



CA Poonam Basak

Deals- Advisory Services

Due Diligence Review

- ▶ *The Need for the
Investigation*



Meaning & Purpose

DD means investigation of a business or person prior to signing a contract, or an act with a certain standard of care.

Due diligence takes different forms depending on its purpose:

- The examination of a potential target for merger, acquisition, privatization, or similar corporate finance transaction normally by a buyer.
- A reasonable investigation focusing on current practices of process and policies. or material future matters.
- An examination aiming to make an acquisition decision via the principles of valuation and shareholder value analysis.

Due Diligence Report

▶ *The Final Product of the
Exercise*



DD Report Contents

- I. Executive summary**
- II. History & Business operations**
- III. Management, staff and pensions**
- IV. Accounting & Information system**
- V. Financial Results**
- VI. Revenue & Cost Analysis**
- VII. Assets & Liabilities**
- VIII. Compliance Matters**



Executive Summary

Highlight of major issues

- Exceptional events, historical changes, etc
- Any abnormalities/ variations in accounting,
- policy changes, any non- adherence of norms

Corrective measures/ Suggestions

- Impact on the company,
- Recommended corrective measures

History & Business Profile

History

- description
- origin of the organization
- and the milestones

Business Profile

- The corporate structure of the group, its primary activities.
 - Organisation structure of the group



Management & workforce

- Management structure
- Details of the directors and senior management, their educational background, experiences
- Current and expected Remuneration
- Broad details of workforce including terms of employment, numbers and remuneration policy.
- Details of profit-sharing and bonus schemes.



Due Diligence Report

▶ *Financial Matters*



Accounting & Information

System of Accounting & MIS

- A description and assessment of the financial records, the management information produced and the system of internal control.
- A brief description and assessment of the costing systems and the budgetary control and forecasting systems.
- Details of material year-end, non-recurring and other adjustments made to management accounts.

Accounting policies

- Details of the accounting policies adopted by the company and details of any changes in policies during the last three years.
- Detailed explanation of methodology for revenue recognition.

Financial Results

Annual financial statements

- Analyse and comment on financial statements for the past five years, which should translate into a trend-line comparison for the five years.

Cash flow analysis

- Be mindful of the information in this report when you are reviewing the income statement, for the target may report substantial profits even while burning through its cash reserves.
 - Report if, there is any cash restricted from use in any way

Disclosures

- These disclosures should be reviewed in detail, since they can reveal a great deal more information about a company than is shown in its income statement and balance sheet.

P&L summary

£'000	FY05 Audited	FY06 Audited	FY07 Audited	2008 Forecast
Turnover	4,658	4,473	4,866	5,841
Cost of sales	(1,626)	(1,120)	(1,029)	(1,278)
Gross profit	3,032	3,353	3,837	4,563
Net operating expenses	(3,197)	(2,565)	(2,792)	(3,112)
Reported EBITDA	(165)	788	1,045	1,451
Normalisation adjustments				
Onerous lease costs (Sunbury)	131	-	-	-
Sunbury lease costs during year	80	-	-	-
Compensation for loss of office	-	-	30	-
Bad debt provision	-	25	(25)	-
Normalised EBITDA	46	813	1,060	1,451
Depreciation	(36)	(31)	(30)	(31)
Amortisation of goodwill	(605)	(601)	(601)	(600)
Normalised EBIT	(595)	181	419	820
Net interest payable	(256)	(220)	(161)	(22)
(Loss)/profit before taxation	(851)	(39)	258	798
Taxation	(52)	(166)	(287)	(419)
Net (loss)/profit after taxation	(903)	(205)	(29)	379
KPIs				
Gross margin (%)	65.1%	75.0%	78.9%	78.1%
Normalised EBITDA (%)	1.0%	18.2%	21.6%	24.8%
Average headcount	51	41	44	52

Balance sheet forecast

£'000	Dec 07 Actual	Dec 08 Forecast
Fixed assets		
Intangible assets	1,265	665
Tangible assets	40	82
Total fixed assets	1,305	747
Current assets		
Stocks	19	5
Debtors	1,404	1,853
Prepayments and accrued income	88	130
Cash at bank	681	829
Total current assets	2,192	2,817
Current liabilities		
Trade creditors	(195)	(150)
Accruals and other creditors	(514)	(364)
VAT and other taxes	(280)	(337)
Deferred income	(2,024)	(2,288)
Corporation tax	(358)	(220)
NVM / Intercompany loan	(1,900)	(1,600)
Creditors < 1 year	(5,271)	(4,959)
Net current liabilities	(3,079)	(2,142)
Total assets less current liabilities	(1,774)	(1,395)
Creditors > 1 year	-	-
Net liabilities	(1,774)	(1,395)
Capital and reserves		
Called up share capital	41	41
Share premium	581	581
Profit and loss account	(2,396)	(2,017)
Shareholders' deficit	(1,774)	(1,395)

Cash flow summary

£'000	FY06 Audited	FY06 Audited	FY07 Audited	3m FY08 Management
Cash flow from operating activities				
Operating profit	(834)	157	414	332
Depreciation & amortisation	641	632	631	6
Stock	6	(16)	(4)	8
Debtors	645	160	101	(612)
Creditors	(439)	(114)	(121)	644
Net cash inflow from operating activities	219	819	1,021	578
Returns on investments and servicing of finance	(192)	(220)	(161)	(39)
Taxation	(40)	-	(116)	-
Capital expenditure	(30)	(25)	(29)	(7)
Acquisitions and disposals	(30)	-	-	-
Financing	(400)	(400)	(600)	-
(Decrease)/increase in cash in period	(473)	174	115	532

Revenue Analysis

- *Revenue stream.* A key value driver in a business is its recurring revenue stream.
Product range, share, etc
- *Pricing philosophy.* Product Pricing policy, its components
- *Accounts receivable.* Aging report to see if there are any customer invoices that are overdue by unusually long periods of time, and find out the reasons why.
- *Customer changes.* Trends in debtors list

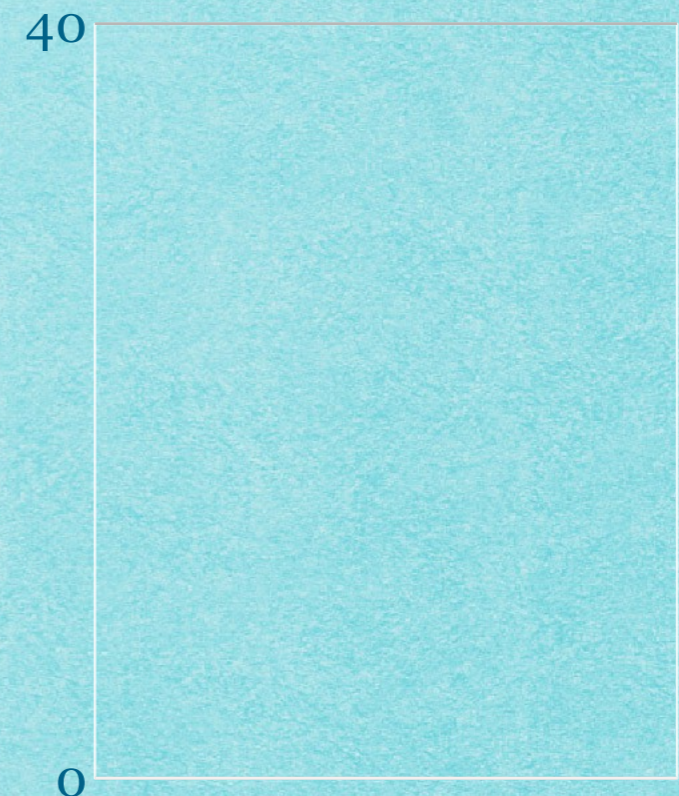
Cost Analysis

Expense trends

- Analysis of income statements for the past 3-5 years to see how expenses are trending.

Extra ordinary Expenses

- Review certain expense accounts for questionable expenditures.
- Expenses categorized as non-operational.
- One-time events - This is a common problem for one-time sales to large customers.



Fixed Assets

- Inspection/Trace the fixed asset register to the fixed asset balance
- Conduct a review of the more expensive fixed assets to see if any are no longer in use.
- Maintenance - Review the repair & maintenance report to see usage of assets
- Assets Valuation. The net book value of fixed assets as recorded in a company's accounting records has nothing to do with what they are actually worth if they were to be sold on the open market.
- Review the Depreciation policy, whether it justify the assets life.

Liabilities

- Accounts payable - Review the most recent ageing accounts payable report to see if there are any overdue payables, and find out why they have not been paid.
- Review the Loan agreements, associated guarantees and verify complying with any covenants included in the debt agreements.
 - Debts to related parties.
 - Interviews with the employees and business partners for Unrecorded liabilities like potentially adverse outcomes of lawsuits, guarantees on behalf of third parties, self-insurance, and contingent fees.
- Verify which assets have been designated as collateral by lenders.

Shareholders

- *Include class of various shares*, major shareholders, along with the share holdings of each one as well as the voting rights associated with each class.
- *Options and warrants* give their holders the right to purchase shares of company stock at a certain price point. See if the expected price per share is likely to trigger the purchase of any stock.
- *Unpaid dividends* - If dividends have been declared but not paid, this becomes a liability of the acquirer.
- *Stock buyback obligations* - Has the company committed to repurchase the stock of any shareholders? If so, at what price and by what date?
 - Dilution impacts of future obligations/ESOP scheme/Minority

Due Diligence Report

▶ *Compliance Matters*



Direct & Indirect Taxes

- *Is the company continuing to pay taxes?* If a company has been paying taxes in the past, then review its accounts payable records to verify that payments are continuing to be made.
- *Is the company paying the correct amount of taxes?* Just because a company is remitting tax payments does not mean that those payments are correct. Accordingly, the team should audit the calculations used to derive a sampling of tax payments, to see if the payments were calculated correctly.
- *Are there undisclosed tax liabilities that have never been paid?* This is by far the most difficult tax due diligence task, for it addresses the complete absence of tax payments.

Legal Matters

- Review Board minutes for authorization of more stock, the repurchase of existing stock, certain compensation packages, acquisitions, and so forth.
- Obtain the meeting minutes for the past few years of shareholder meetings & comment if any abnormality.
- If the board of directors has an Audit committee, it can be useful to review its minutes for the past few years to see if the committee was made aware of any control-related issues.

Lawsuits

- If there are any lawsuits outstanding against the target, ascertain their status.
- Review lawsuits within the past five years that were settled, obtain copies of the settlement agreements.
- Review all invoices paid to law firms in the past three years, and verify from them that all legal issues have been addressed.

Service Expertise:

- Due diligence & Valuations
- Private Equity/Venture
Funding
- Merger & Acquisitions/Joint
Ventures
- Restructuring & Refinancing
- Feasibility study & Project
Finance
- Financial and Accounting
services

