

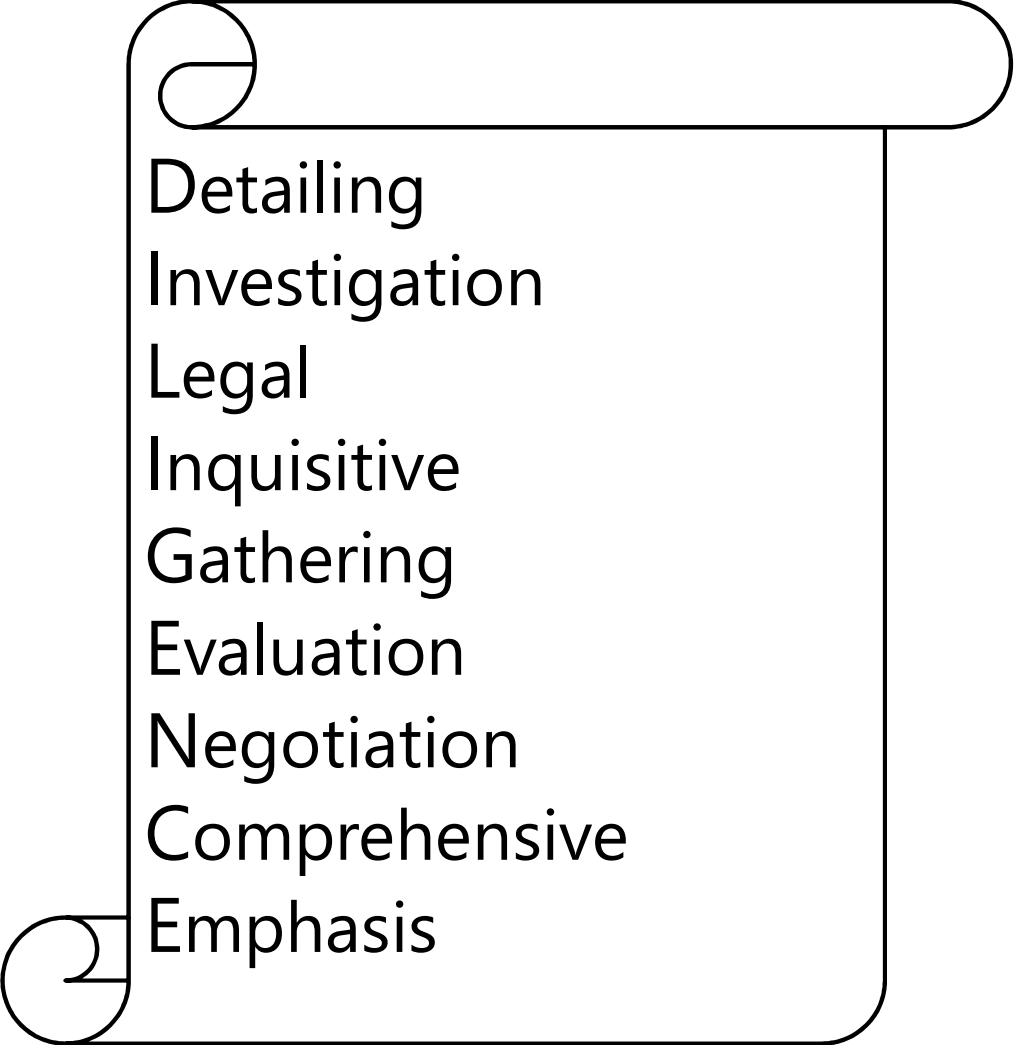
Financial Due Diligence

C.A Sandeep Shah

J. B. Nagar CPE Study Circle of WIRC
Presented on 8th December 2019

Table of Contents

- Background of due diligence
- Overview of financial due diligence
- Process & methodology
- Report
- Key challenges
- Practical tips



Detailing
Investigation
Legal
Inquisitive
Gathering
Evaluation
Negotiation
Comprehensive
Emphasis



Introduction to
Due Diligence

What is Due Diligence



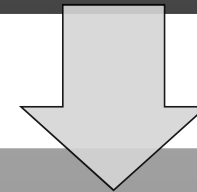
Investigation
prior to acting or
making decision

Scrutiny of
material facts
underlining the
transactions or
deal before legal
contract is signed
by both the
parties

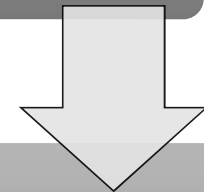
Examination
of financial
records done
before becoming
involved in a
business
arrangement
with it

Relevance of Due Diligence

Ascertain realizable value of assets. Identify unexpected / unrecorded liabilities



Provide comfort to buy / sell



To know the unknown & to confirm the known



Types of Due Diligence



Legal

Evaluate the entire set of financial statements



Financial



Human Resource

BRINGING DISCIPLINE TO
Commercial Due Diligence



Business



Operations

Types of Due Diligence

Financial

Includes an analysis and review of the target company's financial statements, tax returns, accounting policies, and financial trends.

Legal

A thorough analysis and review of corporate documents; contracts and agreements; ongoing, pending and potential litigation; environmental factors; and legal and regulatory compliance.

Business

An analysis and review of strategic and business plans, customers and products, and markets and competition.

Operations

Includes the analysis and review of the company's technology, fixed assets and facilities, as well as real estate, insurance coverage and other significant operational risk that affects pricing or executing the deal at all.

Human Resources

Looks at the organization's structure, employee benefits, management and personnel, and labour matters.



Financial Due Diligence

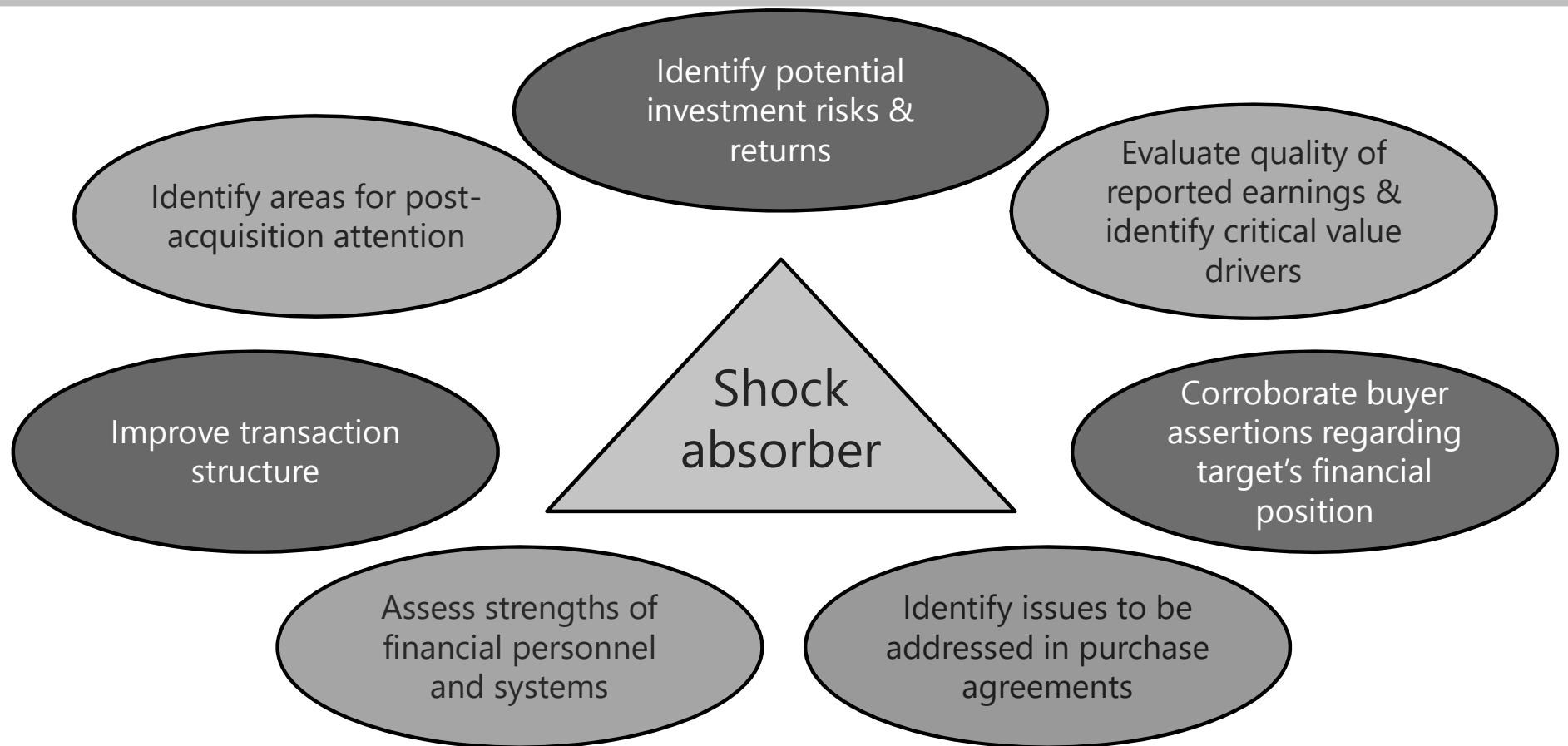
Meaning

**Investigative analysis of financial affairs having material impact on the prospects of the target business
[Historical + Forward Looking]**



Determining whether or not company accounts are consistent, evaluating the real situation of assets, liabilities and potential tax / legal exposures & risks

Purpose



Activities

Understand objectives

- Understand objectives, value drivers of the deal, investment size

Identification and prioritization of risks

- Identify risks where best to focus our efforts
- Prioritize risks as deal breakers, critical and non-critical

Establish action plan

- plan which is pragmatic, based on risk & value of investment, minimum baseline, types of analysis to be performed, etc.

Fieldwork

Review and analyse information for its accuracy and reliability

Tailor-made report

Key findings / adjustments

Types of Due Diligence based on Access

Full Access

- to the target management, staff, accounting, financial and legal data

Limited Access

- to the target management, staff, accounting, financial and legal data

No Access

- strictly controlled environment, typically based on publicly available data

Virtual dataroom

- gaining lot of recognition, especially in cross border deals

Types of Due Diligence based on Purpose

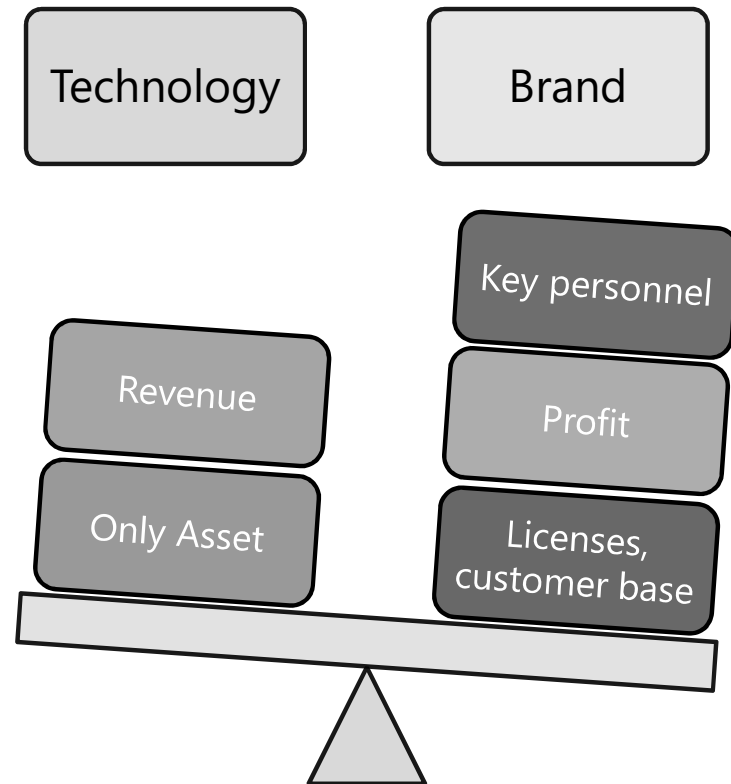
Buy side diligence

Objective is to ensure that prospective investors make an informed investment decision

Sell side diligence (also known as vendor due diligence)

Objective revolves around analysing the opportunities and risks facing their company prior to sale.

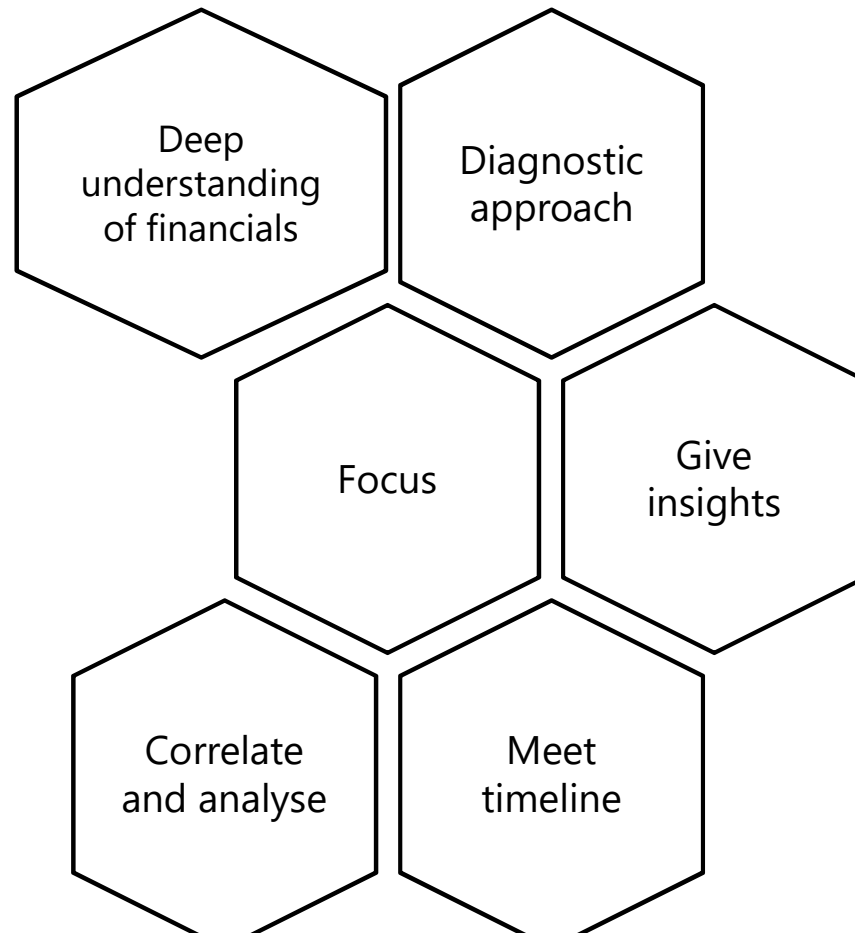
Identify deal drivers / deal breakers



Audit Vs. Financial Due Diligence [DD]

Particulars	Audit	Financial DD
Opinion / Report	True and Fair	Commercial aspects & issues concerning term sheet
Reporting to	Shareholders	Investor / Seller
Timing	Annual closing	Prior to transaction
Attitude	Watch - Dog	Investigator
Access	Full - access	Controlled access

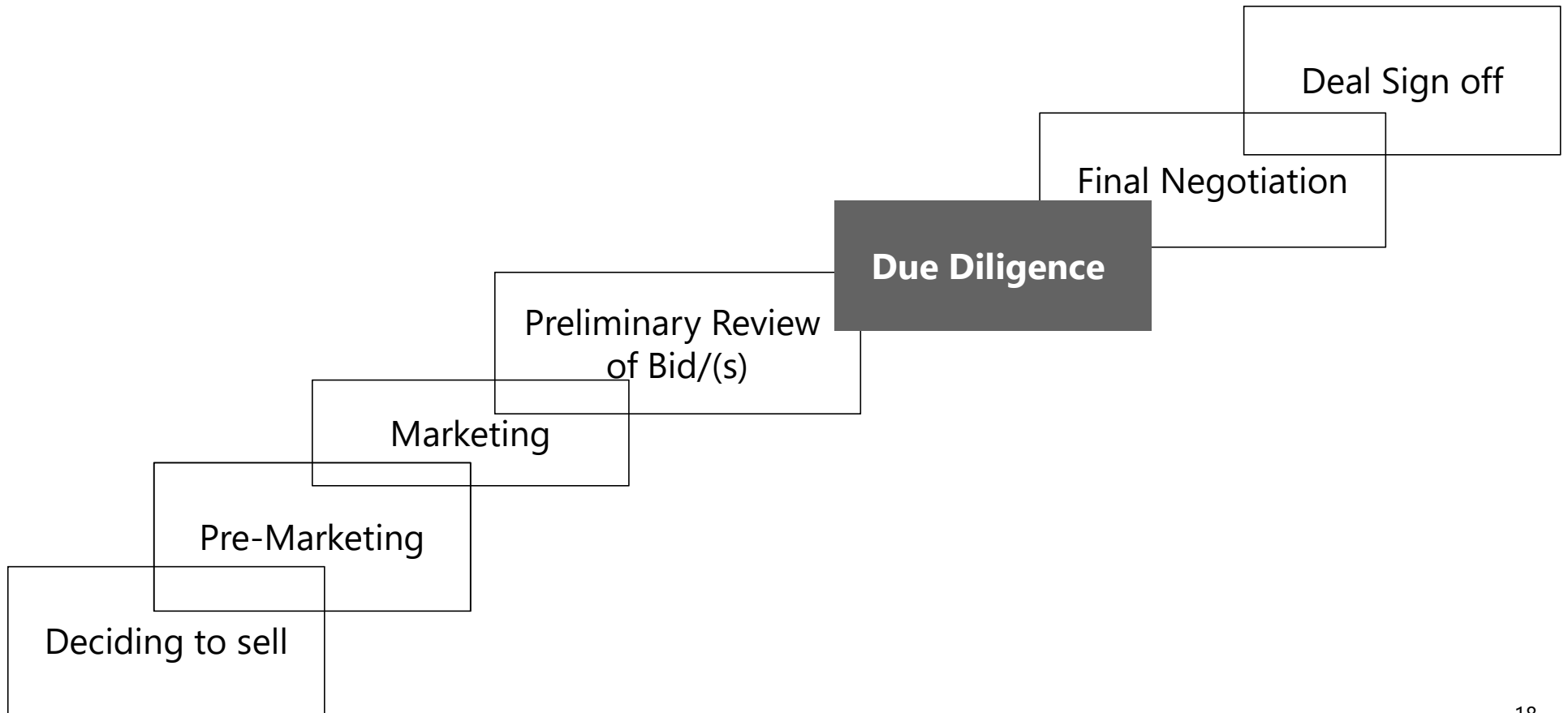
Approach





Process

Seller's Perspective



Buyer's Perspective



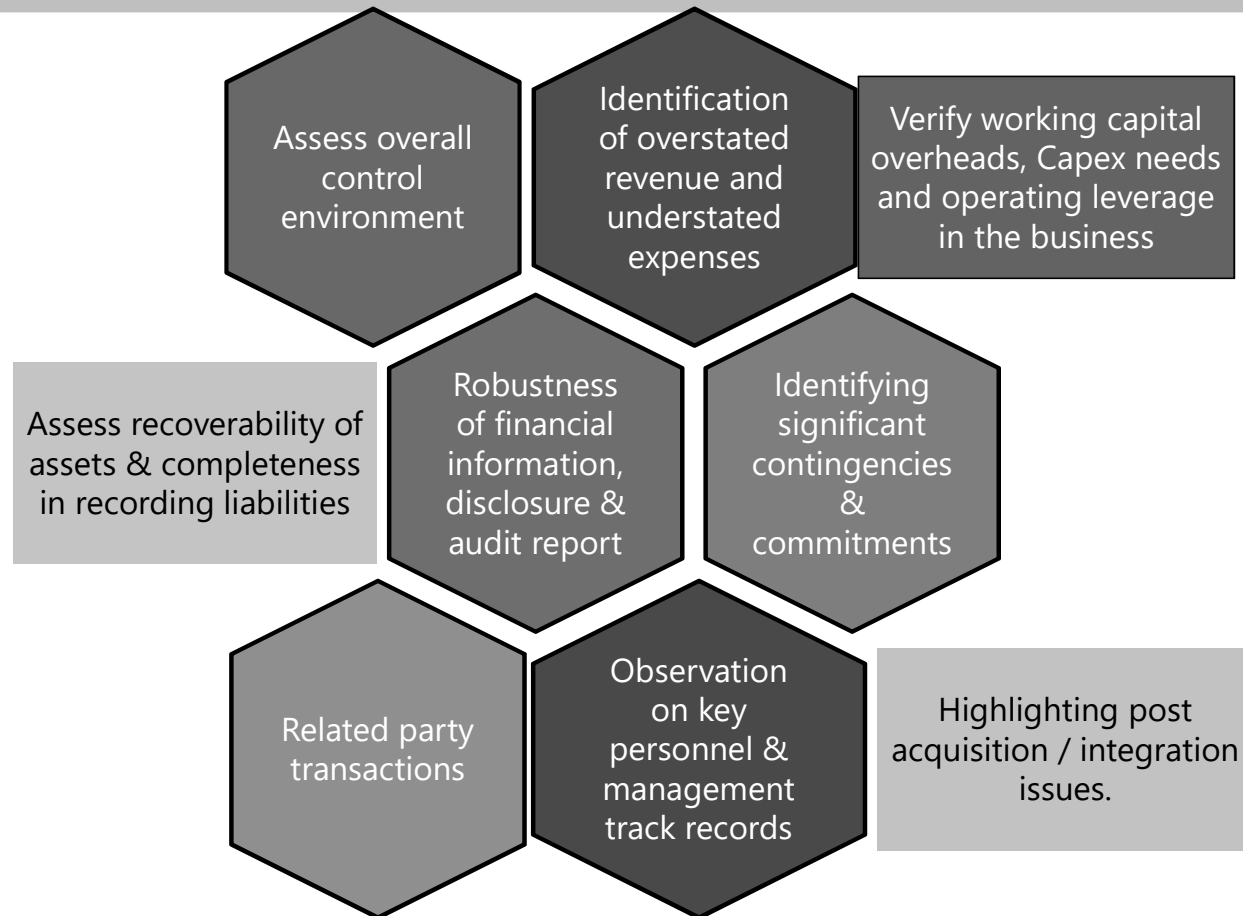
Scope

Scope should be defined & documented

Limitation of scope & to examine its implication on the deal

Scope super-imposed by the investor – Understand intention of the investor

Focus Areas



Review of Financial Statements

Statement of Profit and Loss

- Erroneous accounting
- One – time & extra – ordinary items/ Ind AS adjustments
- Segmental and divisional profitability
- Under provision of expenses
- Quality of earnings

Balance Sheet

- Adjustment required in value of assets
- Assets not usable / impaired assets
- Unrecorded / understated liabilities
- Validate management estimates
- Ind AS adjustments

Cash Flow, disclosures & audit report

- Operating cash flow
- Trend analysis
- Significant non-cash transactions
- Quality of disclosures in policy, notes, MDA
- Audit report

Off balance sheet items to be minutely scrutinized

Methodology

Review Term Sheet, MOU, LOI and Information memorandum



Collect industry and target information and internal & external evidence



Analytical procedures such as performance analysis, trend analysis, etc.



More exhaustive and in-depth as compared to audit



Methodology

Stress on 'value to buyer' concept



Internal communication within team



Timely sharing of work results to the client



Use of expert for industry specific matters





Report

Structure

INDEX of the REPORT

- Background
- Proposed transaction
- Scope & limitation
- Key findings / executive summary – Adjustments to earnings and net-worth
- Analysis & detailed findings
- Limited review of projections (if part of scope)
- Other matters
- Annexures



Key Challenges

Key Challenges – People



Key Challenges – People



Key Challenges – Traps set by seller



- Information provided in bulky format – Hard copies with unimportant details
- Delay in providing data and solving key queries
- Treating recurring items as extra-ordinary costs to get them off the P&L
- Stuffing distribution channels to inflate sales projections
- Exaggerating potential benefit of assets

Key Challenges – Others



- Limited access / no access to confidential data especially when buyer and seller are competitors
- Multi-location and complex related party structure & transactions
- Scope not known to all the members and hence risk of non-detection in certain areas
- Time – constraint as deadline due to nature of deal

Practical Tips

Send exhaustive list of requirements

Update the list periodically and send status

Look for contradictory information / replies

Track time period of replies provided

Look at comments of internal audit report

Ascertain reasons for resistance in providing data

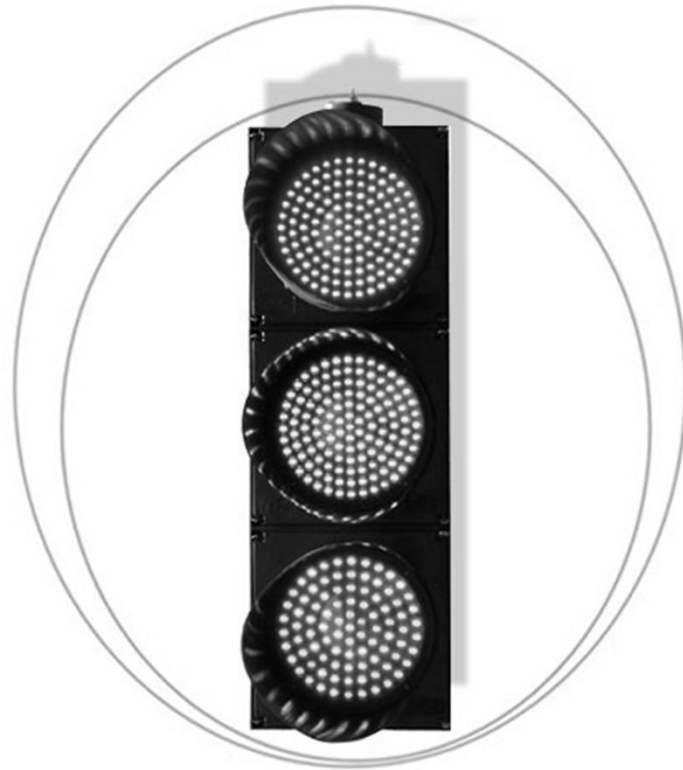
Tone / reply is defensive or attacking

Look for deferment or expedition of transaction

Look transactions post LOI and pre DDR

Review of transaction with related party

Gut – feeling (overall comfort that you derive)



Q & A Session



Thank You

CA. Sandeep Shah
sandeep.shah@nashah.com