Basics of Due Diligence

The practice of undertaking a formal due diligence investigation is of comparatively recent origin in India and was mainly imported as a process by foreign investors/their legal and financial advisors after the economic liberalisation reforms of 1991.

Due Diligence is the assessment that a prudent person might be expected to exercise in the examination and evaluation of risks affecting a business transaction. It should be the first step taken before embarking on any successful national or international business venture.

Due diligence is a detailed investigation of the affairs of a business. As such, it spans investigation into all relevant aspects of the past, present and predictable future of the business of a target company. Due diligence is a process of a thorough and objective examination that is undertaken before corporate entities enter into major transactions such as mergers and acquisitions, issuing new stock or other securities, project finance, securitization, etc.

One of the key objectives of due diligence is to minimize, to the maximum extent practicable, the possibility of there being unknown liabilities or risks. The exercise is multi-dimensional and involves investigation into the business, tax, financial, accounting and legal aspects of an issuer. The aim of due diligence is to identify problems within the business, particularly any issues which may give rise to unexpected liabilities in the future.

A question may arise why due diligence should be conducted. There are many reasons for doing so, including the following:

- ✓ Confirming that the business is what it appears to be;
- ✓ Identifying potential "deal killer" defects in the target and avoiding a bad business transaction;
- ✓ Gaining information that will be useful for valuing assets, defining representations and warranties, and/or negotiating price concessions; and
- ✓ Verification that the transaction complies with investment or acquisition criteria.
- ✓ Public Issue of Securities
- ✓ Good Corporate Governance

Due diligence involves a number of different areas of investigation. For example, the company's financial status will be assessed by accountants and the pension arrangements will be the subject of an actuarial review. Due diligence is the necessary amount of diligence required in a professional activity to avoid being negligent. This commonly arises in major acquisitions where the legal principle of *caveat emptor* (let the buyer beware) requires the purchaser to make a diligent survey of the property or service.

The approach to due diligence depends on the type of transaction and what is intended to be achieved. Due diligence may be of various types:

- ✓ Commercial due diligence – review of industry, market, and the business model of the issuer.
- ✓ Reputational due diligence – review of credit worthiness and reputation of individual counterparties.
- ✓ Financial, Accounting & Tax due diligence – review of tax, financial position, policies and internal controls.
- ✓ Legal due diligence – review of documentation to identify potential legal issues that may be risks/impediments to the (i) transaction or (ii) in the general operations of the issuer, that may affect the value or consideration in connection with the transaction.

- ✓ Human resource Due diligence – review of documentation related to management contracts, bonus schemes, option schemes, details of all employees, consultants, contractors, etc
- ✓ IT Due Diligence – review of information on software licences, data management procedures and copies of IT audit conducted.
- ✓ Operations Due Diligence - review of all operations and their role, utilisation & capacity of each operation.

A little due diligence can go a long way in protecting the business capital and reputation. There is no substitute for a thorough investigation. In these days of strict adherence to regulations, extra effort is what it takes to protect companies when business growth leads into uncharted territory.

Experience has demonstrated that time and money invested in due-diligence investigations have saved many corporations from financial disaster and irrevocable reputation embarrassment. Due Diligence is no longer a luxury; it is a requirement to meet legal and regulatory requirements and to promote corporate integrity and customer confidence.

CONCLUSION

As anyone with personal experience will testify, due diligence can be a lengthy and difficult process, taking up considerable resources and management time. At first sight, due diligence can appear to be an unwelcome distraction for the management and employees of a business which is in the process of preparing for an acquisition or IPO. However, it should be clear from the above that due diligence is a critical element of almost any major transaction. Due diligence sounds impressive, but ultimately it translates into basic commonsense success factors such as "thinking things through" and "doing your homework". The message which this article has sought to emphasize is that preparation is the key to the successful survival of a due diligence exercise. A company which has its affairs properly in order will not only have a less onerous task on an acquisition or IPO, but will find that by following good management practices, it has enhanced the value of its intellectual property.