

Background Material

on

Due Diligence

Committee on Internal Audit



**The Institute of
Chartered Accountants of India**

(Set up under an Act of Parliament)

Background Material on Due Diligence

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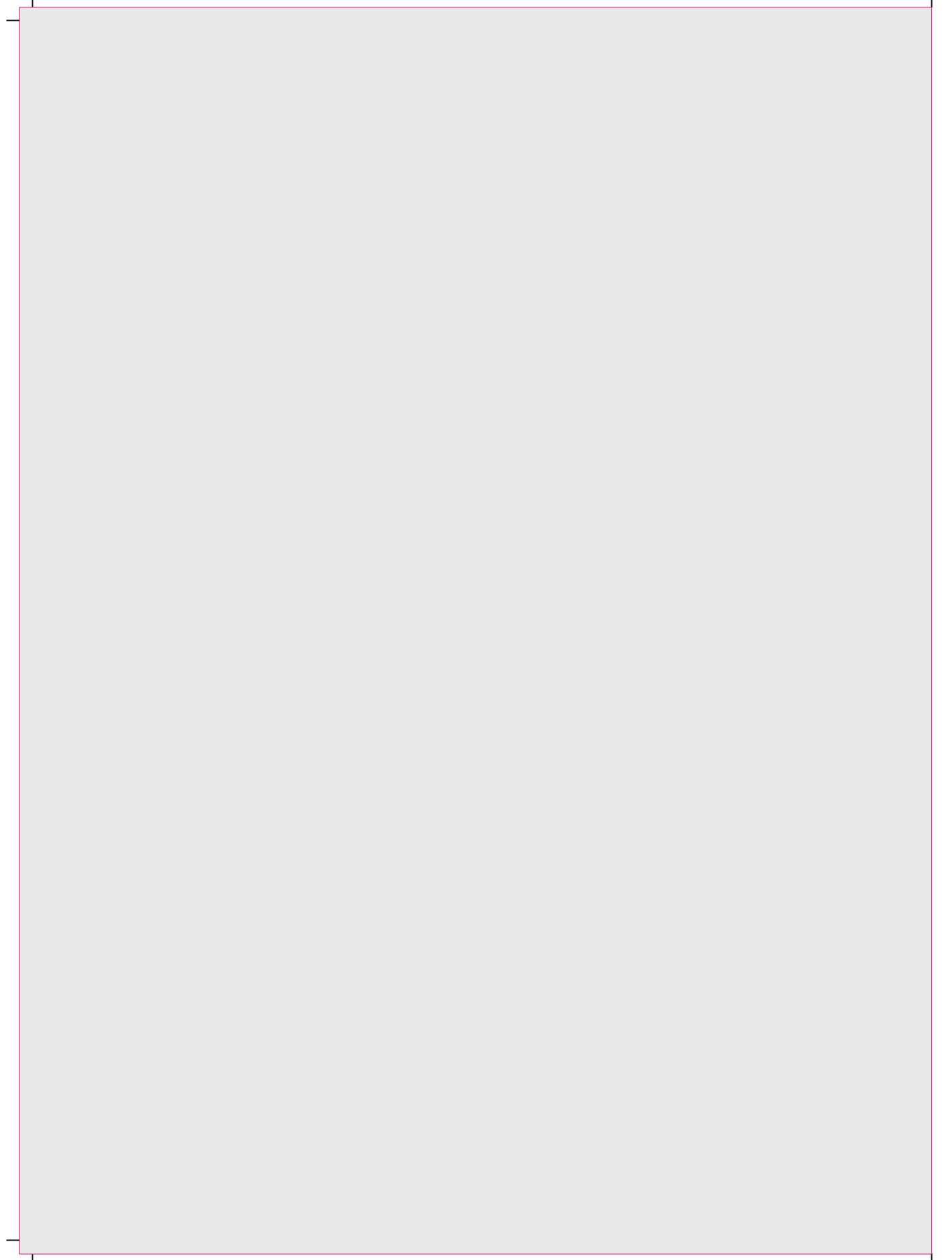
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Foreword

With the all round steady growth being witnessed by the Indian economy, dramatic restructuring of companies in the form of amalgamations, acquisitions, mergers and joint ventures has become common. It is in this context that assessing the potential risks of a proposed transaction by inquiring into all relevant aspects of the business to be ventured has become indispensable. Thus the importance of 'Due Diligence'.

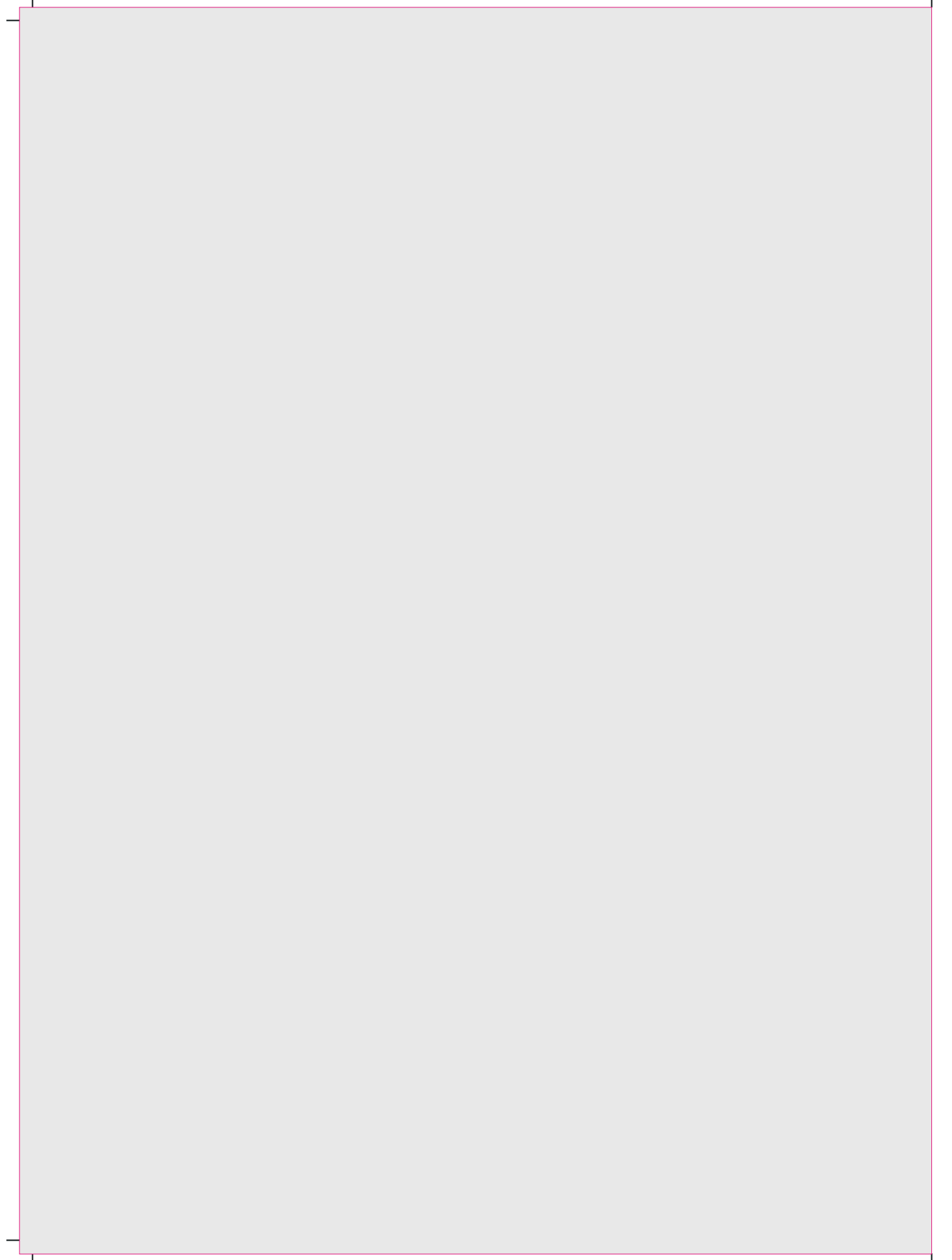
The Institute on its part has been working quite proactively to help members sharpen their skill sets in all the emerging areas of professional relevance by way of technical literature as well as conferences, workshops etc. I am pleased to note that the Committee on Internal Audit of the Institute is issuing this comprehensive background material on 'Due Diligence'.

I congratulate CA. Abhijit Bandyopadhyay, Chairman, Committee on Internal Audit and other Committee members on the issuance of this publication.

I am sure that this book will be of immense help to the members and other interested readers.

29th January, 2008
New Delhi

CA. SUNIL H. TALATI
President, ICAI



Preface

The Committee on Internal Audit has immense pleasure in placing before the members the background material on “Due Diligence”.

Corporate acquisitions/mergers/takeovers have become a part of business strategy to grow rapidly and widely. Due Diligence is used to investigate and evaluate a business opportunity. It involves an analysis carried out before acquiring a controlling interest in a company. Irrespective of the nature of takeover, be it hostile or friendly, it is quite normal for the buyers to seek an independent due diligence report in respect of their target acquisitions. Here lies the scope of a professional to conduct due diligence process on behalf of their clients for proper evaluation of the vendor.

In light of this recent development, it is felt that the members require to be equipped to avail the emerging opportunity of undertaking due diligence exercise. Accordingly, to meet this purpose, the committee has brought out this Background Material on Due Diligence for assistance of the members. It is also aimed at being used as a background material for Training our members in this area which requires specialised skill.

Through this background material an attempt has been made to answer many of the

queries that may be raised by the investigating Chartered Accountants. With a view to providing appropriate guidance in a manner that is easily understood by all the readers, this background material is divided into eight main chapters sequentially as Introduction to Due Diligence, Approach to Due Diligence, Due Diligence for Mergers & Acquisitions, Due Diligence for Venture Capital Investment, Due Diligence for Franchisee, Challenges and Risks Covered in Due Diligence Process, Work Approach for Due Diligence, and Summary. In addition, the material consists of Appendices containing Open House discussion- with sample questions and answers, Group Exercise, and Glossary of Salient Terms for better understanding of the readers.

I am extremely grateful to CA. Amitava Basu, for sparing time out of his professional and personal preoccupations and sharing his wealth of experience in the area of due diligence in the form of this Background Material. I am obliged to CA. Sunil H. Talati, our President and CA. Ved Jain, our Vice President for giving me this opportunity. I also wish to thank my colleagues in the Committee on Internal Audit, CA. Charanjot Singh Nanda, CA. Shanti Lal Daga, CA. Rajkumar S. Adukia, CA. Amarjit Chopra, CA. Sanjeev K. Maheshwari, CA. Mahesh P. Sarda, CA. Atul C. Bheda, CA J. Venkateswarlu, CA. Anuj Goyal, Shri Manoj K. Sarkar CA. Prashant S. Akkalkotkar, CA. Krishan Lal Bansal, CA. Vivek R. Joshi, CA. Shyam Lal Agarwal, CA. Brij Bhushan Gupta, CA. Anil Jain and CA. Satyavati Berera for their invaluable guidance and support in giving final shape to this Background Material. I would also like to place on record my sincere thanks to Mr. Vijay Kapur, CA. Puja Wadhera and the whole team of CIA secretariat for their untiring effort to bring out this publication.

I am confident that this Background Material will go a long way in helping the members understand the fundamental concepts of Due Diligence and sharpen their skill sets in this area.

28th January, 2008
Kolkata

CA. ABHIJIT BANDYOPADHYAY
Chairman
Committee on Internal Audit

1

Introduction to Due Diligence

Introduction

A worldwide earthquake of activity is shaking the foundations of traditional business thinking. It is generating a tidal wave of economic as well as social growth and prosperity. Economic value and wealth creation has accelerated to unprecedented levels. Global capital market is expected to grow about 10 times in less than 10 years, unleashing undreamed of possibilities and solutions to longstanding problems. Though capital and trade have faced shifts around the world for centuries, certain powerful factors such as faster communication and decision-making, emerging global investors and financial markets, and converging consumer expectations across previously distinct regions have permanently altered the face and pace of economic activity.

Under these circumstances dramatic restructuring of companies in the form of amalgamations, acquisitions, mergers, and joint ventures has almost become a norm. New business structures through public-private partnerships, concession arrangements, etc. also have emerged. It is in this context that assessing the potential risks of a proposed transaction by inquiring into all relevant aspects of the past, present and predictable future of the business to be ventured has become

quintessential. This exercise is referred to as 'Due Diligence'.

What is Due Diligence ?

Due diligence is used to investigate and evaluate a business opportunity. It implies a general duty to exercise care in any transaction. Most legal definitions of due diligence describe it as a measure of prudence activity, or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent person under the particular circumstance; not measured by any absolute standard but depends on the relative facts of the special case. In other words, making sure one gets what one thinks he/ she is paying for. Due diligence is a process of investigation, performed by investors, into the details of a potential investment such as an examination of operations and management and the verification of material facts. It entails conducting inquiries for the purposes of timely, sufficient and accurate disclosure of all material statements/information or documents, which may influence the outcome of the transaction. Due diligence involves an analysis carried out before acquiring a controlling interest in a company to determine that the conditions of the business conform with what has been presented about the target business. Also, due diligence can apply to recommendation for an investment or advancing a loan/credit.

Need for Due Diligence

When a business opportunity first arises, it continues throughout the talks, initial data collection and evaluation commence. Thorough detailed due diligence is typically conducted after the parties involved in a proposed transaction have agreed in principle that a deal should be pursued and after a preliminary understanding has been reached, but prior to the signing of a binding contract. There are many reasons for carrying out due diligence including:

- To confirm that the business is what it appears to be;
- To identify potential 'deal killer' defects in the target and avoid a bad business transaction;
- To gain information that will be useful for valuing assets, defining representations and warranties, and/or negotiating price concessions; and
- To verify that the transaction complies with investment or acquisition criteria.

Difference Between Due Diligence and Audit

It needs to be underlined that due diligence is different from audit. Audit is an independent examination and evaluation of the financial statements of an organization with a view to express an opinion thereon. Whereas, due diligence refers to an examination of a potential investment to confirm all material facts of the prospective business opportunity. It involves review of financial and non-financial records as deemed relevant and material. Simply put, due diligence aims to take the care that a reasonable person should take before entering into an agreement or a transaction with another party.

Some Basics

The two questions that frequently arise in the context of due diligence for venturing into a target business are :

- 1) What is expected from the due diligence process?
- 2) How can the confidential information be protected while still moving the process forward?

The answer to these questions may vary depending on a number of characteristics of the acquiring company and the target business, that include size, maturity, process orientation, public or private, and competition for the deal. However, in general, the following are the common matters the due diligence process is expected to cover:

- a) General Corporate Matters
- b) Financial, Accounting and Taxation
- c) Technology and Intellectual Property
- d) Product/Service Offerings
- e) Operations
- f) Sales and Marketing
- g) Human Resources and Personnel
- h) Legal and Regulatory.

For each of the items listed above, there is need for proper documentation and prioritisation. Also, it is important to see projections, reports and other documents

actually used by the target company, as opposed to specially created projections and reports just for this process. Eventually, anything that could be material enough to affect the valuation of the business is to be carefully examined and considered. As it may not be possible to know what is material until the exercise proceeds, the initial due diligence list can be overly long with a number of items that may be irrelevant. This involves visiting the offices of the target company and speaking to most of the top management team.

Apart from due diligence from the buyer's side, there is also usually a requirement of similar exercise from the seller's side. This aspect covers three main items as discussed below:

a) Gauging the seriousness of the potential buyer:

This involves evaluating the financial ability of the potential buyer to acquire and run the business:

- Does the buyer have cash to make a cash deal?
- Does the buyer already carry a large debt burden or has the ability to finance the deal?
- In case of a public limited company is it feasible to consummate a stock deal?
- Does the buyer have a clear and realistic plan on how the deal will be structured and financed?

b) Evaluating the means of initial contact:

- Was it through a senior executive or board member or through a person with less authority?
- If it is through an intermediary, how credible is the intermediary and is it formally representing the buyer?

Protecting Confidentiality of the Information

Staging the flow of confidential information based on the overall progress of the transaction is one of the best means of protection. In other words, less sensitive information should be shared initially, and as the potential buyer progresses and shows seriousness; more sensitive information could be shared. It forces the potential buyer to earn the more sensitive information and limits the number of

parties who see the confidential records.

The phasing of information flow could follow the pattern mentioned below:

- The first phase consists of information that are already in public domain.
- The next phase consists of information that is typically heavier on current and historical matters than on forward-looking projections. Quite a bit of confidential company information is disclosed at this stage, but very little that is competitively sensitive.
- The third phase involves the most sensitive company information, including projections, customer information and any other information requested by the buyer deemed too sensitive to share earlier in the process.
- Finally, the accounting and legal due diligence is usually at the end of the process. This phase is last more for reasons of larger number of people involved and cost than for confidentiality reasons.

Warning Signs

Throughout the process, it is essential for the target seller to continually evaluate the potential buyer. This can be achieved by focusing on aspects such as:

- *The Due Diligence Team* - size of the team, time spent by the team, composition of the team for example, whether professionals such as investment bankers, lawyers and accountants have been deployed for the exercise.
- *Activities and Apparent Intention of the Team* - the seller should assess whether the buyer's team is apparently only fishing for information that is not critical to the deal but could be important to a competitor
- *Level of People Involved* - the seller should assess the level of people involved from the potential buyer's side. Typically, there is mostly management level involvement in the early process and more operational people and specialists come later.

QUESTIONS

Question 1.1

What does Due Diligence mean?

Question 1.2

What does Due Diligence require?

Question 1.3

How is Due Diligence conducted?

Question 1.4

How much Due Diligence needs to be conducted?

Question 1.5

Can Due Diligence efforts be overdone?

Question 1.6

How Much Time is allocated for Due Diligence Completion?

Question 1.7

How should tasks within the Due Diligence efforts be prioritised?

Question 1.8

How to maintain confidentiality during a Due Diligence engagement?

Question 1.9

Does Due Diligence ensure that a business transaction will be successful?

2

Approach to Due Diligence

Due Diligence is the process whereby a potential investor accesses the target company's books and records to verify that all of the information provided thus far is true and accurate. Often, people think that due diligence is simply an exercise to verify the financial position of the company. While this is true to some extent, a proper and effective due diligence goes past the financials.

The Right Approach to Due Diligence

Is this the time to look for things that are wrong with the business? Is this the time to strictly verify numbers? Is this the time to disprove what the investor has been told by the target company? While each of these approaches is somewhat valid none are absolute. While the investor would want to employ a part of each of these strategies, an effective due diligence is when one can really "check things out". This exercise is to be used to determine whether the future looks bright for the business and the industry. To do so, the investor must investigate far more than the financial aspect. Sure, the various financial statements will give the investor a picture of the past and perhaps a glimpse of the future but the past is over and done with. The investor must, therefore, thoroughly review the company's sales, marketing, employees, contracts, customers, competition, systems, suppliers, and legal and

corporate issues. The investor wants to complete the due diligence exercise knowing exactly what one is getting into, what needs to be fixed, what the costs are to fix and if one is the right person to be at the helm to put the plans in place to make a great future for the business.

Due Diligence Period

Target companies normally try to negotiate the shortest due diligence period possible. However, it is impossible to understand a business in a short time. Even for the smallest of companies, an investor would ordinarily need no less than 20 working days. Since a proper investigation reaches farther than just financials the investor must negotiate for adequate time to accumulate the information. For this purpose, the target company should be clearly communicated all that would be investigated. It should also be made clear to the target company that if it truly wants the deal to move forward it must allow the potential investor adequate time to do the proper investigations.

Preparation

Preparation for due diligence begins the moment it is believed that the business may be worth pursuing. After the investor meets the target company's authorities the first time and believes that one may be interested one should begin to organise one's plan. The first step in this direction is preparing lists and noting areas and specific details related to the business that need further review. Once the investor gets closer to a decision to go for the deal detailed, "to do" lists need to be maintained, broken down for each aspect of the business (i.e. Financials, Employees, Sales, Contracts, etc.). The target company should be kept informed of when the investor anticipates beginning the due diligence. Lists of the materials needed from the target company should be first assembled and never the due diligence exercise should begin until the investor has received all of the supporting documents that one needs from the target company.

Getting the Target Company and its Staff to Cooperate

The target company must let its people know that they are to provide one with full access to all files and complete cooperation throughout the investor's investigation.

What if Surprises are Found

This should probably be titled: "What to do "WHEN" surprises are found" because this is likely to happen. On the contrary, if surprises are not found, it may imply that the examination has not been thorough enough. The Due Diligence team needs to deal with each on its own and make sure that each is thoroughly investigated so that the facts are foolproof. However, the exercise should not be bogged down with minor issues and these have to be taken as "part of the due diligence package". Unless something is found that cannot be resolved or is so detrimental that even if the target company significantly lowers the acquisition price, the potential buyer would still walk away from the deal, it is best to take all of these obstacles in stride. Do not publicise them; investigate them. A few issues do not mean that the business is bad. The items or issues must be appropriately weighed with reference to the impact against the future viability of the business. It should be remembered that the goal is to learn what the potential buyer would be getting into and what the future can be with the investor in charge. The option always exists for the investor to renegotiate once the investigation is completed. The investor will be in a much stronger position if one can go to the entrepreneur with very specific concerns, which require reevaluation and renegotiation. With this in mind, the findings should not be discussed with anyone except the accountant or other advisors.

Applications

Most business managers routinely develop critical relationships with new suppliers and customers without much forethought. However, making assumptions about the integrity and ethical standards of the customers and suppliers can leave the business vulnerable. Businesses sometimes find themselves in difficult situations that could have been avoided had they conducted thorough background checks. For example, a "friend" might have been hired to run a new startup, not knowing that he had defrauded a former employer. The mistake of giving him sole signing authority on the startup's accounts may result in victimisation about six months later. Another example could be of an individual from another country claiming that he can broker a substantial financing for the potential buyer, who then engages his services. It is, however, subsequently learnt that this engagement is far beyond the scope of his experience and capability, and that there are some unsavory aspects to the people he represents.

Integrity Due Diligence therefore, is a process of gathering and analysing

information to assess whether or not one wants to do business with a person or company. This intelligence will allow one to make informed decisions and can reduce or eliminate any number of possible risks.

There is a host of legal and ethical information available to help one protect oneself and the business. Most people think that checking references or “asking around” is enough. However, when someone provides with a reference, he usually nominates someone he has hand picked. To get a truly objective feedback a different and much deeper approach is needed to be taken. A comprehensive review could include areas such as:

- Civil litigation history - These records are available on a jurisdiction-by-jurisdiction basis, so knowing where to look is very important.
- Writs of execution - A writ is issued when a judgment has been issued in a civil trial but has not been paid. A writ may be the only evidence of an important case.
- Criminal records - An important check, but it should not stop there. Much of the fraudulent or unethical behaviour in business are civil matters that do not result in criminal prosecution or charges.
- Current charges - A criminal records check will indicate only prior convictions. It also needs to be known if there are any current charges that have not yet gone to court.
- Corporate affiliations - What are other associations? What is the nature of the involvement? What is the history and reputation of these businesses? Commercially available databases of corporate information can help, as can state and national level records.
- News media - A full range of media should be checked; from small local newspapers to the national dailies, as well as industry periodicals and international sources.
- Internet - The Internet has provided a publishing medium to the masses. Someone may have communicated information about the potential business partners that is not in the press but from which one might benefit.
- Credit reports - Available through credit-rating companies such as CRISIL, ICRA, etc. credit reports can provide a lot of useful information on companies and individuals. Personal credit reports are available only with signed consent, but this is not a requirement for obtaining a credit report on a company.

- Insolvency filings - Have the individuals ever filed for, or been petitioned into insolvency? What were the circumstances?

When Should Integrity Due Diligence be Considered

When an investor is looking to enter a new business relationship, it should be considered important to conduct background checks. Examples include:

- Reviewing potential suppliers
- Entering into a licensing agreement
- Reviewing prospective joint venture partners
- Entering new markets
- Reviewing existing customers
- Reviewing potential merger or acquisition targets
- Reviewing individuals who wish to broker opportunities for investing company, including financing, property development, new markets, etc.

The time and money invested in integrity due diligence just might save the investor from a significant business risk.

3

Due Diligence for Mergers and Acquisitions

Mergers, Acquisitions and Takeovers

Expansion either by entering a new market or through expansion in an existing market is becoming a common trend. In that context, Indian business houses are increasingly resorting to mergers and acquisition as a means to growth.

Mergers result in combination of two or more companies into one, wherein the all or all except one merging entities lose their identities. No fresh investment is made through this process. However, an exchange of shares takes place between the entities involved in such a process. Generally, the company that survives is the buyer, which retains its identity, and the seller company is extinguished.

A merger can also be defined as an amalgamation of all assets and liabilities of one company transferred to the transferee company in consideration of payment in the form of equity shares of the transferee company or the venture or cash or of a mix of above modes of payments.

An acquisition, on the other hand, is aimed at gaining a controlling interest in the

share capital of the acquired company. It can be enforced through an agreement with the persons holding a majority interest in the company's management or through purchasing shares in the open market or purchasing new shares by private treaty or by making a take over offer to the general body of shareholders.

The takeover, which is essentially an acquisition, differs from the merger in its approach to business combination. In the process of takeover, the acquisition company decides the maximum price and form that is to be offered to the acquired and hence takes lesser time in completing the transaction than in mergers. In merger transactions, the consideration is paid for in shares whereas in a takeover, the consideration is in the form of cash. However, mergers and takeovers can be treated as similar process since in both cases at least one set of shareholders loses an executive control over a company, which they otherwise hold.

Mergers and acquisitions are prominent in the business world and due diligence is a vital aspect of that activity. Due diligence is used by Mergers and Acquisitions (M&A) professionals, to cover the data-gathering exercise which is a necessary precursor to any M&A deal.

Due diligence is undertaken by the buyer in an attempt to gain an understanding of the business that it is proposing to acquire (the target). It is also one of the key means by which the buyer seeks to gain information that it will use to negotiate the final price, a change in the terms of the deal, or both.

Price Negotiations

"Due diligence is an essential data-gathering exercise for any M&A deal."

Typically, the potential buyer will make an offer for the target company that is subject to a range of conditions, including due diligence. In spite of the fact that it always happens this way, the final price is more than likely going to be lower; and, that lowering is more than likely going to be the result of what is found in due diligence. There has hardly been a price negotiated upwards as a result of issues emerging from due diligence.

Strategic Secrecy

Traditionally, due diligence is a battleground. The seller wants to keep certain

information away from the potential buyer until the latest possible moment. In particular, the seller will not want to disclose commercially sensitive information such as customer names and actual prices. This is more likely if the buyer is a trade competitor rather than an institutional buyer since trade competitors may pose as potential buyers just to gather valuable information from the seller. In any event, if the seller reveals too much too soon, it can kill the value of the deal.

Another aspect of this competitive issue is the problem of multiple disclosures in the course of a sale exercise. An important issue is if ten bidders see the same information, whether the value of that information gets diluted ten-fold. After the deal is done and the business is sold, in spite of the confidentiality agreements that will have been made between the seller and the (nine) other potential buyers, those potential buyers will not obviously be able to un-learn what they have learned. They will know things, which, although un-useable in any overt way because of the confidentiality agreements, might be used covertly or even inadvertently.

Be Prepared

Sellers should consider how much due diligence they should undertake before letting potential buyers anywhere near the target. The last thing the seller wants is a nasty surprise being discovered by a potential buyer as they sift through the due diligence material.

"Trade competitors often pose as potential buyers just to gather valuable information."

In fact, sellers should do more due diligence than buyers. The seller should know everything there is to know about the target company, the buyer should only get to know a limited range of things. The seller should control the information flow. That is only possible if it knows what information exists.

Caveat Emptor

Typically, buyer-side due diligence exercises are too broad and too unfocused on the real value issues underlying the proposed deal. That is, there is too much reliance on the volume of information that is requested and not enough consideration of the

specific aspects of the business upon which the 'buy' decision is, was or will be based.

Due diligence exercises tend to focus on the past (not least because there is a mass of information on that). For example, how did the target company perform one, two, three, or even five or six years ago, what are the accounts like for those years? Further, some key issues, such as tax liability and other potential liability issues can be found in the historical paperwork. However, if the buyer is valuing the business on the basis of its future prospects, it should spend considerable time assessing whether the target company has the ability to deliver on those prospects.

Other aspects normally investigated into by the potential buyers are the condition of the machinery and equipment, the state of the order book and current contracts, research and development activities of the seller, target-customer and target-supplier relations, There is a host of forward-looking information which should be looked at in great detail but which is often ignored or relegated to the 'if we have time' pile.

Discreet Disclosure

For the seller, due diligence is typically seen as a necessary evil. However, there is an alternative view. While accepting that, for the reasons given above, full disclosure is not wise, the seller should consider whether more disclosure, rather than less, is good for both price and potential liability.

At times, the seller may take a stand that though, during due diligence, the potential buyer may decide to walk away from the deal, the initial price offered cannot be changed. A seller can only take that confident stance if it has done its own due diligence. In addition, a buyer will only entertain that approach if it is allowed to undertake extensive and deep due diligence.

Things to Consider

Both the seller and the potential buyer should, therefore, think long and hard about due diligence. Sellers should consider the value and process implications of high quality, pre-sale due diligence. Identifying all the skeletons in the cupboards, as well as all the potential gold mines, will (in either case) have a positive effect on the

negotiations.

Potential buyers, on the other hand, should identify the value in the deal, assess as to why the business is being sought. Whereas history of the business is important, far more so will be the ability of the business to perform in the future, in the hands of the buyer and to the standard expected and paid for. Due diligence should be directed towards those issues.

Sample Due Diligence Check List

At the beginning of the due diligence process, the following documents are normally requested:

- The latest business plan
- Product data sheets and literature
- Analysis of competitors
- Organisational chart
- Capitalisation structure and shareholder information
- Historical balance sheet cash flow and income statements since inception
- Forecast balance sheet, cash flow, and income statements (possibly up to 5 years)
- Current operating budgets compared to actual
- Detailed budget and revenue forecasts
- Tax filings
- Description of leases.

In carrying out due diligence exercise for merger and acquisition, the checks generally followed are provided in **Annexure 'A'** to this Chapter. Further in **Annexure 'B'** to this Chapter, a specimen checklist for preliminary legal due diligence is given, and **Annexure 'C'** contains specimen checklist for commercial due diligence.

Sample Due Diligence Report

Based on the checks carried out in accordance with the guidelines provided in the check list as set out in **Annexure 'A'**, the advisor or the public accountant entrusted

with the due diligence exercise is required to submit a report to the client, viz., the potential buyer. However, a specimen report of due diligence for a prospective investment is set out in **Annexure 'D'** to this Chapter.

ANNEXURE - A

SAMPLE DUE DILIGENCE CHECKLIST

The following due diligence checklist is only a sample, and may differ from the actual list used during the deal process. Some of the information may not be relevant to every situation, and will not be required by the buyer.

A. Organisation of the Company

1. Describe the corporate or other structure of the legal entities that comprise the Company. Include any helpful diagrams or charts. Provide a list of the officers and directors of the Company and a brief description of their duties.
2. Long-form certificate of good standing and certificate of incorporation. Listing all documents on file with respect to the Company, and a copy of all documents listed therein.
3. Current by-laws of the Company (i.e. Articles of Association)
4. List of all jurisdictions in which the Company is qualified to do business and list of all other jurisdictions in which the Company owns or leases real property or maintains an office and a description of business in each such jurisdiction. Copies of the certificate of authority, good standing certificates and tax status certificates from all jurisdictions in which the Company is qualified to do business.
5. All minutes for meetings of the Company's board of directors, board committees and shareholders for the last five years, and all written actions or consents in lieu of meetings thereof.
6. List of all subsidiaries and other entities (including partnerships) in which the Company has an equity interest; organisational chart showing ownership of such entities; and any agreements relating to the Company's interest in any such entity.

B. Ownership and Control of the Company

1. Capitalisation of the Company, including all outstanding capital stock, convertible securities and similar instruments.

2. List of shareholders of the Company, setting forth class and number of shares held.
3. Copies of any voting agreements, shareholder agreements, proxies, transfer restriction agreements, rights of first offer or refusal, preemptive rights, registration agreements or other agreements regarding the ownership or control of the Company.

C. Assets and Operations

1. Annual financial statements with notes thereto for the past three fiscal years of the Company, and the latest interim financial statements since the end of the last fiscal year and product sales and cost of sales (including royalties) analysis for each product which is part of assets to be sold.
2. All current budgets and projections including projections for product sales and cost of sales.
3. Any auditor's (internal and external) letters and reports to management for the past five years (and management's responses thereto)
4. A detailed breakdown of the basis for the allowance for doubtful accounts.
5. Inventory valuation, including turnover rates and statistics, gross profit percentages and obsolescence analysis including inventory of each product, which is part of assets to be sold.
6. Letters to auditors from outside counsel.
7. Description of any real estate owned by the Company and copies of related deeds, surveys, title insurance policies (and all documents referred to therein), title opinions, certificates of occupancy, easements, deeds of trust and mortgages.
8. Schedule of significant fixed assets, owned or used by the Company, including the identification of the person holding title to such assets and any material liens or restrictions on such assets.
9. Without duplication of separate intellectual property due diligence checklist from Section D below, schedule of all intangible assets (including customer lists and goodwill) and proprietary or intellectual properties owned or used in the Company, including a statement as to the entity holding title or right to such assets and any material liens or restrictions on such assets, include on and off balance sheet items.

D. Intellectual Property

List of all patents, trademarks, service marks and copyrights owned or used by the Company, all applications and copies thereof, search reports related thereto and information about any liens or other restrictions and agreements on or related to any of the foregoing.

E. Reports

1. Copies of any studies, appraisals, reports, analysis or memoranda within the last three years relating to the Company (i.e. competition, products, pricing, technological developments, software developments, etc.)
2. Current descriptions of the Company that may have been prepared for any purpose, including any brochures used in soliciting or advertising.
3. Descriptions of any customer quality awards, plant qualification/certification distinctions, ISO certifications or other awards or certificates viewed by the Company as significant or reflective of superior performance.
4. Copies of any analyst or other market reports concerning the Company known to have been issued within the last three years.
5. Copies of any studies prepared by the Company regarding the Company's insurance currently in effect and self-insurance programme (if any), together with information on the claim and loss experience there under.
6. Any of the following documents filed by the Company or affiliates of the Company and which contain information concerning the Company: annual reports, and quarterly reports.

F. Compliance with Laws

1. Copies of all licences, permits, certificates, authorisations, registrations, concessions, approvals, exemptions from all governmental and other operating authorities any applications therefore, and a description of any pending contemplated or threatened changes in the foregoing.
2. A description of any pending or threatened proceedings or investigations before any court or any regulatory authority.
3. Describe any circumstance where the Company has been or may be accused of violating any law or failing to possess any material licence,

- permit or other authorisation. List all citations and notices from governmental or regulatory authorities.
4. Schedule of the latest dates of inspection of the Company's facilities by each regulatory authority that has inspected such facilities.
 5. Description of the potential effect on the Company of any pending or proposed regulatory changes of which the Company is aware.
 6. Copies of any information requests from, correspondence with, reports of or to, filings with or other material information with respect to any regulatory bodies, which regulate a material portion of the Company's business. Limit response to the last five years unless an older document has a continuing impact on the Company.
 7. Copies of all other studies, surveys, memoranda or other data on regulatory compliance including, spill control, environmental clean-up or environmental preventive or remedial matters, employee safety compliance, import and export licences, common carrier licences, problems, potential violations, expenditures, etc.
 8. State whether any consent is necessary from any governmental authority to embark upon or consummate the proposed transaction.
 9. Schedule of any significant import or export restrictions that relate to the Company's operations.
 10. List of any export, import or customs permits or authorisations, certificates, registrations, concessions, exemptions, etc., that are required in order for the Company to conduct its business and copies of all approvals, etc. granted to the Company that are currently in effect or pending renewal.
 11. Any correspondence with or complaints from third parties relating to the marketing, sales or promotion practices of the Company.

G. Environmental Matters

1. A list of facilities or other properties currently or formerly owned, leased, or operated by the Company and its predecessors, if any.
2. Reports of environmental audits or site assessments in the possession of the Company.
3. Copies of any inspection reports prepared by any governmental agency or

insurance carrier in connection with environmental or workplace safety and health regulations relating to any such facilities or properties.

4. Copies of all environmental and workplace safety and health notices of violations, complaints, consent decrees, and other documents indicating non-compliance with environmental or workplace safety and health laws or regulations, received by the Company from local, state, or central governmental authorities. If available, include documentation indicating how such situations were resolved.
5. Copies of any private party complaints, claims, lawsuits or other documents relating to potential environmental liability of the Company to private parties.
6. Listing of underground storage tanks currently or previously present at the properties and facilities listed in response to item 1 above, copies of permits, licences or registrations relating to such tanks, and documentation of underground storage tank removals and any associated remediation work.
7. Descriptions of any release of hazardous substances or petroleum known by the Company to have occurred at the properties and facilities listed in response to Item 1, if such release has not otherwise been described in the documents provided in response to Items 1-6 above.
8. Copies of any information requests, or other notices received by the Company relating to liability for hazardous substance releases at off-site facilities.
9. Copies of any notices or requests described in Item 8 above, relating to potential liability for hazardous substance releases at any properties or facilities described in response to Item 1.
10. Copies of material correspondence or other documents (including any relating to the Company's share of liability) with respect to any matters identified in response to Items 8 and 9.
11. Copies of any written analyses conducted by the Company or an outside consultant relating to future environmental activities (i.e., upgrades to control equipment, improvements in waste disposal practices, materials substitution) for which expenditure significant amount is either certain or reasonably anticipated within the next five years and an estimate of the costs associated with such activities.

12. Description of the workplace safety and health programmes currently in place for the Company's business, with particular emphasis on chemical handling practices.

H. Litigation

1. List of all litigation, arbitration and governmental proceedings relating to the Company to which the Company or any of its directors, officers or employees is or has been a party, or which is threatened against any of them, indicating the name of the court, agency or other body before whom pending, date instituted, amount involved, insurance coverage and current status. Also describe any similar matters which were material to the Company and which were adjudicated or settled in the last ten years.
2. Information as to any past or present governmental investigation of or proceeding involving the Company or the Company's directors, officers or employees.
3. Copies of any consent decrees, orders (including applicable injunctions) or similar documents to which the Company is a party, and a brief description of the circumstances surrounding such document.
4. Copies of all letters of counsel to independent public accountants concerning pending or threatened litigation.
5. Any reports or correspondence related to the infringement by the Company or a third party of intellectual property rights.

I. Significant Contracts and Commitments

1. Contracts relating to any completed (during the past 10 years) or proposed reorganisation, acquisition, merger, or purchase or sale of substantial assets (including all agreements relating to the sale, proposed acquisition or disposition of any and all divisions, subsidiaries or businesses) of or with respect to the Company.
2. All joint venture and partnership agreements to which the Company is a party.
3. All material agreements encumbering real or personal property owned by the Company including mortgages, pledges, security agreements or financing statements.

4. Copies of all real property leases relating to the Company (whether the Company is lessor or lessee), and all leasehold title insurance policies (if any).
5. Copies of all leases of personal property and fixtures relating to the Company (whether the Company is lessor or lessee), including, without limitation, all equipment rental agreements.
6. Guarantees or similar commitments by or on behalf of the Company, other than endorsements for collection in the ordinary course and consistent with past practice.
7. Indemnification contracts or arrangements insuring or indemnifying any director, officer, employee or agent against any liability incurred in such capacity.
8. Loan agreements, lines of credit, lease financing arrangements, installment purchases, etc. relating to the Company or its assets and copies of any security interests or other lines securing such obligations.
9. No-default certificates and similar documents delivered to lenders for the last five (or shorter period, if applicable) years evidencing compliance with financing agreements.
10. Documentation used internally for the last five years (or shorter time period, if applicable) to monitor compliance with financial covenants contained in financing agreements.
11. Any correspondence or documentation for the last five years (or shorter period, if applicable) relating to any defaults or potential defaults under financing agreements.
12. Contracts involving cooperation with other companies or restricting competition.
13. Contracts relating to other material business relationships, including:
 - a) any current service, operation or maintenance contracts;
 - b) any current contracts with customers;
 - c) any current contracts for the purchase of fixed assets; and
 - d) any franchise, distributor or agency contracts
14. Without duplicating the intellectual property due diligence check list as outlined in Section D above, contracts involving licensing, know-how or technical assistance arrangements including contracts relating to any

- patent, trademark, service mark and copyright registrations or other proprietary rights used by the Company and any other agreement under which royalties are to be paid or received.
15. Description of any circumstances under which the Company may be required to repurchase or repossess assets or properties previously sold.
 16. Data processing agreements relating to the Company.
 17. Copies of any contract by which any broker or finder is entitled to a fee for facilitating the proposed transaction or any other transactions involving the Company or its properties or assets.
 18. Management, service or support agreements relating to the Company, or any power of attorney with respect to any material assets or aspects of the Company.
 19. List of significant vendor and service providers (if any) who, for whatever reason, expressly decline to do business with the Company.
 20. Samples of all forms, including purchase orders, invoices, supply agreements, etc.
 21. Any agreements or arrangements relating to any other transactions between the Company and any director, officer, shareholder or affiliate of the Company (collectively, "Related Persons"), including but not limited to:
 - a) Contracts or understandings between the Company and any Related Person regarding the sharing of assets, liabilities, services, employee benefits, insurance, data processing, third-party consulting, professional services or intellectual property.
 - b) Contracts or understandings between Related Persons and third parties who supply inventory or services through Related Persons to the Company.
 - c) Contracts or understandings between the Company and any Related Person that contemplate favourable pricing or terms to such parties.
 - d) Contracts or understandings between the Company and any Related Person regarding the use of hardware or software.
 - e) Contracts or understandings regarding the maintenance of equipment of any Related Person that is either sold, rented, leased or used by the Company.
 - f) Description of the percentage of business done by the Company with

Related Persons.

- g) Covenants not to compete and confidentiality agreements between the Company and a Related Person.
 - h) List of all accounts receivable, loans and other obligations owing to or by the Company from or to a Related Person, together with any agreements relating thereto.
22. Copies of all insurance and indemnity policies and coverages carried by the Company including policies or coverages for products, properties, business risk, casualty and workers compensation. A summary of all material claims for the last five years as well as aggregate claims experience data and studies.
 23. List of any other agreements or group of related agreements with the same party or group of affiliated parties continuing over a period of more than six months from the date or dates thereof.
 24. Copies of all supply agreements relating to the Company and a description of any supply arrangements.
 25. Copies of all contracts relating to marketing and advertising.
 26. Copies of all construction agreements and performance guarantees.
 27. Copies of all secrecy, confidentiality and non-disclosure agreements.
 28. Copies of all agreements related to the development or acquisition of technology.
 29. Copies of all agreements outside the ordinary course of business.
 30. Copies of all warranties offered by the Company with respect to its products or services.
 31. List of all major contracts or understandings not otherwise previously disclosed under this section, indicating the material terms and parties.
 32. For any contract listed in this Section state whether any party is in default or claimed to be in default.
 33. For any contract listed in this Section state whether the contract requires the consent of any person to assign such contract or collaterally assign such contract to any lender.

NOTE: Remember to include all amendments, schedules, exhibits and side letters. Also include brief description of any oral contract listed in this Section.

J. Employees, Benefits and Contracts

1. Copies of the Company's employee benefit plans as most recently amended, including all pension, profit sharing, thrift, stock bonus, ESOPs, health and welfare plans (including retiree health), bonus, stock option plans, direct or deferred compensation plans and severance plans, together with the following documents:
 - a) all applicable trust agreements for the foregoing plans;
 - b) copies of all determination letters of tax authorities for the foregoing qualified plans;
 - c) latest copies of all summary plan descriptions, including modifications, for the foregoing plans;
 - d) latest actuarial evaluations with respect to the foregoing defined benefit plans; and
 - e) schedule of fund assets and unfounded liabilities under applicable plans
2. Copies of all employment contracts, consulting agreements, severance agreements, independent contractor agreements, non-disclosure agreements and non-compete agreements relating to any employees of the Company.
3. Copies of any collective bargaining agreements and related plans and trusts relating to the Company (if any). Description of labour disputes relating to the Company within the last three years. List of current organisational efforts and projected schedule of future collective bargaining negotiations (if any).
4. Copies of all employee handbooks and policy manuals
5. The results of any formal employee surveys.

K. Tax Matters

1. Copies of returns for the three prior closed tax years and all open tax years for the Company together with a work paper therefore wherein each item is detailed and documented that reconciles net income as specified in the applicable financial statement with taxable income for the related period.
2. Audit and revenue agents reports for the Company; audit adjustments

proposed by the Tax Authorities for any year of the Company or protests filed by the Company.

3. Settlement documents and correspondence for last six years involving the Company.
4. Agreements waiving statute of limitations or extending time involving the Company
5. Description of accrued withholding taxes for the Company.

L. Miscellaneous

1. Information regarding any material contingent liabilities and material unasserted claims and information regarding any asserted or unasserted violation of any employee safety and environmental laws and any asserted or unasserted pollution clean-up liability.
2. List of the ten largest customers and suppliers for each product or service of the Company.
3. List of major competitors for each business segment or product line.
4. Any plan or arrangement filed or confirmed under the bankruptcy laws
5. A list of all officers, directors and shareholders of the Company.
6. All annual and interim reports to shareholders and any other communications with them.
7. Description of principal banking and credit relationships (excluding payroll matters), including the names of each bank or other financial institution, the nature, limit and current status of any outstanding indebtedness, loan or credit commitment and other financing arrangements.
8. Summary and description of all product, property, business risk, employee health, group life and key-man insurance.
9. Copies of any judgment or suit searches or filings related to the Company in different states conducted in the past three years.
10. Copies of all filings with the Securities Exchange Board of India or foreign security regulators or exchanges.
11. All other information material to the financial condition, business, assets, prospects or commercial relations of the Company.

ANNEXURE - B

PRELIMINARY LEGAL DUE DILIGENCE CHECKLIST

Table of Contents

Introduction

1. General Information
2. Corporate Organisation and Structure
3. Management
4. Share Capital and Ownership
5. Secretarial and Regulatory
6. Financial Accounts
7. Banking Facilities/Borrowing From Third Parties, Financial Grants
8. Taxation
9. Employment Matters
10. Property
11. Business and Operational Matters
12. Contracts
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14. Legal Proceedings, Disputes and Investigations
15. Insurance Policies
16. Environmental Matters
17. Product/Service Liabilities
18. Impending Legislative Changes
19. Compliance with Special Industry Sector Legislation.

LEGAL DUE DILIGENCE CHECKLIST AND PRELIMINARY ENQUIRIES

Introduction

The following list sets out the information and documents which are initially required in order to conduct the legal due diligence in relation to the proposed subscription to new shares of [ABC] by XYZ (*the Investor*).

In this Checklist:

Company means ABC Limited;

Promoter means the promoters of the Company; and

Subsidiaries means subsidiaries of the Company

In this checklist, the relevant questions have been placed on the left hand side of the page. The responses to the questions may be inserted in the response column on the right hand side of each question.

For ease of reference all questions should be answered, where appropriate in the negative. In the event any question requires a detailed response, the same may be separately annexed and referenced to the left of the concerned question. Wherever the response to any question includes any documents, these may be similarly annexed and referenced. Similarly, all answers and documents to which you refer should be clearly marked with the section and question to which they relate. Where you provide documents, please provide in your answer a brief identification (including identifying to which company the documents relate) where this is not clear from the heading of the document itself. Unless otherwise specified, please provide all information with reference to the Company as well as each Subsidiary.

Where the item requested does not exist or is otherwise inapplicable, please indicate so in the response column. Please also state the reason why it is inapplicable. If in doubt the questions should be answered according to the spirit of information requested rather than merely the letter and too much information rather than too

little should be given. Where the same information and documents are to be supplied in response to two or more different questions, there is no need to repeat your response provided all necessary cross-references are made.

When any specific foreign law, legislation or practice is not referred to in this document and the Company or any Subsidiary operates or has operated in a foreign jurisdiction, each of the enquiries in this document shall apply to such company or companies in relation to its foreign activities and presence as if, where the context admits or requires, references to Indian law, practice and legislation were references to similar law practice or legislation applicable in the relevant foreign jurisdiction in which such activities are or were performed.

After completing the response to the questions on each page, please initial each page before forwarding the response to us.

Where documents are requested to be sent along with the response to this checklist, please provide copies rather than originals. Please arrange to have originals provided at the time of physical verification by us. Further, please ensure that a person so authorised by the Company certifies all copies of documents provided, as true copies. It would also be helpful if you would provide any documents requested in lever arch files with an index correlating to the numbering system used in this list.

Please ensure that all responses are, to the extent possible, complete. Further queries may need to be raised depending on the content of the replies.

During the course of, or subsequent to, the completion of this due diligence exercise, you may be requested to provide certificates as to the completeness and accuracy of the information provided. However, please note that the answers to questions raised in these enquiries or the certificates mentioned above would not comprise formal disclosures for the purposes of any representations or warranties sought by the investor in the legal documents. Any such formal disclosure will be required to be made in the legal documents and such disclosures will be expected to be clear, concise, full and fair disclosures against the relevant warranties.

If you have any queries in connection with this due diligence checklist/questionnaire please contact XYZ at YYY Limited, Delhi at the telephone number or the e-mail addresses mentioned on the cover.

GENERAL INFORMATION

Sl. No.	Question	Response
1.1	Briefly describe the history of the Company and the Subsidiaries since their incorporation, including the details of the acquisition of the Subsidiaries by the Company.	
1.2	Briefly describe the business of the Company and the Subsidiaries, specifically detailing product and service lines.	
1.3	Please provide the full registered name of the Company and each Subsidiary	
1.4	Please provide the date of incorporation and the registration number of the Company and each Subsidiary.	

CORPORATE ORGANISATION & STRUCTURE

Sl. No.	Question	Response
2.1	<p>Please provide details (with a description of the nature and size of such interest) of any interest (including any partnerships, collaborations, associations of persons, sole proprietorships, joint ventures or other entities or interest groupings) held in any enterprise by any of the following:</p> <ul style="list-style-type: none"> (i) Any Promoter of the Company; or (ii) Any company in a group of companies of which any Promoter is a part ("the Group"); or (iii) Any individuals [not covered under sub-clause (c) above] having a controlling interest in the Company or its Subsidiary or in the Group. 	
2.2	Please provide a list of the following (if any):	

Sl. No.	Question	Response
	<p>(i) Subsidiaries of the Company (as defined in section 4 of the Companies Act, 1956);</p> <p>(ii) Companies under the same management as the Company (as defined in Section 370 (1-B) of the Companies Act);</p> <p>(iii) Other interests (including options) held by the Company or its Subsidiary or any of its directors in other companies or businesses (including joint ventures, partnerships, consortiums, or other profit sharing arrangements), stating percentage of total issued capital.</p>	
2.3	Where the Group comprises more than two companies, please provide a structure chart of the Group companies.	
2.4	Please provide organisational and ownership charts or similar information relating to the Company and each Subsidiary.	
2.5	<p>Please provide the following details of relationship between the Company, Promoters, its Subsidiaries and their promoters, affiliated companies, families and friends:</p> <ul style="list-style-type: none"> ■ Details of cross shareholdings. ■ Details of trading relationship. ■ Details of shared facilities. ■ Details of financing arrangements. ■ Details of direct or indirect investments and the reason for each direct and indirect investment. 	
2.6	Please supply copies (or details where unwritten) of agreements or other documentation relating to any joint venture, partnership, consortium or	

Sl. No.	Question	Response
2.7	<p>other profit sharing arrangement to which the Company or any Subsidiary is a party (including those with other companies in the Group or between the Company's shareholders).</p> <p>The following details in respect of every undertaking in which the Company or any Subsidiary has a direct or indirect interest, if the book value of that interest represents at least 5% of the capital and reserves of the Company/Subsidiary or if that interest accounts for at least 5% of the net profit or loss of the Company/Subsidiary, and any other undertakings in which the Company or any Subsidiary has an interest which is liable to have a significant effect on the Company's/Subsidiary's assets and liabilities, financial position or profits and losses: the name and address of the registered office;</p> <ul style="list-style-type: none"> ■ the field of activity; ■ the proportion of capital held; ■ the issued capital; ■ any obligations or arrangements to make further investments or to disinvest; ■ the reserves; ■ the profit or loss arising out of ordinary activities, after tax, for the last financial year; ■ the value at which the Company/Subsidiary shows the interest in its accounts; ■ any amount of dividends received in the course of the last financial year in respect of shares held; ■ any amount still held to be paid up or shares 	

Sl. No.	Question	Response
	<p>held; and</p> <ul style="list-style-type: none"> ■ the amounts of the debts owed to and by the Company/Subsidiary with regard to the undertakings. 	

MANAGEMENT

Sl. No.	Question	Response
3.1	<p>Please provide the following information in relation to the management of the Company and its Subsidiaries:</p> <ul style="list-style-type: none"> (i) Names of the members of the board of directors and a brief summary of their experience and details of directorships held. (ii) Details of interests in shares, options, warrants, etc. issued to any of the directors or shareholders of the Company and/or the Subsidiaries. (iii) Details of any interests of directors and shareholders of the Company and / or its Subsidiaries or affiliates or relatives of any of the aforesaid in all transactions and contracts that were effected or entered into by the Company or its Subsidiary since incorporation. (iv) Details of any outstanding loans granted by the Company or its Subsidiary to any of the directors and also any guarantees provided by the Company or its Subsidiaries for their benefit. (v) Details of any non-arm's length 	

Sl. No.	Question	Response
	<p>transactions between directors and the Company or its Subsidiaries and any other company promoted by the promoters of the Company or its Subsidiaries and the Company or its Subsidiaries.</p> <p>(vi) Are there any restrictions upon the directors' dealings in the Company and its Subsidiaries' shares?</p>	
3.2	Names of the secretary and other key officers of the Company and the Subsidiaries.	

SHARE CAPITAL & OWNERSHIP

Sl. No.	Question	Response
4.1	Please provide particulars of share capital of the Company and the Subsidiaries, showing their authorised and issued and paid up capital, and details of number and classes of shares with their principal characteristics.	
4.2	In the case of the Company as well as each Subsidiary, please provide a summary of any events or transactions that have changed the amount of the issued capital of the concerned company since its incorporation.	
4.3	<p>Please provide details of any issued capital still to be paid up (in respect of the Company as well as each Subsidiary), including statements of:</p> <ul style="list-style-type: none"> ■ The number or total nominal value; ■ The types of shares not yet fully paid up, broken down (where applicable) according to the extent to which they have been paid up. 	

Sl. No.	Question	Response
4.4	Please detail any expected dilution effect of any exercises of conversion rights, options, warrants, etc.	
4.5	<p>Provide Copies (or details here unwritten) of and agreements or documents connected to the Company or any Subsidiary relating to:</p> <ul style="list-style-type: none"> ■ Any agreement or commitment to create, issue or transfer shares (including loan capital and share options); ■ Any rights of pre-emption; ■ Any share conversion rights; ■ Any share option or warrants; ■ Share pledge or similar arrangements affecting the shares of the Company and the Subsidiaries; ■ Any undertakings (e.g. non disposal undertakings) given by shareholders concerning the holding of shares in the Company and/or the Subsidiaries; ■ Any other rights to unissued share capital; put or call provisions; ■ Any hedges that the Company has taken out, against calls, conversions or exercises of options or warrants etc. 	
4.6	Please provide a schedule of all shareholders with direct or indirect holdings in the Company and each Subsidiary showing number of shares held and stating whether held beneficially or otherwise. If any of the shareholders are individuals, please also provide details of any such individuals who may be under any disability, for example infants, bankrupts, or	

Sl. No.	Question	Response
4.7	<p>where probate or letters of administration are pending. Please also specify any such holdings, which the company knows are held directly, or indirectly by members of a family or other connected persons.</p> <p>Please list the names of the persons who, directly or indirectly, jointly or severally, exercise or could exercise control over the Company, including the particulars of the proportion of their voting capital. (Please include details of any lenders who hold charges over any shares in the Company).</p>	
4.8	<p>Trustee shareholders</p> <p>In the case of members of the Company or any Subsidiary who hold their shares on trust, please provide the following:</p> <ul style="list-style-type: none"> ■ A copy of the relevant trust instrument; ■ Advice whether any of the trustees are resident outside India and, if so, their place of residence; ■ The date(s) on which the shares were transferred to the original trustees by the settler; ■ The full name and address of the settler; ■ If any such transfer was made within the last five years, please confirm that the settler, to the best of the vendor's knowledge, was not insolvent at the date of any transfer nor made insolvent as a result of it. Please also provide corroboration of this from the settler's professional advisers; ■ Please confirm that, to the best of the vendor's knowledge, the settler has not been 	

Sl. No.	Question	Response
	<p>adjudicated bankrupt since the date of the transfer(s);</p> <ul style="list-style-type: none"> ■ Advice whether, to the best of the vendor's knowledge, any such transfer was intended either wholly or in part to defeat the settler's creditors. 	
4.9	Please provide copies of any governmental or regulatory approvals obtained by the Company or any Subsidiary or available with the Company or any Subsidiary in relation to the acquisition or transfer of shares of the Company or any Subsidiary.	
4.10	Please provide copies of any court orders or other demerger or merger orders obtained by the Company and each Subsidiary in connection with the acquisition or disposal of any business.	

SECRETARIAL & REGULATORY

Sl. No.	Question	Response
5.1	<p>Please provide copies of the following :</p> <p>(i) Certificate of Incorporation of the Company and its Subsidiaries (including any previous certificates of incorporation and amendments thereto, whether on account of change of name or otherwise).</p> <p>Certificate of commencement of business (if applicable) of the Company and each Subsidiary.</p> <p>Memorandum and Articles of Association of the Company and its Subsidiaries (incorporating any amendments) together with copies of all</p>	

Sl. No.	Question	Response
	resolutions amending the Memorandum and Articles of Association and consents required by law to be annexed thereto.	
5.2	Please provide a confirmation from the Company and its Subsidiaries that all the business that it has carried out is in accordance with the Memorandum of Association and the object clause in the Memorandum of Association permits the Company/Subsidiary to carry on the business as is currently conducted.	
5.3	Please list the addresses of registered office and principal place of business (if different) of the Company and its Subsidiaries.	
5.4	Provide a brief description of all branches, agencies, places of business and establishment of the Company and its Subsidiaries, including a brief description of the business carries out and the number of personnel involved.	
5.5	Please provide the address at which the statutory registers and books are kept, and the address where our personnel, if required can view them.	
5.6	<p>The Company and each Subsidiary are to confirm that all the statutory registers as required under the provisions of the Companies Act, 1956 are being maintained by the Company and the Subsidiary respectively and are upto date, including the following registers:</p> <ul style="list-style-type: none"> ■ Register of minutes of meetings of the Board of directors (and any committees of the Board) of the Company and each Subsidiary. ■ Register of Minutes of Meetings of shareholders of the Company and each Subsidiary. 	

Sl. No.	Question	Response
5.7	<ul style="list-style-type: none"> ■ Register of members and register of transfers (or equivalent) and other statutory registers (required to be maintained under the Companies Act, 1956) of the Company and each Subsidiary. ■ Register of Charges (along with instruments of charges created by the Company and each Subsidiary). ■ Register of Members. ■ Register of Contracts, Companies and Firms in which directors are interested. ■ Register of Directors, Managing Director, Manager and Secretary (along with contracts of terms of appointment of the Managing Director/Manager). ■ Register of Director's shareholdings. ■ Register of Loans to Companies under the same management. ■ Register of Investments. ■ Register of Deposits accepted from the public. <p>Meetings</p> <p>Please provide the address where our personnel can inspect minutes of meetings and agenda papers presented to the following bodies of the Company and each Subsidiary during the last 18 months:</p> <ul style="list-style-type: none"> ■ Shareholders ■ Directors ■ Directors' committees ■ Management committees 	

Sl. No.	Question	Response
5.8	<p>Reports:</p> <p>Please provide copies of all quarterly, annual and other periodical reports and other communications to the shareholders of the Company and each Subsidiary including the following:</p> <ul style="list-style-type: none"> ■ Annual Reports of the Company /Subsidiary for the last three years. ■ Copies of all circulars to shareholders and any other report or communication sent to shareholders of the Company/Subsidiary during the last three years. ■ Any other information distributed to the shareholders of the Company/Subsidiary during the last five years. 	
5.9	Please provide copies of any reports prepared during the last five (5) years or any other relevant reports on the Company or its Subsidiary, for example market research, accountant's report, environmental report.	
5.10	Copies of all prospectuses and placement memoranda relating to any securities offering by the Company or any Subsidiary during the last three years.	
5.11	Copies of any legal notices that have been published by or in respect of, the Company and each Subsidiary during the last three years.	
5.12	Copies of all agreements required to be filed with the registrar of Companies under any provision of the Companies Act 1956 (including sections 75, 192).	
5.13	Copies of all documents filed at (i) Registrar of Companies and (ii) the Securities and Exchange	

Sl. No.	Question	Response
5.14	Board of India within the last three] years. Copies of documents filed with the Registrar of Companies in relation to any amendment to the Articles of Association of the Company and its Subsidiaries	
5.15	Please provide copies of all government or regulatory consents for the Company and its Subsidiaries including without limitation the following: <ul style="list-style-type: none"> ■ Relating to the investment or proposed investment in other company. ■ Shops and Establishment Act Registrations. ■ Professional Tax registrations/challans for last payments. ■ Registrations under Service Tax rules and show cause notices in this regard. ■ Compliance with the provisions of section 372 or 372A as applicable for loans, investment and guarantees. 	
5.16	Copies of any necessary consents in relation to any loans or guarantees made by or given in favour of non-Indian parties, and copies of any related agreements and correspondence.	
5.17	Copies of documentation and correspondence relating to any governmental or regional incentives, subsidies or grants made available in relation to the Company and its Subsidiaries or aspect of their business.	
5.18	Please provide a full list, together with full copies of, all licences, permits or other authorisations issued to the Company and its Subsidiaries by any government agency and any related	

Sl. No.	Question	Response
	agreements and correspondence.	
5.19	Please provide copies of any documents filed with any relevant securities regulatory authority by the Company or any Subsidiary.	
5.20	A list of all performance bonds, guarantees or similar security arrangements entered into by or on behalf of the Company and its Subsidiaries in connection with any of the licences or authorisations held by them.	
5.21	Copies of any reports, notices or correspondence relating to any alleged violation, non-compliance or infringement by the Company and its Subsidiaries of any government regulation, licence, permit or other authorisation.	
5.22	Details of any determinations, declarations or directions given by any relevant regulatory authority, and of obligations or promises made by the Company or its Subsidiaries to such regulatory authorities, including the dates from which the concerned company is bound under each of these determinations, directions, obligations or promises.	
5.23	<p>Please provide, in relation to the Company and the Subsidiaries:</p> <ul style="list-style-type: none"> ■ Copies of any agreement or arrangement with any company (whether intended to be legally enforceable or not) relating to the prices or conditions for the sale of products or provision of services, or for the purchase of supplies (for example, cartels). ■ Copies of any agreements or details of any arrangements in force restricting the freedom of the company to provide and take 	

Sl. No.	Question	Response
	<p>goods and services.</p> <ul style="list-style-type: none"> ■ Copies of any agreements registered under the Monopolies and Restrictive Trade Practices Act, 1969. ■ Copies of internal competition compliance programmes if any. ■ Copies of any undertakings or orders made to competition authorities nationally. 	
5.24	<p>Please provide confirmations that the Company and Promoters have authority to:</p> <ul style="list-style-type: none"> ■ Undertake; and ■ Close this transaction. 	
5.25	<p>Please supply details of any governmental and other consents required for the implementation and closing of the transaction.</p> <p>Listing</p>	
5.26	<p>Are the shares or other securities of the Company or any Subsidiary listed on any stock exchange in India or abroad?</p>	
5.27	<p>Please provide copies of the listing agreement as well as all correspondence in relation to the listing of such securities.</p>	
5.28	<p>Has the listing of these securities been suspended for any reason at any time? If yes, please provide details thereof.</p>	
5.29	<p>Has there, at any time, been any actual or alleged violation of the terms of the listing agreement in relation to such securities?</p>	
5.30	<p>Are any approvals required from the relevant exchange(s) for any further issue of securities by the Company/Subsidiary.</p>	

FINANCIAL ACCOUNTS

Sl. No.	Question	Response
6.1	Balance Sheets of the Company and each Subsidiary of the last three years duly certified by the Auditors.	
6.2	Please provide us with any management accounts and audited accounts prepared since last annual balance date.	
6.3	Please provide copies of all breakdowns, analysis, commentaries and reports prepared in relation to audited annual accounts and management accounts.	
6.4	Details of any actual or Contingent Liabilities of the Company/Subsidiary, whether as original contracting part to, as a guarantor of any party to, or their liability in respect of any freehold or leasehold property or license connected therewith. Please also complete Schedule II in respect of the Company and each Subsidiary.	
6.5	In respect of the Company and each Subsidiary, please provide a record of dividend payments during the last five years (including dividends per share, the number of shares entitled to the dividends at the times they are declared or paid, and the gross amount of the dividends paid).	
6.6	Does the Company or any Subsidiary have a dividend policy? If yes, please provide a copy of the same.	
6.7	In relation to the Company and each Subsidiary, please provide a schedule of dividends declared relative to net profits.	

BANKING FACILITIES/BORROWING FROM THIRD PARTIES, FINANCIAL GRANTS

Sl. No.	Question	Response
7.1	<p>Please provide:</p> <p><i>Accounts</i></p> <ul style="list-style-type: none"> ■ Names and branch addresses of all banks and financial institutions with whom the Company and Subsidiaries hold accounts (including all current, deposit and trust accounts) ■ Titles and numbers of each account. ■ Copies of all existing direct debits, standing orders or similar instructions. ■ Current balance of each account. ■ Copies of latest statement for each account. ■ Copies of mandates for each account. 	
7.2	<p><i>Borrowing</i></p> <p>Please provide details of all borrowing by the Company and each Subsidiary, whether under term loan or overdraft facilities, bonds, loan stock issues, bills of exchange, commercial paper or similar instruments (including share capital redeemable within 10 years of issue), acceptance credit, documentary credit or bill discounting facilities, interest rate swaps, currency swaps, financial options, financial contracts or other similar instruments and finance leases any other forms of debts financing (e.g. receivables, financing or factoring arrangements). This should include inter-group borrowings and loans from directors, employees or shareholders. Without limitation to the above, please provide:</p> <p>A schedule of loan capital and other financing showing maturities, interest rates, any security,</p>	

Sl. No.	Question	Response
	<p>and whether committed or uncommitted. (See Schedule I).</p> <p>Copies of all agreements relating to any borrowings by the Company and Subsidiaries and details of all existing or anticipated breaches of the terms of such agreements by the Company/Subsidiary together with copies of all extant notices, demands or other communications from the relevant lender to the Company/Subsidiary.</p> <p>Particulars and (where applicable) copies of all mortgages, debentures (whether convertible or not), debenture trust deeds, instruments by way of security charges, pledges, liens, encumbrances, conditional sale or other title retention or trust arrangements, deeds of postponement, preferential rights or other agreements or arrangements the effect of which is to create a security over the assets or any part thereof of the Company or Subsidiaries, together with copies of all extant notices, demands or other communications from the beneficiary of the relevant security to the Company or Subsidiaries.</p> <p>Schedule of loan capital and other financing showing maturities, interest rates, any security, and whether committed or uncommitted.</p> <p>Details of the Company's and the Subsidiaries' contingent liabilities.</p> <p>Details of lenders' rights to convert loans into</p>	

Sl. No.	Question	Response
	<p>equity in any circumstances.</p> <p>Confirmation that the Company and Subsidiaries are in compliance with their loan agreements, credit facilities, debt securities and loan capital.</p> <p>Details of any issued loan stock/preference capital.</p> <p>Details of all balances outstanding.</p> <p>Copies (or details where unwritten) of any default notices served on the Company and Subsidiaries together with details of any non-compliance with the borrowing and security documentation referred to above.</p> <p>Confirmation whether it is intended that any borrowings will be repaid before completion of this transaction.</p> <p>Confirmation that the current level of banking facilities generally is adequate for the Company's working capital purposes for the next 12 months.</p> <p>Details of amounts outstanding. Highlighting covenants or events of default restricting :</p> <ul style="list-style-type: none"> ■ Future borrowings; ■ Negative pledges; ■ Issue of equity; ■ Change of control; and ■ Change of management. 	
7.3	<p>Financial Grants or other Assistance</p> <p>Please provide copies of documentation for (or details where unwritten of) financial grants or other assistance from a governmental or other</p>	

Sl. No.	Question	Response
7.4	<p>body by the Company or any Subsidiary.</p> <p>Guarantees, Indemnities, Letters of Credit Please provide copies of :</p> <ul style="list-style-type: none"> ■ Any guarantees, sureties, indemnities or counter-indemnities (including Letters of Comfort, extant notices, demands or other communications from such third parties) given by the Company or Subsidiary in respect of the obligations of another party (including shareholders of the Company or Subsidiary). ■ Guarantee given by Promoters ■ Bank Guarantees for the obligations of the Company/Subsidiary ■ Any bond executed by the Company/Subsidiary for its obligations ■ Any guarantees, sureties and indemnities provided by any third party in respect of the obligations of the Company/Subsidiary together with any security documentation. <p>All letters of credit issued in favour of third parties on application of the Company/Subsidiary.</p>	
7.5	<p>Confirmation that the Statutory Auditors have not commented on the compliance of mandatory accounting standards in terms of section 211(3C) of the Companies Act, 1956.</p>	
7.6	<p>Details of all loans made to or by the Company, including all loans and indebtedness to directors, officers, employees or shareholders of any of the Company and each Subsidiary or any other companies in which any such director, employee or shareholder is interested, together with copies of all loan documentation.</p> <p>Loan/Guarantee to/in favour of Directors;</p>	

Sl. No.	Question	Response
7.7	<p>Loan/Guarantee to/in favour of Employees; Loan/Guarantee to/in favour of connected concern or person</p> <p>Copies of all hire purchase or instalment purchase agreements, finance leases, letters of credit, performance and other bonds and similar</p>	

TAXATION COVERED BY ACCOUNTING DUE DILIGENCE EMPLOYMENT MATTERS

Sl. No.	Question	Response
9.1	<p>Please provide details of organisation charts for employees of the Company and its Subsidiaries, including a list of key personnel as well as details of the number of full-time and part-time employees and whether these employees are permanent or temporary. Please also provide us with the following details for each such company:</p> <ul style="list-style-type: none"> ■ Total number of employees; ■ Average numbers employed and changes therein over the last three financial years (if such changes are material) ■ Management Structure, organisation chart and responsibilities/authorities of key personnel. 	
9.2	<p>Copies of all employment and golden parachute agreements, consultancy agreements, and all agreements with present or former employees in respect of confidentiality, non-competition or indemnities for the Company and each Subsidiary. Please also provide:</p>	

Sl. No.	Question	Response
	<ul style="list-style-type: none"> ■ Details of compensation structure ■ Standard Employment Agreement ■ Service Agreement with Directors ■ Non-compete and confidentiality agreement ■ Letters of confirmation ■ In case of contract labour, copies of contracts executed with contractors and terms and conditions on which labour is taken of contract basis. 	
9.3	Copies of all share option, share incentive, profit sharing or similar arrangements for employees of the Company and the Subsidiaries, including copies of the ESOP Plan	
9.4	<p>Details of the pension, provident or life assurance schemes operated by the Company or its Subsidiaries or in which they participate.</p> <p>Employees' Provident Fund Miscellaneous Provisions Act, 1952.</p> <p>Group Insurance.</p>	
9.5	<p>Details of any other benefits provided by the Company and or its Subsidiaries to their respective employees.</p> <p>Health and other benefits.</p> <p>Voluntary retirement schemes.</p> <p>Redundancy policies.</p> <p>Retrenchment schemes of the company</p> <p>Terms and conditions on which employees hold shares in the company (if any)</p>	
9.6	All employment booklets, manuals or other literature regarding terms and conditions of employment generally furnished to employees,	

Sl. No.	Question	Response
	including details of grievance and disciplinary procedures, normal working hours, guaranteed pay, health and safety procedures and policy, and sick pay. (for the Company and each Subsidiary)	
9.7	All union and collective bargaining agreements and all other agreements with employee representatives, and minutes of meetings with any of such bodies. (for the Company and each Subsidiary)	
9.8	Details of any industrial action or disputes within the last three years (or such shorter period for companies incorporated for less than three years). (for the Company and each Subsidiary)	
9.9	Details of wrongful, unreasonable or unfair dismissal or race, sex, age, disability, religious or other discrimination claims within the last five years and related correspondence. (for the Company and each Subsidiary).	

PROPERTY

Sl. No.	Question	Response
10.1	<p>Please provide details of all freehold property owned or occupied by the Company and its Subsidiaries. If freehold property occupied by the concerned company is not owned by it, details of the ownership and the terms upon which the property is occupied.</p> <p>type of interest (freehold, leasehold or other);</p> <p>tenure of interest; Type of activity conducted at the property;</p>	

Sl. No.	Question	Response
10.2	<p>Details of encumbrances on the properties of the Company and or its Subsidiaries, if any;</p> <p>Details of any dispute relating to the properties.</p> <p>Please also detail all leasehold property occupied by the Company and or its Subsidiaries, including term, rent and any other material provisions.</p> <p>Details of tenanted premises in possession of the Company and or its Subsidiaries and rent receipts in respect of such tenanted premises.</p> <p>Escalation clause</p> <p>Termination clause</p> <p>Extension clause</p> <p>Stamp duty and registration</p> <p>Revenue records and municipal tax paid receipts</p>	
10.3	<p>Please provide details of all licences to occupy property held by the Company and or its Subsidiaries, including copies of all concerned documents.</p>	
10.4	<p>Please provide details of any leases, tenancies or licences to occupy granted by the Company and or its Subsidiaries, including term, rent and any other material terms together with copies of all concerned documents.</p>	
10.4	<p>Please provide copies of any appraisal or valuation reports or surveys on any material properties owned or occupied by the Company or a Subsidiary.</p>	
10.5	<p>Please provide a schedule of all material plant, machinery and equipment, motor vehicles and other tangible assets and movable property used by the Company and each Subsidiary, indicating</p>	

Sl. No.	Question	Response
	<p>the ownership and nature thereof and the material terms of any financial lease or security agreement pursuant or subject to which the same may be leased or owned. These must include (by way of illustration).</p> <p>All plant and machinery required for the purpose of manufacture of the Products Computer and accessories (whether outright purchase of hire purchase, lease etc.).</p> <p>Vehicles (whether outright purchase of hire purchase, lease etc.).</p> <p>Office equipment (whether outright purchase of hire purchase, lease etc.).</p> <p>Documents underlying the abovementioned assets.</p>	

BUSINESS AND OPERATIONAL MATTERS

Sl. No.	Question	Response
11.1	<p>Identify the critical technologies used or to be used by the Company and the Subsidiaries in their respective businesses (Technologies) including, but not limited to:</p> <ul style="list-style-type: none"> ■ Software; ■ Hardware; ■ Integrated Circuitry; ■ Any technologies that are under development. 	
11.2	<p>Confirm as to whether the choice to use any of these particular Technologies by the Company or its Subsidiaries has limited the future direction of such company's business in any way.</p>	

Sl. No.	Question	Response
11.3	Provide copies of any agreements or, if no agreement exists, provide details of any arrangement that the Company or its Subsidiaries has entered into with any suppliers of equipment and/or infrastructure that includes any exclusivity arrangements.	
11.4	Provide details of the source of the rights of the Company and the Subsidiaries to use each of the Technologies i.e. in relation to each of the Technologies advise if it was purchased, leased, licensed, developed internally or developed externally and assigned or licensed to the Company or its Subsidiaries.	
11.5	For purchased Technology - please supply the relevant purchase agreements (and any amending or supplemental documentation).	
11.6	For leased Technology - please supply the relevant lease (or hire purchase) agreements (and any amending or supplemental documentation).	
11.7	For licensed Technology (usually software) - please supply the relevant licence agreements (and any amending or supplemental documentation).	
11.8	For Technology developed externally or internally by a contractor (i.e. not an employee of the Company/Subsidiary) - please supply the relevant development agreements (and any amending or supplemental documentation).	
11.9	To the extent available (and not provided in response to the foregoing questions above) - please supply the following agreements (and any amending or supplemental documentation)	

Sl. No.	Question	Response
	<p>between the Company or its Subsidiaries and any third party:</p> <ul style="list-style-type: none"> (i) technical services agreements; (ii) agreements, memoranda of understanding, letters or intent or otherwise for manufacture, supply, purchase or lease of any critical equipment; (iii) licences for critical software or other technology; (iv) technology development agreements; (v) framework agreements; (vi) technical consultancy agreements, as well as any amendment agreement, side letter or a description of a verbal understanding for amendment of any of the foregoing agreements. 	
11.10	Please supply all maintenance, repair, support, training and other consultancy services agreements in relation to the Technologies.	
11.11	Please advise as to what extent other value-added services have been planned and/or implemented by the Company or its Subsidiaries and whether the Technologies required for these services are in place.	
11.12	To what extent do the Company and Subsidiaries market their services and to what extent do they use distributors or re-sellers?	
11.13	Provide a list of the major (i.e. more than 5% of goods or services supplied in any six month period) suppliers (identifying product or service) of the Company and each Subsidiary.	
11.14	A schedule of all material plant, machinery and equipment, motor vehicles and other tangible	

Sl. No.	Question	Response
	<p>assets used by the Company and the Subsidiaries, indicating the ownership and nature thereof and the material terms of any financial lease or security agreement pursuant or subject to which the same may be leased or owned.</p> <p>Computer and accessories (whether outright purchase of hire purchase, lease <i>etc.</i>).</p> <p>Vehicles (whether outright purchase of hire purchase, lease <i>etc.</i>).</p> <p>Office equipment (whether outright purchase of hire purchase, lease <i>etc.</i>).</p> <p>Documents underlying the abovementioned assets.</p>	

CONTRACTS

Sl. No.	Question	Response
12.1	<p>Copies of all material contracts to which the Company or any Subsidiary is or was a party relating to the acquisition or sales of shares or businesses, joint ventures, partnership or investments in other entities, or reorganisations including the following agreements:</p> <p>Share purchase agreement</p> <p>Subscription Agreement</p> <p>Assignment Agreement</p> <p>Slump Sale agreement</p> <p>Shareholders Agreement</p> <p>Joint Venture Agreement</p> <p>Acquisition Agreement</p>	
12.2	<p>Copies of all licence, distribution, franchise, agency, research and development, marketing,</p>	

Sl. No.	Question	Response
	<p>consulting and management contracts granted to or by or entered into by the Company or any Subsidiary and all other contracts:</p> <p>material to the business of any company; or</p> <p>Containing long-term, unusual or onerous provisions; or</p> <p>Containing exclusivity, non-competition or confidentiality provisions; or</p> <p>Where change of shareholding could give grounds for termination or is otherwise relevant, (to the extent not otherwise covered above).</p>	
12.3	<p>Details of breaches of any contracts by the Company or any Subsidiary whether outstanding or in the past including the following:</p> <p>Breach of contract with a customer;</p> <p>Breach of contract with a supplier;</p> <p>Breach of contract with a licensor</p>	
12.4	<p>Please provide details and documentation of any outstanding quotation or tender for a major contract made to or submitted by the Company or any Subsidiary as well as any incomplete project or assignment.</p>	
12.5	<p>Copies of all contracts with directors or officers of the Company and the Subsidiaries or the companies' shareholders or with any affiliate.</p>	
12.6	<p>Copies of all agreements of the Company and Subsidiaries with governments and government agencies, including, without limitation.</p> <p>Software Technology Part of India.</p> <p>Local Authorities.</p> <p>Special arrangement for any facility for the business of company.</p>	

Sl. No.	Question	Response
12.7	<p>A brief outline, in respect of each type of trading activity, of the method by which the Company and its Subsidiaries documents its arrangements with customers i.e., Standard Terms of Supply;</p> <p>Does the company supply customers on a standard supply order form? If so, please provide a copy.</p> <p>Approximately what percentage of customers would this form apply to?</p> <p>Does this form contain all terms and conditions of purchase when used or does a standard set of conditions, an order acknowledgement form, sales brochure or other document also contain some of the terms and conditions?</p> <p>Customers' Terms of Purchase;</p> <p>Do some customers use their own purchase order form or other documentation?</p> <p>Approximately what percentage of customers would use their own form?</p> <p>In respect of each Company and Subsidiary, please list any major customers, i.e. those accounting for more than five per cent of sales and provide copies of documentation with them.</p>	
12.8	<p>Long Term Contracts: In respect of the Company and each Subsidiary:</p> <p>Please provide copies of any contracts with customers having duration of more than six months.</p> <p>Please provide copies of any power of attorney or similar authority granted by Company and Subsidiaries to a third party, or granted to the Company or Subsidiary by a third party.</p> <p>Non-Compliance with Agreements/Change Of Control.</p>	

Sl. No.	Question	Response
12.9	Please provide details of any non-compliance by either the Company/Subsidiary or the other party in respect of any agreement (whether written or unwritten) entered into by the Company/Subsidiary.	
12.10	Please provide a list of any agreements or arrangements, which are subject to termination or variation, require prior consent or notification, or are contravened or otherwise affected by the transfer of shares in the Company or any Subsidiary.	

INTELLECTUAL PROPERTY

Sl. No.	Question	Response
13.1	Please provide a schedule of all patents, trademarks, service marks, trade names, copyrights, know-how and registered designs owned by or licensed to or by or used by the Company or any Subsidiary and all other intellectual property of the Company and all Subsidiaries, and copies of all relevant registrations, applications, consents, licences and sub-licences.	
13.2	Details of software licence royalties to be paid by the Company or any Subsidiary to the licensor (past, present and future payments)	
13.3	Trademark registration of the logo, name etc of the Company/Subsidiaries.	
13.4	A list of authors, contributors, independent contractors and employees involved in the development of the Company and the Subsidiaries' intellectual property, and copies of any related employment, commissioning or	

Sl. No.	Question	Response
	development agreements and related records and correspondence.	
13.5	In respect of the Company and its Subsidiaries, a list of all proprietary products not protected by patents or registered copyrights, trademarks, etc. and steps taken to ensure their secrecy.	
13.6	Details of any opposition proceedings, petitions or challenges to any of the Company's and the Subsidiaries' intellectual property.	
13.7	Details of any infringement or alleged infringement of the intellectual property rights of any Company or Subsidiary, or of any such rights of others by any Company or Subsidiary, and related correspondence and documentation.	
13.8	All assignments of intellectual property rights by or to the Company or any Subsidiary.	
13.9	All technical assistance, know-how and similar agreements relating to the Company and the Subsidiary.	
13.10	Details of all software and hardware used by the Company and the Subsidiaries, indicating the licensor/owner of any software used and details of any royalties or continuing payments required to be made for the use of any software.	
13.11	Details of all contracts taken out by the Company and the Subsidiaries relating to the maintenance of computer hardware and software.	
13.12	Details of the security and backup arrangements put in place by the Company and Subsidiaries to protect the information maintained by computer and to retrieve information in the event of a computer system shutdown, and of the type and range of information stored by computer.	

Sl. No.	Question	Response
13.13	Details of any governmental or data protection related licences held by the Company or any Subsidiary regarding the storage, transmission or usage of computer-held information.	
13.14	Details of arrangements relating to the source codes of any software developed, owned or used by the Company and Subsidiaries, and of records relating to its creation.	
13.15	Ownership of Intellectual property arising of the product development by the Company or Subsidiaries	
13.16	Details of all trademark searches or other research on trademarks or other designations which are the same or similar to marks or designations used by the Company or any Subsidiary.	
13.17	Details of any material known or suspected problems with the computer systems of the Company or Subsidiaries (e.g. viruses, defects in functioning and material bugs) and details of assessment procedures undertaken to assess such computer systems. Security breaches System shutdown	
13.18	Provide a full list of Internet domain names registered in the name of the Company or any Subsidiary or used in the course of the their businesses including: Key domain names: name registration Negative registration (Whether registered in the name of individuals instead of the company)	

LEGAL PROCEEDINGS, DISPUTES AND INVESTIGATIONS

Sl. No.	Question	Response
14.1	<p>Please provide details of all pending or threatened or anticipated claims, litigation, arbitration proceedings, or governmental investigations and proceedings (domestic or foreign), including parties, damages and other remedies sought, nature of action, details of any actual or potential breaches of contract (all kinds of contracts including those detailed in the Financial, Business and operation matters, Intellectual property, and other sections) or infringement of rights by or against the Company and all Subsidiaries including the following :</p> <p>Disputes with customers.</p> <p>Disputes with third parties.</p> <p>Disputes with suppliers.</p> <p>Disputes relating to intellectual property infringement.</p> <p>Disputes relating to recoveries.</p> <p>Disputes with Employees of the company</p> <p>Disputes with Income tax, Customs, and other authorities.</p> <p>Others.</p>	
14.2	Please furnish copies of all pleadings and other material documents relating to material litigation, arbitration and governmental proceedings in connection with the Company and Subsidiaries.	
14.3	Please attach a schedule of all orders, writs, decrees, injunctions, judgements, awards or rulings (including consent decrees and judgements) by any court, arbitration panel or	

Sl. No.	Question	Response
14.4	<p>governmental agency affecting the Company or any Subsidiary.</p> <p>Please provide copies of all correspondence relating to any threatened governmental investigation or alleged violation of law or regulation by the Company or any Subsidiary.</p>	

INSURANCE POLICIES

Sl. No.	Question	Response
15.1	<p>Please provide details of all material insurance policies taken out by or on behalf of the Company and all Subsidiaries and also furnish copies of all contracts, policies and certificates of insurance including the following :</p> <p>Fire</p> <p>Theft</p> <p>Burglary</p> <p>Professional liability</p> <p>Key employee</p>	
15.2	Please provide copies of any reports or correspondence regarding the adequacy of any insurance coverage, reservation of rights or denial of liability or coverage under any such policies.	
15.3	Please provide confirmations from the Company and its Subsidiaries as to the adequacy of such company's insurance.	
15.4	Please detail the Company's and the Subsidiaries' claims records, rejections and provide copies of related reports and correspondence.	
15.5	Please complete Schedule III for the Company and each Subsidiary.	

ENVIRONMENTAL MATTERS

Sl. No.	Question	Response
16.1	Please provide copies of all internal and external reports concerning environmental matters relating to current or former properties of the Company and its Subsidiaries.	
16.2	Please furnish copies of all permits relating to environmental matters and of any statements or reports by the Company and its Subsidiaries to any governmental, central or local department of environmental regulation or any similar body.	
16.3	<p>Please provide copies of all approvals and permissions obtained by the Company or any Subsidiary under:</p> <p>The Environmental Protection Act;</p> <p>Air (Prevention and Control of Pollution) Act, 1981;</p> <p>Water (Prevention and Control of Pollution) Act, 1974.</p>	
16.4	Please furnish copies of all notices, complaints, suits or similar documents sent to, received by or served upon any of the Company or Subsidiaries by any governmental, central or local department of environmental regulation or any similar governmental, central or local regulatory body, authority or agency.	
16.5	Please provide us with all correspondence, reports and other details pertaining to the notices, complaints, suits, etc mentioned at [16.4] above.	

PRODUCT/SERVICE LIABILITIES

Sl. No.	Question	Response
17.1	Please provide a brief outline of the method by which the Company and each Subsidiary documents its product/service warranties or guarantees given to customers (if any). Please provide copies of the documentation used, including any warranty cards issued.	
17.2	Have there been any product/service warranty claims against the Company or any Subsidiary in the past? If so, please provide details, including present status.	
17.3	Is the Company or any Subsidiary indemnified for any product/service warranties or guarantees by any of its suppliers? If so, please provide details, including copies of the agreements with such suppliers.	

IMPENDING LEGISLATIVE CHANGES

Sl. No.	Question	Response
18.1	Are you aware of any impending legislative changes, which might affect the Company, or any Subsidiary? If so, please provide details of the legislation as well as the possible impact upon the Company or the Subsidiary.	

COMPLIANCE WITH SPECIAL INDUSTRY SECTOR LEGISLATION

Sl. No.	Question	Response
19.1	Are any of the products manufactured by the Company reserved for the small-scale sector as per the Industrial Policy?	

SCHEDULE ONE FINANCE¹

Date of Issue/ Facility ²	Amount
Long-term	
Committed ³	
Drawn	
Undrawn	
Uncommitted ⁴	
Drawn	
Undrawn	
Short-term	
Committed ²	
Drawn	
Undrawn	
Uncommitted ⁴	
Drawn	
Undrawn	

1. Include all forms of debt financing (e.g. loan facilities, issues of bonds, receivables financing, factoring arrangements).
2. Please provide details of the term to run for each facility or loan.
3. Where the issuer has already received the funds or the issuer has an enforceable right to draw the funds, subject only to fulfilling conditions, which it is able to fulfill.
4. Date on which the underlying claim will be released (e.g. the debt guaranteed will be repaid).

SCHEDULE TWO
CONTINGENT LIABILITIES¹

Brief Description ²	Amount ³	Expiry Date ⁴

1. Include all contingent liabilities (e.g. guarantee).
2. Nature (e.g. "guarantee"), identity of beneficiary (e.g. "in favour of XYZ Bank") and identity of person incurring the underlying obligation (e.g. the person guaranteed).
3. Maximum amount of the possible claim.
4. Facilities where either the issuer has received the funds, but the lender can require payment on demand, or where the issuer has no contractual right to draw the funds.

ANNEXURE C

SPECIMEN CHECK LIST FOR COMMERCIAL DUE DILIGENCE

Please prepare a folder containing the information requested below. This checklist is to be placed at the top of the folder and should indicate against each question either an explanation or the reference number of the document in the folder that supports the explanation or both. In case a question is not applicable please indicate as such. All documents in the folder should be numbered and the folder should be indexed.

1. General

- i. List of companies/firms which are a part of the business group to which the target company belongs.
- ii. Brief note on the history of the company being invested in, including reference to its foundation and expansion.
- iii. Brief note on present business and activities, including list of business locations; please provide details for separate product/service verticals embedded solutions, infrastructure for power and software solutions.
- iv. Any recent reports on the company's activities prepared internally or by outside consultants (such as analyst reports, information memorandum, valuation reports etc.).
- v. Copies of any literature prepared by the company illustrating its products, operations, history etc.
- vi. Any agreements or documents recording arrangements between shareholders of the company.
- vii. A list of all licenses and registrations held by the company specifying number, validity period, purpose, granting authority and other relevant details. Copies of the same may also be enclosed.
- viii. Minutes of meetings of the board of directors, shareholders and audit/operational committees since incorporation.
- ix. Brief note on the internal control environment in the division.
- x. Details of bankers, lawyers, consultants and other professional advisers.
- xi. Transactions/agreements with affiliates and related parties especially

with respect to prices, payment terms, etc.

- xii. All statutory registers and returns filed required to be maintained/filed under the Companies Act.
- xiii. Details of intellectual property rights (including trademarks & brands) held by the company, if any.
- xiv. Note on planning and control systems prevalent in the organisation including controls over non financial systems such as production planning, quality control, inventory management, sales etc.
- xv. Details of statutory records maintained under the Companies Act and other applicable statutes.
- xvi. Transaction documents (agreements) for any prior acquisitions done by the company or investments in the company.

2. Financial Statements information for the year ended March 31, 200_, March 31, 200_ and for the nine months ended December 31, 200_.

- i. Audited/un-audited financial statements of the Company along with its reconciliation with management accounts for the year ended March 31, 200_, March 31, 200_ and for the nine months ended December 31, 200_.
- ii. Chart of accounts.
- iii. Accounting policy at present, in particular with respect to income/sales recognition, research and development, exceptional and extraordinary items, acquisition and disposal of assets, differentiating between capital expenditure & repairs and maintenance, valuation of fixed assets, capitalisation of interest, inventory/stock valuation, transfer pricing, preliminary expenses.
- iv. Details of changes in accounting policies over last 5 years.
- v. Closing audit working files prepared by the Company, as appropriate.
- vi. Trail Balance, schedules and groupings supporting the financial statements for the year ended March 31, 200_, March 31, 200_ and for the nine months ended December 31, 200_.
- vii. Audit management letters for the period under review.
- viii. Internal audit reports for the period under review.
- ix. Budgets, comparison with actuals and explanation for variances for last

two accounting periods i.e. FY0-, FY0- and YTD0-. Specifically revenue forecast versus. actuals, expenditure forecast versus. actuals and manpower budget versus. actual headcount.

- x. Cash flow statements for the year ended March 31, 200_, March 31, 200_ and for the nine months ended December 31, 200_.

3. Management Accounts

- i. Copies of monthly management accounts since April 200_ till date.
- ii. Breakdown of above by vertical (separately identifying financials for embedded solutions, infrastructure for power and software solutions).
- iii. Reconciliation of management accounts to statutory accounts for the year ended March 31, 200_, March 31, 200_ and for the nine months ended December 31, 200_.
- iv. Trading Results.

4. Revenues

- i. Split of revenue:
 - Customer wise
 - Product wise/ Service Wise
 - Substation Controllers
 - Distribution Transformer Monitoring System
 - Theft Detection Device
 - Intelligent Automatic Meter Reading
 - General Automatic Meter Reading
 - Spot Billing Machine
 - Computerised Online Data Logging System
 - Energy Audit Services
 - Micro RTU
 - Vertical wise
 - Embedded Solutions
 - Infrastructure for Power
 - Software Solutions

- Geography wise and target industry sector
 - Rural electrification
 - Transmission
 - Oil & gas
 - Technology, and
 - Exports.
- ii. Historic product/service wise contributions earned and gross margin. Also provide details of direct costs. Details of profitability for top 5 customers.
 - iii. Comparison of revenue and contribution reflected in the financial statements with the Management Information System ('MIS') and budgets; analysis of reasons for variance.
 - iv. Average realisations by product/service in last three years for the customers.
 - v. Details of the basis for revenue recognition for all the contracts with customers.
 - vi. Details of deferred revenues year ended March 31, 200_, March 31, 200_ and for the nine months ended December 31, 200_ and bookings carried forward to the next year and the next period.
 - vii. Details on marketing and pricing strategies of the Company; average realisation per hour per contract/agreement for each key customer/product/service of the Company.
 - viii. Revenue per headcount, together with details of employee productivity (monthly data) for the historic period.
 - ix. Discount structures and credit terms for major customers; historic average realization per headcount/service for that customer.
 - x. Details of customer agreements terms, value, rates, penalties, Service Level Agreements, committed headcount and volume and bearing of training costs. Also provide details of revenue by nature of billing cycle, frequency of billing, milestone based or man hours per month basis/transaction.
 - xi. Product wise/service wise/customer wise status of contracts under negotiation and details of the progress in the same.

- xii. Details of customer acquisitions in the last two years ended March 31, 200_, March 31, 200_ and for the nine months ended December 31, 200_.
- xiii. Details of customer attrition rate; clients acquired from competitors and clients lost to competitors along with the reasons for the same over the past for the year ended March 31, 200_, March 31, 200_ and for the nine months ended December 31, 200_.
- xiv. What has been the increase in the size of operation for the existing clients?
- xv. Details of other income.
- xvi. Details of exceptional and extraordinary income items.
- xvii. Pricing movements for the defined historical period together with the nature of movement; pricing differences between clients and reasons for the same; pricing band service wise/product wise, if any.
- xviii. Budget/Actual analysis of product/service-wise and customer wise sales and analysis of the reasons for variations.
- xix. Revenue sharing arrangements and transfer pricing amongst the Divisions, if any as per the terms of the respective contracts.
- xx. Comparison of revenue and contribution reflected in the financial statements with the Management Information System (MIS) and budgets.

5. Customers and Marketing

- i. Write up on selling and distribution methods (systems and procedures followed, *etc*), factors affecting prices, margins, periods of peak and low revenue, *etc*.
- ii. Details on marketing and pricing strategies of the Company.
- iii. Details of various components of freight, tax and other costs from factory sales point to the sale point of the customer.
- iv. Discount structures and credit terms for major customers; historic average price realizations.
- v. Average price realisation (monthly) per unit for each product of the Company in the last two years i.e. March 31, 200_, March 31, 200_ and for the nine months ended December 31, 200_.
- vi. List of all significant marketing agreements and contracts with customers.

- vii. List of major customers for individual products along with details of geographic segments sales (domestic and export) for March 31, 200_, March 31, 200_ and for the nine months ended December 31, 200_.
- viii. Pricing policy for sale to related parties.
- ix. List of any claims/disputes with or complaints from customers giving amounts and background.
- x. Details of all returns by customers with reasons for year ended March 31, 200_, March 31, 200_ and for the nine months ended December 31, 200_.
- xi. List of all competitors, company market share (present and anticipated), etc.
- xii. Status of order book as on December 31, 200_.

6. Suppliers

- i. Purchase policies and procedures.
- ii. List of major suppliers in the period ended March 31, 200_, March 31, 200_ and for the nine months ended December 31, 200_ showing nature of purchase, quantity purchased and amount of purchases.
- iii. Pricing policy for purchases from related companies.
- iv. List of all significant contracts with the suppliers.
- v. Details of purchase at forward prices and forward purchase, if any.
- vi. List of any claims/disputes with suppliers giving amounts and background.

7. Purchases and Consumption Costs.

- i. Material expenditure with the respective supply contracts.
- ii. Consumption costs for individual products; details of actual consumption with standard.
- iii. Details of the power and fuel cost with respect to. unit rates and consumption patterns in the last three years.

8. Expenditure

- i. Details of average headcount cost per customer/service.

- ii. Details of average direct cost per customer/service.
- iii. Direct costs for individual services detailing all components of costs.
- iv. Details of cost structure, breaking it into fixed costs and variable costs.
- v. Personnel cost including perquisites and retirement benefits.
- vi. Details of incentive/commission policy for sales and other of the Company and details of the cost during the historical period.
- vii. Payment of royalty/ technical know-how fees, if any, along with the terms of the respective agreements.
- viii. Details of repairs, rent, stores and spares consumed, carriage and freight, finished goods handling expenses, other expenses, etc.
- ix. Details of the inventory write-offs in the last three years.
- x. Details of provision for bad and doubtful debts in the last three years.
- xi. Administrative and other expenses including professional, legal fees, other expenses.
- xii. Details of the selling and marketing costs.
- xiii. Basis for allocation of common costs and support expenses.
- xiv. Details of financial costs including interest, lease rent and hire charges.
- xv. Details of payment of royalty/ technical know-how fees along with terms of respective agreements.
- xvi. Details of provision for bad and doubtful debts in the last three years.
- xvii. Balance sheet (Details required as on March 31, 2005-, March 31, 200_ and for the nine months ended December 31, 200_, unless otherwise specified).

9. Fixed Assets

- i. Summary showing principal categories of assets at last year end and most recent accounting date showing cost, accumulated depreciation, net book value and depreciation charge for the period.
- ii. Details of valuation/revaluation of fixed assets, if any.
- iii. Details of charges or lien created against any fixed assets through guarantees or loan arrangements.
- iv. Details of insurance policies and coverage of fixed assets.
- v. Details of capital work in progress, if any.

- vi. Contracts for pending capital commitments at last year-end and most recent date - contracted for and authorised but not contracted.
- vii. Copies of leasehold agreements (lease and sub-leases) and tenancy rights, title deeds and other agreements giving amounts and terms involved (renewal options for the lease period).
- viii. Fixed assets ledger/register and supporting documents for fixed assets.
- ix. Physical verification reports and its periodicity.
- x. Procedure for authorising and procurement of capital expenditure.
- xi. Accounting policy for capitalisation of financial costs and details of capitalisation of financial costs.
- xii. Terms and accounting practice for leased/hired assets; details of financing arrangements and payments thereof and details of future commitments, if any.
- xiii. Useful life of assets and depreciation computation.
- xiv. Details of sale of fixed assets and policy for determining prices.
- xv. List of obsolete and idle equipment with cost and net book value attached.
- xvi. List of fully depreciated assets.
- xvii. Details of any restriction on the use or sale of any asset.
- xviii. Foreign exchange fluctuation and accounting thereof.
- xix. List of all properties owned or operated that are connected to the business with details of their book values, usage, title/ lease and rent details.

10. Inventories

- i. Details of inventory/stock as on March 31, 200_, March 31, 2006- and December 31, 2006-.
- ii. Inventory details and classification into raw materials; work in process, finished goods and stores and spares.
- iii. Quantitative reconciliation of opening stock, purchases, sales and wastage, etc. for FY 0-, FY 0- and YTD 0_.
- iv. Inventory valuation workings and its basis. Details of overhead and other costs included in stock values.
- v. Age wise details of inventory as on March 31, 200_ and March 31, 200_.

- vi. Provisioning policy of inventory and details of provision against inventory as on March 31, 200_ and on December 31, 200_.
- vii. Procedure for identification of slow moving and obsolete/unusable inventories.
- viii. Treatment of goods in transit and material at third location and details in respect thereof as on March 31, 200_, March 31, 200_ and December 31, 200_.

11. Receivables

- i. Party-wise break-up of Sundry Debtors with confirmation and reconciliation statements as on March 31, 200_, March 31, 200_ and December 31, 200_.
- ii. Ageing details of Debtors as on March 31, 200_, March 31, 200_ and December 31, 200_.
- iii. Details of subsequent receipts with supporting documents.
- iv. Details of credit terms as per the respective contracts and other supporting documents with details of changes in the credit terms, if any.
- v. Details of provisions for doubtful debts/written off debts and movement in provisions since incorporation.
- vi. Details of subsequent receipts with supporting documents.
- vii. Details of dispute in payment/claims filed by customer.
- viii. Details of actual collections period versus contractual credit period for receivables outstanding.
- ix. Details of write off of bad debts over the last three years ended on March 31, 0- or later financial period as being followed.
- x. Nature and details of transactions with related Company and accounts ledger of these receivables.

12. Loans & Advances and Other Current Assets

- i. Details of Advances recoverable in cash or in kind or value to be received with supporting documents as on March 31, 200_, March 31, 200_ and December 31, 200_. Reasons for advancement, ageing, existence and adequacy of contracts and reasonableness of terms and conditions of each receivable.

- ii. Details of deposits with Public Bodies and others prepaid expenses with supporting documents and balance confirmations. Review of the terms of the deposits, ageing and subsequent clearances thereof.
- iii. Details of Fixed Deposits held for disposal and interest accrued on investments & deposits.
- iv. Details of provision for doubtful advances, if any.
- v. Details of amounts due from staff and officers and their subsequent clearances.
- vi. Details of other receivables on account including reason for advancement, ageing, existence and adequacy of contracts and reasonableness of terms and conditions of each receivable.
- vii. Nature and details of transactions with related company and accounts ledger of these receivables.

13. Cash and Bank Balances

- i. List of bank balances and bank accounts as on March 31, 200_, March 31, 200_ and December 31, 200_.
- ii. Bank reconciliation statements and confirmations as on March 31, 200_ and December 31, 200_.
- iii. Details of the fixed deposit amount providing the date of deposit, interest rates, *etc.*

14. Miscellaneous Expenditure to the Extent Not Written-off

Details of accumulated amortization and net book value as on, March 31, 200_, March 31, 200_ and December 31, 200_.

15. Creditors and Accrued Expenses

- i. List of trade creditors at March 31, 200_, March 31, 200_ and December 31, 200_.
- ii. Ageing details of trade creditors along with supply contracts (including the terms of payments) and subsequent payments.
- iii. Contracts with the Vendors.

- iv. Creditors balance confirmation certificates and reconciliation statements as at March 31, 200_, March 31, 200_ and December 31, 200_ or any other latest date.
- v. Details of accruals with supporting documents and subsequent clearances.
- vi. Details of off Balance Sheet Liabilities (such as leases).
- vii. Details of advances received with aging details, subsequent clearances, etc.
- viii. Basis of accruals of expenses and other liabilities.
- ix. Details of provisions against claims, if any.
- x. Hedging policy, if any and details of purchase commitments as on date of financial statements.
- xi. Detailed listing of overdue payables.
- xii. Details of any penalties/interest levied on overdue payments, if any.
- xiii. Purchase policies and procedures for all operational (ex: content) and administrative purchases (miscellaneous purchases).
- xiv. List of major suppliers in the period showing nature of contract and value of purchases.
- xv. Pricing policy for purchases from related companies.
- xvi. List of any claims/disputes with suppliers, background and current status of the same.
- xvii. Any redundancy or liability clauses against the key suppliers like transportation, food, Server & Switch maintenance vendors etc.

16. Amounts Due to Related Parties

Nature and details of related company dues and account listing of these dues since the incorporation of the Company

17. Secured and Unsecured Loans

- i. Details & terms of working capital loans & other financing from banks & other parties with their respective repayment schedule. Review of the outstanding amounts at March 31, 200_, March 31, 200_ and December 31, 200_, current interest rates, period, loan covenants.

- ii. Provide details of default in repayment of loans and interest in the historic period, if any.
- iii. Bank facility letters for encumbrances on assets.
- iv. Details of outstanding amounts, current interest rates, period, loan covenants.
- v. Details of any corporate/ personal guarantee extended.
- vi. Confirmation from the Bank on the amount outstanding and interest accrued thereon.
- vii. Details of the sales tax deferral scheme, if any.

18. Reserves

- i. Provide details of all the reserves at the historic balance sheet dates for the historical period. Provide the terms for the statutory reserves.
- ii. For all reserves, provide details regarding (i) purpose of reserve, (ii) period reserves were originally established, and (iii) all movements to the reserve (i.e., roll forward payments against, reversals, transfers, and reclassifications) for each period during the historical period.

19. Contingencies

- i. Significant contracts, correspondence with solicitors, tax offices, shareholders register.
- ii. Details of claims against the Company not acknowledged as debt.
- iii. Details of outstanding bank guarantees and bill discounted.
- iv. List of charges, pledges, etc. over assets of group.
- v. Details of capital commitments, non-cancelable operating lease and other commitments and contingencies.
- vi. Details of litigation disputes against the company, promoters and group concerns on the company.
- vii. List & details of any existing and potential lawsuits/claims - cause, amounts involved, latest provisions, etc.
- viii. Disputes/claims with respect to employees, ex-employees, customers, vendors, etc.

- ix. Details of any regulatory claims against the Company.
- x. Confirmation from the lawyers about the list of legal issues and current status of the same.
- xi. List of any claims/disputes with or complaints from customers giving amounts and background.

20. Secretarial Records

- i. Minutes of Board of Directors and Shareholders meetings.
- ii. Shareholders register.
- iii. Register of Directors and Contracts in which Directors are interested.

21. Human Resources

- i. Organization structure and reporting relationships as on March 31, 200_ and on March 31, 200_.
- ii. Number of employees, grade-wise in each of the vertical and by department.
- iii. Details of time management system, together with details of employee productivity over the historic period.
- iv. List of directors, officers, senior staff (considered key to the business) showing position, name, age, length of service, skills, salary benefits, etc.
- v. HR systems prevalent in the organization, including performance appraisal systems.
- vi. Level-wise headcount movement i.e. month-wise number of employees joining and leaving the organisation in the last two years, by department/function. Also provide us with an average replacement time and cost of replacement.
- vii. Employee contracts, service agreements.
- viii. Details of employee union activities and note explaining significant Union activities since incorporation.
- ix. Details of any wages/bonus, etc. agreements signed with the employee unions.
- x. Staff movement i.e. month-wise number of employees joining and leaving

the organisation in the last two years.

- xi. Details of key employees who have left the Company in the past two years.
- xii. Is manpower hired from third parties? If so, agreements with these parties.
- xiii. List of all labor disputes pending as on March 31, 2006 and on December 31, 200_.
- xiv. Employee Provident Fund registration certificate, sample monthly remittance challans,
- xv. annual returns and correspondence with the relevant authorities.
- xvi. Details of accrual of various retirement liabilities viz. leave encashment, gratuity, etc. as on March 31, 200_ and on December 31, 200_. Please also specify how the various retirement benefit liabilities are funded.
- xvii. Actuary certificate for the retirements benefits as on December 31, 200_.
- xviii. Number of employees education wise at the agent and management level.
- xix. The details of the training calendar for the year ended March 31, 200_, March 31, 200_ and the nine months ended December 31, 200_.
- xx. Ratio of full time employed/contracted headcount year ended March 31, 200_, March 31, 200_ and the nine months ended December 31, 200_.
- xxi. Training cost/headcount

22. Forecast

Details of the forecast for FY 200_ (reflecting actuals YTD) and FY 200_ along with detailed assumption on growth assumed in product/service/customer sales, prices, product-wise sales and margins, customers, geographical sales, sales and marketing costs, customer returns, raw material mix-quantity and prices, other administrative costs, interest cost, etc.

Others

23. Technology

- i. Note on the Information technology and the overall control environment of the Company.
- ii. Details of software used for staffing & scheduling, planning and any other key softwares used for the year ended March 31, 200_, March 31, 200_ and

- the nine months ended December 31, 200_ and what is the efficiency of the scheduling for the top 5 customers.
- iii. Are there any knowledge management software being used for the operations & their details.
 - iv. How many licenses are available for different software being used?
 - v. Do you have any documented and implemented Disaster Recovery and Business Continuity plan.
 - i. When was last BCP\DRP test performed and details of the same.

24. Infrastructure

- i. What has been the build up of capacity over the last for the last two years i.e. for the year ended March 31, 200_, March 31, 200_ and the nine months ended December 31, 200_.
- ii. What % is the un-utilised capacity?

25. Taxes

Direct Taxes

Summary Information

- i. Year-wise summary chart for income tax and wealth tax for past five years, detailing the following:
- ii. Current assessment/ litigation status.
- iii. Key disallowances/issues raised by the authorities.
- iv. Amount of demands raised by the authorities and paid by the Company.
- v. Level of settlement of dispute (i.e. CIT (A)/ ITAT/ HC/ SC).
- vi. Taxable profit/ carried forward loss for the year and set off in future years.
- vii. Status of brought forward losses/ allowances, if any.

26. Information for Review Period

- i. Copies of Return, computation of income, transfer pricing report (along with transfer pricing study) for three preceding years.
- ii. Copies of tax audit report and other annexure for the latest three assessment years.

- iii. Copies of intimations, assessment orders, submissions made, appellate orders etc for all open years.
- iv. Details of tax benefits claimed by the Company.
- v. Year-wise details of amount appearing under the heads 'provision for tax' and 'advance tax' as at March 31, 200_ and December 31, 200_.
- vi. Provisional computation of tax liability for the Financial Year 2000-, based on which the Company has paid advance tax installments.
- vii. Computation of amount appearing as deferred tax asset/ liability as at December 31, 200_ and March 31, 200_.
- viii. Copies of legal opinions, if any, obtained by the Company.
- ix. Copies of wealth tax returns (along with all annexure) filed by the Company for three preceding years.

27. Indirect Taxes

Service Tax

Status of compliance and assessment

- i. Statement of domestic revenue streams and whether service tax charged. Verticals can provide details and sub-divisions thereof or chart on reasoned positions adopted regarding applicability of service tax.
- ii. ST-3 and credit returns filed.
- iii. Details of payments to foreign service providers for services rendered in India.
- iv. Details of payments to road transporters.
- v. Details of all payments made to and services received from all foreign service providers.
- vi. Any audit objections received by the company after excise/service tax audit?
- vii. Agreements for services utilized and rendered by the company.

Customs

- i. List of goods, which are generally imported along with tariff classification and rate of duty.
- ii. Bills of Entry for all imports assessed provisionally.
- iii. Licenses granted (for import).

- iv. Licenses granted (under Duty Exemption Scheme).
- v. Status on discharge of export obligation and related documentation.
- vi. Status on discharge of legal undertaking/ bonds.
- vii. Status of show cause notices ("SCN") issued; submissions made, adjudication thereon and appeals.
- viii. Agreements pertaining to import of know how, technology, drawings, designs, etc.
- ix. Legal opinions obtained, if any.

Excise Duty

- i. Status of compliance and assessment.
- ii. Registration certificates.
- iii. Show cause notices, submissions made, adjudication orders and appeals.
- iv. Registers maintained for excise purposes including returns and credit returns.
- v. Documentation in support of credit and refund claims in relation to input duties/ taxes.
- vi. Outsourced job works/ relevant agreements for the same.
- vii. Exemptions claimed in the review period and those that are currently valid.
- viii. Legal opinions obtained, if any.

Sales Tax/VAT

- i. Status of compliance and assessment.
- ii. Assessment orders for last 3 assessed years (for CST, local sales tax).
- iii. Returns filed during the last one-year.
- iv. Details of incentives claimed and periodical reports filed, if any.
- v. Details of declaration form pending receipt.
- vi. Classification determination order, if any.
- vii. Copies of all distribution agreement.
- viii. SCNs, communications from the sales tax authorities.
- ix. Appeal petitions/applications.
- x. Application for any sales tax exemption, along with related documentation.
- xi. Legal opinions obtained, if any.

ANNEXURE D

This specimen report attempts to cover venture finance, investment and a amalgam type transaction and it should not be construed as one intended for only merger & acquisition due diligence. The instructor may use this specimen report to explain the different aspects that a due diligence findings cover and its style of writing.

Sample Due Diligence Report for a Prospective Investment

This report is for the limited usage of the private party that commissioned it, and remains the property of the author. This report and it's information is not for distribution, dissemination, or publication in any form or manner, including excerpts, quotations, summarisation, or paraphrasing, whether written, verbal, or otherwise. This may not be used by anyone, including the party that commissioned it, to persuade or dissuade other prospective investors.

1. Economics

In our limited review, we found some items of concern as reported in this section. These may or may not be indicative of problems, and should probably be followed-up with questions to the Company for clarification. We can pursue this further if desired.

- Evidence of high-end marker - The Plan devotes considerable space to the general prevalence in the country of _____ problems, but shows essentially no data regarding the particular market for people who can afford to pay Rs.____ to Rs.____ (or more) out of personal funds to deal with it in a luxury setting. The presumed existence of such a sub-market is the cornerstone of the whole Plan. This target market may well exist to the point that four dozen such people can be found every month or two, for years to come, but no evidence is presented.
- Inadequate budget to provide deluxe environment - People that are paying this price range may expect private rooms, and better food and more personal attention than what is presently included in the Plan. People are to sleep two to a room, food is budgeted at about Rs.____ per month per person, and the professional staff is budgeted at about _____ professional

(_____, etc.) for each five guests. Taking into account the 24/7 nature of the situation, the 1-to-5 ratio is actually even worse, at this would imply each guest would get about 1 hour per 24-hour day of individual attention, and actually less when further taking into account that some of the professionals' time will be spent in group activities, and thus unavailable for individual attention. Similarly, the Plan appears to provide for very few kitchen staff and housekeepers, especially in light of the 24/7 setting and the high-end clientele. There appears to be no budget for a _____, and a fulltime one would only allow an average of less than one hour per week per patient. It is the nature of most such start-up plans (i.e., for a new business model) to not anticipate all costs, and thus it would be both reasonable and prudent that a non-trivial allowance should also be provided for "Unanticipated Other Costs" (perhaps about 15% of the total of identified costs). These budgeting issues suggest lower profitability than what is indicated in the Plan, or worse, forthcoming client dissatisfaction with the experience, or, perhaps a lack of business/operational/management experience (and/or attention to detail) on the part of the founders.

- Significant omissions in the budget, or extra fees to the clients - The Plan states that "all treatment services" as well as "outside functions" are included in the very large fee. The Plan describes a significant roster of "Adjunct Services" which will be available (e.g., _____ services, _____ management, _____ feedback, conditioning, _____, _____ treatment, _____ services, etc.), all to be provided by outside contractors. There does not appear to be any funds in the budget to cover this, which would likely be a significant cost. The alternative, of charging extra for these items, would not appear to fit well with the high-priced "all inclusive" portrayal.
- Treatment pricing is twice as high - The Plan seems inconsistent as to the average cost per patient, variously citing full term price of Rs._____, a monthly fee of Rs._____ "an average length of stay of two months" (i.e., Rs._____), and Rs._____ per month in the P&L spreadsheet. Additionally, as above, will there be potentially substantial extra fees charged?
- Plan details for equipment and furnishings not provided - Perhaps it has been done and simply not included, but we see no list of major assets required, and associated costs of procurement, nor any estimate of the total funds budgeted. For example, the facility is in effect going to be operating a small restaurant, if it

is to include all meals for 48 or so people (plus staff?), three times a day (plus late-night snacks available for the “deluxe” environment?), seven days a week.

- Financial results for the ramp-up years - The spreadsheet that we examined was not labeled as to what year it represented (i.e., the first year, or the fourth year, etc.), but showed the client load already at essentially full capacity. The economics of the ramp-up years were not shown in our copy; these years could possibly be more problematic in terms of cash flow.
- Higher density per building - The property is reported as _____ acres with _____ existing homes, which are described as capable of housing 6 clients each. The Plan then provides for an additional _____ homes to be built on the property, which implies they would have to house ten clients each to reach planned capacity; this larger group size is not mentioned.
- Competitive advantage - Being “first to market” (as stated in the Plan as a key competitive advantage) in this particular situation does not infer much in the way of lasting competitive advantage, as far as we can tell. Likewise, the Plan statement that their _____ services ... can not be duplicated” rings rather hollow. There is a strong market and few providers, these may not matter. We have not spent time to search for possibly pre-existing high-end competitors; this can be pursued if desired.

2. Usage of Stock Sale Proceeds

In our limited review, we found items of very substantial concern in this section, which we believe should be clarified in writing with the Company prior to any investment.

- Document contradictions - There were two documents provided (“Confidential Private Placement Memorandum; Rs. 10,000,000; _____, Inc.; Equity Shares” and “_____; Confidential Document; Contact _____; _____, Inc.”), and these two documents at times appear to contradict each other, including with regard to the usage of share sale proceeds. It is our lay interpretation that the Private Placement Memorandum would be the definitive legally binding language; if this issue is a concern, an attorney should be consulted for a professional legal opinion on this issue (which we cannot and do not provide). For the sake of brevity, our comments with regard to the usage of proceeds apply primarily to the Private Placement Memorandum (“PPM”) document.

- Half of the proceeds to be raised are targeted to go to what is effectively the apparent anticipated cost of raising the funds. - This “half” also may well be the “first half”, i.e., if the full Rs.10 Million is not raised, the first funds (or perhaps even the first Rs. 5 Million) may go to these ends, leaving even less than half of what is ultimately raised for the business. This would appear excessive, and dangerous to the integrity of the stock investment from the investor's perspective. Of the other half, a significant piece is slated for overhead, analysis, and other “soft” costs; only Rs.4.2 Million of the Rs.10 Million is specifically slated for real estate costs, construction, and asset/equipment requisition. The PPM also states, with respect to the Rs.5 Million that is earmarked for the cost of raising funds, and all other categories, that “any unused sums in any of the above categories may be retained by the Company for any purposes ... including ... payments to the principals for management fees.” It is our interpretation, which may be incorrect, that the PPM states, in effect. That substantial amounts of the Offering may be paid directly to the principals, in unspecified ways, with no defined oversight or scrutiny.
- It is not all clear that the funds earmarked from this stock issuance will be used to purchase any property - The footnote that explains what the “Real Estate Costs” are does not mention the purchase of any property; rather, it says that this Rs.4 Million is “Reserved for the pre-payment and continuing of leases ...”. It further mentions “leasehold improvement for space renovations including architectural drawings and consultation.” This would appear to be a somewhat cryptic reference to the only lease mentioned, which is the presently leased _____, 000 square foot office space, which is not part of the residential property being considered for purchase. The PPM further states “The Company plans to use the capital provided by this Offering for advertising and marketing, accounts payable or other working capital and general corporate purposes that management determines are in the best interest of the Company.” We can find no place in the PPM where it indicates planned usage of the funds for acquisition of the real estate and facilities, which acquisition is the supposed cornerstone of the Plan. Additionally, it states “Management is not restricted in the application of the funds as provided in this Memorandum under the caption 'Use of Proceeds'.” This is close to a “blank check.” In our view, the charitable interpretation of these facts is that the PPM document is poorly written. We regard this as a substantial “red flag.”
- Stock investment could be at substantial risk if inadequate funds are raised in

Offering - The Offering is being conducted on a “best efforts, no minimum basis,” stating that “There is no minimum amount of proceeds that must be raised before the Company may use the Proceeds of this Offering, ... The Company will have broad discretion in the use of these funds. In yet another area it states “Whereas the total amount of the offering may not be raised, there is substantial risk that if the total amount is not raised there may not be sufficient capital to complete any of the projects contemplated. To that extent, the investor may lose all of the investment.” While it can certainly be claimed that this is “just legal boilerplate,” consider two things: 1) subscriptions such as this can be, and often are, structured such that if a certain threshold amount is not raised, then all the funds get returned; this PPM is very pointedly not that way; and, 2) the Company specifically states in the PPM that “The Company has not been represented by legal counsel in connection with the preparation of this Offering”. so who then wanted the deal structured this way, and that language included? If there is inadequate funding raised to accomplish the Plan objectives, the Company is under no obligation to return any funds to stockholders, and from all apparent writings, it would appear that the Company has no intention to return funds under such a scenario. This also plays in to a concern raised in Section 3 below.

3. Ownership, Control, Accountability and Investment Exit

In our limited review, we found items of very substantial concern in this section.

- Present ownership and control: At present, the majority of the Company's stock is reported by the Company to be owned by _____ (35.1%), _____ (19.2%), and _____ (10.6%), collectively 64.9%, with the next largest holder reported at 7.4%. We have absolutely no further information on any of these people, including even what their first names are. They are not listed as Officers. The Board of Directors is not identified, and we do not know if it has even been established at this point. We do not have access at this time to the Articles of Incorporation, or the Bylaws, which could be critical. The PPM states that “certain provisions of the Company's Certificate of Incorporation and Bylaws and of _____ law may delay, defer, or prevent a change of control of the Company and may adversely affect the voting and other rights of the holders of Common Stock.”
- Control by presently subscribing shareholders: The Offering is for 10.0 million

shares, and it states that there are presently only 0.2 million outstanding, and further, that the Company is authorised to issue a total of 25.0 million shares of equity stock, and that the Board can issue the remaining 14.8 million additional shares (subject to _____ law) without stockholder approval. The bolders of these new shares (which could, or may have to be, issued at a vastly lower price) could then control the majority of the Company's stock. There is no mention that we saw in the PPM of any election of Directors shortly after the subscription for the present stock. The PPM states, "The Investors shall not be entitled to receive a copy of the list of Investors." It appears to us as a distinct possibility that unless someone (or a group of parties that knows each other before hand) subscribes to more than half of the current Offering, that the subscribers to the Offering may have absolutely no method of influencing the Board, even if 90% of the shareholders felt the same way.

- **Accountability:** near absolute power of the unidentified Board - The PPM states that if the Company has inadequate funds to carry on it's business, that it may issue more shares in a attempt to raise additional funds. The new shares may be of the same, or a different, "series" of stock. Further, the PPM states that the Board of Directors has the authority, without stockholder approval (subject to _____ law), to alter the rights, privileges, and voting of the shares outstanding (including those being offered in the PPM), and may apparently do so differently by series (e.g., to give the second series different rights than the first series). Lastly, the PPM states "the Board of Directors may authorize and issue Preferred Stock with voting or conversion rights that adversely affect the voting power or other rights of the holders of the Common Stock. In addition, the issuance of the Preference Shares may have the effect of deferring or preventing a change of control in the Company." This appears to be unconstrained by any stockholder vote. Our lay interpretation of this is that the common shareholders do not effectively control the Board here; this is not a legal opinion, and an attorney may not agree with out assessment. We see the combination of the items above as a substantive red flag.
- **Insulation of the Board:** The PPM states "The Company's Certificate of Incorporation and Bylaws contains provisions that limit the liability of directors ... and provides for indemnification of officers and directors under certain circumstances. Such provisions may discourage stockholders from bringing a lawsuit against directors for breaches of fiduciary duty and may

also have the effect of reducing the likelihood of derivative litigation against directors and officers even though such action, if successful, might otherwise have benefited the Company's shareholders. In addition, a stockholder's investment in the Company may be adversely affected to the extent that costs of settlement and damage awards against the Company's officers and directors are paid by the Company pursuant to such provisions." This kind of provision is not all that uncommon, and is sometimes used by bonafide companies to discourage frivolous lawsuits and to entice good people to serve as officers and directors; however, in conjunction with everything else here, it is worrisome. The PPM also states, "Investors shall not have the right to receive copies of any federal, state or local income tax or information returns. ... Investors shall not have access to the books and records of the Company." Again, this may actually be not uncommon, but in our case, no independent outside auditors have been named, nor has there been any mention that some such chartered accountant firm shall be found; only annual reports are committed to (none quarterly, and nothing as to being audited).

- Investment: Substantial restrictions apply with respect to any sale of an investor's stock. Dividends are not assured, even if the Company is profitable. Prospective distributions to investors are not clearly defined. This is not necessary uncommon.

4. Founders, Officers, Principals

In our limited review, this section came up largely neutral. There are a couple of things that would be problematic if they are truly associated with the Principals; we can pursue this further if desired.

- Same level of comfort established - In the time allocated for this section, we did not find any conclusive evidence that any of the principals identified have problematic records. It should be noted that this is not always easy to find, and we did not, for example, spend the time yet to check non-current records. We have not done thorough background checks. We have, however, done enough probing to give us some degree of comfort with respect to the principals. We spent a fair amount of time looking and coming up with nothing, which in general is a good indication. If thorough background checks are desired, please let us know.
- _____ appears to be bona fide. The proposed Chief _____ Officer.

_____, is shown on the website of _____, as the _____ Director of the _____ Centre, where it states that he “has more than 10 years of experience in _____” and that he “received his _____ degree from the University of _____, _____ School and has practiced _____ for 15 years,” among other things.

- No certain information found on other - There was no definitive information of any sort (positive or negative) found regarding _____ (the proposed CEO), or _____ (the President), _____ state corporation records show Mr. _____ as the only listed officer, holding positions of President, Treasurer, and Secretary, and listing a _____ address from him. We likewise found nothing on the two or three largest present shareholders; their last names are somewhat common, and only their first initial is listed (a with no indication of where they reside), so it is not likely that anything conclusive would be found on these names, even if it certainly exists. We have no indication at this point if these shareholders are insiders or exert any real control or influence.
- Potential problem areas - There were several pieces of non-conclusive information, which may well be coincidences that do not pertain to the principals; however, if they did actually pertain, it would be of significance, and troubling. These can be investigated further if desired. They include two of the companies listed in the experience portion of Mr. _____'s bio-data (where he was alternately the _____ manager and the CEO) are not listed with complete names (i.e. “ABCD” and “T.S.G.”); there is (or was) a company called “PMFG” of PQRS City, California that has had troubles with the SEBI; likewise there is a “TSG” that has also had troubles with the SEBI. It would be prudent to simply clarify the complete names of the companies that Mr. _____ worked for. Additionally, there appears to be another, different, _____ on the west coast in the same field; there is _____, Advanced _____ Care” website, with a different educational and professional background; the site also has a photo, at www._____.com. We did not call to check Mr. _____'s prior employment claims.
- Corporate identity - The Company was incorporated Sept. ____200____. The Company has a website domain name reserved at www._____.com (with no functioning website yet). There are at least two previously existing organisations with similar names: the _____ at the University of _____

_____ is sometimes referred to as the _____. There is a _____ in _____, _____ (which may be near _____).

- Officer's stock - The present officers appear to own no company stock at present, although there are _____ shares variously described as either “reserved for management” or “owned by officers and directors” (although there are only _____ shares listed as having been issued to date, and none of these shares are ascribed to any of the listed officers).
- Company's Officers and Directors may beneficially own a significant portion of the outstanding equity Shares of the Company.”
- Officers' compensation - There is conflicting information regarding the proposed compensation of the officers. The PPM states that “All compensation to the Company's Executives will be in the form of stock and/or stock options for the foreseeable future.” On the same page it also says “Officers and Directors are expected to draw limited salaries after this Offering has been successful.” Note that it is generally not common that directors would immediately receive salaries in the initial stages of a start-up, and that the identities of the Directors has not been provided, nor has anything been established with regard to elections of Directors; so who then are the Directors loyal to? The shareholders, or the people that pay (and determine) their salaries? The PPM further states, “For the most part, these persons control, and will continue to control, their levels of executive compensation in future years, which may be significantly higher...” The spreadsheet attached to the other document (not the PPM), shows Mr. _____ with a Rs. _____ per year salary, and a bonus (not necessarily all to him) to be paid of another Rs. _____. While talent should be paid well, and if this is successful such compensation may not be at all out of line, this comes across to us as being handled in a less than forthright manner. Nothing is shown with regard to compensation plans for Mr. _____, who is the only officer listed in _____ corporate records, and who is President and Treasurer, and is not listed as a shareholder in the PPM. Mr. _____ is presumably not doing this for charity, and the complete lack of any disclosure regarding his financial ties adds to the overall problematic lone here.

5. Summary Conclusion

We believe that either this has been inadvertently poorly written and structured, or else it is a rip-off. It is difficult to tell which, even if it is not inadvertent, it is likely

that some of the principals may be entirely innocent, such as Dr. _____ who may have been talked into joining this, and may not be involved in or knowledgeable about the structuring, financial, and business issues. In either case, we would not be comfortable recommending it unless certain aspects of the Offering were changed, and some additional disclosure was made. There are some important issues here (as well as a number of possibly not so important ones). Some of the key ones may largely be legalistic “technicalities,” but they could absolutely be deadly to an investor, and they are in cumulative total, “out-of-line.” If they are not intended, they should be changed.

The investor is, in effect, depending entirely upon the goodwill of the Board of Directors in order to not be screwed, and the Board is neither identified nor is near-term elections plainly provided-for. Important items to consider include:

- This Company has been set-up to largely bypass the normal accountability and checks-and-balances. Perhaps they do not intend to utilise that capability; are you comfortable in counting on that?
- It does not appear that they are bound to use any of the proceeds raised to actually acquire the necessary real estate.
- It appears that if the Offering is less than fully subscribed, then there is significant possibility that the subscribers will lose their entire investment.
- It appears that a huge portion of proceeds raised will be paid to people raising the money, and very possibly to the founders.
- Additionally, there are potentially significant documents not disclosed, and the budgeting appears amateurish.

4

Due Diligence for Venture Capital Investment

Background

Before making any investment, the goal as venture capitalist is to understand virtually every aspect of the target company, the experience and capabilities of the management team, the business plan, the nature of its operations, its products and/or services, the methods by which sales are made, the market for the products and/or services, the competitive landscape, and other factors that may affect the outcome of the investment. While due diligence exercise is viewed by many as mundane and irritating tasks, the process enables venture capitalist to address areas of concern and is an important tool in determining a fair pre-investment valuation, and may help to avoid significant and otherwise unexpected liability following the investment.

For venture capitalist, the due diligence process is a means of identifying and becoming comfortable with the risks to which the capital would be exposed. The due diligence process for venture capitalist involves an assessment of both the microeconomic and macroeconomic factors that can affect the earnings growth of the target company. The due diligence process also includes a review of the corporate and legal records, including the documentation supporting any previous issuances of the company's securities.

Microeconomic Analysis

These are the factors within management's control and include a careful assessment of the management team, the business model, the value proposition, the distribution strategy, the intellectual property, the financial strategy and capital requirements, and the legal structure and records of the company.

Macroeconomic Analysis

These factors are generally outside of management's direct control and include a review of such areas as market size and expected growth potential, the perception of the company and its products by its suppliers and customers, the competitive situation and product differentiation, and government and regulatory influences.

Over the years, an extensive due diligence questionnaire have been developed and fine-tuned which is usually provided to prospective companies at the inception of the due diligence process.

Due diligence, itself, is both a quantitative and qualitative process. The due diligence process commences only after the venture capitalist has spent sufficient time with a prospective company to become convinced that spending the additional time and energy required will be a worthwhile endeavor.

Perhaps, the most critical aspect of the entire process is the close interaction between the venture capitalist and the management team of the company being considered for investing in throughout the due diligence process. In the process of getting better acquainted with the management team, it is important to discern whether the management team is appropriately experienced and committed to the business, as measured through the team's behavior as well as their response to queries.

While some of the findings of the due diligence process do little other than to confirm the initial "gut feelings" of the venture capitalist, there are some areas that are best described as "show stoppers." Show stoppers include determining that the target company has a flawed business plan, is managed by a group of convicted felons, has technology that does not work, or products that cannot be sold. However, there are other, less obvious issues that may arise in the due diligence process to cause a

venture capitalist to break off discussions with a company.

One such problem is the inadvertent violation of provisions of the regulations of Securities Exchange Board of India (SEBI) that occurred when the target company was raising prior rounds of capital. Unfortunately, this is a frequent *faux pas* committed by many early-stage companies that raised their initial capital from family, friends, and casual acquaintances without proper documentation. In this instance, the company and an unsuspecting investor could find a significant portion of the proceeds of new financing being used to fund the repurchase of securities from disgruntled existing investors who may successfully sue for rescission of an earlier and improperly documented securities offering.

For instance, it might be agreed on a preliminary term sheet, subject to the satisfactory completion of due diligence. The due diligence exercise could establish a pre-investment valuation of the company significantly lower than the two previous investment rounds. Individual investors, many of whom were not accredited investors, might have funded both of those financings. Additionally, it could be determined during the due diligence process that there were numerous failures to fully comply with the provisions of SEBI Regulations. Because the proposed financing could be extremely dilutive to the existing common stockholders, there might be considerable consternation among the investors in the prior rounds. Ultimately, it could be concluded that the only cure for the SEBI violations would be for the company to initiate a rescission offer to repurchase any securities that the earlier investors wanted to sell back to the company; the price of the rescission offer would have to be at the price those investors paid for the stock they had purchased. It would be possible that most, if not all, of those investors would tender their shares and recover their original investment. The cost of completing the rescission offer would have consumed a significant portion of the proposed investment and increasing the proposed investment would have adversely affected the economics of an investment in the company. Ultimately, it drives the decision not to proceed with an investment in the company.

Pending litigation can be another issue that can bring the investment discussions to an abrupt halt. Not being able to determine how a court or a jury may rule in a patent infringement suit is generally not a risk that a venture capitalist is willing to assume.

To summarise, if the due diligence process confirms an investors' initial instincts, nothing untoward arises during the review process, and the additional time spent between the venture capitalist and the management team results in a positive working relationship, the result is likely to be successful closure of an investment in the company. Additionally, a detailed due diligence process usually results in a more informed investor who can help management in the value-creation process from inception rather than spending time following the initial investment trying to understand the business and the challenges faced by the management team.

Due Diligence Check List

Typically, due diligence for venture capital financing covers examination of the following:

Corporate Books & Records

- a) Charter and By-Laws
- b) Minutes of Meetings
- c) Recent Records of Officers and Directors
- d) List of Shareholders
- e) Company Registrations
- f) Reports to Shareholders

Financial Information

- a) Financial Statements
- b) Taxation Matters
- c) Indebtedness
- d) Contingent Liabilities

Employee Matters

- a) Organisational Information
- b) Agreements
- c) Benefit Plans

Legal Matters

- a) Regulatory Compliance

- b) Litigation

Contracts, Agreements and Other Arrangements

Proprietary Rights

- a) Licences
- b) Royalty Arrangement
- c) Infringements, if any, on these rights

Plant, Property & Equipment

- a) Real Property/Assets
- b) Encumbrances, if any
- c) Description of Facilities

Insurance

- a) Assets
- b) Employees
- c) Directors
- d) Loss of Profit
- e) Transit Goods

Sales & Marketing

- a) Description of Market and Share
- b) Customer Identification and Profile
- c) Potential Market
- d) Sales Policy

Others

- a) Company's Information Management System
- b) Future Business Plan
- c) Press Releases

5

Due Diligence for Franchisee Arrangement

Franchising is a popular method of doing business and the chances for success are greater than those of independent business owners. To ensure survival some basic but vital steps should be followed. Essentially, conducting due diligence is essential. The fundamental factors for this due diligence are:

- *Know the Market.* Once the picture of what can be afforded and the type of franchise concept is clear, investigate the demand for that particular product or service in the proposed assigned area. Just because one type of business works in one region does not mean it will work in the community where it is proposed to open the franchise. Some things to consider are the level of competition in the target market and whether a concept has only seasonal marketability.
- *Comparison Shop.* Even if the heart is set on one company, it never hurts to look at other opportunities to make sure the investor is signing on with the best concept for the skills and interests. One way to do this is by attending a franchise tradeshow and/or using a franchise consultant who will enter the criteria into a database and then present companies that match the investor's parameters. There are numerous web sites that allow to see a snapshot of several concepts at once. It is a good strategy to talk to existing franchisees of the franchise company in which the investor is interested.

- *Study the Franchisor's Offering.* No contract should be signed or any payment made until the opportunity to investigate the franchisor's offering is obtained. All earnings statements should be substantiated. The franchisor should be requested to disclose important information about the franchise system such as the past earnings, franchise agreement terminations, number of outlets are in operation, etc. Because investing in a franchise involves a substantial investment, it is imperative to consider having a legal review of all documents and franchise agreement, as well as have a financial review of the franchisor's earnings claims.
- Find out the *training and support* (technical, administrative, training, etc.) that the franchisor provides. One of the advantages of buying a franchise is that the franchisor provides intensive training on how to run the business and offers some kind of ongoing support.
- *Talking to existing franchisees.* This is an important step because they can give honest feedback and substantiation of what the franchisor tells. They can be requested to share their experiences and advice, if any. Following is an illustrative set of questions that can be used to gather useful information from the franchisees:
 - Why did you select this particular franchise system over others in the same type of business?
 - What line of work were you in prior to purchasing a franchise?
 - Were you content with the initial training and support you paid for and were promised?
 - Did the training only cover the operating system or did the training prepare you to compete with other businesses providing similar products or services?
 - Did you encounter any problems with the franchisor, the site, or establishing your business and how did the franchisor respond to problems?
 - How would you describe your overall franchisor/franchisee relationship?
 - What are your thoughts on this industry, the products and/or services available, and what trends do you see happening for the future?
 - Do you have any issues or concerns with the franchise agreement? Were there any clauses that stuck out over others that may impact your relationship with the franchisor?

- How has the franchisor responded to your calls for support about business operations or any other general questions you may have had?
- Are you pleased with the quality of ongoing support, mentorship, and advertising campaigns provided by the franchisor?
- Has the franchisor responded to any of your own ideas about improving the franchise system?
- Are there any other franchisees or former franchisees you recommend I contact?

If the individual is a former franchisee:

- Why did you leave the franchise system?
- Did the franchisor cooperate in helping you sell your franchise?
- If there was a termination or non-renewal, did the franchisor explain why and provide a reasonable opportunity for you to cure the problem?
- Would you consider buying a franchise from a different franchisor?

Further, the following guidelines help to make a diligent assessment of the franchise system.

Popularity of the Franchise System

If investment is proposed in a new franchise system (one that has been in operation for less than five years or has less than twenty outlets) it is important to consider that the business that is being bought may not be that well known yet to give an edge over the competition. Buying into a new concept does not mean that it is necessarily making a bad investment; it just means that at the onset, one may not gain the same advantages as those built into a mature franchise concept such as consumer brand awareness.

Franchisor's Management Team and History

It is important to know who the key players are in the franchisor's management team. One may not get access to their resumes but their work experience should be enquired into and more importantly, their franchising experience. Information should also be gathered about aspects such as their membership in certain other organisations, their past track record, any lawsuits or pending convictions against them.

Financial Strength of the Company

If the franchisor is growing the franchise system with the influx of new franchisees and has no working capital or investment backing, this may be a sign of trouble. A review of the financial statements of the company, the financial stability of the franchisor's system can be assessed. Without this financial security, a franchisor cannot sustain operations and worse yet, cannot possibly expand.

Growth of Demand for the Franchised Concept

An easy way to address this question is to do a concept search on many of the franchise directories available online. Market research and review of trade magazines or journals is also useful in this regard. If the concept has been in operation for many years but it is one of few in the marketplace, this may be an indication that it is not a fad. On the contrary, if the concept is extremely unique, it might not have acceptability among public.

Trademark and Brand Protection

The franchisor's trademark is the most important level of protection that makes the concept uniquely distinguished from others in the industry or marketplace. A franchise system could have a number of “marks” such as logos, names, slogans, products, designs or a combination of these.

Franchisor's System for Choosing Franchisees

The franchisor should have a proper system in place for selecting candidates. The primary considerations in allotting/ granting franchiseeship should be examined. The franchisor should not be motivated to sign on franchisees simply because they are lining up to buy franchises. To be granted a franchise means a franchisor's investment in the franchisee.

Operational Outlets and Stores

A schedule that lists the names and locations of franchises that have closed over a certain time frame and the stores that have changed hands as well should be prepared. The reasons for the closures should also be determined. A franchise closure has more negative impact than one changing hands but both needs to be explored. Too many closures and/or terminations can signify an underlying problem or issue regarding the franchisor's reputation.

6

Challenges and Risks Covered in Due Diligence Process

The Value of Due Diligence

Prior to engaging in any business relationship, knowledge of the respective company and individuals must be based on facts, not perception. Due diligence findings have to provide conclusive, documented legal information about the target company's litigation history, credit history, business formation and a host of other pertinent information. In this litigious society it is common to identify pending civil litigation not previously revealed, including discrimination, monopolistic practices, and intellectual property lawsuits.

Acquisition due diligence assesses the risks and opportunities of a proposed transaction. It helps to reduce the risk of post-transaction unpleasant surprises. It is vital that the results of any due diligence process are relevant to the transaction including:

- Valuation of the target and therefore the purchase price
- Sale and purchase agreement (e.g. accounting definitions, accounting and tax warranties and indemnities, etc)
- Integration plan (e.g. deal synergies).

There are a range of circumstances in which companies can benefit from externally provided acquisition due diligence, *viz.*,

- Where any organisation is considering an acquisition, merger or joint venture.
- Where the organisation or deal manager has limited experience in undertaking due diligence.
- Where existing advisers face a conflict of interest, or are not well placed to undertake the necessary due diligence.
- Where the required due diligence demands technical capabilities and commercial experience beyond the organisation's internal resources.

Doing business in emerging markets requires an acute understanding of the unique risks present and an ability to mitigate those risks. Without such an understanding or ability, any business, is exposed to a variety of threats to their operations, assets and profit line.

Having an effective risk management or security programme in place allows a business to protect its bottom line and maintain competitive advantage. The business environments in these markets are all very different, each having its own unique characteristics.

Different Markets, Different Challenges

Each country and its market have different features and therefore different challenges. For example:

- Unfamiliar customs, cultures and languages make understanding and controlling risk difficult.
- Complex regulations, a different legal system and priorities create barriers to enforcement.
- Political and economic change, business closures, rising unemployment and grey markets can create hostile environments.
- Obscured conflicts of interest, intricate personal networks, all make forging business relationships difficult.

Different Challenges, Different Risks

These challenges give rise to various risks that need to be searched and examined during the due diligence process. The risks, generally, entail:

- Revenue losses from counterfeit goods, trademark infringements and grey market activity
- Theft of proprietary information and industrial espionage
- Collusion, corruption and fraud
- Loss or damage to physical assets
- Physical threats to employees and their families
- Damage to business reputation from unethical business practices or local contractors and business partners.

Effectively addressing these risks requires any business to possess an acute understanding of the various ethnic, cultural, socio-political and economic factors affecting the business environment.

Culture Aspect

During the due diligence process, especially in case of merger and acquisition, it is equally important to pay attention to what is called human due diligence. Under “human due diligence,” understanding the culture of the organisation, the roles that individuals play, and the capabilities and attitudes of the people are grouped. During the due diligence process, focus requires to be given on identifying key employees to be retained. The new organisation will need the right talent and an integrated, consistent leadership voice to make the merger successful. But when it comes to how to factor in the two cultures into a new organisation, leaders need to identify something more substantive than “decision making styles” to better understand the role of culture in making or breaking the merger. Therefore, a critical element of the due diligence process is an assessment of how well each company is doing in executing key management practices that have been proven to be linked to bottom line results. One company may be stronger in some practices than the other. When working with companies who are looking to merge or acquire the other, it is important to know how the two companies measure up individually in executing these management practices. This assessment tells where the gaps might be that the leaders will need to address before, during, and after the merger. Otherwise it may be merely looking at what is called “culture” and find out only later

that it was more window dressing than substantive business concerns.

This exercise can give both companies a clear picture of how well each of them is doing in four critical areas that reflect both an external and internal focus:

- Adaptability
- Mission
- Consistency
- Involvement.

It is a matter of concern in a merger that indicates that neither organisation has a particularly strong ability to adapt to market changes and customer needs (Adaptability) than how similar are the dress codes or benefits packages. Not to say that the merger should be abandoned but instead such an assessment will present the post-merger challenges and risks more clearly and concretely to the decision makers. This makes for a more robust due diligence, focused on the key management practices that will ultimately determine the success of the merger and, more importantly, bottom line business results. Otherwise, the two companies run the risk of falling into the trap of assuming the acquiring company or larger company's culture will be the culture of the new company. This could end up perpetuating, or even exacerbating, the deficient management practices in the new company. Better to find out where each company stands during the due diligence process by asking up front the people who see the company's culture from the inside looking out. No matter how challenging a merger or acquisition can be to the executives in charge, it is that much more complicated in the trenches. All the more reason to concentrate on assessing and understanding the culture from grass roots perspective. Otherwise, leaders retained will squander their talent by assuming culture means one thing when it really means another.

Employee Screening

Security risks to companies are both internal and external. Loss prevention begins internally, with the employee or business partner, only following that, does it deal with the non-employee and external factors. Hiring employees is one of the most critical business decisions a company makes. Recruiting new staff members on the basis of personal recommendations and appearance is not enough. Experience has

taught many businesses that if they had objectively and comprehensively screened candidates prior to employment, many malpractices such as conflict of interest, industrial espionage, theft of proprietary information, contravention of business compliance issues, business fraud might have been avoided.

Employment screening is an essential process to safeguard any business from hiring persons who are either unqualified or of questionable integrity. Screening applicants through pre- and post-hire enquiries is loss prevention in its purest sense. This should not be restricted to employees, as the future problems that choosing an unsuitable business partner or vendor may create, should not be underestimated. To address this issue is due diligence and companies are encouraged to approach suitable professionals who specialise in this and related services, with wide network. This places them in an excellent position to screen emerging market-based applicants who may have studied or resided overseas or worked at companies that are incorporated or headquartered outside of India.

The extent of screening is determined by the seniority or sensitivity of the position to be filled; this also applies to joint venture partners or vendors when checking companies. Screening both existing and new employees at all levels is important. Even the lowest level of employee might have access to proprietary information and processes that are critical to the efficient running of the company. Companies should also consider screening personnel being either relocated to or promoted into areas where they will have additional responsibilities.

The overall objective of employee screening is to “protect” a company against hiring personnel who exaggerate or make false claims about their qualifications, work experience and personal background or, identify weaknesses or withheld information that is relevant to employment such as previous criminal convictions or misconduct.

There should, however, be a balance between the risks involved *vis-a-vis* cost of employee screening. Further, though complexity and budget will vary from company to company, initial outlay can assist in reducing potential for large losses. It is a recognised fact that the soul of any organisation is its people and the

company's performance improves by providing care and attention to personnel selection. It is recommended that with any programme embarked upon, screening or background checks must be adapted to job level or size of company to be checked. Selection of an individual or company must be on an objective basis, not a subjective criteria and uniformity of processing is vital if the programme is to succeed, otherwise the programme will be piecemeal and vulnerabilities exist.

For the purpose of due diligence, it is strongly encouraged to contact industry leaders in security who can also be consulted on risk management, commercial enquiries, information security, personal protective services, and many other specialist fields offering premier security consultancy services for a systematic approach to asset protection.

Environment Risk Coverage

Environmental, health and safety (EHS) due diligence is the best way to avoid unforeseen environmental liabilities with new acquisitions.

When carrying out real estate acquisitions, divestitures or stock transactions getting clarity on the environmental, occupational, public health and safety regulations that could influence the investment can be an ordeal. That is why it is imperative to conduct a thorough EHS due diligence assessment before buying a facility or property. EHS due diligence assessment includes the necessary on-site and desk studies for identifying potential environmental liabilities associated with the acquisition, leasing and/or divestiture of real properties. Typically, EHS due diligence is used to determine whether:

- The facility has or will be able to obtain the right permits to do what it is doing or planning to do
- The permits will remain valid
- There are any constraints on permit renewal
- The facility has implemented the proper systems to ensure compliance
- The equipment used on site is safe
- The facility has a proper safety track record, etc.

EHS due diligence assessment analyses and outlines the legal ramifications to help ensure the acquisition company or the investor will not be exposed to liability.

Site Contamination, Liabilities and Hidden Costs

Investing in a new business overseas is always a challenge. Focusing on limiting the risk of acquiring contaminated site liabilities may sometimes overshadow the main purpose of the investment - running a viable and sustainable business that meets high environmental and occupational health and safety standards. Therefore, this part of due diligence combines EHS risk assessment and regulatory compliance verification.

Following are just a few examples of issues that companies frequently overlook during a transaction:

- The absence of an air emission permit.
- The upcoming expiration of a fire safety certificate.
- The obsolescence or non-compliance of electrical installations or working equipment.
- The lack of emergency exits or restrictions on the import or use of an essential raw material.

Further, inspections and analysis, include:

- Subsurface sampling and analysis to confirm the presence or absence of contamination or other problems from soil, surface water and groundwater.
- Building integrity.
- Machinery conformity.

In many countries, these issues can result in significant delays in the start-up of operations. They may also require extensive additional investments to limit the risk of prosecution and other employer liabilities.

Information Technology Security

Majority of the organisations today utilise computer systems for delivery and support of their business. Rapid advances in technology have resulted in

deployment of new information technology (IT) systems. Adequate controls are not typically enforced in these systems resulting in higher risks and vulnerabilities. Concern over security, availability and integrity of IT systems is receiving increased attention.

Reviewing key IT components to help ensure the integrity and accuracy of information contained therein is of paramount importance to all areas of business and industry. A comprehensive technical review of the computing environment includes:

- Operating systems
- Network & Connectivity
- Vulnerability reviews of business applications
- Databases
- Change Management
- Governance
- Risk management
- Helpdesk services
- Disaster Recovery Plan & Business Continuity Planning.

The assessment methodology should cover the following aspects:

- Aligning business and local statutory requirements/mandates
- Performing risk assessment and identify potential risk areas
- Prioritising and categorise these issues
- Possible Action plan to remediate potential risk areas.

Conclusion

In sum, in addition to the traditional financial, legal and technical matters, the challenges cited above emerging with change in business environment and globalisation are significant factors that a comprehensive due diligence is required address.

7

Work Approach to Due Diligence

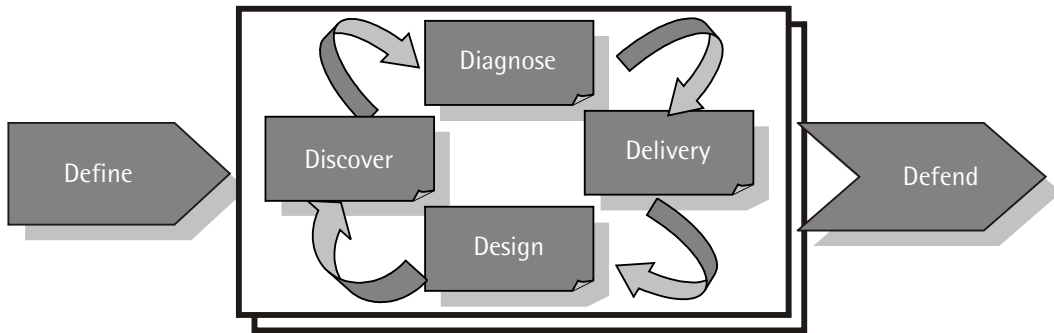
Work Approach to Due Diligence

The purchase of a business in many instances is the largest and most expensive asset purchase in life time and therefore some caution should be exercised through the due diligence process. Therefore, assessing the businesses fair value passes through:

- Reviewing and reporting on the financials submitted by the target company.
- Assessing the business first hand by a site visit (if applicable).
- Working through the due diligence process with the acquisition company or investor by defining the key areas.
- Helping prepare an offer based on completion of due diligence.

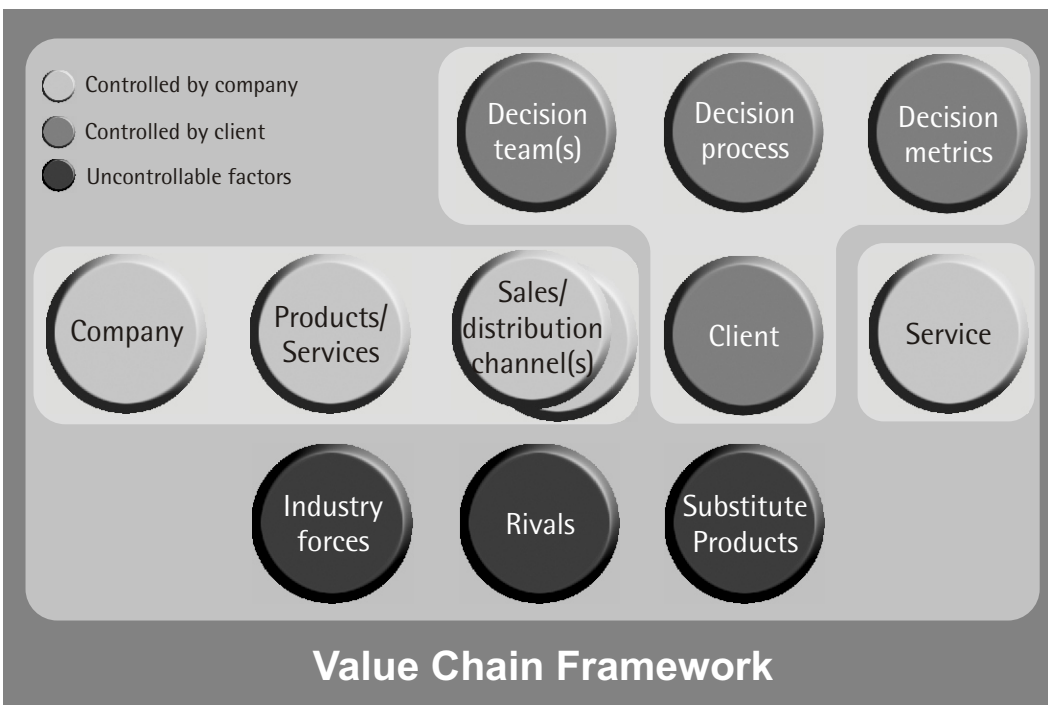
Discovering the correct strategy is always challenging, and even more so during challenging economic circumstances. Each situation is unique. The variables are numerous, including factors such as company age, markets, geography, price levels, competitive dynamics, to name but a few. But when a company and its products are tuned to match market needs and expectations - that is, the decision makers and influencers involved in purchase decision - exceptional changes in performance can occur. However, a comprehensive model that describes this approach to the work is

illustrated in the figure below:



Six Dimensional Process Framework

The approach as illustrated in the figure above is further expanded below to clarify the work stages.



It needs to make sure that no hidden time bombs are ticking away in the business proposed to be acquired. The process kicks off when both the buyer and the seller sign a letter of intent, or term sheet, which sets the starting purchase price for a deal. By signing the letter, the seller agrees to open up the target company to a top-to-bottom examination by the buyer and adjust the sale price based on the findings of due diligence. Here is what to keep in mind:

- a. **It is about managing risk.** Double-check financials, tax returns, patents, and customer lists, and make sure the company does not face a lawsuit or criminal investigation. Extra caution needs to be exercised if the company has never undergone an audit from an outside accounting firm. The company's customers can also be quite informative. The seller can be requested for a list of the most favoured clients and these customers can be called up.
- b. **Prioritise the people.** Background checks on the company's key officers should be undertaken.
- c. **Carry out the checks** as listed in Annexure 'A' of Chapter 3 with reference to documents and third part verification, as appropriate.
- d. **Prepare to fix the price.** The investor can and should use any flaws that the due diligence uncovers to negotiate down the sale price. Due diligence is "a chance to get a better deal."

How to Conduct Due Diligence

- a. Start with an open mind. Do not assume that anything wrong will be found and look for it. What needs to be done is to identify trouble spots and ask for explanations.
- b. Get the best team of people. If you do not have a group of people inside your firm that can do the task (e.g. lack of staff, lack of people who know the new business because you are acquiring a business in an unrelated areas, etc.), there are due diligence experts that you can hire. When hiring such professionals look for their experience record in the industry.
- c. Get help in all areas: finance, tax, accounting, legal, marketing, technology, and any others relevant to the assignment so that you get a 36-degree view of the acquisition candidate.
- d. Talk to customers, suppliers, business partners, and employees are great resources.
- e. Take a risk management approach. So while you want to do your research, you

also want to make sure that you do not antagonise the team of people of the target company by bogging them down with loads of questions.

- f. Prepare a comprehensive report detailing the compliances and substantive risks/issues.

Examples of Different Approaches

By and large, approach to due diligence exercise follows a common line. However, there are methodologies which different practitioners have developed to adequately cover the salient aspects of due diligence for various types of transactions. A vignette of these different approaches is provided in Annexure 'E' of this Chapter.

Valuation

Business valuation is another important task in the due diligence exercise. There are many reasons to know the value of the business -- if it is considered to buy a business, a merger or outright sale. Whatever the reason for needing to know this information, trying to come up with a valid figure can be a major effort and challenge.

A realistic business valuation requires more than merely looking at last year's financial statement. A valuation requires a thorough analysis of several years of the business operation and an opinion about the future outlook of the industry, the economy and how the subject company will compete.

There are many hard-to-measure intangibles that are a factor in the value of a business. It is not simply a process of adding up the numbers from a variety of reports. Business valuation has been called an art, rather than a science. Estimates of a business' value by various experts can vary as much as 30 percent.

Not only is there no consistency in methods used, but also there is also no consistency in naming the methods. Each method has a variety of names. The important factor in any valuation is that the method used is relevant to your type of business, providing a valid and supportable value.

This wide variety of methods available can be a confusing array to choose from. That is why a professional is often helpful. There are plenty of pros and cons for each method - and there seem to always be new valuation methods being touted.

Make certain a clear explanation of the valuation method is provided and justified. The current business owner needs to understand the possible valuation methods to be able to clearly defend the price of their business. For a buyer or investor, the reasoning behind the pricing is critical for evaluating the personal risk involved. Of critical importance to all parties is a sense of honesty in the method used.

While there is no such thing as absolute truth in business valuation, confidence in the eventual number is based on the integrity of the underlying process. To assure that integrity, many valuation professionals use more than one method, computing a weighted average to arrive at their final number.

Following are some common valuation methods.

Adjusted Book Value

It is one of the least controversial valuation methods. It is based on the assets and liabilities of the business.

Asset Valuation

This method is often used for retail and manufacturing businesses because they have a lot of physical assets in inventory. Usually it is based on inventory and improvements that have been made to the physical space used by the business. Discretionary cash from the adjusted income statement can also be included in the valuation.

Capitalisation of Income Valuation

This approach is frequently used by service organisations because it places the greatest value on intangibles while giving no credit for physical assets. Capitalisation is defined as the Return on Investment that is expected. In nutshell, one ranks a lists of variables with a score of 0-5 based on how strong the business is in each of those

variables. The scores are averaged for a capitalisation rate, which is used as multiplication factor of the discretionary income to arrive at the business' value.

Capitalised Earning Approach

This method is based on the rate of return in earnings that the investor expects. For no risk investments, an investor would expect eight percent. Small businesses usually are expected to have a rate of return of 25 percent. Consequently, if the business has expected earnings of say, Rs.50, 000, its value might be estimated at Rs.200, 000 ($200,000 * 0.25 = 50,000$).

Cash Flow Method

This approach is based on how much of a loan one could get based on the cash flow of the business. The cash flow is adjusted for amortization, depreciation, and equipment replacement, then the loan amount calculated with traditional loan business calculations. The amount of the loan is the value of the business.

Cost to Create Approach (Leapfrog Start Up)

This approach is used when the buyer wants to buy an already functioning business to save start up time and costs. The buyer estimates what it would have cost to do the startup less what is missing in this business plus a premium for the saved time.

Debt Assumption Method

This method usually gives the highest price. It is based on how much debt a business could have and still operate; using cash flow to pay the debt.

Discounted Cash Flow

This method is based on the assumption that a rupee received today is worth more than one received in the future. It discounts the business's projected earnings to adjust for real growth, inflation and risk.

Excess Earning Method

This method is similar to the Capitalised Earning Approach, but return on assets is

separated from other earnings, which are interpreted as the "excess" earnings you generate. Usually return on assets is estimated from an industry average.

Multiple of Earnings

One of the most common methods used for valuing a business, in this method a multiple of the cash flow of the business is used to calculate its value.

Multiplier or Market Valuation

This method uses an industry average sales figure from recent business sales in comparable businesses as a multiplier. For instance, the industry multiplier for an ad agency might be 75, which is multiplied by annual gross sales to arrive at the value of the business.

Owner Benefit Valuation

Under this method value of business is computed by multiplying 2.2727 times the owner benefit.

Rule of Thumb Methods

This is quick and dirty methods based on industry averages that help give a starting point for the valuation. While not popular with financial analysts, this is an easy way to get a ballpark on what your business might be worth. Many industry organizations provide rule of thumb methods for businesses in their industry.

Tangible Assets (Balance Sheet) Method

This method is often used for businesses that are losing money. The value of the business is based essentially on what the current assets of the business are worth.

Value of Specific Intangible Assets

This method is useful when there are specific intangible assets that come with a business that are highly valuable to the buyer. For example, a customer base would be valuable to an insurance or advertising agency. The value of the business is based

on how much it would have cost the buyer to generate this intangible asset themselves.

Sales Agreement

The sales agreement is the key document in buying the business assets or the stock of a corporation. It is important to make sure the agreement is accurate and contains all of the terms of the purchase. It would be a good idea to have a lawyer review this document. It is in this agreement that everything should be defined that the buyer intent to purchase of the business, assets, customer lists, intellectual property and goodwill.

The following is a checklist of items that should be addressed in the agreement:

- Names of Seller, Buyer and Business
- Background information
- Assets being sold
- Purchase price and Allocation of Assets
- Covenant Not to Compete
- Any adjustments to be made
- The Terms of the Agreement and payment terms
- List of inventory included in the sale
- Any representation and warranties of the seller
- Any representation and warranties of the buyer
- Determination as to the access to any business information
- Determination as to the running of the business prior to closing
- Contingencies
- Possibilities of having the seller continue as a consultant
- Fee - including brokers fees
- Date of closing.

Due Diligence Team

A due diligence team needs multi-discipline expertise. Finance and accounts and

legal specialists are the core to be adequately supported by market analyst, environmental expert, human resource specialist and the requisite technology specialist. Hence, it is an association or consortium approach that fits the bill for this exercise. Accordingly, the lead manager for the due diligence exercise has to arrange and organise this team. However, it may be mentioned that the description of the team given should not be taken as sacrosanct as this depends on the type and nature of due diligence. For example, in case of franchisee, finance and legal experts together with a market analyst may be sufficient.

ANNEXURE - E

OUTLINE OF APPROACHES FOLLOWED BY DIFFERENT DUE DILIGENCE PRACTITIONERS FOR VARIOUS NEEDS OF THEIR CLIENTS

I. Approach to Acquisition of Overseas Company

XYZ was engaged by two investment firms (“Client Firms”) to perform financial and operational due diligence on a Chinese manufacturer based in Zhejiang Province, China. The Client Firms were in negotiations to acquire a company to which the Chinese manufacturer was a key exclusive supplier. The Client Firms wanted to better understand the Chinese manufacturer's financial controls, performance, and operations in order to decide whether to make the investment and at what valuation. XYZ immediately deployed a team to meet with senior management of the Chinese company and to assess the company's operations and manufacturing capabilities. It carried out

Financial Due Diligence - XYZ addressed issues relating to the company's accounting system, financial performance, transfer pricing, payables to suppliers, royalty payments to the current owner, etc.

Operational Due Diligence - XYZ assessed the effects of changes in raw materials pricing on the business, existing equipment and capital expenditure requirements, worker satisfaction, management quality, potential effects of sales increase on operations, etc.

XYZ's due diligence addressed the key questions and concerns of the Client Firms and gave them the confidence to move forward and close the transaction on the best terms.

(Source: AuBridge Partners, LLC, USA)

II. Approach to Enter a New Market

XYZ advised a leading industrial chains manufacturer on selling its products into

the China market. The following steps were taken in helping the Client enter the China market:

- **Market Research:** XYZ conducted an in-depth research on the China market for the Client's products and identified the largest buyer of these specialty chains in China.
- **Relationship Building:** XYZ visited the potential customer to better understand its product specifications and to establish confidence and interest in cooperating with the Client. XYZ then hosted a meeting in China between the Client and Chinese customer to further build a good relationship between the two parties.
- **Production Due Diligence:** XYZ arranged a visit by the Chinese customer to the Client's factory to assess its products and production capabilities.
- **Contract Negotiations:** XYZ negotiated and finalized the sales contract between the Client and the Chinese customer.

XYZ helped the Client develop a distribution channel in the fastest growing market in the world for its products, despite a relatively late start as compared to its competitors. By selling to one of the largest accounts in China, the Client moved to greatly strengthen its global competitive position.

(Source: AuBridge Partners, LLC, USA)

III. Approach to Identify Manufacturing Partners

The XYZ team was engaged by a major building products and services company to identify potential Chinese manufacturing partners to serve in an OEM capacity. The Client has over 30 years of flooring experience and installations in over 30,000 new housing starts per year. The Client is one of the leading experts in the field of wood flooring and wants to leverage that knowledge into developing and marketing a "best of breed" wood-flooring offering. In January 2005, the XYZ team was retained to develop and implement the Client's product development strategy in China. The methodology followed was:

Phase 1

The XYZ team first conducted an in-depth analysis of the China wood flooring

industry by attending trade shows, visiting domestic point of sales, and speaking with current distributors of Chinese flooring products. Then pre-qualified potential partners were based on the Client's requirements for management style and capabilities and then conducted on-site due diligence and inspections of machinery, materials, production process, QA, and above all, people.

Phase 2

After working with the Client to identify the top manufacturer, XYZ team facilitated all discussions and negotiations between the Client and the Chinese manufacturer throughout the product development stage. This was the first experience working with a foreign company for both the Client and the manufacturer; thus, it was crucial that differences in language, customs, and business practices were properly managed. Over the course of 6 months, 8 new wood flooring lines were developed and approved to the satisfaction of the Client.

Phase 3

(Actually initiated in the middle of Phase 2) The XYZ team negotiated, on behalf of the Client, an Exclusive Supply Agreement for the Northern Regional territory valued at over Rs.500 million over the next 6 years. The XYZ team was able to balance the manufacturer's immediate needs for cash flow with the Client's goal of investing gradually.

The XYZ team has developed a cross-border supply chain for products within the fastest growing wood flooring category by bridging an up-and-coming Chinese wood manufacturer with the right skills and technologies with a leading wood flooring expert who has established distribution channels and marketing know-how.

(Source: AuBridge Partners, LLC, USA)

IV. Approach to Acquisition of Competitor's Retail Network

The Issue

The client company was considering the acquisition of a competitor's network of 10 depots and 350 petrol retail stations, spread across five countries in East Africa.

ABC was engaged to provide the financial due diligence when it was realised that no one was overseeing environmental, health and safety issues.

The Approach

From the project base in New Delhi, ABC:

- Managed an environmental, health and safety and physical asset due diligence of the network. This began with visits to five data rooms, one in each of the target's operating territories, to review available HSE-related information.
- Worked with the client company to modify one of its network site risk assessment tools, making it relevant to the deal context.
- Then applied this tool to the target network.
- Mobilised, during a four-week period, five teams to undertake site visits to over 100 destinations.
- Simultaneously managed the sub-contracting and delivery of intrusive investigations at 20 of the sites to investigate the presence of suspected contamination. This work formed the basis of statistically robust estimates of the level of contamination-related financial liability likely to be associated with the target's network.

The Outcome

The results included the following:

- Identification of a likely Rs.100 million of contamination-related liability in a report produced in time for price negotiations between the client and the target;
- Providing further client support with direct visual evidence of site contamination to counter the target's claims that its sites were essentially clean. ABC understood that these contributions materially affected the sale price in favour of the client company.

The work also equipped the client company with an action plan to effect early improvements to the network, by identifying sites where contamination clean-up was necessary and where early asset replacement, principally underground storage tanks, would avoid future contamination and product loss.

(Source: PwC, UK)

V. Approach to Due Diligence

When PQR handles the detailed analysis and, if necessary, management of difficult situations, credit issues are resolved before they threaten the survival of a company. Increasingly, stakeholders seek the help to ensure their own analysis is comprehensive and validated by an independent source and to build consensus for strategies that maximise value.

PQR's approach is disciplined, predictable, proven and effective. Once PQR has a clear understanding of the engagement and the desired outcome, the issues behind severe business problems are identified and financial models are used to integrate income statement, balance sheet and cash flow projections.

Using the experience, analysis and expertise, PQR developed a realistic plan of action that includes restructuring debt and identification of opportunities to rationalise operations or refocus the business. PQR gains the confidence of company management, which increases their willingness to modify their plan and its implementation. Throughout the process, PQR maintains an active and open dialogue with creditors and company management to build consensus and make sure all parties have a clear understanding of the facts.

When a company is in crisis, the one asset almost as scarce as cash is time. And a response that respects the value of both - in the form of knowledge, experience and a proven methodology - makes the difference between failure and recovery.

With each engagement, PQR works quickly to identify problems, then Analyse, Stabilise, Advocate, Implement and Improve - each process laying the foundation for the next. Using this focused approach as a tool, PQR is able to weigh the variables and make difficult and time-sensitive decisions with confidence.

Analyse

PQR constructs a detailed, comprehensive analysis that examines fixed and variable costs, product line and operating unit performance, operating expense structure, asset performance and operational and financial restructuring options.

Stabilise

Establishing trust and confidence, PQR works with management, lenders and other creditors to prevent any actions that could threaten stability and endanger the recovery process.

Advocate

PQR is the catalyst for understanding and accepting the course of action embodied in the recovery plan. Good communication and cooperation among all constituencies are vital for moving the plan forward.

Implement

Marshaling the internal and external resources required to solve operating and financial problems, PQR motivates all levels of management, labour, creditors and shareholders to work toward successful recovery.

Improve

PQR develops and institutes process and performance improvements that increase profits, enhance corporate value and bring the enterprise to a new level of competitiveness - even excellence. Based on the overall approach described above, PQR undertakes financial and operational review and assesses business/turnaround strategy as indicated below.

Financial and Operational Review

PQR reviews a company's historical financial performance against its financial projections to develop an assessment of the business plan and its risks. The operations are reviewed to assess potential areas for improvement and capabilities to achieve the projected financial performance. PQR assesses potential cash needs and profitability, at the level of detail that provides the clearest support for the desired results.

Business/Turnaround Strategy Assessment

Drawing on the knowledge of the needs of lenders, creditors and investors, PQR uses a straightforward, predictable process to deliver results.

PQR determines the outcome through examination of how achievable the proposed turnaround strategy or business plan is in relation to current market conditions and other operational issues.

PQR evaluates management's ability to implement the proposed strategy and plan.

PQR investigates into the interests and the position of other stakeholders (creditors, suppliers, minority shareholders, key employees and customers) to determine potential risks in achieving the proposed plan.

Also, PQR identifies changes to the strategy and its implementation, as well as its proposed capital structure that would minimise execution risks in achieving the desired outcome.

(Source: Corporate Revitalization Partners, LLC, and USA).

8

Summary

Due diligence is the process of obtaining sufficient reliable information about the proposed acquisition to help to uncover any fact, circumstance or set of conditions that would have a reasonable likelihood of influencing the offer or decision to acquire the business.

The internally-generated information obtained during the due diligence process will help to:

- Verify seller representations
- Assist in the determination of value (assets and liabilities)
- Uncover problems, issues and concerns (current and future)
- Gain a better understanding of the business and industry, key customers, trends and regulatory requirements
- Evaluate management and key employees.

The externally generated information will focus on:

- Public information regarding the company, its principals and key employees, key customers

- Market research to gain a better understanding of the dynamics of the marketplace.

Many buyers of small businesses do not conduct any due diligence or conduct an insufficient amount of this examination because they feel the amount of the purchase price does not justify their time and effort, as well as, the cost of the professionals they might engage. Some buyers feel they lack the knowledge of how to conduct a due diligence investigation. They are not sure about what to look for or where to look.

If the buyer is not sure how to effectively conduct a due diligence investigation, it is advisable that he seeks help of experts in the field. The cost of the investigation should be balanced against the total risk exposure, both now and in the future. Just because the purchase price is small or the seller is offering lucrative terms does not mean that the risk exposure cannot be large. An undiscovered contingent or pending liability could wipe out the total investment not to mention the psychological suffering it can cause. A legal remedy could be costly and time-consuming.

The nature, scope and timing of the due diligence investigation will depend on many factors. Among the more prominent factors are the price of the deal, the perceived risk, the urgency of consummating the deal (buyer or seller) and the cooperation of the seller.

Before getting bogged down in the detail of the due diligence investigation a preliminary investigation should be conducted that would focus on:

- Getting a comfort feeling about those significant factors that make the opportunity attractive to the buyer or investor
- The business practices, values and reputation of the company to be acquired are consistent with the acquisition company's approach to doing business
- Changing a company's way of doing business or trying to improve its reputation can be time consuming and costly
- An indication of price and terms (the following can all be used as a preliminary guideline before engaging in a more sophisticated valuation)

- Industry "rule of thumb" - basic return on investment calculations (price/earnings)
- Cash flow.

Once this preliminary investigation is completed the next step will be to decide whether or not the deal is worth pursuing.

Final tips for conducting a successful due diligence investigation are:

- Professional judgment and experience is critical.
- If you are lacking in certain areas get help.
- Use a questionnaire to help guide the investigation .
- Document the findings of the investigation.
- Be aware of how the nature of the information impacts - its reliability, internal versus external, how and from whom it is obtained, is it independently verifiable
- Be on the lookout for inconsistencies in verbal representations or information that are either individually or cumulatively material.
- Ask open-ended questions rather than asking for the confirmation of a fact, and ask a question that leads you to the same answer.
- Remember that in many instances past behavior can be a good predictor of future performance; this can be crucial in evaluating management's and employee's values, practices and performance.

Due diligence may not and probably will not uncover fraud or a conspiracy to commit fraud. The seller should always be required to sign a representation letter prior to closing the deal.

POSITIVE - confirming all the representations the seller has made

NEGATIVE - no known facts or circumstances that would affect the decision to buy the company under the terms and conditions agreed upon.

Also, it is important to note that from the seller's side, it is necessary to enquire into the buyer's financial strength, business practices, and market reputation and over and above the sincerity of intention to acquire or invest. This is called for so as to

ensure that the efforts for the deal do not go in vain for any deficiencies of the buyer that was not known earlier. Moreover, it provides the seller an idea of whether the business that is build up does not go to hands of those that are not competent to carry on the business or the intention for acquisition is totally different. Besides, from the employees' perspective, it facilitates to assess the change contemplated following the acquisition or merger.

Appendices

Appendix - I
Open House Discussion with
Sample Questions and Answers

Appendix - II
Group Exercise

Appendix - III
Glossary of Salient Terms

Appendix - I

Open House Discussion with Sample Questions and Answers

Introduction

The analysis of financial statements is important for many reasons, and for those people who routinely check the pulse of their companies; many of these reasons are obvious. But when the analysis relates to the acquisition of, or investment in, a new business, most investors will agree that numbers alone are entirely inadequate.

Financial statements provide thumbnail sketches of a business and its history, supplying a few clues and insights into the company's present, and may possibly offer a reasonable guess about its near-term future. But general and specific conditions and events relating to the business's future, and the ramifications of past events and conditions, will determine its eventual success or failure. Using only past results to forecast the future is folly.

Financial statements do not tell about some of the most critical factors that impact businesses, such as management competence and continuity, market trends, production capability, quality, potential litigation, employee turnover, the status of supplier contracts and a host of other items. These

"non-financial" factors, more often than not, determine the future structure and viability of a company. For this reason, potential investors must carefully study these factors during the due diligence phase, before a final agreement is reached.

Planning Due Diligence

Due diligence is one of the procedures that is used to study, investigate and evaluate a business opportunity. It normally occurs after the parties to a deal have decided the deal is financially feasible and after a preliminary understanding has been reached (or appears reachable), but before a binding contract is signed. The term came into common business usage during the 1980s. While the term is new, the activity itself is not. Studying and investigating before buying and investing is as old as trading itself. While the term was originally used in the context of studying a potential acquisition or merger, it has been broadened to cover the study of almost all business transactions, including the issuance of securities and private placements, real estate sales, appraisals and commercial lending.

Due diligence can be accomplished successfully if it is preceded by careful planning. Such planning includes the assessment of available resources, the estimation of risk, selection of management, the recognition of the consequences of failure, the identification of possible obstacles to the deal, the definition of the deal's scope--all of which lead to the crucial decisions essential to produce the results one wants to achieve. All of these major planning elements are essential and must be included in the planning process. Establishing clear objectives is of highest priority. To proceed without them would be like setting out on a trip to an unknown destination.

The objectives and results one hopes to attain must be equated with the number of people and the amount of money one has. The scope of the due diligence is also influenced by other resources one has and by the level of risk one will accept. There will always be some risk, but how much there actually is should be carefully assessed.

Conducting Due Diligence

Investors must be objective, able to maintain an open mind and avoid premature conclusions and yet react quickly to significant adverse information. There is no point in continuing a due diligence programme once defects of a "deal killer" magnitude arise. The most common evidence of a biased mind-set at one extreme is to be awed by a management that seems all virtuous, rarely makes bad decisions, is highly efficient and has total concern for the employees and shareholders. If prominent people or celebrities are involved in the business or promoting the transaction, due diligence investigators should be even more wary and not attribute to the business virtues that do not exist.

An opportunity to acquire a long-coveted business can place blinders on the potential investor. It can be equally erroneous to start with an assumption that the management is evil, solely-concerned with short-term personal enrichment and has survived in spite of itself. A Pollyanna view of looking only at the positive aspects of a business is as much indicative of a closed mind as exclusively concentrating on defects, characterised by the attitude of, "We are going to find out what is wrong with it."

An objective approach free from ill-conceived prejudices, one that quantifies defects, can result in a rational evaluation of the business. Those involved in due diligence soon learn that more often than not what first appears to be a major problem or defect can be explained. Or there may be solutions under way and the problem is of lesser magnitude than first believed. An alarming first impression should only dictate that more study is necessary before conclusions are drawn. However, when critical problems arise, or the full dimensions of others known or suspected are revealed, the investor should reassess his/her position and might even want to suspend further due diligence.

Constructing the Checklist

Once an investor decides to seriously consider a business opportunity, a list of information and documents that eventually may be required should

be compiled. It should contain all essential data yet avoid the superfluous. Such a large quantity of information on so many subjects is needed that an effort must be made to circumvent matters of little importance or those that are irrelevant. Superfluous data will overburden, confuse, delay and distract analysts already confronted with a voluminous amount of data.

Overly burdensome demands for information could jeopardise the potential transaction by antagonizing a seller or whoever provides the data. As a result, the belief that the more information one has about a business, the more likely a shrewd investment decision will result, is not always true. The objective of data collection is to obtain enough information to make an informed business decision. No precise definition exists as to what is "sufficient," but the following questions can help develop the questionnaire:

- Is the information necessary to understand the business?
- Is it necessary for negotiations and to write the contracts to conclude the deal?
- If the information is not requested now, will it be needed at a later date?
- Could mistakes be avoided by obtaining the information?
- Is the information necessary to affect a smooth transition and for those managing the investment to be effective?
- Since it's impossible to predict which subject or document will prove to be of great importance, it is better to include a subject than to delete it.

A due diligence checklist is a memory crutch on a grand scale; it records answers and identifies what is missing.

Due Diligence from a Legal Perspective

"Due diligence" will be involved in almost every type of business transaction and all business persons, including the professionals representing them or otherwise involved in the transaction, should be interested and concerned about conducting proper due diligence. Proper due diligence rewards a cautious person and increases the opportunity to avoid a problem situation. Failure to conduct proper due diligence could lead to other implications, such as liability to third parties or criminal liability. Attorneys,

accountants, broker/dealers, appraisers and other professionals may also find themselves being sued by their clients or by third parties asserting the failure to have conducted proper due diligence.

By being alert to the need for due diligence and focusing on the proper issues at the beginning of any transaction, a person can avoid a bad business transaction or unwanted liability. For example, early due diligence in a business acquisition may alert the purchaser to the need to structure the transaction in such a way as to avoid unassumed liabilities. Proper due diligence may also serve as a legal defence to third-party claims after a transaction closes. Finally, part of the due diligence process in many transactions includes the drafting of contracts and other documents (such as acquisition agreements and loan documents) that contain appropriate representations and warranties that elicit information and identify and address the transaction's risks. The information obtained from proper due diligence will also be critical to negotiating the terms of a business deal.

Business Description and Basic Information

The business description and basic information enumerated in the checklist constitutes the core reports, documents and data necessary to commence due diligence investigations. Financial reports are important, but at this stage additional information on the organisation's structure and the participants is essential. A primary objective of due diligence is to verify, analyse and distill basic information initially accepted at face value. After all, it was this temporary acceptance that spurred some interest or type of agreement to justify the cost of proceeding. It should be an adequate framework within which to plan the due diligence programme.

An overview of the business gained from the basic information enables an investor to plan the due diligence. Planning will be impossible without some general knowledge of the business, its structure and names and responsibilities of the participants. Without this information, the programme's scope cannot be estimated, assignments made or realistic time schedules developed. Requests for data will be misdirected or irrelevant and result in excessive expense, and

needlessly antagonise those interrogated. An objective always should be expeditious completion, something that can only be achieved with intelligent preparation. At this stage, the majority of the basic information for planning the entire due diligence process is probably in the investor's possession.

During the analysis, one should record the time period of the study and the dates and source of documents and information received. Since any business is a moving target, the study is little more than a photograph of a specific time in its history. Business investments usually take considerable time, even when all goes well. The parties may also find agreement impossible or may agree to delay negotiations.

Critical Early Questions

The responses to questions or topics in the checklist and the initial questions the checklist should provide an investor with a comprehensive but not complete understanding of the business.

The ramifications and costs of due diligence require that priority be given to questions, data and analysis most likely to affect an investor's final decision. The answers and analysis may inspire greater interest in the investment's potential, trigger in-depth studies of problem areas or constitute "deal killers" that cause the investor to back out.

Top priority must be given to a dispassionate evaluation of management, since the success or failure of any business is primarily a function of management. The evaluation should include key executives who have managed or had a major influence on the business during the past five years. They are responsible for the business's current condition. However, the most important executives requiring intense evaluation are those responsible today and in the future. The investor should devote the time necessary and use whatever proven techniques are available to reach valid conclusions. Simultaneously, replacements for existing or anticipated management vacancies must be identified and evaluated.

Management evaluations are both objective and subjective. Announced

terminations to retire or take other positions, serious health problems, education and the performance of the business managed are objective factors. Actual results and identifiable accomplishments are of paramount importance. Personality characteristics, management skills, creativity, leadership ability and a myriad of other traits involve subjective evaluations.

Capital Structure and Ownership

A basic part of any due diligence programme is to determine how the business is legally and financially structured and who owns each unit. An investor must know what he is buying, whom he is buying it from and who makes the key decisions. This should be confirmed for each legal entity under consideration, including subsidiaries, joint ventures, partnerships and other business entities. The legal structures may be simple and uncomplicated or complex with multiple classes of securities and debt instruments, each of which has its own rights and obligations. Ownership may be obvious or intricate, difficult to determine and in some cases mysterious

There are two appropriate, revealing follow-up questions relative to structure and ownership issues: why and/or how. Insight can be gained by probing to learn the factors, rationale or chance events that led to current conditions. For example, why is this a corporation rather than a limited partnership? Why are 20 million equity shares of stock authorised and only 1 million issued? Why were preferential rights granted to the share holders? How many shares were acquired for the employee stock ownership plan (ESOP) and why not more or less? By asking such "how" or "why" follow-up questions, the investigator will pursue information in greater depth.

Questions on the legal structure, ownership and control should come early in the due diligence process, since serious issues may emerge requiring resolutions before a deal can proceed. A buy-sell agreement may emerge. A major shareholder may not be committed to the deal. Conversion rights could exist that make the transaction impractical.

For every business, documents describing the legal structure should exist and must be located and reviewed.

Management

Management built the business, operates the business today, and will manage the business in the future. These simple truths should be foremost in the mind of any investor. Due diligence activity relative to management consists primarily of identification of executives and professionals in positions of substantial responsibility, determining their total compensation and associated expenses and, most importantly, evaluating their competence and potential. Current and anticipated vacancies must also be identified.

Management is usually viewed as a group or team, but any study will focus on individual members and team vacancies. The future role for each member of the current team will require decisions after review of their responsibilities, estimates of potential and, not to be overlooked, and the individual's wishes. No due diligence should be considered complete or adequate without personal interviews.

Identification of key management members is a critical first step, but not always a simple one. Officers may not be key employees and key employees may not be officers, because job titles can be misleading. Some companies have both a chairman of the board and a president with either one Chief Executive Officer or the other's job poorly defined. Some businesses have few officers, while in others, such as financial institutions; there may be a large number. Key employees who are not officers, such as managers of important divisions, may have greater responsibility than all officers other than the president. There may be executives with officers' titles who are not formally elected officers, such as division presidents. Compensation may not always indicate importance to the business, since shareholdings, age, former positions and relationships influence compensation. Formal job descriptions cannot be relied upon to learn the true nature of an executive's job. The diversity is so great among businesses that all factors must be considered to sort out the management team.

Products and Services

Comprehensive due diligence requires gauging the importance of products and services to the business. Public perceptions and initial impressions often deviate from reality because many businesses are best known for activity representing only

a small fraction of their total business. Extensive promotion of new products thought to have great potential catches the public eye but today may have minimal revenues or serious quality problems. A business may have a famous name, but the products or services that brought the name into prominence may have long since been replaced. Use of trade names and private label manufacturing contributes to misconceptions. Actual amounts and proportions of sales revenues and operating profits for each product line within a business may prove to be a surprise.

Product line operating income is rarely in direct proportion to sales revenues. What constitutes a product line or category of service will be defined by the business, its organisational structure and its accounting system. The more detailed the breakdown by product segment, the more valuable the information to an investor. However, the existing accounting system that tends to track the organisational structure will largely determine the product breakdown possible. In many businesses this is sales revenue without calculation of separate operating profits. At some point the cost of calculating profits for each small segment of a business, plus the uncertainty caused by the subjective nature of overhead allocations, discourages detailed accounting. The result can be highly profitable or very unprofitable product lines or product line segments concealed in a broad financial report. An investor will likely have to accept whatever product or service breakdowns are contained in the financial statement.

R&D and Technology

Research and Development (R&D) is usually defined as:

“Research and development arising from laboratory or experimental procedures. It includes the cost of developing, or improving a product, a formula, an invention, a plant process, an experimental or pilot model, or something similar. It also includes the cost of any research or experimental work carried on for the organisation by someone else (such as research institute, foundation, engineering company or similar contractor).”

However, the terms R&D, research, development and design may have working definitions that vary from business to business. An understanding of how

management defines the terms will avoid confusion during the due diligence study. To evaluate the R&D effort, the historical and forecast costs should be equated with results, both actual and anticipated. "Results" are commercially profitable products or services. Projected costs to complete R&D projects in progress and the quantity and quality of proposals for new R&D projects should be part of the study. Evaluation may be difficult and require a team of technical, marketing and financial people to ask pertinent questions and comprehend the responses.

R&D, by its very nature, represents the hopes and commitments of individuals and the business with the stakes very high. Since success or failure of R&D projects can easily influence careers, it is understandable that overly optimistic comments may abound from those involved. Identify early the accounts in the financial statements recording R&D expenses.

Real Estate and Facilities

There are four general categories of real estate due diligence subjects: description and location, environmental, financial issues relative to costs and values and operational involving adequacy and continued availability. Unfortunately, opportunities for erroneous, misleading or withheld information, often totally unintentional, regularly occur to confuse or mislead an investor. Book values may have little relationship to true market value, which may in turn have little correlation with appraised values, whether tax, contemporary or anecdotal estimates. Known or unknown title defects may exist. Old photographs or descriptions may describe younger days rather than present conditions.

Facilities may be underutilised, creating unwanted expenses, or be inefficiently crowded, necessitating a costly relocation or expansion. Additionally, leases may expire, forcing an unwanted move, or long-term leases may be a burden or of debatable value.

A visit to each facility and review of ownership or lease documents is highly desirable. Visits confirm prior information; provide information on maintenance upkeep, general condition of facilities, housekeeping, safety, type of neighborhood, appearance of employees and level of utilisation. Leases, deeds, title insurance,

contracts for leasehold improvements and other documents relating to real estate must be located and reviewed for defects and unusual provisions, and to verify basic information.

One business's real estate activity may be static with few past changes and none anticipated. But for others, there are constant requirements to sell existing and/or lease or build new space. Due diligence should not only identify the activity but evaluate the causes or need for each sale or new facility. The causes may reveal or confirm information about the business previously unknown or only suspected. The importance of any real estate for sale is a function of the size of the sale in relation to the business's size.

Markets, Competition and Customers

Due diligence must define markets, competition and customers. They are typical of many nebulous and imprecise terms bandied about in business that create confusion and misunderstanding. The "market" for a specific business may be proscribed by geographical, pricing, service or other limiting factors. "Competitors" include not only today's competition but also those who could enter the market in the future. Pricing changes, influenced by transportation costs or other forms of overhead, could generate new competitors. Investors also must determine how many "customers" are one time, not repeat, buyers and decide whether potential customers, those with a need but no financial resources, should be defined in the market.

Gauging the size of a business's potential market should not be hard. Management will have some facts, estimates, opinions and possibly even detailed information. Trade publications are an excellent source of data for only the cost of a subscription, and various government agencies, security analysts, industry associations, utilities, chambers of commerce, Yellow Pages, economic development agencies and private research groups can produce market studies. Many of the publications and studies will identify both competitors and customers, and the quantity of such reports available usually makes it unnecessary to commission expensive market studies. Reviewing customer lists and identifying individuals and businesses similar to those being served can ascertain exactly who the market's customers are. For some businesses it is possible to identify all existing and potential customers

and accurately determine the total market.

Census and demographic data will be helpful in identifying trends and market size. It is absolutely essential for investors to understand markets, both their size and their customers, to understand a business. Without such information an investor cannot evaluate the present marketing scheme or estimate the business's potential.

Marketing

Marketing is a term used to describe a broad range of activities associated with the sale of a business's products and services. Sales planning and strategy, pricing, staffing, distribution, financing and advertising are all major functions that fall under the general category of marketing. A financial review of marketing in which marketing or selling expense is solely equated to results in the form of sales will be inadequate. However, an overall review of marketing activity without equating cost to results will be equally frivolous.

Understanding and evaluating a marketing programme is both an objective and subjective task in which all factors need to be considered to produce a balanced judgment. Since marketing is an activity for which there may be more than one approach, differences of opinion are common and they complicate evaluations. It is easy to be enthusiastic or critical of what has or has not been accomplished, but no one knows with certainty what sales might have resulted with a different approach.

The level of marketing expense is a fundamental management decision. Whether the programme is adequately, under- or over funded are questions managements continually ponder and are basic to due diligence. There are other important questions: If the business sold more, could it finance, produce and deliver more? How can marketing be improved? Is the present programme adequate or merely a good foundation upon which to build? A business must establish a system for customers or clients to obtain information and enter into contracts or place orders. This may be as simple as a customer talking with a sole proprietor or as complex as an international sales programme involving multiple methods of distribution and hundreds of individuals. The investor should learn how the selling of the business's products or services is accomplished.

Pricing

Due diligence objectives are to analyse all factors affecting pricing, the existence of improprieties and hidden liabilities and, most important, to gather sufficient information to decide if pricing is maximising profits. Pricing directly affects profitability; so pricing improvements may be one of the quickest ways to increase profits.

An investor should understand the pricing philosophy, the method of setting prices and the factors influencing prices. Pricing improprieties and errors are an unpleasant reality that occurs with sufficient frequency that their possible existence cannot be ignored. For each product or service line, pricing should be reviewed separately, because variations can occur regardless of broad corporate policies. Formal pricing policies may clearly set forth the overall pricing philosophy used in setting prices. Such policies tend to be guidelines from which deviations are not permitted without the approval of a senior executive. If written policies exist, copies should be requested. While policies typically are unwritten, they usually are understood within the business. Whether written or unwritten, the pricing approach and policies are as basic information as the business's name and address.

Regardless of pricing philosophy, policies and management statements, it is important to understand and verify precisely how prices are established. There may be large variations between policy and reality. Understanding the nuances can be achieved by obtaining current price lists, recently accepted quotations, or prices marked on merchandise, and then questioning in detail how the prices originated. Were they a fixed percent over cost or based on competition? What was believed to be the most a customer would pay? Were prices simply pulled out of the air? After determining how actual prices are established, a comparison can be made between prices received and those on price lists or quotations.

Advertising and Public Relations

Except for businesses with substantial advertising and public relations expenditures, most investors limit the due diligence efforts on these activities. Dealkilling problems and perils are improbable, but knowledge of the functions will be useful in planning a transition if acquisition occurs. Since the functions are not

precisely defined and do overlap, it is usually wise to study both simultaneously.

Wide variances exist between industries and businesses within industries in the extent and use of advertising and public relations. For smaller businesses, expenditures are minimal, but as businesses grow or try to grow, advertising and public relations become more prevalent. In medium-sized businesses, both advertising and public relations often are combined. In larger businesses, advertising and public relations tend to eventually separate into independent functions.

Advertising is primarily concerned with promoting the sale of products and services, preparing literature, brochures, advertisements and buying media time or space, while public relations seeks publicity through news releases, lobbying and events. Public relations are more concerned with promoting the overall image of the business, government relations, its securities and often its key executives. Public relations informs the public of what the business wants the public to know and tries to cast in the best light whatever it wishes the public to know.

Budgets for the current year and actual expenditures for the last fiscal year indicate the extent of the advertising and public relations programmes and may identify projects and programmes. Information on specific activities and programmes can then be requested for evaluation. Any measures that the business may have of its advertising effectiveness should also be requested. A list of employees and their specific functions will clarify responsibilities.

Purchasing

Purchasing decisions spur broad due diligence questions. Is the function well managed with adequate controls? Does it have the authority and status to be effective? Does it contribute to business success with aggressive buying and by providing a source of intelligence for the entire business? Or is it simply a neglected arm and possibly a centre of conflict of interest and corruption? The importance and stature of purchasing may be evident in the existence of procedural controls and the placement of purchasing executives at senior levels. Regardless of its status, purchasing should be closely reviewed during due diligence, as every rupees saved

in purchasing becomes a rupee of pretax income.

The role and impact of purchasing may be large and not limited to selection and evaluation of suppliers, negotiations, placing and expediting orders. It can be a conduit of information to the organisation on what is available from suppliers. It also can identify supply alternatives and be a valuable source of intelligence on competitors, industry trends and practices. Purchasing establishes controls so orders are precisely written and entered into the financial reporting system. Purchasing monitors and, when necessary, pressures suppliers to meet delivery dates and grant price concessions.

Purchasing does have a dark side because of the opportunities and temptations for personal enrichment. Few employees are entrusted with the business's money like those in purchasing and no other function has the breadth of opportunity for dishonesty. It ranges from the secretary buying personal items from the petty cash fund, to a clerk typing fictitious invoices, to the chief executive officer receiving kickbacks. Entertainment, gifts, kickbacks, conflicts of interest and fictitious purchases can and do happen. Due diligence investigators should be alert to any indication of misplaced trust.

Human Resources

A thorough knowledge of employees, employee costs, employee relations and commitments to current and former employees is an essential part of any due diligence programme.

An investor should know the total number of employees as well as the number in each category and at each location. This information provides another measure of the size and importance of each segment of the business. Careful attention should be given to defining the employment relationship for all individuals providing regular services to the business, including those on a contractual basis. Seasonal factors must also be considered when applicable.

The number of job openings, the length of time each has been open and the circumstances creating the vacancies and any recruiting problems should be

reviewed. It might be that no one is available to fill the positions, that compensation is too low, working conditions unsatisfactory, the job specifications unreasonably high, or the business is ineffective at recruiting. Basic questions for an investor are whether a shortage of employees at any level is adversely affecting the business and what corrective measures are possible. If personnel are not available locally, could they be recruited from other areas? Is subcontracting a partial solution? If the condition does not improve, must relocation be considered? Is the shortage temporary or has it been a chronic problem? Is it possible to quantify how seriously the business has been hurt by the shortages?

Management vacancies and the recruiting and selection methods deserve special attention. The philosophy and attitude of the board of directors and chief executive officer may be reflected in the selection procedures.

Employee Compensation and Benefits

Employee compensation and benefits, for most businesses, constitute a substantial expense that is burdensome but not crushing. However, for some the costs are so great they cannot remain viable without change. In others, unless wages and benefits are increased to attract and hold employees, the business cannot grow or survive. Due diligence should review actual compensation and benefits and causative factors such as competition, affordability, government regulations, customs, employee demands, levels necessary to recruit and retain employees and industry standards. Knowledge of these key factors is particularly important if the investment results in a merger necessitating the integration of operations and work forces. Care should be given to understand and evaluate both current and future costs, because present benefits and commitments for future benefits may not be reflected in financial statements. The lack of disclosure and understanding of future benefit costs is one of the most important areas for due diligence investigation. While reviewing the financial implications, investigators should be alert for compliance with central and state laws and regulations governing benefit plans.

If retirement plans exist, what are their costs and the method and adequacy of funding? What current contributions are required under the plans and are these being made on a timely basis? There is a strong trend away from defined benefit pension plans, but thousands exist with large liabilities. "Unfunded past service

liability" is the amount not paid into a fund actuarially adequate to pay for promised future benefits. The unfunded past service liability can be of such magnitude that a business's ability to ever fund the benefits may be in question. Investigate to learn if these liabilities are fully disclosed in the financial statements and whether practical measures can be taken to fund or reduce the liability.

Corporate Culture

Business deals all too frequently fail because differences in corporate cultures prevent the parties from understanding, accepting, reconciling or compromising. Unfortunately, cultural clashes are usually less a barrier to completing a deal than to success after the deal closes, because investors tend to minimise or ignore differences during due diligence.

Cultural factors may exist because of chance but more likely because individuals in power are convinced they are the right things for the business. The factors become deeply ingrained and difficult to modify. Naive beliefs that cultural differences are interesting but insignificant or can easily be changed have caused many investors to regret the day of their involvement. Cultural clashes are most severe when a business is acquired with a very different culture from the investor, who promptly attempts to revise practices to conform to his convictions or methods. However, if cultural practices have been clearly detrimental to the business, such as oppressive management styles, dishonest or rapacious marketing, excessive political activity and discriminatory employee selection practices, their elimination may have a liberation effect highly beneficial to the business.

Business culture is composed of numerous factors, both obvious and subtle, that have varying degrees of importance. Importance is partially a function of how long a practice has been in existence and if entrenched, fully accepted and expected to continue. Practices and conditions are far more significant when carried to extremes, as would be an authoritarian structure where all decisions are made by the chief executive officer, or a work force that is nearly all one religion or race. Common components of business culture are level of centralisation of authority; relative independence of business units; management approach to employee relations including paternalism, fads, compensation and dress codes; community involvement and the likes.

Legal

Most due diligence issues could conceivably be categorised under the heading "legal" because they directly relate to the compliance or non-compliance with laws. Of particular concern to any investor is whether the business is involved in litigation, and whether as a defendant or as a plaintiff. Similarly, an investor will need to know if the business is under investigation by any governmental agency, if it is subject to fines or penalties, or whether the government, has prohibited it by court order, or by agreement, from engaging in any activities. In addition, the investor will want to probe whether the business's operations meet all legal and regulatory requirements.

An investor does not want to invest in a company that, shortly after closing, will be fined millions of rupees by a government agency or subject to a court verdict. In fashioning legal questions, the investor will find helpful the assistance of a lawyer to ensure that all aspects of the business's operations are adequately investigated. As with other due diligence questions, legal questions should be coordinated with the representations and warranties in the transaction document. In addition, although these questions may be termed "legal" in nature, the investor's financial and operational people, as well as the lawyers, should carefully review the results.

At the heart of the legal due diligence is a review of pending or prospective litigation. The investor will want to review any lawsuits involving the business. Not only might the business be liable for the underlying claim, but also even if the claim is without merit, the business will incur litigation costs. The lawsuits or claims may also indicate a foreboding trend in the business or its industry. The investor should, at a minimum, request the name of the case; the court where the suit is filed; a description of the general nature of the case; the amount sought; the status of the case; and the likely outcome.

Information Systems

Most information obtained during a due diligence review of a business's information systems will be utilised after the investment is completed rather than to decide whether to invest. This will be particularly true if integration of the business's and the investor's systems is contemplated.

Knowledge of the present state of the systems is essential to decide what further additions or improvements are needed and economically justified. However, there are a few broad questions that could affect the investment decision. Are the systems compatible with the investor's? Can the software licences be readily transferred to a new owner? Are the present systems inadequate or obsolete and in need of large capital expenditures? Specific questions regarding the nature, effectiveness, costs of systems, compatibility of systems, proper licensing and future programmes should help answer the broad questions for an investor.

Information systems include communications of all types. While computer technology changes at a rapid rate, the entire field of communications is changing equally fast. Whatever is the state of the art in both technologies, all agree today's technology will soon be obsolete and therefore will complicate any due diligence evaluation.

The first step is to find out what hardware and software is used, what systems they support and what information are provided. An inventory of all systems, records and reports provided through the use of computers and associated electronic equipment will indicate the end product. A second inventory of all hardware, computers, peripherals and software will indicate the type of equipment and software used to provide the systems and reports in the first inventory. The inventories should indicate which systems are being revised or scheduled to be replaced and if any hardware is considered to be surplus either now or in the near future.

Budgeting and Planning

Planning consists of studies, recommendations and decisions as to what products, services and industries the business should be in and what direction it should take. Planning involves establishing an overall philosophy, plan and objectives for the business, while in budgeting, pro forma financial statements are created to forecast, monitor and control existing business units. The financial statements normally reflect anticipated revenues, expense levels and approved capital expenditures. Most budgets have monthly financial statements for the first year and then quarterly or longer periods for future years.

In large corporations, planning and budgeting tend to be segregated into two distinct functions. In medium-size businesses, planning and budgeting often merge, with the chief executive officer or chief finance officer assuming more of the planning function with budgeting folded into the responsibility of the controller or some other financial executive. In small businesses, neither function may formally exist, with planning remaining in the head of an owner consumed with day-to-day operations, and budgeting considered unnecessary.

A primary due diligence should target copies of existing budgets and plans. No documents other than financial statements will be more informative. A comparison of prior years to actual results will provide insight into management's competence, failures, successes and changes in direction. The latest budgets and plans will indicate current thinking and management's views of the prospects for the business. There is little uniformity among businesses and great variation exists in both format and content of plans and budgets. Both become molded to the needs of a business and the preferences or whims of those in charge. They tend to increase in size and scope each year as executives not only see areas to improve and new subjects to cover, but learn from prior failures or overlooked problem areas.

Insurance

Professional assistance is usually necessary to adequately evaluate a business's insurance coverage. For most investors, the professional will be the insurance broker providing their existing insurance, but other consultants free of conflicts of interest can be employed. It is a relatively simple matter to gather the policies, secure premium and other related information, but to fully understand the policies' terms, coverage and common risks not covered is another matter. Most businessmen have a general knowledge of the policies and costs but very limited information on specific terms, at least until a disputed claim occurs.

Evaluation of the adequacy of any insurance coverage is no longer complete with just a study comparing probable risks to the terms of the contracts. The practices of the carriers and their financial capability to pay must also be considered. Carriers are private companies and, as in any industry, there are a few who are disreputable, engage in sharp practice and have limited or no financial ability to pay losses. Even some of the larger, better-known carriers have experienced substantial losses from

poor investments, underwriting or both. The well-publicised financial problems of Lloyds of London, the large number of carriers that have failed, and the shortcomings of regulatory agencies should be a warning, in every due diligence evaluation, that review of the contracts is not enough. There are several companies involved in rating insurance companies that can be a quick reference and starting point. If the business has a significant outstanding but unpaid claim, carrier evaluation will take on immediate importance.

All insurance in effect is described in a contract between the carrier and the insured, and one should assume that if there is no contract or policy, there is likely to be no insurance.

Environmental Issues

A public awareness of environmental hazards has resulted in broad, complex legislation, vigorous enforcement, endless litigation and horror stories in which investors found themselves owners of environmental liabilities that often exceeded their original investment. Today, few investments involving real estate or manufacturing are completed without an extensive review of environmental risks and negotiations to establish responsibility for remedial costs of any hazards that may exist--known or unknown. While no statistics are available, anecdotal evidence indicates that more deals upon which preliminary agreements were reached were eventually terminated over environmental issues than any other. An even larger category is failed deals that never reached the preliminary agreement stage because investors learned of environmental problems.

Due diligence of environmental issues is difficult because of their complexity, nebulous and untested legislation, unreasonable and ill-considered regulations, conflicting and changing regulations, changing technology, difficulty in securing estimates of the cost of remedial measures, difficulty of proving what does not exist.

When environmental issues arise, expert opinions may be necessary to evaluate the risks. Environmental engineers evaluate the nature and extent of the problem. A lawyer specialising in environmental law may be needed. Direct meetings with regulatory agencies may be advisable. All of these activities can become time-

consuming, expensive and often discouraging because of the difficulty of securing precise answers, and differing opinions from the experts.

Debt and Banking

Debt is an extraordinarily broad term that describes financial obligations that must be identified and fully understood during the due diligence study. Debt and all its conditions have variations limited only by human imagination. Timing and terms of repayment, collateral, penalties for default, guarantees and various covenants can result in debt obligations that are extremely onerous or impossible to repay and others in which the debtor can largely repay at his discretion. Due diligence of debt requires studying the details of the actual financial instruments. The tedious fine print cannot be ignored.

An initial step is to identify all indebtedness of the business. Debts may be owed to banks and other financial institutions, shareholders, officers, security holders, individuals, a government and anything or anyone who can be defined as a legal entity. Supporting each debt should be documentation describing the terms and conditions of the indebtedness. Since such documents are often revised or amended, care must be taken to have the complete and latest documentation.

An investor will find it helpful to develop a list summarising all debt, its terms and conditions for use in evaluating the business and planning the programme. At a minimum, the list should include the amount owed, name of lender, repayment schedule, rate of interest, restrictions on use of funds, borrowing base, collateral, prepayment provisions and guarantees. A summary list does not reduce the need to study the individual loan documents. For most businessmen, the detailed study will be a task for their attorneys and accountants.

Any bank or financial institution with which there has been or is a business relationship will have an opinion regarding the business and its management. The nature of the relationship and the opinion of the institution will largely determine the future relationship.

Investments and Cash Management

Investments are extremely variable in their nature and require separate study. An investment may have a market value higher or lower than that recorded or its original cost. Restrictions on liquidity either by contract terms, government regulations or the market's ability to absorb the investment can affect the value. The value of an investment may be instantly discernible, as would be the case with government securities, or extremely difficult to determine, as would be the case with unregistered securities in a private company that was losing money. Some investments have no present market value and cannot be sold, but there remains the possibility that value would return at some future date and under the right circumstances. The due diligence objectives for each investment are to determine present value, quality and liquidity.

Businesses invest surplus cash in nearly every manner imaginable. Each investment should be reviewed, along with the decisions and policies that led to the investment. The investor should understand the rationale for the policies, how they were developed, and how investments were selected. Also to be determined is who makes the investment decisions and what have been the results. Investors should review the business's plans for using the invested funds and determine whether any investments were improper or insider deals. Additionally, the investor will want to review the financial instruments and documentation to confirm each investment.

Loans to shareholders and executives are usually insider transactions for the benefit of the borrower and as such those investments need careful review early in the due diligence process. Their most common purposes are a means of extra compensation, a method of financing stock purchases, financing for personal residences or other executive perquisites.

Taxes

Taxes may be an unpleasant cost of doing business. They contribute nothing directly to the success of a business but indirectly make the business possible, since only the most primitive of trading could occur in the absence of government. The task during due diligence is to identify tax obligations, evaluate how well they are being met, review their impact upon competitiveness and learn the status of any

disputes. Sufficient information should be gathered to determine if excessive taxes have been paid and what steps may be taken to reduce the overall tax burden without violating any laws. Businessmen can readily gather the basic information on taxes and identify obvious problem areas and subjects for further study. However, taxes may be complex, and a professional tax expert may be required to evaluate a business's tax situation. If tax savings are a possibility, an expert usually will be required. Possibly several experts will be needed because of their tendency to specialise. An expert on income tax may know little of local ad valorem taxes or state taxes and their administration, and the reverse can definitely be true. Foreign taxes require experts on a country-by-country basis and the best will most likely reside in the country involved.

The first step in the due diligence study of taxes is to identify the tax reports required. Some will be of much greater importance (such as income tax returns) than others, but any of the taxing authorities has the power to take legal action against the business for failure to file required reports and pay taxes. The legal action may be slow in coming but one can assume it will eventually happen.

A summary of activity relative to each taxing authority will help to understand the effect of taxes upon the business. Identifying the actual amounts paid or due enables a rational determination of the taxes' impact upon profits and the business's competitive position.

General Accounting Questions

There are a number of subjects, questions and issues that apply to the accounting functions and systems in an overall or general way that are not specific to a particular account such as receivables or payables. Since a major part of the due diligence process consists of understanding the financial statements, background and supplemental information are essential to comprehend and verify the statements or determine the facts.

The reliability of the financial statements should be repeatedly questioned during the due diligence investigation. Few mistakes in investing are more common than to automatically assume the financial statements are accurate in all respects. There

are at least three categories of financial statements: monthly or interim reports, annual reports and reports that are part of tax returns. Public companies must submit reports containing financial statements to SEBI. Interim monthly or quarterly reports are not audited except in public companies, where auditors prior to publication may review quarterly reports.

Monthly reports are the least reliable and tend to be used more for internal operating purposes than as a basis for investment decisions. Annual reports may or may not be audited and if audited still may not be adequate. Certainly, the audited accounts have a high degree of reliability.

Accounting Policies

A business's accounting policies and practices can have an extreme effect on the profit or loss recorded in the financial statements. In many cases a recorded profit could just as easily have been a loss with different accounting policies, or the reverse could be true. What appears to be a remarkable turnaround from losses to profitability may be due to accounting policy changes rather than brilliant management. Frequently, large one-time losses are better explained as reversions to more conservative accounting policies or recognition of losses more properly attributed to prior years. A business's accounting policies may be precisely written and elucidated by management, but some tests are always necessary to confirm that actual practices are consistent with policies. Not all executives are willing to admit their practice is to inflate or depress income. In the due diligence process, it is important to determine the accounting approach, policies applied and if a pattern of accounting practices is used to accomplish an objective. If any practice is discovered to either inflate or deflate income, it is highly probable a pattern of similar practices exist. An example is that a business slow to write down obsolete inventory will also be likely to delay recognition of bad debts.

Cash

The cash account is first on the balance sheet and first in concealed characteristics. Many investors' enthusiasm for a business has been enhanced by the presence of a large cash balance only to discover later that much of the cash is gone or inaccessible. Conversely, investors have disparaged businesses because of a low or

negative cash position only to belatedly learn the condition was temporary. Large cash balances can reflect a very temporary condition, bad management or failure to make short-term investments or funds the business is obligated to keep in cash form. A balance sheet is a financial snapshot of the business that captures the cash position on a particular day. Few accounts are subject to change so rapidly and they should be viewed accordingly during due diligence. The cash account is something of a way station for cash after it is received and before it is sent to pay creditors and investors or to be invested. When reviewing cash, there are three other accounts that should be looked at simultaneously:

- Short-term investments, where surplus cash is temporarily placed
- Receivables, from which cash is received
- And current liabilities, where cash goes.

The amounts in these accounts have to be considered and trends identified to fully understand the overall cash account. The business may have cash in bank accounts but all or part may be restricted and cannot be spent. Compensating balances are funds required by a bank to be left in a non-interest-bearing account as part of the price the bank charges for a loan.

Accounts Receivable

A broad study of receivables provides an insight into numerous aspects of a business. Not only is the value of this major asset quantified, but from receivables customers can be identified, the proportion of revenues coming from geographical areas or customers can be determined, knowledge of customer relations can be gained and business problems identified through the existence of disputes.

Certain critical areas of accounting (receivables, inventory, accrued liabilities and income recognition) require intense scrutiny during due diligence because of the possibility of highly discretionary management policies, controversial entries, improprieties and disputes over value. Of these, receivables are easiest to verify and evaluate. Asking the questions in the checklist, coupled with direct confirmation of individual receivables, may give an investor comfort to proceed, information to negotiate adequate guarantees or convincing evidence to forget the entire investment.

Trade receivables are amounts owed to the business from the sale of products or

services. Other receivables that may be included in one all-encompassing receivables account could be from the sale of patents, assets, licensing or royalty fees and other non-trade transactions. Notes receivable can be for anything but most commonly are slow-pay receivables converted into long-term loans to key shareholders and executives who may or may not repay on schedule.

An overview of receivables is possible by classifying the individual receivables into categories defined by the length of time a receivable has been outstanding or unpaid. This practice is called "aging" and an important internal accounting report for most businesses compiled at least monthly are a receivables aging report. An aging report can identify the overdue amounts and individual receivables overdue but it will not identify new receivable that may become overdue.

Inventory

Inventory presents a difficult due diligence challenge because it may be under- or overvalued and the chances of knowing its precise value are remote. The final value will be based on information prepared by accountants and used by the parties to reach an agreement incorporating a value they can accept. Even when management strives for realistic inventory values, the actual values may remain unknown until future sales occur. Management's intent upon manipulating financial statements find inventory an area of extreme opportunity, and it is one of the most frequently used means to inflate or reduce income.

Questioning management and reviewing reports and financial statements are important but should only supplement actual counts and physical inspection of the inventory and inventory records. Verification of the inventory both in count and price is essential and preferably observed by independent auditors. The overall statistics, trends and other information are vital to the study but will not provide sufficient data for comfort in the absence of on-site inspections. Inventory may conveniently be in one location, numerous locations, in transit or on consignment and so complicate the task of verification. Knowledge of its location is not only essential for verification but for studies conducted as to the cost of maintaining inventory at specific locations and the impact of the inventory level on sales. A business's total inventory is important to know, but the information of greatest value is the inventory by product line. The amount of capital committed to

maintaining an inventory for a product line is a key element in evaluating profitability or lack thereof.

The number of inventory turns is a measure of how well a business is being managed in relation to others in the industry.

Fixed and Other Assets

Assets other than current assets may be the business's most important and valuable property. Facilities, production equipment, office and systems equipment are all critical components without which the business could not function. Major tangible assets should be identified along with their value as reported on the financial statements, their estimated market value and importance to the business. Intangible assets are those primarily visible only on the balance sheet, such as goodwill, capitalised expense, customer lists and trademarks. Intangible assets may have great value or even be undervalued, but many are worthless. Determining the origin of each intangible asset is helpful to estimate current value.

Fixed assets may appear on a balance sheet as several line items or an all-in-one general category of "property, plant and equipment" (PP&E). Regardless of how broadly described, this is a reasonable starting place. Using the balance sheet summary, the due diligence investigator can request the records supporting the individual components. They should disclose the original cost as well as the amount of depreciation taken and that remaining. A review of the financial records coupled with visual inspection of the assets is an essential part of due diligence.

A perfectly managed business will have accurate, up-to-date records identifying each fixed asset, its original cost and the depreciation taken to date. However, fixed-asset records often are poorly maintained, dated and do not accurately reflect the actual assets. Significant assets may have been acquired but not recorded and others sold, scrapped or discarded and not removed from the records. If physical inventories of assets are infrequent or never made, that permits the perpetuation of recording errors.

Liabilities

Due diligence requires verification of liabilities both listed and not listed on the balance sheet. To achieve a level of comfort the investor must gain adequate knowledge of the business's liabilities. Since unknown liabilities can emerge after the investment is consummated, the due diligence investigation should reduce this concern to a reasonable and acceptable business risk. It is virtually impossible to prove there are no other liabilities, but it is possible to reach a point where further concern or fears would border on the irrational. Just as identification of liabilities is important, investors should be wary of overemphasis on liabilities and what is wrong with a business rather than its attributes.

Unrecorded liabilities are those that should have been recorded or those in which a probable, undetermined liability exists. Inability to determine the precise amount of a liability is sometimes used as an unacceptable excuse to record no liability at all. A list of all unrecorded liabilities, actual and probable, should be developed for the investor to gain a complete picture. Common areas to search for unrecorded liabilities are litigation, non-capitalised leases, product guarantees, loan guarantees, service guarantees, self-insurance, purchase contracts, employment contracts, severance benefits, pensions and health insurance. These areas are by no means inclusive and each industry may have its own special types of liabilities. Once identified, investors need to determine whether liabilities are valid, estimate when cash outlays will be required and determine probable best or worst case exposure.

Backlog and Income Recognition

Making sales, recording orders and maintaining a backlog are basic activities that commence a sequence eventually resulting in a profit or loss reported on the business's income statement. The level of reported income largely determines the tenure of executives and so produces pressures to perform that should continually be kept in mind during due diligence. Lack of profits will eventually cause failure, the loss of the owner's investment and jobs. A profitability influence the market price of shares, spurs hopes to sell more shares and creates opportunities to exercise options and enjoy bonuses. Budgeted profits, earnings projection, growth targets and unbroken records of increased earnings have often caused managements to engage in dubious practices. The demands for performance are so strong that executives may take regrettable actions that should be ferreted out during due diligence.

Many businesses receive orders for products or services to be shipped or provided at a later date. The cumulative total of all unfilled orders is the "backlog" and is an important indicator of near-term business activity. In manufacturing, construction, contract services and hundreds of other types of businesses, executives watch the backlog closely to plan business activities. Comparisons of the present backlog to prior years and current trends in the backlog will give an investor the single best indication of what is happening to the business and the level of business to expect in the near future.

The amount of gross profit in the backlog is a far better indicator of future pre-tax income than the total level of backlog. In fact, total backlog and trends can be extremely misleading without gross profit data. Low-profit work may have been taken to make the backlog appear good or in the belief that increased pre-tax profits could result from a larger volume of business with a lower margin of profit.

Cost of Sales, Selling and Administrative Expenses

Due diligence should involve gathering sufficient data to analyse and understand the costs and expenses incurred by the business. While the term "costs" usually applies to production-related activities and "expense" to so-called non-production activities such as selling and administrative charges, there is no difference. Hundred rupees of wage cost paid to a production machine operator eventually has the same effect upon the business's income statement as ten rupees of expense paid as part of the chairperson's compensation. Executives who are zealous in "cost" cutting but largely oblivious of "expenses" often ignore this obvious fact.

Financial income statements will provide basic information in summary form and are the proper starting points to evaluate overall costs. Most contain separate information on costs of sales, selling expense and general and administrative expense. From the summary information trends should be discernible, but more specific information must be sought on the composition of each category and any significant shifts in the percentage of the components within a category. As an example in cost of sales, wage costs may be declining and material costs increasing with no net effect. In selling expenses, a large increase in support staff or a shift to telemarketing may be occurring, but selling costs as a percent of total sales may be declining. Trends are of great importance to identify the favourable

accomplishments of the business as well as alert an investor to emerging problems.

Gross profit is the profit calculated by subtracting cost of sales from revenues. They are profits before selling, general overhead charges and administrative expense (SG&A) and are primarily determined by two factors--prices received and cost of sales. Higher prices will increase gross profit and lowering of cost of sales will have the same effect.

Inter-company Transactions

Multiple business units with common ownership or control have evolved to accommodate diversity and growth, spread risk, facilitate management and maintain financial controls. Unfortunately, inter-company transactions can be a source of controversy, complex or misleading financial reports and, in extreme cases, an opportunity for deception. Inter-company transactions have been a favourite playground for those wishing to manipulate the books.

Whenever there are multiple business units controlled, owned or influenced by a common entity, the relationships must be clearly defined from both an operational and a financial perspective. Is the relationship with the parent one of tight or loose control? Do the individual units conduct business between themselves and how are such transactions recorded in the financial statements? Do policies, methods and approach to recording inter-company transactions reflect a desire to accurately record income or losses by each business unit? Are policies designed to benefit the business as a whole rather than individual unit? If statements are audited, consolidating income and balance sheets should indicate inter-company transactions.

Inter-company sales are the sales of products and services from one business unit to another. Some businesses negotiate inter-company sales between units on an arm's length basis without influence of the parent. Products and services purchased may be paid for by cheque. The other extreme is when all inter-company transactions are controlled by detailed policies and only accounting entries are made to record the transactions without cash changing hands.

The investor should identify inter-company sales and learn the policies and

practices influencing pricing and accounting for the transactions. Each line item on the financial statements involved must be identified.

Investment Questions and Issues

There still remain due diligence questions relative to participants in the proposed transaction and the business's value. All professionals, organisations and government agencies that may influence or can affect the investment decisions should be identified. Data useful in estimating the relative value of the business should be reviewed. Information on the business that may have been previously overlooked should be sought, even if it involves locating third parties whose approval must be secured before the investment can close.

Third-party approvals are those required from individuals, businesses, institutions and government agencies that are neither the buyer, seller nor investor. In some cases the third party must approve the entire transaction and in others only one segment. A search for such parties and an evaluation of the time, procedures, difficulty and strategy for securing their approvals should commence early in the due diligence process. The type and structure of an investment will affect the approvals required. If the investment is a purchase of selected assets and liabilities of a going business, approval may be required of lenders and creditors, and to transfer all contracts in effect and government permits. Contracts include leases, customer orders, purchase orders and licenses. In stock acquisitions approvals may be required from lenders, government anti-trust regulators and licensors.

Consultants provide highly specialised skills for projects of relatively short duration where it will be impossible or impractical to employ full time employees. They provide businesses with knowledge and skills often unavailable by any other means. Consultants are not employees and are considerably more expensive, often commanding large fees. The investor should identify the problems for which consultants were hired to solve and compare their costs with the results.

Appendix - II

Group Exercise

Q. How to start the due diligence exercise?

Q. What to read in the Sales/Purchase Agreement?

- Is this a purchase of stock or net assets?
- What is the approximate value of the transaction?
- Will the seller provide indemnification to the buyer for self-insured or uninsured liabilities?

Hint

Before getting started, the due diligence investigator should gain an understanding of the overall situation and the time-line. For example, if the proposed transaction is being conducted as an auction, you may have to get by with the documents in the data room. After the buyer has signed a letter of intent, you should insist on getting whatever reasonable information you think you will need.

Five Process-Planning Items

1. Sign a confidentiality agreement.
2. Obtain the index of the documents in the data room

3. Make sure you know what your scope will be. (Who is doing the Employee benefits, environmental compliance, etc?)
4. Compile the names and contact information of those with who you will be Dealing (buy-out firm partners and associates, heads of risk management and employee benefits at the company, and your client's lawyer, etc.
5. Decide if you will need to visit the business to be acquired to observe operations and conduct interviews.

Q. What to learn from the Information Memorandum and other available information about the company?

- In what business (es) is the company?
- What are its products/services?
- Where are its plants and offices located?
- How many does it employ and what are the occupational classifications?
- What were the revenues and EBITDA over the past three years?
- What is projected for the rest of this and next year?
- What are the approximate values of the raw materials, inventory, plant and equipment on the balance sheet?
- Who are the company's major customers and suppliers?
- Are there any disclosures in regarding to legal compliance, enforcement or tort litigation?

Hint

Look for potential deal-breakers, such as businesses claim and product liability legacy issues. If necessary, search the internet for information about the company, its competitors and the industry. Other red flags to look for are unique exposures that may require special types of examination.

If a purchase of assets and the seller will be retaining the liabilities for workers compensation and other liability claims incurred prior to the sale, carefully read the indemnification provision in the purchase agreement to see if there are any rupees amount or time limits.

Appendix - III

Glossary of Salient Terms

1. **Acquisition**

Assuming ownership of another business. The acquisition can be made through a direct purchase or through a merger agreement that involves the exchange of assets.

2. **Merger**

A full joining together of two previously separate corporations. A true merger in the legal sense occurs when both businesses dissolve and fold their assets and liabilities into a newly created third entity. This entails the creation of a new corporation.

3. **Joint Venture**

Two or more businesses joining together under a contractual agreement to conduct a specific business enterprise with both parties sharing profits and losses. The venture is for one specific project only, rather than for a continuing business relationship as in a strategic alliance.

4. Strategic Alliance

A Strategic Alliance is a partnership between businesses in which you combine efforts in a business effort. The joint effort can involve anything from getting a better price for goods by buying in bulk together to seeking business together with each of you providing part of the product. The basic idea behind strategic alliances is to minimise risk while maximizing your leverage in the marketplace.

5. Appraisal

An estimate of the worth or value of something on the open market. The term is also used for the report that describes how the estimation and conclusion of value was made.

6. Business Valuation

An estimate of the worth of a business entity and its assets.

7. Buying a Business

For many entrepreneurs the idea of starting a business from scratch may seem overwhelming. For them, buying an existing business or a franchise is often a viable alternative.

8. Adjust Purchase Price

This will take care of prorated items such as rent, utilities and inventory up to the time of closing.

Review documents required to be provided by the seller. This will provide a corporate resolution approving the sale, evidence that a corporation is in good standing, any tax releases that may be been promised by the seller. Check with the department of corporate affairs.

9. Security Agreements

These documents may be necessary if the purchase is going to be self financed.

A Security Agreement lists the assets that will be used for security as a promise for payment of the loan.

10. Lease

If it is agreed to assume an existing lease, it is required to execute the assumption. Make sure that the landlords' concurrence to assumption of the lease. Instead there may be a new negotiated lease with the landlord instead of assuming the existing lease.

11. Patents, Trademarks and Copyrights

May need to execute the necessary forms of part of the transaction.

12. Franchise

May have to execute franchise documents if the purchase of the business is a franchise.

13. Closing or Settlement Sheet

The closing or settlement sheet will list all financial aspects of the transaction. Everything listed on the settlement should have been negotiated prior to the closing so there should be no surprises.

14. Covenant Not to Compete

It is a good idea to have the seller execute this agreement. This will help add to the success of the operation of the business without any interference from the previous owner.

Answers to Questions in Chapter One

Response 1.1

The legal side of due diligence is not as exciting and interesting necessarily as the financial end, and how well the buyers can actually model where the business is headed. It is a lot more important than making sure the contracts say what you think they do, although that is an important part what is asked for to be done. It is one aspect.

In simple terms, due diligence is doing the homework on a deal. Of course, it can create reasons not to do the deal, or it can show some hair on the deal, potentially influencing the deal terms. Generally speaking, it is doing the homework, whether it is on the legal side, on personal, on financial, on software, on technology and others. It runs the gamut of doing the homework on the deal before it is closed.

Due diligence could be finding something wrong that does not make the deal or that makes to renegotiate a price, but for someone who does it well, it may be finding value that allows to outbid someone else who has not done the proper homework.

Response 1.2

Normally, Due diligence requires the following:

- (a) Examination of documentation and litigation issues, preliminary and in the review of the financial books, operations and technology to assess the way business is run, possibility of cost savings in operations and means to improve the working capital structure.
- (b) Due diligence also involves background checks on people and it is usually based on bad experiences in the past.
- (c) Due diligence entails the buyer's core competency in judging the business targeted and critically important is judging the management.
- (d) Due diligence should endeavor to find out “what else?” It is not sufficient to stop at such as that it is possible to fill in the product line or to say it is possible to move into the plant. The upside comes on the operating company's standpoint.

Response 1.3

The parties conducting due diligence generally create a checklist of needed information. Management of the target company prepares some of the information. Financial statements, business plans and other documents are reviewed. In addition, interviews and site visits are conducted. Finally, thorough research is conducted with external sources including customers, suppliers, industry experts, trade organisations, market research firms, and others.

Response 1.4

There is no correct answer to this question. The amount of due diligence conducted is based on many factors, including prior experiences, the size of the transaction, the likelihood of closing a transaction, tolerance for risk, time constraints, cost factors, and resource availability. It is impossible to learn everything about a business but it is important to learn enough such that could lower the risks to the appropriate level and make good, informed business decisions.

Response 1.5

Yes. Too much due diligence can offend a target company to the point where it could walk away from a deal. It can also result in “analysis paralysis” that prevents from

completing a transaction or provides time for a better competing offer to emerge. Accordingly, it is important that due diligence be prioritised and executed expeditiously. A sensible level of trust concerning lesser issues must balance appropriate investigation and verification into the most important issues.

Response 1.6

Time allocated for completion can vary widely with each situation. Many preliminary agreements define the time frames in which due diligence would be conducted. Time schedules through the closing of a transaction are typically tight parties should ensure that adequate time is allocated to due diligence.

Response 1.7

Every transaction would have different due diligence priorities. For example, if the main reason for acquiring a company is to get access to a new product it is developing to accelerate buyer's own time to market, then the highest priority task is to ensure that the product is near completion, that there are no major obstacles to completion, and that the end product would meet the buyer's business objectives. In another transaction, the highest priority might be to ensure that a major lawsuit is going to be resolved to the buyer's satisfaction.

Response 1.8

Certain activities conducted during due diligence could breach confidentiality that a transaction is being contemplated. For example, contacting a customer to assess the satisfaction with the target company's products might result in a rumor spreading that the company is up for sale. Accordingly, to maintain confidentiality, often customers may be contacted under the guise of being a prospective customer, journalist, or industry analyst.

Response 1.9

A well run due diligence programme could not guarantee that a business transaction would be successful. It can only improve the odds. Risk could not be totally eliminated through due diligence and success could never be guaranteed.



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