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Chapter 3
Due Diligence - An Overview

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Due Diligence :

It is the process by which confidential legal, financial and other material information is exchanged, reviewed and appraised by the parties to a business transaction, which is done prior to the transaction.

Due diligence is an analysis and risk assessment of an impending business transaction. It is careful and methodological investigation of a business or persons or the performance of an act with certain standard of care to ensure that the information is accurate and to uncover the information that may affect the outcome of the transaction.

It is basically a background check to make sure that the parties to the transaction have the required information they need to proceed with the transactions. It is used to investigate and evaluate a business opportunity. It is a tool that often provides insights into the hidden facts.

Due diligence is necessary to allow the investigating party to find out everything that one needs to know about the subject of due diligence.

Due diligence report should provide information and insight on aspects such as the risks of a transaction, the value at which the transaction should be undertaken, the warranties and indemnities that need to be obtained from the vendor etc.

Need of due diligence :

Misrepresentations and fraudulent dealings are not always obvious or straight. Thus, due diligence is designed to protect the interests of the company by providing objective and reliable information on the target company before making any written commitments.

Thus, Due diligence provides the desired comfort level about the potential investment and to minimise the risks such as hidden uncovered liabilities, poor growth prospects, price claimed for proposed investment being on higher side. Due diligence is also necessary to ensure that there are no onerous contracts or other agreements that could affect the acquirer's return on investment.

Thus, due diligence exercise is needed to confirm about the nature and genuineness of the business, identify defects/weaknesses in the target company and to avoid a bad business transaction and to negotiate in a better manner. In short, due diligence is a SWOT analysis of an investment which is essentially required to make an informed decision about a potential investment.

A thorough due diligence helps to reveal any of the negatives, but the process of due diligence is rarely completed smoothly because of the lack of availability of information. The target company is rarely eager to reveal to the other party all the information. Getting information about existing customers may also be tricky as generally the target company is not willing to disclose such information.

Objective 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 major objective of the due diligence are :

1) Collect material information from the target company
2) Conduct SWOT analysis
3) Improve bargaining position depending on the result
4) To take an informed decision about the investment
5) Identification of areas where representation and warranties are required
6) To provide a desired comfort level in the transaction
7) To ensure complete and accurate disclosure
8) To bridge the gap between the existing and expected
9) To take smooth/accurate action/decision
10) To enhance the confidence of the stakeholders.

The SWOT analysis of the target business has to reveal the strengths and weaknesses of not only the financials but also intangibles. To do this effectively, the professional 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. Similarly, cultural issues has to be addressed in time.

A thorough due diligence helps to reveal any of the negatives. However, the target company is rarely eager to reveal the negatives to other party. Thus, during due diligence, all the information may not be revealed. Thus, extracting information becomes tricky and in such a scenario, services of experts are hired in due diligence.

Scope of Due Diligence : Scope of due diligence is transaction based and is depending upon the needs of the people who are involved in the potential investments. Due diligence is generally understood by the legal, financial and business communities to mean the disclosure and assimilation of public and proprietary information related to the assets and liabilities of the business being acquired.

Due diligence would include a thorough understanding of all the obligations of the target company, debts, rights and obligations, pending and potential lawsuits, leases, warranties, all high and impact laden contracts :

The due diligence inspection scope would cover :

- Compliance with applicable laws
- Regulatory violations or disciplinary actions
- Litigation and assessment of feasibility of pursuing litigation
- Financial statements
- Assets - Real and Intellectual Property
- Unpaid tax liens and judgements

- Exaggerated Credentials and Fraudulent claims
- Misrepresentations or character issues
- Past business failures and consequential debts
- Regulatory violations or any disciplinary actions.
- Cross border issues like double taxation, foreign exchange fluctuation, sovereign risk, investment climate, cultural aspects.
- Reputation, goodwill and other intangible assets.

Types of Due Diligence

In business transactions, the due diligence process varies for different types of companies. The relevant area of concern may include the financial, legal, labour, tax, environment and market/commercial situation of the company.

Other areas may include intellectual property, real and personal property, insurance and liability coverage, debt instrument review, employee benefits, labour matters and international transactions.

1) Business Due Diligence :

Operational Due Diligence	It aims at uncovering operational weaknesses, assessment of the functional operations of the target company, operational efficiency etc. Thus, it basically aims at the assessment of the functional operations of the target company and uncovers the inadequacy of control mechanism
Strategic Due Diligence	It tests the strategic rationale behind a proposed transaction and analyses whether the deal is commercially viable, whether the target company's value would be realised. It considers factors such as value creation opportunities, competitive position, critical capabilities.
Technical Due Diligence :	**Intellectual Property Due Diligence :** The Main object of such due diligence is to ascertain the nature and scope of target company's right over the Intellectual Property, evaluate the validity of the same and check whether any infringement claim is going on against the company. Just like any tangible asset, Intellectual Properties of the company are often sold and purchased in business deals and thus the Intellectual Property Due diligence is very significant before entering into a deal.

Technology Due Diligence : It covers aspects such as current level of technology, company's existing technology, further investments required. Technology is a key component of merger and acquisition activities, its imperative to look at IT considerations.

Environmental Due Diligence

It analyses the environmental risks and liabilities associated with an organisation, confirms legal compliances and gives the information regarding environmental risks associated with the target company's sites and operations.

It 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.

It involves risk identification and assessment with respect to :

- review the environmental setting and history of the site
- assessment of the site conditions
- operations and management of sites
- confirm legal compliance and pollution checks from regulatory authorities etc.

Human Resource Due Diligence

It is crucial to consider cultural and employees issues upfront for success of any venture. If Human Resource issues are ignored then key people may leave unexpectedly resulting in complete disturbance of operational synergy between the parties.

Thus, valuable operational synergies gets disturbed when cultural differences between companies aren't understood or are ignored.

Information Security Due Diligence

It is often undertaken during the information technology procurement process to ensure that risks are uncovered.

Ethical Due Diligence

It measures the ethical character of the Company and identify the possibility of the ethical risks which is a non-financial risk. It helps the organisation to decide whether the partner is ethically viable.

It is an effective reputation management tool for any type of business decisions.

2) **Legal Due Diligence :** It covers the legal aspects of the business transaction, liabilities of the target company, potential legal pitfalls and other related issues.

Apart from document verification, it includes independent check with regulatory authorities.

3) **Financial Due Diligence (including Tax due diligence) :** It analyses all the financial, commercial, operational and strategic assumptions being made. It includes review of accounting policies, review of internal audit procedures, cash flows etc

It provides peace of mind to buyer by analysing and validating all financial, commercial, operational and strategic assumptions being made.

The tax due diligence comprises and analysis of :

- tax compliances
- tax contingencies
- transfer pricing
- identification of risk areas
- tax planning and opportunities

Factors to be kept in mind while conducting due diligence :

1. **Objective and purpose :** A key step in any due diligence exercise is to develop an understanding of the purpose of the transaction. The following points must be kept in mind in this regard :
   - **a.** Be clear about your expectations in terms of revenue, profits and the probability of the target company
   - **b.** Consider whether you have resources to make the business succeed
   - **c.** Consider whether the business gives you the opportunity to put your skills and experience to good use
   - **d.** Learn as much as you can about the industry you are interested in.

2. **Planning the schedule :** The organisation should be clear about the steps to be followed in due diligence process, areas to be checked, aspects to be checked and material and information to be requested from the seller.

3. **Negotiation for time :** It is always better to be completely sure about all the documents and other aspects from the due diligence. If the seller is hurriedly asking for finalisation, it is always better to negotiate for more time before taking a final decision.