

INVESTIGATIONS AND DUE DILIGENCE

Question 1

Your client is contemplating taking over a manufacturing concern and desires that in the course of due diligence review, you should specifically look for hidden liabilities and over valued assets, if any. State in brief the major areas you would examine for the above.

(5 Marks) (November 2010)

Answer

Major areas to examine in course of Due Diligence Review

'Due Diligence' is a term that is often heard in the corporate world these days in relation to corporate restructuring. The purpose of due diligence is to assist the purchaser or the investor in finding out all he can, reasonably about the business he is acquiring or investing in prior to completion of the transaction including its critical success factors as well as its strength and weaknesses.

Due diligence is an all pervasive exercise to review all important aspects like financial, legal, commercial, etc. before taking any final decision in the matter. As far as any hidden liabilities or overvalued assets are concerned, this shall form part of such a review of Financial Statements. Normally, cases of hidden liabilities and overvalued assets are not apparent from books of accounts and financial statements. Review of financial statements does not involve examination from the view point of extraordinary items, analysis of significant deviations, etc.

However in order to investigate hidden liabilities the auditor should pay his attention to the following areas:

- “ The company may not show any show cause notices which have not matured into demands, as contingent liabilities. These may be material and important.
- “ The company may have given “Letters of Comfort” to banks and Financial Institutions. Since these are not “guarantees”, these may not be disclosed in the Balance sheet of the target company.

- .. The 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. These may not be reflected in the books of accounts of the company.
- .. Product and other liability claims; warranty liabilities; product returns/discounts; liquidated damages for late deliveries etc. and all litigation
- .. Tax liabilities under direct and indirect taxes
- .. Long pending sales tax assessments
- .. Pending final assessments of customs duty where provisional assessment only has been completed.
- .. Agreement to buy back shares sold at a stated price.
- .. Future lease liabilities
- .. Environmental problems/claims/third party claims
- .. Unfunded gratuity/superannuation/leave salary liabilities; incorrect gratuity valuations.
- .. Huge labour claims under negotiation when the labour wage agreement has already expired.
- .. Contingent liabilities not shown in books.

Regularly Overvalued Assets:

The auditor shall have to specifically examine the following areas:

- .. Uncollected/uncollectable receivables
- .. Obsolete, slow non-moving inventories or inventories valued above NRV; huge inventories of packing materials etc. with name of company
- .. Underused or obsolete Plant and Machinery and their spares; asset values which have been impaired due to sudden fall in market value etc.
- .. Assets carried at much more than current market value due to capitalization of expenditure/foreign exchange fluctuation, or capitalization of expenditure mainly in the nature of revenue
- .. Litigated assets and property
- .. Investments carried at cost though realizable value is much lower
- .. Investments carrying a very low rate of income / return
- .. Infertuous project expenditure/deferred revenue expenditure etc.
- .. Group Company balances under reconciliation etc.
- .. Intangibles of no value