

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.

**Importance of Due Diligence**

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 company 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**.

**Classification of Due diligence:**

- (i) **Commercial/Operational Due Diligence:** It is generally performed by the concerned acquire enterprise involving an **evaluation from commercial, strategic and operational perspectives**. For example, whether proposed merger would create operational synergies.
- (ii) **Financial Due Diligence:** It involves **analysis** of the **books of accounts** and other information pertaining to financial matters of the entity. It should be performed after completion of commercial due diligence.
- (iii) **Tax Due Diligence:** It is a separate due diligence exercise but since it is an integral component of the financial status of a company, it is generally included in the financial due diligence. The accountant has to look at the **tax effect** of the **merger or acquisition**.
- (iv) **Information Systems Due Diligence:** It pertains to all **computer systems** and related matter of the entity.
- (v) **Legal Due Diligence:** This may be required where **legal aspects** of functioning of the entity are reviewed.
- (vi) **Environmental Due Diligence:** It is carried out in order to study the **entity's environment**, its **flexibility** and **adaptiveness** to the acquirer entity.
- (vii) **Personnel Due Diligence:** It is carried out to ascertain that the entity's personnel policies are in line or can be changed to suit the requirements of the restructuring.

**Scope of Financial Due Diligence:**

(a) Brief history of the target company and background of its promoter;	(b) Accounting policies;
(c) Review of financial statements;	(d) Taxation;
(e) Cash flow;	(f) Financial Projection;
(g) Management and employees;	(h) Statutory Compliance.

**Review of Cash Flow:**

It is important to know if Co. is able to meet its cash requirements.

It is necessary to check that:

- (a) Is the company able to **honor its commitments** to its trade payables, to the banks, to govt. and other stakeholders?
- (b) How well is the company able to **turn** its trade receivables and inventories?
- (c) How **well does it deploy its funds?**
- (d) Are there **any funds lying idle** or is the company able to reap maximum benefits out of the available funds?
- (e) What is the **investment pattern** of the company and are they easily realisable?

**How to conduct Due diligence**

- 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.
- Get **the best team** of people. If. When hiring such professionals, look for their experience record in the industry.
- Get **help in all areas** like finance, tax accounting, legal, marketing, technology, and any others relevant to the assignment so that you get a 360-degree view of the acquisition candidate.
- Talk to** customers, suppliers, business partners, and employees are great resources.
- Take a **risk management approach**.
- Prepare a **comprehensive report** detailing the compliances and substantive risks/issues.

**Work Approach to due diligence:**

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

**Review of Cash Flow:**

Hidden liabilities	Overvalued Assets
1. <b>Tax liabilities</b> under direct tax & Indirect tax	1. Obsolete, slow non-moving <b>inventories</b> or inventories valued above NRV; huge inventories of packing materials etc. with name of co
2. Company may have <b>show cause notice</b> which may have <b>not</b> matured into demand as <b>contingent liability</b> . These may be material & important.	2. <b>Underused or obsolete Plant and Machinery</b> and their spares; asset values which have been <b>impaired</b> due to sudden fall in market value etc.
3. <b>Long pending sales tax assessment</b> .	3. <b>Litigated assets</b> and property.
4. <b>Pending final assessment of custom duty</b> where provisional assessment has been completed.	4. <b>Uncollected/uncollectable receivables</b> .
5. Company may have given <b>letter of comfort</b> to banks & F.I.'s. Since these are not guarantee & may not have been shown in B/s. of target co.	5. <b>Investments</b> carried at cost though <b>realizable</b> value is much <b>lower</b> .
6. <b>Future lease liab.</b>	6. Investments carrying a very <b>low rate of income / return</b> .
7. Agreement to <b>buy back</b> shares at stated price.	7. Infructuous project expenditure/ <b>deferred revenue expenditure</b> etc.
8. Unresolved <b>labour litigations</b> .	8. <b>Intangible assets of no value</b> .

**Content of Due diligence report:**

Executive Summary	Assessment of management structure
Introduction	Assessment of financial liabilities
Background of Target Co.	Assessment of valuation of assets
Objective of due diligence	Assessment of operating results
Brief history of the company	Assessment of taxation and statutory liabilities
Share holding pattern	Assessment of net worth
Observations on the review	SWOT Analysis