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Topic 1: Case Study - ABC Private Limited

1.1 Background

ABC Private Limited was incorporated in the year 2009.

The main business of the company is trading in chemicals which are having wide range of use in various industry. From FY 2019-20, the company has also started manufacturing of chemicals. The company has obtained loans from SIDBI during the year for setting up the manufacturing facility at Silvassa (Refer Note No. 33).

The credit policy offered by the company varies from 15-45 days depending upon the creditability of the customer assessed by the management of the company.

1.2 Allegations against the company

Following allegations are made against the company by banks, tax and regulatory authorities:

1. The profits as appearing in the audited Financials are overstated for the purpose of presenting a more favorable picture to financial institutions.

2. The company has violated various provisions of Companies Act, 2013 w.r.t loans taken.

3. The company has violated various provisions of Companies Act, 2013 w.r.t loans given.

4. Income tax department has alleged that the directors have underreported their income.

5. GST Department has conducted raid at the company's head office at Mumbai.

1.3 Level 1 Observation:

1.3.1 Debtors & Loan Verification

13 . Trade receivables — In ₹ (Rupees)

Particulars	as at 31-Mar-2020	as at 31-Mar-2019
Outstanding for less than 6 months from the due date		
Unsecured, considered good	21,44,716	6,60,18,275
Outstanding for more than 6 months from the due date		
Unsecured, considered good	10,34,83,226	3,55,92,047
Total	**10,56,27,941**	**10,16,10,323**

Finding - Over 90% of Debtors are outstanding since over 6 months. This means that the sales made by the company are not being realized in cash.

Possible reasons -

1. Sales are being overstated only for the purpose of showing high sales and profitability.
2. Several Customers (called Debtors) who have large outstanding balances are actually unable to pay the amounts owed. But, the management is unwilling to write-off these amounts as bad debts. Thus it is carrying “fictious debtors” or “Fictious assets” in its balance sheet.
3. Sales are being booked to related parties to facilitate “round tripping” of money.
4. Credit policy allowed to customer is decided without properly assessing the creditability of the customer by the company.

1.3.2 Round Tripping of Money

The accounting slang term "round tripping" refers to a series of transactions between companies that bolster the revenue of the companies involved but that, in the end, don't provide real economic benefit to either company. While not necessarily illegal, round tripping is at best disingenuous. It's important for a Forensic Auditor to be able to recognize when a transaction may amount to round tripping -- and, just as important, to know when a transaction that may look like round tripping is in fact legitimate. The point of round tripping is to inflate revenue -- to make a company look like it's doing more business than it really is. Although the bottom line for any company is profit, observers often judge a company's growth and size by its sales revenue.

Example: - A common round-tripping maneuver involves reciprocal sales of identical assets. Imagine you own an office supply store, and the owner of a stationery store comes to you with a proposal. He'll buy a pallet (40 cases) of copy paper from you at your retail price of INR 30 a case, for a total of INR 1,200. Meanwhile, you'll buy a pallet of the identical paper from him at the same price, INR 1,200. He's proposing a round-tripping deal. Other, more flagrant examples might include mutual payments for nonexistent "services," or one company "investing" in another, with the second company turning around and using the money to buy goods or services from the first.

Hint to identify Round Tripping of Money: The party from whom money is receivable is also a party to whom money is payable i.e. same party can be found in Accounts Receivable as well as in Accounts Payable.

1.4 Level 2 Observations:

1.4.1 Window Dressing

Window dressing is actions taken to improve the appearance of a company's financial statements. Window dressing is particularly common when a business has a large number of shareholders, so that management can give the appearance of a well-run company to investors who probably do not have much day-to-day contact with the business. It may also be used when a company wants to impress a lender in order to qualify for a loan. If a business is closely held, the owners are usually better informed about company results, so there is no reason for anyone to apply window dressing to the financial statements. Window dressing is a short-term strategy used by companies and funds to make their financial reports and portfolios look more appealing to clients, consumers, and investors. The goal is to attract more people and more money, hopefully boosting the next reporting period's bottom line.

17 . Revenue from Operations — In ☐ (Rupees)

Particulars	1-Apr-2019 to 31-Mar-2020	1-Apr-2018 to 31-Mar-2019
Sale of Products	**54,78,23,889**	**72,15,48,612**
Export Sales	-	7,72,41,027
Local Sales	53,16,80,279	59,08,90,535
High Sea Sales	1,61,43,610	5,34,17,050
Other Operating Revenues	**1,32,00,175**	**61,95,914**
Rebate	(3,54,845)	47,32,127
Currency Fluctuation Gain/Loss	47,60,366	13,10,527
Commission Income	83,12,139	-
Insurance Claim	4,82,515	-
Interest on Late Payment From Debtors	-	1,53,260
Total	**56,10,24,063**	**72,77,44,526**

Findings – The Company has booked Commission Income of INR 83,12,139/- in Current Year, however no such income was available in Previous Year.

Possible Reasons -

1. The company might have booked commission income from related party only for the purpose of making the company look profitable to financial institutions.

1.4.2 Loan from Directors

3 . Long-Term Borrowings — In ☐ (Rupees)

Particulars	as at 31-Mar-2020	as at 31-Mar-2019
Secured		
Term Loans from Banks*	4,61,58,000	-
Unsecured		
Loans and Advances from Shareholders	8,50,00,000	8,50,00,000
Total	**13,11,58,000**	**8,50,00,000**

5 . Short-Term Borrowings — In ☐ (Rupees)

Particulars	as at 31-Mar-2020	as at 31-Mar-2019
Secured		
Other Loans and Advances from banks*	3,49,92,787	3,12,63,915
Unsecured		
From Shareholders	26,09,499	1,42,42,389
Total	**3,76,02,286**	**4,55,06,304**

Check for possible irregularity/non-compliance:

- **Section 179 of the Companies Act, 2013** provides to take prior consent of the Board to borrow money.
- **Section 180 of Companies Act, 2013** provides to take prior consent of the members of the company by way of a special resolution to borrow money, where the money to be borrowed, together with the money already borrowed by the company will exceed an aggregate of its paid-up share capital, free reserves, and securities premium, apart from temporary loans obtained from the company's bankers in the ordinary course of business. Section 180 does not apply to Private Company and as such Private Company can continue to borrow money by simply passing Board Resolution even if the borrowed amount exceeds the above-specified limit.
- If a Company receives the amount from the directors of the company or the relative of directors of the private company out of their own funds, it will be treated as Loans and do not attract the provision of Section 73 or Section 76 of the Companies Act, 2013. However, to avail such relief, the director or the relative of the director as the case may be, needs to furnish a declaration in writing to the effect that the amount is not being given out of funds acquired by him by borrowing or accepting loans or deposits from others and the company shall disclose the details of money so accepted in the Director's or Board's Report. Section 180 will be applicable to the Public Company.
- The said declaration is needed to check compliance with THE BANNING OF UNREGULATED DEPOSIT SCHEMES ACT, 2019. As per the said act, persons are prohibited from indulging in NBFC activities i.e. borrowing from one source and lending the same to another source for the purpose of earning the interest spread.
- Every Public Company and Private Company shall disclose in its financial statement, by way of notes, about the money received from the director or relative of directors (in case of a private company).

1.4.3 Loan to Directors from Companies Act Perspective

15. Short-Term Loans and Advances		In ₹ (Rupees)
Particulars	**as at 31-Mar-2020**	**as at 31-Mar-2019**
Other Loans and Advances (Unsecured, considered good)		
Advance to Suppliers	24,32,358	1,15,50,033
Balance with Government Authorities	49,01,868	72,64,432
Loan to Directors/Entities in which director are Interested	2,08,56,900	-
Deferred Premium Expense	1,75,983	13,15,887
Deposits	1,86,04,270	55,71,585
Forward Contract Amount Receivable	2,73,92,701	17,08,42,735
Prepaid Expenses	2,00,701	5,265
Total	**7,45,64,782**	**19,65,49,936**

Check for possible irregularity/non-compliance with Section 185 (as amended by the Companies (Amendment) Act, 2017):

- **As per section 185 of Companies Act, 2013** no company shall, directly or indirectly, advance any loan, including any loan represented by a book debt, to any of its directors or to any other person in whom the director is interested or give any guarantee or provide any security in connection with any loan taken by him or such other person. However, the above mentioned prohibition does not apply to following 2 cases.

- When company provides loans, guarantee or security in relation to any person in whom any of the directors is interested provided Passing of Special Resolution by the company in a General Meeting (Approval of at least 75% of the members is required) and the said loans shall be utilized by the borrowing company solely for its principal business activities.
- The loans to MD or WTD may be given only if the following conditions are met with: - Where it is part of the Policy of Service of the company to grant loans to all employees. Pursuant to any scheme which is duly approved by the members by way of a Special Resolution.
- The said section is not applicable to:

1. Government Company.
2. Loan given by a company involved in money lending, where loans have been extended in the ordinary course of business.
3. Private Company –
    a. In whose share capital no other body corporate has invested money;
    b. If the borrowings of such a company from banks or financial institutions or anybody corporate is less than twice of its paid-up share capital or fifty crore rupees, whichever is lower and
    c. Such Company has no default in repayment of such borrowings subsisting at the time of making transactions under this section.

1.4.4 Loan to directors from Income Tax Perspective

According to Section 2(22)(e), when a company in which the public are not substantially interested*, extends a loan or an advance to: a. any of its shareholders who has more than 10% voting power in the company or b. to any concern in which such shareholder is substantially interested or c. for the individual benefit of such shareholder or d. on behalf of such shareholder **to the extent the company has accumulated profits**, such payment would be deemed as a dividend under Section 2(22)(e). *a company in which public is not substantially interested is otherwise called a closely held company.

2 . Reserves and Surplus In □ (Rupees)

Particulars	as at 31-Mar-2020	as at 31-Mar-2019
Surplus		
Opening Balance	13,10,54,395	10,09,66,478
(+) Net profit/(Net loss) for the Current Year	11,68,577	3,00,87,918
Closing balance	13,22,22,972	13,10,54,396
Total	**13,22,22,972**	**13,10,54,396**

Check for possible irregularity/non-compliance:

1. Whether Directors have disclosed the said as dividend income to the tax authorities?
2. Whether the Company has paid Dividend Distribution Tax?
3. If the said loan is treated as advance to directors for procuring raw materials or services from Director, then underlying agreement between the company and director need to be scrutinized properly.
4. Loan under circumstances specified below will not be treated as deemed dividend.
    a. Loan given by a company involved in money lending, where loans have been extended in the ordinary course of business.
    b. Advance given for the purpose of procuring goods and services from Directors.

1.5 Level 3 Observations:

1.5.1 GST Law Viewpoint:

6 . Trade Payables In ₹ (Rupees)

Particulars	as at 31-Mar-2020	as at 31-Mar-2019
Creditors for Local Purchase	2,83,73,373	36,68,838
Outstanding for Import Purchase	3,48,34,972	3,60,97,314
Outstanding for Expenses & Others	57,11,191	33,38,681
Total	6,89,19,536	4,31,04,833

- Invoice frauds are the most popular schemes amongst fraudsters. They are designed to generate false payments against: –
    1. false invoices or false entries in the books of accounts
    2. inflated invoices or duplicate invoices or
    3. fake invoices without underlying transactions of goods or services.

  Since the rollout of GST, a large number of fraud cases involving the use of fake invoices for wrong availment of input tax credit (ITC), which is further used to pay GST on outward supply, have been detected. The malafide intent for such fake invoice schemes appears to be fraudulent availment/encashment of ITC credit. Often the unscrupulous entities engaged in this modus operandi also defraud other authorities such as Banks by inflating turnovers, laundering of money, etc.

  Invoice fraud schemes are designed with ulterior motives such as inflation of expenses or turnover, availment of wrongful gains under law such as Input Tax Credit (GST), claim of illegal benefits/ refunds (zero-rated supply of goods), routing of invoices through a series of shell companies and transfer of input tax credit from one company to another, laundering of money, diversion of funds, etc.

To prevent such fraud i.e. excess claim of ITC through Bogus Invoices various efforts have been made by the CBIC such as E-Way Bill was introduced. One of such efforts is insertion of section proviso to Section 16(2). The said section is reproduced below for your reference:

- **Second Proviso to Section 16(2)** :- "Provided further that where a recipient fails to pay to the supplier of goods or services or both, other than the supplies on which tax is payable on reverse charge basis, the amount towards the value of supply along with tax payable thereon **within a period of one hundred and eighty days** from the date of issue of invoice by the supplier, an amount equal to the input tax credit availed by the recipient shall be added to his output tax liability, along with interest thereon, in such manner as may be prescribed :

  Provided also that the recipient shall be entitled to avail of the credit of input tax on payment made by him of the amount towards the value of supply of goods or services or both along with tax payable thereon."

  Check for possible irregularity/non-compliance:

  1. Whether the Company has reversed amount of ITC availed in case of non-payment of dues for expenses beyond 180 days?
  2. Whether company is involved in availing ITC through bogus invoices?
  3. Whether company has received the Goods or Services for which payment is due?

Topic 2: Cash Flow Statement

2.1 Overview:

The statement of cash flows tells you how much cash went into and out of a company during a specific time frame such as a quarter or a year. You may wonder why there's a need for such a statement because it sounds very similar to the income statement, which shows how much revenue came in and how many expenses went out.

The difference lies in a complex concept called accrual accounting. Accrual accounting requires companies to record revenues and expenses when transactions occur, not when cash is exchanged. While that explanation seems simple enough, it's a big mess in practice, and the statement of cash flows helps investors sort it out.

The statement of cash flows is very important to investors because it shows how much actual cash a company has generated. The income statement, on the other hand, often includes noncash revenues or expenses, which the statement of cash flows excludes.

One of the most important traits you should seek in a potential investment is the firm's ability to generate cash. Many companies have shown profits on the income statement but stumbled later because of insufficient cash flows. A good look at the statement of cash flows for those companies may have warned investors that rocky times were ahead.

The Three Elements of the Statement of Cash Flows

Because companies can generate and use cash in several different ways, the statement of cash flows is separated into three sections: cash flows from operating activities, from investing activities, and from financing activities.

The cash flows from operating activities section shows how much cash the company generated from its core business, as opposed to peripheral activities such as investing or borrowing. Investors should look closely at how much cash a firm generates from its operating activities because it paints the best picture of how well the business is producing cash that will ultimately benefit shareholders.

The cash flows from investing activities section shows the amount of cash firms spent on investments. Investments are usually classified as either capital expenditures--money spent on items such as new equipment or anything else needed to keep the business running--or monetary investments such as the purchase or sale of money market funds.

The cash flows from financing activities section includes any activities involved in transactions with the company's owners or debtors. For example, cash proceeds from new debt, or dividends paid to investors would be found in this section.

Free cash flow is a term you will become very familiar with over the course of these forensic audits. In simple terms, it represents the amount of excess cash a company generated, which can be used to enrich shareholders or invest in new opportunities for the business without hurting the existing operations; thus, it's considered "free." Although there are many methods of determining free cash flow, the most common method is taking the net cash flows provided by operating activities and subtracting capital expenditures (as found in the "cash flows from investing activities" section).

Cash from Operations - Capital Expenditures = Free Cash Flow

2.2 Profit & Loss Account – Kingfisher Airlines Limited:

Kingfisher Airlines -

Standalone Profit & Loss account					**------------------ in Rs. Cr. ----- --------------**
	Mar 13	**Mar-12**	**Mar-11**	**Mar-10**	**Mar-09**
INCOME					
Revenue From Operations [Gross]	**501.38**	**5,493.41**	**6,233.38**	**5,067.92**	**5,269.17**
Revenue From Operations [Net]	**501.38**	**5,493.41**	**6,233.38**	**5,067.92**	**5,269.17**
Other Operating Revenues	0	0	126.26	0	0

Total Operating Revenues	**501.38**	**5,493.41**	**6,359.64**	**5,067.92**	**5,269.17**
Other Income	182.08	330.5	135.92	24.36	836.43
Total Revenue	**683.46**	**5,823.91**	**6,495.56**	**5,092.27**	**6,105.60**
EXPENSES					
Cost Of Materials Consumed	0	0	0	1,843.88	2,653.81
Aircraft Fuel Expenses	402.17	2,945.89	2,274.03	0	0
Aircraft Lease Rentals	710.08	868.45	984	0	0
Operating And Direct Expenses	0	0	0	1,108.82	1,112.85
Employee Benefit Expenses	349.16	669.51	676.01	689.38	825.42
Finance Costs	1,436.15	1,276.34	1,312.94	1,007.67	696.23
Depreciation And Amortisation Expenses	238.78	341.87	241.04	162.8	133.2
Miscellaneous Expenses Written Off	0	0	0	54.49	38.39
Other Expenses	1,848.24	3,167.96	2,528.34	2,343.36	2,563.38
Total Expenses	**4,984.58**	**9,270.00**	**8,016.35**	**7,210.39**	**8,023.28**
Profit/Loss Before Exceptional, ExtraOrdinary Items And Tax	**-4,301.12**	**-3,446.09**	**-1,520.78**	**-2,118.12**	**-1,917.67**
Profit/Loss Before Tax	**-4,301.12**	**-3,446.09**	**-1,520.78**	**-2,118.12**	**-1,917.67**
Tax Expenses-Continued Operations					
Deferred Tax	0	-1,118.08	-493.42	-764.63	-558.88
Other Direct Taxes	0	0	0.03	64.63	12.5
Total Tax Expenses	**0**	**-1,118.08**	**-493.38**	**-700**	**-546.38**

Profit/Loss After Tax And Before Extraordinary Items	**-4,301.12**	**-2,328.01**	**-1,027.40**	**-1,418.11**	**-1,371.29**
Prior Period Items	0	0	0	31.28	0
Extraordinary Items	0	0	0	-357.65	-237.54
Profit/Loss From Continuing Operations	**-4,301.12**	**-2,328.01**	**-1,027.40**	**-1,744.49**	**-1,608.83**
Profit/Loss For The Period	**-4,301.12**	**-2,328.01**	**-1,027.40**	**-1,744.49**	**-1,608.83**

2.3 Cash Flow Statement - Kingfisher Airlines Limited

Kingfisher Airlines -

Cash Flow					**------------------ in Rs. Cr. ---- ---------------**
	Mar 13	**Mar-12**	**Mar-11**	**Mar-10**	**Mar-09**
Net Profit/Loss Before Extraordinary Items And Tax	**-4,301.12**	**-3,446.09**	**-1,520.78**	**-2,417.92**	**-2,155.21**
Net Cash Flow from Operating Activities	-1,390.86	-885.55	2.23	-1,665.09	-645.78
Net Cash Used In Investing Activities	-69.72	-387.57	-38.05	235.13	206.63
Net Cash Used From Financing Activities	1,297.36	1,203.02	81.72	1,464.55	290.11
Net Inc/Dec In Cash And Cash Equivalents	**-163.22**	**-70.1**	**45.9**	**34.6**	**-149.04**
Cash And Cash Equivalents Begin of Year	182.27	252.36	206.47	171.87	320.91

Cash And Cash Equivalents End Of Year	19.05	182.27	252.36	206.47	171.87

Observation: The Company is relying heavily on borrowed funds to fund its day to day operations every year. Borrowed fund is utilized by the company for funding its operational cash flow deficit instead of being used for expansion purposes as cash used in investing activities is very negligible compared to Funds availed from Financing activities. The company is in need of strategic transformation to generate operating cash flow in order to continue its business in foreseeable future and prevent the company from going bankrupt.

Topic 3: Ratio Analysis

3.1 Overview:

Ratio analysis is the comparison of line items in the financial statements of a business. Ratio analysis is used to evaluate a number of issues with an entity, such as its liquidity, efficiency of operations, and profitability. This type of analysis is particularly useful to analysts outside of a business, since their primary source of information about an organization is its financial statements.

3.2 Type of Ratios:

3.2.1 Liquidity Ratios

Also known as Solvency Ratios, and as the name indicates, it focuses on a company's current assets and liabilities to assess if it can pay the short-term debts. The three common liquidity ratios used are current ratio, quick ratio, and burn rate. Among the three, current ratio comes in handy to analyze the liquidity and solvency of the start-ups. It should be greater than 1.

- **Current Ratio: Current Assets/Current Liabilities**

Answer & Observation in case of ABC Private Limited:

3.2.2 Working Capital Ratios

Like the Liquidity ratios, it also analyses if the company can pay off the current debts or liabilities using the current assets. This ratio is crucial for the creditors to establish the liquidity of a company, and how quickly a company converts its assets to bring in cash for resolving the debts. It is denoted in times and higher ratio denotes a favorable position for the company in general.

- **Inventory Ratio: Net Sales/Inventory**
- **Debtors Turnover Ratio: Total Sales/Account Receivables**
- **Creditors Turnover Ratio: Net Credit Purchases/ Accounts Payable**

Answer & Observation in case of ABC Private Limited:

3.2.3 Capital Structure Ratios

Each firm or company has capital or funds to finance its operations. These ratios, i.e., the Capital Structure Ratios, analyze how structurally a firm uses the capital or funds.

- **Debt Equity Ratio: Total Long Term Debts/Shareholders Funds.**
- **Capital Gearing Ratio: Equity Share Capital/Fixed Interest Bearing Funds.**

Answer & Observation in case of ABC Private Limited: