

Due Diligence



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What is Due Diligence (DD) ?

- The idea of due diligence is derived from the practice of taking care and caution in entering into a new transaction
- Due Diligence is the process of evaluating a prospective business decision by getting information about the financial, legal, and other material (important) state of the other.

International History of DD

- The term "due diligence" first came into common use as a result of the United States' Securities Act of 1933.
- The US Securities Act included a defense referred to in the Act as the "Due Diligence" defense which could be used by broker-dealers when accused of inadequate disclosure to investors of material information with respect to the purchase of securities

Due Diligence Cycle

The due diligence as a process consists of five stages, they are as follows

- Pre - engagement
- Understanding
- Due Diligence Program
- Substantial Verification
- Reporting

Classification of Due Diligence

Following are the different classifications of the due diligence process

- Classification by Function
- Classification by Process
- Classification by Transaction
- Classification by Scope
- Classification by Perspective

Classification by Function

- Commercial Due Diligence
- Legal Due Diligence
- Operational Due Diligence
- Business Strategy/ Management Culture Due Diligence
- Environmental Due Diligence
- Human Resource Due Diligence
- Marketing Due Diligence
- Business Environment Due Diligence

Classification by Process

- Initial/Preliminary Due Diligence
- Full Due Diligence
- Ongoing Due Diligence
- Cold Due Diligence
- Hot Due Diligence
- Quick/Fast Due Diligence

Classification by Transaction

- Private Equity
- Mergers and Acquisitions
- Joint Ventures
- Venture Capital
- Purchase of Business
- Investment in Business
- Loans for Business
- Partnership in Business
- Substantial Supply to Business

Classification by Scope

- Financial and Accounting
- Tax
- Information Technology
- Strategic and Commercial
- Legal
- Operational

Classification by Perspective

- Investor Due Diligence
- Target Side Due Diligence

Due Diligence Process

Due Diligence process consists of 3 important steps

Step I: Requesting information.

Step II: Gathering information.

Step III: Reporting on information

Due Diligence Process Checklists

I. Financial Information

- a. Annual and quarterly financial information for the past three years
- b. Financial Projections
- c. Capital Structure
- d. Other financial information

Due Diligence Process Checklists

II. Products

1. Description of each product
2. Major customers and applications
3. Historical and projected growth rates
4. Market share
5. Speed and nature of technological change
6. Timing of new products, product enhancement
7. Cost structure and profitability

Due Diligence Process Checklists

III. Customer Information

- List of top 15 customers for the past two fiscal years and current year-to-date by application
- List of strategic relationships
- Revenue by customer
- Brief description of any significant relationships severed within the last two years
- List of top 10 suppliers for the past two fiscal years and current year-to-date with contact information

Due Diligence Process Checklist

IV. Competition

- Description of the competitive landscape within each market segment including:
- Market position and related strengths and weaknesses as perceived in the market place
- Basis of competition (e.g., price, service, technology, distribution)

Due Diligence Process Checklist

V. Marketing, Sales, and Distribution

- Strategy and implementation
- Major Customers
- Principal avenues for generating new business
- Sales force productivity model
- Ability to implement marketing plan with current and projected budgets

Due Diligence Process Checklist

VI. Research and Development

- Description of R&D organization
- New Product Pipeline

Due Diligence Process Checklist

VII. Management and Personnel

- Organization Chart
- Historical and projected headcount by function and location
- Summary biographies of senior management, including employment history, age, service with the Company, years in current position
- Compensation arrangements
- Discussion of incentive stock plans
- Significant employee relations problems, past or present
- Personnel Turnover

Due Diligence Process Checklist

VIII. Legal and Related Matters

- Pending lawsuits against the Company
- Pending lawsuits initiated by Company
- Description of environmental and employee safety issues and liabilities
- List of material patents, copyrights, licenses, and trademarks
- Summary of insurance coverage/any material exposures
- Summary of material contacts
- History of SEC or other regulatory agency problem, if any

Professional Opportunities for Chartered Accountants

I. Consultancy

- Growth in M&A and Private equity activity in India
- Shortage of quality due diligence specialists
- Other opportunities – bank funding, partnership, joint ventures
- IPO Candidates
- International Business Partners
- Strategic Alliance Partners

Professional Opportunities for Chartered Accountants

- Merger & Acquisition Targets Consultants and Representatives
- Franchisees
- Distributors, suppliers and vendors

II. Certifications

- Capital Market Laws,
- Banking Laws
- Such other enactments as may be specified from time to time

Tips for Effective Due Diligence

- Present an exhaustive list of requirements.
- Note contradictory information received.
- Clarify where the intentions / objectives are disguised so that the replier cannot manipulate the reply.
- Read through Internal Audit Reports.
- Identify the reasons for withholding the reply
- Note the time frame within which the replies are provided.

Tips for Effective Due Diligence

- Mark the tone of reply (defensive or attacking).
- Trace transaction which have been deferred or expedited
- Review transactions with related parties and
- Transfer Pricing Policy for inter company transactions to be scrutinized
- Scrutinize the legal and professional aspects of the transaction.

About the Author

- *CA. Rajkumar S Adukia is an eminent business consultant, academician, writer, and speaker. He is the senior partner of Adukia & Associates.*
- *In addition to being a Chartered Accountant, Company Secretary, Cost Accountant, MBA, Dip IFR (UK), Mr. Adukia also holds a Degree in Law and Diploma in Labour Laws and IPR.*
- *Mr. Adukia, a rank holder from Bombay University completed the Chartered Accountancy examination with 1st Rank in Inter CA & 6th Rank in Final CA, and 3rd Rank in Final Cost Accountancy Course in 1983.*
- *He started his practice as a Chartered Accountant on 1st July 1983, in the three decades following which he left no stone unturned, be it academic expertise or professional development..*

About the Author

- *He has been coordinating with various Professional Institutions, Associations, Universities, University Grants Commission and other Educational Institutions.*
- *Authored more than 50 books on a vast range of topics including Internal Audit, Bank Audit, SEZ, CARO, PMLA, Anti-dumping, Income Tax Search, Survey and Seizure, IFRS, LLP, Labour Laws, Real estate, ERM, Inbound and Outbound Investments, Green Audit etc.*
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