Due Diligence

FINANCIAL REPORTING

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Due Diligence

- Doing research or analysis
- Effort made by an ordinarily prudent or reasonable person to avoid harm to another party or for himself
- Performance of an act with a certain standard of care
- Ensure there are no skeletons in the closet/ no last minute surprises
- Unearth potential issues if any – identify risks
- Know exactly what one is getting into

Financial Due Diligence

- **Objective** – assurance engagement enabling a potential investor to make informed decisions concerning the balance of risks present & opportunities available should the transaction complete
- Plan to identify areas of target entity which are material & those areas which can be safely ignored
- Provide crucial information for decision making

Reporting

- Contextual as per agreed upon engagement scope
- Agreed upon with the client
- Reporting by Exceptions
- Detailed Reporting – Methodology
- Bias towards negative reporting
- Use of standardized templates
- Cross references to Annexure
- Documentation
- Understanding the entity, it's environment & assessing the risks of material mis-statements

Benefits

- Cost of doing a business with unexpected difficulties could be disastrous.
  - Withdraw from the deal
  - Adjust valuation of the investment
  - To have a solution/remedy for the problem
- Availability of timely, sufficient & adequate information for effective decision making.
- Helps you get a better deal / price –
- Handy Negotiation Tool

Typical deal process

- Initial presentation to the Investment Committee
- Principal Go ahead for the deal subject to conditions / clarifications
- Conducting due diligence – Technical / Legal / Financial / Tax – Regulatory
- Going back to the IC with diligence findings / clarifications
- IC final approval for the deal
- Documentation / Compliances
- Conditions precedent / subsequent
- Sign off by CFO / Independent auditor
- Funds disbursement – Receipt of Shares

Typical covenants

- Board seat
- Infusion / non withdrawal of capital
- Retention of key employees
- Approval on Compensation plans
- Submission of information (MIS)
- Appointment / Change of Auditors – Statutory / Internal
- Exit clauses
- Minimum IRR

Typical covenants

- Drag along Rights – Enable the majority stakeholder to force a minority stakeholder to join in the sale at the same price, terms & conditions as any other seller
- Tag along rights – Enables the minority stakeholder to force the majority stakeholder to let him join the transaction & sell his stake at the same price, terms & conditions.
- Pre-emption rights -right to purchase additional shares in the company before the general public has the opportunity in the event there is a seasoned offering.

Typical covenants

- ROFR – Right of First Refusal – similar to a call option right – only if the holder turns it down, can the seller approach other parties

  A plans to sell an asset to B for 1 Crore – C holds a ROFR – A therefore has to first offer to C & only if C declines can he sell the asset to B –

- ROFO – Right of First Offer – or Negotiation – The seller has to undergo negotiations with the ROFO holder before negotiating with other parties

  Here C holds a ROFO – A has to negotiate with C first & only if they fail to reach an agreement, can A sell to B at any price or terms

Information Obtained

- Historical financial data
- Current financial data
- Forecasted financial information
- Business plans/ budgets
- Confirmation/ Representations from lenders & debtors
- Contracts with key staff/suppliers/customers

Techniques

- Informal discussions
- In depth Interviews
- Observing ongoing daily activities
- Surveys
- Analysis
- Surprise visits
- Information from external sources – customers/vendors

Things to be kept in mind

- Expectations – Clarity
- Commitments
- Strengths
- Knowledge of business
- Preparation

'Cost of due diligence is insignificant compared to the cost of a bad decision'

Phases

- Planning
  - Scope definition
  - Area of focus
  - Team structure
  - Responsibility delegation
  - Time schedules
  - Communication
- Data Collection
- Data Analysis
- Report Finalization

Financials

- Assets & Liabilities – Capex
- Cash Flows
- Inventories
- Turnover
- Receivables & Payables
- Revenue Recognition
- Accounting procedures & policies
- Organization structure
- Contingent Liability – Tax demand / pending litigation
- Technology
- Market-share

Information Sources

- Internet
- News paper reports
- Market intelligence
- Regulatory Organizations & databases
- Competitors
- Suppliers
- Customers
- Industry Associations/ Chambers of Commerce

Documentation

- Articles/ Memorandum/ Partnership Deeds
- Minutes & resolutions
- Organization Chart – Employee benefit schemes
- Schedule of accounts
- Relevant material agreements
- Latest shareholding pattern/ Directorship
- Schedule of locations
- Financial Statements
- Schedule of Leases
- List of suppliers/ customers
- Intellectual Property
- List of software - licenses
- Product Documentation
- Confidentiality & NDAs
- Licensing requirements

Financial Statement Frauds

- In 1985 James Treadway, a former SEC Member stated on fraudulent financial reporting –

  Fraudulent financial reporting does not begin with an intentional act to distort the financial statements; rather it frequently comes about as a series of acts designed to respond to operational difficulties. Initially the activities may not be fraudulent but in time they become increasingly questionable until someone finally steps the line. At the core it is all about ***'Pressure'***

- Financial statement fraud can be perpetrated when 3Cs are present-

  Condition, Corporate Culture & Choice

Financial Statement Frauds

- Fictitious or illegal booking of income
- Timing of revenue recognition
- Failure to provide for impairments
- Side arrangement w.r.t unilateral cancellation
- Improper revenue recognition
- Improper related party transactions
- Non-booking or non-accrual of expenses
- Improper capitalization
- Improper authorization
- Omission of liabilities for future obligations
- Improper use of estimates - calculation of useful life of assets / Actuarial valuation of leave benefits

Financial Statement Frauds

- Inadequate discussion/omission to disclose material key information in Notes to Accounts /MDA
- Misclassification of income
- Adjusting Prior Period Items to reserves
- Adjustment above the line items as below the line items
- Companies intentionally disseminating information that suits them
- Research report issued at behest of management
- Improper asset valuation
- Improper cutoff procedures at year-end

Governance Policies

- Compensation Policies
- IA Charter
- Insider Trading Policy
- Code of ethics
- Sexual Harassment Policy
- Succession Planning
- Whistle blower policy
- Independent Directors
- Hedging Policy
- Related Party Transactions
- Board Performance Reviews
- System of risk management & IC
- Responsiveness of complains
- Reporting lines & organization structure

Financial Indicators

- Net Present Value / Pay back Period
- Profitability Index= NPV/Initial Investment
- IRR = Discount rate that makes the present value of all cash flows ‘0’
- Cash Flows
- Scenario Analysis
- Yield to Maturity
- Leverage
- Breakeven return
- Cost of Capital
- Dividend Payout Policy / Rights & bonus issue / Repurchase of shares
- Revaluation Policy
- Liquidity Management

Ratio Analysis

- Turnover Ratios
  - Inventory Turnover
  - Receivables Turnover
  - Working Capital
  - Asset Turnover
- Operating Cycle
  - No. of days Inventory/Receivables/Payables cycle
- Liquidity Ratio
  - Current Ratio
  - Quick Ratio
  - Cash Ratio

Ratio analysis

- Solvency Ratios
  - Debt to Asset
  - Debt to Equity
  - Asset to Equity
- Coverage Ratios
  - Interest Coverage Ratio= EBIT/Interest Payments
  - Cash flow to debt ratio
- Profitability Ratio
  - Gross Profit Margin
  - Operating Profit Margin
  - ROE = PBT - PAT
- Other Ratios
  - EPS
  - PE Ratio
  - Dividend Payout Ratio
  - Plough back Ratio

Behavioral Finance

'Influence of reasoning on financial decisions'

- Gut feel
  - Decisions made on whether the chosen outcome or path feels right emotionally.
  - Decisions made on instant intuition or experience. However, they can be complements to formal analysis & not substitutes.
  - Needs careful structured thinking.
- Bias in decision making
  - Over confidence – Error in judgment
  - Over optimism – Over estimation of likelihood of good outcome
  - Confidence bias – Focus on information agreeing to your opinion & ignore information not in support with your position.

Behavioral Finance

- Framing Effects - Making potentially inconsistent & different decisions depending on how a question or a problem is framed.
  - Loss aversion – narrow framing
  - Difference between real & nominal buying power
  - Considering something owned to be worth much more than it would have if you had not owned it
  - Aversion to ambiguity
  - Recency bias – Time constraints
  - Availability bias
  - False consensus
  - Pressure of targets / Desire to do the deal at any cost

Some due diligence assignments

- KYC – KYCB
- Enhanced Due diligence – High Risk Customers profiled by the bank
- Diligence Reporting in Banks – lending under consortium / Multiple Banking arrangements – RBI Circulars dated Sept 19th 2008 & February 10th – strengthening information sharing system
- Scope determined by nature, size, complexity & client requirements

Concepts

- Governance –
  Transparency & Disclosure
  Responsibility & Accountability
  Fair Conduct

- Taking an informed risk decision
- Professional Skepticism
- Bloodhound v/s Watchdog Approach
- More than reasonable care exercised by a normal prudent man

- The more you learn, you learn that you still have a lot to learn –
- Learn – Unlearn – Relearn –
- Data – Information – Knowledge – Wisdom
- LUCK – Learning under conscious knowledge