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DUE DILIGENCE:
A COMPREHENSIVE WAY TO INVESTIGATE THE BUSINESS

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ABSTRACT

What we should think about while acquiring the business of others or when selling our business to others? What should we think about when we are going to be the partner of some one? These are very obvious questions that come in the mind of any person when he or she is taking any of such decision. The answer is very simple and well known. Two questions shall be asked before making such a decision. The first one is that, what is the value of the business, not in terms of book value but in terms or market value and economic Value. Second what should be the right price to pay to acquire the business? However being as a lay person, obtaining answer of both the question is quite impossible. To know the value of Business, someone must know the values of its Assets and Liabilities as shown by books and those not shown by books. We called them as hidden Assets and Liabilities. Only a professional person like a chartered accountant may know what are the hidden Assets and Liabilities. These are never disclosed by seller of the business and at any later date may put the buyer into huge losses. Same as to calculate the price to be paid, various technical methods are used so that actual price can be known. Hence Due diligence is conducted by any professional who gives consideration to the all aspects of the business including Tax Aspects. This article is going to enlighten the various aspects of Due Diligence from the prospective of Different users of Due Diligence concept.

Keywords: *Due Diligence, Merger & Acquisition, Global Aspects, Economic Value.*

Introduction

Due Diligence has emerged or incepted due to various weaknesses caused in the historical system of business Valuation and evaluation used while making Corporate Restructuring which includes Internal Restructuring, Amalgamation, or Spin off or like nature such as Mergers, Joint Ventures etc whether in internal or external. Since the conventional system of business valuation was totally of consideration of financial aspects which is profit earning or not and was lacking with many aspects on the part of taxation, Information Technology, environment etc, hence a system which incorporates all those aspects of business which shall be looked into while dealing with corporate Restructuring was very much needed. Due Diligence is that kind of system which has all these features and evaluates the business form these all aspects. However sometime people get confused with the term Audit and mean the word due Diligence as Audit. Both are absolutely different. Due Diligence is to be used for measuring the overall performance of the business, the Audit is termed as independent examination of Financial Statements of the entity with the whole sole view of expression of opinion on them. Due diligence is used while making acquisition of Business such as merger or venture capital funding or leverage buyouts. It is used for examination of a potential investment Opportunity with considering the all material and financial and non financial aspects. Hence in today's world the Due Diligence plays a significant and multi dimension role. Only in case of mergers or buyouts, but in all those cases where any kind of integration or disintegration occurs the role of Due diligence automatically comes into the picture. For example when a Person joins a firm or when Bank is looking to give corporate loan to any entity. However, it is very important to know that it is never easy to make Due diligence as it involves a multidimensional knowledge on the part of due diligence conductor and must have knowledge of all the relevant areas.

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Corporate benefits of Due Diligence

The reasons to use Due Diligence are wide range. However the primary and first most reason is to find out the actual position of the business than what is shown by Books of Accounts of the company. The second big reason is to find out what could be possible defects in targeted deal which could kill the deal and make a bad transaction. Apart from above these two major reasons, the other reasons are to get full information about valuation of Assets, various warranties given by the entity, to negotiate on price to be paid and last but not the least to check that proposed acquirer is within the investment limit. These all reasons combines one single benefit of the Due Diligence is, it ensures the Buyer any defect in the deal or proposed acquisition that could urge any huge loss in coming future and will eat all the investments made or may put the acquirer into any dispute so the investment made will become an onerous asset. The cost incurred in conducting the Due Diligence is not doubt significant, but still not more than the loss what could be incurred by the buyer in future due to his negligence. Now one question which is very important to know is what the areas which are covered by Due Diligence are. Although, there are number of areas which are suppose to be covered by a Due Diligence investigation. Due Diligence has to be undertaken from all aspects of a business whether it is Taxation or Commercial or Financial.

- **Commercial or Operational Due Diligence:** It is treated as most widely used Due Diligence throughout the all business segments, as it covers the variety of areas in Due Diligence such as commercial, Strategic and operational. It gives a detailed idea whether the proposed business decision will give any synergy benefit or not.
- **Financial Due Diligence:** It the secondly most used Due diligence which is widely used even in small business acquisitions such as acquiring a proprietary firm or partnership firm or becoming Partner in any existing Firm. Since it covers almost all the areas of business because it is based on the aspect of examination of Books of Accounts, hence analyzing the business becomes easy. However it is preferable to conduct the same only after the commercial Due Diligence especially in the case of Large Business Decision.
- **Legal Due Diligence:** Although this diligence is the part of Commercial Due Diligence but sometimes it is conducted alone or A special stress is given on it when it is observed that certain legal matters are complex or involvement of some kind of commercial or legal disputes.
- **Tax Due Diligence:** It is a separate Due Diligence which is conducted to identify the Tax implications of Financial Matters of the company as an integral part of the company's whole business prospect. The expert has to look into the tax effect of the merger or amalgamation.
- **Personnel Due Diligence:** It is carried out to find out that whether entities Policies related to Personnel or Human resource management is in accordance of acquirer's Business or not and whether there is any need to make substantial changes in it or not.
- **Information System Due Diligence:** It is related to Technical evaluation of the company's Information Technology system and analyzing whether it will be in conjunction with Acquirer's system or not.

Methods of Due Diligence

However over a period of four decades, number of methods has been evolved for conducting the due diligence. In general two methods of doing Due Diligence is used which are simple due diligence and Financial Due Diligence. Simple due diligence covers all the areas without giving specific stress on a particular diligence. In process of simple due diligence, the Accountant should verify the various matters to complete the due diligence process. The matters which covered are brief description of history of the business, Background of promoters, Accounting policies and practices, Management Information system (MIS), Details of management structure, Trading results both for past as well as present, Assets and liabilities as per latest balance sheet, Current status of income tax assessment including appeals pending against tax liability, Cash flow pattern, and Projection of future profits abilities.

The Financial due diligence can be termed as overall due diligence if it is sufficient to cover all above aspects. Financial Due Diligence requires checking of various items. The first one is Brief history of the company. Brief history of the company to be acquired and check backgrounds of its promoters. The accountant have to check the details that how company was setup, who was it original promoters, various Turning points of the company, survival strategies, market share enjoyed by it, product life cycle and adequacy of resources. Apart from above, other factors should also be checked such as Nature of business, Location of production facilities and warehouses, Employment level of the company, Products or services and their market, History of business with important suppliers and goods and services, Inventories, franchises and license, foreign currency assets and its liabilities, Various Litigations and regulations followed by it. The second one is Accounting policies. For this He should study the accounting policies and to find out whether they are appropriate or not, Recent changes in accounting policies, Main effect of accounting policies on overall profitability and correctness, Material change in Accounting Policies, Summary of significant accounting policies and Areas where the accounting policies of an entity to be acquired is different from the acquired entity. The third factor is Review of Financial Statement. The Expert shall check whether financial statements of target entity have been prepared according to the statute govern by it, Relevant accounting standards and any deviation from them, Review of operating results, extraordinary items of income and expenditure, comparison of actual with budgeted figures and the reasons of variations, Use of the expert Valuer for valuation of various assets and liabilities, Impact of under/over valuation of assets and liabilities on Net Worth. Check out the hidden liabilities, if any. The nest is Taxation. He should checkout whether any further registration required or not, company is regular in paying tax or not and tax effect of merger and acquisition. Then he shall check Cash flow. Expert should checkout historical pattern of cash flow, its merger trends, the ability to meet its cash requirements, the ability of company to honor its commitment, turnover of stock and debtors into cash and any ideal funds of company. After that financial projection shall be examined in detail. He should obtain the financial projection made by target company and evaluate the appropriateness of assumptions used, its impact over the valuation of company, arithmetical calculation made in the valuation. Another factor to examine is Management and Employees. For this he should make Analysis of how much labor force will retain after acquisition, the job profile of various administrative and managerial staff, whether provisions have been made for PF, ESI gratuity, leave encashment etc. or not, actuarial valuation have been made or not, the pay packages of key employees and ESOP or any other bonus incentives etc. which are pending for payment. The Last factor to be examined is Statutory Compliance. He should make a list of all applicable statutory laws and checkout whether company compliance with these laws or not and if it not followed by company than quantify the effect of same in future.

The Purchase of entire Business is probably the largest and most expensive purchase of Assets in the life time of an entity. Hence it needs consideration to various factors such as company age, Markets, Geography, Price Levels, Competitive dynamics etc. A due Diligence Process for assessing Business 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 for prepare an offer based on completion of Due Diligence.

Steps in Conducting Due Diligence

Generally Due Diligence is conducted in three steps. These are Pre Due Diligence Period, Due Diligence Process & Negotiation Phase and the last one is Closing & Post Closing Process. The step one which is pre due diligence period involves various sub steps such as Discussion with client to gain understanding of the Transaction, Assessment of most appropriate scope of work and Methodology, Centralized Coordination of Project Team, Preparation of Due Diligence Request List to target specific areas of concern. The Second step which is Due Diligence Process & Negotiation Phase, involves Working Off site and on site, Flexible Approach even after project kick off, Question & Answer process with management, Report drafting, including assistance in the definition of financial agreements and wordings of financial clauses, Regular update with client. The last stage which is Closing & Post Closing Process involves Preparation of review of closing documents prepared by Target, PPA assistance and other post closing transactions review, Involvement in the price adjustment procedure using findings of the due diligence.

At the end a Due Diligence Report is prepared for concluding the Due Diligence findings based on which the buyer takes his decision. Such report although do not have any specified content prescribed anywhere and prepared based on need of the user of the report. However in general such report contains details of Executive Summary, Objective of Due Diligence, Terms of reference & Scope of Verification, Brief History of company, Shareholding Pattern, Assessment of Management structure, Assessment of Financial Liabilities, Assessment of Valuation of Assets, Comments on properties, terms of Lease, Assessments of Operating Results, Assessment of Statutory & Taxation liabilities & possible Liabilities on account of Litigation, Assessment of Net Worth and Suggestions on ways & mean including affidavits or any other solution.

Conclusion

In today's competitive world, it is seek important to take appropriate business decisions. A wrong business decision turns the entire business potential into a waste. This becomes more important when decision is a long term decision and relating to going concern of business such as Merger or acquisition or amalgamation etc. In case of wrong acquisition of business or acquisition of Business in a wrong way occurs, it will lead the whole business into a waste including the existing business. Hence an all around analysis and investigation is a very much need of such decisions. Due Diligence fulfills this need by finding out the roots of existing business and happenings of business from past to present, including the object and purposes for which the business was setup to the reason of selling or merger of business. That is the reason for having an increased demand of Due Diligence even such business decision is related to a small business like Partnership Firm or Proprietor firm. The cost incurred in such Due Diligence is comparatively quite low or rather to say not comparable to benefits which expected to occur from Due Diligence. It saves the investor from going into a Black Hole.

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