



Due diligence: An analysis of past, present and future of the business transaction

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Abstract

Due diligence is an analysis and risk assessment of on impending business transaction. It is the careful and methodological investigation of a business or persons, or the performance of an act with a certain standard of care to ensure that information is accurate, and to uncover information that may affect the outcome of the transaction. Scope of due diligence is transaction based and is depending on the needs of the people who are involved in the potential investments, in addressing key uncovered issues, areas of concern/threat and in identifying additional opportunities. Due diligence considers the industry of the target company. It examines the business affairs having a significant impact on the prospects of the business. It explores significant business practices and business models. It examines relevant aspects of the past, present and near future of the business. It also assesses the advantages and risks associated with a particular transaction.

The most important part of due diligence is writing of report in a presentable form. If the report does not provide the actual view of the organization than the activity will become worthless. Identifying the problem is not the only work of due diligence. A good diligence report should also provide the suggestions for solving the problem. The report may interalia cover General Information, Financial Data, relevant business agreements, pending litigations, contingent liabilities, details of intangible assets like IPRs, marketing position, Internal Controls, Environmental compliance, position of CSR aspects, Human resource assets and the culture of the organisations. The report should also make the reference and purpose of the conducting DD. The report should also include the source of information. List of document reviewed including the documents not available should also be the part of the report. Assumptions wherever made should be part of report.

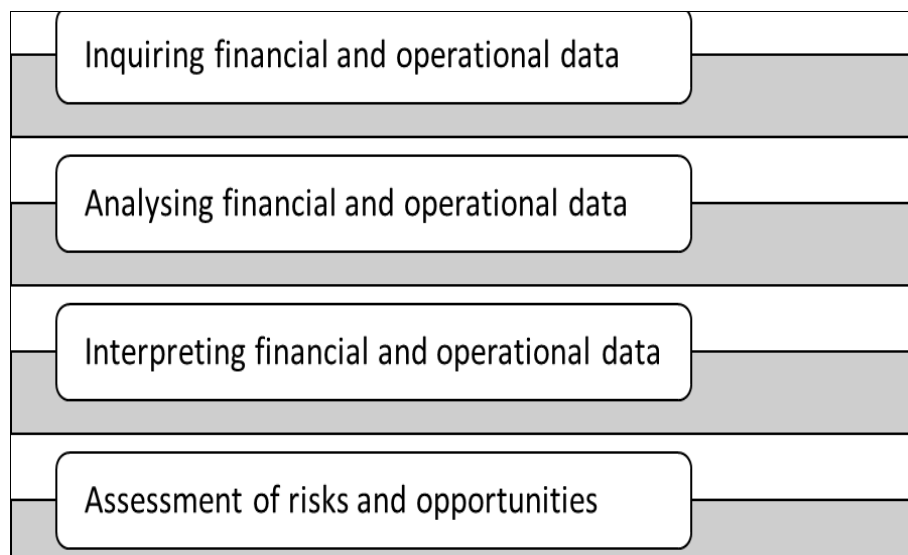
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Introduction

Due diligence refers to investigation into the affairs of an entity prior to its acquisition, restructuring, fund raising or other similar transaction. Due Diligence is not restricted to check the facts but also to evaluate, interpret and

communicate the facts so as to ensure that prospective investors make an informed investment decision. It is process of gathering information about the target company, its business and the environment in which it operates.

A Due diligence is an interactive process that includes:



As a part of the business strategy, the Companies before making any relationship with the other party conduct the background checks of the client, customer, supplier etc. to ensure that the parties to the transaction have the disclosed the information as required to proceed with the transaction and is a process to completely understand a business capability and its past performance.

While exploring any business opportunity, it is the foremost requirement for a corporate to investigate and evaluate the potential and risk associated with such business. The due diligence covers the activities relating to pre-transaction, during the transaction and post transaction exercise with all relevant aspects of the past, Present, and predictable future of the any business.

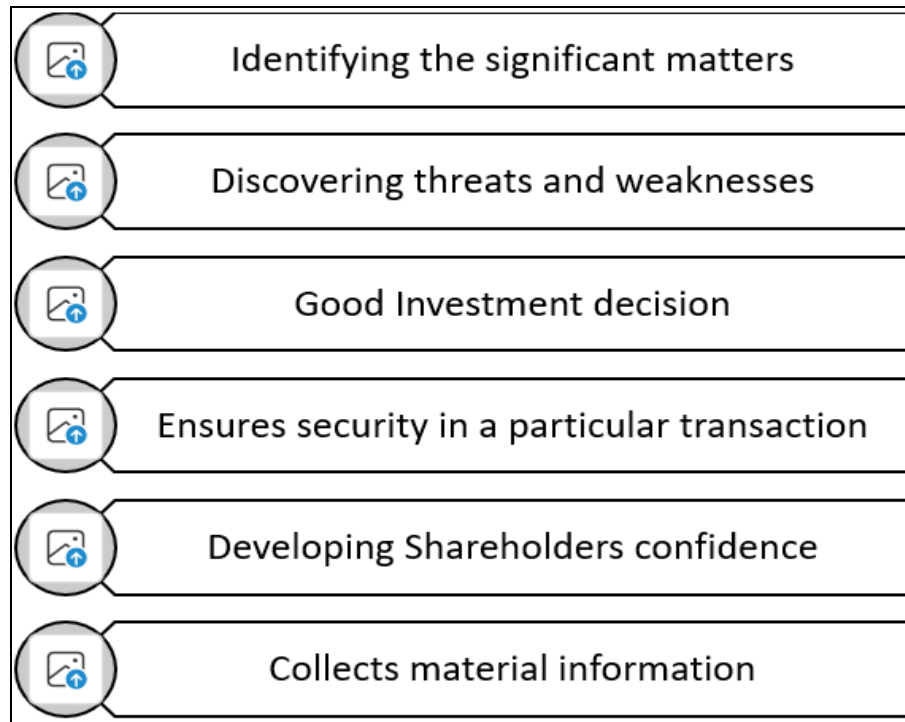
After the conduct of the due diligence, a due diligence report prepared to provide information and insight on various aspects such as the risks of a transaction, the value at which a transaction should be undertaken, the warranties and indemnities that needs to be obtained from the vendor etc

In any transaction, the seller does investigation of a buyer to ensure that the buyer has adequate resources to complete the transaction, as well as other business aspect covering the technical and human resource, cultural, taxation etc. which would affect the company after entering into the transaction.

The chapter covers the various types of due diligence performed by the company on voluntarily and for entering to the any business transaction or before going for any corporate action relating to the merger, de-merger, amalgamation, take over, joint venture etc

Objectives of Due Diligence

The objective of due diligence is to verify the strategic identification or attractiveness of the target company, valuation, risk associated etc. The objective of due diligence may be to



Generally, the SWOT analysis of any business carried out as a part of due diligence to reveal the strengths and weaknesses of not only the financials but also intangibles. To perform effectively, the potential buyer needs to be clear about the goals and motives for acquiring the target company, as well as the value the buyer is attempting to create with the purchase. For example, if there is a legal risk, such as an outstanding lawsuit, that will not only jeopardize the financial stability of the company but also the loyalty of existing customers. This will erode the target company's market of customers by a new and stronger competitor. The target company's talent is the asset desired, and much of this depends on employee relations and accordingly cultural issues have to be addressed in time.

Need for Due Diligence

A thorough due diligence helps to reveal any of the negatives, but the process of due diligence rarely goes smoothly because of one major stumbling block and that is availability of information. The target company is rarely eager to reveal to the other party that it is up for sale and wants to keep this information confidential from its competitors, customers and employees. So getting any information from these sources can be tricky, depending upon what the potential buyer wants to gain from the transaction. The buyer who aims to get new market of customers with the transaction wants to make sure that the target company has a good relationship with existing customers.

Due diligence is needed

- To confirm that the business is what as it appears;
- To create a trust between two unrelated parties;
- To access the risks and opportunities of a proposed transaction;
- To reduce the risk of post transaction;
- To investigate into the affairs of business as a prudent business person;
- To confirm all material facts related to the business,
- Representation & warranties for indemnification,
- Negotiation price concessions,
- To verify that the transaction complies with investment or acquisition criteria;
- To investigate & evaluate a business opportunity,
- To determine compliance with relevant laws and disclose any regulatory restrictions on the proposed transaction,
- To evaluate the condition of the physical plant and equipment, as well as other tangible and intangible assets,
- To ascertain the appropriate purchase price and the method of payment
- To determine details that may be relevant to the drafting of the acquisition agreement.
- To discover liabilities or risks that may be deal-breakers;
- To analyze any potential antitrust issues that may prohibit the proposed M&A
- To evaluate the legal and financial risks of the transaction.

Scope of Due Diligence

Due diligence is generally understood by the legal, financial and business communities/ potential investors to mean the disclosure and assimilation of public and proprietary information related to the assets and liabilities of the business being acquired. This information includes financial, human resources, tax, environmental, legal matters, intellectual property matters etc

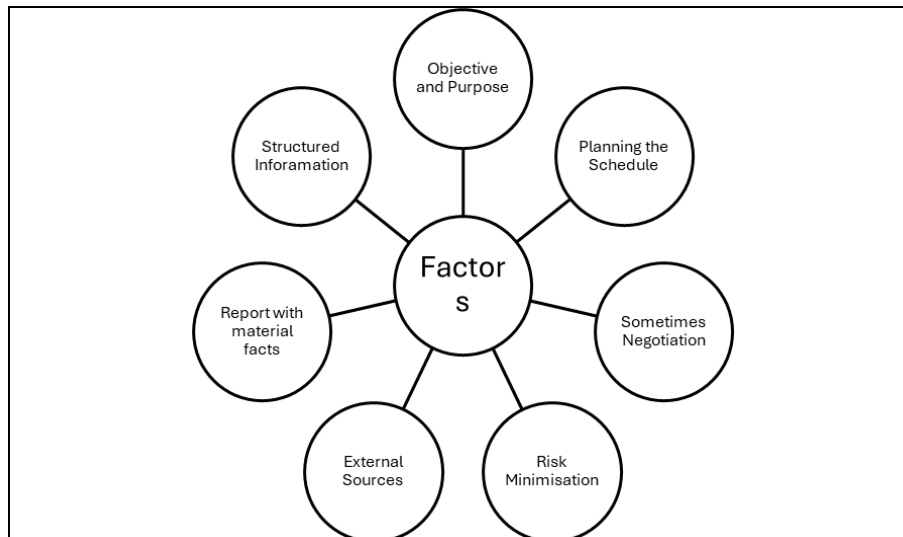
Due diligence would include thorough understanding of all the obligations of the target company: debts, rights and obligations, pending and potential lawsuits, leases, warranties, all high and impact loden contracts - both Inter-corporate and intra-corporate.

The investigation or inspection would cover below mentioned aspects

- To determine tox structure and its implications;
- To assist in determining the final value of financial investment,
- To determine overvalued assets or under recorded liabilities, hidden assets or liabilities,
- Ensuring the all applicable tow compliances;

- Ascertaining the penalties in case of non-compliances of statutory laws applicable to the company
- Assessing the quality of management and identification of key employees of the Target Company:
- To assess the commercial and technical feasibility;
- To assess the resource availability of the business;
- To synergise between the organisations (In case acquirer company and target company).
- Litigation and assessment of feasibility of pursuing litigation:
- Financial statements;
- Assets-real and intellectual property, brand value etc.;
- Unpaid tax liens and/or judgments,
- Past business failures and consequential debt;
- Exaggerated credentials/Fraudulent claims;
- Misrepresentations or character issues:
- Cross-border issues - double taxation, foreign exchange fluctuation, sovereign risk, investment climate, cultural aspects.
- Reputation, goodwill and other intangible assets.

Factors to be kept in Mind While Conducting Due Diligence



1. Objectives and purpose

A key step in any due diligence exercise is to develop an understanding of the purpose for the transaction The goal of due diligence is to provide the party proposing the transaction with sufficient information to make reasoned decision as to whether or not to complete the transaction as proposed. It should provide a basis for determining or validating the appropriate terms and price for the transaction incorporating consideration of the risks inherent in the proposed transaction

The following factors may be kept in mind in this regard:

1. Be clear about your expectations in terms of revenues, profits and the probability of the target company to provide you the same.
2. Consider whether you have resources to make the business succeed and whether you are willing to put in all the hard work, which is required for any new venture.
3. Consider whether the business gives you the opportunity to put your skills and experience to good use.

4. Learn as much as you con about the industry you are interested in from medio reports, journals and people in the industry

2. Planning the schedule

Once it is decided for a particular business, make sure of the following things:

- Steps to be followed in due diligence process
- Areas to be checked
- Aspects to be checked in each area
- Information and other material to be requested from the seller

3. Negotiation for time

Sometimes, it may be the case that, sellers want the process to get over as soon as possible and try to hurry the proceedings. When the seller gives a short review period, negotiations can be made for adequate time to have a complete review on crucial financial and legal aspects.

4. Risk Minimisation

All the information should be double checked- financials, tax returns, patents, copyrights and customer base to ensure

that the company does not face a lawsuit or criminal Investigation. The financials are very important, and one needs to be certain that the target company did not engage in creative accounting.

The asset position and profitability of the company are vital. Since, due diligence exercise deals with the overall business, it is important to consider aspects such as:

- background of promoters
- performance of senior management team
- organizational strategy
- business plans
- risk management system
- technological advancement
- infrastructure adequacy
- Optimum utilization of available resources.

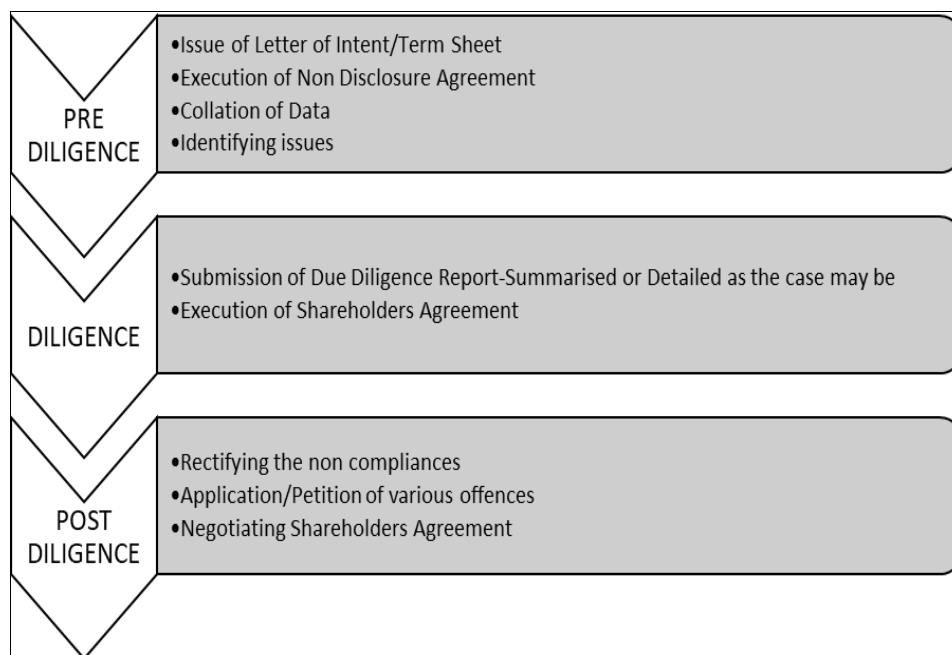
5. Information from external sources

The company's customers and vendors can be quite informative. It may be found from them whether the target company falls in their most favoured clients list. Any flaws that the audit uncovers help to re-negotiate down the sale price. Hence, the Due diligence is "a chance to get a better deal".

6. Limit the report with only material facts

While preparing the report it is advisable to be precise and only the information that has a material impact on the target company is required to be included.

7. Structure of information



Techniques of Due Diligence and Risk Assessment

Due diligence and risk assessment and control represent separate and distinct processes that take place prior to the commencement and throughout the duration of a commercial agreement respectively.

The Due diligence and risk assessment and control processes are central to good business practice. These processes are particularly important in taking leadership in the market and charge premium rate services. Where

Once the due diligence process is over, while preparing the report, information has to be structured in an organized manner in order to have a better correlation on related matters.

Challenges in Conducting Due Diligence

A professional may face many challenges while conducting due diligence. He needs to deal with these challenges and bring the best result of due diligence. Few examples of the challenges faced are as under:

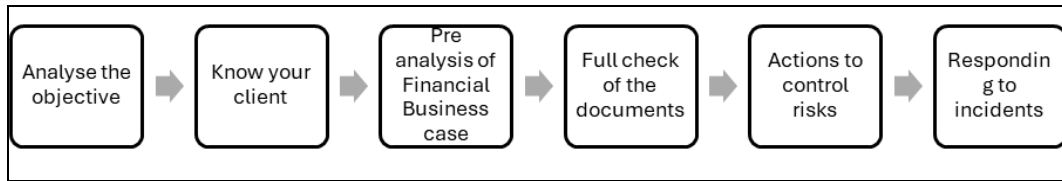
- **Non-availability of the information or incomplete information:** For eg. Non availability of evidence related to compliances. While dealing with difficulty, he can try to find the alternate source of getting the information.
- **Lack of time:** Many a times a professional cannot check all the information due to paucity of time. A professional may confine the scope of checking in this scenario,
- **Non-cooperation by the employees:** It is possible that few of the employees may start non-cooperating as this may lead to focus on their mistakes. Reporting to the concerned authority may be a good solution in this scenario.

Process and Stages of Due Diligence

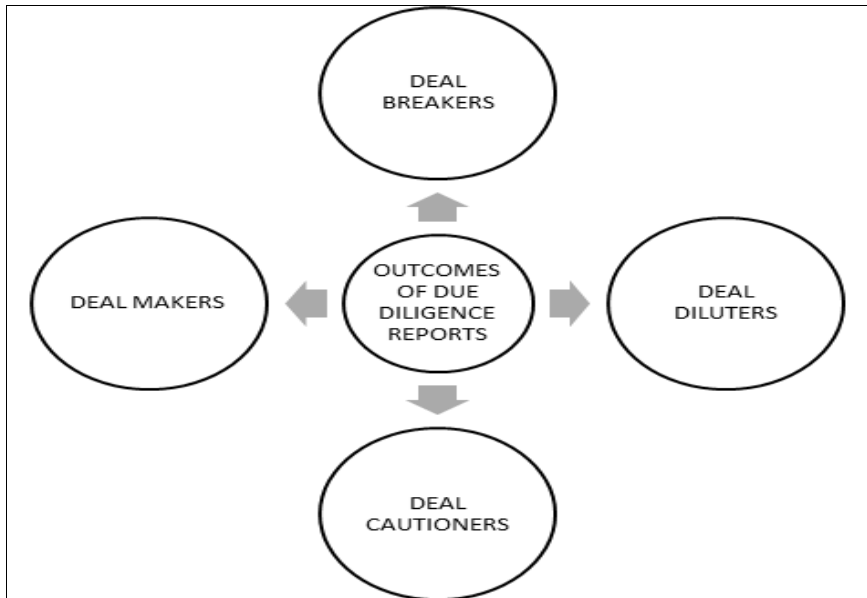
A due diligence process can be divided into three stages i.e. (i) Pre Diligence, (ii) Diligence, and (ii) Post Diligence.

services are delivered to clients through Associates, which con, on occasion, include many different parties, the professional should prior to contracting with such party write down the expectation from such party in the process of due diligence.

All parties in the Due diligence team should be confident that the established team is for good positive business and industry-wide growth. Such processes are built on the following cornerstones:



Outcomes of Due Diligence Reports



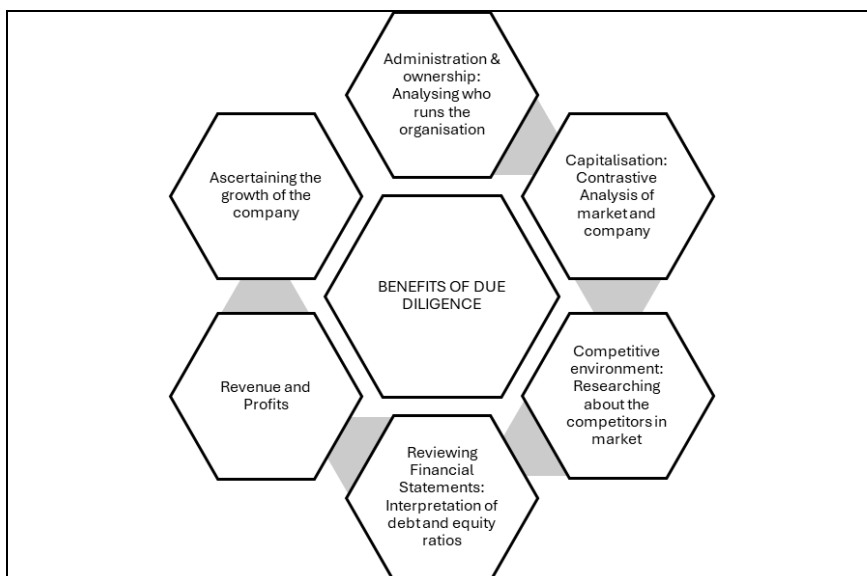
- **Deal Breakers:** In their report, the findings can be very glaring and may expose various non-compliances that may arise any criminal proceedings or known liabilities
- **Deal Diluters:** The findings arising out a diligence may contain violations which may have an impact in the form of quantifiable penalties and in turn may result in diminishing the value of company
- **Deal Cautioners:** It covers those findings in a diligence which may not impact the financials, but there exist certain non-compliances which though rectifiable, require the investor to tread a cautious path.

diligence team have not been able to come across any violations, leading them to submit what is called a 'clean report'.

Advantages of Due Diligence

Due diligence analyses who administers, owns and run the organisation. It examines the company and the market in a contrast way to assess the volatility of the market. It researches about the competitors of the target company existing in the market. It reviews the financial statements of the company such calculating debt equity ratio, etc. It examines the rise or falls in revenue/profits of the company. It expects the growth of the company with maximisation of the profits of the organisation.

Deal Makers Which are very hard to come by and may not be a reality in the strict sense, are those reports wherein the



Conclusion

Due diligence is not limited to accounting analysis but has a business oriented approach. It analyses the information on the basis of the actual facts. A pre diligence is primarily the activity of management of paper, files and people.

During the diligence, care should be taken to adhere to certain hospitality issues, like:

1. Be warm and receptive to the professionals who are conducting diligence.
2. Enquire on the Due Diligence team.
3. In case of any corrections-admit and rectify.

As regards the process of diligence, as a professional care should be taken to scrutinize every document that is made available and ask for details and clarifications, since the Due diligence is a time bound activity and is needed to be wrapped up at the earliest. However, the company may be provided an opportunity to clear the various issues that may arise out of the diligence

After the diligence is conducted, the professionals submit a report which in common parlance which is called as Due Diligence report. These reports can be of various kinds, a summary report, a detailed report or the like; and the findings mentioned in the report can be very significant, in as much as the deal is concerned.

Post diligence sometimes result in rectification of non-compliances found during the course of due diligence. There can be interesting assignments arising out of the diligence made by the team of professionals. It can range from making applications/filing of petition for compounding of various offences or negotiating the shareholders' agreement, since the investors will be on a strong wicket and may negotiate the price very hard.

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