Importance of Due Diligence

Is It Worth Buying? Due Diligence plays a vital role in answering this question in Mergers and acquisitions (M&A) transactions.

Due Diligence gives deep insights into the target company/seller, its business model, the assets, its people, and how it operates. It is a corporate investigation conducted to reconfirm what is been claimed by the seller before agreeing.

With more than 1000 transactions globally per year, M&A transactions have been increasing astronomically compared to the last two decades, primarily to get a competitive advantage with the acquisition of new technologies, forward and backward integrations, addition to the product portfolio, cross-selling, geographical diversification, economies of scale, and low production costs. Previously due diligence was mostly confined to checking the accuracy of financial information provided by the seller but over the years, it has evolved to cover other crucial aspects of the business including audit of the technology, business processes, internal policies, and contracts, amongst others.

Why Due Diligence Is Important?

It is as good as taking a test drive to make sure all parts are working well before going ahead with the purchase of a car. Due Diligence gives the buyer the required comfort and indication of any risks associated with the transaction by thoroughly examining the target company's financial, legal, commercial, regulatory, and tax records. Key objectives include:

- Identify contingent liability or unforeseen claim in the future and accordingly, pre-emptive measures can be taken
- Check accuracy, legitimacy, and sufficiency of the information/records to validate the value being assigned to the business/assets
- Plan post M&A activities such as smooth transition of customers, employees, role definitions, and responsibilities

How Is It Done?

A dedicated cross-functional team is assigned to check their respective areas of expertise. This requires months depending on the complexity of the transaction. Major areas include:

Chart

Legal Due Diligence – This process walks through the legal documentation of the target company, which can make or break the deal. It involves inspections of gathered legal documents of the target such as clear titles of the assets, contracts with customers and suppliers, leases, pending and potential lawsuits, Intellectual Property/patents, tax liabilities, environmental laws, representations and warranties, and any other definitive agreements.

HR Due Diligence – Target company's HR-related aspects including contracts and appointment letters, employee policies, culture, workplace relations, payroll processing, and current and historic employee disputes are put under a microscope. This helps in understanding the organization structure, employee mindset, and level of talent available. It is important to plan the transition of employees as the loss of talents post transaction may stall desired growth of the business.

Financial Due Diligence – It is also known as accounting due diligence. It sheds light on the financial health of the target company. This is the assessment of financial information which includes accounts and the supporting files with the vouchers and invoices, fixed assets registers, audited financial statements, balance sheets, assets and liabilities, cash flows, and capital expenditure for the period under investigation. This aims at proving the legitimacy of the financial information shared by the target company and analyzing if there is under or reporting which may affect the agreed valuation. In addition, it helps to identify any liability which may arise in the future.

Tax and Regulatory Due Diligence – This helps to identify if there is any lethargy in the system to file periodic returns and necessary forms, or if there are any pending claims or litigations with the authorities. The risk can also be mitigated by requesting a no-dues certificate from the tax and other regulatory authorities.

Intellectual property/patent/trademark Due Diligence – People often turn a blind eye to Intellectual Property (IP) during Due Diligence. In this process, IP lawyers review and analyze patents and patent applications, trademarks, copyrights, slogans and brand hashtags, publicity rights, and software and databases. Based on the same, they evaluate the quality and value of IP assets. This can be an important aspect depending on the agreed valuation and its components for the transaction.

IT/ Systems Due Diligence – IT Due Diligence helps understand IT structures, which include technical liabilities, software licensing, open-source components, technical risks, and security testing. This process also analyzes the potential risk involved as well as the management and protection of sensitive data. The importance of IT due to diligence would vary depending on the sector and nature of business.

Common Challenges Faced by the Buyer and Seller in Due Diligence

Inadequate Planning – Road map to the transaction is always crowded with multiple tasks and priorities. The dedicated teams are always occupied with a load of work to finish but often fail to deliver due to inadequate planning, prioritization, and lack of firm leadership.

Poor Communication – Clear and effective communication during the Due Diligence phase is a must for both buyer and seller sides, be it preparation of data room, checking the records, or discussing the aberrations and extreme findings before finalizing the Due Diligence report.

Adjustment in Valuations – If any adverse findings come up in Due Diligence, negotiations for valuation adjustments take place between both parties. If not handled diligently, it may result in withdrawal from the transaction by either of the parties.

Time Overruns– Due to unorganized data or insufficiency of data, poor communication and clarity between the parties about the objectives of Due Diligence, it may take longer than the expected timeframe.

Difficulty in Evaluation Based on The Limited Data in Limited Timeframe- Major challenge for a buyer is to analyze the limited data available in the limited time frame to justify the agreed valuation and estimate any liability that may come up in the future. It is not always foolproof but the risks can be mitigated by strong and exhaustive definitive agreements to be signed between the parties including all required disclaimers, warranties, and affidavits.

With an increase in the number and complexity of the M&A transactions, it is of paramount importance to strategize the whole process especially Due Diligence. The risks can also be

mitigated by having strong definitive agreements offering the best possible protection to the buyer and the best possible comfort and transition to the seller. The right expert equipped with experience and expertise can bring two companies with different mindsets, motives, and business models together; as well as lead the transaction to the closure.