

A Practical Guide to

Financial

Due Diligence

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**Financial
Due Diligence**

Third Edition

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B L O O M S B U R Y
NEW DELHI • LONDON • OXFORD • NEW YORK • SYDNEY

Third edition, 2023
Second edition, 2021
First published in India, 2021
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ISBN 978-93-5640-293-5

Bloomsbury Publishing India Pvt. Ltd
DDA Complex, LSC Building No.4
Second Floor, Pocket C-6 & 7, Vasant Kunj
New Delhi 110070
Phone: +91-11-40574957, 40574954
www.bloomsbury.com
CIN: U22130DL2012PTC232353

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About the author

B D Chatterjee is a finance leader with over 40 years of rich industry experience in overall business and finance function. He is a Chartered Accountant with CS and CMA qualifications and holds a diploma in IFRS from UK.

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Preface

In these uncertain times we witness on the one hand conventional businesses going out of existence one by one and on the other new doors of opportunities opening up in other spheres. As a fall out of this, the emergence of inorganic growth through mergers and acquisitions has become more relevant, where financially viable organizations are planning to take over comparatively weaker organizations to bring about more synergies and usher in consolidation and growth for the foreseeable future. This thought induced me to come up with a book on Financial Due Diligence based on my practical experience of many years.

It is known that an effective financial due diligence exercise is the cornerstone of a successful merger & acquisition deal between a prospective buyer and a seller willing to carry out an arm's length deal throwing up a win-win situation for both. A robust financial due diligence is even more necessary in today's business environment to critically assess the health and hygiene of the target entity and drive a proper valuation acceptable to both the constituents.

The book professes to address the following areas:

- (a) It starts with a curtain-raiser on corporate restructuring including the possible impact of the ongoing pandemic on the target organization,
- (b) It provides a broad commentary on the due diligence approach,
- (c) The seller side approach to financial due diligence and the pitfalls leading to a proverbial black hole of valuation has been explained,
- (d) A deep dive is carried out into the buyer side approach to financial due diligence including detailed checklist to review and evaluate each section of Financial Statements,
- (e) It delves into the tools used to handle financial due diligence, which are:
 - Financial modelling;
 - Financial statement analysis and use of financial ratios;
 - Various methods in use in Business Valuation with illustrations;
 - Distress Analysis of target entities.
- (f) It discusses in detail Enterprise Risk Management through control environment, mitigating defective controls and its impact on Financial Due Diligence approach,
- (g) Finally, it highlights certain practical case studies, which I picked up from my experience of many years in this field.
- (h) At the end, a brief questionnaire has been added as guidance to carry out financial due diligence exercise.

A Practical Guide to Financial Due Diligence

I would like to take this opportunity to mention that while considerable care has been taken to ensure that the contents of the book are accurate, a few errors and omissions might have crept in, for which I seek with all humility to my readers to bear with me.

I would like to dedicate this book to my wife Debika, my daughter Bidyut and my son Badri, all of whom have stood by me while developing this body of work.

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Chapter 1

Corporate Restructuring

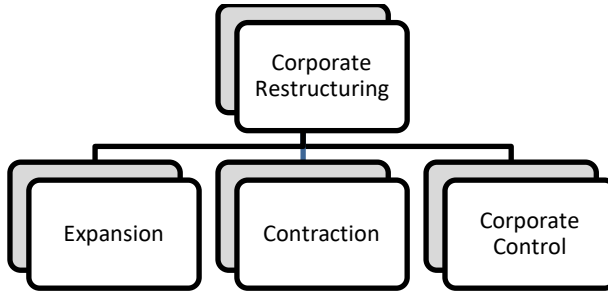
1.1 INTRODUCTION

Corporate Restructuring has become an integral part of today's business world, where macro-economic environment is constantly going through metamorphosis of change. As controls and restrictions give way to competition and free trade, restructuring, reorganization, and growth through the inorganic route has become essential. Restructuring usually involves tectonic shift in corporate strategies to meet increased competition or changed market conditions. Furthermore, with the onset of current pandemic which has thrown all kinds of businesses in complete disarray, this has assumed paramount importance to ensure businesses keep the heads above water and not wither away.

This restructuring process takes shape and form through mergers, acquisitions, takeovers, collaborations, consolidation, diversification etc. Domestic firms have taken steps to consolidate their position to face increasing competitive pressures and transnationals have taken this opportunity to enter Indian corporate sector.

The forces that drive corporate restructuring and consequent Merger & Acquisition activities are as under:

- | | |
|-------|---|
| (i) | Rapid pace of technological change; |
| (ii) | Low costs of communication and transportation; |
| (iii) | Globalization and global markets; |
| (iv) | Nature of competition in terms of forms, sources and intensity; |
| (v) | Emergence of new types of industries; |
| (vi) | Regulation in some industries and sectors; |
| (vii) | Liberalization in some industries and sectors; |
| (vii) | Growing inequalities in incomes and wealth. |



The forms of corporate restructuring are summarised in the following chart:

Expansion

The modes of expansion in Corporate Restructuring are enumerated below

Expansion
<p>Amalgamation</p> <p>This involves fusion of one or more companies where the companies lose their individual identity and a new company comes into existence to take over the business of companies being liquidated.</p>
<p>Absorption</p> <p>This involves fusion of a small company with a large company where the smaller company ceases to exist after the merger.</p>
<p>Tender offer</p> <p>This involves making a public offer for acquiring the shares of a target company with a view to acquire management control in that company</p>
<p>Asset acquisition</p> <p>This involves buying assets of another company. The assets may be tangible assets like manufacturing units or intangible like brands</p>
<p>Joint venture</p> <p>This involves two companies coming whose ownership is changed</p>

Contraction

The modes of contraction in Corporate Restructuring are depicted below

Contraction
<p>Demerger-spin off</p> <p>This type of demerger involves division of company into wholly owned subsidiary of parent company by distribution of all its shares of subsidiary company on Pro-rata</p>

basis. By this way, both the companies i.e., holding as well as subsidiary company exist and carry on business

Demerger - Equity carve out

This is similar to spin offs, except that same part of shareholding of this subsidiary company is offered to public through a public issue and the parent company continues to enjoy control over the subsidiary company by holding controlling interest in it.

Demerger – Split-up

This type of demerger involves the division of parent company into two or more separate companies where parent company ceases to exist after the demerger.

Asset sale

This involves sale of tangible or intangible assets of a company to generate cash. A partial sell off, also called slump sale, involves the sale of a business unit or plant of one firm to another. It is the mirror image of a purchase of a business unit or plant. From the seller's perspective, it is a form of contraction and from the buyer's point of view it is a form of expansion

Divestiture

These are sale of segment of a company for cash or for securities to an outside party. Divestitures, involve contraction.

Corporate control

The categories related to corporate control are summarized below.

Corporate control

Going private

This involves converting a listed company into a private company by buying back all the outstanding shares from the markets

Equity buy-back

This involves the company buying its own shares back from the market. This results in reduction in the equity capital of the company. This strengthens the promoter's position by increasing his stake in the equity of the company

Leveraged buy-outs

This involves raising of capital from the market or institutions by the management to acquire a company on the strength of its assets.

Anti – takeover defences

With the incidence of high value of hostile takeover activity in recent years, takeover defences both premature and reactive have been restored by the companies.

Legislative provisions related to the corporate restructuring are highlighted in the following paragraphs

- (a) Companies Act, 2013.
- (b) Income Tax Act, 1961.
- (c) Accounting Standards.

In this section, we have not included the provisions of Foreign Exchange Management Act and SEBI guideline, RERA, RBI regulations and labour related laws as this book covers aspects of Financial Due Diligence.

1.2 LEGISLATIVE PROVISIONS RELATED TO CORPORATE RESTRUCTURING

1.2.1 Under the Companies Act, 2013

Salient features of the provisions of the Companies Act 2013 on corporate restructuring are summarised in table below:

Provisions under Companies Act, 2013	Description
Sec 230	This corresponds to section 391 of the Companies Act, 1956 and provides for power to Tribunal to make order on the application of the company or any creditor or member or in the case of company being wound up, of liquidator for the proposed compromise or make arrangements with creditors and members.
Sec 231	Corresponding to section 392 of the Companies Act, 1956, this section provides for power of NCLT to supervise the implementation of the compromise or arrangement and enforce the same. The section also provides that if the Tribunal is satisfied that such compromise or arrangement cannot be implemented satisfactorily with or without modifications, and the company is unable to pay its debts as per the scheme, it may make an order for winding up of the company
Sec 232	Corresponding to section 394 of Companies Act 1956, this section seeks to provide powers to NCLT to order for holding meeting of the creditors or the members and to make orders on the proposed reconstruction, merger, or amalgamation of companies.
Sec 233	This is a new section and seeks to provide for merger or amalgamation between two small companies or between a holding company and its wholly owned subsidiary company by giving notice of the proposed scheme inviting objections or suggestions by both