

DUE DILIGENCE

Q 1. Lalit Ltd. entered into a deal with DRB Ltd. For buying its business of manufacturing wooden products/ goods. Lalit Ltd. has appointed your firm for conducting due diligence review and they want to know the cash generating abilities of DRB Ltd. What points will you check in order to ensure that the manufacturing unit of DRB Ltd. Will be able to meet the cash requirements internally? (icai study mat)

Ans : Conducting Due diligence to examine cash generating abilities:

In order to ensure that the manufacturing unit of DRB Ltd. will be able to meet the cash requirements internally, one is required to verify:

- Is the company able to honour its commitments to its trade payables, to the banks, to the government and other stakeholders?
- How well is the company able to convert its trade receivables and inventories?
- How well the Company deploys its funds?
- Are there any funds lying idle or is the company able to reap maximum benefits out of the available funds?
- What is the investment pattern of the company and are they easily realizable?

Q 2. CA Trupti is acting as Credit manager in branch of ICICI Bank Ltd. A company has approached the branch for a request to sanction credit facilities worth ` 10 crore for meeting usual business requirements. It is a prospective new client. She checks past history of the company, back ground of promoters & directors, shareholding pattern and nature of business. Assessment of financial results of past years & future projections is also undertaken. She also carries out SWOT analysis.

Besides, assessment of net worth of directors is also undertaken. Status of CIBIL score and position of name of promoters/directors in RBI defaulter list is also verified.

She also makes discreet inquiries from few clients of the branch engaged in similar line of activity regarding credit worthiness of company, its promoters and directors. Based on above:

- (i) Identify activity being performed by CA Trupti and discuss its nature.**
- (ii) Would your answer be different if this activity was to be performed by a person not qualified as a Chartered Accountant? Can a non-CA perform such activity? State reason.**
- (iii) Name any three other areas where identified activity can be undertaken.**

[MTP-April 23; RTP-May 23]

Ans : Due diligence:

- The activity described in the situation is Due diligence. Due diligence is a measure of prudence activity, or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent person under the particular circumstance, not

measured by any absolute standard but depending upon the relative facts of the case. It involves a careful study of financial and non-financial possibilities. It implies a general duty to take care in any transaction.

- 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. It entails conducting inquiries for the purpose of timely, sufficient and accurate disclosure of all material statements/information or documents, which may influence the outcome of the transaction. Due diligence involves a careful study of the financial as well as nonfinancial possibilities for successful implementation of restructuring plans.
- Due diligence involves an analysis carried out before acquiring a controlling interest in a company to determine that the conditions of the business conform with what has been presented about the target business. Also, due diligence can apply to recommendation for an investment or advancing a loan/credit.
- There would be no difference in answer if above activity was to be performed by a person who is not a Chartered Accountant. The activity would remain due diligence. Due diligence can be performed by any person. It is not necessary that due diligence can only be carried out by a Chartered Accountant. As due diligence involves exercise of prudence and general duty to take care in any transaction, it can be undertaken by any person.
- The areas where due diligence may be undertaken are: -
 - (i) Corporate restructuring
 - (ii) Venture capital financing
 - (iii) Offerings

Q 3. CA Yash is employed with a leading private sector HDFC Bank posted in Noida branch. One of the existing borrowers has approached branch with a proposal to sanction fresh term loan of ` 5 crore with commensurate increase in working capital credit facilities relating to expansion of its garment manufacturing unit. While performing due diligence, he notices that company was formed just two years ago and had availed term loan of ` 10 crore and cash credit facilities of ` 5 crore respectively. Its sales have increased from ` 25 crores in first year to ` 45 crores in year just ended. It is generating cash profits and is timely servicing its debts.

The borrower was earlier catering to domestic market. However, now it is in process of procuring export orders and working assiduously in this regard. The expansion plans are in line with development in area of marketing relating to exports.

However, there a large number of units catering to domestic and export market of garments in Noida, Delhi and surrounding areas. There is also demand slump in biggest US market.

Besides, the unit is family-based and relies upon marketing skills of its main promoter. There is lack of well-paid qualified staff with the borrower to deal effectively with its customers both domestic as well as foreign.

Lack of well-paid qualified staff to deal effectively with its domestic and foreign customers is an area of weakness.

He starts jotting down and elaborating above points. Identify what he is trying to do as part of due diligence.

Ans : SWOT Analysis:

- As part of due diligence exercise, he is performing SWOT analysis of borrower. He is making analysis of strengths, weaknesses, opportunities and threats (SWOT) pertaining to borrower.
- Features such as rise In sales, generation of cash profits and timely service of debts represent borrower strengths.
- Lack of well-paid qualified staff to deal effectively with its domestic and foreign customers is an area of weakness.
- Entering into export market presents opportunity for borrower.
- Presence of large number of competitors and demand slump in US market reflect threats.

**Q 4. Sri Majan is above 80 years old and wishes to sell his proprietary business of manufacture of specialty chemicals. Creta Ltd. Wants to buy the business and appoints you to carry out a due diligence audit to decide whether it would be worthwhile to acquire the business. What procedures you would adopt before you could render any advice to Creta Ltd.?
(icai study mat- I don't think aise que exam me aayenge)**

Ans : Due Diligence Procedure:

1. **Studying the Business History:** Accountant should make relevant enquiries about history of target's business products, markets, suppliers, expenses, operations.
2. **Significant Accounting Policies:** Study accounting policies followed and ascertain whether any accounting policy is inappropriate.
3. **Review of F.S.:** Examine whether F.S. of target company have been prepared in accordance with the Statute governing the target entity, Framework for Preparation and Presentation of the F.S. and the relevant ASs. Review operating results of the target entity in great detail.
4. **Taxation:** Check whether business is regular in payment of taxes to Government. Also look at the tax effects of the merger or acquisition.
5. **Cash Flow:** Review historical cash flows and their pattern to determine cash generating abilities. Check whether entity is able to honour its commitments to its trade payables, to the banks, to government and other stakeholders.
6. **Financial Projections:** Evaluate projections for the next 5 years with detailed assumptions and workings and the appropriateness of assumption used in the preparation and presentation of financial projections. If assumption used by the company appears to be are unrealistic, consider its impact on the overall valuation of the company.

7. **Management and Employees:** Examine status of work force, staff and employees and their retention. Match the job profile of the administrative and managerial staff with the requirements of the new incumbents.
8. **Statutory Compliance:** Make a list of laws that are applicable to the entity as well as to make a checklist of compliance required under those laws.

Q 5. Write short note on: Example of headings of a Due Diligence Report.

[RTP-Nov. 21]

OR

An American Company engaged in the business of manufacturing and distribution of industrial gases, is interested in acquiring a listed Indian Company having a market share of more than 65% of the industrial gas business in India. It requests you to conduct a "Due Diligence" of this Indian Company and submit your Report. List out the contents of your Due Diligence Review Report that you will submit to your USA based Client.

OR

Manak Co. is currently a large organisation trading in items of office furniture. The entity wants to expand and hence are looking at acquisition of Ratan Co. which deals in items of household furniture. Manak Co. hires a CA to conduct a due diligence to consider whether there is the potential for additional value to be brought out of the target company by improving its operational function and also whether there are serious operational risks about which the potential buyer should be concerned (thereby allowing the buyer to consider aborting the deal or renegotiating the price). Which of the due diligence review would be helpful to achieve the above objective? You are also required to briefly discuss the contents of a due diligence report.

[MTP – April 19]

Ans : Contents of a Due Diligence Report

1. Executive summary.
2. Introduction.
3. Objective of due diligence.
4. Terms of reference and scope of verification.
5. Brief history of the company.
6. Summary on capital structure and group structure of company.
7. Shareholding pattern.
8. Observations on the review.
9. Assessment of Management structure.
10. Assessment of financial liabilities.
11. Assessment of valuation of assets.
12. Assessment of operating results.
13. Assessment of taxation and statutory liabilities.

14. Assessment of possible liabilities on account of litigation.
15. Assessment of net worth.
16. Any liabilities not provided for in the books.
17. SWOT analysis comments on future projections.
18. Status on charges, liens, mortgages and assets of the company.
19. Ways and means to cover unforeseen contingent liabilities.
20. Aspects to be taken care of before/after merger.
21. Interlocking investments and financial obligations with group/associate companies amounts receivable subject to litigation.

Q 6. “Due diligence is different from audit” – Explain the difference between due diligence and audit. (icai study mat)

Ans : Difference between Due Diligence and Audit:

- Audit is an independent examination and evaluation of F.S. on an organization with a view to express an opinion thereon.
- Due diligence refers to an examination of a potential investment to confirm all material facts of prospective business opportunity. It involves review of financial and non-financial records as deemed relevant and material. It aims to take the care that a reasonable person should take before entering into an agreement or a transaction with another party.

Q 7. Kalash Ltd. is intending to acquire Meet Ltd. Your firm of Chartered Accountants is appointed to conduct due diligence. While reviewing hidden liabilities list out any five areas which will be specifically examined by you in your due diligence exercise.

[Jan. 21 (5 Marks)]

Ans : Investigation of Hidden Liabilities:

In order to investigate hidden liabilities, following areas need to be examined:

- Any show cause notice, which have not matured into demands but may be material and important.
- Contingent liabilities not shown in books.
- Company may have sold some subsidiaries/businesses and may have agreed to take over and indemnify all liabilities and contingent liabilities of the same prior to the date of transfer.
- Product and warranty liabilities, product returns & discounts, liquidated damages, etc.
- Tax liability under direct and indirect taxes.
- Long pending sales tax assessment.
- Cases of custom duty where only provisional assessment has been made and final assessment is yet to be completed.
- Agreement to buy back shares at a stated price.

- Future lease liabilities.
- Claims against the company including third party claims.
- Unfunded retirement benefit of employees.
- Labour claims under negotiations.

Q 8. KDK Bank Ltd., received an application from a pharmaceutical company for takeover of their outstanding term loans secured on its assets, availed from and outstanding with a nationalized bank. KDK Bank Ltd., requires you to make a due diligence audit in the areas of assets of pharmaceutical company especially with reference to valuation aspect of assets. State what may be your areas of analysis in order to ensure that the assets are not stated at overvalued amounts.

[May 18 (5 Marks), MTP-Nov. 21, March 22]

OR

A European company engaged in the business of manufacturing and distribution of industrial gases, is interested in acquiring a listed Indian Company having a market share of 51% and assets over ` 1,000 Crores. It requests you to conduct “Due Diligence” of assets of this Indian Company to find out, if any of the assets is overvalued. List down the areas of due diligence exercise to find out overvalued assets.

[Jan. 21 (5 Marks), MTP-Oct. 22]

Ans : Regularly Overvalued assets: Examine the following areas:

- Uncollectable receivables.
- Obsolete, slow and non-moving inventories and inventories valued above NRV, if any.
- Obsolete and unused plant and machinery and their spares.
- Assets value of which have impaired due to sudden fall in market value.
- Assets shown in books above market value due to capitalization of expenditure/foreign exchange fluctuation or capitalisation of revenue expenditure.
- Assets under litigation.
- Investment shown at cost whose market value is much lower.
- Investment carrying very low rate of return.
- Infertuous project expenditure.
- Intangibles of no value.