

Due Diligence – A Perspective



Due diligence is an on-going, proactive and reactive process through which companies can ensure that they respect human rights and do not contribute to conflict. A strong due diligence process is critical to make aware the proposed investor of all aspects of the deal and provides access to vital intelligence that is used to negotiate the final price and integrate the new corporations more effectively. The due diligence report should provide a recommendation, based on the risks that have been identified, as to whether a proposed transaction should be entered into with the target company or not. The article looks at the basics of due diligence, its purpose and how it differs from audit, the role of the chartered accountant in the process of due diligence and the methodology, reporting and other aspects relating to the subject. Read on...

Overview

"Believe nothing merely because you have been told it. Do not believe what your teacher tells you merely out of respect for the teacher. But whatsoever, after due examination and analysis, you find to be kind,

conducive to the good, the benefit, the welfare of all beings -- that doctrine believe and cling to, and take it as your guide" – Buddha. Due diligence philosophy is in line with this doctrine and belief of Buddha. The primary purpose of due diligence is to enable the potential investor to make informed decisions concerning the risks present and the opportunities available in the proposed transactions. It provides an assurance on current earnings, assets realisation, unrecorded or understated liabilities, financial statement projection evaluations, cash flows and potential frauds. In other words, it is a mechanism



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by which future negative consequences to either party involved in the proposed transaction, can be prevented.

Due diligence is generally conducted after the buyer and seller have agreed in principle to a deal, but before a binding contract is signed. Or it can be said that it is the investigation of the affairs of a company by, or on behalf of, a potential investor or purchaser before the transaction is completed. Conducting due diligence is the best way to assess the value of a business.

Due diligence is generally performed by a lawyer, chartered accountant or any other business adviser from different perspectives. The due diligence process may uncover information that will require addressing the critical question of whether or not to proceed with the transaction.

Generally, 'due diligence' is of the following types:

1. Financial due diligence
2. Legal due diligence
3. Operational due diligence

Financial due diligence should be undertaken whenever a company is considering acquiring new business (by either acquiring share capital of an existing company or purchasing the business operations and assets only). However, the benefits of financial due diligence reviews are not limited to merger and acquisition decisions. They can also be useful in assessing the merits of disposing of certain existing business divisions within an organisation. A financial due diligence review is also an essential component of assessing investment requirements for venture capital arrangements.

A financial due diligence review would not only look at the historical financial performance of a business but also consider the forecast financial performance of the company under the current business plan and consider the reasonableness of such forecasts. Also, under financial due diligence, reviewers investigate the reasons for the trends observed in the operating results of the company over a relevant time period and report on this in terms of relevancy for the proposed transaction.

Clearly, the scope of each financial due diligence will be unique depending upon the nature of the transaction and the size of the company or business operations being acquired. In general, a financial due diligence would typically involve a review of the following areas:

historical financial results, current financial position, forecast financial results, working capital requirements, employee entitlements provisions, valuation implications, identification of risks and opportunities, and taxation implications.

The key to determine an appropriate scope for financial due diligence is clear identification of the risks surrounding the potential acquisition.

Due Diligence vs. Audit

Financial due diligence is not similar to an audit. An audit is only concerned with historical financial information and provides an assurance as to whether the financial information gives a "true and fair view" of the company's operations. On the other hand, a financial due diligence is wider in scope.

Financial due diligence may apply certain aspects of auditing standards, but an audit assignment must apply all applicable auditing standards.

As mentioned above, the primary objective of the due diligence assignment is not to express an opinion on the truth and fairness of a target's financial statements; it is merely to provide a potential investor with crucial information, gathered as a result of the due diligence assignment, to enable the potential investor to make informed decisions about the potential investment/acquisition in/of a target company.

Reviewer (generally, chartered accountants) performs certain aspects of the due diligence assignment in accordance with Standards on Auditing (SAs), but in contrast to statutory audit, the scope of the due diligence assignment is very much driven by the nature, size, complexity and client-requirements.

The reviewer may undertake a certain degree of the financial due diligence by applying SAs.

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Knowledge of accounting standards is required to ensure that transactions and events have been properly accounted for in annual financial statements and any interim financial statements that the reporting accountant may use in his/her review.

Similar to any other assurance engagement, sufficient planning is also crucial in due diligence assignments, to enable the reviewer to carry out the necessary procedures and to carry out the assignment to the highest standards.

In many cases, the reviewer may be required to undertake a due diligence exercise on the company in which he may not necessarily have any past experience or dealings. In such circumstances, it is vital that the reviewer plans the due diligence carefully and obtains an understanding of the target company and the environment in which it operates. The reviewer may, therefore, consult the provisions in standard on auditing (SA) 315 "Identifying and assessing the risk of material misstatement through understanding the company and its environment".

Role of A Chartered Accountant in Due Diligence

Merger and acquisitions are very often nowadays. A due diligence review can be conducted either internally, or by independent external experts. Chartered accountants play a significant role in the financial due diligence process, because they are considered as financial experts. It is a good opportunity in our way. We can advise on the best structures and breakdown of sale/acquisition/merger /any other agreements after due consideration to tax planning.

Information Gathering

Once instructions have been taken from the client, the terms of the engagement have been agreed and sufficient planning has taken place, information can be gathered to enable the reviewer to report back to the client. The extent of verification of such information will largely depend on the requirements of the client and the scope of the engagement.

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An illustrative list of requirements/information that the reviewer would be needed in order to perform financial due diligence is given as follows:

1. Details of the group structure (wherever applicable);
2. Shareholding pattern of the target company along with detail of shares pending allotment;
3. MOA and AOA of the target company;
4. Minutes of meetings of the shareholders or members, board of directors, or any committee thereof, for the last 3 years;
5. All external correspondences (either with business parties or with authorities) having significant matters and material agreements/deeds/arrangements including relating to acquisitions/financing during last 10 years, if any with the company;
6. Documentation relating to all joint venture, partnership, mergers, acquisitions relating to the company or any of its subsidiary;
7. All accounting records especially relating to revenue, fixed assets, inventory, cash and cash equivalent, employee related cost, accrual of expenses, *etc.* including accounting and HR policies/tax records/list of options, rights, and warrants, *etc./* registers/returns;
8. Audited financial statements of the target company including internal reporting packages for the last three years, with the auditor's report, as the case may be, together with supporting analysis;
9. Un-audited financial statements of the target company for the most recent month or quarter end including the company's forecast projections for performance for the next three years;
10. List of any off-balance sheet arrangements, liabilities or obligations of any nature;
11. Comparison of last two years forecasted budgets compared to actual performance;
12. Detail of capital expenditures for the last three years;
13. Obtain receivables and payable aging schedule;
14. List of pending litigations and regulatory matters;
15. Obtain disaster recovery plan/policy of the company;

Auditing

16. Obtain corporate governance policy and procedures.

Methodology

Checking methodology will remain almost similar to audit to an extent. Sample testing is used in performing both control and substantive procedures. This would comprise meetings, site visits, communications, and data analysis which include trend analysis, budget vs. actual analysis, benchmark (based on competitive data) analysis, *etc.*

The reviewer analyses the collected data based on the aforesaid approach and arrives at a conclusion based on critical factors like business criticality, functional complexity, technical complexity, infrastructure requirements, *etc.* During the course of testing, the reviewer understands the organisation's financial health, its capacity to deliver in future, its reputation and approach to working. The reviewer also gets a perspective on the leadership of the organisation.

Working Papers

There are no strict guidelines for preparing work papers during such type of assignments. Generally, work undertaken during the due diligence is documented in accordance with the procedures performed by the reviewer. Again, whilst the due diligence exercise is not an audit, however, compliance with standard on auditing (SA) 230 (revised) "Audit Documentation" may be considered appropriate by the reviewer.

It should demonstrate clearly the basis of results/ findings of due diligence engagement. This would be helpful in giving deliberated answers to the questions asked by the client (potential investor).

Reporting

The form and content of reporting should be agreed at the outset of the assignment. It should serve the purpose for which potential investor had asked for due diligence report to identify ongoing and potential risks in order to be able to make informed decisions about the target company.

Typically, a due diligence report would normally consist of the following:

- (a) Scope of the engagement;
- (b) Executive summary;

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- (c) History of the target;
- (d) Nature of the target company including its business, group structure, internal processes, principal activities, *etc.*;
- (e) Financial reporting and accounting controls;
- (f) Critical accounting policies;
- (g) Summary of the latest approved financial statements and a summary of any available up-to-date management/interim accounts;
- (h) Review of the financial position, financial performance and cash flows of the target for the relevant period;
- (i) Details of significant matters such as relating to mortgages, financing, charges, taxations, *etc.*;
- (j) Reviews of budgeted information and projections including future plans of business;
- (k) Other relevant matters.

Conclusive Remarks

The due diligence process is more than collecting information and simply checking boxes. Most acquisitions are based on the value of future cash flows. Although it is important to ascertain and understand the specific assets you are buying or the liabilities you are assuming, it is equally important to analyse the information in the context of how future cash flows will be affected by the issues examined during due diligence. The chartered accountants have an important role to play in the financial due diligence since they are considered as financial experts. ■