

DUE DILIGENCE – A WAY TOWARDS SUCCESSFUL BUSINESS TRANSACTION*

Introduction

Due Diligence (DD) has opened various gates of opportunities for professionals. Due diligence may be required for varied reasons including Mergers and Acquisitions, Important purchase of Assets, Checking Statutory or regulatory Compliances etc. It is evident from the present scenarios of business environment of the country that every major transaction like Public Offers, Takeovers, Merger & Amalgamations calls for the need of Due Diligence. Due diligence is conducted from the perspective of the both seller and the buyer. While the buyer checks aspects relating the financials, litigations, patents and complete magnitude of pertinent information, the seller lays emphasis on the background of the buyer pertaining to the financial capabilities of seller to complete the transaction and the ability to honor the commitments accepted. Achievement of growth is an integral part of any form of business organization and that calls for compromise and arrangements. The need for these transactions may be achieve economies of scales, expanding the geographical presence, technological upgradations, achieving competitive edge, regulatory requirement of cross border transactions etc. With the needs for entering into varied range of transactions, there comes the risk of failure of these transactions. There may be some hidden aspects which does not come in front on bare understanding of the available documents. Therefore, the need arises for due diligence, which can go in details and find out the unwanted and hidden risks associated with the transactions. As Company Secretaries are recognized by various regulatory authorities for conducting due diligence, it has become important to understand this topic in details. For eg. RBI has advised that the banks get the due diligence conducted by the company secretaries.

Transactions requiring due diligence

Due diligence may be required for varied reasons. The form of DD depends on the purpose for which it is conducted. Few of the purposes of DD is enumerated as under:

* *Directorate of Academics*

Views expressed in the Article may not express the views of the Institute.

Process of Due Diligence

1. Suitability and Comptability aspects

- In this step, the information is gathered from the perspective of checking the suitability of the other party. For eg. In case of a takeover, the buyer will check the risks associated with the company and seller will check the financial ability of the buyer to complete the transaction.

2. Financial aspects

- In this step, the information related to the fairness of financial accounts may be checked.

3. Production aspects

- In this step, the ability of other party relating to productions may be checked.

4. Environment aspects

- In this step, various non-compliances of environmental laws may be checked.

5. Technology aspects

- In this step, the technological capabilities may be analysed.

6. Legal aspects

Scope of Due Diligence

It is necessary that before starting the conduct of due diligence, the scope should be decided. Confinement of scope always gives better results of the due diligence. The following points may be observed while deciding the scope:

- i) Important points relating to the purpose of transaction.
- ii) Important offices and departments required to be checked.
- iii) Important Policies and Procedures.
- iv) Important questions required to be answered.
- v) Coverage of books and registers.
- vi) Filling with various government offices or statutory authorities.
- vii) Method of sampling.
- viii) Meeting with the person in-charge of the records.

Vertical or Horizontal approach

One of the most important aspect of due diligence is finding out the approach required for DD. The decision on this point depends on the purpose of the transaction. If the transaction is specific, than the vertical approach will work better. For eg. In case of mergers specific information in detailed form would be beneficial. If the DD is for the purpose of compliance

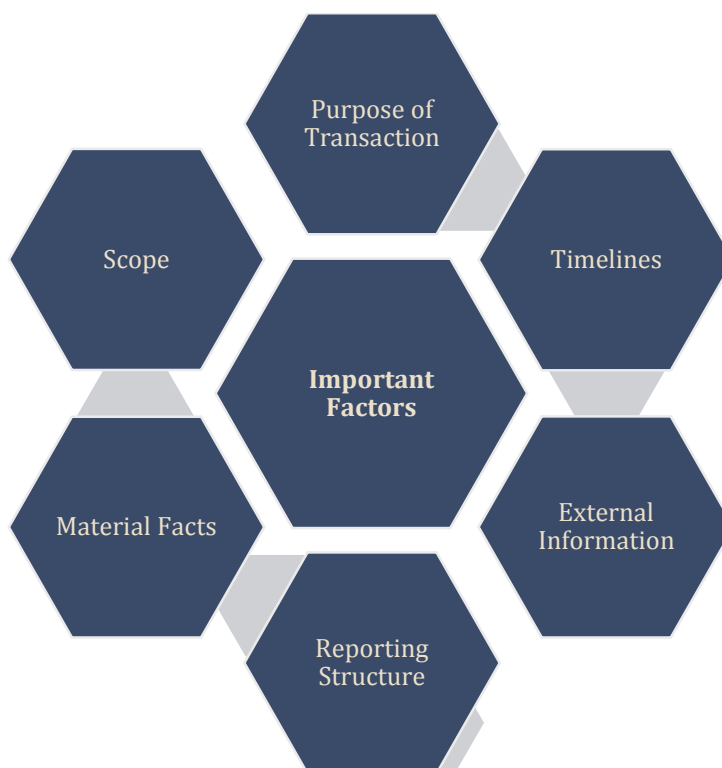
than Horizontal approach may be followed. For Eg. In case of secretarial audit, compliance related to mostly all the laws are required to be checked. In horizontal approach more information may be checked and in vertical approach information in details may be checked. Time is also an important aspects while the deciding the approach to be followed. If time is limited, a professional can face the difficulty while checking the information in details.

Challenges in conducting due diligence

A professional may face many challenges while conducting due diligence. He needs to deal with these challenges and bring the best result of due diligence. Few examples of the challenges faced are as under:

- i) Non-availability of the information or incomplete information: For eg. Non availability of evidence related to compliances. While dealing with difficulty, he can try to find the alternate source of getting the information.
- ii) Lack of time: Many a times a professional cannot check all the information due to paucity of time. A professional may confine the scope of checking in this scenario.
- iii) Non-cooperation by the employees: It is possible that few of the employees may start non-cooperating as this may lead to focus on their mistakes. Reporting to the concerned authority may be a good solution in this scenario.

Important factors to be remembered while conducting due diligence



Risk Analysis

DD may not only require the gathering of information but also includes to find out the risk associated with that particular information. Risk Analysis can only be done effectively by in-depth analysis of information. A general analysis may not fulfill the purpose. For enhancing the effectiveness of a transaction, it is necessary to analyse the risk associated with the information. The purpose of the Due diligence provides a fair idea how much depth analysis

is required. While reporting the risks, care shall be placed on the assumption made at the time of analysis.

Document Review

It is necessary to review all the important documents that are analysed for DD. The inclusive list of documents required to be reviewed is as under:

1. Review of MCA documents
2. Charter of the Company i.e. MOA and AOA
3. Statutory Registers including register of loan, charge, minute books etc.
4. Financial Statements for the current and previous years
5. Verification of Assets and Liabilities.
6. Compliance relating Laws of Taxation, Labour, Corporate Laws etc.
7. Statutory Liability.
8. Contingent liabilities.
9. Operational aspects.

Report writing

The most important part of due diligence is writing of report in a presentable form. If the report does not provide the actual view of the organization than the activity will become worthless. Identifying the problem is not the only work of due diligence. A good diligence report should also provide the suggestions for solving the problem. The report may *inter-alia* cover General Information, Financial Data, relevant business agreements, pending litigations, contingent liabilities, details of intangible assets like IPRs, marketing position, Internal Controls, Environmental compliance, position of CSR aspects, Human resource assets and the culture of the organisations. The report should also make the reference and purpose of the conducting DD. For eg. Whether it is conducted due to statutory requirements or for entering into Business transaction or as a fact finding analysis. The report should also include the source of information. List of document reviewed including the documents not available should also be the part of the report. Assumptions wherever made should be part of report. Reference to reliance on certain undertakings and certificates should also made part of DD report. Risk analysis section should also one of the mandatory part of the DD report. The report shall also state the confidentiality and restriction clause providing the limited use of the report, wherever feasible.

Importance of Due Diligence for Mergers and Acquisitions: Case analysis

Bharti – Zain Deal

Airtel acquired Zain a Kuwait based telecom company's assets in Africa's 15 countries. The company suffered low EBITDA even after 5 years. Various reasons like Africa's economy contributed to the failure of the acquisition. The due diligence of Bharti lacked somewhere to appreciate and identify the risks of failure in this acquisition. A comprehensive and complete due diligence could have placed Bharti Airtel in a better position.

Tata Corus deal

Tata steel completed acquisition of Corus in 2007, at the peak of the boom that ended with the Global Financial Crisis in 2008 by paying out \$12.1 Billion (of which \$6 Billion was debt)

with the objective to pave the way for the Tatas to enter the UK steel sector. Global steel demand, especially in developed markets like Europe, has remained muted following the financial crisis of 2008. Cheap Chinese steel dumped across the globe has rendered the business unviable in the face of the continuing financial crisis impact. Tata Steel over last 10 years has reduced the production capacity of Corus from 18 MTPA to 10 MTPA. The company further cut its European exposure by reducing the stake from 100% to 50% after combining the business with Thyssenkrup. Tata Steel used the cash box to shop for distressed assets in India – Bhushan Steel. But these new purchases mark the persistence of an old problem—debt. Tata – Corus transaction came at a time that commodity prices had peaked. The basis for valuation was production capacity despite an auction and reservations on valuations, Tata Steel ended up paying 30% more than the negotiated price – prestige at play. Finally, this was a leveraged buy out with no clear debt paring plan present with the buyer. The success of this could have been ensure by making the complete and comprehensive due diligence.

ESG Due Diligence

In the present business scenarios of the country, Issues such as child labour, carbon emissions, fair tax and corruption can make or tarnish the image of the organizations. It is necessary that enough care should be taken on the issues of environmental, social and governance (ESG). Therefore, ESG due diligence can act as deal maker or deal breaker. ESG due diliegence have become the important part of decision making before going for Mergers and acquisitions. It can help to overview of how emerging social and environmental megatrends are likely to affect the business. This aspect is so important that it may force for revaluation of the organization at the time of Mergers and Acquisitions.

Conclusion

Due diligence is required at the time of entering into any major transaction. It provides the security to one who wants to enter into a transaction. DD has gained its importance over time due to the changes in business culture of the country. With the growth of businesses, the chances for the fraud has also increased. In order to get rid of these fraud it is necessary that with every big decision should be backed with the surety of due diligence report. The completeness of due diligence and accurate reporting in one another aspect of DD. It is pertinent to note that incomplete due diligence or inaccurate reporting may be equal or worse than the conduct of due diligence. With all the reasonable steps, the due diligence may prove to the base of major corporate and business decisions.

References:

1. Article written by professionals for chartered secretary.
2. https://www.icsi.edu/media/webmodules/linksofweeks/ICSI-October_2021.pdf
3. https://www.nishithdesai.com/fileadmin/user_upload/pdfs/Ma%20Lab/Bharti-Zain%20Deal.pdf
4. <https://blog.ipleaders.in/examples-of-failed-mergers-and-acquisitions-in-india/>
5. <https://home.kpmg/xx/en/home/services/advisory/risk-consulting/internal-audit-risk/sustainability-services/esg-due-diligence-services.html>
6. <https://www.alphainvesco.com/blog/failed-mergers-and-acquisitions/>
