

FINANCIAL DUE DILIGENCE



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COVERAGE

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Introduction

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- India is emerging as one of the most popular investment destinations for investors and acquirers seeking high growth global opportunities
- The cross border business acquisition and the growing appetite of global players to bite the potential of the emerging economies call for a very dynamic and farsighted “Due Diligence” to minimize the related risks
- The acquirer has to ensure that they execute business deals that will benefit the organization
- The acquirer should be aware of :
 - what they are getting into?
 - what needs to be fixed?
 - what it will cost to fix them?
 - the Strengths and Weaknesses of the business
 - whether it is the right time to take on the business?



MEANING OF DDR

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- ❑ Dictionary Meaning of 'Due' is 'Sufficient' & 'Diligence' is 'Persistent effort or work'
- ❑ It is an investigation into the affairs of an entity prior to its acquisition, flotation, restructuring or other similar transaction
- ❑ Due Diligence Review is a process whereby an individual or an organization seeks sufficient information about a business entity to reach an informed judgment as to its value for a specific purpose



Due diligence is not an audit

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Due Diligence is dependant on potential acquisition/regulatory requirement and is not a statutory obligation

Due Diligence involves:

- A detailed analysis of the business, and is not restricted to accounting analysis
- Due Diligence is an opinion, which provides comfort and it does not provide true and fair view as in audit
- Commencement of the process prior to the transaction, unlike audit which requires reporting post closing of the financial period
- Exercise which provides support to the Transaction, whereas audit is reporting to shareholders

Situations calling for Due Diligence

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- ❑ On a potential acquisition
- ❑ Investment banker considering underwriting a public security offering or promoting a private placement
- ❑ Banker considering the granting of a loan
- ❑ Venture capitalist considering an investment
- ❑ Business broker offering a company for sale

(Contd...)

Situations calling for Due Diligence

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- ❑ Security analyst preparing a buy, hold or sell recommendation on a public security
- ❑ Firm considering a commercial transaction involving long-term commitments (including Franchise Arrangements)
- ❑ Investments by Private Equity Funds in listed or unlisted entities
- ❑ Appraiser retained to estimate the value of a business unit
- ❑ Seller of a business commissioning a DDR

Objectives of Due Diligence

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- ❑ To ensure that prospective investors make an informed investment decision
- ❑ Business oriented analysis not an accounting analysis
- ❑ Fact gathering exercise with focused analysis of information
- ❑ To understand the industry of the target
- ❑ To initiate reasonable level of enquiry into the affairs having material impact on the prospects of the business
- ❑ Evaluation of business model and key business practices

Scope of Due Diligence

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- ❑ Scope is determined by the client
- ❑ The degree of diligence required in any given review cannot be precisely defined
- ❑ Purpose for review defines what is 'due' or 'sufficient' diligence
- ❑ Extent of the review required is a judgment call
- ❑ Engagement letter with the client is important



Who conducts a DDR?

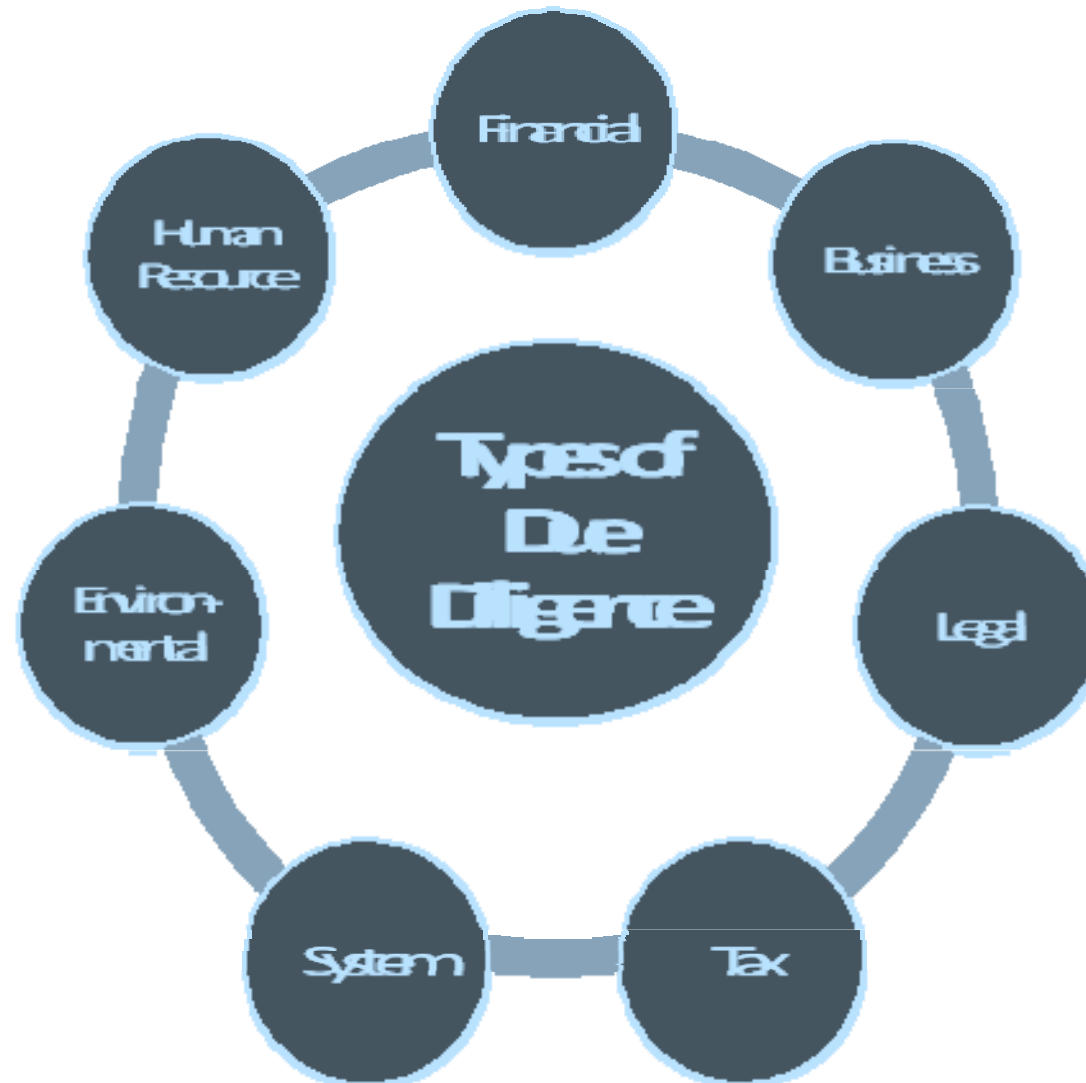
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- ❑ Chartered Accountants
- ❑ Investment Bankers
- ❑ Attorneys
- ❑ Lead & Co-Investors
- ❑ Corporate Development Staff



Types of Due Diligence

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Types of Due Diligence

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Business Due Diligence

- ❑ A review of the market for the company's product
- ❑ A background check on the founders and key management team
- ❑ Analysis of the Company's competition
 - ❑ Existing Market Share
 - ❑ Expansion plans
 - ❑ Analysis of Comparative Profitability & reasons for deviation, if material
- ❑ Discussions with the Company's key customers
- ❑ Review of management structure
- ❑ High dependence on single customer/supplier
- ❑ High influence of Government policies on the business

Types of Due Diligence

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Legal Due Diligence

- ❑ Looks at identifying issues related to contractual obligations which have not been fulfilled by the Company
- ❑ Review of key contracts related to customers, suppliers, employees and services
- ❑ Review of agreements/filings related to patents, copyrights, trademarks, intellectual property rights, etc
- ❑ Compliance with the Companies Act and various other statutes applicable to the Target
- ❑ Review of Litigation for and against the Company

Types of Due Diligence

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Tax Due Diligence

- ❑ Identifies and quantifies areas of tax risk to the extent possible and assesses future tax implications
- ❑ Deals not only with historical liabilities but also assesses future tax implications and finds opportunities to minimize tax
- ❑ Tax implications of the various possible structures
- ❑ Tax DDR is a key ingredient in assessing whether to proceed with a deal

Types of Due Diligence

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System (IT) Due Diligence

- ❑ Review the framework for hardware and software
- ❑ Review of the Disaster Management Plan
- ❑ Coordination that all the software's are working in sync and there is no conflict between any of them
- ❑ Software Licenses are not pirated
- ❑ Compatibility of the Software used by the Acquirer and Target

Types of Due Diligence

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Environmental Due Diligence

- ❑ Environmental due diligence provides the acquirer with a detailed assessment of the historic, current and potential future environmental risks associated with the target organisation's sites and operations
- ❑ Confirm legal compliance and pollution incidents from regulatory authorities
- ❑ The internal environmental norms of the acquirer are met
- ❑ Review contractual and other associated risks

Types of Due Diligence

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Human Resource Due Diligence

- ❑ Human resource due diligence attempts to evaluate how people are managed
- ❑ How the acquirer plans to maximize the value of human resource capital?
- ❑ What is the appropriate mix of pay and benefits for the new organization?
- ❑ What incentive programs are needed to retain essential personnel after the acquisition is announced?
- ❑ How are employees rewarded and compensated by the Target Company and how it compares with the market place?
- ❑ Review of comparative pay scales and designations between the acquirer and target company

Types of Due Diligence

Financial Due Diligence

“Financial due diligence has the highest significance –the final decision, for an investor, would be in the form of financial terms and information. It is therefore imperative that the results of all kinds of due diligence should be translated in monetary terms.”

- ❑ Identification of hidden risks & deal breakers
- ❑ Ensuring that all liabilities, current and contingent, are considered
- ❑ Establishing price adjustments/negotiation extent of dependency on customers and vendors
- ❑ Off balance sheet financing
- ❑ Identification of specific indemnities & warranties required from target

Types of Financial Due Diligence

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Buy Side

- ❑ Due Diligence commissioned by the acquirer
- ❑ Focused on areas of interest for potential acquirer
- ❑ Reporting – generally issue based
- ❑ Data room < > exclusive

Sell Side (Vendor DD)

- ❑ Independent due diligence commissioned by the vendor
- ❑ Key tool for maximising saleability of the business in a reduced timetable
- ❑ To identify potential issues and take corrective measures upfront

Types of Financial Due Diligence

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Limited

- ❑ Focus on certain key areas based on the level of comfort desired by the client

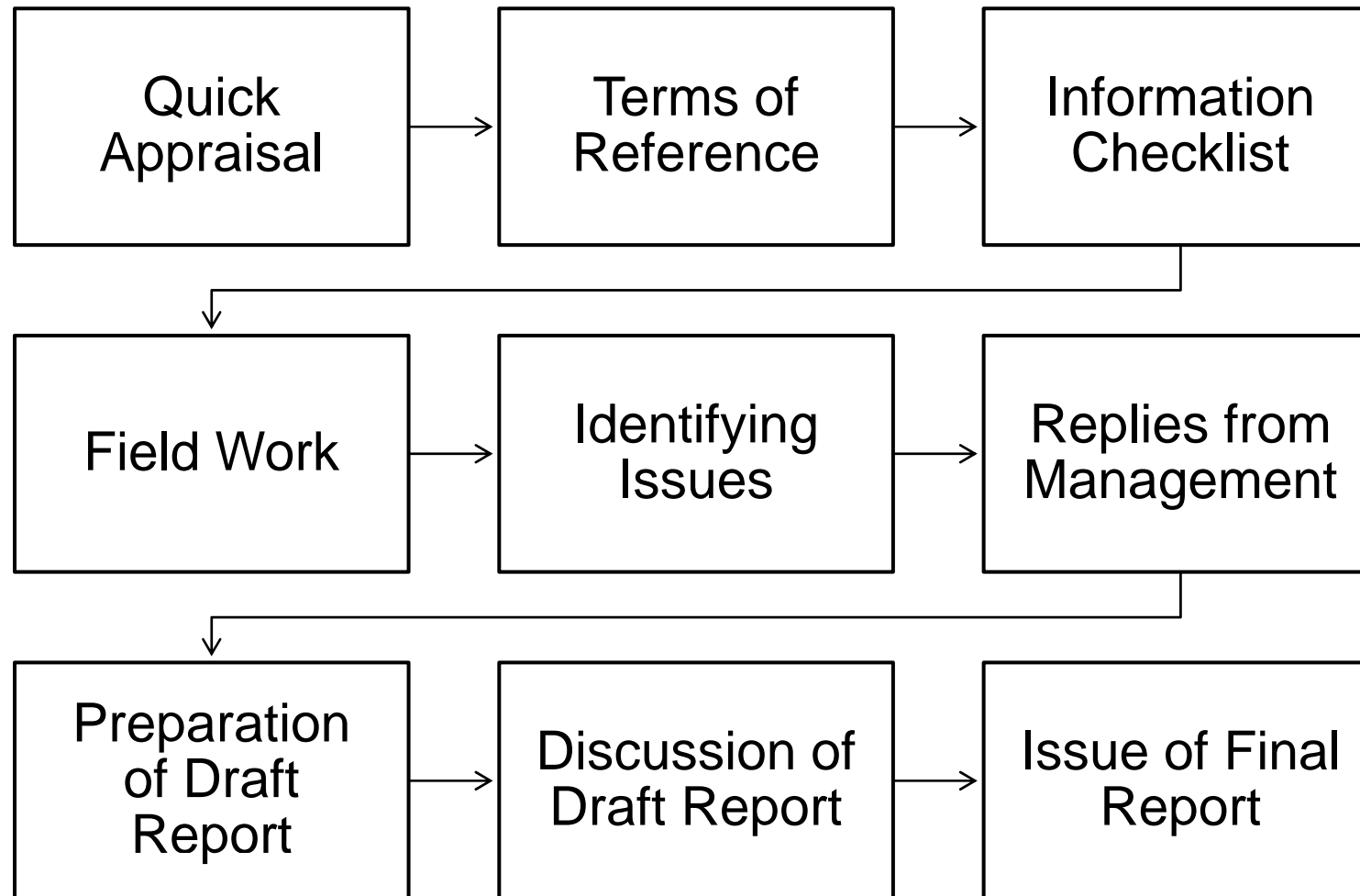
Full Scale

- ❑ Focus on all major aspects of financial statements
- ❑ Extent of detail is more as compared to limited due diligence

It is important to know what's driving value for your clients

Methodology of financial due diligence

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Practical Areas in Financial Due Diligence

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Business Environment

- This would typically assess the effect the external factors have upon business. This when compared with the internal strengths and weakness, provides a good understanding of the state of business. External factors generally include markets, competition, regulation and technology.

Company Operations

- This would involve understanding the business model of the target and the value chain of its business. Other than the main value creating functions viz. procurement and its logistics, production, marketing and sales and distribution logistics, attention is also given to the functions that support these activities.

Practical Areas in Financial Due Diligence

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Quality of Earnings

- Evaluation of the build up of operating profits
- Identifying key sensitive parameters which would adversely impact the profitability of the business
- The rate of growth in sales, EBITDA and earnings
- Sustainability of earnings / cash flows
- Normalised EBITDA

Cash Flows

- Analysing cash flows generated from operations and how the same are employed
- Understanding the level, stability, timing and certainty of future cash flows
- Analysis of working capital

Practical Areas in Financial Due Diligence

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FIXED ASSETS

- Underused/obsolete plant & machinery
- Assets carried at much more than current market value due to capitalization of revenue expenditure or foreign exchange fluctuation
- Capitalization of interest in an expansion project subsequent to stoppage of the construction work
- Litigated assets & property
- Adjustments for capitalization of assets, software expenses, etc

INVESTMENT

- Investments made, carrying value, valuation policies and potential diminution in the value of the investments
- Whether Investments are in the name of the Company?

Practical Areas in Financial Due Diligence

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NET WORKING CAPITAL

- Receivables (ageing analysis, recoverability, bad debts and provisioning policy)
- Uncollected/ uncollectible receivables
- Inventory (ageing, valuation, write off/provisioning policies)
- Cash balance and bank reconciliations
- Verification of high value cash transactions
- Verification of Group company balances under reconciliation
- Analysis of other current assets like loans and advances, deposits, etc
- Sundry creditors (ageing analysis, subsequent payment of creditors dues)
- Provision for ESIF, PF, Leave encashment, Gratuity, defects & other liability claims, Sales returns & discounts, liquidated damages for late deliveries, etc
- Review of all other current liabilities & provisions to see that all known liabilities are fully recorded and all provisions are made

Practical Areas in Financial Due Diligence

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TAXES- DIRECT AND INDIRECT

- Timely payment of Advance tax, TDS, PF, ESIF, etc.
- Timely submission of VAT/CST/Income tax/Service Tax/ TDS returns
- Details of pending assessment with various taxation authorities and probability of liability materializing
- Adjustment for possible liability arising out of non-submission of Forms 'C' & 'F'
- Liability on account of Export Promotion Counter Guarantee (EPCG)
- Tax benefits and their availability in future
- Comment on any other outstanding tax liabilities / material issues
- Tax benefits enjoyed by the target Company

Practical Areas in Financial Due Diligence

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OTHER AREAS

- Share Capital and Convertible instruments, ESOPs / Warrants / CCD / OFCD, etc.
- Commitments including long term contracts.
- Review of various agreements / arrangements with related parties and assessment of various transactions with them
- Evaluation of commitments to / from related parties
- Significant labour claim
- Any show cause notices which have not matured into demands will not be shown as contingent liabilities. However, provision for such notices to be considered
- “Letters of Comfort” given to banks & FI’s. Since these are not “guarantees”, these may not be disclosed in its balance sheet

Practical Areas in Financial Due Diligence

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PROFIT & LOSS STATEMENT

- Identifying seasonality in sales, Revenue Mix, etc.
- Policies pertaining to trade, quantity and cash discount. Whether any irregular discount provided
- Impact of Inventory valuation policies
- Dependency on Key customers/suppliers
- Revenue recognition and cut off procedures
- Items of one off / non recurring nature
- Impact of stand alone costs
- Capital Expenses charged to Profit & Loss Account

Key Issues

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Deal Breakers

Negotiation Points

Issues for Agreements

Commercial Override

Benefits

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- Identification of Deal Breakers and formulation of business solutions
- Avoids unanticipated costs as it mitigates future risks
- Helps in identification of expectations and inconsistencies
- Facilitates planning avenues

Limitations

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For Service Providers

- ❑ Limited scope of review fixed by the client
- ❑ “Too much to see in too little time”

For Acquirers/Investors

- ❑ Inability to determine the scope
- ❑ Inability to ensure proper co-ordination between service providers

Risks Involved

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For Service Providers

- ❑ Failing to meet the needs of the party commissioning a due diligence
- ❑ Financial indemnification of the consequential loss

For Acquirer/Investor

- ❑ The investor may pay higher than the fair price for acquisition
- ❑ The investment performance may not be upto the expectation or may perform badly
- ❑ A bad strategic investment may result in losing a considerable market share or reputation

Steps to Mitigate Risks

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By Service Provider

- ❑ Clearly understand the objectives & the complexities of the assignment based on which the scope should be finalized
- ❑ A proper engagement review should be carried out before accepting the assignment and deciding the scope

Steps to Mitigate Risks

By Service Provider (Cont..)

- ❑ The DDR report should disclose all the limitations of the assignment
- ❑ Collect from the client reports of all other due diligences
- ❑ Schedule meetings with other reviewers
- ❑ The due diligence team should consist of at least one person who is familiar with the industry the target is involved in

Steps to Mitigate Risks

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By Acquirer/ Investor

- ❑ Should ensure that the scope is comprehensive
- ❑ Proper coordination amongst all service providers should be encouraged
- ❑ An integrated service provider may be hired
- ❑ To ensure that the target provides all necessary information

DDR Report

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- ❑ Background of the target and business
- ❑ Limitations
 - ❑ Scope is determined by client
 - ❑ Client has to ensure that the scope determined and exact of our check is sufficient for his overall acquisition strategy.
 - ❑ No detection of fraud
- ❑ Summary of Observations
- ❑ Detailed observations about each item
- ❑ Conclusion

To Conclude ...

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Due Diligence plays an important role in identifying, quantifying and reducing the risks of an acquisition

Although Due Diligence focuses on negative information, the aim is not to raise obstacles to transactions, but rather to facilitate transactions by identifying problems and risks by devising solutions to problems or devices to reduce or manage the risks involved in corporate acquisitions

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