Deciphering risks in investment deals

kpmg.com/in

Amongst the emerging markets, India has been one of the most attractive investment destinations over the past few years and has witnessed a huge spike in the number of investment deals (private equity / institutional investors / joint venture partners). Private Equity (PE) and Venture Capital (VC) firms invested USD77 billion across 1,266 deals in India in 2021, a 62 percent increase from USD47.6 billion across 923 deals in 2020[1]. Despite the recent downtrend in PE-VC investments in 2022, Foreign Portfolio Investment (FPI) inflows are expected to remain strong in the future, given India's resilient growth outlook[2].

Prior to such investment deals, the transactions of the entity either in which the investment is made or with whom a joint venture transaction is undertaken (target entity) are often overlooked and this could lead to financial as well as reputational implications on the investors. These transactions may include instruments (e.g., immovable property) used to park illicit funds, use of shell company as a vehicle for money laundering, circuitous transactions and round tripping among others.

The Prevention of Money Laundering Act 2002 (PMLA) has provisions to attach immovable properties and other assets derived from proceeds of crime if the parties had knowledge or suspicion about such acts/process of money laundering.

Further, the PMLA states that though the actual crime or illegitimate activity may have been carried out by an entity not directly linked to the target entity, if proceeds of crime were used for any operational expenses or asset creation in the target entity, such assets or expenses could also become questionable, and liable to legal action.

The Financial Action Task Force (FATF), which is the global money laundering and terrorist financing watchdog, has provided 40 recommendations that lay out a framework of measures to counter money laundering/terrorist financing activities and have appropriate preventive/detective mechanisms in place. In its recommendations, the FATF also states that financial institutions should be required to have appropriate risk-management systems to determine whether a customer or beneficial owner is a domestic Politically Exposed Person (PEP) or a person who is or has been entrusted with a prominent function by an international organisation[3].

1. Investment in India, India Brand Equity Foundation, December 2022
2. Resilient growth outlook seen bringing FPI flows back to India, Business Standard, January 2023
3. Amendments to PMLA rules and its impact on 'politically exposed persons', NGOs, The Indian Express, March 2023

Understanding and identifying the risks

It is imperative for investors to understand the following key money laundering risks pertaining to the prospective investee to protect themselves from future liabilities and reputational damage.

A Use of potential illegitimate source of funds in the business operations

Risk: Potential illegitimate funds used in the target entity/investee.

Typical concerns

1. **What are the credentials of the target entity? Whether such entity is doing genuine business?**
2. **What were the source of funds invested in the target entity?**
3. **Are there any loans or advances received by the target entity from entities or individuals with adverse background?**
4. **Were promoters or their connected parties of the target entity involved in any adverse or potential criminal activities?**
5. **Was any black money (undisclosed income) used by the target entity to purchase assets/shares in the past?**

Implications: If the funds were derived from such dubious activities and used for creation of assets/ operations by the target entity, it could lead to attachment of such properties by law enforcement agencies or subject to regulatory action.

B Diversion/siphoning of funds by the target entity/investee

Risk: Diversion/siphoning-off funds may include –

- Use of loan funds, customer advances or any other funds in contravention with the letter of sanction/purpose of obtaining the funds
- Transferring borrowed funds to subsidiaries/group companies or other corporates. It may be noted that the definition of group companies is quite broad in this context
- Routing of funds through any bank other than the lender bank or investment in other companies without proper permission of the lender.

Additionally, siphoning of funds is construed to occur if any borrowed funds from banks/financial institutions are used for purposes unrelated to the operations of the target entity and detrimental to the financial health of the target entity or the lender. In India, it is frequently observed that connected entities, who may not fall in the legal definition of 'related party', are used for diversion/siphoning of funds. Such entities are still controlled indirectly by the management/shareholders of the target entity through distant relatives, friends, trust structure, layered corporates among others and used to undertake transactions that are not at arm's length, or devoid of economic substance. Further, the use of Accommodation Entry Operators (AEO), who can give expense entries with proper documentation, taxes and payments in banking channel, is also common to divert/siphon funds.

Typical concerns

1. **Are all the transactions commensurate with the nature of the business of the target entity?**
2. **Are the funds utilised for the purpose for which they were obtained?**
3. **Are there any round tripping transactions in the past recorded in the target entity?**
4. **Are there any suspicious related party or connected party transactions?**
5. **Are there any transactions which are not at arm's length?**

Implications: Diversion/siphoning of funds may lead to penalties and other liabilities that the entity may have to bear. Further, in case of regulatory or legal matters, this could also lead to attachment of properties and assets of the target entity and action on investors if they had knowledge or reasons to suspect such transactions in the operations.

C Fictitious/inflated assets and expenses

Risk: The value of assets or capital expenditure may be inflated due to fictitious charges such as asset acquisition, rental of assets, setting up manufacturing plants, payment for advisory services and connected/related party transactions among others.

Typical concerns

1. **Were any payments made to fictitious vendors or third parties?**
2. **Are there adequate supporting documents and business justification for major transactions from an anti-money laundering perspective?**
3. **Were there any major expenses recorded in the name of related/connected parties but not at arm's-length?**

Implications: Inflated operating or capital expenditures could lead to undue higher valuation of the target entity.

D Bribery and corruption

Risk: Organisations have multiple government touchpoints for obtaining approvals, licences, permissions among others in day-to-day operations. In such scenarios, facilitation payments and bribery of government officials could be undertaken to expedite the procedures or obtain fraudulent licences or permissions or approvals.

Typical concerns

1. **Are there adequate receipts or supporting documents for payments to statutory authorities?**
2. **Are there undue benefits in cash or kind given to any agents, third-party intermediaries for obtaining licences or permissions or approvals?**
3. **Are there any cash payments being made without adequate supporting documents?**
4. **Are there any payments or charitable donations made to political parties?**

Implications: Bribery and corruption could lead to violation of Anti-Bribery and Corruption (ABC) laws that could lead to heavy penalties being imposed and criminal liabilities on the organisation, its directors and other officials, and also damage the hard-earned reputation. It may be noted that according to the recent developments, some enforcement authorities are shifting the burden of corporate malfeasance from shareholders to individual employees and corporate leaders who are directly responsible for wrongdoing in order to cultivate a responsible corporate behaviour.

Key considerations for the investors

It is imperative for investors to adequately evaluate the above-mentioned risks pertaining to the target entity/ investee prior to any investment deals and be aware of any liabilities or regulatory issues pertaining to Anti-Money Laundering (AML) provisions or ABC regulations. Below indicative steps may be considered but a situation based, full risk assessment is needed to meet specific needs:

Area	Key diligence steps which may be considered
Use of potential illegitimate source of funds in the business operations	• Validate various sources of funds based on review of financial records (AML due diligence) • Identify any adverse or criminal information on the promoters or shareholders or lenders (Integrity due diligence)
Diversion/siphoning of funds by target entity/ investee	• Identify any linkages of the entities or individuals from whom funds were received with any other entities or individuals with adverse or criminal background (AML due diligence)
Fictitious/inflated assets and expenses	• Ascertain if any illegitimate sources of funds were used for operational and/or capital expenditure and its quantum (Forensic due diligence) • Identify any instances of round tripping transactions and diversion of funds (AML due diligence) • Test check veracity and genuineness of the expenses and review adequacy of the supporting documents for payments (AML due diligence)
Bribery and corruption	• Identify the critical government touchpoints and high-risk areas pertaining to bribery and corruption (ABC due diligence) • Review adequacy of supporting documents for payments to statutory authorities and donations to political parties (ABC due diligence) • Ascertain veracity of payments to third party intermediaries and employees for the purpose of liaising with government authorities for obtaining approvals, licences and permits among others. (ABC due diligence)

Notes

KPMG in India contacts:

To learn more about how KPMG in India can assist you, please contact us:

Vijay Chawla
Partner and Head
Risk Advisory
T: +91 80 6833 5509
E: vschawla@kpmg.com

Jagvinder S. Brar
Partner and Head
Forensic and F-Tech
T: +91 97169 09339
E: jsbrar@kpmg.com

Suveer Khanna
Partner and Head
Forensic Investigations
T: +91 96196 32131
E: skhanna@kpmg.com

Mustafa Surka
Partner
Forensic Services
T: +91 98199 88629
E: mustafasurka@kpmg.com

Geetu Singh
Partner
Forensic Services
T: +91 96193 90060
E: geetusingh@kpmg.com

kpmg.com/in/socialmedia

30 years and beyond

KPMG Assurance and Consulting Services LLP, Lodha Excelus , Apollo Mills Compound, NM Joshi Marg, Mahalaxmi, Mumbai 400 011 Phone: +91 22 3989 6000, Fax: +91 22 3983 6000.

Printed in India. (015_BRO0723_KK)