and was not allowed to retain even the photostat copies lest the information is leaked out to competitors.

The same auditor was also managing the audit of a banking entity. The project work on getting the financing done for the management was offered to an independent consulting firm at the behest of the audit firm. The management as a confidence building exercise with the auditors, also assigned, a consultancy assignment to define the business process, the accounting manual and to carry out a due diligence exercise to such consulting firm in lieu of arranging of the finance.

The bankers of the company wanted a due diligence exercise to be carried out to establish the credibility of the company operation. This called for an investigation into the billing and realisations of the IT company. The billing was classified into deputing manpower, the process support in developing and customisation of software and implementation of the software. The customer confirmation was received from the front company and the remittances were recorded against each of such billings in a sequential manner. Do you see any conflict in the role of the audit firm? Do you believe this could be a management fraud? How would you carry out this assignment?

3.18 Standard on Auditing (SA) 240 *"The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements"* issued by the Institute of Chartered Accountants of India, lays down the objectives of the auditor as follows:

(a) *To identify and assess the risks of material misstatement in the financial statements due to fraud;*

(b) *To obtain sufficient appropriate audit evidence about the* *assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and*

(c) *To respond appropriately to identified or suspected fraud.*

The auditor shall make inquiries of management regarding:

(a) *Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments;*

(b) *Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist;*

(c) *Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and*

(d) *Management's communication, if any, to employees regarding its views on business practices and ethical behaviour.*

An effective internal audit team can be extremely helpful in performing aspects of the oversight function. Their knowledge about the entity may enable them to identify indicators that suggest fraud has been committed.

Statement on the Companies (Auditor's Report) Order, 2003

3.19 Clause 4 (xxi) of the Statement on the Companies (Auditor's Report) Order, 2003, deals with matters relating to reporting on fraudulent activities on whether any fraud on or by the company has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated.

This clause requires the auditor to report whether any fraud has been noticed or reported either on the company or by the company during the year. If yes, the auditor is required to state the amount involved and the nature of fraud. The clause does not require the auditor to discover the frauds on the company and by the company. The scope of auditor's inquiry under this clause is restricted to frauds 'noticed or reported' during the year. The use of the words "noticed or reported" indicates that the management of the company should have the knowledge about the frauds on the company or by the company that have occurred during the period covered by the auditor's report. It may be noted that this clause of the Order, by requiring the auditor to report whether any fraud on or by the company has been noticed or reported, does not relieve the auditor from his responsibility to consider fraud and error in an audit of financial statements. In other words, irrespective of the auditor's comments under this clause, the auditor is also required to comply with the requirements of Standard on Auditing (SA) 240, *"The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements".*

3.20 Although fraud is a broad legal concept, the auditor is concerned with fraudulent acts that cause a material misstatement in the financial statements. Misstatement of the financial statements may not be the objective of some frauds. Auditors do not make legal determinations of whether fraud has actually occurred. Fraud involving one or more members of management or those charged with governance is referred to as "management fraud"; fraud involving only employees of the entity is referred to as "employee fraud". In either case, there may be collusion with third parties outside the entity. In fact, generally speaking, the "management fraud" can be construed as "fraud by the company" while fraud committed by the employees or third parties may be termed as "fraud on the company".

3.21 Two types of intentional misstatements are relevant to the auditor's consideration of fraud— misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.

Fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting may involve:

- Deception such as manipulation, falsification, or alteration of accounting records or supporting documents from which the financial statements are prepared.
- Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information.
- Intentional misapplication of accounting principles relating to measurement, recognition, classification, presentation, or disclosure.

3.22 Misappropriation of assets involves the theft of an entity's assets. Misappropriation of assets can be accomplished in a variety of ways (including embezzling receipts, stealing physical or intangible assets, or causing an entity to pay for goods and services not received); it is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing.

3.23 Fraudulent financial reporting may be committed by the company because management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target particularly when the consequences to management of failing to meet financial goals can be significant. The auditor must appreciate that a perceived opportunity for fraudulent financial reporting or misappropriation of assets may exist when an individual believes internal control could be circumvented, for example, because the individual is in a position of trust or has knowledge of specific weaknesses in the internal control system.

While planning the audit, the auditor should discuss with other members of the audit team, the susceptibility of the company to material misstatements in the financial statements resulting from fraud. While planning, the auditor should also make inquiries of management to determine whether management is aware of any known fraud or suspected fraud that the company is investigating.

3.24 The auditor should examine the reports of the internal auditor with a view to ascertain whether any fraud has been reported or noticed by the management. The auditor should examine the minutes of the audit committee, if available, to ascertain whether any instance of fraud pertaining to the company has been reported and actions taken thereon. The auditor should enquire of the management about any frauds on or by the company that it has noticed or that have been reported to it. The auditor should also discuss the matter with other employees of the company. The auditor should also examine the minute book of the board meeting of the company in this regard.

3.25 The auditor should obtain written representations from management that:

(i) it acknowledges its responsibility for the implementation and operation of accounting and internal control systems that are designed to prevent and detect fraud and error;

(ii) it believes the effects of those uncorrected misstatements in financial statements, aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representation;

(iii) it has disclosed to the auditor all significant facts relating to any frauds or suspected frauds known to management that may have affected the entity; and

(iv) it has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.

Because management is responsible for adjusting the financial statements to correct material misstatements, it is important that the auditor obtains written representation from management that any uncorrected misstatements resulting from fraud are, in management's opinion, immaterial, both individually and in the aggregate. Such representations are not a substitute for obtaining sufficient appropriate audit evidence.

Clause 49 of the Listing Agreement

3.26 Clause 49 of the Listing Agreement *interalia* requires the CEO, i.e., the Managing Director or Manager appointed in terms of the Companies Act, 1955 and the CFO, i.e., the whole time Finance Director or any other person heading the finance function shall certify to the Board that:

(a) They have reviewed financial statements and the cash flow statement for the year and that to the best of their knowledge and belief:

   (i) these statements do not contain any materially untrue statement or omit any material fact or contain statements that might be misleading;

   (ii) these statements together present a true and fair view of the company's affairs and are in compliance with existing accounting standards, applicable laws and regulations.

(b) There are, to the best of their knowledge and belief, no transactions entered into by the company during the year which are fraudulent, illegal or violative of the company's code of conduct.

(c) They accept responsibility for establishing and maintaining internal controls and that they have evaluated the effectiveness of the internal control systems of the company and they have disclosed to the auditors and the Audit Committee, deficiencies in the design or operation of internal controls, if any, of which they are aware and the steps they have taken or propose to take to rectify these deficiencies.

(d) They have indicated to the auditors and the Audit committee

(i) significant changes in internal control during the year;

(ii) significant changes in accounting policies during the year and that the same have been disclosed in the notes to the financial statements; and

(iii) instances of significant fraud of which they have become aware and the involvement therein, if any, of the management or an employee having a significant role in the company's internal control system.

3.27 The above also relate to the role of internal auditors as facilitators or assessors of internal control. Each company should devise back-up procedures as part of its reporting structure that is appropriate for its management and business. Combination of following activity could be helpful in this respect:

- Request back-up certificate from responsible subordinate officer.
- Review functioning and effectiveness of internal auditor and external auditor.
- Review companies financial reporting system and controls with internal auditor and risk manager.
- Solicit views of audit committee, independent directors and legal counsel about adequacy of these procedures.
- Document the process used for review of all of the above.

Chapter 4

Corporate Fraud Control Plan

Chapter Summary

The chapter focusses on options available to a corporate entity in managing the risk of fraud. There is an attempt to provide an insight into operation of an investigative cell (in a private entity) and advising the management on creating awareness among employees on fraud alerts through proper code of conduct. The process of escalation of irregularities and reporting to designated authority has also been discussed. Finally, there is a comment on the role of company's legal department in initiating legal action and alternative remedies for settlement of damages. At the end of the chapter there is a suggestion on evolving fraud control strategies to management including instilling of confidence and motivation to employees for ethical behaviour post discovery of fraudulent activity.

4.1 Any relationship between like minded people largely revolves around mutual trust, faith and respect for each others' opinion. Even in day-to-day business matters there is an element of people outwitting one another to prove their point or achieve a desired objective. However, this is different from the use of deceit. It is pertinent to note that the use of deception has been practiced since time immemorial and compels us to believe that we have to live with this risk eternally despite strengthening of controls. There is always need for this caution in managing the risk of fraud before, during and after the event has occurred. Further, a fraudulent activity may not necessarily be a single event and, therefore, there are chances that an alert management is in a position to notice the leads that are available to identify suspected frauds before extensive damage is done to the organization. Materiality in audit findings is a significant factor for follow-up action by management. In fraud parlance this may not always be true as timely detection and remedial action would prevent significant damages. Hence, greater attention would be needed towards fraud risk in the risk management process.

4.2 Most organisations are averse to setting up an in-house investigative cell as the investigation team is exposed to extensive risk that could affect physical security. There is, therefore, more dependence on outsourced agencies who are independent or bring the requisite expertise to conduct investigative assignments. There is also a tendency to downplay irregularities considering that it carries a reputational risk to the organisation. Therefore, where there are internal investigative assignments where trail is destroyed when it is detrimental to the larger business objectives. In a weak control environment with inadequate internal audit system, there is a greater probability of fraud occurrence. From this perspective, let us examine what management ought to do to tackle this menace.

4.3 A CEO faces the task of constantly differentiating the good, bad and the ugly from his most trustworthy team of comrades. He has to run the business in the most pragmatic manner where mutual trust reigns supreme. When an auditor, whistleblower or informer points the needle of suspicion, the concern is manifold; there exists the risk of targeting the wrong person and one cannot rest till action is taken on the erring person. There is a need to draw the right inferences at each stage of investigation and forming an opinion on who are all involved. At times, the scapegoat tends to be the person who is at the front end of the fraudulent act and the person who masterminds the act is never in the picture. He remains unscathed, and thereby emboldened for further committing the fraud or even moves over to another organization before his deeds get unravelled.

Hence, it is essential for an organisation to first ensure that employees are aware of what constitutes a fraud, how they should avoid such acts, stay alert and bring to the notice of the management any deviations that can be construed as fraudulent to the appropriate authority. The management should also ensure in-built systems to detect frauds. Once detected, it must ensure yet another stream of steps to gather evidence against the perpetrators of fraud.

Fraud Detection and Fraud Deterrence

4.4 Each organization has its own established value systems and, therefore, would like its employees to follow the same through a code of conduct. This also provides the management a medium to interact with employees in defining the ground rules to be followed and actions that are not acceptable. This can also be termed as adhering to the principle of natural justice in amply clarifying to the employee the work culture that is encouraged in the organization. For the purpose, management must define what type of conduct may involve conflict of interest (or potential for a conflict of interest) vis-à-vis the official duties. This may or may not involve any pecuniary interest and may extend to any bias towards third persons in the official dealings/ decisions. Hence, non-competitive pricing of products or unjustified commercial dealings could also be within the purview of this code of conduct.

4.5 Generally, employees are the first point of contact in noticing a fraudulent activity arising out of certain unusual or abnormal practices. These remain unreported to the superior reporting officer due to lack of training and awareness among the employees. The insecurity among employees is another reason for not escalating the matter to the reporting authority. Therefore, employees must be made aware of their role in detection as well as deterrence to such fraudulent acts and also apprise them of the reporting process through appropriate mediums.

4.6 Apart from providing abundant opportunity to the employees within the organization to stay away from fraudulent acts and report of any such deceit, it is also essential to set up independent monitoring system or devise strategies which work coherently with the following objectives:

(a) Identification and reporting of unusual activities;

(b) Isolating deviations and surveillance mechanism in the day-to-day operations;

(c) Use of computer applications and audit tools in keeping track of unusual transactions;

(d) A robust accounting and management information reporting system; and

(e) Effective interaction with the Chief Internal Auditor for appropriate audit reviews.

4.7 It is preferable that there should be an effective incident reporting process normally to a designated official (heading the investigative cell or compliance officer) to whom all the suspected activities will be reported. It should also be his responsibility to promptly update the management of such incidents.

The senior management executives need to consistently make an effort in educating the employees and related third parties on how to be alert to fraudulent activities, including suspicious activities and the manner in which the same needs to be communicated. In addition, the internal audit observations can be filtered to identify red flags and used as a medium to apprise employees of internal control gaps in prevention or detection of frauds.

4.8 When a financial fraud is suspected, certain immediate steps may need to be taken to prevent loss of evidence or furtherance of such acts. For the purpose, records and documents are taken in safe custody, and the persons connected with the activities are generally transferred to other activities till the perpetrator of the fraud is identified. The scope and period of coverage is dependent on judgement by the Chartered Accountant and this in turn would determine the time required to complete the assessment process.

These may relate more to the activities impacted due to fraud including fraudsters' access to records, documents and information. Unravelling the modus operandi of the fraudulent act could be equally complex with reference to identifying and deciphering the trail left by the fraudster and in gathering requisite evidence. This is followed by an assessment of damages arising out of the wrongful act. In case the entity has an insurance cover, the insurer is informed of the incident and thereafter the extent of damages is also notified. The management has the option of either proceeding for legal action or can take disciplinary action on the erring employee or third party if the situation warrants. Where the perpetrator is not known steps may be taken for in-depth investigation either by in-house resource or external agencies.

Initiating Investigative Process

4.9 Once a fraud is reported, a preliminary investigation has to be conducted first to assess and verify the enormity of the act and then the next step is to substantiate it with evidence. It is preferred that this is carried out under the aegis of the Compliance Officer (generally, a Chief Financial Officer or a Chartered Accountant in full time employment with the company).

The Compliance Officer should, generally, be a person of integrity and based on his past track record, should have the ability to manage situations of fraud risk. He is, normally, a person who is trusted by the management in safeguarding the reputation and image of the organization.

4.10 To achieve this objective, a Compliance Officer is an official who by the nature of his duties, generally, reports to the senior most officer in the Company (CEO or Managing Director) and may derive his power from the audit committee or statutory regulator. The Compliance Officer may seek the support of the internal auditor in discharging his duties on matters relating to the investigation.

The Compliance Officer will conduct a preliminary assessment of each situation and depending upon the magnitude of suspected fraud (which is by and large a matter of subjective judgment) will decide whether he has the resources within the organization to carry out a full-fledged investigation and the extent of outsourcing of the investigative activities.

4.11 The Compliance Officer is, generally, in an advisory role to the senior most officers in the management hierarchy. His roles and responsibility may include the following:

(a) Interaction with the internal auditor of the company.

(b) Resource mobilization, either internally or outsourced, in engaging the services of chartered accountant firms for conducting investigation.

- Sequencing of the events and activities for diagnosis of the problem.
- Internal control assessment in highlighting vulnerabilities.
- Preliminary assessment on the role of internal and external persons who are suspected to be involved in the alleged irregularities and details thereof.
- Damage assessment arising out of the reported incident.
- Collation of information on suspected fraudulent activity.

(c) Ensuring a reporting format to the senior management or regulators such as, RBI, IRDA, SEBI, NHB, etc.

(d) Comment on available evidence to form an opinion.

Considering the sensitivities involved in any information that relates to a fraudulent activity, it is essential that adequate confidentiality is ensured in collating such information and reporting. Based on his report management can form an opinion on the future course of action including referral for legal action, reporting to police authorities, filing of insurance claims, disciplinary action on employees, etc.

Managing Fraud Risk

4.12 The role of an investigating Chartered Accountant is different from that of the line functionaries, as his primary concern would be to corroborate facts based on available evidence, within the legal realms. Senior executives must give a free hand to the investigating officer and should not intrude into their investigative approach and methodology. Such intrusion tends to be counter productive. The desired course of management action will depend on the regular updates on the progress made in the investigation. It may be noted that just as the senior management is responsible for initiating the investigation, they have a similar right to call off an investigation.

4.13 Post discovery of a fraudulent activity, the manner in which the enquiry process is conducted may be defined through a policy document. This will also include the options available for disciplinary actions that could be explored by the management.

Anti-fraud programs enable the management in identification of areas that are vulnerable to potential fraudulent activities. Where such events are inherent to the business environment, counter measures for identification of irregularities and timely action should be ensured.

4.14 Unless warranted by law or regulatory institutions such as, Reserve Bank of India norms, it is the management's discretion on whether an incident needs to be reported to the police authorities. A weak or inadmissible evidence or reputation risk to the organization is sometimes a reason for not proceeding legally against the erring employees.

The management must also ensure that the above incidents are brought to the notice of the Chief Internal Auditor in a timely manner, including management action plan and corrective steps that are to be taken post discovery of the fraud. There should also be a standard format in which the management informs the audit committee and the board about the status of frauds reported, persons involved, type of fraud, recoveries, corrective measures and regular update on investigations in progress.

Management Fraud – From an Audit and Investigation Perspective

4.15 While evaluating the performance of a Chief Executive Officer or reporting of extra ordinary performance by a Chief Financial Officer, there is a need for caution so that such performance do not subsequently turn out to be abnormalities. The consistency in applying the accounting policy is given a greater importance and an error at the outset may remain buried over successive years. The declaratory statements obtained from management akin to a certification of key balance sheet items cannot absolve the auditor from the larger responsibility in the event of a management fraud. The focus of review from an investigation perspective could extend beyond these statements given by the management.

4.16 Since external information is considered a superior form of evidence, it is important that these are not fabricated to convince an auditor. (For example, by operating a fictitious entity in a third party name, funds could be surreptitiously deposited and transferred through a bank account – termed by tax consultants as 'entry business'). This may also involve creating a 'front company' as an intermediary between the entity and the bankers or vendors. The perpetrator of management fraud could use an individual's identity (name lending) or 'morphed' document (such as, pledging the fixed deposit receipts or gold purchase and sale transaction of a third party or the purchase or sale of stocks through a sub-broker). This makes the unravelling of management fraud more challenging. It is in these situations that the efficacy of the internal audit function (in the normal course of business) and the experience of the investigator (once a red flag is identified) are of paramount importance.

4.17 Finally, the need for an abundant caution is a necessity considering that a poorly conducted investigation or a disciplinary action that is unjustified will affect the organization in terms of its reputation. It can also lead to unnecessary defamation suits by the affected person or even lead to destruction of the evidence which is central to an investigation. A poor control environment could also lead to inadmissible/ inadequate evidence in a court of law and a temptation for the employees and outsiders to engage in wrongful deeds tarnishing the image of the organization. To avoid this, the management should ensure an effective internal audit function that monitors the effectiveness of the preventive and corrective steps.

Case Studies

4.18 A company had a project office in India for the release of certificates to students for certain courses through a process of e-learning. The billing and collection were remitted electronically outside the country. Thus, the expense projections (budgets) and actual expenditure became the medium for the foreign company to fund the operations in India. The management of the foreign company considering the increased spend on operating expenses, especially, in hiring of lawyers rising consumer complaints took the assistance of Chartered Accountants in ascertaining the fact of the case.

It come to notice that what started as a need to spend the available funds within the time targets became an allurement for the CEO. He resorted to collecting bills and letter heads and used them in padding expenses. To prevent in-house staff being aware of these acts, he switched over to outsourcing of the accounting function. The accountant kept booking the false bills without being aware of the fraudulent act. A scrutiny of the records revealed that the CEO had opened a manpower consultancy firm in the name of his brother-in-law earning commission for each recruitment in the company, entered into a contract with his sister-in-law for hiring of the most expensive of the car for the company (the monthly instalments being equal to the fixed hire rentals paid by the company), and opened bank accounts in the name of other relatives for payment of exorbitant advertisement expenses. This was camouflaged by ensuring namesake participation in exhibition stalls and campus visits. These resulted in extensive personal gain without incurring such expenses. Surprisingly, the letter head of the lawyers was also misused by the perpetrator of fraud in the process pocketing litigation expenses too.Thus, a scrutiny of the exception reports and unfavourable trends could have provided ample scope for isolating red alerts.

4.19 In decentralised operations there are compulsions for the management to delegate powers to a regional authority including that of defining of policies customised to local needs. Here, such regional managers may not welcome any independent controls or checks on their activities stating that this will hamper their freedom to operate effectively. Primarily the cause of fraud in these circumstances is due to absence of filters in the form of exception reports. The absence of incident reporting mechanism, covering up of anomalies by framing policies at a localised level and special approvals are factors that compound the problem.

4.20 In this web based world, the perpetrator of fraud can easily trap a target (there are greater avenues for a fraudster to mislead the management) through sending messages to a personal e-mail or to a unused e-mail account that is not in use by a designated authority. He maintains a record of such e-mails including delivered messages as a follow up action. At a later stage when he is caught in the act of wrongful gain, he points the finger at the senior management official stating that the action was duly notified to the senior management. The perpetrator as a result is able to strengthen his defence and cause nuisance value during the scrutiny process. Thus, misuse of e-mails can be a medium to impact the reputation of persons by the wrongdoer.

4.21 A company was engaged in wholesale trading of agriculture produce through a panel of brokers, the process of entering into a 'sauda' (deal) was, generally, verbal and later on converted into formal documentation released by the back office. Considering the critical nature of the operations, the company representative had to be person of high integrity in day-to-day dealings. The supply and demand in the market along with foreign exchange rates influenced the pricing decisions. The terms of payment were dependent on the past business deals with the broker and the volume of business offered. As a result, the most critical of the activities of entering into deals was retained with the Chief Operating Officer. A new broker was empanelled on trial basis as he was operating for the competitors' as well. This was to ensure to capture a larger market share by the company. Initially, advance payment was insisted by the company and considering the size of business and performance, the credit facility was extended up to seven days. Immediately on extending the credit facility, the broker defaulted in payment resulting in heavy loss to the company.

The internal auditor was called to quantify the extent of damages and study the available documentary evidence. Investigations revealed that the broker's employee had taken advantage of the verbal 'sauda' process. He had managed to collect the cheque dishonour statements from the company's banker preventing the company to be aware of the cheque dishonours in a timely manner and gave a false presumption that the cheque was under clearing. He then managed to divert the stock and absconded with the amount realised. The obtaining of acknowledgement on the 'sauda chitti' (deal Slip) was not a market practice.

4.22. The user acceptance test is a common phenomenon in software customisation process. There was a dedicated official responsible for creditors' scrutiny and release of payments to vendors. The official befriended the software developer during the customisation process. In the Technical Committee meeting, he managed to convince the management on need for changes to vendor codes while generating the payment vouchers. The person responsible for signing the cheque used to ascertain the vendor dues by referring to the balance in the vendor account in the system. By changing the vendor codes, the perpetrator of fraud resorted to lapping of cheque payments and diverted the duplicate payments to his personal account.

4.23 A Joint Venture company had received advance payments from abroad and as per the terms of contract was supposed to export commodities (processed spices) over a three month period under a forward rate contract. The management noticed that its coffers were empty and the reason for the shortage in funds was not traceable.

The internal auditor was brought in to trace the flow of funds among the various business divisions and group companies. Before initiating the investigation process, the computer system had crashed and the employees expressed their inability to co-operate in the matter. As a result, a single entry system was adopted and details reworked. It was noticed that the advance money was diverted towards payment to rice mills and that the price of 'basmati rice' had dropped down heavily resulting in unviable business option. The advance meant for procurement of spices was no longer available. To maintain their company reputation, the partners to the joint venture had to honour their commitment despite incurring a substantial loss.

4.24 The scrap committee in a company had decided to categorise the conditions for declaration of scrap and defined parameters for segregation. The stores person (an accomplice with the fraudster) advised the scrap dealer that it would not be possible to declare the round bars as scrap as these exceeded the criteria of two feet in length. Further, the reconciliation of project steel scrap was to be done only at the end of the project and in the mean time calibrations were used for issue and consumption of steel to record stock movement. The steel stock differences were pending for reconciliation and consumption estimates seemed to be off the mark.

The operating management stated the prime reason for high consumption to be errors in calibration in recording of conversions of assorted size of steel items, and the overall difference in stock would be within the two percent deviation limits.

An audit review was recommended into the differences that required item-wise updating of stock record at various stages of work-in-progress. While this was a complex exercise, the internal auditor was called in to investigate into the matter. it came to light that the scarp dealer had coerced the stores personnel to ensure that the round bars and other steel scrap fitted into the criteria for declaration as scrap (by cutting the round bars below two ft in size to fit into the scrap declaration parameter). The damages were assessed and reported to the management for further action.

4.25 The company policy required just in time inventory management system. There was a pile of raw material stock that was creating a problem for the local management in offering justification. Under the pretext of better inventory management these were shipped to other plant locations before fresh orders were again placed. Despite prudent measures the cost of procurement remained uncontrolled. The management called in the auditors to undertake a special investigation into inventory movement system.

The inventory module for the purpose of ageing of stock was using a FIFO method and the GRN date was the key field based on which the ageing of inventory was reported. There were two issues that came to light and revealed that the Plant accountants were portraying efficient inventory management system. The inventory remained at the transporters warehouse for substantial time while it was knocked out from the transferor company. The transferee company was not required to record stock inward in its books as the stock was in transit. The rotation of stock in the system ensured that the ageing of the stock remained below the stipulated level, as decided by the company management, to meet the just in time model.

4.26 The bankers of a private company had a high lending exposure to a closely held group of companies. They were perturbed by the steep rise in loss booked in one of the companies to which major portion of lending was done. Over the past three years while the top line business was showing encouraging results, the cash flow position was not satisfactory with default in repayment of loan instalments. The management of the company had yet again forecasted poor performance in the following financial year. The bankers feared that the company would opt for insolvency and apply for restructuring of loan to avail concession in rates of financing as applicable to sick companies. Accordingly, they instituted a special audit akin to a financial due diligence to understand the key concerns.

The findings of the special investigation revealed that the current year's financial results were above the targeted level of performance. The management, as a matter of strategy, had created a cushion in the form of forced provision for doubtful debts casting doubts on the genuineness of the customer billings. There were several dealings with a group shell company (paper company) wherein the funds from the parent company were diverted. The procurement of raw material was fabricated as the vendors did not exist at the defined address given on the purchase bills. Fictitious labour contracts were prepared to inflate the wage bill. All these factors resulted in higher cost of operation. Extensive insurance policies were taken for stock and assets of the company. In the past several months, several manufacturing company in the vicinity had incidents of fire where the warehouses were gutted. The bankers appreciated the investigation effort and issued a show cause notice to their client for further action.

Chapter 5

Investigative Tools and Techniques

Chapter Summary

The important factor in an investigation is that a Chatered Accountant has to rely on factual information and available evidence in reaching a definitive conclusion. The client, therefore, requires an assurance about the skill sets and comfort on the methodology adopted in conduct of an investigation and in safeguarding of evidence.This chapter deals with the investigation methodology in generating leads, especially, relating to manipulation to financial statements and safeguarding of evidence.

5.1 The investigator and the client should have a mutual understanding on terms and conditions to withdraw at any stage of the assignment especially under circumstances involving threat to physical safety of the investigation team. The conclusions depend on the scope of the assignment, methodology adopted, extent of independence, and available trail of evidence and any other legal constraint in the conduct of the assignment.

The clients also tend to be apprehensive about the extent of confidential/ classified information that the investigators should be allowed access. The time slot for conclusion of any investigative assignment is a factor that is difficult to determine and has a direct relation to the cost of the assignment. The cost of conducting an investigation may also vary depending upon the specialist manpower resources deployed.

5.2 The CFOs/ accountants are the gatekeepers of control in any organization and have to exercise due diligence against any false booking of transactions. As a prudent risk management policy, some companies pass on their risk through engagement with distribution network or intermediaries as a cushion to manage their debtors' position/ cash flows or resort to outsourcing of accounting function. However, the following example illustrate how the control gaps impact the financial statements of such intermediaries:

(i) To get additional funds/ borrowings the lending agency may review the business performance before disbursal of funds. The sales section may indulge in parking the stock with an intermediary and billing them as customers to disclose a positive business performance. As a result, the role of intermediary (in any business) has to be seen with caution whether it be a local broker/ distributor or off-shore distribution network. For the purpose, a periodic confirmation from the ultimate customer is desirable on veracity of the billings. The receipt of the consideration amount from the end customer under the circumstances is also important. The stock piling with an intermediary should also be a cause for concern. At times, the billing and receipts are not backed by physical transfer of the product billed and this may be further explored for any fictitious billing to boost top line.

(ii) Generally, the seller/ manufacturer does not have control over billing operations of intermediaries and also on decision on retail prices. This could be another area of concern in validation of retail and market share. The problem is compounded when an employee indulges in fictitious transactions through a 'front company', 'SMEs', 'consultancy firms', etc. Generally, these may belong to a friend or a relative who does not form a part of definition of 'related party' transaction. These may also result in teeming and lading of remittances.

(iii) Generally, competitors may indulge in strategies to subvert the competition by jacking up the demand by pushing fictitious buyers through the distribution network and have a budget to fund these operations. This induces the manufacturer to produce more against demand orders, at a later date the product gets sold in the resale market at a highly discounted price thereby killing competition in a phased manner. Where a push model of sales is followed, the manufacturer ends up with high level of stock and tends to be debt ridden. It is a common practice for CFOs to defend their position by discontinuing the operations or terminating the services of senior employees indulging in abnormalities, to prevent further damage.

(iv) Fictitious sale, normally, could involve sale and buy back arrangements or bulk deals wherein a third party or a front company is used to inflate the sale projections and billing to overcome depleting sales. Generally, abnormal sales at particular time of year or at the time of closure of accounts require special attention.

(v) The ‘off book’, debts or borrowings being shown as realization of debtors is also a method of disguising the cash flow position in the books. Generally, these are resorted to get more funding from bankers. Similarly, false sale projections may also be indicated by showing these borrowings to be advance received from customers towards sale orders.

(vi) Sudden change in accounting and operational policies needs to be seen from the point of manipulation of financial statements. The accountants may during their internal review notice difficulties in recovery of dues, especially, for debit notes raised towards incidental service conditions such as, billing the customer for warranties, spares, etc. In order to cover up these deficiencies they may resort to issuing of credit note or journal entries for adjusting these dues that may be sometimes not justified. The policy changes may be directed towards removal of audit trail for future by alteration of the terms of conditions with the vendors or customers as the case may be. An external confirmation is highly desirable in these circumstances. The audit trail may have been removed in this manner of detecting any short recovery of dues or adjusting long outstanding advances to vendors.

(vii) The pre-shipment and post-shipment packing credit is an interesting activity for validating the overseas billing and collection process. The accountant may find himself in a situation where the billings done are resulting in stock pile up at the off-shore location that may have remained concealed. If the same is done through a distributor or front company, the risk of non-moving stock is a serious cause for concern. Alternatively, the undisclosed sale of stock while sending a pile of stock is also a method to fraudulently divert funds. The concessional rate offered for these transactions may not be available for indefinite period and force the accountants to manipulate the debt covenants. Similarly, the same situation may occur when there is no control over movement of stock or debtors by the manufacturer vis-à-vis dealers/ distributors or intermediaries. Availing of multiple loans or credit against the debtors or stock is also an area of fraud risk concern.

(viii) Outsourcing/ centralization of accounting function is also a method at times used for manipulation of accounts as the fraud is committed through the involvement of booking clerk least suspected of manipulation. The booking clerk in this scenario is bereft of the ground realities and of the business model and also of the control check points. As a result, any fictitious transaction may get processed without evaluation of these control check points. There is a greater reliance on the information supplied by the CFO/ operations team to such outsourced booking clerks.

(ix) For off-shore operations or fund transfers to remote locations, the cash flow position may be doctored to get additional fund allocation (time- cushion in managing operations) from a central authority. This reflects on lack of planning and improper estimate of cash flow needs by accountants. Thus, this is followed by a rationalization of thoughts by accountants that untimely remittance of funds by head office or central office makes it difficult to manage the operations at the remote locations. To show lower balances at month ends and quarter ends, the accountant may be indulging in window dressing of balances, that may result in blocking of idle funds to avoid any inconvenient questions. The periodicity of the bank reconciliation process, the extent of uncleared cheques could be indicative of such abnormalities. Sometimes, the cheques payments being of identical amounts, induces accountants to indulge in teeming and lading activities. To remove surplus funds, there is also a tendency to create fictitious transactions or sharing the surplus of such fictitious transactions with vendors.

(x) Hidden cushions, secret reserves and unjustified provision for doubtful debts are sometimes used to spread the super profits in a year to the subsequent years, especially, when the future revenues are uncertain. This enables the management to spread the risk of declining revenues over a particular time horizon. Generally, an in-depth scrutiny of the bad debts or doubtful debts is not done in these companies citing external limitations.

Pre-emptive Measures

5.3 The following are some pre-emptive measures that can be taken by investigation team:

(i) Generally a lead and lag analysis and scrutiny of accounts over a three year time horizon would reflect any incident of manipulation by the management.

(ii) The cash flow analysis with external evidence of source of funds and a balance sheet audit with a reality check of true net worth of the company are highly desirable at periodic intervals.

(iii) Tracking abnormal trends/ high performers, i.e., a zero trauma' test is also a good measure to ensure timely detection of irregularities. A zero trauma is a management expectation that there are no pleasant surprises or shocks in disclosure of financial results or operating performance. From an investigative perspective any abnormal unreasonable business trend *vis-a-vis* industry experience is a factor that can be further explored. This could be followed up with background checks on persons suspected of irregularities in a covert manner.

(iv) Ensure independent vendor audits/ dealer audits, external timely confirmations, job rotations which are confidence building measures. Stoppage of the business or dealings for a brief undefined period is also a desirable practice to detect abnormalities.

(v) Stock transfers at month end or inter-unit transfers that are not confirmed in a timely manner are also a source of concern in finalization of accounts. The periodicity of such confirmation is also of importance in ensuring better controls.

(vi) Cut-off procedures for operational documents and input documents for accounting of transactions at the quarter or month end are of significance for any abnormal adjustments and these should include independent scrutiny of journal vouchers, credit notes and debit notes raised.

5.4 The following aspects are important while scrutinising manipulated accounts:

(i) The change in policy guidelines or operational methodology by management without sufficient justification is another area that is a pointer to a senior management level fraud. Such leads need to be further corroborated with external reviews such as, background checks and identification of possible beneficiaries.

(ii) The study of board meeting minute books and resolutions are another source of information that provides sufficient leads on any unfavourable decisions, especially, in a closely held company or joint ventures.

(iii) Where critical accounting entries are centralised with one or two persons in the organisation relating to journal entries or closure of books, then this would need a caution in conduct of investigative assignments. The lack of audit trail on cut-off documentation and Re.1 transactions or creating buffer of documents for creation of fictitious sales or inflating top lines are common examples of gathering leads.

(iv) Encouraging creation of fictitious expense bills for employee reimbursments in lieu of staff welfare expenses.

(v) The submission and maintaining of multiple books of account in different accounting packages. Operational records not synchronizing with the accounting records, etc., are further mechanism to gather leads.

(vi) Surprise independent balance confirmations from banks, vendors, customers, securities and assets or balance sheet audits are mechanism to establish whether the financial statements reflect true and fair view.

(vii) The procrastination of stock reconciliation, absence of stock summary, debtors' summary, debtors' confirmations or vendor account reconciliation also are lead indicators.

(viii) The 'U' alphabet series in any ledger account is important for unreconciled accounts or suspense account. There may be a tendency to adjust unrelated debit and credit balances under a common head and this is a high risk area for potential frauds.

(ix) The preparation of bank reconciliation statement and data entry or updating of the bank register by the same employee without segregation of duty is also a risk area for perpetration of fraud.

(x) The absence of supporting documents on cost grounds are also a reason to suspect unauthorized payments such as, absence of itemized bills for telephone bill reimbursement could lead to personal expenses being claimed as official expenses. The use of cash memo bills from stationery shops is a common feature for small denomination expenses frauds. The serial control over these cash memos need to be verified along with other circumstantial factors. Recycling of old bills and invoices through alteration in dates is also a common example for fraudulent expense claims. This is also prevalent in areas where food coupons are distributed to the employees.

(xi) Proper documentation for registration of patents, trademarks, copyrights and violations in these areas are categorized as high definition frauds and are difficult to unearth and may require the services of specialists. The copyrights are generally, not quantified adequately and reflected in the financial statements that may result in potential litigation.

(xii) The scrutiny of non-moving ledger accounts and inactive accounts are good lead indicators for detection of fraudulent activities. The carry forward and brought forward balances should be verified across a substantial period for any past period adjustments whether in stock or any other ledger account.

(xiii) Any inconsistency in accounting practices over corresponding previous period is an area that would need further scrutiny for any justification for changes in accounting treatment. The lack of transparency in accounting or grouping of accounting heads is also an area that provides leads to suspected irregularities.

(xiv) The transition to a new accounting package, improper data migration, delays in passing accounting entries, extensive data entry errors are indicators of fraud prone entities. Conflicting roles in Information Technology department in developing and running of programs are areas that may need engaging of information security specialists.

(xv) The lack of proper segregation between cash book and bank book is a common area for adjusting shortages in cash balances and contra entries.

(xvi) The periodic non-reconciled inter-unit balances, contra entries, absence of cheque counterfoils or incomplete entries in cheque counterfoils would need further scrutiny that could turn out to be a lead indicator.

(xvii) Bribery and corrupt practices within the organisation without adequate checks and balances on such officials. Extensive appointing of consultants and liasoning agents are, generally, indicators of organised fraud. Bestowing of discretionary power at decentralised locations without a monitoring mechanism is also an indicator.

(xviii) Organised white collar crime involve inking of contracts in a manner which leads to booking of revenue and expenses in different entities. The accounting policy of these entities could be different and, therefore, window dressing is ensured. The cash flow is also accordingly managed in a manner that is most beneficial to these organisations. However, these may indirectly result in diversion of funds to entities where a section of the management has beneficial interest. Most of these front companies or sub-contracting entitites tend to be closely held companies or partnership firms that may not be governed by disclosure norms as applicable to listed corporate entities.

Steps/ Methodologies Involved in an Investigation

Preliminary Assessment

5.5 The primary steps involve extensive planning and brainstorming sessions in getting to a gut feel on whether there is a risk of fraud in the area under review.

Generating Investigative Leads

5.6 The leads are gathered to further strengthen the above perception. First and the foremost challenge are the standards evolved by the management and to ensure a critical review of the policies and procedures that are put in place during the period wherein irregularities are suspected. The lead gathering could involve trend analysis, internal audit findings, process gaps, vulnerabilities testing and the missing link from such employees who have left the organisation or contracts discontinued under suspicious circumstances.

Data Analytics and Data Inter-relationships

5.7 Data analytics focuses on inference, the process of deriving a conclusion based solely on what is already known by the researcher. Banks and credit cards companies, for instance, analyze withdrawal and spending patterns to prevent fraud or to identity theft.

Data analytics as a technique is extremely useful in generating leads and would depend on the area of review. Data inter-relationships involving two independent set of data and logical deduction of sequence of events, time chart analysis by plotting the date and timing of events relating to the leads or irregularities, occurring of events concurrently at two different places involving the same person, comparison of data relating to two independent departments for audit trails such as stores and quality control, standardisation of data and relating it to persons, assets or movement of asset/ people are methodologies, abnormal increase in expenditure relating to a particular department or a person are very userful in generating leads.

5.8 The comparison of the average tare weight of a particular vehicle category, the consistency in consumption standards over a defined period, the physical confirmation of stock or tracking of results of data analysis with a walk through analysis of ground realities provide clues to isolate abnormalities. For example, the reconciliation of stock records with physical inventory, the gate inward of items from gate controls to consumption and stock on hand as against work executed.

Comparison of the quality control reports on rejections, qualitative classification of scrap by manufacturing units before transfer to scrap yard and scrap disposal by stores when properly reconcilied would provide a clue on adequacy of scrap billing and collections.

5.9 Fudging of production records across batches in a production line to adjust shortages and surpass quality control tests, the illegal storage of items in stock on behalf of third parties, spurious spare parts from a data analysis of frequent breakdowns and replacements, the use of letter heads and bills of vendors to book duplicate bills, use of high standards of consumption for diverting stock (aluminium ingots or other metal items) to other production lines or personal business, the use of stolen goods and rebranding the same through repackaging, frequency of MIS reports, common source of authority and responsibility allowing manipulations (usurping of authority), false accounting entries based on modification to files (especially in excel spreadsheet), false indents and production plans to remove stock of items from plant, mixing of scrap and rejected items in lieu of good stock and adjusting shortages, false incentive schemes resulting in abnormal increase in sales, absence of periodical review of outstanding statements are source of potential leads to unearthing irregularities.

5.10 Cross verification of freight bills with procurement and stock records, third party confirmation for stock retained at places outside the entity are practices that provide leads to any fictitious booking of bills. The use of multiple copies of the freight consignment notes (book copy, consignor or consignee copies) at different locations may lead to splitting of single trips into multiple freight billings.

Data Mining

5.11 Data mining is the process of extracting hidden patterns from data. Data mining is an important tool to transform this data into knowledge. It is commonly used in a wide range of applications such as, marketing, fraud detection and scientific discovery. Data mining can be applied to data sets of any size, and while it can be used to uncover hidden patterns, it cannot uncover patterns which are not already present in the data set.

Use of specific audit tools ensures greater performance in less time. The sample size is no longer a constraint and substantive checks are now feasible on entire population. The developing of scripts (software programs) enable repeated use of a defined logical analysis and are useful in generating exception reports that enable identifying abnormalities over the entire population. The use of these tools has revolutionized the manner in which investigations are conducted by providing linkages to data; intelligence is gathered in terms of duplicate entries, data inaccuracies, the linkage among sub sets of data for a meaningful analysis, etc.

5.12 The term data mining is often used to apply to the two separate processes of knowledge discovery and reaching definite conclusion. Knowledge discovery provides explicit information that has a readable form and can be understood by a user. Data miners sort through huge data sets using sophisticated software to identify undiscovered patterns and establish hidden relationships.

Information Security, Screenings and Detecting Leakages

5.13 Parallel telephone connections could be a reason for loss of business and information that would require some technical expertise to identify such leakages of information in private offices. The eavesdropping by unauthorised persons within the office premises, unauthorised retrieval/ loss of documents or removal of documents and records in relation to certain events are also a good lead indicator for any discrepancies. Employees sitting late or an accountant or cashier volunteering to undertake multiple tasks on a regular basis or late sitting in office perennially are indicators of abnormal situations. Rotation of employees across locations, mandatory leaves, etc., are good practices that result in uncovering of leads on any suspected fraudulent activities.

5.14 The abnormal entries in system, the unauthorised access, the signing of documents when the employee is not present in office, any favourable treatment to vendors, persistent employee referrals, personal information in HR records such as names of relatives of employees (father, mother, brother, dependent sister) and similar data in vendor or customer records, the use of residence telephone and dummy addresses, creation of work orders to facilitate fictitious billings or procurements, sabotage by competitors through house keeping or other agencies unknown to the client, developing informers within the entity who are in the know of happenings, communication gaps between two locations of the company, use of facsimile machine for fictitious entities operated from employee homes, alterations in the input documents and data keyed in the system, etc., may pose threat to information security.

Extraction of deleted files or unauthorised copying of sensitive information from system in pen drives, frequent system breakdown, lack of adequate back up of information or loss of information trail are useful in generating leads.

Manipulations in Basic Documentation

5.15 Use of carbon copies for marking additional figures or manipulating the expense amount is also a methodology that should be related to the basis of billings and whether proper validation exist in the bill passing procedures. Alteration in dates and amount figures or reuse of prior period bills and supportings are also means of manipulation.

Use of two independent receipt books for customer and for company bookings are another source for perpetration of fraudulent activity. Some other sources are duplicate or photostat copies of bills and receipts used for accounting entries and in maintaining of cash book, or use of memorandum books to deceive the customers and maintaining a separate books for accounting records. Improper use of all the copies of a documentation for the intended purpose such as, goods consignment notes (freight, consignor, consignee and book copies), invoice copies (customer, office copy, accounting, book copy), not scrapping and destruction of unused letter heads, invoice and receipt copies, unauthorised use of rubber stamps in bills and records for communication with customers, etc., may get used in fraudulent activity.

'Entrapments' by Fraudster

5.16 Luring of potential targets by fraudster using 'simple vulnerability testing methods' akin to a trial run before a full fledged fraud is committed. A fraudster, generally, indulges in confidence builidng measures or rapport with the potential target. For e.g., he may build confidence with the distributor or manufacturer as a preferred customer through regular business transactions and ensure prompt payments to create an image of a customer with a reasonably good credit record. This encourages the client to enhance credit limit and the fraudster creates an opportunity and defaults in payment.

5.17 The dry run by the potential fraudster is a common practice wherein the auditors' practices are studied regarding sample size, the documentation review style and time interval between two reviews. The fraudster does a dry run on a sample basis to test vulnerability of getting caught before causing extensive damages. For the purpose, he gets into a position of confidence with the internal audit co-ordination matters. Another method adopted is to create sufficient documentary trail and retain the control within the department rather than allowing an independent verification by an accounts team. At a first glance, the entire documentary trails as required by the auditors are maintained. In such situations, there is a need for cross check or independent confirmation ensured on whether the activity was undertaken.

5.18 The retention of records and documents and the manner of filing of documents for easy retrieval is a factor that also would need close scrutiny. The fraudster tends to maintain the record in a manner that makes the audit process complex within a given time frame. The records and documents may also get transferred to a distant location within a short period of time to prevent access to the internal auditors. Rewriting or creation of records and documents exclusively for internal audit purpose is also a factor that needs caution while conducting investigation assignments.

5.19 The crashing of system or loss of data is a common example that is given by the suspects in an investigative process. At times, situation may demand rebuilding of data using single entry method or based on data from external sources as a part of investigative process. The facility to add suffixes or prefixes to payee names in cheques, identical payment or receipt amount not backed by confirmation from vendors or customers are areas of suspected irregularities. The improper tax registration numbers on sale or purchase invoices or improper telephone numbers or item descriptions, photostat copies instead of originals are indicators of irregularities that would need appropriate scrutiny.

5.20 The master mind fraudster may use the services of gullible employees or undetectable third parties in indulging in irregularities.

In the event of the fraudulent activities being uncovered, the master mind remains elusive due to lack of direct evidence. Under the circumstances, surveillance and background checks is resorted to uncover such remote control based fraudulent activities. Generally, such irregularities are done in connivance unsuspecting third parties outside the organisation. These, generally, surface through a whistleblower mechanism (please refer to Chapter 11 on role of whistleblowers and informers in investigation).

Logical Deductions

5.21 The procurement of material when sufficient stock is indicated in the books or not purchasing of material at competitive prices are indicative leads. In a chemical processing or edible oil processing units quantity reconciliation in a reverse direction from output to input (flashing back akin to an ERP system) would provide sufficient direction on manipulation in stock or consumption patterns. The cross check with quality records would provide evidence of any manipulation in records vis-a-vis deviation in quality or adjustment of shortages. Any change in the frequency of MIS reports for each batch production could also be a lead indicator of any manipulation in production records.

Lifestyle and Employee Behaviour Pattern

5.22 The background checks on employees, their movements, their interactions, gathering intelligence on their lifestyle and past track records are effective means to establish integrity of employees.

Time/ Motion Study and Documentary Trails

5.23 The in-out timings of vehicles/ employees during abnormal office timings, the start and end time of activities and comparison with standard timings are examples of gathering leads. The attendance and leave records with reference to employee user IDs are examples relating information against two sets of data.

5.24 Some examples of diversion of funds include:

(a) Booking of revenue in an off-shore company while booking the expenses (manpower cost) in a local comany with marginal revenue projections. The contracts between the two companies (local and off-shore) tend to be sham contracts that help in doctoring the revenue statements. The terms and conditions of contracts are, generally, termed confidential to the audit team. The internal audits of the revenue and cost statements are based on the information as shared by the management based on certifications. This is a common problem in companies handling projects abroad or foreign companies having project offices in the country. The cost of audit of these entities is considered prohibitive especially involving travel and stay abroad. As a result, these audits of off-shore entities tend to be done locally based on photostat copies as forwarded by such entities. Confirmation of customer billings and cost becomes a constraint in these kind of internal audit assignments.

(b) The productivity analysis of the manpower cost would provide a ready guide on diversion of revenue to front companies. The expense ratios are of extreme importance in such analysis prior to engaging in a detailed scrutiny. For example, a company employed about 400 labourers for gardening and maintaining of ETP plant. The labourers used to clock in their time cards, but were predominantly used in the farm house of the head of administration department. The labourers used to be again brought back at the company premises during their official time out hours. A surprise count of labourers in a covert manner with the attendance record over a period time revealed ghost workers. A background check revealed that these were deployed for personal purposes.

(c) The purchase of heavy steel and other machineries through a front company (closely held) and inflating project cost leads to fund diversion to such entitites. These are more relevant during end use monitoring or in due diligence audits on behalf of banks and financial institutions.

(d) A foundary was sub-contracted the job of preparing moulds for two wheeler hoods. The input material was aluminium ingots that was procured by a listed company and supplied to the front entity on a contractual basis. The front entity has estimated high standards of consumption that resulted in diversion of aluminium ingots for other applications such as, manufacture of fan blades, etc. The standard loss of aluminium ingots was never challenged. Similarly, this is a common problem in supply of MS sheets and other metal items to fabricators.

(e) Competing bids is also a common method for diverting the business to front companies. Here the front company along with the main corporate entity becomes joint bidders to garner larger market share. This is a common factor for fraudulent activity wherein designated officials start clandestine operations of floating private ventures and diverting business while in employment with the main company.

(f) Another difficult area of investigation is uncovering of front running practices wherein employees indulge in placing their personal interest first while engaging in large security trading deals on behalf of the company. Fund managers getting secret commissions is also an area of serious concerns that is difficult to uncover and may require the services of specialists especially involving background checks. Most company's except for obtaining declarations from employees do not monitor these dealings as these tend to be managed through brokers or persons who do not come under the purview of term "relatives". The settlement of the deals in these dealings may happen at an uncertain future date or cross deals among entities.

(g) In a company, cash receipts issued to customers clearly stated the purpose for which the cash was collected and ensured greater transparency on charges that were levied and collected from customers. This provided a trail of account heads and the purpose for which the amount was collected from the customer. This provided greater accountability on usage of funds and detection of any diversion of funds for purposes other than what these were meant for. The CFO decided to overcome this problem of accountability by removing the detailed break-up of the charges on the face of the receipt to divert funds for purpose other than what the customer has paid for.

5.25 Certain resources such as IT support and technical support may not be required in every form of investigative assignment. These may, therefore, be outsourced on a need basis to maintain cost competitiveness in execution of the assignment. These agencies are more in the nature of specialised service providers in gathering of evidence. For these agencies an interview with the user can yield valuable information about the system configuration, applications, encryption keys and methodology.

Collecting Digital Evidence

5.26 Digital evidence can be collected from many sources. Obvious sources include computers, cell phones, digital cameras, hard drives, CD-ROM, USB memory devices, and so on. The principles applicable in detection of cyber crime can be applied effectively and consistently to a relational database. Additional copies of database evidence are made in order to preserve the evidence for future presentation during a legal process.

5.27 Other specific practices that have been adopted in the handling of digital evidence include:

(a) Handle original evidence as little as possible to avoid changing the data.

(b) Establish and maintain the chain of custody.

(c) Documenting everything that has been done.

(d) Only use tools and methods that have been tested and evaluated to validate their accuracy and reliability.

Imaging Electronic Media (evidence)

5.28 The Chartered Accountants should use the support of Technical experts for capture of evidence or for working on a database in the investigation process. The process of creating an exact duplicate of the original evidentiary media is often called **Imaging.** Using a standalone harddrive duplicator or software imaging tools, the entire hard drive is completely duplicated. This is usually done at the sector level, making a bit stream copy of every part of the user accessible areas of the hard drive which can physically store data, rather than duplicating the file system. The original drive is then moved to secure storage to prevent tampering. During imaging, a write protection device or application is used to ensure that no information is introduced onto the evidentiary media during the investigative process.

Time Flow and Document Flow Reviews

5.29 The time flow and document flow analysis with reference to an activity where fraudulent act is suspected provides vital clue on the following:

(a) The time avaliable for manipulation in data entry;

(b) The lead and lag between happening of event and recording in system;

(c) Any mismatch in events in the entire sequence of an activity can be uncovered;

(d) Any loss of data or human intervention can be uncovered; and

(e) Any destruction of evidence can be uncovered.

CCTV Footage

5.30 CCTV cameras with various resolutions are fitted at key installations and locations. These have a defined storage period and a back up policy defines the storage of data up to a particular time period. This provides physical evidence of events happening at sensitive locations for further analysis.

Flow Charts

5.31 There are software tools that enable relational database analysis and provide leads on linkages between people who might be remotely connected in a fraudulent activity or who are associated with a fraudulent activity. As data is captured the critical data such as, address, telephone number, activity and other details are mapped and when the exercise is complete the flow chart displays the linkages.

Financial Ratios

5.32 Financial ratios provide a good insight in identifying areas of concern; these ratios can be considered as a starting point in the analytical process and even help in assessing the impact of fraudulent activity. Unlike the normal evaluation of business performance using these ratios, a shadow profiling of company's activities need to be undertaken that will enable the investigating officer to isolate key concerns. For example, a favourable inventory ratio could be due to improper valuation of inventory, change in consumption standards during the year as compared to the previous year, write-off of inventory, fictitious purchases or inventory considered without booking of purchases, excess provisioning, etc.

5.33 The basic thumb rule for investigative an assignment is to obtain independent corroborative evidence on whatever documentary or circumstantial trail is placed before the investigating team. The simulation techniques of recreating the sequence of events in gathering leads and in defining milestones in the investigative approach would help drive the entire assignment.

Chapter 6

Diagnosing Fraud Behaviour

Chapter Summary

Since fraud is usually concealed, material misstatements due to frauds are difficult to detect. Nevertheless, the auditor may identify events or conditions that indicate incentives or pressures to perpetrate fraud, opportunities to carry out the fraud, or rationalizations to justify a fraudulent action.

Such events or conditions are referred to as "fraud risk factors". Fraud risk factors do not necessarily indicate the existence of fraud, however, they often are present in circumstances where fraud exists. When obtaining information about the entity and its environment, the internal auditor should consider whether the information indicates that one or more fraud risk factors are present. The internal auditor should use his professional judgment in determining whether a risk factor is present and should be considered in identifying and assessing the risks of material misstatement due to fraud.

Fraud Triangle

6.1 The factors that should be identified and removed to deter fraud (as described above) are best described in the "Fraud Triangle." This idea was first coined by Donald R. Cressey. There are three Fraud Triangle conditions that are present when a fraud occurs. First, there is an incentive or pressure that provides a reason to commit fraud. Second, there is an opportunity for fraud to be perpetrated (e.g., absence of controls, ineffective controls, or the ability of management to override controls). Third, the individuals committing the fraud possess an attitude that enables them to rationalize the fraud.

6.2 The Fraud Triangle describes three factors that are present in every situation of fraud. According to it, the three main factors that induce a person to commit a fraudulent act would be as follows:

(i) *Motive (or pressure)* – It is the need for committing fraud (need for money, etc.). This is a key ingredient to any illegal activity more relevant to criminal law. Usually, in case of frauds, the motive is quick and easy financial gain. The motive could emanate from economical, social or personal prejudices.

(ii) *Rationalization* – It is the mindset of the fraudster that justifies him to commit fraud. When a wrongful act is justified, the fraudster is emboldened to carry out such acts.

(iii) *Opportunity* – It is the situation that enables fraud to occur (often when internal controls are weak or non-existent). A person with fraudulent tendencies looks for opportunities when there is a least likelihood of detection. For the purpose, such a person may indulge in trial runs and test the vulnerability on a sample basis. As the confidence level increases, there is a tendency to increase the frequency of such acts and cause further damages. The fraudster is, generally, aware of the consequences and takes a calculated risk.

6.3 While it is extremely difficult to prepare a comprehensive list of factors that lead to commitment of fraud as these cannot be generalized to any given situation, the following are the reasons that may help identify the perpetrator of fraud or in evaluating whether an organization is susceptible to a fraudulent activity:

(i) Crossing ethical barriers due to personal pressures such as, performance targets and personal habits.

(ii) Business strategies overriding control environment and effective governance with undue emphasis on targets and compensation.

(iii) Disgruntled employee with revengeful attitude.

(iv) A liking for breaking defined rules with employees displaying resentment to directions from superiors.

(v) Greed and deceptive behaviours.

(vi) Operating and financial decisions are dominated by a single person or few persons acting in concert.

(vii) 'Subject' normally is evasive to audit queries and has frequent disputes with auditors coupled with a weak control environment. There are obstacles in ensuring proper audits and significant difficulty to audit certain transactions due to absence of adequate audit trails and documentation. There may also be lack of awareness about internal controls. Sometimes, the audit recommendations are not considered pragmatic and are ignored.

(viii) Undue empowerment of authorities at decentralized locations.

(ix) Financial results are inconsistent with the industry.

(x) Excessive cash transactions without adequate control such as, extensive balance confirmations or customer reach out programs.

(xi) Common Red Flags —

- Significant inventory surplus/ shortages;
- Rising trend of operating expenses;
- Unexplained rise in cost of goods sold;
- Sudden decrease in profitability;
- Spurt in material orders at the time of employee resignation; and
- High level approval of a trivial transaction.

Fraudster uses simple common sense and not complex logic

Before Fraudulent Act	***After Fraudulent Act***
Amount in payment voucher approved by receiver before presenting to cashier had a blank before the amount in figures of ₹ 100. Rupees 100 Total 100 (One hundred only)	Amount One thousand was inserted in payment voucher approved by receiver before presenting to cashier. (amount altered to ₹ 1,100) Rupees 1,100.00 Total 1,100.00 (One thousand one hundred only)

Common Indicates of Fraudulent Activities

6.4 The following are some common indicators of fraudulent activities:

(i) Alterations made to sensitive documents through:

- Overwriting on existing contractual rates; or
- Use of photostat copies to hide manual alterations.

(ii) Use of internet as a means of deceptive communication.

(iii) Use of websites as tool for deception.

(iv) Impersonation and use of scanners for forging signatures.

(v) Creating avenues to deceive through cleverly drafted policy guidelines.

(vi) Loss booking through fake vendor bills.

(vii) False sale orders, financing arrangements and customer realization.

(viii) False entities and use of fax messages in these names for business.

(ix) Fake academic/ qualification certificates.

(x) Computer generated bills for consultancy or labour bills that cannot be corroborated.

(xi) Splitting/ duplication of bills.

(xii) Submission of inflated bills for documentation purposes such as, loan processing, medical reimbursements, etc.

(xiii) Declaring insolvency and diverting assets to relatives and/ or known persons.

(xiv) Creating avenues for mishaps for availing insurance claims.

(xv) Planting persons for sabotage of competitor's product launch.

(xvi) Stealing of confidential strategic information and selling them to competitors.

(xvii) Loan borrowed from local money lenders are reflected in books as advance from customers towards sale orders.

(xviii) Identity theft.

Case Studies

6.5 The following are some case studies on fraudulent activities:

(i) The audit coordinator in a company was getting impatient on the slow progress on the audit front and was hinting at serious irregularities in several audit areas that need immediate attention. While he was forthcoming with extensive details, a closer view of his responsibilities revealed conflicting roles and override of authority. He was indulging in wrongful activities and was trying to divert attention of the auditors.

(ii) The stores personnel explained to the auditor that the local scrap dealer was a brother of a local politician and was a powerful man. He suggested them to avoid venturing out for physical verification of stock or any confrontation with the scrap dealer. A closer review of the operations revealed that the storekeeper himself was being bribed and was indulging in issuing false gate passes for removal of material. The gate pass for MS and aluminium scrap as per the company policy manual was to be signed by Stores section and for garbage the same was to be signed by Administration department. Incidentally, the gate pass issued by stores section had indicated the item lifted as garbage and not scrap items. The security cell was not aware of the authorised signatory though a manual existed resulting in fraudulent activities.

(iii) A senior official was getting irritable with the auditors even for trivial audit queries. This made the auditors suspicious. Further investigations revealed that he was engaged in siphoning of funds by manipulating creditors account, bank reconciliation statement and payment vouchers. The primary lacuna was non-verification of the source document by the cheque signing authority and instead the signing officer used to see the balance outstanding in the system. The suspect convinced the software professional to provide a facility of shifting the vendor codes in the system that enabled shifting of the transactions from one ledger account to another without a journal entry. This facilitated the issue of duplicate cheques to the same vendor accounts and misappropriation of funds through opening of dummy bank accounts and tampering of cheques by adding suffixes in the payee name. The internal auditor uncovered the fraudulent act while comparing the vendor related transactions with the material inward entries. The gate passes of earlier years were reused by modification to the input documents to cover up the duplicate entries. The internal auditor also found manual corrections at the input stage of the material inward records. There was no segregation of duty in preparing the bank reconciliation statements. The suspect was involved in software development, in scrutiny of creditors ledger account, in generating of payment vouchers, in preparation of the vendor cheques, took over the charge of assisting in preparation of bank reconciliation statement, was responsible for handover of cheques to vendors and was also in an uneviable position in matters involving strategic decisions.

(iv) An employee at a decentralised remote location had no avenue for promotion; yearly pay revisions were low despite his best performance on the work front. Alternate job was difficult to find in the place where he was posted. His income was insufficient to run the household expenses that included payment of house rent, education of two school going children and food expenses. He was frustrated and had lost faith in getting any response from the management. He had the need and was looking for opportunities to bridge the imbalance between his income and expenses.

He booked the creditors' bills (expenses related to office administration expenses) both as cash as well as credit purchases. The cash payments were pocketed by him, and the creditors were paid from the head office by cheque at monthly intervals. The internal audit coverage at such a remote location was not a regular feature. A scrutiny of the petty cash register with the ledger and control check points revealed duplicate entries, both in cash and credit entries, being made by the employee.

(v) A foreign company engaged in e-education business had its operations in India and funds were remitted on the basis of projections given by the Chief Financial Officer. There was a budget exercise done at the beginning of the calendar year for the following financial year. To the extent the budget remained less utilised, a downward revision was ensured. The time taken to remit the funds was of one month from the foreign Corporate office based on a internal due diligence exercise. The Chief Financial Officer, in order to ease the funds requirement, started indulging in excess provisioning and creating secret reserves. The greed overtook his needs and he started indulging in booking fictitious bills. The collection of letter heads and blank bills from vendors became his habit. Further, booking commission payments and false consultation charges bills were other means he used to inflate the expenses. These enabled him to disclose increased unitilisation of sanctioned budget amount. Initially, the Chief Financial Officer used these methods to manage funds shortage in the transit period. For the purpose, he opened bank accounts in the name of relatives who were not part of the definition of the related party transaction disclosure requirements. This also resulted in opening fictitous entities (proprietary firms) for the purpose of transport hire companies, HR consulting firms, recruitment agencies, and advertisement agencies. Contracts were entered with these entities to bring sanctity to the dealings. This resulted in diversion of funds through booking of expenses against these entities. He outsourced the entire accounting function (data entry activity) to ensure that these activites are not detectable by in-house employees. He also gradually replaced old time employees by new recruits known to him and supportive of his actions. During the investigative process, he defended and explained to the internal auditor that the company officials from abroad were victimising him and that there won't be any discrepancy relating to documentation and supporting to the vouchers. This statement under the circumstances gave sufficient lead to the internal auditor and the case was solved in no time as the perpetrator of fraud was fabricating documents to claim fictitious expenses and falsification of financial statements. The required evidence in the form of unused letter heads, rubber stamps of all the entities were recovered from the office premises thereby providing conclusive evidence.

Chapter 7

External/ In-house Investigations

Chapter Summary

When does one realize that the internal audit gets into the nature of an investigative assignment? Simply stated it is a matter of common knowledge that when there is a doubt involving dishonest intention then the nature of assignment gets modified. Although there is no ready formula for the conduct of an investigation, it is desirable that such assignments follow a set framework of execution. The chapter elucidates the importance of mandate and confidentiality in an investigation irrespective of whether carried out in-house or through an outsourced agency.

Mandate for Investigation

7.1 While starting an internal audit, if we stumble across areas that are touching upon a suspected fraud, pause for a moment; think about the area that is creating an issue for the company, persons who are involved, materiality of the transaction and its impact on the overall operations. Sometimes, the management may be reluctant to spend time for unnecessary work. For instance, issues such as duplicate bill being submitted for Travel Allowance can be handled even by a departmental head without any special investigation. During the internal audit one should be alert to areas that need special attention. It is always preferable to prepare a summary report and submit it to the Head of internal audit department or bring it to the notice of the immediate superior in the reporting hierarchy. The message is not to commence investigation without a formal mandate.

7.2 It could be possible that the internal audit assignment is carried out by outsourced firm in an organization or by an in-house audit cell. The basic requirement when faced with such a situation where audit takes the form of an investigative assignment is to seek a referendum from the Chief Audit Executive. Further, the objective and methodology in an investigation also depend on this mandate. From the client perspective, the investigation by an external investigative firm carries a greater acceptance considering the independent nature of the assignment.

As a matter of principle, the ability of the firms in conducting investigation is of paramount importance in awarding an investigative assignment. Similarly, it is essential that the private investigators accept assignment for which they have the domain expertise. The greatest conflict arises when an investigation is carried out by an investigative arm or a subsidiary in an organization for its competitor.

7.3 During the course of audit one does comes across situations of suspected fraud. In this case, it is better not to come to a hasty conclusion alleging that a particular employee or person has committed a fraud on the company. As an internal auditor, one must put facts in an assertive manner to the extent that the reporting officer may take a serious note of the problem addressed and is convinced that there is a need for a thorough probe. The management's immediate reaction to a fraudulent activity is to seek explanations from the internal auditor on whether any vulnerability was noticed in the past and brought to the notice of the management through their internal audit reports.

7.4 What constitutes a mandate for an investigative assignment ? A mandate provides a medium to clearly understand from the client or the head of the internal audit department, the objective for undertaking an investigative assignment. This is essential in the context of defining the areas of review and the restrictions and the jurisdiction beyond which a person is not supposed to extend his review. It also enables ascertaining the available time limits to conduct the investigation. Where there are time constraints, the investigating officer may find himself at the wrong end, affecting the quality of work in execution of the assignment. Delays may result in action being taken on the wrong person, denying promotion or not declaring bonus to a deserving employee in the interim thereby affecting the reputation for the investigating personnel and the client at large.

The mandate in case of an external investigation covers the following:

- **Terms of reference**
- **Engagement letter**
- **Investigation methodology**
- **Resource deployment (optional)**
- **Fee structure and expense reimbursements**
- **Limitations and restrictions**
- **Security concerns and safeguards (optional)**
- **Expected deliverables (may not always be feasible to predict)**
- **Reporting requirements.**

7.5 Contrary to the above there are circumstances during an internal audit when a 'perpetrator of fraud' (suspect) would be anxious to know the audit approach of the internal auditor including the audit plan, the scope of coverage and the time schedule during which the audit will be conducted. He will constantly attempt to read the auditors' thought process and is most likely to try to remove the critical files or documents that contain vital information. In case an internal auditor is apprehensive of vital documents being removed or there is sufficient ground to raise suspicions, it is advisable to secure the documents, the photocopy at least and where permissible the original documents too should be kept in a secured manner. The client needs to be formally notified as they may need these documents for further action.

7.6 A screening of the prospective client who approaches for investigative assignments is also preferred by the private investigators. This is due to some considerations. Normally, assignments on behalf of individuals or partnership firms are not accepted as there are difficulties experienced in settling the assignment fee and subsequent recoveries. In exceptional circumstances, where the stakes are high and client relationships matter then such assignments are accepted in the larger business interests. The second important aspect is the background of the client who approaches the investigative agencies. Where the stature of a client involves a reputation risk for the investigative firm, there may be an aversion in conducting assignment for such clients.

7.7 In case of accounting and audit firms that specialize in investigative assignments, clarity of thought must emerge within the investigation firm in relation to conflict of interest that may arise in terms of other client engagements. For instance, in a client relationship the acceptance of the assignment or the outcome of the investigation may result in conflict of interest with reference to the other assignments handled by the same investigating entity.

Abundant caution is required in ascertaining whether the investigative process is being used as a ploy to settle scores in disputes wherein the investigating officer is used as a pawn in the removal of evidence in order to weaken the defence in a legal proceeding. Further, caution is also needed in ensuring that the engaging client is not drawing the investigative firm as a party to a potential litigation or making them a party to a legal suit filed by the engaging client.

Letter of Engagement

7.8 The most important aspect in initiating the investigative process is the preparation of the letter of engagement (LOE). For in-house investigative assignment these could be alternatively supplemented by an inter-office memo (IOM) or a mandate given to a subordinate officer from his reporting superior. Whether it is a LOE or an IOM, there should be abundant clarity in the subject matter for investigation. This should be listed down at the time of engaging in a discussion with the management or the concerned superior. Any additional work that is required to be done during the course of the assignment should be backed by separate mandates. In a situation, where the investigative process involves engaging the services of other vendors then the same should be stated clearly to the client. For example, in an investigation involving scrap disposal, for establishing whether the rates negotiated are competitive or to understand impact of fluctuation in steel price, there may be need for engaging the services of a vendor to gather the requisite information.

7.9 When using the services of a vendor, it is essential to verify whether there exists any conflict of interest in engaging his services *vis-à-vis* other assignments handled by him for the client or a competitor/ third party. In some cases, there may exist any relationship wherein the vendor happens to be related to the client or such third party. Alternatively, whether the vendor happens to be related to the person against whose actions as a result of investigation process is being initiated upon. As in the case of LOE and IOM, there has to be a contractual arrangement in engaging the services of a vendor, including a non-disclosure agreement with such vendor as otherwise there could be legal hassles if confidentiality of information is not maintained. Especially, where the vendor is not professional in his approach and happens to be a small time vendor who may not be aware of the implication of his actions. It is essential to make such vendors understand that he or his personnel cannot indulge in loose talk about the matter being investigated in public domain. In the above example of ascertaining the rates for disposal of scrap, the vendor while indulging in 'mystery shopping' should not divulge to any person whether internal to the client company or any outside person of the matter that is under investigation. The agreement with such vendor should include a liability clause for the purpose. In a nutshell, the mandate which the investigating officer has with the vendor should also be properly documented.

7.10 There should be a clear understanding in any investigation process, as to who will be the key contact person. A single point of contact is most preferred and can either be the Chief Financial

Officer or the Chief Executive Officer. The discussions on the matter being investigated should not be delegated to a junior person in the hierarchy. Many a time the client may not be in a position to appreciate this aspect and, therefore, it is imperative that the investigating officer should take the management into confidence in ensuring better control over the investigative process by holding discussions with senior personnel.

Non-disclosure Agreement (NDA)

7.11 There should also be a Confidentiality Agreement or Non-disclosure Agreement (NDA) between the investigating officer and the client. There is a general presumption that such a NDA is required for investigation assignment to be carried out by external agencies. This is not true and such an arrangement is equally applicable to an investigation conducted by an in-house department, and it should be specific to the matter being investigated. As otherwise where this precaution is not taken, there is a tendency to discuss the matter at public places where a person inadvertently reveals classified information. The personnel in charge of investigation, in whatever capacity, should be made aware that they will be held responsible for any leakage of information relating to the matters under investigation. Even within the same department (whether within investigation agency or in the client company), the information on investigation is to be shared on a need to know basis. The members within the investigation department may not be privy to all the information or assignment handled.

Case Studies

7.12 The following are some case studies on aspects discussed above:

(i) A leading private company had reported loss of nearly ₹ 400 plus crores due to unauthorised investments by the managing director of the company. There is an element of delegation of power in matters relating to investments. Front running (akin to insider trading where employees riding their personal investments along with large scale investments on behalf of company) was a common phenomenon in regular business transactions that was difficult to monitor and was left to employees for self-declaration. Matters on business strategies were, generally, discussed at the board level and were not considered appropriate to be discussed with the internal audit functionaries due to strategic nature of the activity. Such a situation brings us to the question that who would be responsible for reporting on management fraud.

The internal auditor would need to define of the scope of the assignment once a mandate is given to him through a letter of engagement. The diversion of funds or assets is a common ground for most investigative assignments. The difficult proposition is to establish that these were unauthorised investments not referred to the board. Generally, a blanket right is given to the senior management within an overall limit. This could be stated as background to the assignments and rights under these powers that were abused. The internal auditor would seek special permission to probe into the aspects relating to diversion of funds to the personal account of the suspect or his relatives through these unauthorised investments. These may involve some part of the review being outsourced to outside firms and referral to legal experts. The investments could be fungible and exchanged for other benefits that are difficult to fathom. These could be cited as limitations. For how long these investments remain vested in various related group companies of the managing director is also a matter that needs to be taken into consideration for highlighting any abnormalities in reporting to the Board.

The above situation clearly highlights that the mandate for investigation is of paramount importance in understanding the management expectations.

(ii) An investigative firm is appointed a vendor for certain support services. There was a dispute between the main investigative firm and the vendor in sharing of reviews in accordance with the agreed terms. At a later stage, the vendor felt that the amount he had agreed was not sufficient with respect to the work assigned to him. He had secured certain vital information during the investigative process. He threatened to sell the information as there was no direct agreement with the client. Where did the investigative firm failed in its engagement finalising process?

There was no confidentiality (non-disclosure) agreement with the sub-contracting firm binding him to act in a defined manner in relation to client information. (The example is illustrative and is not purported to be a real life example.)

Chapter 8

Pre-requisites of A Good Investigation

Chapter Summary

In any investigative assignment, the rights available under the law of the land must be respected and awareness of the local laws and regulation is absolutely essential. Whatever may be the compulsions, any violation of the rights of individual or tresspass would be counter-productive to the investigative process. While this may sound to be stating the obvious, let us understand the implications of actions to the contrary.

Methodology Used for Investigation cannot be Fraudulent

8.1 One ponders 'whether the use of deceit in conduct of investigation is permissible'? It is a fundamental principle to any investigation that the methodology used for investigation to surface the truth cannot be fraudulent. The Indian Penal Code refers to cheating as an act of using deceit on anybody to achieve valuable gain or causing loss to such other person. In the context of an investigation, where there is a use of deceit in ascertaining the truth, such a conduct by the investigating officer may land him into trouble and he may be susceptible to a criminal and/ or civil litigation suit being filed against him. The use of deceit can result in committing the crime of 'cheating' in the eyes of law. For e.g., any misrepresentation by the investigation officer (Chartered Accountant) as representing a company say 'XYZ' and thereby gathering information or enabling action or refrain by the subject can result in trouble to the investigation officer. There is a risk of litigation that the investigating officer should bear in mind. Hence, one should refrain from use of illegal means in the conduct of investigative assignments and act within the laws of the land.

8.2 There are two facets to an investigation. First, these may relate to accounting records and documents, largely internal to the organisation with certain validation checks from external agencies. However, in investigative parlance where the accounting entries seem to be concocted or there is a doubt on the veracity of the transactions, external checks may also be needed. The second facet of the investigation involves gathering of information on out of books entries, background checks or surveillance on the suspect or any person external to the organisation. The later aspect of the investigation could preferably be outsourced/ sub-contracted or done by experts or specialisits (qualified professionals other than chartered accountants such as, legal experts or informers) who are in a position to provide advise or corroborative information that could clear the doubt or confirm the wrongful activities. Such specialists/ agencies have a network of contacts in the market and their predominant daily routine consists of engaging in field activity. They are in an advantageous position to collect information, and to assess the market scenario. These agencies are in a position to carry out the field work legitimately too. Instead of carrying out the entire facets of investigation by Chartered Accountants, it is preferable to sub-contract or develop sources/ vendors. It is desirable that appropriate monitoring mechanism is in place for such external vendors/ sub-contracted activities by the Chartered Accountant firms.

8.3 Such an arrangement should be documented through an agreement describing the purpose of the engagement, the deliverables and the use of legitimate means to gather the requisite information or monitor the action. For e.g., let us examine a situation where the company has anonymous information that the bidding process for sale of assets is a facade as the entire operation is done through a team of bidders who are operating in a cartel, and there seems to be a collusion with certain officials in the company in fixing the bid price and the entire decision on whom to sell to and the sale price is doctored. As a result, the entire open bid process is clouded as a sham transaction. For gathering information from the market, or bidding for contracts, there are genuine operators whose job is to solicit information within the legal realm.

One of the approaches to this investigation could be to engage the services of specialist bidders and ensure engaging surveillance specialists who are better suited to conduct background checks and 'shadowing' targeted individuals, to establish truth about the allegations. Such an arrangement in the conduct of 'mystery' shopping or surveillance is referred to outsourced agencies, which are backed by formal agreements explicitly stating the use of legal means and abundant safeguards in getting the required information. Once a list of vendors is given to these agencies, they normally do possess the skill sets to ascertain whether any relationship exists among vendors, where they meet and whether any cartel exists, etc. This type of work is more suitable to a person who is adept at field work, who can do the surveillance, who has much more network in the market in which these vendors operate, who can with in the legally permissible limit intrude into these vendor companies and understand their operations.

8.4 As an investigation process, this work of surveillance can be entrusted to them by ensuring that the terms of engagement with such parties are legal. For instance, it may be stated that a group of vendor companies have given their quote to buy certain material. It may be requested to find out the following:

(a) Whether the constituents of the groups of vendor companies are related to each other.

(b) What is the reputation of these companies in the market?

(c) Are they really dealing in this material?

(d) Are their partners, proprietors or directors inter-related?

It has to be explicitly stated that keeping in view these objectives, no methods that are contrary to law will be used and all norms will be adhered to. The above ensures protection to the investigating officer (Chartered Accountants) and the Company that engages these services.

Avoid Impersonation during Investigation

8.5 Impersonation from a fraudster perspective involves identity theft. This is usually a situation where the criminal is trying to assume the identity of another, in order to commit fraud, such as accessing confidential information, or to gain property not belonging to them. This is also known as social engineering.

In this context, impersonation in place of another person/ fictitious person in an investigation is not acceptable. In this scenario, the subject believing the person who is indulging in impersonation may be revealing certain information vital to the investigative process that still will be considered as a deceit. In the eyes of law the investigating person has played a mischief and can be construed as a criminal offence and the investigator can be taken to task in a civil court and even sued for damages or criminal suit may be filed. Thus, in the pursuit of ascertaining the truth in the matter under review, the investigating officer may land in trouble.

8.6 Let us explore another scenario in the context of search and seizure in the investigative process. In a private investigation, where there is information that letter head, quotations, duplicate bills by the purchase officer or buyer are retained in his house, despite there being confirmed information, there is no right to enter the house. Such search operations can be done only in client's office or in such other office where the work is assigned. Even as an internal auditor one cannot search and seize material evidence, from the private desk of the 'subject' without seeking prior permission of the superior officer for possession of such material that can be produced as evidence.

8.7 The legal point of view is that there is no such authority of search and seizure to a private investigator (Chartered Accountant). Suppose bills, letter heads are in the private possession (outside the client's office premises) by the purchase officer; there is no right of search and seizure and tresspass in the investigative process to the private office or home of the suspect. To conclude, a private investigating officer (Charetered Accountant) does not have the right of search and seizure. One can however carry out search and seizure operations within the office premises (of the client) where he is working for the organization.

The traits of an Investigator can be summarized as under:

- **Confidentiality, Honesty, Integrity**
- **Trust/ faith**
- **Composure**
- **Capability, knowledge, skill**
- **Experience.**

Precautions in Investigative Assignments

8.8 The stakes at times in an investigative assignment are high and there are compulsions wherein a suspect tries to indulge in assessing the strength and weakness of the investigating officer (members of the investigating team). He is curious to know the strategies and tries to wipe out evidence or creates stumbling blocks or distractions in the investigative process. It is essential for the investigating officer (Chartered Accountant) to be unbiased, to build trust among the team of investigators and vendors. He should not compromise position during the course of investigation due to threat or other inducements and adhere to the code of conduct norms of the Institute of Chartered Accountants of India. The secrecy of information is also a matter of paramount information, and should be above personal prejudices among the team members. Care should be taken to brief inexperienced team members not to indulge in planting of evidence to improve the chances of success in an investigation. This may prove to be counter productive and harm the investigation process. The biggest task for a lead investigation firm is to prevent the chances of selling or sharing of information to undesirable sources. Thus, it is equally essential to build appropriate checks and controls in the investigation process. The management also must take abundant caution in engaging the services of private investigators as the fee largely depends on the man hours spent and scope of the engagement that is not, generally, within the control of the management. There is, therefore, a need for constant updates on the progress made in investigation and ensure that there is no perception that there has been an undue advantages in the minds of parties to the engagement.

8.9 Perhaps the biggest security for an investigating officer is when he represents an organization (a Chartered Accountant firm) or works as a team, as distinguished from working in an individual capacity. This mitigates the threat on the investigating officer (an individual Chartered Accountant) on duty as the suspect is dealing with an organization (firm) and any physical assault or threat to the investigating officer will act against his interest. It is also preferred that there is adequate security cover provided to the investigating team. Such a protection may not be always possible and an investigating officer is expected to exercise diligence in taking decisions and is answerable for his actions.

Case Studies

8.10 The following are case studies highlighting the abovementioned aspects:

(i) The internal auditors of a reputed multi-national company brought to the notice of the head of the legal department that certain abnormal travel and administration expenses could not be corroborated with the corresponding legal activity. There were fictitious letter heads and rubber stamps of outside entities. The evidence was not in the private office of the persons claiming such expenditure.

The abnormal expenses could be identified through the inadequacies in the supporting documents for travel, local conveyance and recording of minutes. These were not conclusive and similar practices were followed by most other departments within the organisation. Any implication of a particular staff in legal department to the exclusion of other departments would have resulted in a biased investigation. Finally, the evidence was available through scrutiny of the itemised cell phone bills, the outward records maintained in the despatch section and the boarding and lodging bills of the concerned employee. These pointed out that the expenses were of personal nature and not related to business activity. The investigation in this manner was finally concluded without resorting to trespass into the suspect's private office to gather the evidence.

(ii) An internal auditor in the course of audit review and validation of the audit findings was on a field visit on an asset tracing job in a finance company. A review of the R.T.O records revealed that the vehicle had changed hands. The documents that were handed over to a broker for completion of R.T.O formality were misused and vehicle had been sold to a third party under a bank finance arrangement. The finance company officials were not aware of this vehicle changing hands and they had repossessed the vehicle. Since the papers submitted to the R.T.O were cleared by the finance company employee though misused by the broker, the company had no right to repossess the vehicle as the banker had the rightful lien over the asset. The new borrower threatened to register a police complaint against the finance company officials and as a result the vehicle had to be released back.

(iii) The former employees of a company colluded with outside elements and started a competing business with the company. The company was dealing in a product that was not available in the local market and imported the same from its manufacturing units abroad. These groups of people (former employees) used an insider to divert this product to a place outside the manufacturing unit. The internal auditor summarized the following:

(a) In the production planning process, the indents placed were in excess of requirements. There was no confirmation on record of the material shipped vis-à-vis indents received from some of the locations.

(b) The daily MIS was converted into a monthly MIS for monitoring loss in transit and manufacturing loss.

(c) Certain new local transporters were appointed and contracts entered. The freight bills for these transporters were cleared within 15 days as compared to 30 days of credit allowed to other transporters. Authorization rights/ approvals for freight bills were localized in the recent period of audit that was hitherto approved from Head office.

(d) The material was shipped to a local unit outside the factory premises and material transshipped to outside elements. The transport operator was a conduit in this process and was paid in cash immediately on transshipment of goods to outside elements. The internal auditor could not trespass into the transit unit as the same belong to outside parties not belonging to the company.

(e) A review of the local transport freight bills and cross verification with the security guards and outside informer helped establish that the vehicle belonged to the spouse of the indentor employee. The same was corroborated through the R.T.O office records (external validation).

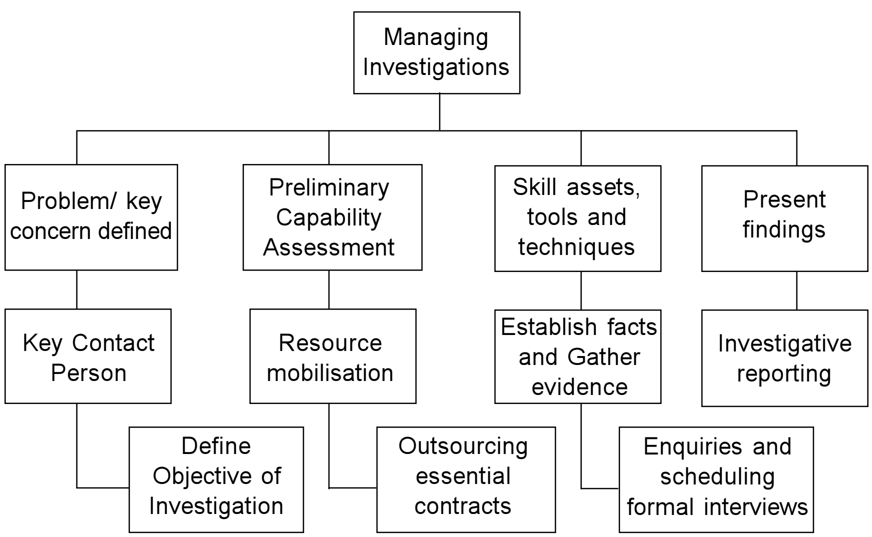
(f) Based on the reconciliation of the Form F under the Sales Tax Act for inter-state stock transfers, it was concluded that the indents were fabricated and the material was diverted to outside premises amounting to theft of the goods.

Chapter 9

Managing Investigative Assignments

Chapter Summary

This chapter provides an overview of investigative process starting from problem definition, capability assessment, skill sets required, mobilisation of resources, time and cost estimates to final presentation of the results. The importance of planning, client confidentiality and precautions on use of tools and techniques to a limited extent is also elaborated. While an attempt is made to make the reader aware of the pre-requisites of handling an investigative assignments, however, these would primarily depend upon client expectations and status of trails available in carrying out an investigation.



9.1 The investigators have to conduct assignments in varied business enterprises with varied situations. Fundamentally it is their approach in managing the assignment and skill sets that are important. An investigator may not be fully aware of the domain knowledge of the business enterprise where he is commencing an assignment. However, he must have the ability to quickly grasp information on business process knowledge, people engaged, critical documentation requirement, activity flow and timing of these activities, and also the chain of authority and responsibility within the organization or environment in which the investigation is being conducted. He thereafter looks for any clue based on deviation in these processes. He is expected to apply the skill sets as may be required in a given situation.

Problem identification - Key Concerns

9.2 The objective of carrying out the investigation will depend upon the key concerns expressed by the client. There could be allegations against employees that need to be corroborated like, kickbacks and allurements to employees, appointment of business heads, extension of services of employees as a matter of gratitude, propriety audit for key managers leaving the entity, red flags identified by internal auditors, information gathered from whistleblowers on unusual or unacceptable practices, contractual arrangements to the detriment of the company, misuse of authority, conflict of interest, breach of contract, attempt to sabotage a product launched by third parties or competitors, the leakage of research and development papers, clandestine transfer of secret product formula, damage claim filed on the company and validation thereof, disputes among key constituents of a business entity, formation of dummy companies operating against the interest of the company, misinformation or falsification or distortion in financial results by management, theft on the company, spurious and counterfeit products affecting the companies market share, etc.

Preliminary Capability Assessment

9.3 Vetting of the key concerns is the first step in confidence building exercise with the engagement client. It is imperative for both the client and investigative firm to understand the key concerns and assess capabilities in managing the assignment within the legal realms. Similarly, there are assignments that involve conducting of interviews with the suspect or the use of gadgets in a lie detector test which are exclusive rights given only to police authorities under a defined process. It is of common knowledge that these gadgets are not allowed to be used to unearth information by the common man.

Key Contacts and Roles

9.4 A record of key contacts should be maintained and filed properly. Preferably standard format should be put to use for ease of retrieval. There should be a common understanding with the engagement client or the key person with whom the progress of the investigation and other requirement will be discussed. Generally, there is a single point contact person for meeting the investigation needs and he acts as the co-ordinator.

Creating Project Codes

9.5 Each assignment is given a unique project code that is used for all the internal and external communications. The project code enables in keeping track of the time and money spent on the assignment. Any cost overrun is notified to the customer for necessary approvals. This also helps in understanding whether the cost and fee projections are in order. The assignment of project codes also helps in maintaining confidentiality about the client and the assignment handled *vis-à-vis* the outside world.

Investigation Methodology

9.6 Depending upon the nature of the assignment, the approach could be either a covert or an overt approach. A leading foreign company having operations in India approached an investigation firm to discuss whether there is any diversion of business. The foreign company had an Indian arm, a company registered in India and was informed that for conducting business in India, there is a need for operating through such a front end company. The first attempt by the investigation firm was to create a relationship of trust with the lead investigator. The condition put forward by the client was that the investigation should be done in a manner that the business interests of the foreign company in India are safeguarded. However, a covert assignment ultimately comes into the open at some stage of the investigation. In the present case, the investigation had to be conducted across the globe involving extensive coordination among two investigative firms one based in India and the other firm based at Canada. The investigation revealed diversion of business by the management personnel in India to a private closely held company. Using the resources of the parent company the persons in India were operating a business within a business and had resorted to activities for personal gain. The investigation efforts included safety of the senior management personnel during their stay in India and also while managing the entire exercise.

The investigators tend to have an overt approach when the fraudulent activity has already been uncovered and is known to the suspect, and there is a likely belief that the evidence could be tampered with or destroyed.

Identifying Resources

9.7 Depending upon the nature of activities based on the preliminary assessment and the geographical spread, the client is given an indication of the resources that will be deployed including stay arrangements, the IT support, and the key safety measures wherever necessary. Further, confidentiality is maintained of the people engaged especially for background checks and field activities. The engagement of law firms for legal support or lead firm where there are various territories is also a matter to be decided in advance to ensure proper co-ordination. The timing of engagement of various team members is also decided as a strategic matter. At this stage, the decision on cost of the investigation is of paramount importance and client acceptance is very important to prevent any disputes at a later stage.

9.8 Irrespective of the nature of investigative assignment, a conservative approach with utmost care is required to be taken in terms of engagement of resources till the conclusion of the investigative process. This may require many hours of brainstorming, drawing up strategies and simulated exercises to prevent any act that may affect the quality of investigation.

Defining the Objective of the Investigation

9.9 Understanding the objective of the investigation is of utmost importance. Any ambiguity in this area leads to futile efforts and such miscommunication would lead to disputes in settlement of dues for the investigating firm. Hence, the objective of the investigation and background to the investigation should be formally communicated to the investigating team.

Drawing the Scope of Coverage

9.10 In any untoward incident, it is important to shut the doors and draw boundaries. This is a preventive measure from loss of any vital clue and removal of evidence. This also ensures a focused approach towards investigation. In a controlled environment, there are systematic checks and balances that are ensured by a professionally managed company. Any attempt by the suspect to cover up the audit trail will require camouflaging all these checks and balances. A good investigator will take stock of all these controls to be in place in the investigative process. It is important that all the outlets or escape routes in terms of removal of evidence are blocked to prevent any mishap in the investigative process. At this stage, it is essential to define the timelines for the assignment and for various constituents of the investigation team.

Safeguards in use of Tools and Techniques in Investigation

9.11 There are sophisticated tools such as, voice recorders, cameras, bugs, video shoots, CAAT, spying software, frequency analyzers for detecting whether there is any eavesdropping.

Flowcharting and data relational analysis, physical inspection, interviews are some of the techniques that are commonly used in an investigation. The investigating officer must first ascertain whether the local laws and regulations permit the use of the tools, gadgets and methods that will be deployed in the conduct of the investigation.

Use of Voice Recorders, Cameras and Video Shooting

9.12 It is a prefereable that any audio or video recording of events be informed to the subject to ensure that these do not infringe privacy laws before engaging in such activities where these are private conversations. Recording of telephone conversation should be with permission from subject and must be informed to him. The responsibility on the investigator for in camera investigation is extremely difficult and requires extra caution in terms of addressing the subject. Any careless recording could lead to negation of evidence and care should be taken not to infringe on the privacy of the individuals. As regards video/ voice recording is concerned, it cannot be construed as substantial evidence and the same can be refuted in the court. At the best it can only be a corroborative evidence.

Profiling of Key Suspects and Informants

9.13 Profiling can be done either on suspects or informants to establish a fact and it helps in progressive steps in an investigation. For example, the frequent loss of cartridges/ stationery in a common pool of printer, an information that administration department accepts bribe in allotting canteen contracts, etc., are situations that normally suit an investigation by a police authority. However, during the course of internal audit when the company officials would prefer to internally investigate the matter then profiling of suspects comes handy. Profiling helps in narrowing down on the suspects out of a group of people involved in an activity.

In simple terms evidence can be categorized into:

a. Testimony

b. Documentary evidence including digital evidence

c. Physical evidence

d. Circumstantial evidence including eye witness and personal observation

Gathering and Interpretation of Evidence

9.14 In an allegation by a third party that the purchase officer in a company was accepting bribes, a real time pre-audit of the activity was conducted wherein the vendors were engaged to record the proceedings and the profiling was done to establish whether the suspect was engaging in such an activity. During the course of the discussion the purchase officer vehemently stated that there are many others who wanted to engage in a business arrangement and, therefore, something had to be done to promote the business relationship. The place and time of payment of the bribe was finalized and this fact was recorded in the presence of witnesses. On the appointed day when money exchanged hands, the immediate superior who was asked to be present within the premises was informed of the development and when confronted, the suspect had no option but to admit his wrongful act. The role of an independent witness is very important in the entire process. Such an admission before an independent witness is like an extrajudicial confession.

9.15 When an accused is produced before a magistrate during an enquiry or a trial, the investigating officer should produce the case file after having completed the daily diary including the time of investigation. These diaries are an aid to an enquiry or a trial. The entries in this diary are to be filled in a chronological order in an objective manner. These details are not required to be shared with the accused for the simple reason that the details of the informants which are generally kept confidential will be revealed and could endanger such an informant. The daily diary improves the credibility of the investigation process. It is advisable that even in a private investigation the investigating officer should maintain a case file and a daily record of events in a chronological manner. This will assist in continuity of investigation in the event of handover of charge to a new investigating officer if such a situation arises.

In such a situation, it is advisable to document the sequence of the events as distinguished from a case diary, i.e., recording the events during the course of investigation. An independent witness to the events with the working notes duly signed would hold well in any investigation.

9.16 Whether during the course of internal audit turning into an investigation or when there is a suspicion on vital evidence being retained in the drawer at the office work station, it is important to gather the evidence in a proper manner, even when these are retained within the office premises of the engagement client. The superiors need to be informed of the intended action. The details of the actions need to be documented including the findings in the sequence of events notings and signed by an independent witness. The extent to which a person can retain his personal belongings in the office premises depends on the rules of the organization. That is the reason some companies impose restrictions by obtaining declaration from employees on limited retention or non-retention of personal belongings including money in the office premises.

Whether it is a case of retention of foreign currency or personal cash in the personal locker in a gymnasium or in office premises, the above process of documenting the evidence is admissible in a court of law. Whether this will stand test of scrutiny is a separate issue. Further, investigation related to activities helps in establishing the source of money to strengthen the test of scrutiny.

Schedule of Evidence and Working Papers

9.17 A schedule of evidence gathered and working papers should be maintained. The working papers should be prepared in a manner under the presumption that these may required to be presented as evidence in litigation suits or during the formal interview phase at a later stage in the investigation. The exhibits and key evidence should be kept in a secured manner free from any tampering or destruction.

Documenting the Sequence of Events and Related Key Concerns

9.18 This is an important aspect in any investigation. A well documented investigative process ensures that irrespective of the presence of the investigator at a later date, it is easily understandable and retrievable by successors. Especially when litigation proceedings prolong for long duration, the standards for documentation can be customized to investigating officers' needs and as such there is no standard format that is comprehensively used. This also includes documenting of assumptions at each stage of the investigation.

Interview Process

9.19 The objective of an interview is to establish the truth and, hence, it forms an important aspect of any investigation. There are ground rules for conduct of an interview within legal realms.

Presentation of Results including Reporting

9.20 The presentation of results should be defined at the time of finalizing the engagement terms. The results could be verbal, presentation through visual aids, or formal reports. In private investigations, where the management is not interested in prosecution of the suspect and is only interested in confirmation of a doubt for internal reasons, and then the same is ensured without a formal report being submitted, i.e., through verbal briefing. Where these are issued for limited internal use, the same should be mentioned in the reports. The language of the investigative report should be simple and easily understandable, especially, when submitted to a legal authority or for filing a police compliant. There should be no subjectivity or bias in the report as it is a report from an independent agency. The investigative reporting and presentation of findings is dealt with in chapter 13 of the Guide.

Case Studies

9.21 The following case studies illustrate situations discussed above:

(i) Three persons, *viz.*, a business magnate, a prominent socialite and a media person came together at a common event on a trip abroad. Their acquaintances turned into friendship. They decided to give a shape to their relationship by starting a business venture. The socialite assured all help in getting permissions but insisted a sizeable upfront contribution to his social outfit. The business magnate offered financial assistance but had very little time to attend to day-to-day business operations. The business relationship commenced with a share in profit between the business magnate and the media person under a mutually acceptable formula in sharing of profits arising out of the venture. Years passed by, the media person landed in trouble and there arose a reputation risk to the business magnate. The socialite had already distanced himself at the outset. The business magnate was now looking for an avenue to severe his relationships. He summoned his trusted partners and sought clarification on how the business performed. To his surprise, explanations to several queries remained unanswered by the operating management. The Chartered Accountant was approached for ascertaining the areas of revenue leakages and the extent of damages suffered by the client engagement. A review of the financial statements revealed diversion of assets and funds to another entity. The minutes of the meeting could not provide corroborate information on key decisions taken by the operating management. The Chartered Accountant also had a role to conclude the investigation through proper conflict resolution measures and had to quantify the amount to be settled between the parties to the dispute.

(ii) A foreign company had set up it’s operations across the globe and was monitoring the business operation through designated offices. The company officials were informed that to operate in the line of the business there was a need for an Indian company. The audit head from the designated office had doubts about this requirement and, therefore, approached the Chartered Accountant with caution and requested that the assignment need to be carried out in a covert manner. In the course of the investigation if it is confirmed that there is indeed a need for an Indian company to run the business then there is a need to maintain utmost secrecy in the matter as otherwise this will result in loss of business opportunity the impact of which could be significant. The Chartered Accountant had to plan his strategies in minute detail and studied the fund flow pattern and usage thereof. Under the pretext of change of software applications for accounting package across the globe and for standardisation, the data in the hard disk was copied by the investigation team and was provided to the senior engagement partner of the Chartered Accountant firm for further scrutiny. The operating management had diverted business to their own entity in every 2 out of 3 bids for various projects. The investigation revealed a closely held company was operated in the form of a company within a company resulting in diversion of business to such other company. The entire operating management had to be overhauled.

(iii) The internal auditor during regular vouching at a manufacturing plant saw several instances of stapler pins being used for the supporting vouchers. These were all photostat copies and originals were retained at the corporate office. The auditor was inquisitive regarding consistent use of stapler pins in the weigh slips considering that the tare weight of the vehicles in the weigh slips was not in line with the carrying capacity of the truck. The management mandated investigation into the matter and it was found that the computerised weigh scale operator was fiddling with the dot matrix printer to ensure that perforations are aligned in a manner that the gross and tare weight slip can be mismatched. This resulted in 3 to 4 tons of steel scrap being clandestinely shipped out of the plant (being the difference in the tare of a bigger vehicle being swapped against the gross weight of a smaller capacity vehicle).

(iv) During an internal audit it was noticed that the scrap lifting time was generally during the change in shift. At a manufacturing plant, there was this urgency to catch the shift bus failing which other means of transport was an expensive proposition for the company employees. With the permission of the senior officials an investigation was done to conduct a surprise check during one of the shift change timings. The perpetrator of fraud observed this urgency factor and considered this as the most vulnerable time to upload and transport aluminium ingots along with the MS scrap from the plant. Around 275 kilograms of aluminium ingots were downloaded from the loaded truck. The scrap dealer accepted his mistake.

(v) The average time in lifting of garbage was, generally, half an hour and the comparison of the gate entry timings revealed an average upload time of one and a half hour that was the normal duration for loading of scrap. The gate pass was prepared and signed by storekeeper while for garbage these gate passes were supposed to be prepared and approved by the administration department. It may be noted that the guidelines for material movement were perfectly in order, there was a scrap disposal committee in place and a scrap disposal manual was also available for referral. The security guards were under a contractual arrangement and were not aware of the signatories to the gate passes. On suggestion from the Chartered Accountant who conducted the investigation, as a preventive measure, the management created separate earmarked area for segregation of scrap material, constructed separate bins, installed a CCTV camera for monitoring the weighment and despatch activity. The authority and responsibility for lifting of scrap was redefined. There was a periodic reconciliation of scrap material ensured and proper segregation of scrap material into capital project scrap and regular production scrap was ensured.

(vi) The management of a leading pharmaceutical company had a peculiar dilemma, the internal audit reports and anonymous letters referred to extensive corrupt practices in almost each department, especially, at senior managerial levels. The company operations were comparable to best in the world and, therefore, such allegations were hard to believe. After initial reluctance on whether the management should engage in a full fledged investigation, the matter was referred to the Chartered Accountants. It was agreed that there would be a preliminary assessment which would primarily involve understanding the internal audit perspective on the alleged irregularities. The allegations included extensive bribery in allotting of contracts and superfluous work allotment in civil work, labour contracts, purchases, projects, etc. The objective of the assignment was to gather evidence to substantiate these alleged irregularities. If the alleged irregularities were proved correct then this was to be followed by formal interviews for necessary management action. The Chartered Accountant firm conducting the investigation ensured that all the vital documentation and records were taken possession of. There was a profiling done of all the contract renewals and cancellations. Informants were identified for gathering vital information for reason for cancellation and simultaneous scrutiny of the work orders and bills ensured. The result revealed anomalies in scope of work defined in work orders, conflict of interest in allotment of contracts, and the reconciliation of thinner and paint stock inside the factory revealed disproportionate work execution for the payments made to contractors. There were bills cleared for road repair works that could not be corroborated with the work done and justified. The work measurement sheet was inaccurate. Spillting of work orders to overrule authority levels were noticed. There were group of labourers meant for gardening and ETP plants diverted for personal work in farms. This was corroborated through a physical count of labourers as compared to the punch (pay) cards in the custody of the administration department. The comparative rate of hire of bus for transportation of employees from their homes to offices were compared with similar facility in the vicinity and vast differences in payment were noticed. Drawings for civil work were not in line with the final execution of the work. Rework charges were not adequately explained.

(vii) The painting contract work allotments revealed a large number of work order released in the name of select contractors. The grapevine revealed that whenever a senior official from the head office visited the plant even for a small time the entire cabins were painted to ensure that neatness and cleanliness was maintained. The investigator had doubts on whether the painting contract was really executed. The work order of value above ₹ 50,000 was to be referred to a superior officer. All the work orders were within this limit. The management is desirous of appointing you as the investigating officer on this assignment. What would be your approach on this assignment? To provide you a hint, the work order had specifications mentioned in the form of work schedule with number of coats and area to be painted. The bills submitted were in line with the area mentioned on the work order and the work was certified by the authorised signatory to the work order.

A review of the gate records and the stores record was done to identify the extent of paint stock and primer that was brought inside the plant. The paint company provided a mathematical formula on area wise paint consumption. This was applied to the overall estimated and actual area billed by the contractor. The contractor had all the contacts under the earth to wipe the paint on the wall to clean it, and the quantity of thinner had far exceeded the requirement.

(viii) In manufacturing industries, there are general standards relating to basic cost, pricing and consumption standards for materials, especially, for recording in an ERP system. In a cement manufacturing company, the supply of coal was generally from the collieries. The internal auditor had raised several queries during the routine scrutiny relating to high level of stock as per excise records in some months and at the same time questioned the need for buying the coal stock from the open market. Further, transportation by road resulted in double the cost of procuring directly from collieries by rail. He also noticed that quality of coal had high moisture content and was also high on ash content. The management ordered for investigation in the matter and it was noticed that the physical stock of coal was negligible as compared to a significant book stock. When the production records were scrutinised for the previous years, it was noticed that the head of production had resorted to altering the standards coal usage percentage from 22 to 24 percent in the production process. This resulted in covering up the pilferage and diversion of coal stock.

(ix) A review of the transportation cost in an engineering industry was showing an abnormal increasing trend. The company had many outlets from which the freight operator plied (milk van distribution system). It was noticed that the authorisation of the bills and documentation requirements resulted in multiple goods consignment note being prepared. In a day of 8 hours a vehicle could ply at the most two full (to and fro) trips including the loading and unloading time to a particular destination. A consolidation of the freight payments for the same vehicle across locations revealed that the freight operator had resorted to splitting of a single trip into multiple trips and submitted separate claims through sets of bills at each of the locations of the company for the same trip. The freight operator was a regular contractor for the company for more than a decade and finally had to be blacklisted.

(x) A regional manager in a chemical plant was in charge of collating indents and production planning. In addition, he was given the charge of handling freight payments. The regional manager by a defined date used to collate the indents from various states across the country. He introduced certain additional indents on his own and in the process imported material and repacked it and sent to his personal warehouse where it was rebranded and sold in the market on cash basis. The material was shown as indented from a place in north India where it was never needed. The material was transported through a mini truck belonging to his wife. He had finalised a rate contract in his wife's name and ensured that the freight payments were made within 15 days of despatch. He had cheated the company of a significant sum of money (₹ 20 million in 2 years). The company wants your opinion in pursuing legal action on the employee. What is the control weakness that would enable the company in succeeding in this endeavour?

At the year end, for each of the indents received from across the states there was this need for Form F that had to be collected for the purpose of Sales tax. The regional manager in order to cover up his follies had forged the Form F entries that never emanated from the concerned offices in north India.

(xi) Corruption charges were levied against a plant supervisor and management decided to undertake an in depth investigation into the matter. The Chartered Accountant divided his team into two categories, each team working independently. One of the teams entered the plant and commenced data analysis while the other team was in charge of undertaking field work. The condition was that none of the team members would interact with each other unless the vital evidence was gathered. The in house team meanwhile isolated the list of contractors whose contracts were discontinued over the past two years. A disgruntled contractor was developed as an informant and the external team gathered vital information relating to mode of operation. The vital question was how to prove bribery allegations as these are very difficult to prove in a real time situation. The contractor was asked whether any cheque payment was ever made by him to the company official. There was one incident where about three years back a cheque was issued by the contractor. However, he was illiterate and could not have written the cheque. This made the job simpler. The contractors' bankers were approached and with the help of the contractor the old cheque could be retrieved. The bearer cheque was prepared by the plant supervisor in his handwriting and his father-in-law had gone to the bank for cash withdrawal. To ensure that there are no chances, the HR records were perused to unearth the marriage card of the employee and it was established that it was indeed the father-in-law who had visited the bank. During the formal interview that followed, the plant supervisor readily agreed to the misdeed.

(xii) A client approached an investigative firm to ascertain misuse of credit card that was sent by courier by Non Resident Indians (NRIs). The courier company had 100 employees who used to carry out sorting and it was difficult to identify at any given point of time which groups of employees used to flick the credit card and misuse them. The following steps were taken by the courier company as a control measure:

- Installing of in house CCTV cameras to track pilferage.
- Warning customer not to send credit cards and debit cards through courier.
- Insurance policy as a matter of control was ensured by the credit card companies for any misuse arising out of theft of credit cards.

Despite the above measures, the pilferage and misuse of credit cards could not be controlled. The investigative firm refused to take up the assignment as they did not possessed the requisite skill sets to carry out the assignment. The other reason was that the goods bought by the fraudster from the misuse of credit card had exchanged many hands and it was difficult to carry out the investigation without trespassing into the final buyers' home. The client had only the option of referring the matter to police authorities.

Chapter 10

The Interview Process

Chapter Summary

Interview forms the major source of evidence and adds colour to opinions. The purpose of an interview is to obtain the truth, to detect deception and to ensure that information gathered is a fact and not an opinion. It is also essential to obtain complete facts. The purpose of the interview also includes obtaining of confession or signed statements. It is an art to establish facts through questioning and expressions without threat, inducements or coercion. The chapter is intended to provide an insight into the preparatory steps, types of interviews and certain attributes of interviewer and interviewee.

10.1 Interview is the task of obtaining information from witnesses, victims and suspects. This is more of a question and answer session with an informant, witness or suspect designed to get the required information. The information obtained here may be true or false. Generally, an informant is friendly in nature and gives information. The interviewer should also ensure a friendly approach.

The witness is a person who could be friendly, neutral or hostile in nature. The approach to elicit information is through examining the witness. The suspect is a person when there is reasonable suspicion or could be identified as the actual perpetrator. Generally, the suspect tends to be hostile in nature and should be subject to a thorough questioning.

The fundamental requirement in an interview comprises of extensive planning, conducting the interview according to self governed rules and maintaining notes (recording).

Types of Interviews

10.2 The following are various types of interviews:

(i) **On the scene interview:** This is similar to an interview done by internal auditors and is not, generally, planned in advance. This is essentially to capture an event on a real time basis.

(ii) **Formal interview:** These are well planned and involve an objective approach. The following four important facts to be borne in mind by the interviewer in a formal interview:

(a) One must not reveal any essential information.

(b) All the statements made by the interviewee should be corroborated. This is achieved by series of questions that are meant to further elucidate or provide information that can be cross checked beyond doubt on the statements made by the interviewee.

(c) Exploit an advantage secured during questioning. The interview is normally conducted with a limited objective of establishing truth in a matter under suspicion and any response from the interviewee that facilitates this objective should be fully exploited by the interviewer.

(d) The objective is to maintain a proper record of all information gathered during interview. This is very essential as the interaction between the interviewer and interviewee could be the basis for any future course of action or deriving a conclusion or could be used in a legal suit. Such a record also prevents any misinterpretation or misunderstanding in ascertaining the facts or denial at a subsequent date.

(iii) ***Group interview***: It is rarely used and involves situations where the target audience could be a group of persons. This is primarily used in labour union discussions or when there is suspicion among a group of people. Various techniques are used to isolate the suspects including planting of interviewees in the group. These interviewees raise contentious issues in the group that are challenged by other group members thereby exposing them. The investigator by his mere observation is able to identify the suspects.

Primary Rules for an Interview

10.3 Privacy is to be maintained during an interview and one must ensure that there are no interruptions by calls through telephones, mobiles, fax machines or other distractions. The interview should be conducted in the client office environment and not at the suspect's place. It should be conducted in a tranquil environment. It is imperative that at any given time during the interview a single person performs the role of the lead interviewer with a specific role assigned to the rest of the members. Group interviewers (all the participants talking by turns) should be avoided.

10.4 A good interview comprises of establishing a rapport with the interviewee. There should be no dearth of queries posed to the suspects. The queries should be structured in a manner to uncover relevant facts. Questions should be framed such that all pertinent issues are addressed sufficiently to reach a conclusion. This requires the interviewer to have abundant perseverance. The funnel effect ensures that the questioning process filters irrelevant information and is objective in its scope.

Plan the Interview

10.5 The most important aspect in an interview is planning for the interview. The primary question is to decide the manner in which the interview might support the investigative process. The objectives for the interview, therefore, must be defined in line with the desired outcome to facilitate progressive enquiries. There should be constant focus on issues that will elicit new information and information that needs to be further corroborated. There is a need to visualise the target and to ensure that the interview proceeds in the planned direction to get to the relevant points and also ensure that the evidence/ facts collected are unassailable. The place of the interview, the number of persons to be present during the interview, knowledge about the regulatory provisions that need to be adhered to, the intended course of actions depending upon the probable outcome of such interviews is a matter to be decided in advance.

Preparatory Steps before an Interview

10.6 Setting the environment where the interview will be held is the first step. This is followed by collecting all equipment such as, writing materials, gadgets, etc., in place. The evidence gathered and the timing is of essence in challenging the interviewee, therefore, the support staff at the interview should be well informed of the requirements.

10.7 A robust mechanism of retrieval of essential documents also must be ensured for an organised conduct of the interview. The availability of the interviewee should be confirmed as otherwise this may result in waste of time and resources. As a part of the advance planning it is essential to ascertain whether the interviewee is likely to be present at the place of the interview. There should be no prior intimation about the purpose of the interview as this will kill the surprise element.

10.8 The timing of the interview should be scheduled appropriately, and the sequence of questions and clusters of topics should also be worked out. The questionnaire and documentation process should be a record of the statements in a chronological order. It is important that there is adequate background check ensured of the target. This includes ascertaining whether witness is a related party of the suspect.

The practice session prior to the interview is termed as a 'Mock Trial' and it enables to simulate the interview conditions. It is an essential part of any interview process wherein one of the investigating team member plays the role of 'devils advocate'.

10.9 There should preferably be a written interview plan to understand the roles of participants as to who would be the lead interviewer, who would take notes, etc. While all the abovementioned procedures are ensured, it is unfortunate that the documentation of the preparatory steps is not usually done adequately in most investigative assignments as this is considered as a cumbersome process.

Interview Techniques

10.10 The interview techniques could be direct technique or commence with a signed statement. Team interrogation, group interview, feigned information, duress, bright lights, denial of requirements, use of force are things that need to be avoided in an interview. Within the legal framework, the interview tactics could vary according to the targets depending on whether the subject is a casual offender or professional criminal with premeditated offences.

Questioning the Interviewee

10.11 The starting point in an interview is to build rapport with the interviewee. Care should be taken to avoid leading questions. Let the target do the talking without any interruption or coercion. Time the questions effectively. There should not be any hesitation in asking silly questions occasionally. As an interviewer, ensure that there are multiple options during the questioning process and seek documentary evidence in support of the subject's version, wherever possible. Lay the foundation for the interview process and pin the interviewee's story. Confront him with contrary evidence when he goes awry in his replies, cut off false denials promptly, break up the interviewee's version and draw out and pin down the interviewee's admission.

Documenting the Interview

10.12 Notes should be taken for the entire interview with the help of a note taker. It should be ensured that sufficient guidelines are laid down for taking notes during the interview. These must be more detailed for crucial and formal interviews. These notes may need to be placed as evidence in civil and criminal proceedings.

Recording the Interview

10.13 Extra caution is needed while conducting an in camera interview or using a voice recorder. The interviewer must diligently frame the questions in advance. The interviewee must be informed about the use of voice recorder just before the interview in order not to violate privacy laws. Confessional statements should reflect clarity and interpreters should be used wherever necessary.

Why Interviews Fail?

10.14 The following are some of the reasons for failure in interviews:

(a) There is lack of planning, preparation and information.

(b) There could be ignorance or shallow knowledge of facts and events

(c) Sometimes there is lack of technical knowledge.

(d) Interviewee could be stubborn and the interviewer is unable to channelize or direct the discussions as per plans and/ or may deviate from the main purpose of interview.

(e) There is disregard for the legal/ statutory requirements while conducting the interview.

Sequence of Events in an Interview

10.15 As discussed above, the sequence of events in an interview and certain prerequisites are listed as follows:

(i) Getting Engaged

- First impression;
- Managing first contact;

- Creating the right atmosphere;
- Building rapport;
- Addressing needs and concerns; and
- Showing empathy and interest.

(ii) Seek Explanations for Interview

- Reason for interview to establish truth;
- Introduction;
- Ground rules – breaks and refreshments;
- Background and time factor;
- Introduction of exhibits/ documents;
- Explain formalities;
- Explain use of audio/ video recording of interview; and
- Outline of interview.

(iii) Keep an Account

- Setting the scene;
- Obtain an uninterrupted account of happenings;
- Identification of the events, recalling, probing and summarizing; and
- Remain flexible and responsive to information uncovered.

(iv) Evaluation and Learning

- Review the interview critically *vis-à-vis* investigation;
- Improvements needed and learning for others (for rest of the interviewees);
- Manage Interruptions smoothly without disrupting continuity;
- Malfunctioning equipments should be tried and tested prior to the interview; and

- Be aware of the 'subject' behaviour, especially, the use of aggressive language.

General Profile of a Successful Interviewer

10.16 The following are general profile of a successful interviewer:

(i) Posture

- Upright;
- Frontally aligned;
- Open, no crossed arms or legs;
- Avoid slouching; and
- Always maintain eye contact when asking questions. Look away when suspect gives denials.

(ii) Facial Expressions

- Avoid expressions of disbelief, shock, anger, humour, disgust and skepticism;
- Show interest; and
- Express or display understanding and acceptance for suspect's actions.

(iii) Tone of Voice

- Confident and believable;
- Smooth speech;
- Controlled;
- Modulate at appropriate times; and
- Don't use a skeptical or disbelieving tone.

(iv) Hand Gestures

- Palms should be up and arms open;
- Avoid negative or strong gestures;
- Be careful about touching as this is not desirable and could be seen as offensive;
- Meet and greet;
- Start with non threatening conversation; and
- Allow interviewee to like you.

(v) Building Rapport

- Observe interviewee's verbal and non-verbal behaviour;
- Consider use of formal titles e.g., Dr., Mrs., Mr., Sir., etc;
- Never let interviewee take control of the interview; and
- Use observations during pre-interview stage as a basis of comparison during 'behavioural analysis' stage.

Characteristics of Body Language of Interviewee

10.17 The following are some characteristics of body language of an interviewee:

(i) Defensiveness

- Rigid body;
- Arms and legs crossed tightly;
- Minimal eye contact;
- Head down with chin depressed toward chest;
- Fists clenched; and
- Crossed arms.

(ii) Evaluating

- Slightly tilted head;
- Sitting on front portion of chair with upper torso forward;
- Hand to cheek gesture; and
- Stroking chin or pulling beard.

(iii) Nervousness

- Clearing throat;
- Hand-to-mouth movements;
- Covering mouth when speaking;
- Tugging at ear;
- Twitching lips or face;
- Playing with objects or fidgeting;
- Shifting weight while sitting or standing;
- Tapping fingers;
- Waving foot and pacing back and forth restlessly; and
- Whistling.

(iv) Suspicion/ Secrecy

- Failing to make eye contact;
- Glancing sideways at you;
- Rubbing or touching nose; and
- Squinting.

(v) Needing Reassurance

- Pinching the fleshy part of hands;

- Gently rubbing or caressing some personal object like, ring, jewellery, watch; and
- Biting fingernails or examining cuticles.

(vi) Frustration

- Tightly clenched hands or shaking fists;
- Hand wringing and rubbing back of neck;
- Controlled short breathing;
- Blind staring;
- Running hands through hair; and
- Stamping foot.

(vii) Points to Ponder during Interviews

- People often lie with words;
- Body language tends to be more honest;
- People don't realise that the body language is being assessed;
- Transitions count more than positions;
- Look for conflict between spoken words and body language;
- Look for clusters of behaviour inconsistent with the spoken word; and
- Be mindful of mirroring behaviours.

Interview Techniques Essential

10.18 The following are some essential elements of interview techniques:

- Active listening and responsive style;
- Proper environment necessary;

- One person to interact at a time;
- Unbiased regardless of the outcome;
- Record facts and not opinions;
- Read non-verbal communication;
- Detection of deception; and
- Focus on conversational techniques.

Queries during Interview

10.19 The following queries should be considered during an interview:

- What, where, who, when, why and how?
- What was in suspects mind and why did he do it?
- The act – what was done?
- The modus operandi – How?

10.20 The following tips are useful during questioning:

- Use open questions —
  How did you do that?
  What happened next?
  Where were you then?
- Use closed questions only to confirm facts and save time - Did you steal the money?
- No leading questions - Having found the safe open did you close the door to make it secure?
- No multi-themed questions - Where did you spend the money and what did you buy for whom and why?

Don'ts in an Interview

10.21 The following should be avoided during an interview process:

- Oppressive or threatening behaviour;
- Offensive language or behaviour;
- Offering inducements;
- Physical force;
- Fabrication or trickery;
- Do not interrupt; and
- Maintain structure, sequence and control.

Closure of Interview

10.22 The following aspects are important during closure of interview:

- Summarize main points;
- Ask subject – add, clarify, change the points;
- Has the subject any questions or comments on the conduct of interview;
- Formally 'sign off'; and
- Actions.

Question Typology

10.23 The question typology is, generally, as follows:

(i) Introductory- provide the introduction, establish rapport, observe reactions and establish the purpose of interview.

(ii) Informational – non-confrontational, non-threatening, information gathering and unbiased factual information.

(iii) Closing – A positive note, reconfirming the facts, further facts or opinions and stressing the confidentiality.

(iv) Admission – of incriminating documents, of incriminating conducts or confirms voluntary participation and disclosure.

Question Methodology

10.24 During questioning it is better to be general to specific and reach backward, i.e., from known information to unknown areas. Further, the following are also some important aspects in this regard:

- Start with open questions that make the interviewee talk.
- It should be followed by closed questions to conclude an interview.
- During interview avoid double negative questions.
- Avoiding complex questions lest the interviewee has difficulty in responding.
- Avoid sensitive questions that may irk the interviewee.

Finally, avoid emotive words as interviewee may take control over interview.

Chapter 11

Investigation Report*

Chapter Summary

The purpose and importance of investigative reports stems from the understanding of the terms of the engagement as stipulated by the management. Although an investigation is, normally, conducted always under the presumption that the final outcome and methodology should withstand the test of scrutiny in a court of law. However, private investigations generally end up with briefing the management. The chapter is an attempt to make the readers aware of certain thumb rules that are important in drafting investigative reports.

11.1 The medium of presentation of the findings vary according to the subject matter under investigation. There are occasions when the management is interested only in material evidence and does not insists on a formal report. There are also occasions where video or power point presentations are made. It is necessary to understand the prerequisites of a good investigative report.

11.2 Each investigative firm has its report format and has its own style of representing facts and evidence to the engagement client. Generally, the formats designed for investigative reporting are consistent with reference to the objective of the investigation. The subject matter of the report could be results of surveillance, violation of patent or trade marks, reporting on background/ reference checks, providing a specialist opinion, conclusive investigative assignments, etc.

11.3 The management sees the investigator also as an advisor and is, therefore, consulted for the future course of action once the process of gathering evidence is completed and the report is

* Report drafting format may vary in private investigations.

submitted. He is also expected sometimes to comment on the adequacy of the evidence in seeking a legal remedy. Hence, depending upon the importance of the matter under investigation, the discretion of whether to include such recommendations, opinions or conclusions in the investigative report is with the investigation firm. The investigative reports are restricted to gathering and presenting of evidence to the management.

Objectives of an Investigative Report

11.4 The primary objective of an investigative report is to logically present facts and evidence gathered that will enable the management to reach an informed opinion on the subject matter that is under investigation.

Salient Features of an Investigative Report

This is an indicative format and can be suitably modified depending upon the nature of assignment.

(i) A Cover Sheet

For external investigative firms — With client information, investigation assignment reference, date and header signifying confidentiality of information and Investigation 'title'.

For in-house investigations – 'Subject information' – (name, designation, function, department, location), investigation reference number, year/date, alleged violation, name of investigating officer and department references.

Each page has a similar indication of confidentiality of information.

(ii) Table of Contents

(is optional and is, generally, not used in private investigations.)

(iii) The Report Titles May Contain

Background – Point of reference in conduct of the investigation.

Introduction – Terms of reference and key contact(s) with representative(s) of engagement client.

Scope of coverage – including place where investigation is being conducted.

(iv) Other Important Information

Limitations, constraints, indemnities including exclusions in scope of coverage (if any).

Statement of facts.

Modus operandi and sequence of events .

Comments on available evidence.

Supplementary information on results of surveillance, background checks, interviews, results of engaging the services of expert witness, etc. (wherever relevant).

Explanations and defence offered by subject (wherever relevant).

Conclusions and recommendations (may be qualified depending on sufficiency of evidence).

List of Appendices (Annexure).

List of Witnesses and Exhibits (Annexure).

11.5 The investigative report should enable a reasonable person to reach the same conclusions and understand the recommendations based on the facts presented. There should be abundant caution in ensuring that the report is not circulated to any person other than those entitled to the classified information.

While drafting the investigation report care should be taken not to deviate from the main objective of the investigative assignment. The following are not desirable in investigative report writing:

(a) The report covers multiple facets of the problem without reaching a conclusion. The use of words such as, 'appear', 'seems to be', 'perhaps' indicate that the report is inconclusive.

(b) A careful reading of the findings may result in reaching more than one conclusion.

(c) Personal bias or subjectivity in reporting facts without a comprehensive review could hamper the final outcome.

(d) There should not be any offensive or abusive language in the report, especially, against the subject or any other person referred to in the report.

(e) There should not be any remarks that are sarcastic in nature.

(f) The report should not reflect a personality clash between the investigating officer and the 'suspect', or written in a manner to appease the engagement client.

Planning the Report Contents

11.6 The investigating officer while drafting the report should obtain opinion from his team members and legal counsel or the reviewing authority on the sufficiency of the evidence gathered, the method of proof to be used, and the proposed recommendations.

Planning a final report is a process that begins at the time an investigation is initiated and is assigned to a designated official in the investigative team. Report writing can be simplified if the evidence is organized in a neat, concise, logical, and easily retrievable manner. The 'specimens', 'photographs', results of analysis, computer generated records (CDs, DVDs etc.,) or exhibits need to be kept in a neat and structured manner in a working paper folder.

11.7 In case of a private investigation, the original documents are generally handed over to a superior authority within the organization, whilst a photocopy is retained by the investigative firm. In most investigative assignments post completion the back up exhibits or evidence collected is handed over to the client and not retained by the investigative firm. Such a handover is also formally documented both while collecting the documents, during the course of the investigation as well as when these are given back to the engagement client.

11.8 The investigative working formats must include a 'Summary of Statements given by Witnesses and Records document'. This document should be comprehensive and should list all witnesses contacted and nature of evidence obtained from those witnesses, irrespective of whether these are cited or not in the investigative report. At the same time, this summary information should be brief and to the point. Care should be taken to see that there is no duplication in the documentation.

11.9 In case the report content is witness oriented then numbered files can be established for each witness. The witness's testimony and any supporting document that is obtained from the witness should be appended with each such witness file. A separate witness folder should be created for each person contacted during the investigation and should include such person's identity such as, name, address, telephone number(s), voter ID or any other identities of the witness. Where the evidence is too large to fit neatly into the witness folder, the same should be kept in a readily accessible manner with appropriate location or packed corrugated box duly referenced to the witness folder. Generally, a bar coded packing system for the purpose is ensured. The evidence file retention retrieval process is also managed by specialized agencies and can, therefore, also be outsourced. The work papers that contain vital evidence are also kept sealed (such as, plastic strips that need to be broken to open the seal) and at a secured place by the investigating officer.

Report Writing

11.10 Chartertered Accountant firms specialising in investigation normally maintain a document manager that is web based and also retain hard copies at the respective locations where the investigation is in progress. Some of these firms have offices across vast geographies or distant locations across the globe and, therefore, need interactive facility between the investigating officer (investigative staff) and the reviewer (senior engagement partner), who may be centrally located at the Corporate Head office. To ensure standardization in reporting, audit report templates and links are maintained as database in a central server. This allows the investigative team to effectively prepare an integrated, complete and accurate report. The 'pre-designed template' only enables standardization in format and not in content as these largely depend on the drafting skills of the designated investigation team member.

Reporting Facts

11.11 Facts stated must be unbiased and not subjective. The interpretation of facts should preferably be left to the reader as these tend to be consistent in reaching to a common conclusion. This is because any distortion or misrepresentation of facts will diminish the quality of report and credibility of the person preparing the investigative report.

To ensure that the report deals with facts and does not digress into expression of matters that appear to be opinions and vitiate from the objective of the investigative reporting and to ensure that the reading of the report reflects an impersonal attitude, use of personal pronouns should be avoided. An exception to this rule is in situations when there is a need to quote information gathered from witnesses or other persons during the investigative process. It is in this context that a testimony obtained from witness should also be presented fairly. In order to ensure that the report is unbiased, independent and objective the signatory to the investigative report should not refer to themselves as the undersigned, the writer, or your representative (meaning client – agent relationship).

11.12 There is a need for abundant caution in use of quotes in the report. The person drafting the report must extract and represent information from documents with reference to proper context. Any attempt to conceal or omit facts that tend to favour the subject could influence the outcome of the investigation and should be avoided.

Accuracy in Reports

11.13 Investigative reports are the basis for the management to initiate disciplinary and legal actions and, therefore, accuracy of facts is non-negotiable. Inaccuracies can negate the value of the report and diminish the reputation of the investigative firm and also the credibility of the investigation officer including the person drafting the report.

There is a need to draw a distinction between fact and opinion. Avoid using statements such as "the subject could give no plausible explanation". It is a conclusion and others may find that the explanation is plausible. The report should state what the subject has said and let the evidence show whether the statement is worthy of belief. Do not allow conclusions to surpass the evidence. A conservative statement that is consistent with the facts is stronger than an exaggeration. Exaggerations tend to raise doubt relating to all the evidence presented in the report.

Essential of a Good Report

Fair reporting

Accurate - adequately validating the figures (if any values are quoted) in the report

Complete – including a defined scope of coverage

Brief, concise and relevant

Logical presentation

Structured format with appropriate main and sub-headings

Grammatically correct
Cross references to annexure and exhibits
Unambiguous, easy understandable and without technical jargons
No offensive remarks on the subject and should be impersonal.

11.14 Restricted circulation (marked strictly confidential), judgment in the choice of words, punctuation that clarifies the meaning, and a correct application of the rules of grammar are essential to accurate reports, appendices, schedules and exhibits. Errors in these essentials have an unfavourable effect upon the mind of the reader. Carelessness in detail, errors in computations and incorrect dates materially affect the value of a report.

Mathematical computations in the report, appendices, schedules, and exhibits should all be verified for accuracy. Although special investigation teams have computer applications that verify that the data and formulae are correct. For review purposes, supply a tape of the computations or the electronic file so that these may be verified.

11.15 Preferably avoid using technical jargons, including those used in accounting and legal parlance. However, in some instances, vernacular terms (or terminologies that are locally prevalent) may be necessary for clarity in reporting the results of investigations, particularly those involving subjects in wrongful activities. The meaning of the particular term should be explained when it is first used in the report. For example, it may be advantageous in a report concerning a pyramid scheme to describe the nature of the operation, including the technical jargons used therein, before presenting evidence of the violation. If numerous technical terms are necessary, it is advisable to prepare a glossary.

11.16 While drafting the report, present the material with the objective that it could be clearly understood by a reader who had no knowledge of the facts surrounding the investigation. The report drafting person must exercise good judgment in selecting the facts that are material to the matter and ensure that nothing essential to a complete understanding of the investigation is omitted. This is especially true for any information that is favourable to the subject. All statements of material facts relating to the violation should be supported in the investigative report by evidence that will establish the truth and accuracy of the statement. The source of the evidence should be documented. Each statement of material fact in the investigative report, with the exception of statements made in the section on conclusions and recommendations sections, must be supported by evidence citations. These citations must be specific, including page and paragraph numbers. Statements made in the conclusions and recommendations sections must be supported by evidence cited elsewhere in the report. No unsupported statements may appear anywhere in the report.

11.17 All defences of the subject and their representatives must be refuted, and any mitigating circumstances, exculpatory evidence, or other impediments to a prosecution recommendation must also be fully addressed. Speculation concerning potential defences or explanations that have not been raised by the subject and/or their representative should not be included in the report.

If it was impossible to interview a key witness or to take any other pertinent investigative step, this should be explained in the “Other Pertinent Data” section of the report. For example, in an investigation on misappropriation of consideration on sale of product in which the customer was not approachable for being interviewed, the reason the interview could not be conducted should be noted. Addressing such issues will underscore the thoroughness of the investigation and prevent unnecessary requests for supplementary information.

Finally, in order to ensure completeness, the report should be read and revised as often as necessary before it is submitted for review.

Brief and Concise

11.18 Conciseness necessitates removal of all superfluous material. The rule of conciseness applies to the entire report and repetition in the content of the report should be avoided. Schedules, summary exhibits, tables, footnotes, and appendices may be especially useful in reducing the length of the narrative and financial evidence detailed.

Logical Presentation

11.19 A well-written report may lose its effectiveness for lack of a logical presentation. A mass of data indiscriminately presented in the report is confusing and may impair the reader's ability to comprehend the facts relating to the investigation. A well-written report requires adherence to the primary purpose of the report. Irrelevant material should be excluded. Clarity and presentation of communication is important. Each sentence, paragraph, and section of the report should help serve the primary purpose of the report. A well-written report requires careful planning, critical review, and frequent revision by the report writer.

11.20 Each paragraph should be classified according to the subject matter (theme) and any new topic or idea should be the subject of a new paragraph. Any special emphasis can be brought out through a separate sentence or a passage. Such emphasis can also be brought out through numbering, indenting and by use of summary schedules.

11.21 The investigation report is addressed to the designated official of the client engagement. Where interim reports are issued to the client, the same should be stated in the header or footer of the entire report. Similarly, the term confidential should be stated in the header of each page. There is also a reference to the person who is required to be contacted as a representative of the investigating firm. The date of the investigation report will be the date forwarded to the engagement client.

Peer Review

11.22 The investigative report should preferably be referred to a superior officer within the investigation firm to ensure that evidence gathered and conclusions reached are reasonable. Where there is a limitation in arriving at a decision in a matter under investigation, it is important that the report is adequately qualified. Most investigative firms engage the services of a legal expert or ensure that the investigative report is vetted for meeting the legal requirement and to safeguard the interests of both the engagement client as well as the investigation firm.

11.23 Once the investigation report is presented, there should be a process of formal closure of the assignment through a closing meeting. The documentation requirements relating to working paper management and custody thereof should be formally communicated to the client and retention norms should be specified for safekeeping of the records and documents. It is to be ensured that the draft report are stamped and cancelled to prevent misuse of the same. The duplication in papers should be avoided.

There should be clarity in disclaimers in the report and adequate safeguards for the investigative firm in matters of litigation. There should be restricted circulation of the report unless otherwise authorized by the client. At the same time, it should also be ensured that the investigation report is not used for purposes other than those specified for, in the terms of engagement between the client and the investigative firm.

A peer review of the performance of the investigative staff may be conducted at periodic intervals. This should also include reporting norms and retention of working file documentation.

The Final Report

11.24 The final report is a confidential document and it's primary purpose is to apprise the superior officers and legal counsel of the organisation of the result of the enquiries with a view to assess the merits and demerits of a matter under investigation and facilitate reaching a conclusion. It is imperative that the final report presents a clear, complete and well connected picture of the matter under investigation and explain and analyse the available evidence. This report is generally for in-house use of the business entity and shall not be discussed/ quoted outside the entity. Some important aspects are as follows:

(i) The typing should be in double space. The ink impression should be dark enough for easy reading. Para numbers should be given.

(ii) Enquiries/ investigations should be through and complete and the information supplied in the final report should be adequate on all points so that it is not necessary for senior officers to raise any avoidable queries.

(iii) The allegations, facts of the case, evidence available and the opinions and comments should not be mixed up in the final report. They should be dealt with separately and succinctly.

(iv) Repetition should be avoided. The allegations should be listed in proper order in a clear and definite form and discussed separately in detail.

(v) The analysis of the facts of the matter under investigation should be kept separate from the opinion. When there are multiple allegations and more than one suspect, care should be taken that the conclusion is drawn for each of the allegations and each of the suspects.

(vi) If any of the witness could not be questioned or documents could not be obtained, the same should be mentioned clearly with reasons in the final report.

(vii) There should be no delay in submission of the final report or in furnishing of supplementary information to the senior management to whom the report is addressed. The investigation officer and the legal officer should be given time targets to furnish the report and information sought with their comments.

(viii) The opinion received from experts or the relevant portion thereof should be incorporated in the final report.

(ix) The legal officers should not merely summarise the evidence collected during the investigation or enquiry. They should give a careful analytical note which should interalia, bring out the points to be established and the evidence that substantiates these points. They should highlight the important propositions requiring decision of the senior management. Any further investigation to be done should be set out in the final report.

Chapter 12

Legal Action

Chapter Summary

Contrary to management expectations, investigating firms are reluctant to engage in matters relating to court appearances (other than as expert witness) and filing of police complaints, etc. The investigating firm plays an advisory role in these matters. In this chapter, certain basic legal aspects that may be relevant to the management have been examined.

Use of Investigation Reports to Pursue Legal Action

12.1 The management may want to proceed legally in filing a complaint with the police authorities once an investigation report is submitted. There is no defined format or the medium (e-mail, telephone call, registered telegrams, etc.) to lodge a police complaint. Police complaint can be lodged by any person, anywhere at any time. In such complaint correct facts only should be stated. The key co-ordinator of the engagement client should engage effectively in defining the process and circumstances of the case to the police authorities. Formal acknowledgement of the complaint filed is advisable and is given by the police authorities especially to corporate representatives. The technical details should be explained in a lucid manner and in matters involving financial crimes the use of internal documentation such as, goods receipt notes, delivery 'challan', gate pass, internal control system and abuse of authority and other matters need to be elucidated clearly to such authority where circumstances warrant. The management should be in a position to display independent and unbiased approach in stating the facts to the police authorities. The following criteria should be applied to all such investigation reports used for filing a police complaint or registering a legal case:

(i) Maximum use of appendices (annexure and exhibit) helps in eliminating the need for detailed explanations of each of the supporting exhibits and minor details of the investigation. When appendices are used, each should have complete references to all relevant testimony and documentary evidence.

(ii) Preferably abbreviations should be avoided.

(iii) If the facts and circumstances surrounding two or more subject investigations are same or are intermingled, the results of the related investigations should be presented in a single report.

(iv) It is recommended that a table of contents reflecting report sections and page numbers be submitted as part of the investigation report where the report content in size is significant. However, prior to submitting the investigation report, the page fields should be updated. Generally, in investigation reports the legal format in number of pages is used.

(v) The table of contents is designed to provide quick reference to important sections of the report. The complexity of the investigation and the circumstances of the investigation will determine the amount of detail to be included in the report. Additional section headings may be included in the investigative report, if warranted. The list of witnesses and exhibits and the title and number of pages of each appendix should be included in the table of contents.

First Information Report (for criminal cases)

12.2 Any person can give information to the police relating to the commission of a cognizable offence and the Criminal Procedure Code provides for the manner in which it is to be recorded. A copy of the information has to be given to the informant. An FIR sets the criminal law into motion.

An FIR is not substantive evidence but it can be used to corroborate an informant or to contradict him, if he is called as a witness to a trial. Telephonic complaints can be taken for investigation as suo moto case by the police. Not all complaints can be converted into an FIR unless the police is satisfied primafacie.

12.3 If complaints are not registered then one can approach the local magistrate court under section 156 and the court may if satisfied may register the crime, alternatively it will direct the police under section 202 for investigation and report. It is to be noted that the submission of report is only to explain the facts of the case to the police authorities while lodging a complaint or filing an FIR (in case of criminal cases). The police authorities would be conducting an independent assessment and investigation of the matter brought to their notice.

Pros and Cons of using Affidavits

12.4 When the 'subject' seeks legal remedy there are occasions that there is an allegation that the investigation was not conducted in a fair manner. The investigating officer must take abundant caution when statements are obtained from the 'subject' as proof of irregularity being committed and may have to approach the local magistrate in registering the statements in the presence of an independent witness to ensure that the statements are not retracted subsequently. For example, let us take the example of financial irregularities through offering of excessive discounts by dealers beyond the stipulated limits prescribed by the manufacturer. The situation may involve obtaining of declaratory statements by the staff of the dealer who while replying to the questions raised by team of senior officials of the company may have revealed of the dealer being involved in excessive discounts as against the company policy affecting the company operations. The investigating officer (the chartered accountant or his support team) can be confronted by the owner of the dealership and the statements can be challenged in a court of law stating that the employee of the dealer was coerced into making such a statement and that the company officials have not allowed such dealer employee to reach out to the owner. Such a counter allegation may result in retraction of all the statements and claims on the dealer. Under these circumstances, when an investigation assignment involves visiting offices of third parties, the concerned 'subject' who makes the statements should be taken to a local magistrate and an affidavit should be prepared and signed before a local magistrate and duly registered. Being an independent agent, this adds value to the investigative process and makes it difficult for the defence to purge these statements. Even a simple affidavit duly recorded and notarized before Public Notary helps a lot. Any evidence of the facts may be attached to the affidavit. In the above case, if the employee can procure any form, etc., filled by the buyer who got the excessive discount should be attached. The place or territory where the crime has occurred is the place where the complaint has to be lodged.

Chapter 13

Investigative Audit and Allied Services

Chapter Summary

The investigative audit field is a unique combination of accounting, investigation and legal knowledge and, therefore, is not restricted to conduct of investigation alone. There are other specialised areas that provide an entire gamut of services that add value to the clients. These are extensions of the skill sets that are required for carrying out the investigative assignments. The salient features and pre-requisites for each of these products are discussed in this chapter.

Due Diligence

13.1 The investigative practice is bestowed with one portion of the entire due diligence activities due to its inherent networking of people and ease in gathering and validating data or information. Whenever new alliances are formed or there is a business expansion plan or a merger and acquisition plan that is formulated, due diligence activity comes into prominence. When a company is desirous of venturing into unknown businesses or geographical territories, due diligence activity is immensely useful in situation where there are unfamiliar customers, varying cultures and languages, legalities that make the understanding and controlling of the entity in such a market difficult. There is tendency to conduct this exercise in-house by most corporate and consultants are hired only on a need basis where certain critical information is required. Prior to engaging in any business relationship, it is advisable to possess knowledge of the respective company and individuals based on facts and not just perceptions.

13.2 The due diligence activity ensures whether the business of the target company concurs with that projected to the client. It ensures a reputation check on the target and includes activities such as, valuation of the business. It may involve profiling of individuals/ corporate entities for historic background information, positioning in market, reputation check, distribution network, litigation cases, etc, The assignment basically depends on specific requirement of the client. The fee level depends on the information sought by the client. These can be categorised as follows:

(i) Basic information that is available in the public domain comprising of data base check, data mining, websites search, research reports telephone search, media search (newspapers reports, etc.), credit rating companies research reports, data base updates through 'crisil', ICRA, etc.

(ii) Financial records review, visit to ROC, search reports, etc.

(iii) Visit to the target business, asset verification, surveillance, etc.

(iv) Police check in order to confirm whether the target is not involved in any activities that could pose reputation risk, crime record checks, number of court cases pending against the target, etc.

(v) Sensitive information relating to the target that is normally not available in public domain such as, civil litigation history, any crime history, corporate affiliations and details thereof in terms of kind of business interest, nature of share holding, history and reputation of those businesses, etc.

Integrity Check Services

13.3 When an investor is looking forward to enter a new business relationship then background checks are the most sought after services. Such background checks may involve:

(a) Review of potential suppliers;

(b) Entering into a licensing agreement;

(c) Reviewing prospective joint venture partners;

(d) Diversifying into new markets;

(e) Review of existing customers;

(f) Reviewing potential merger or acquisition targets; and

(g) Reviewing individuals or small and medium sized firms those are engaged as brokers or consultancy agents for investing company. The background check helps in ascertaining their capability and mode of dealings are within the ethical norms for the investing company.

13.4 The time and money spent on these assignments are generally rewarding for the client and might safeguard them from a significant business risk. In many such assignments giving clean chit to the 'targeted party' is a difficult proposition to substantiate than a negative 'findings' report.

Background Checks and Surveillance

13.5 These are more suited to non accounting professionals and involve extensive field work and data mining. Excellent networking is a prerequisite to handle these kinds of assignments. A typical assignment would consist of ascertaining the reputation of the business partners before entering into a business relationship.

Pre-employment Screening

13.6 Experience has taught many businesses that if they had objectively and comprehensively screened candidates prior to employment, many malpractices such as, conflict of interest, industrial espionage, theft of proprietary information, contravention of business compliance issues and business fraud might have been avoided.

13.7 Employment screening is an essential process to safeguard any business from hiring persons who are either unqualified or of questionable integrity. Screening applicants through prior and post hiring enquiries is loss prevention in the real sense. This screening can be extended further to business partners, vendors and dealer networks. This is, generally, a volume activity and work profile involves screening of individuals from senior management to the operating level. The senior the hierarchy the higher the information requirements, the time span for completion and resultant service fee levels. For mass employment screening, the fee are generally negotiable and tend to be competitive. This includes resume check, telephone check, database searches, pretext enquiries, review of university records, enquiries with the local police station and other information available in the public domain. The objective is to filter any false claims about qualification, work experience and personal background or identify weakness on account of withheld information that is relevant to employment such as, previous criminal convictions or misconduct.

Tackling Ethical Dilemma

13.8 Every organisation has an in built value system with its own mission statement, code of conduct and core values that need to be imbibed in the work environment. There are several business situations that create a situation of ethical dilemma in the minds of employees that require a greater understanding of these value statements. Whether it is conflict of interests or protection to the whistleblowers, role of ombudsmen, effective upward communication and workshops bring greater clarity in the minds of the operating people. Abundant experience and knowledge of work culture is essential in addressing these issues and is a highly specialised activity. To append a value to these activities is a difficult task.

Investigation into Financial Crimes

13.9 Investigative assignments although of primary importance do not ensure a perennial stream of work. Hence, it is important to ensure a minimum allocated percentage of time in a year towards building these kinds of assignments. This is the only way sustainability can be brought to the investigative practice. This can be achieved through product differentiation between consulting, internal audit and investigative assignments. The resource constraints can hamper the accepting of investigative assignments and, hence, regular updating of skill sets is a critical factor in managing these kinds of assignments.

Identify End Use of Funds

13.10 These assignments are similar to bank audits except that the client could be Non-Government organisations, World Bank projects and many social projects wherein the donor is interested in deriving a comfort about the end use of funds. Any diversion of funds not in accordance with the objective of the organisation would hamper the reputation of the organisation and future in flow of funds.

Asset Tracing

13.11 Asset tracing investigations suit debt recovery process for banks and financial institutions. Asset tracing is desirable but not of the recovery proceeds as these are high risk proposition and are difficult assignments. Accordingly, there is a need for abundant caution in understanding the mandate from the management and deliverables. Asset tracing are also done for merger and acquisition activities as part of due diligence activities of the organisation. In a disproportionate asset case, the asset tracing team plays a major role in evaluating the asset amassed by the employee vis-à-vis his disposable income.

Legal Support

13.12 This practice should be seen from an accounting perspective and involves pre-trial discovery, various forms of alternative dispute resolution in business, providing assistance to lawyers with accounting, business solution, and valuation aspects in legal initiatives. This will include damage analysis or defending a claim for damages. Generally, this should be the preferred practice of Chartered Accountants. This will be inherent strength for the members who already are well versed with court matters.

Expert Witness

13.13 An expert witness or professional witness is a specialist who by virtue of his education, training, skill or experience possesses knowledge beyond that of an average person and sufficient to the extent that his opinion about an evidence or fact with the scope of reference is called an expert opinion.

A qualified expert may testify by giving an opinion or otherwise and such a testimony should be based on sufficient facts or data and should also be a product of reliable principles and methods. The expert witness must have applied the principles and methods reliably to facts of the case in forming an opinion. A Chartered Accountant with his domain professional knowledge can play the role of expert witness effectively.

Damage Assessment/ Business Valuation

13.14 It will require reports from the Chartered Accountants on account of business interruption, loss of stock/ assets, ocean loss claims, fire claim, damages arising out of professional negligence, product liability (warranties) and loss of profits due to disputes, breach of contract, business valuation for new acquisitions, etc.

Intellectual Property Rights Protection

13.15 Some of the investigative firms are backed by retired police officials or army officials and experienced lawyers who have a wide network of contacts. They provide adequate training for isolating incidents of counterfeit products being sold in the market. The source of such product is also traced most of the time, and with the help of local police network the operation is successfully completed including seizure of unauthorised machinery, closure of manufacturing facility and suggesting remedial measures to the affected client. This practice also includes corporate brand vulnerability assessment.

Anti-Fraud Reviews (AFR)

13.16 These reviews are a tool for fraud deterrence, and are used for identifying the root cause for the occurrence of a fraudulent activity. This requires improvement in the existing procedures to eliminate the 'fraud enablers'. The short term steps are more procedural and long term changes includes ethics workshops and focussing on cultural changes within the organisation. AFR is a process of assessing the vulnerabilities in the present work environment of a business entity. The process requires visualising fraud scenarios under a set of pre-defined conditions. Identifying the critical areas for review is an important step in this type of assignment. This is followed by creating hypothesis of events called 'triggers for fraud'. The fraud trigger is tested with reference to people, processes, timing, reporting and documentation of activities. The past occurrence of fraud, the frequency of such occurrence over a defined period, the impact on the entity in terms of materiality and on its reputation are influencing factors in the risk profiling process. The exercise concludes with prioritising these risks and suggesting remedial measures. Essentially, this exercise is revisited after a defined time interval.

The diagnostic review for assessing vulnerabilities to fraud is a step towards deterrence of fraud. From a management perspective elimination of fraudulent activities though desirable is improbable. Hence, any remedial measure arising out of diagnostic reviews should be subjected to a cost benefit analysis and should not result in degrading the functioning of business entity.

Cyber Crime

13.17 The services under this category among firms vary depending upon their in-house capabilities. The services include data recovery that enable the retrieval of e-mail messages and deleted documents. The services include creation and maintenance of evidence to ensure proper collection and presentation of data in court, data imaging and information security compliance audits.

Case Studies

13.18 The following case studies illustrate the situations mentioned above:

(i) The CFO/ CEO of a company had excelled in ensuring a consistent business performance coupled with a hyper growth in business volumes. This has brought in greater expectations from the board members in terms of using their expertise in other new business ventures and similar expectations from the audit committee members in strengthening the internal controls with more delegation of power. This has necessitated reorganisation of the reporting structure including identifying a new breed of leaders who can carry on the good work. The HR Head was summoned and was referred some eligible candidates within the organisation and also to look for new talent outside the business realm. The HR person started profiling the candidates and had reservations on the integrity of the persons to whom the business mantle can be handed over, based on grapevine information. However, to prove this point he was in need of the right feedback and supporting evidence to corroborate facts. An investigation firm was called in to ensure a background check seeking specific information about the candidate without revealing the real objective that he was a potential candidate for a senior position. Do you consider this appropriate in not revealing the true objective?

(ii) The competitors in a business managed to launch their competing product despite company's best efforts to maintain confidentiality of information. This brought in an element of distrust within task force on information leakages to the competitor. The management realised the need for conducting an information security review to identify the control gaps that lead to this mishap time and again. The internal auditor was summoned to undertake a covert assignment (Special audit assignment) to identify the manner in which information reached the competitors.

A part of the assignment required the internal auditor to look into avenues for leakage of information and a specialist was needed on matters relating to use of technology and review of telecommunication lines. Accordingly, a decision was taken to outsource the technical aspects of the review. Using the services of technicians for presence of any bugs and an effective surveillance mechanism they were able to successfully isolate the problem. The technical surveillance revealed that none of the internal task force members were responsible for information leakage.

Chapter 14

Market Scenario for Investigative Work

Chapter Summary

The chapter provides an insight into the market scenario for investigative type of work that has a room for all types of operators whether it is a freelancer or a group of persons handling various facets of investigative type of work under a contractual relationship. Infact there is a dirth of operators as the type of work requires exceptional skill sets, risk element and has immense stress in getting the resources for the existing operators. The chapter also deals with client concerns and precautions to be taken in assinging of jobs.

14.1 In an open economy with a focus on globalization, foreign companies are setting their sights on India and vice versa resulting in forging of alliances giving thrust to due diligence activities. However, any fallout in such relationships at a later stage may give rise to a situation requiring mediation and conflict resolution.

These companies in India that have tie ups with foreign entities do have the risk of facing allegations of manipulation of accounts outside India. These developments could result in unanticipated reputation risk and unforeseen strain in business relationships. The assertion by the management that the Indian operations are insulated from such developments should be seen in the proper perspective. To take a decision on whether to continue or sever the business relationship, management needs to revisit the due diligence exercise done prior to forging an alliance. This exercise can be more ably done by a Chartered Accountant.

From an investigative services perspective, this is an area to watch out for in the next few decades and has immense potential for the investigative practice.

14.2 This brings the several questions to the forefront like, who is the client, how to vet referral of assignment, how to assess fraud risk, what is the expectation of the client and finally how to make a beginning in an investigation assignment, etc. Generally, investigation is used as a tool for confidence building by borrowers *vis-a-vis* the lenders or could be on behalf of the lenders to ensure checks and balance on safety of their investment or loan disbursed. Here the target client could be a money lender or the borrower client. Similarly, where the assignment is about integrity check or surveillance, the HR department personnel could be the target client.

Types of Operators

14.3 The market scenario for investigative assignments is very encouraging with enough space for all kinds of operators in these types of engagements to the extent permissible under the law. Primarily, this market is unorganized and private investigators can be classified into the following categories:

(a) Freelancers (retired police officers, ex-army personnel, etc);

(b) Private detective agencies;

(c) Risk management firms (with a global network being an advantage);

(d) Audit firms (proprietary, medium sized partnerships, and large firms);

(e) In-house departments (on behalf of the management).

14.4 Apart from the above, investigations may be mandated under Statute. For e.g., investigations instituted under direction from regulating authorities (Banks, Financial institutions, Registrar of companies, Reserve Bank of India, Insurance Regulatory and Development Authority, Securities and Exchange Board of India, etc.) or by Law enforcement agencies (on behalf of the State or Court of Law).

Resources in an Investigative Firm

14.5 Generally, the assistance of retired Intelligence Bureau officers, CBI officers, or Ex-officers of high profile regulatory authorities and former Government officials from investigative background with integrity and proven track record are considered as an essential support for brand building and the training needs within the investigation firms. These officials are also considered essential for field work and form an integral resource in establishing a network of informers and are a source of information vital to the objective of conducting investigation within the legal framework. Since clientele information cannot be shared by investigative firms, the experience of the team members and the presence of a multi-faceted team (CAs, MBAs, Law Graduates, Psychologists, Historians, Sociologists, IT professionals, Statisticians, etc.) become a confidence building measure to ensure core competency. An investigation being a specialized activity involving multi-faceted skill sets, there is a tendency to form limited liability companies that suits brand building too.

14.6 A distinct feature in this field is the high attrition rate among the investigative personnel. Considering the quality of personnel, and risk and skill sets involved, the compensation is generally benchmarked with the best in the industry with reference to other professional services. Cost considerations are a critical factor in the engagement process, both for the management as well as the investigating firm. The engagement fee mainly depends on the time spent and objective of the assignment and may vary from firm to firm, based on their skill sets.

14.7 A Chartered Accountant in accordance with his professional knowledge base is able to be an efficient co-ordinator among these agencies ably supported by analytical skills, working knowledge in process evaluation and requisite documentation, especially for investigation involving financial crimes. He is, therefore, at an advantage to play the role of a strategist in carrying out the investigation. However, for field work, services of non-Chartered Accountants may be used.

14.8 For the above agencies, there is also a need to ensure that resources both in terms of manpower or investigative tools are gainfully deployed. Hence, multiple services apart from core investigation are created. This comprises of conducting surveys, research reports, media exposure, periodical representations to management, due diligence, conducting background checks (surveillance), reference checks for appointment of personnel to important posts in an organization, reference checks for HR department (large volume contracts), integrity checks for employees, assignments related to patents and trademarks violations, business ethics workshops, validation of processes for game shows in media, etc. are some examples. An internal auditor who has a better understanding of financial as well as operational audits is more suitable to be engaged in investigative assignments, whenever the situation warrants. It is also desirable for investigating firms to engage in a dialogue with the internal auditors at the planning stage to evolve their strategies.

Chapter 15

Way Forward

Chapter Summary

The chapter is intended to encourage the members to hone their skills to look for opportunities and develop resources to ensure greater diligence in executing their professional responsibilities. This practice rather than being seen as fault finding exercise should be construed as confidence building measure that requires the attention of members, management and audit committee representatives.

Representations to the Members

15.1 Investigative practice is a specialised field and is a confluence of the fields of Accounting, Law, Information technology, Sociology, Psychology, Journalistic aptitude, Business communication and Business administration. Investigation is a team effort and, therefore, a post qualification course covering any of these fields could immensely help members in honing their skills. This would mean more members take up investigative practice in an endeavour to minimise corruption in society. There is a need for a functional interface between the world of accountants and the legal profession.

15.2 The investigation work in private companies is largely unorganised and unregulated and often involves experimenting on the job at the risk of the engagement client. This creates the need for extensive training workshops in developing the skill sets of members. With the rise in financial crimes, it is imperative that a Chartered Accountant is alert to the new accounting world order in developing processes that enable isolation of fraudulent activities.

Representation to Management

15.3 The management could allocate a budget for addressing risk of fraud as a part of the overall risk management plan. This could include structured anti-fraud programs at pre-defined intervals, keeping in view the existing control environment. Where fraudulent activities are found to be rampant in certain sectors, the formation of an investigative cell by whatever name called to ensure an array of activities including a surveillance mechanism to identify red alerts within the organisation could be an added advantage suplementing the internal audit function.

An in-house coordinator (could be the compliance officer or the chief audit executive) to advice on matters relating to investigative support within the organisation could be designated.

Representations to the Audit Committees

15.4 There is an increasing role of the audit committees (especially, the independent directors) whose expertise could be of immense use in functioning of the enterprise. While the mandate for investigation is a management decision, the audit committee has the right to seek clarification from the management on the action taken on red flags as highlighted by the internal auditors. This strengthens the role of internal audit functionaries in terms of evaluating the control environment of the entity at the same time bringing service differentiation between audit and investigative assignments.

Appendix A

Recommended Reading Material/ Website References for Readers

Recommended Reading Material

- Constitution of India
- Prevention of Corruption Act, 1988 (applicable mainly to public servants)
- Foreign Corrupt Practices Act of 1977 (applicable to Indian companies having overseas operations)
- The Indian Penal Code, 1860
- The Indian Evidence Act, 1872
- The Code of Criminal Procedure, 1973
- The Civil Procedure Code, 1908
- The Indian Contract Act, 1872
- Law of Torts
- Industrial Disputes Act, 1947
- The Private Detective Agencies (Regulation) Bill, 2007

Recommended Websites

www.sfio.nic.in (organisation to investigate serious financial frauds)

www.sebi.gov.in (on corporate governance)

www.rbi.org.in (for fraud monitoring and reporting process)

www.cvc.nic.in (disciplinary action on public servants)

www.cbi.gov.in (investigative approach)

www.irs.gov (for investigation report drafting)