PERIYAR UNIVERSITY

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SALEM - 636 011, Tamil Nadu, India.

CENTRE FOR DISTANCE AND ONLINE EDUCATION

(CDOE)

MASTER OF COMMERCE

SEMESTER - II

ELECTIVE COURSE III B

AUDIT AND DUE DILIGENCE

(Candidates admitted from 2024 onwards)

PERIYAR UNIVERSITY

CENTRE FOR DISTANCE AND ONLINE EDUCATION (CDOE)

M.Com 2024 admission onwards

ELECTIVE – Audit and Due Diligence

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SYLLABUS

AUDIT AND DUE DILIGENCE

UNIT1- Introduction to Audit

Audit: Meaning – Types of Audit: Corporate Governance Audit: Meaning and scope; Corporate Social Responsibility Audit: Meaning and objectives; Insider Trading Audit: An introduction – Labour Law audit: Meaning, process and benefits — Environment Audit: Meaning and Need – Social Audit: Meaning and implications – Introduction to Takeover Audit.

UNIT II - Secretarial Audit

Secretarial Audit: Meaning – Need – Applicability of Secretarial Audit under Companies Act, 2013 and SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 – The process of Secretarial Audit – Scope and Benefits of Secretarial Audit.

UNIT III- Introduction to Due Diligence

Due diligence: Meaning, Need, Objectives and Scope — Factors to be considered while conducting due diligence — Process of due diligence – Techniques of due diligence.

UNIT IV- Types of Due Diligence

Types of Due Diligence: Operational, Strategic, Financial, Technical, Legal, Management, Technical, Environmental, Human Resource.

UNIT V- Due diligence for Mergers and Amalgamation: Introduction and Process, Preparation of scheme of amalgamation - Due diligence for takeovers - Guidance on diligence reporting – Format of diligence report.

TABLE OF CONTENTS

AUDIT AND DUE DILIGENCE

Unit I- Introduction to Audit

Audit: Meaning – Types of Audit: Corporate Governance Audit: Meaning and scope; Corporate Social Responsibility Audit: Meaning and objectives; Insider Trading Audit: An introduction – Labour Law audit: Meaning, process and benefits – Environment Audit: Meaning and Need – Social Audit: Meaning and implications – Introduction to Takeover Audit.

UNIT OBJECTIVES

Learners will have a solid understanding of the fundamentals of audits, as well as their types, scope, and objectives, after completing this subject. Learners will gain an in-depth understanding of many audit types in this course, including corporate governance audit, corporate social responsibility, insider trading, labor law, environment, social, and takeover audits. Through the completion of this course, students will have a thorough understanding of audit ideas, kinds, and procedures, as well as the larger implications of these knowledge for maintaining organizational practices that are transparent, accountable, and trustworthy.

SECTION 1.1: INTRODUCTION TO AUDIT

1.1.1 Introduction

Auditing is as old as accounting. The word audit is derived from Latin word “*AUDIRE*”, which means “*To hear*”. In early days an auditor used to listen to the accounts read over by an accountant in order to check them.

In ancient times, whenever frauds were suspected, proprietors of the business used to appoint some experienced and impartial persons to check the correctness of the accounts. The hearing from the book keepers all the accounts relating to the business came to be known as Audit and the persons, who heard from the book keepers, came to be known as Auditors.

Auditing is as old as accounting, and there are signs of its existence in all ancient cultures such as Mesopotamia, Greece, Egypt, Rome, UK, and

India. In olden days the key purpose of audits was to gain information about the financial system and records of the business. However, recently auditing has begun to include non-financial subject areas such as safety, security, information system performance and environmental concerns. With the non- profit organization and government agencies, there has been an increasing need for performing an audit, examining their success in satisfying mission objectives of the business.

It was an Italian, ***LUCA PACIALO***, who first published his book on double entry system in 1494, where he mentioned and described the duties and responsibilities of an Auditor. Auditing evolved and grew rapidly after the industrial revolution in the 18^{th} century with the growth of the joint stock companies the ownership and management became separate.

1.1.2 Auditing in India

Let us now understand the growth of auditing in India. The Indian Companies Act, 1913, prescribed for the first time the qualifications of an Auditor. The Government of Bombay was the first to conduct related courses of study such as the Government Diploma in Accountancy (GDA).

The Auditor's Certificate Rule was passed in 1932 to maintain uniform standard in Accountancy and Auditing. The Chartered Accountant Act was enacted by the Parliament of India in 1939. The Act regulates that a person can be authorized to audit only when he qualifies in the examinations conducted by The Institute of Chartered Accountants of India. Following are a few other points related to Auditing in India:

- Members of Institute of Cost and Works Accountant of India are authorized to conduct cost audit according to Section 233-B of the Companies Act, 1956.
- Companies Act 1931 was replaced by Companies Act 1956.
- An Auditor can be appointed only by a special resolution as per section 224. The Companies (amendment) Act, 1974

a. Bookkeeping

A Bookkeeper records day-to-day transaction in the books of accounts in a systematic manner. Bookkeeping includes Journalizing, Posting to ledger, Totaling and balancing of ledger accounts.

b. Accountancy

The job of Accountancy begins where bookkeeping ends and includes the following are Rectification of errors, Preparation of Trial Balance and Preparation of financial statements (Trading and Profit & Loss account and Balance Sheet, etc.)

c. Auditing

Preparation of accounts is not the duty of an Auditor. “Auditing begins, where accountancy ends”. Auditor is only concerned for checking and verification of records. Auditor is a qualified person appointed for the purpose f certification of work done by others.

d. Investigation

An investigation may be done with a specific purpose. It is usually conducted to know the financial position of a business, extent of fraud and misappropriation and the earning capacity of any business unit, etc. The time duration for investigation may also extend beyond one year. Investigation may not be necessarily done by a qualified Chartered Accountant.

1.1.3 Meaning and definition of Auditing

Auditing refers to a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events

to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users.

Auditing is done by the independent person or body of persons qualified for the job with the help of statements, papers, information and comments received from the authorities. So that the examiner can confirm the authenticity of financial accounts prepared for a fixed term and report that:

- The balance sheet exhibits an accurate and fair view of the state of affairs of concern
- The profit and loss accounts reveal the right and balanced view of the profit and loss for the financial period
- The accounts have been prepared in conformity with the law.

Audit is performed to ascertain the validity and reliability of information. Examination of books and accounts with supporting vouchers and documents to detect and prevent error, fraud is the primary function of auditing.

"An audit is an examination of accounting records undertaken with a view of establishing whether they correctly and completely reflect the transactions to which the purport to relate." –**Lawrence R. Dickey**

"Audit is defined as an investigation of some statements of figures involving examination of certain evidence, so as to enable an auditor to make a report on the statement." –**Taylor and Perry**

"Audit such an examination of the books of accounts and vouchers of a business as will enable the auditor to satisfy himself that the balance sheet is properly drawn up so as to give a fair and true view of the state of affairs of the business and the whether the profit and loss of accounts gives a true and

fair view of profit and loss for the financial period according to the best of his information and explanations given to him and as shown by the books and if not in what respect he is not satisfied." –**Spicer & Pegler**

1.1.4 Features of Auditing

- Audit is systematic and scientific examination of the books of account of a business/non-business entity.
- Audit is a verification of the results shown by the Profit & Loss Account and the state of affairs as shown by the Balance Sheet.
- Audit is a critical review of the system of accounting and Internal control.
- Audit is on-site verification activity, such as Inspection or examination of process or quality system, to ensure compliance to regulatory and other laid down requirements.
- Audit is undertaken by an independent person or body of persons who are duly qualified for the job.
- Audit is done with the help of vouchers, documents, information and explanations received from the authorities of a business/non-business entity to evaluate evidence, documentation and economic aspects of a financial transaction.

The auditor has to satisfy himself about the authenticity of the financial statements and report as to whether the same exhibits a true and fair view of the state of affairs of the concern.

1.1.5 Importance of an Audit

Without a system of internal controls or audit systems to verify the efficacy thereof, an entity would not be able to create reliable financial statements for internal or external purposes. Accordingly an audit system is crucial in preventing material misstatements in an entity's financial statements

1.1.6. Purpose of an Audit

<u>The main purpose of an audit is to provide</u>

1. An objective and independent examination of the financial statements

2. To enhance the credibility of the financial statements prepared by the organisation
3. To increase the confidence of users in the financial statements
4. To reduce risk to investors

Thus, the basic purpose of an audit can be described as:

1. To assess whether or not the financial statements are in conformity with Generally Accepted Accounting Principles (GAAP) and the prescribed accounting standards.
2. To provide assurance about the accuracy of financials.
3. To ensure compliance with established internal control procedures by examining
   records, reports, operating practices and documentation.
4. To certify the assets and liabilities by comparing same to available documentation.
5. To verify compliance, conformance or performance.
6. To follow-up on the completed/contemplated corrective action plan of an organisation.

1.1.7 Scope of Audit

The scope of audit is increasing with the increase in the complexities of the business. It is said that the long-term objectives of audit should be to serve as a guide to the Management's future decisions. The scope of audit encompasses verification of accounts with an intention of giving opinion on

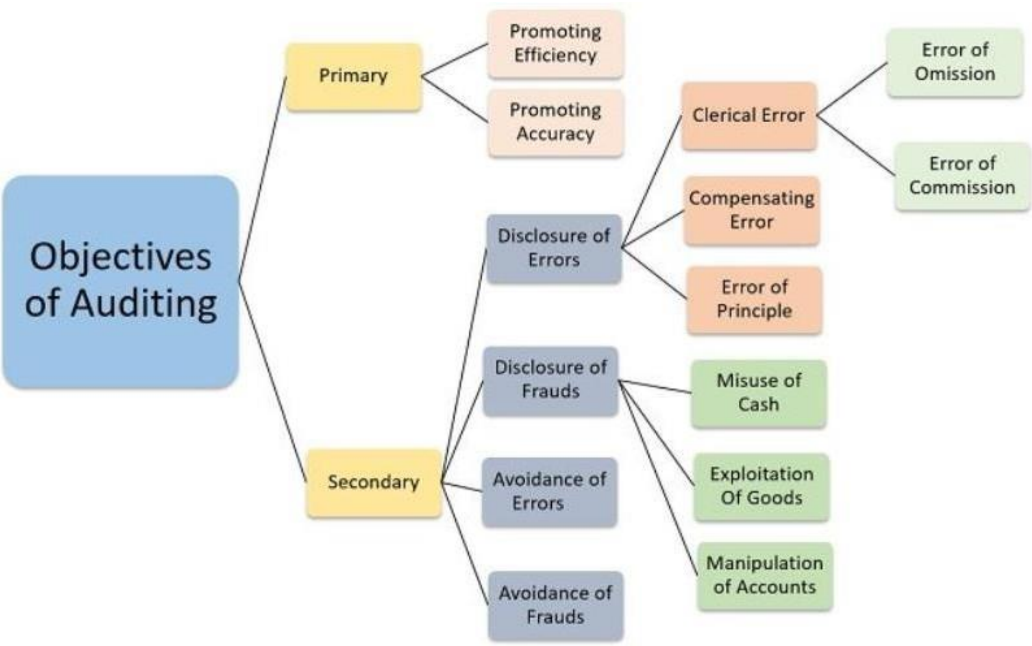
its reliability. Hence it covers cost audit, management audit, social audit, etc. It should be remembered that an auditor just expresses his opinion on the authenticity of the accounts. He has no power to take action against anybody. That is why it is said that **"an auditor is a watchdog but not a bloodhound."**

1.1.8 Objectives of Auditing

Auditors are basically concerned with verifying whether the accounts exhibit a true and fair view of the business. The objectives of auditing depend upon the purpose of his appointment.

Primary objective:

As per Section 227/143 of the Companies Act, 1956/2013, the primary duty (objective) of the auditor is to report to the owners whether the Balance Sheet gives a true and fair view of the company's state of affairs and the profit and loss account gives a correct figure of profit and loss for the financial year. The auditor is also concerned with verifying how far the accounting system is successful in correctly recording transactions and to ascertain whether the accounts are prepared in accordance with the recognised accounting policies and practices and as per statutory requirements and in his opinion, the financial statements comply with the accounting standards



Source : https://theinvestorsbook.com/auditing.html

Secondary Objectives:

The following objectives are incidental to the satisfaction of the main objective of auditing. The incidental objectives of auditing are:

Detection and prevention of errors and frauds.

Detection of material frauds and errors as an incidental objective of independent financial auditing flows from the main objective of determining whether or not the financial statements give a true and fair view. As the statement on auditing practices issued by the Institute of Chartered Accountants of India states, an auditor should bear in mind the possibility of the existence of frauds or errors in the accounts under audit since they may cause the financial position to be misstated.

Errors refer to unintentional mistake in the financial information arising on account of ignorance of accounting principles i.e. errors of principle, or error arising out of negligence of accounting staff i.e. clerical errors.

Errors are mistakes committed **unintentionally** because of ignorance.

Types of Errors

Types of Errors		Details
A.	Errors of Omission	These are errors which arise on account of the transaction being recorded in the books of account either wholly/partially. If a transaction has been totally omitted it will not affect the trial balance and hence it is more difficult to detect. On the other hand, if a transaction is partially recorded, the trial balance will not agree and hence it can be easily detected.
B.	Errors of Commission	When incorrect entries are made in the books of account ei- ther wholly or partially, such errors are known as errors of commission. e.g. wrong entries, wrong calculations, postings, carry forwards, etc. Such errors can be located while verifying.
C.	Compensating Errors	When two/more mistakes are committed which nullify each other. Such errors are known as compensating errors. e.g. if in an account the amount of a transactions is wrongly debited by Rs. 100 less and if in same account another transaction is wrongly credited by Rs.

		100 less, such a mistake is known as compensating error.
D.	Error of Principle	These are the errors committed by not properly following the accounting principles. These arise mainly due to the lack of knowledge of accounting e.g. Revenue expenditure being treated as Capital Expenditure or *vice versa.*
E.	Clerical Errors	A clerical error is one which arises on account of ignorance, carelessness, negligence etc. and may include one or more of the above except D.

The auditor has to inspect, compare, check, review, scrutinize the vouchers supporting the transactions and examine correspondence, minutes book of shareholders, directors, Memorandum of Association and Articles of Association, bye laws etc., in order to establish correctness of the books of account.

Location of Errors

It is not the duty of the auditor to identify the errors but in the process of verifying accounts, he may discover the errors in the accounts. The auditor should may follow one or more of the following procedures in this regard to locate errors and to rectify same:

Check the trial balance, compare supplementary totals of debtors and creditors with balances of main ledger extracted to the trial balance, Compare the names of accounts appearing in the Ledger with the names of accounts in the Trial balance, Verify the totals and balances of all accounts and see that they have been properly shown in the Trial Balance, Check the posting of entries from various books ledger. Check differences involving round figures such as 10, 100, 1000 etc. and their difference is divisible by 9 which could mean interchange of figures or total takes etc. Timely careful scrutiny is the only remedy for detection of errors.

II. Detection and Prevention of Fraud:

A fraud is an error committed **intentionally** to deceive/to mislead/to conceal the truth or material facts. Frauds may be of three types.

Types of Frauds		Details
a.	Misappropriation of Cash	This is one of the major frauds in any organisation and normally occurs in the cash department. This kind of fraud takes place either by showing more payments or recording less receipts. 1. The cashier may show more expenses than what are actually incurred and may misuse the extra cash. e.g. showing wages to dummy workers. Cash can also be misappropriated by showing less receipts. Cash received from 1st customer is misused, when the 2nd customer pays, it is transferred to the first customer. When the 3rd customer pays, it is transferred to the 2nd customer. Thus the fraud goes on forever. Such fraud is called **"Teeming and Lading**". To prevent such frauds, the auditor must check in detail all books and

		documents, vouchers, invoices, etc.
b.	Misappropriation of Goods	Here records may be made for the goods not purchased for/ not issued to the production department and the goods may be used for personal purpose. Such a fraud can be detected by checking stock records and physical verification of goods.
c.	Manipulation of Accounts	This is finalizing accounts with the intention of misleading others. This is also known as "**Window Dressing".** It is very difficult to locate, because it is usually committed with or without the connivance of higher-level management. The objective of "Window Dressing" may be to evade tax, to borrow money from bank, to increase the share price, etc.

Till recently, the principal emphasis was on arithmetical accuracy. The Companies Act, 1956 required the auditor to state inter alia whether the statements of account are true and fair. This is what we can take as the present-day audit objective. There has been a shift of emphasis from arithmetical accuracy to the question of reliability of the financial statements. The Companies Act, 2013 (section 143) now requires the auditor to express his opinion on whether the financial statements comply with the accounting standards. It is not the main objective of the auditor to discover frauds and errors. But if he finds anything of a suspicious nature, he needs to make a detailed enquiry and verification report his findings. The provisions of the Companies (Audit and Auditors) Amendment Rules, 2015 issued in December 2015 require inter alia (These rules get amended from time to time (last amendment came in effect from April 1, 2021)

1. Reporting by statutory auditor to Central Government for frauds which involve/ are expected to involve individually an amount of Rs. one crore or above.
2. In case of fraud involving lesser than above amount, statutory auditor has to report the matter to the audit committee/Board of the Company.

1.1.9 Advantages and Limitations of Audit

The public good derived from auditing is reasonable assurance that financial statements and disclosures are free from material misstatements.

The following advantages from various viewpoints are derived from audit:

1. Business Point of view
2. Investors Point of view
3. Others Point of view

(I) Advantages of Audit

Sr. No.	Business Point of view	Investors Point of view	Other Advantages
1	Detection of errors & fraud	Protects interest	Evaluates Financial Status
2	Helps in Loan Formalities	Moral check	Listing of shares/payment of dividend
3	Builds reputation	Proper valuation of investments	Settlement of claims and Settlement of accounts
4	Proper valuation of assets	Good Security	Evidence in court as Audited accounts are treated as an authentic records of transaction.
5	Government acceptance as it facilitates taxation.	Updated position of accounts available then and there	Facilitates calculation of purchase consideration

(II) Limitations of Auditing

1. First of all, the auditors work involves exercise of judgment, for example, in deciding the extent of audit procedures and in assessing the reasonableness of the judgment and estimates made by the Management in preparing financial statements. Further much of the evidence available to the auditor can enable him to draw only reasonable conclusions therefrom. The audit evidence obtained by an auditor is generally persuasive in nature rather than conclusive in nature. Because of these factors, the auditor can only express an opinion. Therefore, absolute certainty in auditing is rarely attainable. There is also a likelihood that some material misstatements in the financial information resulting from fraud or error, if either exists, may not be detected.

2. The entire audit process is generally dependent upon the existence of an effective system of Internal Control. Further, it is clearly evident that there will always be some risk of an internal control System failing to operate as designed. No doubt, the Internal Control system also suffers from certain inherent limitations. Any system of Internal control may be ineffective against fraud involving collusion among employees or fraud committed by management. Certain levels of management may be in a position to override controls, for example, by directing subordinates to record transactions incorrectly or to conceal them, or by suppressing information relating to transactions.

Sr. No.	Limitations of Auditing	Details
1	Non-detection of errors and frauds	Auditor may not be able to detect certain frauds which are committed with **mala fide** intentions.
2	Dependence on Explanations by others	Auditor may not be able to find out misrepresentations if any given by others if they are given with a view to conceal fraud detection.
3	Dependence on opinions of others	Auditor has to rely on the views or opinions given by different experts *viz*. Lawyers, solicitors, engineers, architects, etc. He can't be an expert in all the fields.
4	Conflict with others	Auditor may have difference of opinion with the accountants, management, engineers, etc. In such a case, his personal judgment plays an important role. It differs from person to person.

5	Effect of inflations	Financial Statements may not disclose the true picture even after the audit due to inflationary trends. (as statements are prepared on historical cost basis)
6	Corrupt practices to influence the auditors	The management may use corrupt practices to influence the auditors and get a favourable report about the state of affairs of the organisation.
7	No assurance	Auditor can't give any assurance about future profitability and prospects of the company.
8	Inherent limitations of the financial statements	Financial statements do not reflect the current values of the assets and liabilities. Many items are based on personal judgment of the owners. Certain non-monetary facts may also distort the true position.
9	Detailed checking not possible	Auditor can't check each and every transaction.

1.1.10 Types of Audit:

An audit provides credibility to the policies, procedures and finances of a company. This provides the shareholders with confidence that the accounts of a company are true and fair. To maintain a good business reputation, it is essential to understand audits and how businesses conduct them. There are several types of audits that a business can choose to implement to assess the overall health of the company. They are:

Source : https://www.wallstreetmojo.com/audit-objectives/

i) Internal Audit

Internal auditing is a vital independent activity that boosts an organization's performance. It's all about making sure things run smoothly by evaluating and enhancing governance processes. This includes setting up internal controls to manage risks and achieve organizational goals. There are three main types of internal audits:

1. **Performance Audit:** This audit ensures that the organization meets its standards and performs efficiently. Management sets the bar, and the team works to meet it while following regulations.
2. **Environmental Audit:** Here, the focus is on whether the company is following eco-friendly policies and staying within the bounds of environmental laws.
3. **Information Technology Audit:** This audit evaluates the technical setup of the organization, checking hardware and software to ensure they're functioning properly. Cyber security issues are also identified and addressed as necessary.

ii) External Audit

External audits, conducted by independent professionals, offer an unbiased evaluation of a company's financial health. They aim to spot any significant errors in financial reports. Companies benefit by gaining impartial insights to make better business choices. Here are the main types:

1. **Financial Statements Audit:** External auditors examine a company's financial reports to ensure accuracy and transparency, helping companies understand their true financial position.
2. **Operational Audit:** This type focuses on how a company's operations contribute to its goals, ensuring efficiency and effectiveness.
3. **Compliance Audit:** Internal auditors check if the company follows relevant laws and regulations in its operations.
4. Forensic Audit: These audits aim to uncover any financial wrongdoing, helping organizations protect themselves against fraud.

iii) Government Audit

This type of audit is how the government checks the financial records of organizations or individuals. It's to make sure everything's accurate, especially regarding taxes. The audit can happen by mail or in person, with the entity being audited notified by email. The IRS does routine checks to confirm taxpayers' returns are correct. They use a statistical formula to pick who to audit. Even if a company makes tax errors, they might still get audited. Secretarial audits are done by independent firms. They check a company's secretarial records to make sure there are no big mistakes from fraud or errors in following the law.

iv) Forensic Audit

Forensic audits are deep dives into financial records to find fraud or dishonesty. They're common before legal battles. They cover areas like fraud detection, checking insurance claims, solving financial disputes, and understanding bankruptcy reasons and any shady dealings.

v) Tax Audit

Tax audits are checks done by tax authorities to ensure that what you reported on your tax returns matches your actual income and deductions.

There are a few types of audits:

1. **Desk Audits:** These are basic checks done at the tax office.
2. **Field Audits:** More thorough examinations done at your place, either home or office.
3. **Correspondence Audits:** These are conducted via mail for smaller issues.
4. **Employer Audits:** Focused on payroll taxes and work-related tax matters.

vi) Compliance Audit

Compliance audits make sure companies follow outside laws, rules, and their own guidelines.

- Healthcare Compliance: Stays in line with healthcare rules.
- Environmental Compliance: Checks if environmental laws are followed.

- Safety Compliance: Ensures safety rules are obeyed.
- Financial Compliance: Keeps up with financial regulations.

vii) Information System Audit

IT audits, also referred to as information technology audits, are evaluations of an organization's IT system controls. Here's a breakdown of the key areas covered in IT audits:

1. **Systems and Applications Audit:** This assesses the various systems and applications utilized by the organization.
2. **Information Processing Facilities:** This evaluates how the IT systems are set up and managed.
3. **Systems Development:** This ensures that any systems currently being developed align with the organization's goals and objectives.
4. **Management of IT and Enterprise Architecture:** This involves reviewing the structure of IT management within the organization.
5. **Client/Server, Telecommunications, Intranets, and Extranets:** This part of the audit assesses the network and communication systems in place, including client/server setups, telecommunications infrastructure, and internal/external networks.

viii) Operational Audit

Operational audits are like thorough check-ups for how well a company does its work. They look at everything from how tasks get done to how good those methods are.

- **Process Audits:** These check how well certain tasks are done in a company.
- **Department Audits:** These focus on how one part of a company works.
- **System Audits:** These see how well a whole system in a company does its job.

ix) Financial Audit

Financial audits are checks that make sure a business's financial reports are fair and accurate. There are two main types:

- **Statutory Audit:** This is a legally required review of a company's or government's financial records to ensure they're accurate.
- **Voluntary Audit:** This kind of audit isn't legally required. It's done by choice, often for internal reasons within the company.

x) Performance Audit

Performance audits look at how well a company is doing in terms of being efficient, effective, and economical.

- **Economy Audit:** Checks if the company is getting resources at the best prices.
- **Efficiency Audit:** Looks at whether resources are used effectively to get the desired results.

Let's Sum Up

Dear Learners, in this first section, we have seen that basic concept of auditing and its definitions. Various authors define auditing as the examination of accounting records, investigation of some statements of figures, examination of the books of accounts and vouchers of a business. So, Audit is an examination of the books of accounts and vouchers of a business as will enable the auditor to satisfy himself that the balance sheet is properly drawn up so as to give a fair and true view of the state of affairs of the business. Accordingly, an audit system is crucial in preventing material misstatements in an entity's financial statements. Detection of material frauds and errors as an incidental objective of independent financial auditing flows from the main objective of determining whether or not the financial statements give a true and fair view. Finally this section explain various kinds of audit which helps to the learner to know the each kinds of audit and its importance.

Check your Progress - QUIZ – 1

1. What is the etymological origin of the word "audit"?

   a) Derived from Greek, meaning "to see"

   b) Derived from Latin, meaning "to hear"

   c) Derived from French, meaning "to verify"

   d) Derived from German, meaning

2. Which type of errors arises on account of the transaction being recorded in the books of account either wholly/partially?

a) Errors of omission b) Errors of commission c) Compensating errors d) Clerical errors

3. Reporting by statutory auditor to Central Government for frauds which involve/ are expected to involve individually an amount of----------------------

a) Rs. one crore or above. B) Rs. Two crore or above c) Rs. Five crore or above d) Rs. Ten crore or above

4. ______ audit helps to know at how well a company is doing in terms of being efficient, effective, and economical.

a) Performance audit, b) Tax audit c) Compliance audit d) ITax audit

5) -------------- audits make sure companies follow outside laws, rules, and their own guidelines.

a) Performance audit, b) Tax audit c) Compliance audit d) IT audit

SECTION 1.2 CORPORATE GOVERNANCE AUDIT

1.2.1 Meaning and definition of Corporate Governance Audits:

Corporate Governance Audits are an essential tool for ensuring that Companies operate in a transparent, ethical, and accountable manner. These Audits assess the policies, procedures, and practices that a Company has in place to manage its operations and ensure compliance with legal and regulatory requirements.

Definition: Corporate Governance as a system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. This audit defined as “a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance", (OECD, 1999, p.11).

1.2.2 Scope of Corporate Governance Audits

The scope of Corporate Governance Audits can vary depending on the size and complexity of the Company being audited. However, in general, Corporate Governance Audits evaluate the following areas:

1. Board of Directors

The Board of Directors is responsible for setting the organization's strategic direction, ensuring effective management of resources, and providing oversight to management. Governance Audits evaluate the board's composition, structure, and processes to ensure that the board is functioning effectively and efficiently. It also reviews the board's decision-making process, independence, risk management practices, the effectiveness of the board's oversight role of the company's management and communication channels to ensure that they are aligned with the organization's objectives

2. Ethical Leadership and Corporate Citizenship Management

Ethical Leadership and Corporate Citizenship are the hallmarks of good governance and assist to achieve organizational effectiveness. Governance Audits assess the organization's ethical standards and practices, including its code of conduct, anti-corruption policies, and whistleblower protection mechanisms. It also reviews the organization's engagement with its stakeholders and the broader community to ensure that it is fulfilling its corporate social responsibility obligations.

3. Accountability, Risk Management, and Internal Control

Accountability, Risk Management, and Internal Control are critical components of effective Governance. Governance Audits evaluate the organization's Risk Management Framework, Internal Control systems, and financial reporting practices. It also assesses the effectiveness of the organization's internal audit function.

4. Transparency and Disclosure

Transparency and Disclosure are essential to sustaining the confidence of Investors, Stakeholders, and the wider society and provides opportunities for continuous improvement of business structures and processes. Governance Audits evaluate the organization's disclosure practices, including the quality and timeliness of financial reporting, and the transparency of the organization's decision-making processes.

5. Shareholder Rights and Obligations

Shareholder Rights and Obligations are critical components of good governance and are essential to ensuring their equitable treatment. Governance Audits evaluate the organization's shareholder communication practices and assess the effectiveness of the organization's shareholder engagement initiatives. It also reviews the organization's compliance with legal requirements related to shareholder rights, such as proxy voting and disclosure requirements.

6. Stakeholder Relationships

Stakeholder Relationships are essential to building trust and confidence in the organization's Governance practices. Governance Audits assess the organization's Stakeholder engagement practices, including its communication channels and engagement initiatives. It also reviews the organization's compliance with legal requirements related to Stakeholder Rights and Engagement.

7. Compliance with laws and regulations

Compliance with laws and regulations is a fundamental requirement of good Corporate Governance as an organization is expected to conduct its business affairs in full compliance with all applicable laws, rules, and regulations and in line with accepted national and international standards, as well as, its internal policies. Governance Audits evaluate the Company's compliance practices, including its adherence to legal and regulatory requirements. It further assesses whether the company is complying with relevant laws and regulations, including those related to data privacy, anti- corruption, and environmental protection.

8. Sustainability and Performance Management

Sustainability and Performance Management are essential for the long-term success of any organization. Governance Audits evaluate the company's sustainability practices, including its environmental, social, and governance (ESG) initiatives. It further assesses whether the Company has a robust performance management framework, including key performance indicators (KPIs) and metrics, to measure and improve its sustainability performance.

1.2.3 Need for Conducting Corporate Governance Audits

- **Enhancing Transparency and Accountability**

Corporate Governance Audits assist companies to be more transparent and accountable by identifying areas of improvement and providing recommendations for remedial actions. This, in turn, promotes trust and confidence among stakeholders, which is essential for long-term success.

- **Risks Reduction**

Corporate Governance Audits assist to identify potential risks and weaknesses in the Company's policies and procedures thereby enabling management to take appropriate measures to mitigate these risks. This aids to prevent or minimize financial and reputational damage to the company.

- **Ensuring Compliance**

Corporate Governance Audits assist to ensure that the Company complies with laws and regulations, including those related to Financial Reporting, Internal Controls, and Risk Management. This reduces the risk of legal and regulatory sanctions and protects the company's reputation.

- **Improving Efficiency**

Corporate Governance Audits assist to identify areas where the Company can improve its efficiency and effectiveness, such as by streamlining processes, reducing waste, and optimizing resources. This can lead to cost savings and increased profitability.

- **Promoting Good Governance**

Corporate Governance Audits promote good governance by ensuring that the company's policies and procedures align with its mission and values, and by promoting ethical behavior and responsible decision-making.

Corporate Governance Audits are therefore a vital tool for ensuring that companies operate in a transparent, ethical, and accountable manner. These audits assist to identify potential risks and weaknesses, ensure compliance with laws and regulations, and promote good governance. By undertaking regular Corporate Governance Audits, Companies can enhance transparency and accountability, reduce risks, improve efficiency, and protect their reputation.

Ultimately, this can lead to long-term success and sustainability for the company and its stakeholders.

Let’s Sum Up

Corporate Governance Audits are an essential tool for ensuring that Companies operate in a transparent, ethical, and accountable manner. These Audits assess the policies, procedures, and practices that a Company has in place to manage its operations and ensure compliance with legal and regulatory requirements. By undertaking regular Corporate Governance Audits, Companies can enhance transparency and accountability, reduce risks, improve efficiency, and protect their reputation. Ultimately, this can lead to long-term success and sustainability for the company and its stakeholders.

Check Your Progress - QUIZ – 1

1. The primary stakeholders are:

a) Customers b) Suppliers c) Shareholders d) Creditors

2. The goal of corporate governance and business ethics education is to

a. Teach students their professional accountability and to uphold their personal Integrity to society

b. Change the way in which ethics is taught to students

c. Create more ethics standards by which corporate professionals must operate

d. Increase the workload for accounting students.

3. The corporate governance structure of a company reflects the individual companies’

a) Cultural and economic system

b) Legal and business system

c) Social and regulatory system

d) All of the above.

4. Undertaking regular Corporate Governance Audits, Companies can enhance

a) Transparency and accountability,

b) Reduce risks

c) Improve efficiency

d) All the above

5 Which of the following is not one the underlying principles of the corporate governance Combined Code of Practice?

a) Accountability

b) Acceptability

c) Openness

d) Integrity

SECTION 1.3 CORPORATE SOCIAL RESPONSIBILITY AUDIT

1.3.1 Meaning

"A Corporate Social Responsibility (CSR) audit aims at identifying environmental, social or governance risks faced by the organization and evaluating managerial performance in respect of those."

The corporate sector in India both public and private, have been implementing CSR activities for a long time without any mandatory requirement. It was being done more as charity or philanthropy and was focused on creating basic social infrastructure like primary schools, health centre, orphanages, etc. The objective was the feel-good factor by meeting the thriving deficiency of basic social infrastructure facilities. The concept of the responsibility to stakeholder and the consideration of community as stakeholder were missing. The national voluntary guidelines for social, economic and environmental responsibilities of business brought in the formal concept of responsibilities of business to all stakeholders which was endorsed under the Companies Act, 2013. The Act created a level playing field by mandating expenditure on CSR activities. The regulatory mechanism of social compliance is gradually becoming more comprehensive. At the same time, stakeholders are expecting greater accountability to see the impacts of this CSR activities. It is becoming important for both government and the corporate to assess whether the social investments in the CSR activities are in compliance with the provisions of the Companies Act and whether these investments are making an impact by giving the social dividend to the corporate and the nation.

1.3.2 NEED FOR CSR AUDIT

An audit is an important Management Information System (MIS) tool upon which many management decisions are dependent. The purpose of any audit is to acquire information and provide additional discipline on the internal processes to validate proper functioning of the specific system. Benefits of such an exercise in reducing the waste and cost and improving the efficiency and efficacy in the system are evident. A CSR audit is a management tool comprising a systematic, documented, periodic, and objective evaluation of how well CSR organization, process and management are performing with the aim of creating social value to stakeholders. It is an independent evaluation of: i) Compliance to policy and principles, ii) Compliance to systems, procedures, and practices, iii) Performance of elements relating to CSR, iv) Compliance to regulatory requirements, and v) Reliability of data management, records, and disclosure. The advantages of such an exercise are not only assuring conformance/ compliance with statutory requirements but also reducing social risk and liability; and increasing efficiency and efficacy of CSR projects. A good system of audit is the backbone of every successful programme. The process of audit gives a better understanding of the monitoring practices, availability of records, and input for evaluation of programmes.

1.3.2 Objectives of CSR audit:

1. Verifying Compliance

- A CSR audit ensures that the company is complying with the CSR provisions mandated by laws and regulations.
- It verifies whether the company is spending the required amount on CSR activities and adhering to the specified activities listed under the law.

2. Assessing Impact and Effectiveness

- The audit assesses the impact of the company's CSR initiatives on various stakeholders and the community.
- It evaluates the effectiveness of CSR programs in achieving the intended social and environmental outcomes.

3. Evaluating CSR Policy and Strategy

- The CSR audit reviews the company's CSR policy and strategy to ensure they are aligned with its core values and business objectives.
- It evaluates whether the company's CSR initiatives contribute to long-term sustainability and stakeholder engagement.

4. Measuring Transparency and Disclosure

- A CSR audit assesses the company's transparency and disclosure practices related to CSR activities.

- It ensures that the company is providing accurate and comprehensive information about its CSR initiatives in public reports.

5. Identifying Areas for Improvement

- The audit helps identify areas where the company can enhance its CSR performance and make a more significant impact.
- It provides recommendations for improving CSR practices and aligning them with global best practices.

6. Engaging Stakeholders

- Conducting a CSR audit involves engaging with various stakeholders, including employees, customers, communities, and NGOs.
- Stakeholder input and feedback play a vital role in shaping the audit's scope and identifying key areas of concern.

7. Enhancing Credibility and Trust

- A comprehensive CSR audit conducted by an independent third party enhances the company's credibility and fosters trust among stakeholders.
- It demonstrates the company's commitment to accountability and responsible practices.

1.3.4 THE SCOPE OF CSR AUDIT

The output is the quantitative impact of the CSR activities carried out by the organization. The audit will include assessment of the physical changes that have taken place during an identified span of time because of the activities undertaken. This impact would vary depending upon the efficiency of the community development activities carried out, the number of intended beneficiaries identified, and the social/physical infrastructure provided to the community.

I. Audit for financial resources and utilisation This covers the primary aspects of the project management that is, if the CSR project was delivered within time, within estimated cost and with required quality. This is generally covered under the financial audit of the corporate.

II. Audit for compliance to the Companies Act and the CSR policy & CSR Audit business process of the company This will ensure that the system and process both under the Companies Act and under the corporate plan, strategies and policies are complied with. It will also enable the company to examine and ensure that the CSR is fully integrated into business processes, business plans and business risk register.

i) **Compliance with the Companies Act** This covers the audit of compliance to processes identified in the section 135 of the Companies Act. This may include how the CSR projects are identified, CSR goals established, and CSR projects formulated. It also covers auditing the identification of CSR projects vis a vis the activities identified under Schedule VII of the Companies Act and the clarifications given by Ministry of Corporate Affairs from time to time.

ii) **Effectiveness of CSR policy** This covers the audit of the effectiveness of the CSR policy, whether it has given the desired results and what changes have been made or should be made to deliver the stated aims and objectives of the policy.

iii) **Identification and formulation of CSR projects** The audit will cover the identification and the formulation of the CSR projects including defining the output and outcome that it intends to achieve. The audit will cover whether adequate resources were deployed to achieve the objective. The audit will also cover whether the need assessment survey was aligned with the national goals and the sustainable development goals as per the national plan of the government.

iv) **Institutional setup** The audit will cover the assessment of the deployment of suitable human resources and their efficient utilisation by the implementing agency whether in-house or through an NGO or any other lawful agency. The human resource audit would identify the suitability of the staff deployed and their training needs. The audit would provide data to the management on efficient use of the resources per unit of production thereby reducing resource consumption and minimising the waste. The audit will cover the training requirement and management of the CSR staff and the NGO deployed for planning and implementation of the CSR activities.

v) **Data management:** The audit will cover the adequacy of the data management system and the communication system with the stakeholders and the beneficiaries. vi) Stakeholder engagement The CSR projects are the only activity which a company does not plan for its own benefit but for the benefit of communities which are its stakeholders. Hence, the stakeholder engagement becomes the most important aspect of planning, implementing, and reporting. Without appropriate engagement, the objective of implementing the CSR projects gets distorted and perceived to benefit the company rather than the stakeholders.

III. **Audit of outcome as per the project report**: Social impact evaluation basically means the evaluation of qualitative impact of the community development programmes carried out by the organization for the community. The evaluation includes assessment of the awareness and perception of the people for whom the activities were aimed. The assessment could be on the economic aspect or the sociocultural aspect or on both the aspects. This impact would vary depending upon the effectiveness of the community development (CD) activities carried out. Social impact evaluation would help to determine the extent to which the community people have got benefited from the CSR-CD activities implemented for them and whether CSR-CD activities have been able to bring desired changes in the educational/ health/ economic status of the communities.

LET'S SUM UP

CSR audit is a basis for developmental planning whose ultimate aim is social benefits. It could help the industry in assessing the performance of business in terms of value addition to social capital. The CSR audit will not only ensure the legal compliance and the financial prudence of CSR activities, but also improve the effectiveness of creating the social and community capital and also facilitate optimal utilisation of resources invested in CSR projects. It will also enable the company to minimize and mitigate the risk related to legal compliance, social discontentment and reputation. In this unit you have read about various aspects of CSR audit. The unit deals in detail with the need and scope of CSR audit. You have also read about the audit procedure and selection of audit personnel.

Check your progress- Quiz-1

1. Which of the following is NOT a common area of focus for CSR initiatives?

A) Environmental sustainability

B) Employee satisfaction

C) Profit maximization

D) Community development

2. CSR aims to strike a balance between which two important aspects?

A) Economic growth and environmental conservation

B) Employee welfare and customer satisfaction

C) Profitability and market share

D) Regulatory compliance and shareholder dividends

3. Which stakeholder group is typically the primary focus of CSR initiatives?

A) Shareholders

B) Employees

C) Customers

D) Government

4. In the context of CSR, what does the acronym “ESG” stand for?

A) Environmental, Social, and Governance

B) Economical, Societal, and Global

C) Ethical, Sustainable, and Green

D) Employee, Supplier, and Government

5. What is the primary goal of a CSR audit?

A) Maximize shareholder profits

B) Assess the financial performance of a company

C) Evaluate the effectiveness of CSR initiatives

D) Increase advertising budgets

SECTION 1.4 INSIDER TRADING AUDIT AND LABOUR LAW COMPLIANCE AUDIT

1.4.1 Meaning of Insider trading

Insider trading is a controversial practice that has long captivated investors, authorities, and the general public. This illegal activity includes purchasing or selling shares based on important secret information that gives some people a disproportionate advantage in the world of finance. These people, often known as insiders, have special access to information that could include impending corporate statements, financial outcomes, or significant events that could significantly impact the price of a company's shares. Insider trading threatens the integrity and dependability of the financial system as a whole and undermines the principles of open and equitable markets.

Insider trading audit:

An insider trading audit is a process conducted by a company or an external auditor to ensure compliance with regulations and internal policies regarding insider trading. Insider trading refers to the buying or selling of a company's stock by individuals with access to non-public, material information about the company. This practice is illegal and can lead to severe penalties for both the individuals involved and the company itself.

1.4.2 Procedure for insider trading audit:

1. Review of Policies and Procedures: The audit begins with a review of the company's policies and procedures related to insider trading. This includes examining the company's insider trading policy, code of conduct, and any relevant regulatory requirements.

2. Identification of Insiders: The audit identifies individuals who have access to material non-public information about the company, such as executives, directors, employees, and certain contractors or consultants.

3. Monitoring and Surveillance Systems: The audit assesses the effectiveness of the company's monitoring and surveillance systems for detecting potential instances of insider trading. This may include reviewing trading records, access logs, communication systems, and other relevant data.

4. Training and Awareness Programs: The audit evaluates the company's training and awareness programs designed to educate employees about insider trading laws and company policies. This ensures that employees understand their responsibilities and the consequences of engaging in insider trading.

5. Transaction Reviews: The audit examines recent transactions involving insiders to identify any suspicious or potentially illegal activity. This may involve analyzing the timing and nature of trades, as well as comparing them to known events or announcements.

6. Documentation and Reporting: The audit ensures that appropriate documentation is in place to record insider trading activities and investigations. This includes maintaining insider trading reports, disclosure forms, and communication records.

7. Compliance Oversight: Finally, the audit assesses the effectiveness of the company's compliance oversight mechanisms, including the role of the board of directors, audit committee, legal counsel, and compliance officers.

By conducting regular insider trading audits, companies can demonstrate their commitment to ethical behavior, protect against legal and reputational risks, and maintain the integrity of the financial markets. Additionally, these audits help foster a culture of compliance within the organization, where employees understand the importance of following insider trading laws and company policies.

1.4.3 Labour Law Compliance Audit

An audit is all about unraveling the policies of the company. It is to make sure that all the labour laws are being followed thoroughly. Audits can help in finding current loopholes in the process and organization. Internal and external audits both are necessary to skip any possible error or miss. These kinds of audits can help organizations in taking timely corrective measures.

1.4.4 Need of labour law compliance audit

Labour audits define the corporate culture of an organization. Companies are now becoming more employee-centric, leading to good relationships and bonding. Labour audits offer a variety of benefits to both employees and employers.

- Timely payments and proper rollout of benefits are the foundational parameters for building synergy between the employer and employee. This becomes possible with labour law compliance and further audits to improve the system.
- Such audits provide a feeling of security. This in turn increases productivity and a sense of being valued, resulting in better retention and less absenteeism.
- These kinds of compliance audits help in creating a brand value and name, with a subtle yet impactful positioning in the market.

1.4.5 The process of labour law audit:

It is vital to understand what the organization does and which industry it falls under. The auditor then segregates the laws based on geography. Apart from this, assessing the manpower is also essential for correct evaluation.

1. *Relevant labour laws and their compliance*

The next essential point to know is which laws are even relevant and need a go-through during the audit. Listing down all the laws which are relevant to the organization is an important step. The compliance of these laws needs to be monitored along with scrutinizing the concerned authority responsible for doing so. Checking the compliance records comes last.

2. Present compliance status

During labour law audits, external parties try to understand the process of compliance. The auditors look at the past complaints and actions taken against the same. On top of this, they assess the areas of improvement where non-compliance is happening.

An extensive report is thus prepared based on the findings and investigation. These reports find the risks and areas that fall under the non-compliance zone. Further on, a variety of corrective measures are taken.

1.4.6 Challenges of labour law compliance audit

The labour law compliance audits are multi-layered. These audits can be done internally or can be delegated to external auditing firms. Labour audits consist of many challenges which need a keen understanding and resources, to overcome them. Here are a few challenges that are often faced at times of audits:

Lack of documentation

It is often noticed that there is no proper method to document the details of employees and their other details related to wages. This is one of the most challenging aspects of the audit as it is the foundational aspect of leading an audit.

Lack of accuracy

With manual compliance checks and audits in process, accuracy is often left behind. Mistakes in creating reports and filing the form returns create a large gap and miss at the time of audit.

To deal with these challenges, an automated process is required. Companies can maintain all details in a dashboard, with handy reports and repositories, along with timely reminders. In short, organizations need a system that helps them in maintaining the labour law compliance, to skip the rush hour at the time of audits.

1.4.7 Benefits of Labour Law Compliance Audit.

1. Benefits to the Labour

- It will increase their Social Security.
- It will secure timely payment of wages, gratuity, bonus, overtime, and compensation etc. of the workers.
- Also, timely payment of entitlements will reduce absenteeism in the organisation.
- Thus, it will inculcate on workers a sense of belongingness towards their employer.

2. Benefits to the Employer

- Increased productivity in view of lower absenteeism in the enterprise. Higher the productivity, higher will be the profit.
- Status in the Society for the employer will increase, in view of the recognition that may be bestowed on them by the Government.
- Strict compliance of all labour legislation will be ensured by each of the employers, which, in turn, will reduce or even eliminate penalties/ damages/fines that may be imposed by the Government.
- To improve the labour relations, co-operation of and understanding with the workers is a must. Therefore, the congenial atmosphere is indispensable for good corporate governance.

3. Benefits to the Government

Reduction in the number of field staff for inspection of Industries/Factories/ Commercial Establishments as most of their work will be done by an Independent Professional like Company Secretary in Whole Time Practice.

- To ensure compliance with past defaults with Compulsory Labour Audit.
- The revenue of the Appropriate Government will rise phenomenally. To introduce filing fees for Compliance Report under Labour Legislation, in case the Government seeks.

LET'S SUM UP

Insider trading is a controversial practice that has long captivated investors, authorities, and the general public. Insider trading threatens the integrity and dependability of the financial system as a whole and undermines the principles of open and equitable markets. An insider trading audit is a process conducted by a company or an external auditor to ensure compliance with regulations and internal policies regarding insider trading. The unit deals in detail with the insider trading audit and its procedures.

Labour law compliance audits help to see if all the required labour laws are being followed and all the compliance is done as required. It is to make sure that all the labour laws are being followed thoroughly. Audits can help in finding current loopholes in the process and organization. Internal and external audits both are necessary to skip any possible error or miss. These kinds of audits can help organizations in taking timely corrective measures.

Check your progress- Quiz-1

1. What is considered insider trading?

A) Trading based on publicly available information

B) Trading based on non-public, material information

C) Trading in small quantities to avoid detection

D) Trading only during market hours.

2. Which of the following is NOT a key element of an effective insider trading compliance program?

A) Regular training of employees on insider trading policies

B) Monitoring of trading activities and reporting

C) Encouraging employees to trade based on rumors

D) Clear policies regarding trading windows and blackout periods

3. What are the advantages to enterprises for conducting labour law audit in an enterprise?

a) Increased productivity in the business

b) Increased status in society of the employer

c) Improve labour relation

d) All the above

4. Which of the following is a primary objective of labor laws?

A) Maximizing company profits

B) Ensuring fair treatment of employees

C) Promoting shareholder interests

D) Minimizing government intervention

5. What is the purpose of conducting an audit of labor law compliance?

A) To minimize employee benefits

B) To reduce employee turnover

C) To ensure legal compliance and mitigate risks

D) To increase labor union participation

SECTION 1.5 ENVIRONMENTAL AUDIT, SOCIAL AUDIT AND TAKEOVER AUDIT

1.5.1 Meaning

Environmental auditing is a systematic, documented, periodic and objective process in assessing an organization's activities and services in relation to:

- Assessing compliance with relevant statutory and internal requirements
- Facilitating management control of environmental practices
- Promoting good environmental management
- Maintaining credibility with the public
- Raising staff awareness and enforcing commitment to departmental environmental policy
- Exploring improvement opportunities
- Establishing the performance baseline for developing an Environmental Management System (EMS)

1.5.2 Objectives of environmental audits:

- Assess the company's compliance with laws and regulations and other relevant requirements.
- Establish a performance basis for planning and developing an environmental management system.
- Promote good environmental management.
- Maintain credibility with the public.
- Raise awareness and enforce the company's internal commitment to environmental policies.
- Minimize risk exposure from environmental issues to health and safety.

1.5.3 Need for Environmental audit

- It help business to assess the environmental impact of their operations.
- It ensure that the corporate decisions are not spoiling company's market for its products, destroying the source of essential supply, damaging or polluting the very infrastructure that makes usage and demand of the product grow.
- It highlights areas of inefficiencies in process.
- It highlights excessive wastes.
- It provides opportunity for business to decrease its wastes output and reduce the cost of waste treatment or waste disposal.

1.5.4 Importance of an environmental audit

In a broad sense, environmental auditing aims to help protect the environment and minimize the risks of business activities to the environment and human safety and health. Whereas, in the company's perspective, it aims to check whether the company has complied with the environmental regulations and requirements and achieved the previously set environmental goals.

1. **To build a good company reputation.** Environmental audits can strengthen the company's image. For example, although it may not be fully compliant, the improvement efforts made will be seen as a positive step by the public. And, if it is compliant, it can lead to positive publicity, encouraging the public not to hesitate to continue buying products from the company. Audits help businesses become more sustainable. It also creates new marketing opportunities with other consumers. For example, companies use formal recognition or accreditation as a tool to create preferences for the company's products.

2. **To avoid negative campaigns.** Increasing external demands for environmental responsibility by pressure groups and environmental activists

are forcing companies to check their compliance with environmental requirements. The increasing concern for the environment has made these demands more and more popular. If the company is not compliant, for example, they can campaign to boycott its products.

3. **To adapt and comply with more stringent environmental regulations.** Governments adopt more stringent environmental regulations and standards, usually by international consensus. It forces companies to comply if they do not want to be penalized. Then, when done properly, a comprehensive environmental audit can uncover problem areas and provide recommendations for follow-up. So, the company can fix it before its reputation is destroyed and regulatory problems arise.

1.5.5 Process of Environmental Audit:

Source: https://appliedes.com.au/environmental-audits/

Step 1: Plan the Audit

The first step in the environmental audit is to establish and document the scope and terms of reference. The scope could include one or more sites or specific operations to be audited. While the terms of reference is the reason for the audit such as ISO 14001 certification or compliance with specific legislation requirements.

Step 2: Prepare for the Audit

An environmental audit guidance tool must be prepared for each audit activity. The audit guidance tool may be in the format of a checklist, list of interview questions, marked-up procedures, flow charts or mind maps. An audit plan should also be developed. The audit plan is used to schedule activities and meetings with auditors within each audit, including the opening meeting and interviews.

Step 3: Conduct the Audit

Prior to conducting the audit, all relevant personnel in the audit team should meet to discuss the scope of the audit, proposed audit agenda, audit objectives, any personnel that need to be contacted or interviewed, and a tentative time to hold the closing meeting.

Step 4: Develop an Audit Report or Action Plan

The environmental audit team needs to prepare a report based on all the objective evidence that is collected during the audit. The audit report should be completed based on agreed content in the closing meeting.

Step 5: Audit Follow-Up

Following the completion of the audit, actions to close out any non-conformances or suggested improvements should be implemented and tracked. This can be done separately or as part of the audit report.

1.5.6 Social Audit

A social audit is a formal review of a company's endeavors, procedures, and code of conduct regarding social responsibility and the company's impact on society. A social audit is an assessment of how well the company is achieving its goals or benchmarks for social responsibility.

A Parliamentary Standing Committee on Rural Development had recommended strengthening of comprehensive Grievance Redressal Mechanism, Social Audit from grassroots with periodic reviews to be conducted for timely follow-up. The committee has recently expressed dissatisfaction over the progress. The Government says that only ten states viz. Andhra Pradesh, Chhattisgarh, Gujarat, Karnataka, Mizoram, Sikkim, Telangana, Tamil Nadu, Tripura and Uttar Pradesh have operationalized social audit units as laid down in Social Audit Rules 2011 and states of Madhya Pradesh, Odisha, Manipur, Meghalaya, Rajasthan and Jammu and Kashmir are in the process of doing it. This monograph studies the Social Audit in detail.

Social auditing is a process by which an organization / government accounts for its social performance to its stakeholders and seeks to improve its future social performance. The concept was pioneered by Charles Medawar in 1972.

A social audit helps to narrow gaps between vision/goal and reality; and between efficiency and effectiveness. It allows us to measure, verify, report on and to improve the social performance of any government effort or organization.

Social Audit is different from the development audit. The key difference between development audit and social audit is that a social audit focuses on the neglected issue of social impacts, while a development audit has a broader focus including environment and economic issues, such as the efficiency of a project or programme.

1.5.7 Implications of Social Audit

- Social auditing creates an impact upon governance. It values the voice of stakeholders, including marginalized/poor groups whose voices are rarely heard.
- Social auditing is taken up for the purpose of enhancing local governance, particularly for strengthening accountability and transparency in local bodies.
- Social Audit makes it sure that in democracy, the powers of decision makers should be used as far as possible with the consent and understanding of all concerned.

1.5.8 Objectives of Social Audit

- To assess the physical and financial gaps between needs and resources available for local development.
- Creating awareness among beneficiaries and providers of local social and productive services.
- Increasing efficacy and effectiveness of local development programmes.
- Scrutiny of various policy decisions, keeping in view stakeholder's interests and priorities, particularly of rural poor.
- Estimation of the opportunity cost for stakeholders of not getting timely access to public services.

1.5.9 Social Audit in India

In India, social audits were first made statutory in a 2005 Rural Employment Act and government also issued the Social Audit Rules in 2011 under the MGNREGA Act.

Important Facts about Social Audit: Social audits are generally supervised by autonomous bodies consisting of government and nongovernment representatives.

- The 73rd Amendment of the Constitution empowered the Gram Sabhas to conduct Social Audits in addition to other functions.
- Kindly note that CAG not empowered to conduct Accounting Audit of PRIs in the whole country.
- No central policy or regulation making accounting audit and social audit mandatory.
- The most appropriate institutional level for social audit is the Gram Sabha, which has been given 'watchdog' powers and responsibilities by the Panchayati Raj Acts in most States to supervise and monitor the functioning of panchayat elected representatives and government functionaries, and examine the annual statement of accounts and audit reports. These are implied powers indirectly empowering Gram Sabhas to carry out social audits in addition to other functions. Members of the Gram Sabha and the village panchayat, intermediate panchayat and district panchayat through their representatives, can raise issues of social concern and public interest and demand an explanation.

The Gram Sabha should have the mandate to

- Inspect all public documents related to budget allocations, list of beneficiaries, assistance under each scheme, muster rolls, bills, vouchers, accounts, etc., for scrutiny
- Examine annual statements of accounts and audit reports
- Discuss the report on the local administration of the preceding year

- Review local development for the year or any new activity programme
- Establish accountability of functionaries found guilty of violating established norms/rules
- Suggest measures for promoting transparency in identifying, planning, implementing, monitoring and evaluating relevant local development programmes
- Ensure opportunity for rural poor to voice their concerns while participating in social audit meetings.

1.5.10 Advantages of Social Audit

1. Encourage community participation among different business entities.
2. Ensure continuous efforts towards environmental protection and use of environment friendly production processes.
3. Building Customer Satisfaction and trust through ethical business practices.
4. Promotes collective decision-making and sharing of responsibilities.

1.5.11 Takeover Audit:

A "takeover audit" typically refers to an examination or assessment conducted by a company or individual considering acquiring another company. This audit aims to evaluate various aspects of the target company to determine its financial health, operational efficiency, potential risks, and overall suitability for acquisition.

Key areas usually examined in a takeover audit may include:

1. Financial statements: Analyzing the target company's financial records, including balance sheets, income statements, and cash flow statements, to
assess its financial performance and stability.

2. Assets and liabilities: Reviewing the target company's assets, such as property, equipment, and intellectual property, as well as its liabilities, such as debts and obligations, to understand its financial position.

3. Legal and regulatory compliance: Ensuring that the target company complies with relevant laws, regulations, and industry standards, including environmental regulations, labor laws, and intellectual property rights.

4. Operational performance: Assessing the efficiency and effectiveness of the target company's operations, including its production processes, supply chain management, and customer relationships.

5. Market analysis: Studying the target company's market position, competitive landscape, and growth potential to evaluate its long-term prospects and strategic fit with the acquiring company.

Overall, a takeover audit helps the acquiring company make informed decisions about whether to proceed with the acquisition and, if so, at what price and under what terms. It also helps identify potential risks and challenges that may need to be addressed during the acquisition process or integrated into the post-acquisition strategy.

Let’s sum up

An environmental audit is a systematic evaluation of an organization's compliance with environmental regulations, policies, and standards. It assesses the impact of the organization's activities on the environment, identifying potential risks and opportunities for improvement in environmental performance. Typically conducted by qualified auditors or environmental specialists, the audit examines areas such as waste management, pollution control, energy consumption, and resource efficiency.

By conducting a social audit, organizations can identify strengths, weaknesses, and areas for improvement in their social practices, thereby enhancing trust, reputation, and sustainable development outcomes within their communities and beyond.

A takeover audit, also known as a due diligence audit, is a detailed examination conducted by a prospective acquiring company on a target company before completing a merger or acquisition. This audit aims to assess the target company's financial health, operational efficiency, legal compliance, market position, and potential risks. It involves reviewing financial statements, conducting interviews with key personnel, evaluating contracts and agreements, and analyzing market and competitive factors.

CHECK YOUR PROGRESS – QUIZ - 1

1. What is the primary objective of an environmental audit?

A) Maximizing profit margins

B) Ensuring compliance with environmental regulations

C) Increasing market share

D) Reducing employee turnover

2. Which of the following is typically evaluated during an environmental audit?

A) Sales performance metrics

B) Employee satisfaction survey results

C) Waste management practices

D) Customer retention rates

3. What is the primary focus of a social audit?

A) Maximizing shareholder dividends

B) Evaluating employee productivity

C) Assessing the impact on stakeholders and society

D) Increasing market share

4. Which of the following aspects is typically included in a social audit?

A) Financial performance analysis

B) Environmental impact assessment

C) Employee training effectiveness

D) Community engagement and philanthropy

5. During a takeover audit, what is a key area of focus for evaluating the target company?

A) Market share growth

B) Compliance with labor laws

C) Supplier relationships

D) Intellectual property rights

1.6 UNIT SUMMARY:

This unit introduces the basic concepts of audits and their various types. The first section covers definitions from different authors and explores the different types of audits, emphasizing their significance for learners to grasp each type's importance. The second section delves into Corporate Governance audits, crucial for ensuring companies operate transparently, ethically, and accountably. Another section focuses on CSR audits, essential for developmental planning aimed at maximizing social benefits. Insider trading audits highlight the threat posed to financial integrity and market equity. Labour law compliance audits assess adherence to labor laws and required compliance. Lastly, environmental audits systematically evaluate an organization's adherence to environmental regulations. Social audits help organizations identify strengths, weaknesses, and areas for improvement, fostering trust, reputation, and sustainable development. A takeover audit, or due diligence audit, involves a thorough examination by a prospective acquiring company of a target company before merger or acquisition completion.

1.7 Glossary

GDA	The Government Diploma in Accountancy
EMS	Environmental Management System
ESG	Environmental, Social and Governance
MIS	Management Information System
Corporate governance	Corporate governance refers to the system of rules, practices, and processes by which a company is directed and controlled.
Legal and regulatory compliance:	Ensuring that the target company complies with relevant laws, regulations, and industry standards, including environmental regulations, labor laws, and intellectual property rights.
Monitoring and Surveillance Systems	The audit assesses the effectiveness of the company's monitoring and surveillance systems for detecting potential instances of insider trading.

1.8Self-Assessment Questions Short Answers: (5 Marks)

1. Define audit and its importance.

2. Describe corporate governance audit and its scope.

3. Define corporate social responsibility audit and its objectives.

4. Write about: insider trading, insider trading audit and Procedures.

5. What is the meaning of Environment and social audit?

Essay Type Answer: (10 Marks)

1. Explain types of audit based on its objectives.

2. Explain Corporate governance audit and its procedures

3. Explain labour law audit and its benefits.
4. Explain environmental audit.

5. Explain labor law and takeover audit.

1.9 Activities:

1. Visit the CSR department of a company in your vicinity. Ask the CSR employees, about their felt needs of training. Ask them about the types of training that has been provided to them. Write down their responses.

2. Visit the CSR department of a company in your vicinity. Ask them about the categories of CSR audit done in their company. Write down their responses.

1.10 - Topics for Discussion

1. Discuss the different types of audits such as financial audit, operational audit, compliance audit, and their respective purposes in ensuring organizational effectiveness and accountability.

2. Discuss the rise of ESG audits and their role in assessing companies' sustainability practices, ethical governance, and social responsibility efforts.

3. Share experiences and insights into interpreting audit findings, communicating results effectively, and implementing audit recommendations for organizational improvement.

4. Brainstorm on the future landscape of the audit profession, potential disruptions, evolving roles of auditors, and skills needed to thrive in a digital and data-driven audit environment.

1.11 Suggested Readings / References

1. The Companies Act, 2013, MCA notification dt 27th February' 2014

2. The Companies (Amendment) Bill, 2017, MCA general circular dt 28th May 2018

3. DPE guidelines on CSR and sustainability dt 21st October 2014

4. Guide on Corporate Social Responsibility (CSR) Audit by The Institute of Chartered Accountants of India.

5. Saha, Sushil Kumar. "Social Audit Handbook." Concept Publishing Company, 2012. ISBN: 978-8180698401.

6. Crane, Andrew, et al. "The Oxford Handbook of Corporate Social Responsibility." Oxford University Press, 2008. ISBN: 978-0199211593

UNIT II-- Secretarial Audit

Secretarial Audit: Meaning – Need – Applicability of Secretarial Audit under Companies Act, 2013 and SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 – The process of Secretarial Audit – Scope and Benefits of Secretarial Audit.

UNIT OBJECTIVES:

This units helps to the student's acquiring knowledge about secretarial audit and its need and applicability Under the Companies Act of 2013 and the SEBI (Listing Obligations and Disclosure Requirements) Regulations of 2015 will be thoroughly explained. It also explains the benefits of secretarial auditing as well as how it works. The student will acquire in-depth knowledge of secretarial audit.

SECTION 2.1 SECRETARIAL AUDIT

2.1.1 Introduction

Secretarial Audit is a compliance audit. It is a part of total compliance management in an organization. It is an effective tool for corporate compliance management, which helps to detect noncompliance and to take corrective measures. The term "Secretarial Audit" is a mechanism which is connected with the audit of the non- financial aspects of the company. It gives necessary comfort to the management, regulators and the stakeholders, as to the compliance by the company of applicable laws and the existence of proper and adequate systems and processes in the company.

Every form of business must adhere to a multitude of applicable laws, rules, procedures, regulations, and internal regulatory frameworks. The corporate sector in India is governed by a number of Acts and the rules and regulations enacted there under.

According to the majority of laws, Key Managerial Personnel—which includes the Managing Director, Whole-Time Directors, the Company Secretary, the Chief Financial Officer, Managers, and officers designated to ensure compliance with applicable laws, rules, and regulations on a company—are accountable for compliance and subject to punishment for non-compliance.

Under the Companies Act, 2013, a Company Secretary, along with other Key Managerial Personnel and Whole time Directors may be treated as 'officer who is in default' and will be liable for penal consequences for non-compliance, while under most of the other laws, persons in charge of and responsible for the conduct of business of the company are held responsible.

Role of company secretaries have increased manifold under the Companies Act, 2013. Not only under the Companies Act, 2013 but also under the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 [SEBI LODR], SEBI (Prohibition of Insider Trading) Regulations, 2015 and other Regulations, the regulators have expressed faith on the profession of Company Secretary for furtherance of better control and development of the good governance in the Corporate Sector in India.

Every Company, while pursuing its business activities, has to comply with the rules and regulations relating to the Companies Act, Securities laws, FEMA, Industry Specific laws and General laws like Labour laws, Competition law and Environmental and Pollution related laws and should also pursue the good governance practices.

Secretarial Audit covers non-financial aspects of the business impact on the performance of the company and verifies compliances of applicable laws, regulations and guidelines. Nonetheless, this exercise will enhance the capabilities of the management and also mitigates business & reputation risk to a great extent. It also evaluates the manner in which the affairs of a company are conducted to a great extent. The

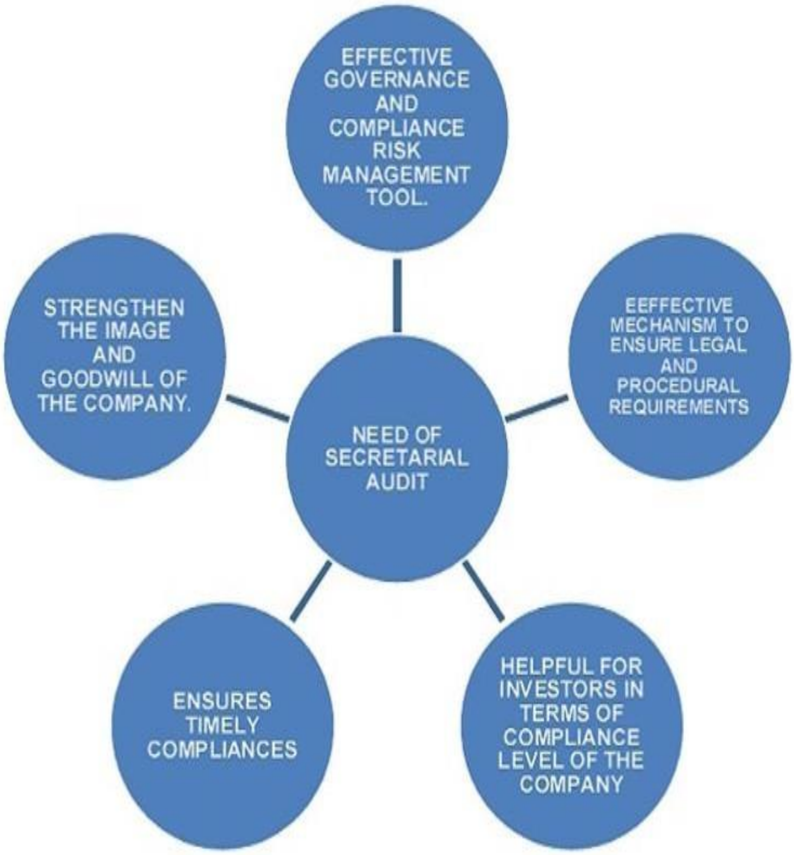
Secretarial Audit postulates for an independent verification of the records, books, papers and documents by a Company Secretary to check the compliance status of the company according to the provisions of various statutes, laws and rules & regulations and also to ensure the compliance of legal and procedural requirements and processes followed by the company.

2.1.2 Meaning:

Secretarial Audit is an audit of the compliance management system of an organization. It is an examination by an independent professional to check whether the organization compiles with applicable laws, rules, and regulations or not. Additionally, it involves the verification of compliance processes followed by a company.

2.1.3 Need for Secretarial Audit:

Secretarial Audit provides an effective mechanism to ensure that compliance of various legislations and regulations including the Companies Act, SEBI Law, Secretarial Standards and other corporate and economic laws applicable to the company has been diligently done. This would give necessary comfort to the Management, Regulators, and the stakeholders. The periodical Secretarial Audit helps to detect the instances of non- compliances and facilitates taking corrective-measures well in time to avoid any further risk.



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.Secretarial Audit facilitates monitoring compliances with the requirements of law through a formal compliance management programme which can produce positive results to the stakeholders of a company:

- Companies that go the extra mile with their compliance programs lay the foundation for good governance.
- Companies with an effective compliance management programme have lesser chance of receiving penalties, both monetary and by way of imprisonment.
- Companies that imbibe business and personal ethics and an effective compliance management programme within their work culture often enjoy

employee and customer loyalty and public respect for their brand, which can translate into better market capitalization and shareholder returns.

- Recognition for the company as a good corporate citizen.
- Provides a level of confidence to the directors & Key Managerial Personnel etc.
- Secretarial Audit ensures legal and procedural requirements so directors can concentrate on important business matters.
- Strengthen the goodwill of a company for their regulators and stakeholders.
- Secretarial Audit is an effective governance and compliance risk management tool.
- It helps the investor in analyzing the compliance level of companies, thereby increases the reputation

2.1.4 Objectives of secretarial audit:

Secretarial audit is a comprehensive review of compliance aspects of a company, primarily focusing on adherence to legal and procedural requirements. The objectives of secretarial audit typically include:

1. Ensuring Compliance: The primary objective is to verify whether the company complies with all applicable laws, rules, regulations, and guidelines relevant to its operations. This includes corporate laws, environmental laws, labor laws, taxation laws, etc.

2. Identifying Non-Compliance: To identify instances where the company has not complied with statutory requirements or internal policies. This helps in addressing these issues promptly to avoid legal consequences or penalties.

3. Risk Management: Assessing the adequacy and effectiveness of internal controls and risk management systems in place to prevent non-

compliance. This helps in mitigating risks associated with legal and regulatory requirements.

4. Improving Governance: Evaluating the governance framework of the company, including the roles and responsibilities of directors and senior management. This ensures that governance practices are transparent and effective.

5. Protecting Stakeholder Interests: Safeguarding the interests of stakeholders, including shareholders, creditors, employees, and the government, by ensuring that the company operates within the legal framework and ethical standards.

6. Enhancing Corporate Reputation: Maintaining and enhancing the company's reputation by demonstrating a commitment to compliance and ethical business practices.

7. Providing Assurance: Offering assurance to the management, board of directors, regulators, and other stakeholders that the company is managed in accordance with legal requirements and best practices.

8. Detecting Fraud: Detecting any potential fraud or misconduct within the organization that could have legal or financial implications.

9. Ensuring Due Diligence: Conducting due diligence during mergers, acquisitions, or investments to ensure that the target company is compliant with all legal requirements.

10. Preparing for Regulatory Changes: Anticipating and preparing for changes in regulatory requirements that may impact the company's operations and compliance obligations.

Overall, the objectives of secretarial audit aim to promote transparency, accountability, and sustainability within the organization while minimizing legal and reputational risks.

2.1.5 Scope of Secretarial Audit

Secretarial Audit has a wide scope as the applicability of laws differ from company to company and industry to industry. However, the Secretarial Auditor should check compliance with the following laws in general —

1. Companies Act, 2013, and the governing rules;
2. Securities Contracts (Regulation) Act, 1956, and the governing rules;
3. Depositories Act, 1996, and the governing rules;
4. Foreign Exchange Management Act, 1999, including rules relating to Foreign Direct Investment, Overseas Direct Investment, and External Commercial Borrowings;
5. Regulations and Guidelines under the Securities and Exchange Board of India Act, 1992, mainly SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018, SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, SEBI (Prohibition of Insider Trading) Regulations, 2015, etc, if applicable;
6. Compliance with Secretarial Standards issued by the Institute of Company Secretaries of India;
7. Compliances with the Listing Agreement entered into with Stock Exchange(s), if applicable;
8. Industry-specific laws and regulations relevant to the company's sector, for instance, laws applicable to the insurance industry in the case of the insurance company, laws applicable to the banking industry in the case of the banking company, laws applicable to the pharma industry in the case of a pharma company, etc.;

2.1.6 Benefits of a Secretarial Audit

A secretarial non-compliance, a legal suit or other legal, ethical and governance problems can give rise to catastrophic effects on the continuing viability of the company. The Statute prescribes mandatory Stakeholders. Many companies voluntarily conduct Secretarial Audit to minimize the possibility of various issues which may disrupt their companies' progress.

The Secretarial Audit lays the groundwork for the establishment of an ongoing Secretarial and Legal compliances and a prevention program to ensure the company's goals, structure and ongoing operations are consistent with the latest developments in business and the law governing the Corporate Entities.

A comprehensive Secretarial Audit would examine a wide range of issues which may be as mundane as whether or not the company is qualified to do business in various jurisdictions or as complex as an analysis of the company's Board Compliances in order to ensure consistency with current requirement under the Companies Act, 2013 and the all the events/ Corporate action occurred during the year are in compliance with the Companies Act, 2013. The topics for audit would include choice and structure of the entity; the decisions of the board of directors and documentation (or lack thereof) relating to those decisions; observance of the Secretarial Standards and Board processes, protection of intellectual property; forms and methods of maintaining records, pending and threatened litigation, insurance coverage; listing under securities laws and compliance, and related trade regulations; labour laws, environmental laws; and a review of compliance of all industry specific laws such as laws relating to say, cement sector, fertilizer sector, sugar sector and so on.

Naturally, the extent and complexity of the Secretarial Audit would vary depending on the size of the company in terms of the horizontal and vertical scales i.e. size of business, area of operations, turnover, product line, age of the company and type of businesses, such as trading, services, Manufacturing, the number of shareholders and employees, the extent to which the company does business as a “regulated industry,” and a host of other factors.

A dispensation with such an independent secretarial audit could well lead to significant problems for the company and its stakeholders. The risks of non-compliance with these many laws and regulations include:

- Failure to keep proper books and records or non-compliance with the provisions of corporate laws and securities laws, executing certain unviable or undesirable corporate actions or transactions with related parties or loan to directors, issue, allotment and transfer of Security or otherwise, without proper authority of the Board of Directors or the General Meeting or the Memorandum of Association, etc., could lead to the ability by third parties to play with the stakeholder’s limited liability protection.
- Failure to obtain proper approvals/permissions/licenses could lead to fines, penalties or/and imprisonment in some cases, even closure of the business by government or governmental agencies.
- Failure to comply with certain laws and regulations may lead to initiation of action by the regulators like MCA, SEBI, RBI or others which may jeopardize the very stability of the financial and manufacturing operations.
- Failure to adopt proper environment law compliance and policies which are reviewed periodically could give rise to governmental and civil liability.
- Failure to keep accurate records and minutes of its decision-making procedures, such as proving that directors are exercising informed judgment, could subject the company and its board to liability to its shareholders and investors.
- Failure to monitor the company’s reporting requirements may put the company into default with lenders or investors.

- Company Secretary in Practice acts as an extended arm of the regulators in ensuring the compliances, Detecting and reporting any non-compliance before it takes seriously alarming shape.

Other benefits to the Stakeholders are:

(a) Promoters: Secretarial Audit assures the promoters of a company that those in-charge of its management are conducting its affairs in accordance with the requirements of laws and the owners stake is not being exposed to unintended risks.

(b) Non-executive/Independent directors: Secretarial Audit provides comfort to the Non-executive/Independent Directors that appropriate mechanisms and processes are in place to ensure compliance with laws applicable to the company, thus mitigating any risk from a regulatory or governance perspective.

(c) Government authorities/regulators: It also facilitates reducing the burden of the regulators in ensuring compliances and they can take timely actions against the offenders.

(d) Investors: Secretarial Audit helps the investors in taking informed investment decision, as it evaluates the company in terms of compliance and governance norms being followed by the company.

(e) Other Stakeholders: It is an effective due diligence exercise for the prospective investors or joint venture partners. Further Financial Institutions, Banks, Creditors and Consumers can measure the law abiding nature of company management.

Let’s sum up

Secretarial Audit is a proactive governance measure that will have a positive effect on corporate entity. Secretarial Audit is a form of Compliance Auditing that is used in carrying out auditing of compliances with all laws, rules and regulatory requirements applicable to the company. It looks into all the events, compliance and records created during the audit period to check whether the Company really complies with the applicable laws and standards. It may be noted that creation of the checklist of Secretarial Audit differs from company to company. Hence, it is advised to the student to also see updates on the changes in the various Compliance requirements. The objective of the study lesson is to familiarize the students with the process of conducting Secretarial Audit and various aspects of legal compliance requirements stipulated under the Secretarial Audit prescribed under section 204 of the Companies Act, 2013.

Check Your Progress – Quiz -1

1. What is the primary objective of secretarial audit?

A) Maximizing profits

B) Ensuring compliance with legal and procedural requirements

C) Marketing the company's products

D) Reducing operational costs

2. Which of the following is NOT typically covered in the scope of secretarial audit?

A) Board meeting procedures

B) Financial performance analysis

C) Compliance with statutory regulations

D) Maintenance of statutory registers

3. Who are the beneficiaries of secretarial audit?

a) Promoters
b) Government authorities

c) Non - executive directors

d) All the above

4. Who typically conducts a secretarial audit in a company?

A) External auditors appointed by shareholders

B) Marketing department managers

C) Board of Directors

D) Secretarial department staff

5. Which legal framework is primarily considered during a secretarial audit in India?

A) Companies Act, 2013

B) Indian Penal Code

C) Income Tax Act, 1961

D) Reserve Bank of India Act, 1934

SECTION 2.2 APPLICABILITY OF SECRETARIAL AUDIT UNDER COMPANIES ACT, 2013 AND SEBI (LODR) REGULATIONS, 2015

2.2.1 APPLICABILITY OF SECRETARIAL AUDIT UNDER COMPANIES ACT, 2013:

Section 204(1) of the Companies Act, 2013 read with rule 9 of the Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014 provides that

1. every listed company;

2. every public company having a paid-up share capital of fifty crore rupees or more; or

3. every public company having a turnover of two hundred fifty crore rupees or more. shall annex with its Board's Report made in terms of sub- section (3) of section 134, a Secretarial Audit Report, given by a Company Secretary in practice, in such form as may be prescribed.

Ascertainment as to whether the Secretarial Audit is applicable on a particular company or not has to be made by checking below mentioned parameters:

(i) Status of a Company – Public or private;

(ii) Whether the securities of the company have been listed;

(iii) Whether the company is subsidiary or associate company of a listed company;

(iv) Turnover of the company.

The term 'Turnover' has been defined in section 2(91) and amended under the Companies (Amendment) Act, 2017 (effective from 09.02.2018 to mean the gross amount of revenue recognised in the profit and loss account from the sale, supply, or distribution of goods or on account of services rendered, or both, by a company during a financial year.

Earlier the term "Turnover" was defined as "the aggregate value of the realisation of amount made from the sale, supply or distribution of goods or on account of services rendered, or both, by the company during a financial year". [from 12.09.2013 up to 08.02.2018]

In view of considering the turnover/paid up share capital as per latest audited financial statement, as has been provided in section 149 regarding the appointment of women director/ independent director, the thresholds specified in section 204 shall be required to be checked throughout the year. Therefore, the secretarial audit report shall be required to be annexed with the Board report:

(i) if any time during the year (in respect of which board report is prepared) any security of the company has remained listed on any recognised stock exchange; or

(ii) if any time during the year (in respect of which board report is prepared) the company been a public limited company, having turnover of Rs. 250 crores or more or having paid up share capital of Rs. 50 crores or more.

Applicability of Section 204 to a Private Company which is a subsidiary of a Public Company:

Section 2(71) of the Companies Act, 2013 defines

a "Public Company" as a company which

(a) is not a private company; and

(b) has a minimum paid-up share capital as may be prescribed.

The provision to the definition states that “Provided that a company which is a subsidiary of a company, not being a private company, shall be deemed to be public company for the purposes of this Act even where such subsidiary company continues to be a private company in its articles.”

In view of this, it is clear that Section 204 is applicable to a private company which is a subsidiary of a public company, and which falls under the prescribed class of companies.

Although, the companies which are not covered under section 204 may opt for conducting Secretarial Audit voluntarily as it provides an independent assurance of the compliances of applicable laws by the company.

The section further provides that Secretarial Audit Report is to be submitted in a format prescribed under the rules. As per sub-rule (2) of rule 9, the format of the Secretarial Audit Report shall be in Form No. MR-3 which shall be issued by a Company Secretary in Practice (Annexure A).

2.2.2 SECRETARIAL AUDIT APPLICABILITY UNDER THE SEBI (LODR) REGULATIONS, 2015:

Secretarial Audit has been made mandatory by SEBI also. Accordingly, SEBI amended Regulation **24A of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015** to include Secretarial Audit for every listed entity and their unlisted subsidiaries incorporated in India.

There is already a provision under the Companies Act, 2013. Section 204(1) of the Companies Act, 2013 read with Rule 9 of the Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014 and Rule 8 of the Companies (Meetings of Board and its Powers) Rules, 2014 provides for Secretarial Audit for

i) Every listed company; and

ii) Every public company having a paid-up share capital of Rs. 50 crore or more; and

iii) Every public company having a turnover of Rs. 250 crore or more.

This shall be applicable for every listed company and its unlisted material subsidiary, from the financial year ended 31st March 2019 onwards. In addition to this mandatory requirement, he concept of Secretarial Audit provides transparency to the management, Board, regulators and the stakeholders etc. that compliance by the company of applicable laws are done, and there exists proper and adequate systems in the company. It confirms the verification of records, books, papers and documents in accordance with the laws and rules & regulations.

The regulations will entail following Compliances:

1. **Submit Annual Secretarial Report** by Practicing Company Secretary (PCS) in **Form MR-3** as mentioned under the Companies Act, 2013 read with rule 9 (Appointment and Remuneration of Managerial Personnel) along with its annual report.

2. **Annual Secretarial Compliance Report** by Practicing Company Secretary after checking compliance of SEBI regulations, circulars and all applicable laws. It should be in the form specified under this regulation. To be submitted to the stock exchange within 60 days from the end of the Financial Year.

Secretarial Auditor: only *a member of the Institute of Company Secretaries of India [ICSI] holding certificate of practice is allowed to* conduct Secretarial Audit and furnish the Secretarial Audit Report. Appointment of Secretarial Auditor shall be done by the Board of Director of the Company in their Board Meeting.

Following the contents of **Form No.MR-3**, a Secretarial auditor has to examine and report compliance of the following laws:

1. The Companies Act, 2013 and its rules;

2. The Securities Contracts (Regulation) Act, 1956 ('SCRA') and its rules;

3. The Depositories Act, 1996 and the Regulations and Bye-laws framed there under;

4. Foreign Exchange Management Act, 1999 and its rules; and also covering Foreign Direct Investment, Overseas Direct Investment and External Commercial Borrowings;

5. The following Regulations and Guidelines prescribed under the Securities and Exchange Board of India Act, 1992 ('SEBI Act'):

a. SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011;

b. SEBI (Prohibition of Insider Trading) Regulations, 1992;

c. SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009;

d. SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999;

e. SEBI (Issue and Listing of Debt Securities) Regulations, 2008;

f. SEBI (Registrars to an Issue and Share Transfer Agents) Regulations, 1993 regarding the Companies Act and dealing with client;

g. SEBI (Delisting of Equity Shares) Regulations, 2009; and

h. SEBI (Buyback of Securities) Regulations, 1998;

With the Notification of SEBI (Listing Obligations and Disclosure Requirement) (Amendment) Regulations, 2018, the Secretarial Audit is mandatory for listed entities and their material unlisted subsidiaries incorporated in India and shall be annexed with the Annual Report of the company.

Let's sum up

Every company have chances to face non- compliance risk like fine imprisonments penalties, loss of goodwill etc in order to avoid such compliance risk and pursue the good governance. Secretarial audit is very important audit for a company. Section 204(1) of the Companies Act, 2013 provides that- every listed company, every public company having a paid-up share capital of fifty crore rupees or more, every public company having a turnover of two hundred fifty crore rupees or more; or every Company having loans or borrowings from banks or public financial institutions of one hundred crore rupees or more, shall annex with its Board's Report made in terms of sub-section (3) of section 134, a Secretarial Audit Report, given by a Company Secretary in practice, in form MR- 3.

SEBI (Securities and Exchange Board of India) issued regulations regarding secretarial audit in 2015 primarily aimed at enhancing corporate governance practices among listed companies. These regulations mandate that every listed entity should undertake a secretarial audit and provide the audit report by a practicing company secretary. The audit ensures compliance with SEBI regulations, Listing Agreement requirements, and other applicable laws.

Check your progress – Quiz-1

1. Which of the following acts do not have any coverage under Secretarial Audit?

a) The Securities Contracts (Regulation) Act, 1956

b) Foreign Exchange Management Act, 1999

c) Specific Regulation of Securities and Exchange Board of India Act, 1992

d) The Companies Act, 1956 and the rules made under there

2. Which section of the Companies Act, 2013 mandates the requirement of secretarial audit for certain companies?

a) Section 134 b) Section 177 c) Section 205 d) Section 149

3. Annual Secretarial Compliance Report by Practicing Company Secretary after checking compliance of SEBI regulations to be submitted to the stock exchange within--from the end of the Financial Year.

a) 60 days b) 90 days c) 100 days d)3o days

4. Submit Annual Secretarial Report by Practicing Company Secretary (PCS) in --------------------------- as mentioned under the Companies Act, 2013 read with rule 9 (Appointment and Remuneration of Managerial Personnel) along with its annual report.

a) Form MR-3 b) Form MR-6 c) Form MR-2 d) None

5. SEBI amended Regulation --------------- **of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015** to include Secretarial Audit for every listed entity and their unlisted subsidiaries incorporated in India.

a) 24A b) 25 A c) 24 B d) 24 C

SECTION 2.3 SECRETARIAL AUDIT REPORT AND COMPANY SECRETARIES IN PRACTICE

Section 204 provides that Secretarial Audit Report is to be submitted in a format prescribed under the rules. As per sub-rule (2) of rule 9, the format of the Secretarial Audit Report shall be in Form No. MR-3 which shall be issued by a Company Secretary in Practice only.

In order to provide guidance to its members who are in practice to adopt a robust and efficient process of Secretarial Audit, the Institute of Company Secretaries of India has issued this guidance note. Further, to facilitate the members of ICSI, the Institute through an agency has a developed a tool for facilitating conduct of Secretarial Audit. The nomenclature of the tool is Compliance Management and Auditing Configuration (CMAC). The CMAC has illustrative checklists for around 35 Industry Verticals and 50 Industry sub verticals. The detailed checklist of laws covering the Central and State Acts can be downloaded in editable MS- Excel Format. This tool is available at ICSI website which is available free to use.

2.3.1 Appointment of Secretarial Auditor - In terms of section 204(1), only a member of the Institute of Company Secretaries of India holding certificate of practice (company secretary in practice) can conduct Secretarial Audit and furnish the Secretarial Audit Report to the company. As per rule 8 of the Companies (Meetings of Board and its Powers) Rules, 2014, secretarial auditor is required to be appointed by means of resolution at a duly convened meeting of the Board of Directors of the company. Time of Appointment It is advisable that the Secretarial Auditor is appointed at beginning of the financial year as secretarial audit entails checking of compliances on a continuous basis.

As a good practice, the Secretarial Auditor should submit a report to the Board at the end of each quarter as to the compliances of the company. ICSI Auditing Standards ICSI has constituted the Auditing Standards Board to lay down the principles for evaluation of statutory compliances and corporate conduct in relation to secretarial audit and to inculcate best auditing practices amongst the members of ICSI. Upon issuance of these Standards by ICSI, it would become generally accepted principle relating to the secretarial practices to be followed while conducting secretarial audit by a practicing member and developing a unified manner for Reporting by the auditors.

Secretarial Auditor's right to receive Notice of Annual General Meeting Para 1.2.1 of Secretarial Standard on General Meetings requires that the notice in writing of every Meeting shall be given to every Member of the company. Such Notice shall also be given to the Directors and Auditors of the company, to the Secretarial Auditor, to Debenture Trustees, if any, and, wherever applicable or so required, to other specified persons.

Powers and duties of Secretarial Auditor under the Companies Act, 2013 Section 143 of the Companies Act, 2013 deals with powers and duties of Auditors. Subsection (14) of section 143 provides that the provisions of this section shall mutatis mutandis apply to the Company Secretary in Practice conducting Secretarial Audit under section 204.

Company to provide all necessary information and assistance for conducting Secretarial Audit Section 204(2) of the Companies Act, 2013 provides that it is the duty of the company to give all assistance and facilities to the company secretary in practice, for auditing the secretarial and related records of the company.

2.3.2 Approach to Conduct Secretarial Audit:

The object of the Secretarial Audit is evaluation and form an opinion and to report to the shareholders as to whether, the company has complied with the applicable laws comprising various statutes, rules, regulations, guidelines, followed the board processes and to also report on the existence of compliance management system. This requires knowledge of the corporate laws, securities laws, economic laws, FEMA, other laws specifically applicable to the company, corporate governance provisions, Secretarial Standards, SEBI (LODR) Regulations, etc.

To be able to give an effective report, a Company Secretary in Practice is expected to have the following:

(1) Knowledge: While conducting the Audit, the Secretarial Auditor should have the knowledge of exact nature and activities of the company and the laws which are applicable to the company. He should have understanding to judge existence of compliance system, Board processes & procedures and practical knowledge for implementation of secretarial standards etc.

(2) Team: The Secretarial Auditor is required to ensure that his team is appropriately trained, who can support the preparation of the report. Most importantly they should be informed of the basic principles of audit and have good ethical values. It is also important that the team should be regularly updated with the related legislative and administrative updates to build and maintain the expertise.

(3) Documentation & backup: He is expected to develop a customized checklist, according to the requirements of the company, which will help in, evaluation process and forming of Opinion. He is required to keep proper record of documents checked; evidence gathered during the course of audit.

(4) Third party support and evidences: It would always be helpful to cross verification of the filing made by the company at MCA, SEBI & other authorities independently. Verification of record and enquiries can also be made with the other statutory and internal auditors and consultants and Independent Directors of the Company.

(5) Adhering to the timelines: Adhering the time lines and schedule set to conduct the audit process will not only gain the confidence of the client but also provide a room to management to rectify defaults in time and this will also boost the morale and increase the efficiency level of the team.

(6) Honesty and impartiality: A Company Secretary in Practice has the professional duty to provide an unbiased view on the compliance status of the Company. A Company Secretary in Practice should be independent from the company being audited. The Secretarial Auditor is expected to ensure that activities of the client company are in accordance with the applicable procedure and that supporting evidence maintained by the company is genuine.

(7) Maintaining Audit Diary: The Audit exercise needs to be planned and executed professionally and verifications done by the team members should be recorded daily. Such maintenance of diary would help in keeping audit trail that would come in handy to ensure the quality of audit.

(8) Back up papers to be maintained: The Secretarial Auditor should maintain Audit Diary and back up papers like working papers, supporting documents, observations, management explanations, basis for his conclusions more particularly for qualifications in the report etc. as these will provide the audit evidence for defending himself in any possible allegation of misconduct so also peer review and help in defending himself in case of any enquiry or questions from regulators.

2.3.3 Procedure of the Secretarial Audit

The procedure for Secretarial Audit is given below:-

- **Appointment of Secretarial Auditor**

The appointment of a Secretarial Auditor is made by passing a resolution in the Board Meeting.

- **Communication to earlier Incumbent**

After passing the resolution, the next step is formally informing the secretarial auditor about his appointment. This can be done by proposing an engagement letter to the Secretarial Auditor.

- **Acceptance of Appointment by the Secretarial Auditor**

After the formal communication of employment, the secretarial auditor needs to accept the appointment by signing the Letter of Engagement.

Initial Discussions about the company with the Secretarial Auditor
The next step is to discuss the company with the secretarial auditor so that he know the structure of the company.

- **Preliminary Meeting with the Auditor**

After this, there is a meeting with the auditor to decide to make an audit plan.

- **Finalization of the Audit plan and briefing the staff**

After the meeting with the auditor and discussing the audit plan, the next step is to finalize the audit plan and inform others about the same to other staff.

- **Testing, Interview and Analysis**

  After this step, the next step is to do the testing interview and analysis.

- **Preparation of Working Report**

  The next step is preparing the working report by the secretarial auditor. A working report consists of all the Secretarial audit reports of the company.

- **Audit Summary for Discussions**

  The next step is to prepare the audit summary and discuss the same with the concerned persons.

- **Submission of Secretarial Audit Report**

  The final step is the submission of the report by the secretarial auditor

2.3.4 Secretarial Audit Report

A Practicing Company Secretary shall only prepare and sign the Secretarial Audit Report. It shall be furnished in Form MR-3 and annexed with the Board Report of the Company.

Further, if the Secretarial Auditor makes any qualification/ observation/ remark in his report, it shall be explained by the Board of Directors in their report.

Process Reporting Qualification in the Secretarial Audit Report

During the preparation Secretarial Audit report, the auditor can point out where there is noncompliance of the required laws in Bold type or Italics. in case the auditor is unable to express an opinion on any matter he can specify the same, stating the reasons thereof.

The auditor should provide all the limitations in the report and the reason why he cannot give an opinion on the same Further, the Board of Directors (BoDs) of the company shall mention all the remarks of the auditor in the resolution.

2.3.5 Documents need to be verified for conducting Secretarial Audits

1. Incorporation of Documents

The MOA and AOA contain all the details of the company signed by all the shareholders agreeing to incorporate the companies. The certificate of incorporation and list of shareholders will be required.

2. Board of Directors and Shareholders meeting

The notices and minutes of the board of the meeting and general meeting and also the resolution passed by the directors or shareholders in the company.

3. Register and Records

The records of the registration of members, the board of directors, and key personnel, as well as the register of the contracts and arrangements, are required at the time of the secretarial Audit.

4. Deposits taken by the Companies

The details of the deposits taken by the companies.

5. Compliance Certificates

The secretarial compliance certificate and the compliance certificate related to other specific laws or regulations are required.

6. Financial Statements and reports

The financial statement and annual reports by the shareholders or directors of the company are required at the time of the secretarial Audit.

7. Policies and Procedures

The policies and procedures followed by the companies for corporate governance and the code of conduct made by the company for its functioning are required for the secretarial Audit.

8. Statutory registers including the share transfer register

Under the Companies Act, 2013 provisions a company must maintain a statutory register of shares and other securities bought back and the authorized buyback shares all the details are to be maintained in the statutory register which is required to be examined at the time of secretarial Audit.

9. Regulatory Filings

The copies of filings made within the regulatory authority and annual returns filed with the companies' registers.

10. Board and General Meeting Agendas

The boards' and general meetings' agendas are required to be checked to determine whether they comply with the laws or not at the time of the secretarial Audit.

11. Contracts and Agreements

The copies of the contracts made between the company and other parties need to be presented at the time of the secretarial audit to check whether the provisions of the contracts comply with the laws.

12. Licenses and Approvals

The copies of the license or approval secured from the government for running a business are required for the secretarial Audit.

2.3.6 Important Provisions pertaining to Secretarial Audit

The necessary provisions pertaining to Secretarial Audit are given below

1. Matters that are needed to be mentioned in the Audit.
2. Compliance Certificate.
3. Verification of Documents and records
4. A Crucial area of the Secretarial Audit report under the Companies Act 2013.
5. A crucial area of the Secretarial Audit report under SEBI Rules and Regulations.
6. A crucial area of the Secretarial Audit report under other laws.
7. Period of the Secretarial Audit.
8. Disqualification for the appointment of the Secretarial Auditors.
9. The company has to provide all assistance.
10. Objectives of Secretarial Audit

2.3.7 Secretary's obligation to notify the relevant authority about the fraud report:

According to Section 143 of the Companies Act, 2013, if an auditor has a reason to believe that fraud has been committed by the officers or employees of the company, then it’s his/her duty to report such fraud to the appropriate authority.

Penalty for Fraud and False Statement

The Companies Act 2013 provides the penal provisions related to committing fraud and giving a false statement. The penal provisions are given below —

- **Section 447**

This section states that if any person is found to commit fraud shall be liable for a minimum imprisonment of 6 months which may extend to 10 years, along with a fine which can be thrice the amount of the fraud committed.

In relation to the affairs of the company, fraud can be defined as the commission of any illegal act or omission of any legal act, abuse of position, concealment of fact with the intention to deceive, gain undue advantage or hamper the interests of the shareholder or creditors of the company or any other individual irrespective of the fact that there is a wrongful loss or wrongful gain.

- **Section 448**

This section deals with the penalty for false statements. The section provides that if in any report, certificate, return, financial statement, prospectus, statement or other Document required by, or for any of the provisions of this Act or the rules made there under, anyone makes any false statement about any material particulars, knowing it to be false; a statement that omits any material fact, knowing it to be material.

The appropriate authority for reporting fraud depends on the amount of offense and hence can be classified into the following categories: -

Fraud of Rs. 1 crore or above

A fraud that involves an amount of Rs. 1 crore or above shall be reported to the Central Government.

However, the auditor shall first report the matter to the Board of Directors or Audit Committee of the company within 2 days of his knowledge. The Board of Directors/ Audit Committee shall reply to the same within 45 days. Then, within 15 days, the auditor shall forward his report along with the reply received from the Board of Directors/ Audit Committee to the Central Government.

Moreover, if the Board of Directors or Audit Committee fails to reply within 45 days, then the auditor shall send a note to the Central Government stating that he forwarded the report to the Board/ Audit Committee but did not receive any reply from them.

Fraud involving amounts less than Rs. 1 crore

Those frauds that involve an amount less than Rs. 1 crore shall be reported by the auditor to the Board of Directors or Audit Committee of the Company within 2 days of his knowledge. Such report shall specify —

- Nature of the fraud;
- Approximate amount involved in the fraud; and
- Parties that are involved in such fraud.

Further, this information along with the remedial actions taken shall be disclosed in the Board Report of the Company.

Penalty for Non-Compliance

The Companies Act, 2013 provides for the following penalties in case of non- compliance relating to Secretarial Audit.

Penalty for Contravention

If a company or any of its officers or a Practising Company Secretary contravenes the provisions of Secretarial Audit specified in Section 204 of the Companies Act, 2013, then such company, officer, or Practising Company Secretary shall be liable to a penalty of Rs. 2 lakhs.

Penalty for Failure to Report Fraud

If a Secretarial Auditor fails to report fraud to the appropriate authority as mentioned above, then he shall be liable to a penalty of Rs. 5 lakhs in the case of a listed company/ Rs. 1 lakh in the case of other companies.

MODEL SECRETARIAL AUDIT REPORT:

FORM NO. MR-3

SECRETARIAL AUDIT REPORT FOR THE FINANCIAL YEAR ENDED

[*Pursuant to section 204(1) of the Companies Act, 2013 and rule No.9 of the Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014]*

To,

The Members,

… Limited

I/We have conducted the secretarial audit of the compliance of applicable statutory provisions and the adherence to good corporate practices by (name of the company).(hereinafter called the company). Secretarial Audit was conducted in a manner that provided me/us a reasonable basis for evaluating the corporate conducts/statutory compliances and expressing my opinion thereon.

Based on my/our verification of the ....……………………….. (name of the company's) books, papers, minute books, forms and returns filed and other records maintained by the company and also the information provided by the Company, its officers, agents and authorized representatives during the conduct of secretarial audit, I/We hereby report that in my/our opinion, the company has, during the audit period covering the financial year ended on, complied with the statutory provisions listed hereunder and also that the Company has proper Board-processes and compliance mechanism in place to the extent, in the manner and subject to the reporting made hereinafter:

I/we have examined the books, papers, minute books, forms and returns filed and

v) The following Regulations and Guidelines prescribed under the Securities and Exchange Board of India Act, 1992 ('SEBI Act') :

(a) The Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011;

(b) The Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992;

(c) The Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009

(d) The Securities and Exchange Board of India (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999;

(e) The Securities and Exchange Board of India (Issue and Listing of Debt Securities) Regulations, 2008;

(f) The Securities and Exchange Board of India (Registrars to an Issue and Share Transfer Agents) Regulations, 1993 regarding the Companies Act and dealing with client;

(g) The Securities and Exchange Board of India (Delisting of Equity Shares) Regulations, 2009;

(h) and (h) The Securities and Exchange Board of India (Buyback of Securities) Regulations, 1998;

(vi) (Mention the other laws as may be applicable specifically to the company)

I/we have also examined compliance with the applicable clauses of the following

(i) Secretarial Standards issued by The Institute of Company Secretaries of India.

(ii) The Listing Agreements entered into by the Company with Stock Exchange(s), if applicable; During the period under review the Company has complied with the provisions of the Act, Rules, Regulations, Guidelines, Standards, etc. mentioned above subject to the following observations: Note: Please report specific non compliances / observations / audit qualification, reservation or adverse remarks in respect of the above para wise.

I/we further report that:

The Board of Directors of the Company is duly constituted with proper balance of Executive Directors, Nonexecutive Directors and Independent Directors. The changes in the composition of the Board of Directors that took place during the period under review were carried out incompliance with the provisions of the Act.

Adequate notice is given to all directors to schedule the Board Meetings, agenda and detailed notes on agenda were sent at least seven days in advance, and a system exists for seeking and obtaining further information and clarifications on the agenda items before the meeting and for meaningful participation at the meeting.

Majority decision is carried through while the dissenting members' views are captured and recorded as part of the minutes.

I/we further report that there are adequate systems and processes in the company commensurate with the size and operations of the company to monitor and ensure compliance with applicable laws, rules, regulations and guidelines.

Note: Please report specific observations / qualification, reservation or adverse remarks in respect of the Board Structures/system and processes relating to the Audit period.

I/we further report that during the audit period the company has................................ (Give details of specific events / actions having a major bearing on the company's affairs in pursuance of the above referred laws, rules, regulations, guidelines, standards, etc. referred to above).

For example:

(i) Public/Right/Preferential issue of shares / debentures/sweat equity, etc.

(ii) Redemption / buy-back of securities.

(iii) Major decisions taken by the members in pursuance to section 180 of the Companies Act, 2013.

(iv) Merger / amalgamation / reconstruction, etc.

(v) Foreign technical collaborations.

Place: Signature:

Date:

Name of Company Secretary in Practice /Firm:

ACS/FCS No. :

C P No.:

Let's sum up:

A secretarial audit report is a detailed assessment conducted by a practicing company secretary to evaluate a company's compliance with applicable laws, regulations, and corporate governance norms. The report provides an overview of the company's adherence to statutory requirements concerning board procedures, disclosure practices, maintenance of statutory registers, and compliance with SEBI regulations for listed entities. The audit procedure involves a systematic review of documents, records, and procedures followed by interviews with key personnel to ascertain the effectiveness of internal controls and governance structures. The report typically highlights any non-compliance issues or areas needing improvement, offering recommendations for corrective actions. It serves as a crucial tool for enhancing transparency, ensuring legal compliance, and bolstering investor confidence in the company's governance framework.

Check your progress – Quiz-1

1. What is the primary purpose of an audit report?

A) To provide recommendations for marketing strategies

B) To assess the financial performance of the company

C) To evaluate compliance with legal and regulatory requirements

D) To monitor employee productivity

2. Which of the following statements about an audit report is true?

A) It is prepared by any senior manager in the company.

B) It includes financial forecasts and projections.

C) It is based on interviews with external stakeholders.

D) It highlights findings and recommendations based on audit procedures.

3. Who typically signs off on an audit report?

A) Chief Executive Officer (CEO)

B) Chief Financial Officer (CFO)

C) External Auditor

D) Company Secretary

4. When conducting a secretarial audit, the auditor is required to disclose any frauds involving less than ---- to the company's Board of Directors or Audit Committee
within two days of becoming aware of them.

a) Rs. 1 crore b) Rs. 10 crore c) Rs. 100 crore d) Rs. 5 crore

5 ------------------- deals with the penalty for false statements.

a) Section 448 b) Section 344 c) Section 445 d) Section 404

2.4 UNIT SUMMARY:

The purpose of this unit's first portion is to provide basic, tangible understanding about secretarial auditing by explaining the meaning, scope, objectives, and benefits of the practice. Information about the applicability of secretarial audit under the Companies Act of 2013 and the SEBI regulations of 2015 is provided in the second part. This provides information on the legal guidelines that the secretary audit follows under these two acts. A thorough explanation of the secretary audit report and audit procedures is provided in the final part. The general modules provide special knowledge about this audit by covering the framework of secretarial audit.

2.5 Glossary

Compliance	Adherence to laws, regulations, and internal policies relevant to corporate governance and operations.
Corporate Governance	The system of rules, practices, and processes by which a company is directed and controlled, encompassing the relationships among stakeholders and the goals for which the corporation is governed.
Statutory Registers	Registers maintained by a company as required under the Companies Act, containing important information such as details of shareholders, directors, and charges created by the company.
SEBI Regulations	Regulations issued by the Securities and Exchange Board of India (SEBI) governing the conduct and practices of listed companies, including disclosure norms, corporate governance guidelines, and insider trading regulations.
Non-Compliance	Failure to adhere to legal or regulatory requirements, internal policies, or governance standards.

Internal Controls	Policies, procedures, and mechanisms designed to ensure the reliability of financial reporting, compliance with laws and regulations, and the effectiveness and efficiency of operations.
Corporate Ethics	Standards of conduct expected from individuals within a corporation, encompassing honesty, integrity, fairness, and accountability in decision-making and actions.

2.6 Self-Assessment Questions Short Answers: (5 Marks)

1. Write the meaning of secretarial audit and its importance.

2. Describe applicability secretarial audit under companies act,2013.

3. Define secretarial audit benefits.

4. Write about: secretarial audit report.

5. What are the Documents need to be verified while conducting Secretarial Audits?

Essay Type Answer: (10 Marks)

1. Discuss the need for and scope of Secretarial Audit.

2. State the guidelines evolved by the Institute for appointment of Secretarial Auditor.

3. What are the points to be kept in mind by the Secretarial Auditor while conducting Secretarial Audit of the company?

4. What all points are to be appraised while checking the compliance of a listed company?

5. What are the benefits of Secretarial Audit?

6. Explain Secretary's obligation to notify the relevant authority about the fraud report.

7. Explain Secretarial audit report.

2.7 Activities:

1. Preparation of a comprehensive audit report highlighting findings, observations, and recommendations for corrective actions to address identified deficiencies and enhance compliance and governance practices.

2. Monitoring and follow-up on the implementation of audit recommendations by management to ensure timely remediation of identified issues and improvement in compliance and governance standards.

3. Review of internal controls and procedures implemented by the company to ensure the reliability of financial reporting, safeguarding of assets, and compliance with laws and regulations.

2.8 - Topics for Discussion

1. Adherence to the Secretarial Standards issued by the Institute of Company Secretaries of India (ICSI) or relevant standards in your jurisdiction.

2. Compliance with procedural aspects related to board meetings, general meetings, etc.

3. Assessment of the company’s initiatives related to environmental sustainability.

4. Review of social responsibility initiatives and community development programs.

5. Discussion on emerging regulatory trends impacting corporate compliance.

2.9 - Suggested Readings / References

Books:

1. **Secretarial Audit, Compliance Management and Due Diligence** by Mamta Bhatt and Arun Kumar Bhatt - This book provides a comprehensive overview of secretarial audit practices, compliance management, and due diligence in the Indian context.

2. **Secretarial Audit and Compliance Management** by Sangeet Kedia - This book covers the legal and regulatory framework governing secretarial audit in India, including practical aspects and case studies.

3. **Secretarial Practice** by Dr. M.C. Kuchhal - A textbook covering various aspects of secretarial practice, including secretarial audit, corporate governance, and compliance.

4. **Secretarial Standards – A Comprehensive Commentary** by Kamal Garg — This book provides a detailed commentary on the Secretarial Standards issued by the Institute of Company Secretaries of India (ICSI).

Journals

1. Company Secretary Journal - Published by ICSI, this journal includes articles on secretarial audit, corporate governance, and compliance-related topics.

2. Corporate Governance: An International Review - A scholarly journal covering research articles on corporate governance practices globally, including aspects relevant to secretarial audit.

3. Journal of Corporate Governance - Another academic journal focusing on various aspects of corporate governance, including compliance and audit practices.

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UNIT III: Introduction to Due Diligence

Due diligence: Meaning, Need, Objectives and Scope – Factors to be considered while conducting due diligence – Process of due diligence – Techniques of due diligence.

UNIT OBJECTIVES

The meaning, need, objectives, and scope of due diligence will be addressed in this unit. Through this unit, the learners will gain knowledge about the factors to be taken into account while conducting due diligence as well as the process and techniques of due diligence. With this unit, they will have an extensive comprehension of the concepts of due diligence.

Section 3.1 Introduction to Due Diligence

3.1.1 Introduction

Due diligence is the investigation or exercise of care that a reasonable business or person is normally expected to take before entering into an agreement or contract with another party or an act with a certain standard of care.

Due diligence can be a legal obligation, but the term more commonly applies to voluntary investigations. It may also offer a defense against legal action. A common example of due diligence is the process through which a potential acquirer evaluates a target company or its assets in advance of a merger or acquisition.[1] The theory behind due diligence holds that performing this type of investigation contributes significantly to informed decision making by enhancing the amount and quality of information available to decision makers and by ensuring that this information is systematically used to deliberate on the decision at hand and all its costs, benefits, and risks.

Due Diligence is used to investigate and evaluate a business opportunity. It implies a general duty to exercise care in any transaction. Most legal definition 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 measure by any absolute standard but depends on the relative facts of the special case.

Source : https://dealroom.net/faq/due-diligence-meaning

3.1.2 Development of the term

The term "due diligence" can be read as "required carefulness" or "reasonable care" in general usage, and has been used in the literal sense of "requisite effort" since at least the mid-fifteenth century. It became a specialized legal term and later a common business term due to the United States' Securities Act of 1933, where the process is called "reasonable investigation". Under Section 11b3, a person could avoid liability for an untrue statement of a material fact if they had, "after reasonable investigation, reasonable ground to believe and did believe, at the time", the truth of the statement.[4] The defense at Section 11, referred to later in legal usage as the "due diligence" defense, could be used by broker-dealers when accused of inadequate disclosure to investors of material information with respect to the purchase of securities. In legal and business use, the term was soon used for the process itself instead of how it was to be performed, so that the original expressions such as "exercise due diligence in investigating" and "investigation carried out with due diligence" were soon shortened to "due diligence investigation" and finally "due diligence".

As long as broker-dealers exercised "due diligence" (required carefulness) in their investigation into the company whose equity they were selling, and as long as they disclosed to the investor what they found, they would not be found liable for non-disclosure of information that was not discovered in the process of that investigation.

The broker-dealer community quickly institutionalized, [when?] as a standard practice, the conducting of due diligence investigations of any stock offerings in which they involved themselves. Originally the term was limited to public offerings of equity investments, but over time it has become associated with investigations of private mergers and acquisitions (M&A) as well.

3.1.3 Meaning:

"Due diligence" is an analysis and risk assessment of an impending business transaction. It is the careful and methodological investigation of a business or persons, or the performance of an act with a certain standard of care to ensure that information is accurate and to uncover information that may affect the outcome of the transaction.

Due diligence is a comprehensive process in business transactions involving the exchange, review, and appraisal of confidential legal, financial, and other material information between parties before finalizing the transaction. Companies conduct background checks on clients, customers, and suppliers to ensure accurate disclosure of information.

The process involves investigating and evaluating potential risks and opportunities associated with a business opportunity, covering Pre-Transaction, During the Transaction, and Post-Transaction activities.

3.1.4 NEED FOR DUE DILIGENCE:

Misrepresentations and fraudulent dealings are not always obvious or straight. These are to be uncovered, especially in a major business transaction, as it would create a major impact on the business. Proper due diligence services explore and asses the details behind the same and to become fully informed about the financials, business, internal systems, profitability, key operational aspects, management team, promoters and other material factors that will help in making an informed decision about an investment.

Due diligence is designed to protect the interests of the Company by providing objective and reliable information on the target company before making any written commitments. Due diligence is an investigative process for providing, the desired comfort level about the potential investment and to minimize the risks such as hidden uncovered liabilities, poor growth prospects, price claimed for proposed investment being on higher side etc.

Due diligence is also necessary to ensure that there are no onerous contracts or other agreements that could affect the acquirer's return on investment. The procedures and analyses ultimately represent a window into the target Company’s success and potential, including what opportunities exist to grow the business further to meet your goals and objectives.

Due diligence exercise is needed to confirm that the nature and genuineness of a business, Identify defects/weakness in the target company and to avoid a bad business transaction, to gather information that is required for valuation of assets, and to negotiate in a better manner. In nutshell due diligence is a SWOT analysis of an investment which is essentially required to make an informed decision about a potential investment.

Due diligence is necessary to allow the investigating party to find out everything that one needs to know about the subject of the diligence. The objective is to allow the investigator to consider the following options, considering the facts found in the course of due diligence.

(i) Withdrawal of deal — if the due diligence uncovers information that disclosed the investments, loan or participation, a risky or undesirable one and which cannot be adequately resolved then the investigator may withdraw from the deal.

(ii) Adjusting the valuation of the investment — the investigator may revise his valuation of the company or reassess the price at which it will provide services. More often, the information will be adverse and therefore the valuation will go down or the price will go up.

(iii) Solving of problems uncovered — it may be possible for a problem uncovered by the due diligence to be solved before the deal goes ahead. For example, unpaid stamp duty could be paid, company filings could be put in order or, if negative information is uncovered on a principal of the target company, the investor may put pressure on the target is put into a state that the investigator is happier with before it deals with it.

3.1.5 OBJECTIVES OF DUE DILIGENCE

The objective of due diligence is to verify the strategic identification or attractiveness of the target company, valuation, risk associated etc.

The objective of due diligence may be to—

1. Collect material of information from the target company.

2. Conduct a SWOT analysis to identify the strength and to uncover threats and weaknesses.

3. For improving the bargaining position depending on SWOT analysis.

4. To take an informed decision about an investment.

5. Identification of areas where representations and warranties are required.

6. To provide a desired comfort level in a transaction.

7. To ensure complete and accurate disclosure.

8. Bridge the gap between the existing and expected.

9. To take smooth/accurate action/decision.

10. To enhance the confidence of stake holders.

The SWOT analysis of the target business carried out as a part of due diligence has to reveal the strengths and weaknesses of not only the financials but also intangibles. To do this effectively, the potential buyer needs to be clear about the goals and motives for acquiring the target company, as well as the value the buyer is attempting to create with the purchase. For example, if there is a legal risk, such as an outstanding lawsuit, that will not only jeopardize the financial stability of the company but also the loyalty of existing customers. This will erode the target company's market of customers by a new and stronger competitor. The target company's talent is the asset desired, and much of this depends on employee relations and accordingly cultural issues has to be addressed in time.

A thorough due diligence helps to reveal any of the negatives, but the process of due diligence rarely goes smoothly because of one major stumbling block and that is availability of information. The target company is rarely eager to reveal to the other party that it is up for sale and wants to keep this information confidential from its competitors, customers and employees. So getting any information from these sources can be tricky, depending upon what the potential buyer wants to gain from the transaction. The buyer who aims to get new market of customers with the transaction wants to make sure that the target company has a good relationship with existing customers. But, during due diligence, the target company does not want any contact with its existing customers for fear that customers might leave because of the impending sale. As another example, a potential buyer sees the employee talent as the company’s main asset, but the target company is nervous about letting the potential buyer talk to key employees because it does not want to let on that it is going to be sold. Because of the confidential nature of transactions, not all the information that is necessary to make a good decision can be revealed. This is why services of experts are hired in due diligence before beginning the process so the buyer receives reliable guidance. It is also critical to meet with trusted advisors— both inside and outside about what has been discovered and brainstorm the different scenarios of what can go wrong before going ahead with the deal.

Once a purchase price is agreed upon the prospective buyer usually enters into a conditional agreement with a due diligence clause with the target business, in which the buyer has a limited period to conduct due diligence. During this time, the potential buyer requests full access to all relevant materials in the target business, all customer, vendor, financial and other information in order to conduct a thorough investigation. Here it is to be ensured that the potential buyer does not use this information for its own benefit if it decides to back out of the deal, a confidentiality agreement is usually signed to protect the target businesses’ interests. But a possibility of re-negotiation of the purchase price or cancellation of the agreement on the part of buyer is seen if the information found is not acceptable to the potential buyer. Again after due diligence, the goal is to either reaffirm the purchase price or renegotiate, depending on what was discovered. But the ultimate goal is to make a rational decision based on the facts. While it may be hard to overcome the excitement of purchasing a business, here the potential buyer is prepared to cancel the deal as earlier said if something is discovered that runs counter to why the business looked like a good deal in the first place.

3.1.6 SCOPE OF DUE DILIGENCE

Scope of due diligence is transaction-based and is depending on the needs of the people who is involved in the potential investments, in addressing key uncovered issues, areas of concern/threat and in identifying additional opportunities.

Due diligence is generally understood by the legal, financial and business communities/potential investors to mean the disclosure and assimilation of public and proprietary information related to the assets and liabilities of the business being acquired. This information includes financial, human resources, tax, environmental, legal matters, intellectual property matters etc.

Due diligence would include thorough understanding of all the obligations of the target company: debts, rights and obligations, pending and potential lawsuits, leases, warranties, all high and impact laden contracts — both inter-corporate and intracorporate.

The investigation or inspection would cover:

— Compliance with applicable laws

— Regulatory violations or disciplinary actions

— Litigation and assessment of feasibility of pursuing litigation

— Financial statements

— Assets, real and intellectual property, brand value etc.

— Unpaid tax liens and/or judgements

— Past business failures and consequential debt

— Exaggerated credentials/Fraudulent claims

— Misrepresentations or character issues

— Cross-border issues

— double taxation, foreign exchange fluctuation, sovereign risk, investment climate, cultural aspects.

— Reputation, goodwill and other intangible assets

Let's sum up

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 purpose of timely, sufficient and accurate disclosure of all material statements/information or documents, which may influence the outcome of the transaction. Due diligence involves a careful study of the financial as well as non-financial possibilities for successful implementation of restructuring plans. 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. Due Diligence may also require to be performed in cases of corporate restructuring, venture capital financing, lending, leveraged buyouts, public offerings, disinvestment, corporatization, etc.

Check your progress – Quiz-1

1. What is the primary objective of due diligence in a business transaction?
A. To maximize shareholder value
B. To minimize risks associated with the transaction
C. To increase market share
D. To secure financing for the transaction

2. Which of the following is NOT typically included in the scope of due diligence?
A. Financial analysis
B. Operational efficiency assessment
C. Brand marketing strategy review
D. Legal and regulatory compliance review

3. Due diligence is a process of ___________, into the details of a potential investment such as an examination of operations and management and the verification of material facts.

a) audit performed by internal auditor.

b) investigation performed necessarily by statutory auditor

c) audit performed by statutory auditor.

d) investigation performed by investors.

4. “Due diligence” is an ------------- of an impending business transaction.

a) Analysis and risk assessment

b) I*nvestigation and enquiry*

c) Valuation and verification

d) All of the above

5. The objective of due diligence may be to-----------------------

a). Collect material of information from the target company.

b) To take an informed decision about an investment.

c) Identification of areas where representations and warranties are required.

d) All the above

Section 3.2 Factors, Types and process of Due Diligence

3.2.1 Important basic factors of Due Diligence

Purpose of transaction: A key step in any due diligence exercise is to develop an understanding of the purpose for the transaction. The goal of due diligence is to provide the party proposing the transaction with sufficient information to make a reasoned decision as to whether or not to complete the transaction as proposed. It should provide a basis for determining or validating the appropriate terms and price for the transaction incorporating consideration of the risks inherent in the proposed transaction.

SCOPE:

(i) Be clear about your expectations in terms of revenues, profits and the probability of the target company to provide you the same.

(ii) Consider whether you have resources to make the business succeed and whether you are willing to put in all the hard work, which is required for any new venture.

(iii) Consider whether the business gives you the opportunity to put your skills and experience to good use.

(iv) Learn as much as you can about the industry you are interested in from media reports, journals and people in the industry.

Planning the schedule: Once it is decided for a particular business, make sure of the following things: —– Steps to be followed in due diligence process

— Areas to be checked

— Aspects to be checked in each area

— Information and other material to be requested from the seller

Negotiation for time: Sometimes, it may be the case that, sellers want the process to get over as soon as possible and try to hurry the proceedings. When the seller gives a short review period, negotiations can be made for adequate time to have a complete review on crucial financial and legal aspects.

Risk Minimisation: All the information should be double checked– financials, tax returns, patents, copyrights and customer base to ensure that the company does not face a lawsuit or criminal investigation. The financials are very important and one needs to be certain that the target company did not engage in creative accounting. The asset position and profitability of the company are vital.

Since, Due diligence exercise deals with the overall business, it is important to consider aspects such as:

— background of promoters

— performance of senior management team

— organizational strategy

— business plans

— risk management system

— technological advancement

— infrastructure adequacy

— optimum utilization of available resources.

Information from external sources: The company's customers and vendors can be quite informative. It may be found from them whether the target company falls in their most favored clients list.

Any flaws that the audit uncovers would help to negotiate down the sale price. Due diligence is "a chance to get a better deal". But don't go overboard. Remember that the whole point of buying a company is to add people to your own organization. Even if the seller and staff do not stay on after the deal, they may prove useful as advisers in the future.

Limit the report with only material facts: While preparing the report it is advisable to be precise and only the information that has a material impact on the target company is required to be included. Structure of information Once the due diligence process is over, while preparing the report, information has to be structured in an organized manner in order to have a better correlation on related matters.

3.2.2 FACTORS TO BE KEPT IN MIND WHILE CONDUCTING DUE DILIGENCE:

Due diligence is a vital step in any industrial project, especially when it involves cross-border business. Conducting due diligence on cross-border industrial projects involves a detailed assessment of various factors to ensure that the project is financially sound, feasible, and legally compliant. Here are some key factors that you should consider when conducting due diligence in cross-border industrial projects:

1. **Political and Economic Environment:** The political and economic environment in the country where the project is being undertaken plays a critical role in the success of the project. You need to assess the political stability, economic policies, exchange rate, and inflation rate to evaluate the viability of the project.

2. **Legal and Regulatory Compliance:** Laws and regulations vary from country to country, and compliance requirements may be different as well. It is essential to conduct a comprehensive review of all applicable laws and regulations and ensure that the project complies with them.

3. **Market Analysis:** You need to assess the market potential and competition in the industry in the country where the project is being undertaken. This will help you determine whether the project is feasible and financially viable.

4. **Operational Assessment:** You need to evaluate the operational and technical capabilities of the project. This involves a detailed review of the manufacturing process, production capacity, and supply chain management.

5. **Financial Analysis:** Conducting a financial analysis is a critical step in due diligence. You need to assess the financial viability of the project, including the projected revenue, cash flow, and profit margins.

6. **Cultural Differences:** Understanding cultural differences is essential when dealing with cross-border business. You need to assess the cultural differences between the home country and the host country to ensure that the project is culturally sensitive and appropriate.

7. **Human Resources and Employment Laws:** Employment laws and human resource practices vary from country to country. You need to assess the labor laws and employment practices in the host country to ensure that the project complies with them.

8. **Intellectual Property Rights:** Intellectual property rights are critical for any industrial project. You need to evaluate the intellectual property rights in the host country and ensure that the project complies with them.

9. **Environmental Impact:** Environmental regulations may vary in different countries. You need to assess the environmental impact of the project and ensure that it complies with all applicable regulations.

10. **Risk Assessment:** Conducting a comprehensive risk assessment is critical to identifying and mitigating risks associated with the project. This involves a detailed review of all potential risks, including legal, financial, operational, and reputational risks.

3.2.3 PROCESS OF DUE DILIGENCE

A due diligence process can be divided into three stages

(i) Pre diligence,

(ii) Diligence, and

(iii) Post diligence.

Image: Due Diligence Process*

(i) Pre diligence:

A pre diligence is primarily the activity of management of paper, files and people.

1. Signing the Letter of Intent (LOI) and the Non-Disclosure

Agreement Understand the purpose for the transaction

Plan the schedule of Due diligence

Negotiate for adequate time to analyse the facts

Background check of promoters and senior

management Infrastructure adequacy Information

from external sources

Observation of culture of employees

Limiting the Report only with material facts Important things to remember while carrying out due diligence exercise (NDA)/ Engagement letter.(A sample format is enclosed at Annexure I)

2. Receipt of documents from the company and review of the same with the checklist of documents already supplied to the company.

3. Identifying the issues.

4. Organising the papers required for a diligence.

5. Creating a data room.

The first and foremost in a deal for the management of the target company, is that the investor is to sign a Letter of Intent (LOI) or a term sheet which underlines the various terms on which the proposed deal is to be concluded. Immediately on receipt of the LOI the investors sign an NDA with the various agencies conducting a diligence, be it finance, accounting, legal or a secretarial diligence.

The company, would usually receive a checklist from the agency conducting the diligence. The checklist is invariably exhaustive in nature, and therefore, the company may either collate and compile the documents in- house, or outsource this to an external agency. While the data is being collated care should be taken to ensure that there are no loose ends that may probably arise.

As regards a data room, some of the important things that one should take cognizance of from the corporate view point are the following:

(a) Do not delay deadlines (leads to suspicion).

(b) Mark each module of the checklist provided for separately.

(c) In case some issues are not applicable spell it out as "Not Applicable".

(d) In case some issues cannot be resolved immediately, admit it.

(e) Put a single point contact to oversee the process of diligence.

(f) Keep a register, to track people coming in and going out.

(g) An overview on the placement of files.

(h) Introduction to the point person.

During the diligence, care should be taken to adhere to certain hospitality issues, like:

(a) Be warm and receptive to the professionals who are conducting diligence.

(b) Enquire on the DD team.

(c) Join them for lunch.

(d) Ensure good supply of refreshments.

(e) In case of any corrections – admit and rectify.

As regards the process of diligence, as a professional care should be taken to scrutinize every document that is made available and ask for details and clarifications, though, generally the time provided to conduct the diligence may not be too long and though things have to be wrapped up at the earliest. The company may be provided an opportunity to clear the various issues that may arise out of the diligence.

(ii) Diligence:

After the diligence, is conducted, the professionals submit a report, which is common parlance is called the DD report. These reports can be of various kinds, a summary report; a detailed report or the like; and the findings mentioned in the report can be very significant, in as much as the deal is concerned.

There are certain terms used to define the outcome of these reports:

Deal Breakers: In this report the findings can be very glaring and may expose various non-compliance that may arise – any criminal proceedings or known liabilities.

Deal Diluters: The findings arising out a diligence may contain violations which may have an impact in the form of quantifiable penalties and in turn may result in diminishing the value of company.

Deal Cautioners: It covers those findings in a diligence which may not impact the financials, but there exist certain non-compliances which though rectifiable, require the investor to tread a cautious path.

Deal Makers: Which are very hard to come by and may not be a reality in the strict sense, are those reports wherein the diligence team have not been able to come across any violations, leading them to submit what is called a 'clean report'.

Interestingly, only after the reporting formalities are over and various rectifications are carried out, the "shareholders agreement" (which is the most important document) is executed. This agreement contains certain standard clauses like the tag along and drag along rights; representations and warranties; condition precedents, and other clauses that have an impact on the deal.

(iii) Post Diligence:

Post diligence sometimes result in rectification of non-compliances found during the course of due diligence. There can be interesting assignments arising out of the diligence made by the team of professionals. It can range from making applications/ filing of petition for compounding of various offences or negotiating the shareholders' agreement, since the investors will be on a strong wicket and may negotiate the price very hard.

Example of due diligence process in a M&A strategy

Stages	For Buyer	For seller
Preparation Stage	M&A Strategy formulation Prepare a of List of potential targets Appoint external advisor for evaluation of targets Short list targets Create Due diligence team	Structure a Business plan Prepare a list of potential buyers Appoint external advisor Shortlist buyers
Pre diligence	Approach targets Negotiate initial terms Execute Non-Disclosure Agreement Compile a list of data required	Approach buyers Negotiate initial terms Execute Non-Disclosure agreement Create a Data room
Due diligence	Inspection of Data room	Assistance in data room

	Analysis of private documents Evaluation of risk and return Structuring the terms and conditions	Setting deadlines for offer
Negotiations	Make final offer Negotiate and agree on terms	Compile final offers select best offer negotiations
Post diligence	Post merger integration and cultural adjustments	Termination of data room and ownership exchange

3.2.4 Techniques of Due Diligence:

In general, due diligence can be conducted by various parties involved in a transaction or decision-making process. Some of these parties include:

- **Buyers or investors —** These could be an entity or individual seeking to invest by assessing the risks, financial health, and opportunities linked to the target company.
- **Sellers —** Companies or individuals selling an asset or business can also perform due diligence to clearly understand potential liabilities prior to entering into a deal.
- **Accountants —** Certified public accountants (CPAs) and accounting firms are frequently hired to examine financial records, check the accuracy of financial statements, and identify accounting irregularities.
- **Financial advisors —** Financial analysts or consultants typically assist buyers and sellers with due diligence by providing their expertise in financial analysis, risk assessment, and market research.

- **Legal advisors —** Legal teams and lawyers particularly review contracts, identify legal risks, and ensure regulatory compliance concerning the transaction.

Such parties typically work together to analyze information, assess risks, and make informed decisions based on their findings during the due diligence process.

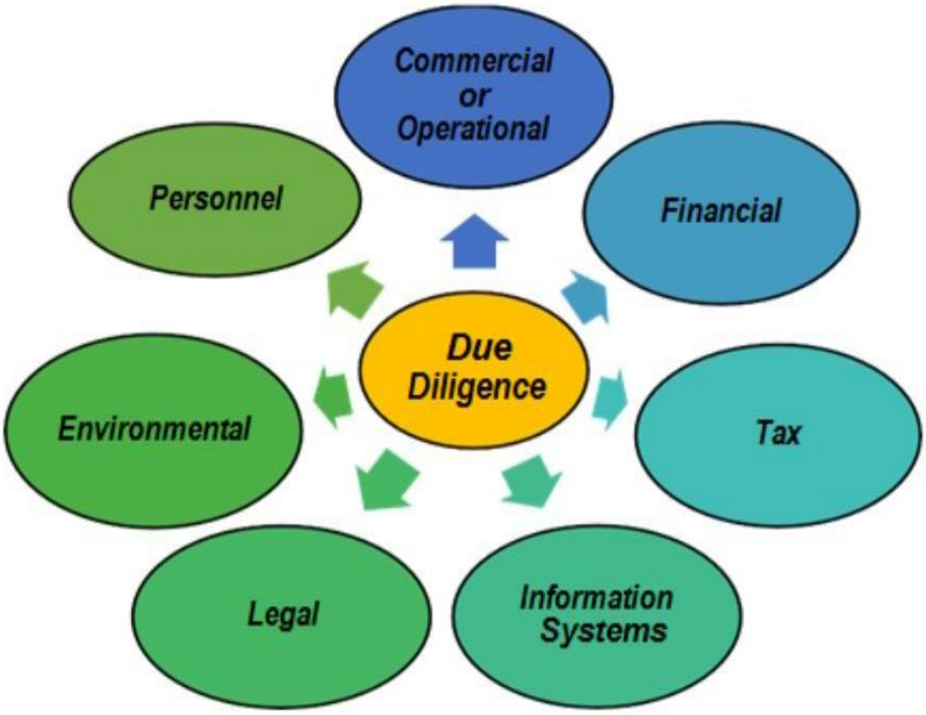
When to conduct due diligence?

Due diligence is typically conducted before any business transaction. The bigger and more complex the deal, the more extensive due diligence is needed. More so, it can be performed at various stages of the decision- making process — from pre-transaction to actual risk management. As a general rule, due diligence should be completed before the deal closes.

3.2.5 Types of Due Diligence:

i) Hard Due Diligence

ii) soft Due Diligence



i) Hard Due Diligence

Considered the *traditional* approach, hard due diligence involves the collection and verification of concrete data and numbers. This category covers the majority of due diligence, focusing on the enterprise's financial aspects, taxes, and operations.

Hard due diligence primarily looks into three things: **facts** about a company's status, **figures** based on its financial documentation, and **legal** for compliance and litigation concerns. These are some of the types of hard due diligence:

Financial Due Diligence

This type is conducted to ensure the accuracy of a company's financial records stated in its confidential information memorandum. Financial accounts, business forecasts, and inventory schedules are often investigated.

Performing financial due diligence also involves analysis of profit margins, fixed and variable cost analysis, customer account verification, and analysis of internal control procedures. Moreover, the company's debt situation is checked, evaluating its ability to pay its outstanding debt and if needed, secure more financing.

Legal Due Diligence

Checking into legal matters can make or break a business deal. In most cases, legal due diligence impacts how or if the transaction will move forward. The deal's structure can be influenced by issues such as pending or previous litigation, non-compete clauses, or breached contracts.

This procedure is also known to be a mandatory consideration for companies before entering an M&A. Legal due diligence requires an evaluation of all material contracts, including:

- Loan and bank financing agreements
- Licensing or franchise agreements
- Partnership agreements
- Guarantees
- Copy of Memorandum and Articles of Association
- Board meeting meetings over the past three years

Tax Due Diligence

Also known as fiscal due diligence, tax due diligence refers to the careful examination of tax liabilities. This type particularly looks into the company's current tax structure, pending tax-related cases, and level of compliance with tax laws.

Conducting such analysis ensures that all the organization's taxes are being reported and paid. Some documents that are subject to validation include tax audits, tax returns for the past three to five years, and agreements with tax agencies.

Operational Due Diligence

This type of due diligence covers all the operation risks and processes that can either negatively or positively impact the deal. It concentrates on the company's operating model to identify gaps and opportunities that require development or investment. This covers areas such as company assets, products and services, technology, supply chain, sales, marketing, and any existing facilities,

Intellectual Property Due Diligence

Intellectual property (IP) refers to tangible assets that contribute to an organization's market position and competitive advantage. IP due diligence aims to evaluate assets such as:

- Patents for technologies or inventions developed by the company
- Copyrights for business software and creative assets
- Existing trademarks that could lead to legal disputes
- Chain-of-ownership documentation

Moreover, IP due diligence also focuses on safeguarding the trade secrets of a company and ensuring confidentiality is maintained. By performing due diligence, companies can assess the value and risks associated with IP assets. Hence, avoiding legal complications as well.

ii) Soft Due Diligence

Soft due diligence is known to be harder to conduct since it concentrates on the company's culture fit and other facets related to human capital. Or, to put it simply, it investigates the elements related to how people work or fit into the organization's culture.

Human Resources Due Diligence

Human resources due diligence focuses on the most valuable asset within a company: the employees. This process is considered to be as extensive as financial due diligence, and involves the analysis of the following:

- Current positions and vacancies
- Current salaries of employees during the last three years
- Benefit and retirement packages
- HR policies for annual and sick leaves
- Employee issues, such as alleged discrimination, harassment, or wrongful termination

Employment contracts, from nondisclosure to non-competition agreements HR due diligence can help identify any people-based risks before making a deal, and get a complete picture of the organization's culture. In short, this process covers the workforce's entire spectrum and all documentation related to it.

Administrative Due Diligence

This form of due diligence entails the verification of any administrative-related elements, including business facilities, occupancy rates, and workstations. Such aspects and their costs are closely connected to a company's financials. Administrative due diligence aims to verify the properties a company owns and determine whether operational expenditures are declared in the financials.

ESG Due Diligence

Environmental, social, and governance (ESG) due diligence focuses on the target company's adherence to ethical, sustainable, and well-governed policies. It aims to uncover material ESG risks, liabilities, and opportunities related to a transactional target or a portfolio company.

ESG due diligence places significance on non-financial factors that affect an enterprise's reputation, financial performance, and regulatory standing. It also helps uncover a company's ESG policies and risk factors, enabling ethical investment decisions, mergers, and acquisitions.

Commercial Due Diligence

In this type, a company's ecosystem is examined to determine its position in the market. Commercial due diligence looks into market conditions, trends, and competition. For instance, in a merger and acquisition, this process can help the buyer understand the company based on its market and how is it likely to change in the coming years.

3.2.6 Procedure for due diligence

1. Establish a due diligence team

Regardless if it's a small or huge transaction, assembling a qualified due diligence team can be beneficial. Building the right team should be focused on experience and competencies. It is ideal to have experts in relevant fields, including finance and accounting, operations, law, and risk management. Some roles you can consider are:

- **Financial analysts —** To analyze financial statements and assess financial performance.

- **Legal advisors —** To provide expertise in contract law, litigation matters, intellectual property rights, and other legal aspects of the transaction.
- **Operational experts —** To evaluate operational efficiency, production processes, and supply chain management of the target entity.
- **Compliance specialists —** To assess the target entity's compliance with applicable laws and regulations, as well as contractual obligations.

While there's no limit to the number of people to have on your team, it is crucial to have a leader or project manager to oversee the due diligence process. Your team does not have to be entirely in-house. Seeking external sources like outsourcing industry or niche-specific consultants is ideal to further ensure independent and objective investigation.

2. Gather all relevant documentation

Before you can proceed with the assessments, having the necessary documentation is critical. This will help your team prepare the diligence reports and verify whether or not the transaction is doable. Plus, this can guide you in assessing the target company's overall viability. Here's a checklist of some documents you'll need:

Financial Documents

- Audited financial statements for the past 3-5 years
- Management accounts and financial projections
- Tax returns and related filings
- Bank statements and loan agreements
- Any financial agreements, such as leases or financing arrangements

Legal Documents

- Articles of Incorporation and organizational documents
- Shareholder agreements and ownership structure

- Intellectual property documents (patents, trademarks, copyrights)
- Litigation history and pending legal matters
- Environmental assessments and compliance reports

Operation Documents

- Business plans and strategic documents
- Operations manuals and standard operating procedures (SOPs)
- Quality control and assurance documents
- Supply chain information, including supplier contracts and relationships
- IT infrastructure and cybersecurity policies

Regulatory and Compliance Documents

- Regulatory filings and compliance reports
- Health and safety records
- Environmental assessments and permits
- Data protection and privacy policies
- Compliance with industry standards and certifications

3. Verify accuracy and completeness

Once you have the documents you need, it’s time to start verifying the data’s accuracy and completeness. Besides cross-referencing or reviewing supporting documents, you can perform verification through independent sources or third-party verification methods.The easiest on the list is hiring external auditors or appraisers to validate financial, legal, and technical information. You can also obtain confirmation from counterparties or conduct background checks.

Moreover, conducting site visits and inspections is also advisable. This helps you verify the target company's operational status, or confirm the value of assets like inventory, equipment, or real estate properties.

4. Conduct post-due diligence actions

Executing post-due diligence actions is crucial for monitoring the initial phase of the transaction. This can provide an evaluation of the target entity and if the deal is running as it should. If significant issues are identified, you can develop a remediation plan to address these concerns (e.g. renegotiating the terms and conditions, or recreating transition plants).

Additionally, monitoring the performance and integration of the acquired assets or operations should be considered. You may also conduct a post- mortem analysis to evaluate the effectiveness of the due diligence process and get insights for future transactions. This feedback loop can help improve your due diligence practices too.

3.2.7 Technology enhances the due diligence process:

Technology can significantly improve the due diligence process in several ways, including:

- Efficient collection and aggregation of large volumes of data, from databases, online repositories, and internal systems.
- Provide secure and centralized repositories for organizing, storing, and sharing due diligence documents. Most tools even offer features like version control, access controls, audit trails, and document indexing.
- Analyze and visualize complex datasets to identify patterns and gain insights. This may involve the use of dashboards, charts, and graphs.
- Facilitate collaboration and communication among due diligence team members and stakeholders. Many platforms like Convene can enable

seamless information sharing, task assignment, progress tracking, and decision-making, regardless of users' geographical location.

Let's sum up

The above section reveals the Conducting due diligence on cross-border industrial projects involves a detailed assessment of various factors. The company need to evaluate the political and economic environment, legal and regulatory compliance, market analysis, operational assessment, financial analysis, cultural differences, human resources, intellectual property rights, environmental impact, and risk assessment. By conducting a thorough due diligence process, they can ensure that the project is feasible, financially sound, and legally compliant, which can lead to its success in the long run. Building the right team should be focused on experience and competencies. It is ideal to have experts in relevant fields, including finance and accounting, operations, law, and risk management

Check your progress- Quiz -1

1. Which of the following factors is considered in legal due diligence?

a. Market share analysis
b. Compliance with environmental regulations
c. Customer satisfaction survey results
d. Marketing campaign effectiveness

2. What does operational due diligence primarily involve?

a. Analyzing financial statements
b. Reviewing legal contracts
c. Assessing day-to-day operations
d. Evaluating market trends

3. Which of the following is a key aspect of due diligence related to legal compliance?

a. Reviewing customer feedback
b. Checking employee satisfaction

c. Assessing compliance with labor laws
d. Analyzing product pricing strategies

4. What is the first step in the due diligence process?

a. Conducting interviews with key personnel
b. Analyzing financial statements
c. Defining objectives and scope
d. Visiting the target company's site

5. Which of the following is NOT a technique used in due diligence?

a. Document review
b. SWOT analysis
c. Financial analysis
d. Interview with stakeholders

SECTION 3.3 TECHNICAL DUE DILIGENCE

A strong business plan is crucial in today's rapidly evolving business landscape. However, the strength of your business plan relies heavily on the technology that underpins it. This is where Technical Due Diligence becomes essential, particularly when potential investors, merger partners, or other stakeholders request it. TDD isn't reserved for tech experts; it's a vital consideration for anyone exploring a business opportunity in our digital era.

Technical Due Diligence is like a detailed check-up for the tech companies' technology environment before getting investments. It looks at things like how that companies product works, the quality of the company code, and any possible problems. It's all about making sure that the company make smart decisions before getting money. Requesting and initiating the Technical Due Diligence process at an early stage is highly advisable. Doing so can lead to significant cost savings, reducing project expenses by up to 20%.

Document every finding carefully. Use specialised software to look at the data, as doing it by hand could lead to mistakes about 30% of the time. It helps the company spot strengths and weaknesses in the system, before allocating the budget and investments.

3.3.1 Need for Technical Due Diligence

When it comes to making smart decisions in the tech world, having TDD (technical due diligence) can be a game-changer. It helps you avoid costly mistakes and ensures the companies investments are solid.

a) Early-Stage Startups and Seed Funding

For startups in their infancy, Technical Due Diligence may not be the first priority. However, it shouldn’t be overlooked. Conducting a preliminary Technical Due Diligence before seeking seed funding can establish a strong technical foundation. It sets a precedent for operational excellence, allowing the startup to attract initial investors with greater confidence.

b) Mergers and Acquisitions

In addition to already established points, M&A activities necessitate a detailed Technical Due Diligence from both the buyer and the seller. The buyer performs TDD to precisely understand what they are acquiring, while the seller uses it to justify their valuation and expedite the acquisition process. This dual Technical Due Diligence process ensures that both parties are on the same page, reducing the risk of post-acquisition complications.

c) Regulatory Compliance Checks

Strict compliance standards govern industries like energy, healthcare, finance, and data analytics. Periodic Technical Due Diligence checks are essential to ensure that the technology adheres to the requisite laws and regulations. This not only helps in avoiding legal repercussions but also boosts the company's credibility in the market.

d) Preparing for an IPO

When a company is planning for an Initial Public Offering (IPO), a thorough Technical Due Diligence can add significant value. It offers potential investors an in-depth view of the company's technical maturity, thereby contributing to a more accurate and potentially higher company valuation.

3.3.2 Significance of Technical Due Diligence:

Technical Due Diligence is a crucial process that holds immense value throughout various stages of a business's journey. Whether you are seeking investments, aiming to highlight your technological advantages and competitive edge, or providing evidence of your return on investment (ROI). Technical Due Diligence plays a vital role. Let's explore why it is essential at different stages!

1- Securing Investments

Technical due diligence acts as a foundation when you're on the lookout for investors. It helps potential backers understand your business's technical capabilities, risks, and growth potential. Here's how it aids in securing investments:

- Risk Mitigation: By thoroughly assessing your technology, investors can identify potential risks and challenges, ensuring their investments are well- protected.
- ROI Projections: A robust technical due diligence report provides investors with insights into the expected return on their investment. This helps them make informed decisions about funding your venture.

- Competitive Advantage: It showcases your technological strengths and how they set you apart from competitors, making your business more attractive to investors.

2- Highlighting Technological Advantages

The company must focus on their technological advantages to stand out in the competitive business landscape. Technical Due Diligence helps them achieve this in the following ways:

- In-depth Analysis: It involves a comprehensive examination of your technology stack, allowing you to showcase your strengths and innovations.
- Validation of Claims: It provides concrete evidence to support your technological claims, assuring stakeholders of the authenticity of your capabilities.
- Strategic Positioning: By highlighting your competitive edge, you can position your business as a leader in your industry, which can be beneficial in negotiations or partnerships.

3- Facilitating Mergers

When considering mergers, both parties need a clear understanding of each other's technological assets. Here's how Technical Due Diligence contributes to a successful merger:

- Compatibility Assessment: It evaluates the compatibility of the technologies of both merging entities, ensuring a smooth integration process.
- Risk Identification: Any potential technical risks that may arise during the merger are identified and addressed proactively, reducing post-merger complications.
- Valuation Guidance: Technical due diligence helps determine the fair value of each company's technology, ensuring an equitable merger agreement.

4- Enabling Buyouts

In buyout scenarios, Technical Due Diligence is essential to assess the value and potential of the target company. Here's why it's crucial:

- Asset Evaluation: It provides a detailed assessment of the target company's technical assets, helping the buyer make an informed decision.
- Due Diligence Report: The findings of Technical Due Diligence form the basis of negotiations and pricing in the buyout process.
- Risk Management: It identifies any technical risks associated with the target company, enabling the buyer to develop risk mitigation strategies.

By conducting TDD diligently, the company not only make their business more attractive but also ensure that all stakeholders have a solid understanding of their technological prowess, setting the stage for successful endeavors.

3.3.3 Process of Technical Due Diligence

Getting an external viewpoint can provide the final seal of approval. Consult people outside the division of business you are investigating for an unbiased view.

1- Pre-Due Diligence Preparation

- *Conducting Internal Audit*

Before undergoing external Technical Due Diligence, it's prudent to conduct an internal audit. This involves identifying your technology's key components, features, and limitations, preparing you for the questions and scrutiny that will come during the formal TDD process.

- *Assembling Documentation*

A crucial step in preparation is gathering all relevant documentation. This includes code repositories, architectural diagrams, development and deployment pipelines, and any existing internal audit reports.

2- Initial Technical Assessment

- *Reviewing Software Architecture*

Evaluating the software architecture involves multiple layers of scrutiny. One must look into how the various components interact, the data flow among them, and how they are deployed. Any bottlenecks, security vulnerabilities, or issues with scalability are to be highlighted at this stage.

- *Evaluating the Codebase*

The codebase isn't merely about lines of code. It's about coding standards, reusability, and maintainability. Code should be clean, commented, and adhere to the best practices in the industry. Any tech debt should be quantified because it can significantly impact the cost and timeline of future development.

3- Stakeholder Engagement

- *Role of Tech Leads and Developers*

Tech leads and developers are often the ones most acquainted with the technical details. They can provide insights into why certain architectural choices were made, how they have evolved, and what technical debt or challenges exist.

- *Business Analysts' Contribution*

  Business analysts focus on the commercial aspects. They look at how the technical components align with the business goals, what kind of customer data is handled, and how it's protected, and they often translate technical metrics into business KPIs for easier understanding by non-technical stakeholders.

- *Legal Compliance and Advisors*

  Legal advisors are indispensable in navigating the regulatory landscape. Their scrutiny ensures that software licenses are in order, that data handling complies with privacy laws like GDPR, and that there are no impending legal issues that could jeopardise the project.

- *Role of Project Managers*

  Often overlooked, project managers play a vital role in aligning the TDD findings with the project's timeline and budget. They take into account the recommendations from the TDD and reassess the project plans accordingly.

4- In-Depth Analysis and Validation

- *Performance and Scalability Testing*

  Performance and scalability tests should be conducted after the initial assessments and stakeholder inputs. These tests validate the system's capacity to meet future demands and the feasibility of scaling operations.

- *Security Audit and Vulnerability Assessment*

  A detailed security audit identifies potential threats and vulnerabilities in the system. This step is crucial for protecting valuable intellectual property and sensitive customer data.

- *Compliance and Regulatory Checks*

Beyond the regular legal framework, compliance checks are especially relevant for industries that have additional regulatory bodies. These could include financial auditing for fintech companies, HIPAA compliance in healthcare, or accessibility standards for consumer-facing apps.

5- Final Evaluation and Reporting

A final Technical Due Diligence report is compiled once all the individual components have been reviewed and validated. This document should be comprehensive, covering every assessment aspect, the findings, and recommended action steps. This report serves as the cornerstone for decision-making for investors, acquirers, or internal stakeholders.

3.3.4 Checklist of Technical Due Diligence

1- Preliminary Steps

- *Gather Previous Audits and Evaluations*

Before starting with a new Technical Due Diligence, assembling any previous internal or external audits can provide valuable context. These reports may highlight past issues and how they've been addressed.

- *Initial System Health Check*

Use automated monitoring tools to gather baseline statistics. This data can include system uptime, error rates, and average response times, which offer a snapshot of system stability.

2- Expert Evaluation

- *Architecture Review*

  Examine the system's architectural design, specifically focussing on modularity, fault tolerance, and system scalability. Evaluate how changes to one component might affect others.

- *Code Quality Checks*

  Automated tools can help scan the codebase for adherence to coding standards, reusability, and common errors. This step helps identify whether the code is high quality and maintainable.

- *Dependency Analysis*

  Catalogue the third-party libraries, services, and components that the system relies on. Evaluate their licenses, longevity, and track record for security and updates.

3- Security Audits

- *Infrastructure Vulnerability Assessment*

  Assess the security measures in place to protect the infrastructure. This includes firewalls, encryption, and intrusion detection systems to identify any potential vulnerabilities.

- *Data Protection and Privacy Review*

  Especially vital for businesses that handle sensitive data, this step ensures that the business is in compliance with data protection laws like GDPR or CCPA.

4- Performance Metrics

- *Load Testing*

  This involves simulating real-world loads on the software to test its performance. It can help identify bottlenecks in the system and indicate how it performs under stress.

- *Benchmarking*

Benchmark the system performance against industry standards or competitor software. This can provide an objective measure of how the software performs in comparison to others in the same domain.

5- Quality Assurance and Testing

- *Test Suite Review*

Examine the quality and coverage of automated test suites. A comprehensive test suite can accelerate future development by quickly identifying regressions.

- *Manual Testing*

Even with robust automated tests, some issues only emerge during manual testing. This phase can uncover user experience issues, bugs, or inconsistencies that automated tests may miss.

6- Final Documentation

- *Compilation of Findings*

Aggregate all the findings into a single, comprehensive report. This should include both the strengths and weaknesses identified during the technical due diligence.

- *Action Plan*

Based on the findings, compile an action plan outlining the steps for remediation. Prioritise these steps based on their impact on security, performance, and business objectives.

3.3.5 Best Practices technical due diligence

In the realm of technical due diligence (TDD), it’s essential to be armed with the best practices and tips for a successful evaluation. These valuable insights will help you navigate the technical due diligence process effectively, ensuring a thorough assessment of technical aspects.

1- Planning and Preparation

- *Start Earlier*

Initiating Technical Due Diligence activities early can provide ample time for assessment and remediation. Don't leave TDD to the last minute, as rushed jobs lead to overlooked details.

- *Assemble Core Team*

Choose a team of professionals that includes coders, architects, and business experts. A well-rounded team ensures a 360-degree view during Technical Due Diligence.

2- Technical Check-up Tips

- *Use Code Review Tools*

Automated code review tools provide an efficient way to identify glaring issues. However, remember that human input for complex logic is irreplaceable.

- *Focus on Key Components*

Zero in on the most critical software modules. These usually have the greatest impact on business operations and potential valuation.

3- Security Practices

- *Ongoing Vigilance*

Security measures should be continually updated. Regular audits and vulnerability assessments will help keep your systems secure.

- *Encryption Standards*

Ensure that all sensitive data is encrypted, both at rest and in transit. This is essential for compliance and risk mitigation.

4- Stakeholder Communication

- *Transparent Reporting*

Be transparent in all reporting stages of the Technical Due Diligence process. This helps build trust and creates a robust roadmap for future actions.

- *Educate Stakeholders*

Both technical and non-technical stakeholders must understand the Technical Due Diligence findings. Conduct briefings to bridge the knowledge gap.

5- Data Management Best Practices

- *Audit Data Flows*

Analyse how data moves through the system. This can reveal inefficiencies and potential security risks that may otherwise go unnoticed.

- *Comply with Regulations*

Make sure you are up-to-date with data protection regulations like GDPR. Non-compliance can result in hefty fines and legal complications.

6- Documentation and Reporting

- *Keep Records*

Thorough documentation can be a lifesaver, especially when changes in staff or management occur. Keep meticulous records for future reference.

- *Executive Summaries*

An executive summary that highlights key findings and recommendations is invaluable. It helps decision-makers quickly grasp the TDD's implications.

7- Post-TDD Follow-up

- *Implement Changes*

Once the Technical Due Diligence report is out, prioritise and implement the suggested changes. Time is of the essence, especially if critical issues are identified.

- *Review and Update*

Technical Due Diligence is not a one-off activity but should be periodically revisited. Consistent reviews help to keep your systems updated and secure.

Let's sum up

Technical Due Diligence is a well-impactful point for businesses looking to make informed decisions. In a world where every decision can make or break your business venture, consider TDD very seriously and make your best

strategic plans. Organisations can mitigate risks, identify opportunities, and ultimately optimise their investments by understanding when and how to perform a Technical Due Diligence. It's crucial to ensure that technical aspects align with strategic goals, providing a solid foundation for future success.

Check your progress – Quiz – 1

1. In technical due diligence for a software company, which of the following would be a primary concern?

a). Compliance with labor laws

b). Market share analysis

c). Code quality and scalability

d). Customer satisfaction metrics

2. What aspect of technical due diligence involves assessing the architecture and infrastructure of a company’s IT systems?

a. Financial analysis

b. Operational efficiency

c. Technology stack evaluation

d. Legal compliance review

3. In technical due diligence, what does a technology stack assessment involve?

a. Evaluating the physical infrastructure of the company

b. Assessing the company's cyber security protocols

c. Reviewing the software development tools and platforms used

d. Analyzing financial statements

4. Why is it important to assess scalability during technical due diligence?

a. To determine market demand

b. To evaluate potential for growth

c. To comply with regulatory requirements

d. To assess employee productivity

5. What aspect of technical due diligence focuses on evaluating a company’s adherence to industry standards and best practices?

a. Financial analysis

b. Operational efficiency

c. Compliance review

d. Brand management

****

3.4 UNIT SUMMARY:

Explain each of the three sections of the due diligence idea in this unit. According to the first section, doing due diligence entails carefully examining both the financial and non-financial prospects for the successful execution of restructuring plans. In order to fully understand the financials, business, internal systems, profitability, important operational aspects, management team, promoters, and other relevant factors that will aid in making an informed investment decision, proper due diligence services investigate and evaluate the details behind the same. The sorts of due diligence and crucial considerations that must be made while performing due diligence on cross- border industrial projects are explained in the second part. A thorough evaluation of numerous aspects to guarantee the project's viability, financial stability, and legal compliance. The last part offers information regarding Knowledge on technical due diligence requirements, important steps, procedures, and check lists are provided in the last part. may facilitate the learners' simple understanding of this subject.

3.5 Glossary

Anti-Money Laundering (AML) Due Diligence	Processes and procedures designed to prevent the use of financial systems for money laundering activities, including customer due diligence and ongoing monitoring requirements
Third-Party Due Diligence	Due diligence conducted on third parties such as suppliers, distributors, contractors, or business partners to assess their reliability, reputation, compliance, and potential risks to the organization.
Data Room	A secure virtual or physical repository where confidential and relevant documents of the target company are stored and made accessible to potential buyers or investors during due diligence.

Red Flags	Warning signs or indicators identified during due diligence that suggest potential issues, risks, or discrepancies that require further investigation or consideration
Letter of Intent (LOI)	A preliminary agreement between parties outlining the proposed terms and conditions of a transaction, often issued after initial due diligence to signify serious intent.
Synergies	Benefits or advantages expected from combining two entities, such as cost savings, revenue enhancements, operational efficiencies, or market expansion opportunities, which are assessed during due diligence.
Earn-out	A financial arrangement in mergers and acquisitions where part of the purchase price is contingent upon the future performance of the acquired company, often used to bridge valuation gaps and align interests

3.6 **Self-Assessment Questions Short Answers: (5 Marks)**

1. Write the meaning of due diligence and its needs.
2. Describe objectives of due diligence.
3. Define important factors of due diligence.
4. Write about: checklist of due diligence.
5. What is the meaning of technical due diligence .and write its significances?

Essay Type Answer: (10 Marks)

1. Explain types of due diligence.
2. Explain process of due diligence.
3. Explain technical due diligence.
4. Explain factors considering while conducting due diligence.
5. Explain process of technical due diligence.

3.7 **Activities:**

1. Examining historical financial statements (income statements, balance sheets, cash flow statements) to assess the financial health and performance of the target company.
2. Evaluating the legal structure, ownership, governance practices, and compliance with regulatory requirements.
3. Analyzing customer concentration, revenue sources, sales pipeline,

and market positioning.

3.8 **Topics for Discussion**

1. Discuss the how the target company aligns with the acquirer's strategic objectives and long-term goals.
2. Discuss the sustainability and consistency of the target company's earnings and cash flow.
3. Evaluating the technology infrastructure, IT systems, cyber security measures, and potential vulnerabilities.
4. Share experiences about Supply Chain and Vendor Relationships.

3.9 **Suggested Readings / References**

- **Books:**
  - *Due Diligence: Planning, Questions, Issues* by Gordon Bing.
  - *Due Diligence Handbook: Corporate Governance, Risk Management, and Business Planning* by Peter Howson.
- **Journals and Articles:**
  - Harvard Business Review articles on due diligence processes and case studies.

UNIT IV: Types of Due Diligence		
Types of Due Diligence: Operational, Strategic, Financial, Technical, Legal, Management, Technical, Environmental, Human Resource.		
4.1.1	**Types of Due Diligence**	**Page No.**
4.1.2	Operational Due Diligence	163
4.1.2.1	Importance of operational due diligence	164
4.1.2.2	Objectives of operational due diligence	165
4.1.2.3	When to start operational due diligence	165
4.1.2.4	Methods of operational due diligence	166
4.1.2.5	Outcome of operational due diligence	167
4.1.3	Strategic Due Diligence	168
4.1.3.1	Key area of analysis in strategic due diligence	168
4.1.3.2	Process of strategic due diligence	169
4.1.4	Financial due diligence	171
4.1.4.1	Need of Financial due diligence	171
4.1.4.2	Importance of Financial due diligence	173
4.1.4.3	Financial due diligence checklist	173
4.1.5	Technical due diligence	174
4.1.5.1	Need of Technical due diligence	175
4.1.5.2	Importance of Technical due diligence	176
4.1.5.3	Process of Technical due diligence	176
4.1.5.4	Key elements of Technical due diligence	180
4.1.5.5	Different stages of Technical due diligence	181
4.1.5.6	Best practices for Technical due diligence	186
4.1.6	Legal due diligence	187

UNIT OBJECTIVES

This unit aids in the learners' acquisition of comprehensive knowledge on the goals, scope, procedure, and other crucial terms of various forms of due diligence. A thorough understanding of operational, strategic, financial, legal, managerial, technical, environmental, and human resource due diligence will be imparted to learners.

SECTION 4.1: TYPES OF DUE DILIGENCE

4.1.1 Types of Due Diligence

Audits should be all-encompassing, which makes it difficult to even know where to begin or what to look at. Detailed are types of investigations that should be undertaken to ensure comprehensive coverage of risks and pressure points.

Source : https://dealroom.net/faq/due-diligence-meaning

4.1.2 Operational due diligence:

Operational due diligence is a comprehensive and complete review of the main operations of the target company and its primary task is to ascertain if the business plan of this company is realistic and achievable or not. Next, the operational due diligence review will explore and examine the operational functions and structural processes in the target business and will also try to define whether there are serious operational risks that the potential buyer should consider regarding accepting or aborting the deal or renegotiating the price. Whether it is a merger or acquisition, the investor is looking to maximize returns and benefit from synergies. Therefore, the target company must improve its operations — unlock value, seize opportunities, minimize risks, and maximize the efficiency of cash flow throughout the investment lifecycle. In order to achieve this, the buyer should analyze functional and departmental processes, including manufacturing operations, supply chain, and distribution channels, the potential for performance improvement, procurement, working capital risks, information technology, as well as back- office operations such as finance, accounting, and human resources.

4.1.2.1 Importance of operational due diligence

The operational analysis of the target is crucial. A buyer needs to recognize and understand which risks exist in the company. The key to understanding a business the investor is going to merge with or acquire is having deep industry knowledge and the capacity to evaluate the competitive landscape and the technological trends along the industry's value chain. In this case, it is essential to conduct proper due diligence for the purpose of ensuring that the nature and level of risk involved in the potential deal are fully understood so that there are no hidden problems that might threaten the deal or, even the stability of the investor's business. Besides market opportunities, the target's operational improvement potential is of major importance in a successful acquisition. Very often, not inspecting the company's operations can break even the most promising acquisitions. Deals that appear initially attractive often fail because of internal and structural inefficiencies that remain unnoticed during the pre-purchase commercial and operational due diligence. Therefore, the buyer should be aware of the target's risks across the whole business.

4.1.2.2 Objectives of operational due diligence

The due diligence process is much more than a standard checklist of procedures with the aim of providing approval for a proposed acquisition. When done properly, an operational due diligence review provides valuable information to support the proposed acquisition. In order to save the cost of a bad acquisition, the investor should assess the full potential for operational savings and efficiency improvements as well to identify and quantify potential risks of the target company. Operational due diligence should be conducted with the following objectives:

- Get a comprehensive understanding of a target's operations and risks, including the cost base and CAPEX requirements
- Identify performance gaps and potential improvement opportunities, e.g., cost reduction and or revenue enhancement
- Know how to evaluate and prioritize the potential savings from operational improvements and based on that to form the investment case and conduct purchase price negotiations
- Get a clear understanding of how to develop and implement a plan to create maximum value and how to prioritize value creation opportunities
- Know how to assess progress, completion, and contingency plans
- Determine if the expected synergies can be realized and remain sustainable in the future
- Check that there are no hidden problems that might threaten the deal or, even the stability of the investor's business
- Use the operational due diligence review to create an achievable business plan and to prepare the post-acquisition integration plan

4.1.2.3 When to start operational due diligence

Operational due diligence can vary case-by-case and can be a costly and time-consuming exercise. Therefore, it is important to determine when the process should start. In general, it is recommended to start after the negotiations are open and a letter of intent (LOI) has been provided and signed, i.e., it should start simultaneously with legal and financial due diligence. It is also important for the buyer to know how many other potential investors have performed due diligence on the selected target. This is crucial information because if there are too many, the buyer takes an elevated risk that he will not end up as the final buyer and will have wasted his time and investment in the due diligence process. Hence, it is important to have exclusivity and an agreed letter of intent including the price and other conditions. Once an LOI has been drafted that describes the structure of the deal, operational due diligence should begin. Adequate time and resources should be allocated to the operational due diligence process as the outcome of the review can provide valuable information regarding a realistic purchase price.

4.1.2.4 Methods of operational due diligence

Operational due diligence can be performed by several diverse methods. The most common methods are to investigate, analyze and assess the following aspects of target operations and business strategy and conditions: product management and logistics processes, IT and business processes, store locations, online channels, functional and departmental processes, and back-office operations. In addition to the operational due diligence methods, there are other aspects of the process connected with the terms and practices of commercial due diligence. Its objectives include analyzing the market in which the business operates and assessing the industry and market conditions: state of the industry, competitive landscape, supply chain dynamics, market trends, and stability of demand and customer behavior. The most effective methods for commercial due diligence include conducting interviews with industry experts, independent primary and secondary market research, analysis of competitors using wide-ranging research techniques, along with detailed industry knowledge and expertise, as well as internal and external research. In general, there is no ideal case for operational and commercial due diligence. It always depends on the acquisition's target, the investor's budget, and the quality of desired information. It is important that the operational due diligence is conducted by independent advisers or specialists that give an independent assessment and opinion. This is important in order to have an operational due diligence outcome that gives a fair, open and objective opinion.

4.1.2.5 The outcome from operational due diligence

The outcome generated from operational due diligence is different and depends on the buyer's assignment. In general, it is good to have an integrated DD process covering operational and commercial due diligence, and even financial DD. This is because the investor needs to confirm whether the target company is as viable as its business plan might suggest, to explore the potential for adding value and synergy that could be gained from the target company and to successfully manage the post- acquisition integration. This more integrated approach enables the buyer to gain a more coherent idea of the direction of the company, a holistic view of the transaction opportunity, and the potential for growth and development of the acquired business. Here are some of the integrated outcomes of the operational and commercial due diligence process:

- Target's operational risk assessment
- Business and strategic plan review
- Operational and financial planning
- Working capital assessment
- Manufacturing and operations evaluation
- Supply chain operations assessment
- Procurement and supply review
- Technology capability, risk, and process capacity planning
- Sales and marketing effectiveness assessment
- Merger and acquisition planning
- Human resources assessment

4.1.3 Strategic due diligence

Strategic due diligence is a comprehensive assessment process that organizations undertake before making significant business decisions, such as mergers, acquisitions, partnerships, or investments. Unlike financial due diligence, which primarily focuses on assessing the financial aspects of a deal, strategic due diligence delves into broader factors affecting the viability and success of a transaction.

Strategic due diligence is a critical process for assessing the value and risks of a potential merger or acquisition (M&A). It involves analyzing the strategic fit, market dynamics, competitive position, and financial performance of the target company and the combined entity. In this article, you will learn the key steps and tools for conducting a strategic due diligence that can help you make informed decisions and avoid costly mistakes.

4.1.3.1 Key area of analysis in strategic due diligence:

1. Market Analysis: Evaluating the target company's position in its industry, including market size, growth prospects, competitive landscape, and regulatory environment.

2. Business Model Assessment: Understanding the target company's business model, revenue streams, customer base, and operational strategies to determine its sustainability and potential for growth.

3. Synergy Identification: Assessing potential synergies between the acquiring and target companies, such as cost savings, revenue enhancements, or strategic advantages that could result from the transaction.

4. Risk Assessment: Identifying and evaluating potential risks associated with the transaction, including financial, operational, legal, regulatory, and reputational risks.

5. Management and Culture Evaluation: Assessing the leadership team's capabilities, corporate culture, and compatibility with the acquiring organization to ensure a smooth integration process.

6. Technology and Intellectual Property Review: Evaluating the target company's technology assets, intellectual property portfolio, and IT infrastructure to assess their value and potential risks.

7. Strategic Fit: Analyzing how the target company aligns with the acquiring organization's overall strategic objectives, long-term goals, and growth plans.

8. Financial Analysis: While not the primary focus, financial analysis is still an essential component of strategic due diligence. It involves reviewing the target company's financial statements, performance metrics, cash flow projections, and valuation to ensure that the deal is financially viable.

Overall, strategic due diligence aims to provide the acquiring organization with a comprehensive understanding of the target company's strengths, weaknesses, opportunities, and threats, enabling informed decision-making and reducing the likelihood of post-transaction surprises.

4.1.3.2 Process of strategic due diligence:

1. Define the objectives and scope

The first step of strategic due diligence is to define the objectives and scope of the analysis. This means clarifying the rationale and goals of the deal, the key questions and hypotheses to test, and the data sources and methods to use. The objectives and scope should align with the deal strategy and value drivers, and cover both the upside and downside scenarios.

2. Conduct external analysis

The second step of strategic due diligence is to conduct external analysis of the target company and its industry. This involves evaluating the market size, growth, trends, and attractiveness, as well as the competitive landscape, customer segments, and regulatory environment. The external analysis can help you identify the opportunities and threats for the target company and the combined entity, and benchmark their performance against peers and best practices.

3. Conduct internal analysis

The third step of strategic due diligence is to conduct internal analysis of the target company and its operations. This involves examining the business model, value proposition, product portfolio, revenue streams, cost structure, profitability, and cash flow. The internal analysis can help you assess the strengths and weaknesses of the target company and the combined entity, and identify the synergies and integration challenges.

4. Validate assumptions and projections

The fourth step of strategic due diligence is to validate the assumptions and projections of the target company and the combined entity. This means verifying the accuracy and reliability of the data and information provided by the target company, and challenging the assumptions and projections used in the valuation and business plan. The validation can help you reduce the uncertainty and risk of the deal, and adjust the price and terms accordingly.

5. Communicate findings and recommendations

The fifth step of strategic due diligence is to communicate the findings and recommendations of the analysis to the relevant stakeholders. This means presenting a clear and concise report that summarizes the key insights, conclusions, and implications of the strategic due diligence, and provides actionable recommendations for the deal execution and integration. The communication can help you build trust and alignment with the target company, the deal team, and the senior management.

6 Review and update

The sixth and final step of strategic due diligence is to review and update the analysis as new information and developments emerge. This means monitoring the changes in the market, competitive, and financial conditions that may affect the value and risk of the deal, and updating the assumptions and projections accordingly. The review and update can help you adapt to the evolving situation and ensure that the deal remains attractive and feasible.

4.1.4 Financial Due Diligence :

Due diligence is a critical part of investing or an M&A transaction. It's the process of researching a company or project to give investors the information they need to make an informed decision. Financial due diligence checks a company's financials, accounting policies, and other factors that could affect its business and investment risk. It's an essential part of the process, especially for sophisticated investors.

The goal of financial due diligence is to uncover any potential issues with the company's finances and operations — and to correct them if possible. Financial due diligence is different from operational due diligence, which looks at the company's management and how it runs its day-to-day operations.

4.1.4.1 Need of Financial Due Diligence:

Financial due diligence examines the company's balance sheet, income statement, and cash flow statement — along with any other relevant financial documents, such as securities filings and contract details. The information gathered during financial due diligence is used to evaluate a company's financial condition and its ability to repay debts and fund future operations. It's also used to assess the company's risk.

Financial due diligence also uses normalization to smooth out any one off events such as sale of an asset, a bonus etc. This leads to a clearer picture from studying the trends of the business directly linked to its trading activity. Any elements that may be considered as a debt or a liability such as advanced revenue collected, lease obligations and accrued interest etc. might also be reclassified as debt. This is done as many deals and investments are done on a cashfree debt free basis.

Here are some of the things financial due diligence can tell you about a company: - Where the company's money comes from and goes — financial due diligence reveals where a company gets its money and reveals any potential issues with the company's cash flow.

- How profitable the company is — financial due diligence shows you how much profit a company made during a specific time frame and how much it spent to make that profit.

- How much debt the company is carrying — financial due diligence shows you how much debt a company has and how it plans to repay that debt.

- The company's growth strategy — financial due diligence explains how a company plans to increase its revenue and profits in the short and long terms.

- The company's financial health — financial due diligence shows you a company's debt to equity ratio, its profitability, its revenue and expenses, and how much profit it's generated over a specific time frame.

- The company's growth prospects — financial due diligence shows you how strong the company's growth prospects are.

- How much working capital is needed—financial dude diligence evaluates the working capital requirements for the coming months and what condition of working capital would the project or business be taken over in by an investor.

- What are the net assets of the company—financial due diligence gives and adjusted figure of net assets after reviewing elements of the business and determining what the real net assets of the company are in the context of the deal

- Quality of earnings- financial due diligence looks into how the revenue of the business is generated by looking at multiple aspects like the breakdown of customers, geographical landscape, product mixes, revenue recognition methods and much more. This process provides an adjusted revenue or EBIDTA based on findings.

4.1.4.2 Importance of Financial Due Diligence:

The information gathered during financial due diligence can help make an informed investment decision. It can also protect from investing in a company that may overextend itself — or one that's on the brink of bankruptcy. If a company is close to bankruptcy, it may not be able to repay when investors want to redeem their shares. In that case, an investment could end up being worthless.

4.1.4.3 Financial due diligence checklist:

1. **Income statements** (past five years) showing income and expenditure, profit and loss
2. **Balance sheets** (past five years) showing company assets and liabilities
3. **Cash flow statements** (past five years) showing all cash inflows and cash outflows

4. **Management discussions around financials**, including meeting minutes and emails
5. **Operating margin**, reflecting the percentage of profit the company produces from its operations before subtracting taxes and interest charges
6. **Gross margin** (amount of money left after subtracting all direct costs of producing or purchasing company goods or services)
7. **Profit margin**, i.e. net income divided by net sales or revenue
8. **Interest coverage** (earnings before interest and taxes divided by interest expense)
9. **Debt to equity ratio**, showing how much debt there is compared to assets
10. **Asset turnover**, showing how many sales were generated from every dollar of company assets
11. **Return on assets**, showing level of efficiency in earning profit from company resources
12. **Return on equity**, i.e. net income divided by shareholder equity
13. **Tax due diligence**, showing direct and indirect taxes the company is liable to pay

4.1.5 Technical Due Diligence:

A technical due diligence audit is an unavoidable part of almost any IPO, M&A, or seed investment round. Yet, for most new companies, a startup due diligence check can be one of the most stressful parts of these processes.

Tech due diligence (or tech DD) is a comprehensive and independent audit of the technical condition of the product, code quality, the logic of the decision-making process, and the assessment of all possible risks before obtaining the necessary investments.

The technical due diligence process provides a development team with an in- depth analysis of the product's strengths and weaknesses. At the same time, investors are making sure that they make the right choice investing in your project.

4.1.5.1 Need of technical due diligence:

Before M&A (merger and acquisition), IPO, or getting a seed investment. For instance, venture fund Super angel conducts due diligence in early-stage startups before the pre-seed funding round.

Reasons for conducting tech due diligence may vary. Investors want to ensure they invest in a reliable and safe product that will deliver on its promises (e.g., investment platform). To do this, they need to:

- Understand the competence of entrepreneurs
- Assess inherent risks
- Deeply study the technical side of the product and its prospects (which means any code shortcuts should be refactored before technical due diligence starts)
- Test the workload
- Forecast its payback

when investors want to join a startup or a software product, they are especially interested in recognizing technology risks and costs to reduce them. In turn, an IT due diligence audit enables startup owners to detect potential shortcomings of their products and rectify them in time. In other words, well-performed tech due diligence is a pass card to investor interest.

The initiator of tech due diligence is usually an investor. As a rule of thumb, it is an expert of the investment fund with a tech background or a third party agreed upon by the investor and the startup. Based on our experience, comprehensive technical due diligence covers the following risk areas:

- Customer service model (including security)
- Technological stack
- Innovation roadmap and capabilities (competitiveness)

4.1.5.2 The Importance of Technical Due Diligence

The key benefit to technology due diligence for an acquirer or investor is a transparent and cohesive look under the hood of the startup, ensuring no glaring issues with technology or security are present. TDD of a product shows its risks, cost, investment, and opportunities (RCIO) strategy; potential growth and scalability recommendations; existing IT spending analysis; and security posture and possible remediation approaches.

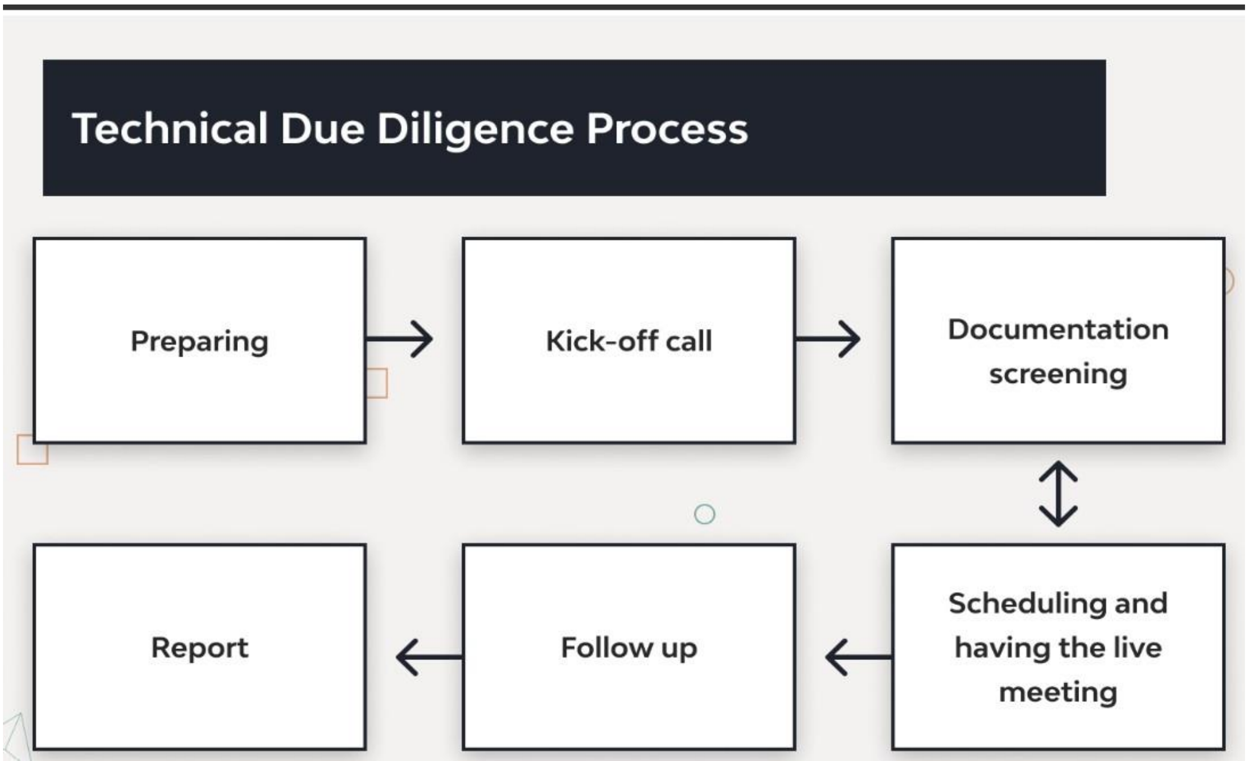
Every startup has to assess its prospects continuously. However, in rapidly growing projects, changes are so unpredictable that founders can sometimes shift focus from the concept with which they have started. At the same time, tech due diligence allows for verifying whether the existing product follows the initial idea.

On the investor side, a due diligence audit is key to clarifying financial risks. It also allows an investor to explore a product from the inside and judge its market potential.

There are also benefits of software due diligence for startups. Due diligence helps analyze all the product's ups and downs, along with its strengths and weaknesses. While regularly assessing these is good practice in any software development process, an audit is a good opportunity for startups to take a step back and form plans for future development.

4.1.5.3 Process of Technical Due Diligence

The IT due diligence process phases may vary depending on the stakeholders involved. For instance, in some cases, we were engaged as CTO on the client side (the company has a product, and we are its developers). In other cases, we participated as independent technical experts for code checks (identifying strong and weak points of a product) before passing due diligence.



Source : https://djangostars.com/blog/tech-due-diligence/

#1. Preparing

This is the initial step, where the software developer (either a startup or an outsourcing vendor) conducts a code review.

A code review is a full code check for errors, inaccuracies, and general programming style. It differs from the one that is performed when the pull requests are checked. This one is of a more general nature. Which include:

- Documentation review (examination of how fully it is described, its accuracy, and transparency)

- Code verification, integrations, components, and solutions
- Identifying strengths, such as unique solutions to programming problems and challenging implementations
- Coverage of weaknesses. Usually, these are the points that belong to the category 'to be done later'
- Discovering how to work with these shortcomings in the future
- Prioritization

Naturally, it's bad practice to be fixing code on the eve of tech due diligence. Instead, success at this stage mostly hangs on the three final points: identifying code weaknesses, investigating them, and prioritizing action to be taken.

#2. Kick-off call

The kick-off call is a discussion of the business side of the product and further due diligence stages.

The product vision, concept, market niche, and value proposition for users and prospects should be delivered to potential investors as straightforwardly as possible. This task falls on the CEO's shoulders.

It's not necessary to build a complicated plan for the first call. As representatives of venture fund Superangel point out, consideration of sales and marketing (not just code) will resonate with investors.

A potential funder will be interested in the uniqueness of the technology and market prospects, meaning they will appreciate an awareness of the product's value for consumers and projected returns.

In our experience with technical due diligence, there was a second call with the product owner (the person on the client's side who has the product requirements and delivers them to the developers).

#3. Documentation screening

Few people are passionate about documentation, but it can play a decisive role here.

Once everything is in order and a kick-off call with investors has gone well, the party responsible for conducting due diligence examines all the company's existing documentation. This includes not only an overview of the architecture, integrations and tech solutions, backup and recovery, and servers but also the process frameworks for development.

A well-documented product will give due diligence analysts the information they need in less time and create a good impression of a product's worth.

#4. Scheduling and having a live meeting

This stage marks a shift to internal processes. To review and explore them, a personal meeting with the developers is scheduled.

The tech due diligence officer (or team conducting the audit) will expect positive and productive communication with the project leader. It can be helpful to prepare slides of architecture and integration schemes.

The main goal of the tech diligence meeting is to convey the benefits and business value of the product and explain the logic and awareness behind past decisions.

#5. Follow-up

When the person conducting tech due diligence has gathered the needed answers and is ready to share the intermediate results of their assessment, they will usually be covered in a follow-up report. In Django Stars' experience, this report can be given orally.

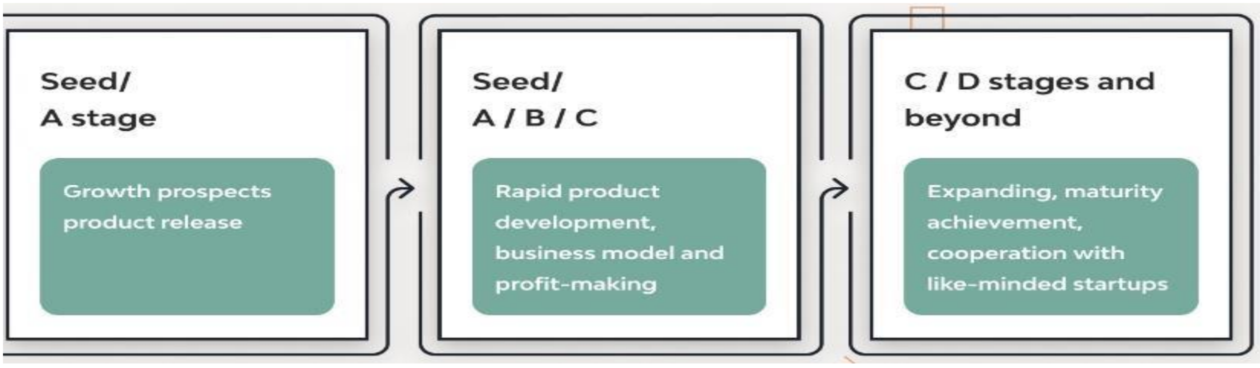
#6. Report

The final outcome of tech due diligence is a detailed report, as objective as possible, compiled by the reviewer based on document screening and meetings with founders, product owners, and tech leaders. Here, all the risks, pros and cons, and prospects are brought together and evaluated. Finally, the technical due diligence report is sent to the investors and the startup team.

These are the general stages of a due diligence process. The next step is to understand how IT due diligence works.

4.1.5.4 Key Elements of Technical Due Diligence

The focus of tech due diligence changes in different investment stages.



Source: https://djangostars.com/blog/tech-due-diligence/

- At the Seed stage, technology due diligence focuses more on a startup's prospects as the product is being developed.
- At stages A/B, this focus shifts to the development timeline, a startup's business model, and projected profits.

- At stages C, D, and beyond, a startup is eager to expand, achieve maturity, and cooperate with like-minded startups, and tech due diligence also concentrates on these points.

During the technical due diligence process, the validity of decisions plays an important role. The critical goal for founders is to show how deeply they know their product, why certain decisions were made, and how they can justify the validity of these decisions in the future.

So, different investors carrying out tech due diligence inspect different sides of the product

4.1.5.5 Different stages of technical due diligence

#1. Architecture & Infrastructure

At this stage of IT due diligence, the task is to describe the technology as much as possible and provide the prepared in-detail developer documentation. This might include product architectural descriptions, design documents, or API documentation. Moreover, investors will look for evidence of a product's uniqueness based on research into competitor technologies.

At this stage, it's key to invest resources wisely.

Startups at the beginning of product development have limited time and money. In this case, there is no point in spending a year on architecture development. Instead, developing a quickly-made prototype to test the idea will be more efficient. Moreover, such decisions should not be a point of embarrassment. An experienced vendor understands this and can suggest the right solution.

Important! The choice of architecture must be justified. Monolithic and microservice architectures are two very different approaches, and there is no right answer. The right choice depends on the project stage and its future goals. The tech due diligence checks it all together.

Micro service architecture:

In our practice, a client who had opted for a monolithic architecture actually impressed the tech diligence reviewer. It appears that many startups choose a microservice structure because of its high popularity among majors. But it’s complex. It requires decent team communication and is hard to test and monitor.

In the end, startups drown in micro services, as at the early stage, companies have limited resources and no time to stipulate the limits of micro services and properly integrate the architecture. With a monolithic architecture, additional services can be implemented through integrations. There are pros and cons everywhere.

The high costs associated with immature infrastructure are not what investors want. Therefore, a company’s choice of infrastructure should be rationalized by operational costs, opportunities, and risks throughout the entire product lifecycle.

Examples of questions to prepare for:

- What’s the type of architecture – monolith, microservices, serverless?
- Apps — native or not?
- How is the infrastructure built? —– Who is the cloud provider? E.g., AWS, Google Cloud
- What are the code infrastructure features? E.g., Terraform, Docker, Kubernetes

#2. Code/Data Quality

During tech due diligence checks, investors pay particular attention to the code quality and the logic of the decisions made to avoid additional and unforeseen development costs in case the code is poorly written.

Important! Writing high-quality code should be done by an experienced team to avoid problems such as crutches, large technical debt, or unnecessary costs in the future. Startups also need to factor in error reporting and complex unit testing on the back-end, front-end, and data repository.

Examples of technology due diligence questions to prepare for:

- Is the stack hirable? Is it niche technology, or is there plenty of talent? What's the onboarding speed?
- Are clean code/SOLID principles followed?
- Are common patterns and known technologies used?
- Modularization. Are abstractions in the right places, e.g., around external integrations?
- Are APIs well-structured, e.g., RESTful API?

#3. Scalability

All companies want to grow and expand, but not all consider how it will happen. Sooner or later, however, this need will arise, and an astute auditor will look for evidence that a company will be able to scale technically and expand the team.

Again, microservices (as opposed to a monolithic architecture) are not necessarily the right option here. A monolithic architecture can also be scalable with the right technical planning and strategy.

Important! Investors will look for long-term ideas, not short-term solutions. Ideally, a product will reach maturity and scale.

Examples of questions to prepare for:

- Is the system ready for unexpected growth?
- Have all safety aspects been considered?

#4. People

Each person in the team is endowed with a specific role, and the success of a product depends on how well and effectively they perform it.

Yet team engagement and collaboration are also crucial.

The task in this area is to convey the goal of the product to the entire team as clearly and fully as possible so that all members understand the rationale behind decisions.

Important! Always try to keep an up-to-date organizational chart. Keep a database with the resumes of all employees and contractors in an organized manner, as well as their contracts and associated costs.

Examples of questions to prepare for:

- Do you take competent people to the team and rely on them?
- Can team members manage themselves? Do they seek feedback?
- Are cross-functional teams productive? Do they have all the competencies to execute their plan, e.g., analytics, product owner, engineers, and design?
- What about ways of thinking? Can a software engineer in the team correctly take feedback from the end user, test, and measure the result?

#5. Workflow

An expert conducting due diligence will pay attention to operational processes, including iterations, quality assurance, security testing processes, deployment, codependences, and other operations.

As a result, startups should be ready to describe clear workflows with roles and responsibilities for each developer.

Important! Document everything as much as possible and as often as possible.

Examples of questions to prepare for:

- Do you have a meeting schedule? E.g., daily, weekly, monthly, quarterly sessions or reports.
- Does the team work proactively or reactively?

#6. Security

Maximum possible security is a must-have for the product. This is how startups show they care about the user and respect their needs. It’s also at the top of the software development due diligence checklist.

Important! Security checks are essential in any development process and should be handled well in advance of tech due diligence.

One way to carry out security checks is to hire a company to test the product in terms of its resistance to security issues such as hacks, malware attacks, and fake accounts. This provides a more comprehensive check against official software quality standards.

The security check explains the tech strengths and weaknesses in development.

Examples of questions to prepare for:

- What precautions are taken to secure the product and system?
- Do you perform user testing? How regularly? (e.g., 3-5 users twice a week).

#7. Intellectual Property

Investors want confirmation that a product and concept are unique. In addition to an attribution report, startups will usually be required to provide patents confirming and protecting their intellectual property, as well as proof of non-infringement.

Important! Keep your finger on the pulse. Check the documentation of all development patents. During due diligence, be prepared to show that the product meets all the requirements. Track all open-source project components, including licenses and sources.

Examples of questions to prepare for:

- Do you update the company's patents regularly?
- Do you track all open-source components used by the team?
- Are third-party components also documented?

All of these areas are complex, but they can be successfully addressed with the right approach. The question is how to set priorities and allocate resources correctly to ensure that technical due diligence is a mere formality.

4.1.5.6 Best Practices for Tech Due Diligence

Startup due diligence checks are unavoidable since any startup will consider M&A, IPO, or VC investment at some point. They can't be shrugged off, but neither are they the goal — they are simply the means to ensure that product development is on the right track.

Good preparation for due diligence essentially means building the product correctly from the ground up:

- Follow code delivery best practices and avoid shortcuts. These provide short- term benefits but result in long-term technical debt, undermining future growth.
- Document everything in as much detail as possible. This will help immensely in case of code refactoring or going from monolithic to microservices later.
- Check the documentation of all third-party services.
- Consistently perform cybersecurity checks.
- Perform automated unit testing during every sprint, etc.

When the software development process is organized correctly, passing a TDD at any startup lifecycle stage becomes just another project, not a nightmare.

4.1.6 Legal Due Diligence

Legal due diligence is an investigation into a business by re viewing documents and interviewing employees. A legal due diligence investigation is completed when a business or investor is interested in buying a business or investing in that business.

A legal due diligence investigation is seeking information about the business to make sure that the investment or purchase is beneficial. The investigation seeks to reveal all important facts and potential liabilities. Once the facts are collected and analyzed, an informed decision can be made.

There are subcategories of legal due diligence. These subcategories seek more specific pieces of information.

- **Intellectual property due diligence**
- **Business due diligence**
- **Accounting due diligence**

Due diligence is most often performed in preparation for a merger, acquisition, licensing, or other transaction. Due diligence seeks to understand all of a company's obligations. This includes:

- **Debts**
- **Pending and potential lawsuits**
- **Leases**
- **Warranties**
- **Long-term agreements**
- **Contracts**
- **Distribution agreements**
- **Compensation**
- **Much more**

4.1.6.1. Importance of Legal Due Diligence:

- **Better understand the company**

Legal due diligence is commonly thought of an investigation performed by one company on another company. It is most helpful when the event of a merger or major sale. Before negotiations begin, it's important to understand the worth of the business.

A legal due diligence investigation can also help the buyer better understand the company. This includes all of the agreements that make it up.

- **Value a Target Company**

  In the same way that a legal due diligence investigation can help the company value itself, a legal due diligence can help to understand the value of another company. Legal due diligence seeks to understand a value through information on the company's agreements, assets, and potential problems.

- **Drafting and Negotiations**

  A large part of a merger or acquisition is negotiating and drafting the agreement. The good and bad information gathered during the legal due diligence will lend support to the negotiations. This is true whether a merger or acquisition.

  The information discovered in a legal due diligence is especially helpful in assessing risk.

  Drafting of the agreement is in-depth and complicated. This should be created by an experienced lawyer.

- **Identify Potential Closing Problems**

  A legal due diligence may also find potential problems that could delay closing the deal. There are many steps that must be taken before closing. A legal due diligence gathers the information to make that list.

- **Legal Opinion**

  A legal due diligence is typically completed by an attorney who specializes in due diligence investigations. The lawyer or lawyers will prepare a legal opinion based upon all of the gathered factual information. Often, a legal due diligence investigation is completed by the selling company and the buying company. This insures an unbiased opinion.

- **Goals of Legal due diligence**

The goal of legal due diligence investigation is to assess the potential benefits and risks of selling or buying another business or business assets. There are two main areas of focus in a due diligence investigation.

1. **Current status**
2. **Consequences of potential agreement**

- **Status**

At the beginning of a legal due diligence investigation, lawyers are seeking to understand the current status of the business. This includes investigating relevant laws, governing documents, and contracts. Determining status can also help to value a company and find ways to potentially improve that value.

- **Consequences**

Along with the good, lawyers must establish a company's negative qualities during a legal due diligence investigation. This includes seeking potential problems with the transfer of assets or potential litigation.

4.1.6.2 Need of Legal Due Diligence:

Legal due diligence is most common in two situations:

1. **Sale of the** proprietary rights **to goods or services**
2. **Sale or purchase of a business in a merger, acquisition, or** partnership

The sale of proprietary rights to goods has become more common in the digital age. With the sale of intangible goods and trademarked intellectual property, an investigation into right to use and ownership is very important.

Legal due diligence investigations are must more comprehensive for a merger or acquisition. There's simply more information to sift through and investigate. Mergers often include intellectual property and digital information now as well.

4.1.6.3 Process of Legal Due Diligence :

A legal due diligence investigation takes place in three stages.

1. **Preparation**
2. **Investigation**
3. **Results**

The most time-consuming part of the process is the investigation or the gathering of facts.

- **Preparation**

This stage of the legal due diligence is to set goals and priorities. Often there is one central goal or multiple smaller important goals that stand out from the rest. Legal due diligence investigation are often limited by time and budget pressures. It's important to prioritize what information is most important.

- **Investigation**

During the investigation a lawyer or team of lawyers collect facts and documents. The findings will allow them to formulate a legal opinion as to whether the sale or purchase is worthwhile. There are many parts to the investigation.

- **Establish the Big Picture**. This comes back to the goal of the investigation. It's important to formulate the investigation around the central question or goal. This is also a good time to help the investigating lawyer understand the broad overview of your company.

- **Provide Documents and Interviews**. The list of documents and interviews necessary for a legal due diligence investigation will likely surprise you with its length. The list of documents requested will likely be more documents than are actually necessary. The lawyer's job is to create a full picture, which means being thorough in gathering information. Consider making one of your c-level officers available to answer questions. Interviews are an efficient way to gather information.
- **Results**

The results of a legal due diligence investigation are revieled at the end of the investigation. In the results, the lawyer will present the data in as concise way as possible. The lawyer will also present a results summary which will point out the most important discoveries. The results may also provide analysis or opinion. The lawyer may offer an opinion as to the validity of the sale or purchase.The results may be provided in written format or verbal conversation. This depends upon the size of the investigation and the preference of the lawyer and the client.

The findings of a legal due diligence investigation are really only important to a buyer and the buyer's counsel. The buyer will typically want the due diligence finding to be presented in a compact and user-friendly way. The presentation can take many forms:

- **Verbal conversation:** This is a great method for small deals or a buyer who is concerned about cost.
- **Memorandum:** This memorandum can greatly range in length and depth. For larger deals, the written document will be longer. Whichever form it takes, the presentation of the legal due diligence investigation findings should describe all of the reviewed documents, analysis of key issues discovered, and make recommendations as to a solution to presented issues.

4.1.6.4 Documents Examined During a Legal Due Diligence Investigation:

There are many types of documents that are examined during a legal due diligence investigation. The documents provide information about the company and it's current performance.

Organizational Documents

This section includes documents such as:

- Certificate of incorporation
- Company by-laws
- Limited liability agreement
- Stockholder agreement

Common problems to look for here include:

Ownership: By looking through these documents, the lawyer is looking to establish who owns the company's equity. This establishes the majority equity owners and any subsidiary owners. This will also attempt to show if there will be any issues when acquiring the company.

Consent: What actions of the sale will require consent? From whom?

Transfer: Are there any restrictions on transferring company equity? Do equity holders have rights?

Dividends: What is the dividend policy? How can it be changed? Unusual points: Are there any points of agreements that seem unusual? Is there anything strange that could affect the transfer of the company?

Contracts

This part of the investigation looks at all of the contractual agreements that the company is a part of. This includes:

- Customer contracts
- Supply contracts
- Operating contracts
- Licenses

Common problems to look for here include:

Parties: What parties have entered into the contractual agreement?

Change of control: Do the contracts provide regulations for a change of control?

Assignment: Can the contract be assigned? What are the provisions for an assignment?

Termination: What is the contract's termination policy?

Economics: What are the contractual agreements on economics? Can they be changed?

Merger and Acquisition Agreements

This section looks for any provisions for a potential merger or acquisition.

Parties: Who is part of the agreement?

Purchase price: Are there any purchase price adjustments that affect the business?

Escrow: Are there any escrow accounts? What funds are in the accounts? How will the funds be used?

Survival of warranties, representations, and indemnification**:** Does the business anticipate further indemnification claims?

Unusual provisions: Look for non-compete obligations and agreements.

Finance Documents

This part of the investigation looks at all financial documents. This includes:

- Loan agreements
- Hedging agreements
- Guarantees
- Promissory notes

Common problems to look for here:

Parties: What parties are named on the contract?

Basic terms: Is there outstanding debt? Are there loans?

Contingent obligations: This includes guarantees.

Restrictive covenants: Look for restrictions that could affect future transactions and operations.

Change of control: Are there any provisions for change of control?

Liens: Are there any liens on the business?

Litigation

Any current or potential legal issues should be examined here. This includes:

Pending claims: How many pending claims? What is the damage estimate?
Litigation history: What claims have been paid in the past? Any class action lawsuits?

Litigation trends: What types of litigation has the company been involved in? What are the average damage costs?

4.1.6.5 Legal Due Diligence Checklist

When completing a legal due diligence investigation, it's common for lawyers to use a due diligence checklist to create organization. The checklist should include a suggested list of documents to gather.

The legal due diligence checklist is also used to keep the investigation focused on the primary goals. The due diligence checklist can also improve the efficiency of the investigation.

Legal Documents

- A list of all company subsidiaries, direct or indirect
- Company capital
    - Number of authorized share for each class or series of stock
    - The number of issued and outstanding shares of each class or series of stock
    - The record owners of each class or series of stock
- Certificate of incorporation
- Company bylaws or articles of organization
- Meeting minutes from stockholder meetings, board of director's meetings, and any committee meetings for the past three years
- Stockholder agreements relating to management, ownership, or control of the company

- Documents pertaining to prior financings or equity issuances. This might include:
    - Stock purchase agreements
    - Stockholder agreements
    - Registration rights agreements
- All correspondence between the company and the directors that relate to:
    - Indemnity
    - Employment
    - Loans
    - Advances
- Stock records
    - Books
    - Transfer ledgers
    - Other records
- Any documents issued by the company such as options, purchase rights, and warrants. These documents must include:
    - Name of the holder
    - Number of options
    - Rights or warrants issued
    - Date granted
    - Option or purchase price
    - Position of the holder within the company
- Address list of all land, buildings, and improvements leased or owned by the company.

- All pertinent government permits, licenses, or authorizations. This should include all related correspondence.
- And federal, state, or local regulatory agreements in which the company is a party.

Example of Legal Due Diligence

A legal due diligence investigation can take many forms and gather many different types of information. Each legal due diligence investigation will be unique.

Take the example of a property transaction. This type of legal due diligence will need to assess:

- Environmental liabilities
- Real estate records
- Liens on the property
- Itemized list of necessary repairs
- Deferred maintenance items
- Compliance issues
- Building code requirements
- ADA regulations

The nature of the legal due diligence investigation depends upon the transaction.

Intellectual Property Map

A legal due diligence investigation gives the owner an opportunity to create an intellectual property map also known as an IP map.

An IP map documents:

- Each component of IP
- The inventor or creator of each IP component
- The current owner or licensee of the IP component
- Identifies the chain of ownership from inventor to owner to licensee. These cross references multiple supporting documents that validates each link. These documents might include:
    - Employment contract
    - Collaboration agreement
    - Joint venture agreement
    - Assignment from a student
    - Assignment from a contractor
    - Consultancy agreement
    - License
    - Material transfer agreement
    - Consent from a joint owner
    - Many others

There are two main goals of an IP map:

1. Facilitates an IP owner in undertaking a legal due diligence investigation. It helps to identify any gaps or problems. It begins the process of fixing any gaps or problems.
2. The IP map can be presented to anyone who is interested in the IP and who might want to perform their own legal due diligence. This document may be able to help speed up any purchases or sales that are being done.

Proof of Due Diligence

A due diligence affidavit is provided to prove efforts made. Often this is the case of an attempt to serve papers. The affidavit will list each attempt to serve the papers. The affidavit might also list the efforts made to locate the person being served.

The affidavit is used to show a court that all legal obligations to notify the person have been met.

4.1.6.6 Limitation of Legal Due Diligence:

- **Time Taken**

Legal due diligence investigation take a proportional amount of time to information. The more information that needs to be investigated, the longer the investigation takes.

A legal due diligence investigation can take anywhere from a few days to several months. The size of the company also plays a role in the length of the investigation.

The time required for the legal due diligence is determined by the buyer. Once the buyer is satisfied that enough information has been gathered, the investigation is completed.

A mistake that is commonly made is not leaving enough time to complete a thorough due diligence investigation. The limit may be due to time or budget.

- **Common Mistakes**

Not Enough Resources

It's common for legal due diligence investigations to be limited by time and budget. This limitation can result in a lack of thoroughness. If the investigation isn't thorough, important potential problems may not be identified.

Not Completed

Some companies choose not to complete a legal due diligence prior to a sale or purchase. This greatly increases the risk of potential problems in the transaction.

Some problems may not appear for extended periods of time. There is no legal recourse for solving those problems after the transaction is complete.

- **Bias**

Whether intentional or unintentional, owners, managers, employees, or researchers may influence the results of the legal due diligence investigation. This influence may taint the outcome of the legal due diligence investigation.

If the investigation is being done by in-house lawyers, consider getting a second opinion from unbiased lawyers.

- **Check Legal Coverage**

The potential legal risks are often the most important aspect to assess in a legal due diligence investigation. It is pertinent to not skip this aspect of the investigation.

4.1.6.7 Protection from Mistakes

It is becoming more common for businesses to seek extra protection when entering into a transaction such as a merger or acquisition.

This extra protection can come in the form of special insurance. This insurance is known as "representations and warranties liability insurance." This insurance basically protects a business from wrongful acts.

Wrongful acts might include:

- Misstatements
- Misleading information
- Errors

A legal due diligence investigation provides insight into the new business. It also gives an information to make an informed decision. A lawyer who is knowledgeable in legal due diligence can help you complete the investigation.

4.1.7 Management Due Diligence:

Management Due Diligence (MDD) is a comprehensive evaluation process that scrutinizes an organization's senior management team. It aims to assess the effectiveness of key executives and leaders in contributing to the achievement of the company's strategic objectives. MDD goes beyond financial analysis and delves into the qualitative aspects of leadership.

4.1.7.1 The Role of MDD in Decision-Making:

MDD plays a crucial role in informed decision-making, especially in significant business transactions such as mergers, acquisitions, partnerships, and joint ventures. It provides decision-makers with insights into the strengths, weaknesses, and potential risks associated with the management team, helping them make strategic choices that align with the organization's goals.

4.1.7.2 Importance of MDD:

MDD is vital in transactions where leadership alignment and effectiveness can determine the success or failure of the deal. It ensures that both parties have a clear understanding of the leadership dynamics and potential challenges they may face post-transaction. MDD minimizes the risk of unforeseen management- related issues that could impact the overall success of the transaction.

- **Leadership Traits Evaluated in MDD:**

MDD focuses on assessing key leadership skills and characteristics of the organization's managers. These include adaptability to changing environments, effective communication, strategic thinking, decision-making, and the ability to lead teams towards common objectives. These traits are essential for successful leaders to navigate complex business landscapes.

- **Linking Effective Management to Strategic Success:** Effective management is integral to achieving an organization's strategic objectives. Leaders who possess the evaluated traits contribute significantly to the implementation of strategic plans, fostering a culture of innovation, and ensuring alignment throughout the organization. MDD helps identify leaders who can drive the organization towards its long-term vision.

4.1.7.3 Transactions that Require Management Due Diligence:

- **Mergers, Acquisitions, and Strategic Alliances:** In mergers and acquisitions, leadership dynamics can determine the success of integration. MDD assesses whether the leadership teams of both entities align culturally and strategically. In strategic alliances, MDD evaluates how the combined leadership can collaborate effectively to achieve shared goals.
- **Partnerships and Collaborations:** Before entering into partnerships, MDD examines the leadership styles, values, and compatibility of both organizations' management teams. This ensures that the

partnership is based on a solid foundation of understanding and collaboration.

- **Joint Ventures and Their Leadership Dynamics:** Joint ventures require leaders from different organizations to work together closely. MDD assesses the potential challenges and benefits of such collaborations, ensuring that the leadership teams are equipped to navigate the complexities of joint ventures successfully.

4.1.7.4 The Process of Management Due Diligence

1. Preparation Phase: In this phase, organizations define the objectives of the MDD, assemble a team of experienced professionals, and establish the scope of the assessment. Clear objectives and a well-defined scope ensure that the assessment is focused and aligned with the organization's goals.

2. Execution Phase: Data collection is a critical aspect of this phase. It involves conducting interviews with key leaders, assessing their communication skills, decision-making processes, and interactions with teams. Behavioral assessments may also be employed to gain deeper insights into leadership styles and characteristics.

3. Closure Phase: The findings from the assessment are compiled into a comprehensive report. This report highlights the strengths, weaknesses, and potential areas for improvement within the management team. Decision-makers use this information to inform their strategies, negotiations, and post-transaction integration plans.

4.1.7.5 Key Aspects of Management Due Diligence

- **Assessing Leadership Qualities:**

  MDD evaluates leadership qualities such as adaptability, strategic thinking, problem-solving, and team management. These qualities determine a leader's ability to guide the organization through challenges and uncertainties.

- **Role-Specific Duties:**

  MDD considers the specific roles and responsibilities of each leader within the organization. This assessment ensures that leaders are aligned with their roles and contribute effectively to their respective areas.

- **Impact of External Market Factors:** External factors such as market trends, industry disruptions, and regulatory changes can influence leadership effectiveness. MDD analyzes how well leaders navigate these external influences to drive the organization’s success.
- **Objectives for Effective MDD:** Clearly defined objectives guide the MDD process and ensure that assessments are focused on the most relevant aspects of leadership.
- **Identifying Strengths and Committing to Success:** Recognizing leadership strengths allows organizations to leverage these qualities for strategic advantage. Committing to success involves addressing weaknesses and nurturing leadership development.

4.1.7.6 Limitations and Drawbacks of Management Due Diligence

- **Balancing Costs and Benefits in MDD:** MDD can be resource-intensive in terms of time and financial investment. Organizations must weigh the benefits of enhanced decision-making against the costs of conducting a thorough assessment.

- **External Experts’ Influence on Analysis:** In some cases, organizations may seek external expertise to conduct MDD. While this can provide valuable insights, it’s important to strike a balance between external input and internal understanding of the organization’s dynamics.

4.1.8 Environmental Due Diligence

Environmental Due Diligence is the process that evaluates the environmental conditions and risks associated with a property. The process can be at the request of land developers, lenders, attorneys, or private owners who intend to purchase, refinance, or occupy a property.

Environmental Due Diligence can include reviews of:

- Proximity to sensitive habitats
- Historical structure and materials
- Safe disposal of hazardous materials
- Operational procedures
- Potential soil and groundwater contamination

Environmental Due Diligence is typically split into two categories:

- Traditional Environmental Due Diligence **(TEDD)**: ensuring hazardous materials and pollutants are properly found, handled, permitted, and mitigated
- Natural Resources Environmental Due Diligence **(NREDD)**: ensuring natural resources, such as waters, wetlands, endangered species, historical sites, etc. are properly identified, mitigated, and permitted.

4.1.8.1 Importance of Environmental Due Diligence:

Environmental due diligence is a form of proactive environmental risk management. It is an essential liability protection measure to reduce risks and prevent unnecessary expenditure by accessing the potential environmental liabilities. Unfortunately, many projects fail or have their development stunted by lawsuits, fines, and ecological remediation without a proper environmental due diligence process.

i) Environmental Site Assessment (ESA)

Environmental Site Assessment (ESA) is a type of due diligence that takes the form of a report that is prepared for any real estate asset, identifying possible or existing environmental contamination. This analysis of a real estate asset addresses the underlying asset and the physical improvements to that asset.

Specifically, the environmental site assessment is a method of performing any reasonable review into the land's past or current use to decide if the land is impaired by the Recognized Environmental Condition (REC). ESA is an essential part of due diligence when buying a commercial property, and it should be done before closing the deal. The purpose of ESA is to ensure that the environmental contamination liability of a purchaser is limited.

Triggering Actions for an Environmental Site Assessment

The following events can trigger an environmental site assessment:

A property or business is being sold or purchased

If someone wants to sell or purchase a property and/or business, due diligence is required to determine whether the property or the operating business faces any current or possible environmental liability, including lack of licenses, hazardous material contamination, violations of permits, and enforcement deficiencies.

Understanding the requirements allows the purchaser to assess the possible restrictions, obligations, and hazards associated with the land.

The property is being refinanced

If a property is required to be refinanced, the bank will require an environmental site assessment to access the property for possible environmental contamination risks.

Transfer of property to a family member after retirement

If someone is planning to retire with plans of transferring the real estate asset to family members, he/she should conduct an environmental site assessment to ensure that they are covered from environmental liability.

Necessitated by a regulatory agency

If a regulatory agency suspects that toxic conditions prevail on the property or land, it may order the owner to perform an environmental site assessment. Moreover, in case of a municipal body request for a change of authorization related to property usage or other discretionary land usages, the municipal body will require an environmental site assessment to be performed.

Desired by existing owners

The existing property or business owners may want to identify the toxic history of the real estate asset.

4.1.8.2 Phases of Environmental Site Assessment

Phase I

The due diligence process starts by carrying out a Phase I or Level I environmental site assessment, an analysis of recent and past events at and around the property to determine possible or current environmental pollution obligations. The Level I ESA may be requested by a bank or other financial entity during the borrowing period or advised by the business advisors.

The Level I environmental site assessment aims to collect appropriate evidence to provide an unbiased expert opinion on the environmental status of the property and to recognize the real or possible environmental pollution that may have an effect on the valuation of the property or have an effect on the innocent property owner after purchase.

The Phase I environmental site assessment involves the following:

1. Review historical documents to determine past use. Review the public documents, such as fire insurance maps, historical aerial photos, topographic maps, and historical city directories.
2. Conduct site visits and investigation to observe present and historical conditions and usages of the land and related properties.
3. Interview the present and former property owners, managers and tenants, or those who are familiar with the land.
4. Review regulatory records for the site and surrounding properties. Also review the federal, state, territorial, and municipal regulatory databases, such as the underground storage tanks (USTs), overground storage tanks (ASTs), suspected or known release incidents, storage of toxic substances, and management of hazardous waste, including petroleum goods, and administrative and engineering controls.

The Level I environmental site assessment does not involve real sub-surface samples, such as groundwater and dirt. There is, moreover, a requirement to be followed under the American Standard for Monitoring and Components or ASTM, which involves addressing the issues associated with soil vapor degradation and the possibility of vapor migration posing a danger to on-site and off-site tenants.

Environmental Professionals analyze the study to determine possible environmental hazards to the land, such as existing or past activities that are documented or believed to have used toxic chemicals or petroleum products in on-site operations. After Phase I ESA is finished, the EP will summarize the issues found on the property and make suggestions as to what steps are taken to resolve the issues.

A recognized environmental condition (REC) shows either familiar contamination or the subsurface's potential to be affected by contamination. Whenever a REC is identified, it is often followed by a recommendation for Phase II ESA.

Phase II

Phase II of the environmental site assessment requires collecting soil, groundwater, or building materials samples to examine different pollutants. It offers a clearer understanding of the soil's state, the groundwater, and the property structures. When Phase I discovers possible environmental concerns, it typically prompts further actions.

Petroleum hydrocarbons, pesticides, heavy metals, asbestos, solvents, and mold are the most commonly tested compounds in Phase II or level II environmental site assessment.

Phase III

Phase III or Level III environmental site assessment is an inquiry requiring the remediation of a site. The goal of the inquiries of Phase III is to delineate the physical extent of exposure based on the recommendations made in Phase II evaluations.

Phase III investigations can include rigorous preparation, sampling and tracking, modeling including fate and transport tests, and probability studies designed for corrective and remediation plans. It typically includes the evaluation of possible clean-up approaches, logistics, and costs. The related report outlines the actions taken to clean up the site and oversee the monitoring of residual pollutants.

Regulations controlling activities that can impact the environment come under federal and provincial authority and vary from area to area. The guidelines for determining responsibility for contamination can be complex and time- consuming.

4.1.9 Human Resource due diligence:

HR due diligence is the process by which an acquiring company analyzes the human capital within a company as well as all of its procedures and policies surrounding the human capital of the company.

Good procedures in HR have the effect of maximizing employees' potential, so in some regards, an acquirer will often be pleasantly surprised to learn that a target company's staff are not reaching their full potential, possibly opening the way for them to find 'quick wins' with the employees after the transaction has taken place.

4.1.9.1 Need for Human Resource due diligence:

Engaging in HR due diligence helps an acquiring company ensure that the staff within the target company are able to complete tasks efficiently and have the resources necessary to succeed when the acquisition officially concludes. It's especially important for companies that want to avoid a potential loss of critical employees resulting from the acquisition.

Even if a target company has excellent financials and utilizes its operations well, high turnover has the potential to affect the success of the acquisition.A target company's human capital, or the economic value of its employees, has the potential to create value for the acquiring company.

Ensuring the proper utilization of human capital can help increase productivity, improve company culture, processes and channels of communication. It helps prevent internal conflicts from occurring within the organization due to different management styles. It can also minimize potential risks that might arise during or directly after the acquisition by helping the acquiring company create an effective retention strategy and an inclusive and cohesive company culture.

4.1.9.2 Five key components of an HR due diligence:

An HR due diligence checklist allows an acquiring company to better understand the target company's employees and its culture. While it's important to collect operational, financial and commercial data during an acquisition, it's often equally important to gain as much information about a company's people and human resources processes as possible. Acquiring companies often include the following five items on their due diligence checklists:

1. Overview of current staff

A key component of an HR due diligence checklist is a basic overview of all individuals who work at the company, beginning with the company's key positions and ending with its low-level employees. This section often includes a list of all employees in the company, along with their salary information, their primary responsibilities and their time at the company. It may also include their specific job title and provide insight into how many employees they're responsible for managing and training.The overview section typically includes information about the training each employee completed and whether they participated in an educational program paid for by their company. This can provide insight into each employee's level of expertise and whether they require additional training. The section may additionally include an audit of the company's human resources information systems

(HRIS). An HRIS is a software solution that helps streamline organizational processes and improve employee productivity. Generally, the overview section concludes with a breakdown of the HR department's operational expenses, which might include the cost of hiring and retaining employees.

2. Assessment of HR policy

An HR due diligence checklist also includes an assessment of the target company's HR policy. An HR policy is a set of guidelines for hiring and training new employees, providing current employees with compensation and promoting them to new positions. It might also address sick leave, employee absence, maternity leave, social media usage in the company and general workplace policies. It also assesses the company's code of ethics or conduct. A code of conduct determines how employees are to behave during regular work hours and shares the company's overall expectations with them.The HR policy portion of a due diligence checklist can also include an inspection of the company's employee handbook. An employee handbook often includes additional information about specific policies and procedures, such as internal reporting procedures. It also describes the company's mission, vision, strategic goals and the employees' inherent rights in the company. While the length of the handbook often varies depending on the company, it's often several pages long and begins with a table of contents that lists its different sections.

3. Review of legal and compliance documentation

Many acquiring companies also include a detailed review of all legal and compliance documentation, including the employment contracts of all current employees. These employment contracts outline employees' rights and obligations during their time at the company. A legal and compliance review also typically includes assessing the employment contracts or agreements between the company and its informal employees, such as freelancers, contractors and part-time staff.It can also be important to review the details of any non-compete contracts, which restrict employees from entering a similar profession or organization for a certain period of time after their employment. Confidentiality agreements can also be important considerations. These agreements are legally binding contracts that require employees to keep certain information confidential and not disclose it to others without authorization by their employer.

4. Examination of HR benefits

An examination of a target company's HR benefits is another useful component of an HR due diligence checklist. This often includes details regarding the compensation that the company provides to its employees, including both monetary and non-monetary allowances like the promise of an extra day off or a free vacation for high-performing employees. It includes information about extra pay provided to employees, such as commissions and bonuses. It may also include information about severance plans and packages, or the benefits the company provides when an employee leaves the company.Retirement and savings plans, pensions and health insurance plans and policies are additional checklist considerations. Typically, larger companies provide more benefits to employees, such as additional insurance options and paid time off. Smaller companies and startups may offer more creative forms of compensation like bonus payments and free products in place of traditional pay.

5. Review of training and development processes

This section includes a detailed review of the company's training and development processes for both new and current employees. It often includes a list of the training programs that the company offers to help employees acquire the knowledge and skills necessary to perform in their current roles and complete tasks effectively. In addition to this list, it may also contain an assessment of the company's development processes. These processes help to ensure that employees are productive and that they're able to develop new skills and progress in their careers.

4.1.9.3 Importance of HR due diligence on the buyer's side vs. the seller's side

While HR due diligence is primarily a process that an acquiring company engages in on the buyer's side, the target company on the seller's side often engages in the process as well by assessing its own staff and human resources policies. This helps the target company to find and resolve issues before it's acquired, allowing for the acquisition process to become much easier. Typically, the seller's side engages in HR due diligence directly before the acquisition process, while the buyer's side engages in the process during acquisition. For the seller, HR due diligence involves making sure that the company is able to represent all its employees properly and that its HR processes are adequate. For the buyer, it primarily involves identifying major risks that have the potential to affect the integration process of the acquisition. During the integration process, the target company combines its operations with those of the acquiring company.

Examples of HR due diligence:

Here are a few examples that can serve as a guide to show how professionals might engage in HR due diligence during acquisitions:

Employee training example

A large technology company is in the process of acquiring a smaller company that sells computer keyboards. The larger company decides to engage in HR due diligence by evaluating the smaller company's practices for training new employees. It then discovers that the smaller company didn't have a way to train new sales employees on how to engage with customers. Because of this, the larger company decides to invest more in training processes to ensure that both current and new sales employees develop the basic sales skills required to be successful in their roles after the acquisition.

Organizational culture example

An e-commerce company decides to acquire a company that sells digital resources. The e-commerce company assesses the organizational culture of the other company, including its hiring practices and employee programs. It discovers that the company has a program to help employees exercise by allowing them to participate in a running class once a week. The company decides the program is good for helping employees stay fit and since many employees already use it, its leadership decides to continue it.

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Check your progress- Quiz -1

1. Which type of due diligence primarily focuses on evaluating the financial health and performance of a company?

   a) Operational due diligence

   b) Financial due diligence

   c) Legal due diligence

   d) Strategic due diligence

2. What is the main objective of legal due diligence in the context of mergers and acquisitions?

   a) Assessing market opportunities

   b) Evaluating operational efficiency

   c) Identifying legal risks and liabilities

   d) Calculating financial projections

3. Operational due diligence typically involves assessing:

a) Market share and competitive analysis

b) Customer demographics and preferences

c) Supply chain management and operational workflows

d) Financial performance and profitability ratios

4. Strategic due diligence focuses on:

a) Evaluating financial statements and key ratios

b) Assessing operational workflows and efficiencies

c) Identifying cultural fit and synergy opportunities

d) Reviewing legal contracts and compliance issues

5. Compliance due diligence primarily involves:

a) Assessing financial performance metrics

b) Reviewing IT infrastructure and cybersecurity measures

c) Ensuring adherence to regulatory requirements and industry standards

d) Evaluating customer retention rates and supplier relationships

6. What does environmental due diligence primarily assess?

a) Financial stability and profitability

b) Environmental impact and regulatory compliance

c) Customer satisfaction and market share

d) Supply chain management and operational risks

7. Technology due diligence focuses on:

a) Assessing customer preferences and market trends

b) Evaluating IT infrastructure, systems, and intellectual property

c) Reviewing financial performance and profitability metrics

d) Identifying legal risks and litigation potential

8. Cultural due diligence in a merger or acquisition context primarily examines:

a) Financial projections and growth opportunities

b) Customer and supplier relationships

c) Organizational culture and employee integration

d) Legal contracts and compliance issues

9. Market due diligence focuses on:

a) Evaluating supply chain management and operational efficiencies

b) Analyzing customer demographics and market trends

c) Assessing financial performance and profitability metrics

d) Identifying legal risks and compliance issues

10. What is the primary objective of tax due diligence?

a) Assessing operational risks and efficiencies

b) Evaluating financial performance and profitability

c) Identifying potential tax liabilities and risks

d) Reviewing legal contracts and compliance issues

4.2 UNIT SUMMARY

Due diligence refers to the process of investigating and verifying information about a business, individual, or investment opportunity before making a decision. Here's a summary of the types of due diligence commonly conducted:

Financial Due Diligence:- Focuses on examining the financial records, statements, and performance of a company. Aims to assess the accuracy of financial information and evaluate financial health.

Legal Due Diligence- Involves reviewing legal aspects such as contracts, agreements, litigation history, intellectual property rights, and compliance with laws and regulations. Helps identify potential legal risks and liabilities associated with a business or transaction.

Commercial Due Diligence: Investigates market dynamics, competitive landscape, industry trends, and customer relationships. Provides insights into the commercial viability and growth prospects of a business.

Operational Due Diligence: Examines operational processes, management capabilities, IT systems, and infrastructure. Aims to assess the efficiency of operations and identify any operational risks.

Environmental Due Diligence: Focuses on environmental risks and compliance with environmental regulations. Includes assessments of environmental impact, pollution liabilities, and remediation costs.

Technological Due Diligence: Reviews technology assets, intellectual property related to technology, cyber security measures, and IT infrastructure. Assesses technological capabilities and potential vulnerabilities.

Human Resources Due Diligence: Looks into the organization's workforce, including key employees, organizational structure, HR policies, and labor relations. Identifies any HR-related risks and evaluates the strength of the management team.

Each type of due diligence plays a crucial role in providing a comprehensive evaluation of different aspects of a business or investment opportunity, helping stakeholders make informed decisions and mitigate risks.

4.3 Glossary

Business Model Assessment	Understanding the target company's business model, revenue streams, customer base, and operational strategies to determine its sustainability and potential for growth
Strategic Fit	Analyzing how the target company aligns with the acquiring organization's overall strategic objectives, long-term goals, and growth plans.
Kick-off call	The kick-off call is a discussion of the business side of the product and further due diligence stages.
REC	A recognized environmental condition (REC) shows either familiar contamination or the subsurface’s potential to be affected by contamination.
TEDD	Traditional Environmental Due Diligence **(TEDD)**: ensuring hazardous materials and pollutants are properly found, handled, permitted, and mitigated
Synergy Identification	Assessing potential synergies between the acquiring and target companies, such as cost savings, revenue enhancements, or strategic advantages that could result from the transaction

4.4 Self-Assessment Questions Short Answers: (5 Marks)

1. Describe operational due diligence.

2.. Describe Importance of Financial Due Diligence.

3. Write about checklist of Financial Due Diligence.

4 Write about the importance of managerial due diligence.

5. Describe the Phases of Environmental Site Assessment.

Essay Type Answer: (10 Marks)

1. Explain types of due diligence.
2. Explain Process of Legal Due Diligence
3. Explain Key Elements of Technical Due Diligence.
4. Explain process of Technical due diligence.
5. Explain key components of an HR due diligence.

4.5 Activities:

1. Financial Due Diligence: Reviewing financial statements (income statement, balance sheet, cash flow statement) for accuracy and consistency.

2. Legal Due Diligence: Examining contracts and agreements (customer contracts, supplier agreements, leases).

3. Commercial Due Diligence: Conducting market research and analysis on industry

4. Operational Due Diligence:

Evaluating supply chain management and vendor relationships.

Analyzing IT systems and infrastructure for reliability and security.

5. Environmental Due Diligence: Conducting environmental site assessments (Phase I and Phase II).

6. Technological Due Diligence: Analyzing IT infrastructure and systems architecture.

7. Human Resources Due Diligence: Evaluating employee demographics, turnover rates, and workforce stability.

4.6 - Topics for Discussion

1. Discuss the different types of due diligence.

2. Discuss how environmental due diligence assesses risks related to climate change, regulatory compliance, and environmental impact.

3. Debate the role of emerging technologies (e.g., AI, blockchain) in reshaping the landscape of technological due diligence practices.

4. Discuss specific activities involved in technological due diligence, such as assessing intellectual property, cybersecurity, and IT infrastructure.

5. Analyze the importance of conducting comprehensive due diligence across multiple dimensions to mitigate risks and ensure the success of M&A transactions.

4.7 Suggested Readings / References

Book:

1. "Financial Due Diligence: A Comprehensive Guide to Financial Reporting and Analysis" by Mario J. Mauceri

2. "Legal Due Diligence in Private Equity Transactions" by Ignacio Hernández-Ros

3. Commercial Due Diligence: The Key to Understanding Value in an Acquisition" by Jonathan Green

4. Environmental Due Diligence Handbook" by Andrew S. Balcerak and Karen J. Clark

5. Technology Due Diligence: Best Practices for Chief Information Officers, Venture Capitalists, and Technology Vendors" by Christopher Keane

Report:

Journal:

1. Financial Due Diligence: A Critical and Overlooked Aspect of Mergers and Acquisitions" by Jeffrey J. Sherman and David N. Perkins

2. Legal Due Diligence: A Framework for Success" by Marc C. Swanson

3. "Commercial Due Diligence: A Practical Guide" by EY (Ernst & Young

4. "Environmental Due Diligence in Real Estate Transactions" by U.S. Environmental Protection Agency (EPA)

5. Technology Due Diligence: Assessing the Value of a Technology Company" by Deloitte.

UNIT V: Due Diligence for Takeovers and Due Diligence Report
Due diligence for Mergers and Amalgamation: Introduction and Process, Preparation of scheme of amalgamation - Due diligence for take overs - Guidance on diligence reporting – Format of diligence report.

UNIT OBJECTIVES

Students will gain an understanding of merger and amalgamation due diligence through this unit. They will apply this knowledge to the development of amalgamation schemes and due diligence for mergers. Gain knowledge on due diligence reporting is given to them, and they understand the due diligence report format.

SECTION 5.1: DUE DILIGENCE FOR TAKEOVERS AND DUE DILIGENCE REPORT

5.1.1 Introduction:

The process of due diligence is a prerequisite for merger and acquisition (M&A) deals. It is a type of legal audit and research activity that offers the investor a precedent guarantee and contentment with the entity they are acquiring or merging. Before beginning to structure the deal, M&A lawyers organize this material by researching and developing a thorough M&A due diligence checklist.

Due diligence in M&A can be followed by determining the objectives of the merger, acquisition or sale and investigating the potential business model. The investor can then lay out the compliance with their legal due diligence requirements after evaluating the risk and potential rewards of the transaction. The target company is then in charge of creating an online data room where all the material is provided for the investor's evaluation in accordance with the investor's due diligence checklist, which is provided to the target company.

An M&A deal might succeed or fail based on due diligence, particularly legal due diligence. It can help both the investor and the target company to discover potential liabilities and comprehend any legal risks by doing a crucial legal analysis of the documents and information.

Takeovers, mergers and acquisition activities continue to accelerate. From banking to oil exploration and telecommunication to power generation, companies are coming together as never before. Not only this new industries like e-commerce and biotechnology have been exploding and old industries are being transformed. Corporate Restructuring through acquisitions, mergers, amalgamations, arrangements and takeovers has become integral to corporate strategy today.

Mergers: A merger has been defined as 'the fusion or absorption of one thing or right into another'. A merger has also been defined as an arrangement whereby the assets of two (or more) companies become vested in, or under the control of one company (which may or may not be one of the original two Companies), which has as its shareholders all or substantially all, the shareholders of the two companies.

In a merger, one of the two existing companies merges its identity into another existing company or one of more existing companies may form a new company and merge their identities into the new company by transferring their businesses and undertakings including all other assets and liabilities to the new company (hereinafter referred to as the merged company). The shareholders of the company or companies, whose identity/ies has/have been merged (hereinafter referred to as the merging company or companies, as the case may be) will have substantial shareholding in the merged company. They will be allotted shares in the merged company in exchange for the shares held by them in the merging company or companies, as the case may be, according to the shares exchange ratio incorporated in the scheme of merger as approved by all or the prescribed majority of the shareholders of the merging company or companies and the merged company in their separate general meetings and sanctioned by the court.

Amalgamation: Amalgamation is an 'arrangement' or 'reconstruction'. Amalgamation is a legal process by which two or more companies are joined together to form a new entity or one or more companies are to be absorbed or blended with another and as a consequence the amalgamating company loses its existence and its shareholders become the shareholders of new company or the amalgamated company. In case of amalgamation a new company may come into existence or an old company may survive while amalgamating company may lose its existence.

5.1.2 Process of due diligence for Mergers and Amalgamation:

Due to the complex nature of merger and amalgamation the due diligence process can last several weeks to several months.

- **Gathering a team: The** first step of the process involves gathering a team who will be responsible for conducting the due diligence. To ensure that the process is executed properly, the buyer will need a team of legal and financial experts with special knowledge in M&A. A due diligence team typically consists of investors, accountants, lawyers, personal consultants, and possibly other service providers based on the industry your business is in.

- **Gathering of important documents: The** next step in the process involves the gathering of important documents. The due diligence team will create a detailed checklist of what documents are needed and in what time scale the documents are due. Once a confidentiality agreement is signed, the due diligence team can then request this information from the target company.

- In some instances, the buyer and target company will arrange a meeting or series of meetings to discuss the M&A process and document requirements. During these meetings, both parties are better able to determine their compatibility and the buyer can make sure that the investment is sound.

- While the exact documents required during due diligence can range depending on the type of business, size of the business, and similar factors, there are several kinds of data that are commonly requested across the board. These typically include corporate records, IP contracts, stockholder information, and a history of litigation. The buyer may also request regulation information, insurance information, leases, and other financial information.

- Overall, the buyer will need to get a solid understanding of the target company's financial health, operational assets, legal matters, and strategic position. If any of the information provided poses a problem, the business deal may not occur.

- **Reviewing all of the information**: The next step of the due diligence process involves reviewing all of the information provided by the target company. If the buyer has any questions regarding the documents, now is the time for the target company to address their concerns.

- If for whatever reason the buyer is unable to find certain answers based on the information provided by the target company, then the buyer can request additional information. There are certain things that the due diligence team will look for when reviewing the documents, such as 'red flags' that could indicate a potential problem with the deal.

- During the review process, the team will determine if the problems found may result in the deal being abandoned altogether or if the offer should be modified. In some cases, information found could change the structure of the deal or its timeline.

- To help speed up the process, the due diligence team may hold meetings with the target company to try and address any questions or concerns in a timely manner. Once the buyer is satisfied with the information given and chooses to proceed with the transaction,

- **Write a purchase agreement:** the final step is to write a purchase agreement and send it to the target company for approval. This report will include a summary of any problems that were discovered during the due diligence process, as well as any areas that were found to be satisfactory. At the end of the report, the buyer will conclude with a final assessment of the deal. In many cases, the buyer will see the acquisition as a sound investment and the transaction will continue as planned.

- However, in some instances, the buyer will request for the deal to be adjusted based on their findings during the due diligence process. If the problems are found to be too challenging to overcome, the buyer may abandon the deal.

5.1.3 Scheme of Amalgamation

The companies that propose to amalgamate must prepare a "Scheme of Amalgamation" ("Scheme"). The Scheme is basically a document that provides for all the terms and conditions of the proposed amalgamation which are finalized by the board of directors of the amalgamating companies. The Scheme being the most fundamental document in the entire process of amalgamation must be drafted with utmost care and precision by taking into consideration all the possible implications under various laws applicable to the amalgamating companies.

Key Points while drafting a Scheme of Amalgamation under Companies Act 2013:

The Scheme of Amalgamation can broadly be divided into three parts, namely —
1.The Preamble,2. The Scheme of Amalgamation, 3. The General terms and conditions applicable to the Scheme.

A. Preamble of the Scheme:

The preamble of the Scheme is basically the introduction of the Transferor and the Transferee Company wherein the description of the business of the companies is set out. This clause should also mention the rationale (i.e. the purpose) for carrying out such amalgamation. The rationale of the Scheme must be in interests of the shareholders/members of the companies. The preamble of the Scheme is basically the introduction of the Transferor and the Transferee Company wherein the description of the business of the companies is set out. This clause should also mention the rationale (i.e. the purpose) for carrying out such amalgamation. The rationale of the Scheme must be in interests of the shareholders/members of the companies.

B. Scheme of Amalgamation:

The Scheme of Amalgamation sets out important terms and conditions as laid down and agreed between the board of directors of the amalgamating companies. These are as follows —

i. Definitions: This clause provides definitions for terms like — Act, Appointed Date, Board of Directors, Effective Date, Record Date, Registrar of Companies, Scheme, Transferee Company, Transferor Company, Undertaking and other terms that are significant in the matter. Such terms should be well framed before the same are finalized.

ii. Share Capital: This clause provides the details of authorized, issued, subscribed and paid up share capital of the Transferor Company and the Transferee Company.

iii. Transfer & Vesting of Undertaking: This clause ideally provides the details of — Transfer and vesting of Undertaking (all assets whether moveable or immoveable) Transfer and vesting of Licenses, Permissions, Rights, Approvals (if any) Transfer and vesting of all the debts and liabilities Tax payments by the Transferor Company Transfer and vesting of investments.

iv. Legal Proceedings: This clause provides that upon the Scheme coming to effect, all the legal proceedings shall be enforced by or against the Transferee Company.

v. Date of taking effect and the operative date: The Scheme, although operative from the Appointed Date, shall become effective from the Effective Date.Such date shall be mentioned herein the clause.

vi. Employees & Staff of the Transferor Company: This clause essentially provides that all employees of the Transferor Company shall become employees of the Transferee Company without any break or interruption in service and on such terms and conditions as to remuneration not less favorable than those subsisting with reference to the Transferor Company. It must also provide for the treatment to the Gratuity Fund, Provident Fund etc of the employees of the Transferor Company.

vii. Issue of shares by the Transferee Company : This clause provides for the details of the shares issued by the Transferee Company to the Transferor Company in the form of a consideration to the proposed amalgamation. The Share Certificates in relation to the shares held by the Equity and Preference Shareholders of the Transferor Company whose names are recorded in the Register of Members of the Transferor Company on the Record Date, fixed by the Board of Directors of the Transferee Company, shall be deemed to have been automatically cancelled and be of no effect on and from such Record Date. If there is any, cancellation of shares that can also be provided for.

viii. Accounting Treatment: This clause provides for the method of accounting (as provided under AS-14) adopted for the proposed amalgamation. It provides the manner of treatment of assets and liabilities appearing in the balance sheets of the amalgamating companies, certain individual items like investment, amounts lying in miscellaneous expenditure etc. This clause also contains the provisions relating to treatment of unabsorbed depreciation, discharge if liabilities etc.

ix. Other terms may include clauses relating to — change in authorized share capital of the Transferee company (if any), board of directors, conduct of business by the Transferor Company till the Effective date, treatment to the contract, deeds, bonds and other instrument of the Transferor Company upon amalgamation, declaration of dividend etc.

C. GENERAL & OTHER TERMS & CONDITIONS

The general terms and conditions are applicable to the Scheme as a whole. These terms may include the following clauses — Effect of modification/amends to the Scheme Application to the National Company Law Tribunal and other authorities. Dissolution of Transferor Company Approval/Sanctions required for the Scheme to be effective Resolutions subsisting on the effective date Expenses incidental and connected to the Scheme of Amalgamation & Any other such terms which may deem fit for the proposed scheme of amalgamation

The Scheme of Amalgamation is the primary yet the most important step towards restructuring the business of any company. The same should be drafted with utmost accuracy taking into consideration all the relevant laws, rules and regulations and their implications on the proposed amalgamation.

5.1.4 TAKE OVER

Takeover means acquisition by one company of control over another, usually by buying all or a majority of its shares. A transaction or a series of transactions by which a person acquires control over the assets of a company is generally known as takeover of the company. On the other hand an arrangement whereby the assets of two companies vest in one is known as merger.

Takeover has been defined as a business transaction whereby an individual or a group of individuals or a company acquires control over the assets of a company, either directly by becoming owner of those assets or indirectly by obtaining control of the management of the company. In the ordinary case, the company taken over is smaller but in a ‘reverse takeover’ a smaller company gains control over the larger company. This is different from ‘merger’ wherein the shareholding in the combined enterprise will be spread between the shareholders of the two companies. Normally the company which wants to takeover the other company acquires the shares of the target company either in a single transaction or a series of transactions. In case of amalgamation under Section 391-394 of the Companies Act, 1956 the amalgamating as well as amalgamated company have to apply to the High Court(s) for making order of amalgamation. However, the regulatory framework for controlling the takeover activities of a company consists of the Companies Act, 1956, Listing Agreement with Stock Exchanges and SEBI’s Takeover Code.

5.1.5 Takeover Bid

In simple language a takeover is acquisition of shares, voting rights in a company with a view to gaining control over the management of the company. A “takeover bid” is an offer addressed to each shareholder of a company, whose shares are not closely held, to buy his shares in the company at the offered price within the stipulated period of time. It is addressed to the shareholders with a view to acquiring sufficient number of shares to give the offeror company, voting control of the target company. It is usually expressed to be conditional upon a specified percentage of shares being the subject-matter of acceptance by or before a stipulated date. A takeover bid is a technique, which is adopted by a company for taking over control of the management and affairs of another company by acquiring its controlling shares.

5.1.5 KINDS OF TAKEOVERS

(1) Friendly takeover;

(2) Hostile takeover.

- **Friendly Takeover**

A friendly takeover is with the consent of taken over company. There is an agreement between the management of two companies through negotiations and the takeover bid may be with the consent of majority or all shareholders of the target company, which is referred to as friendly takeover bid.

- **Hostile Takeover**

When an acquirer company does not offer the target company the proposal to acquire its undertaking but silently and unilaterally persues efforts to gain control against the wishes of existing management such acts of acquirer are known as 'takeover raids' or hostile 'takeover bids'.

The main distinction between a friendly takeover and hostile takeover is whether there is a mutual understanding between the acquirer and the taken over company. When there is a mutual understanding, it is friendly takeover otherwise it is termed as hostile takeover.

In a takeover, the taking over company has two options, viz.,

(I) to merge both companies into one and operate both the undertakings as a single entity, and

(ii) to keep the taken over company a separate and independent company, with changed management, changed policies or even with a changed name.

Takeover may be of different types depending upon the intention of the management of the taking over company.

1. A takeover may be a straight takeover which is accomplished by the management of the taking over company by acquisition of shares of another company with an intention to maintain and operate the takeover company as an independent legal entity.

2. Another type of takeover may be with an intention of capturing the ownership of the taken over company in order to merge both companies into one and operate business and undertakings of both the companies as a single legal entity.

3. A third type of takeover is the takeover of a sick industrial company for the purpose of revival of its business. This is accomplished by an order of the Board for Industrial and Financial reconstruction (BIFR) under the provisions of the Sick Industrial Companies (Special Provisions) Act, 1985

4. Bail out takeover is substantial acquisition of shares in a financially weak company not being a sick industrial company, in pursuance to a scheme of rehabilitation approved by a public financial institution or a scheduled bank (hereinafter referred to as the lead institution). The lead institution is responsible for ensuring compliance with the provisions of the SEBI (Substantial Acquisition and Takeovers) Regulations, 1997, which regulate the bailout takeovers.

Let’s sum up

Due diligence is a crucial step in mergers and acquisitions because an M&A deal can be a complex and expensive process. The investor, their consultants and accountants, must perform extensive due diligence to protect them from unexpected risks. Additionally, the target company must be ready for these due diligence tasks and make sure that everything goes smoothly and provide all relevant documents, efficiently, and in the best interests of all parties involved in the transaction. A scheme of amalgamation is a structured legal framework under which the process of amalgamation is executed, detailing the terms, conditions, and procedures for consolidation, ensuring regulatory compliance and fairness to stakeholders involved in the merger. It

serves to streamline operations, enhance market presence, and achieve synergies while adhering to legal and financial regulations governing corporate mergers.

CHECK YOUR PROGRESS – QUIZ - 1

1 What is the primary objective of amalgamation in corporate restructuring?

a) To increase competition within the industry.

b) To combine entities for operational efficiency and synergy.

c) To create barriers to entry for new competitors.

d) To reduce shareholder dividends.

2. In a scheme of amalgamation, what is the role of shareholders of the merging companies?

a) They do not have any role in the process.

b) They exchange their shares for shares in the new entity or receive cash/securities.

c) They appoint directors for the new entity.

d) They veto the amalgamation process.

3. Which of the following is true about the legal framework of a scheme of amalgamation?

a) It is optional for companies to follow.

b) It details the terms, conditions, and procedures for the consolidation of companies.

c) It only applies to privately held companies.

d) It is applicable only in certain industries.

4. What does the term 'synergy' mean in the context of amalgamation?

a) Conflict arising between merged entities.

b) Financial loss due to merger costs.

c) Benefits arising from the combination of entities that exceed the sum of their individual parts.

d) Decrease in market share after the merger.

5. Which regulatory body is typically involved in overseeing the process of amalgamation to ensure compliance with laws and fairness to stakeholders?

a) International Monetary Fund (IMF)

b) Securities and Exchange Board of India (SEBI)

c) World Trade Organization (WTO)

d) United Nations (UN)

SECTION 5.2 DUE DILIGENCE REPORT

The information gathered throughout the due diligence process is compiled in a due diligence report**.** The due diligence process, which entails a systematic investigation and analysis of all aspects of a proposed transaction, is carried out in order to improve investment decisions and mitigate risk for a company.

The due diligence process includes a comprehensive evaluation of an entity's financial viability in terms of assets and liabilities, a detailed analysis and verification of its operations, and a comprehensive examination and verification of its material facts regarding a proposed transaction. It also entails analyzing a company's financial records and comparing them over time with those of competitors to understand the financial status and performance of the company. Further due diligence process also takes into account all legal and tax aspects including that of the directors of the Company. The results of these investigations are then compiled in a report known as the due diligence report**.**

5.2.1 Need for Due Diligence Report:

Prior to making an acquisition, investment, business partnership, or taking a bank loan or other major decisions, due diligence is done to assess the value of the subject (a company or an entity) and identify major issues. The data gathered during this process is compiled into a report which clarifies how the business intends to increase profits. It presents a quick overview for understanding the situation at the time of purchase, sale, etc. Getting a clear picture of how the business will perform in the future is the ultimate goal of the report.

Due diligence report used on the various industries:

- **Real Estate -** Due diligence reports are used by real estate investors and developers to assess a property's potential profitability, CAP rate (the capitalization rate is used to denote the projected rate of return on an investment property), anticipated vacancy rates, and potential capital improvements. The following items should also be on the real estate professional's due diligence checklist:

1. Property taxes
2. Comparable properties
3. Inspection reports
4. Opportunities for further development

- **Business Valuation -** Business valuations are essential for making better decisions if a company is growing, going public, or going through a merger or acquisition, etc. A **due diligence report** for valuations is generally centred on:

1. Financial statements
2. Financial projections
3. Capital structure
4. Strengths, weaknesses, opportunities and potential threats in the marketplace

When looking for funding from outside investors or when requesting a business loan, it might be necessary to submit a business valuation due diligence report**.**

- **Sales, Acquisitions, or Mergers -** A company that is for sale and is considering a merger or the acquisition of another organization will need a **due diligence report**. The report should provide a brief overview of the pertinent financial data, upcoming business opportunities, and challenges.

This includes:

1. Corporate records
2. Financial information
3. Debt
4. Information on real estate, owned or leased
5. Legal documents

6. Supplier and customer information
7. Joint venture, marketing, and licensing agreements

5.2.2 Aspects covered in a due diligence report:

- **Viability**: A thorough analysis of the company's business and financial plans can be done to determine the target company's viability**.**
- **Monetary Aspect:** Analyzing ratios and using key financial data is necessary to get a good handle on the situation.
- **Environment:** No company operates independently. Consequently, it is essential to consider the macro environment and how it will affect the target company in the long run.
- **Personnel:** Key considerations include the competence and reputation of the people running the company.
- **Existing & Potential Liabilities**: Any ongoing legal matters and regulatory concerns must be examined.
- **Technology:** Assessing the technological capabilities of a business is a crucial factor to be taken into consideration. Such an evaluation is crucial since it informs choices on future projects.

5.2.3 Types of Due Diligence Report

- **Business Due Diligence**: This entails detailed scrutiny of each party in a transaction, as well as the business's prospects and the investment's potential.
- **Financial Due Diligence**: The viability of the company's finances, operations, and business depend on this stage. It gives the acquiring company a clear picture of whether the acquisition is profitable or not. Internal controls, tax conformity, auditing processes, and accounting regulations are all carefully examined.
- **Legal Due Diligence**: This kind of **due diligence** focuses on any potential legal issues associated with a transaction. It scans for any potential legal pitfalls or obstacles. Typically, it includes both internal and external business transactions.

5.2.4 Due Diligence Checklist:

The following documents are taken into account for the **due diligence** process: Comprising balance sheets, financial statements, income and expense statements, profit and loss accounts, articles of association, memorandum of association, shareholding pattern, certificate of incorporation of the Company, income tax returns, bank statements, employee records, director and management information, utility bills, statutory registers, tax registration certificates, intellectual property registration and other application documents, operational, legal and other financial documents, and so on.

5.2.5 Importance of Due Diligence Report

- A thorough report aids in understanding the business and its long-term plans to generate extra earnings, whether monetary or not.
- The report acts as a quick reckoner or ready-to-serve document to help understand the issues and difficulties that may arise during a purchase or sale.
- It provides a comprehensive picture of the company's past, present, and projected future performance.
- Before finalizing the transaction, an acquirer can identify and comprehend the risks, liabilities, and issues that exist in the company with the help of **the** due diligence report**.**
- It also aids in averting losses and undesirable outcomes in the future.

5.2.6 Benefits of Due Diligence Report:

Consistency:

A due diligence report format ensures that all essential aspects (facts that you are looking for) are covered consistently in every report. A standardized report format ensures uniformity in the presentation of information. This consistency helps the decision makers easily navigate and compare different reports, fostering a standardized approach across various assessments.

Clarity:

Using a structured format in a due diligence report aids in reader comprehension and navigation. By presenting data in a clear, logical, and organized way, the format improves the clarity of the information. This approach helps readers easily grasp the content, pinpoint crucial information, and derive pertinent insights from the report.

Time Efficiency:

Time is of crucial essence when it comes to executing a due diligence process. Having a due diligence report format beforehand will give you an edge to become more time efficient in the process. A report format gives clarity on what data points you want to collect, how much you want to go in depth, how the analysis of the data should be made and how you want it to get presented.

A due diligence report format is crucial to define all these attributes hence giving more clarity in the process and also help the decision makers navigate better through the reports and focus on the elements they want to see in the report.

Professionalism:

A well-organized report format enhances the professional appearance of the report. Standardized formats contribute to a professional image. They demonstrate a commitment to thoroughness and organization, instilling confidence in stakeholders, whether they are internal team members, investors, or external partners.

Compliance:

Adopting a standardized due diligence report format aids in meeting legal and industry standards when required. By following a set format, the due diligence process aligns with regulatory norms and industry benchmarks. This is vital for legal and compliance reasons, as it minimizes the risk of missing important details and guarantees that all essential information is accurately recorded.

5.2.7 GUIDANCE ON DILIGENCE REPORTING:

Compliance Inputs and checklist are indicative and PCS shall not exclusively rely upon that, but use that as a guide and apply his own judgment to determine what is to be checked and to what extent.

Period of Reporting

Annex. III to the RBI Notification provides that the Diligence Report shall be made on a half yearly basis.

Secretary in Whole-Time Practice

Section 2(45A) of the Company Secretaries Act, 1980 defines "secretary in whole-time practice" as a secretary who shall be deemed to be in practice within the meaning of sub-section (2) of section 2 of the Company Secretaries Act, 1980 and who is not in full-time employment. Thus, a member of the Institute of Company Secretaries of India, who is not in full- time employment can become a Secretary in whole-time practice (hereinafter referred to as PCS) after obtaining from the Council of the Institute a Certificate of Practice under section 6 of the Company Secretaries Act, 1980 and the regulations there under.

Right to Access Records and Methodology for Diligence Reporting :To enable the PCS to issue the Diligence Report, the Company (borrower) should provide the PCS access at all times to the books, papers, minutes books, forms and returns filed under various statutes, documents and records of the company, whether kept in pursuance of the applicable laws or otherwise and whether kept at the registered office of the company or elsewhere which he considers essential for the purposes of Diligence Reporting.

The PCS shall be entitled to require from the officers or agents of the company, such information and explanations as the PCS may think necessary for the purpose of such Reporting. However, depending on the

facts and circumstances he/she may obtain a letter of representation from the company in respect of matters where verification by PCS may not be practicable, for example matters like ––

(i) dis-qualification of directors;

(ii) show cause notices received;

(iii) persons and concerns in which directors are interested, etc.

5.2.8 Reporting with Qualification:

The qualification, reservation or adverse remarks, if any, may be stated by the PCS at the relevant places. It is recommended that the qualifications, reservations or adverse remarks of PCS, if any, should be stated in thick type or in italics in the Diligence Report.

If the PCS is unable to form any opinion with regard to any specific matter, the PCS shall state clearly the fact that he is unable to form an opinion with regard to that matter and the reasons thereof.

If the scope of work required to be performed, is restricted on account of limitations imposed by the company or on account of circumstantial limitations (like certain books or papers being in custody of another person or Government Authority) the Report shall indicate such limitation. If such limitations are so material as to render the PCS incapable of expressing any opinion, the PCS should state that: “in the absence of necessary information and records, he is unable to report compliance(s) or otherwise by the Company”.

PCS shall have due regard to the circulars and/or clarifications issued by the Reserve Bank of India from time to time. It is recommended that a specific

reference of such circulars at the relevant places in the Report shall be made, wherever possible.

5.2.9 Professional Responsibility and Penalty for False Diligence Report: While the RBI Notification has opened up a significant area of practice for Company Secretaries, it equally casts immense responsibility on them and poses a greater challenge whereby they have to justify fully the faith and confidence reposed by the banking industry and measure up to their expectations. Company Secretaries must take adequate care while issuing Diligence Report.

Any failure or lapse on the part of a Practicing Company Secretary (PCS) in issuing a Diligence Report may not only attract penalty for false Reporting and disciplinary action for professional or other misconduct under the provisions of the Company Secretaries Act, 1980 but also make him liable for any injury caused to any person due to his / her negligence in issuing the Diligence Report. Therefore, it becomes imperative for the PCS that he/she exercises great care and caution while issuing the Diligence Report and also adheres to the highest standards of professional ethics and excellence in providing his/her services.

Disqualifications of Secretary in Whole-Time Practice:

With a view to ensure that PCS shows utmost integrity and independence of judgment in the performance of his/her duties, it is desirable that he/she, should not accept any assignment for giving Diligence Report to a Bank, if he/ it is-

(a) a body corporate;

(b) an officer or employee of the company;

(c) a person who is a partner, or who is in the employment, of an officer or employee of the company;

(d) a person who is indebted to the company for an amount exceeding one thousand rupees, or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding one thousand rupees;

(e) a person holding any security of that company which carries voting rights.

However, any securities held by such person as nominee or trustee for any third person and in which the holder has no beneficial interest shall be excluded from such disqualification. Further, if a person is not qualified for appointment as PCS of a company for reasons stated above, then he is also disqualified for appointment as PCS of any other body corporate which is that company's subsidiary or holding company or a subsidiary of that company's holding company, or would be so disqualified if the body corporate were a company. If a PCS becomes subject, after his appointment, to any of the disqualifications specified above, he should vacate his office as such.

Communication to earlier incumbent: In view of the provisions of clauses (8) and (11) of Part I of the First Schedule to the Company Secretaries Act, 1980, whenever a new incumbent is assigned the Diligence Report work, he should first communicate his appointment to the earlier incumbent in writing by registered post.

Where, however, in the same year a Secretary in whole-time practice is appointed in place of another Secretary in whole-time Practice, who was appointed initially, the new incumbent should not only first communicate the same to the previous incumbent in writing by Registered Post but also first seek his consent (preferably in writing).

5.2.10 The format of a due diligence report:

When preparing the diligence report, it's essential to tailor the content and level of detail to the needs of the intended audience, whether it's the executive team, board of directors, investors, or external advisors. Clear and concise communication of the findings and recommendations will facilitate informed decision-making and support the successful execution of the takeover.

The format of a diligence report can vary depending on the preferences of the organization and the specific requirements of the transaction. However, a typical diligence report often follows a structured format to ensure clarity and ease of understanding. Here's a suggested format for a diligence report:

1. Title Page:

- Title of the report (e.g., "Due Diligence Report for [Target Company Name]").

- Date of submission.

- Names and titles of the individuals or teams involved in the diligence process.

- Contact information for the primary point of contact.

2. Table of Contents:

- List of sections and subsections with corresponding page numbers for easy navigation.

3. Executive Summary:

- A concise overview of the key findings, recommendations, and conclusions.

- Highlights of significant risks, opportunities, and value drivers.

- Summary of the rationale for the acquisition and potential synergies.

4. **Introduction:**

- Brief overview of the purpose and objectives of the diligence process.

- Explanation of the methodology used and the scope of the assessment.

- Overview of the target company and the context of the transaction.

5. Detailed Sections:

- Financial Due Diligence:

  - Analysis of financial statements, including balance sheets, income statements, and cash flow statements.

  - Assessment of key financial metrics, trends, and performance indicators.

  - Identification of any significant financial risks or opportunities.

- Legal Due Diligence:

  - Summary of the corporate structure, including subsidiaries, joint ventures, and affiliates.

  - Review of contracts, agreements, and legal documents, highlighting any material issues or risks.

  - Analysis of regulatory compliance, litigation, and other legal matters.

- Operational Due Diligence:

  - Evaluation of operational processes, including production, supply chain, and distribution.

- Assessment of operational efficiency, scalability, and potential areas for improvement.

- Identification of operational risks and opportunities for optimization.

- Commercial Due Diligence:

- Analysis of the target market, competitive landscape, and customer relationships.

- Assessment of market trends, growth drivers, and competitive positioning.

- Identification of growth opportunities and potential synergies.

- Environmental, Social, and Governance (ESG) Due Diligence:

- Overview of ESG risks and opportunities identified during the diligence process.

- Assessment of environmental impact, social responsibility initiatives, and governance practices.

- Recommendations for integrating ESG considerations into the post- acquisition strategy.

- Tax Due Diligence:

- Summary of tax compliance status, exposures, and optimization opportunities.

- Identification of tax-related risks, liabilities, and planning considerations.

- Recommendations for tax structuring and planning post-acquisition.

- Human Resources Due Diligence:

- Overview of the target company's workforce, culture, and key personnel.

- Assessment of HR-related risks, such as labor disputes or talent retention challenges.

- Recommendations for workforce integration and management post- acquisition.

- Integration Planning:

- Overview of key integration considerations, challenges, and milestones.

- High-level integration plan, including timelines, responsibilities, and synergies.

- Recommendations for successful integration and value creation post- acquisition.

6. Conclusion:

- Summary of the key findings, risks, opportunities, and recommendations.

- Reiteration of the rationale for the acquisition and potential value creation for the acquiring company.

- Final considerations or next steps for the transaction.

7. Appendices:

-

- Supplementary materials, such as detailed financial analyses, legal documents, or supporting data.

- Any additional information referenced in the report for further reference.

8. References:

- Citations or sources for any external data, reports, or resources referenced in the diligence report.

9. Acknowledgments:

- Recognition of individuals or teams involved in the diligence process, including internal and external stakeholders.

10. Confidentiality Statement:

- Reminder of the confidential nature of the information contained in the report and any applicable disclosure restrictions.

The format and content of the diligence report should be tailored to the needs of the intended audience and the specific requirements of the transaction. Clarity, accuracy, and thoroughness are essential to ensure that stakeholders can make informed decisions based on the findings and recommendations presented in the report.

Format of Diligence Report

DILIGENCE REPORT

To The Manager,
____________________(Name of the Bank)

I/We have examined the registers, records, books and papers of .... Limited having its registered office at .... as required to be maintained under the Companies Act, 1956 (the Act) and the rules made thereunder, the provisions contained in the Memorandum and Articles of Association of the Company, the provisions of various statutes, wherever applicable, as well as the provisions contained in the Listing Agreement/s, if any, entered into by the Company with the recognized stock exchange/s for the half year ended on In my/our opinion and to the best of my/ our
information and according to the examination carried out by me/us and explanations furnished to me/us by the Company, its officers and agents. I/ We report that in respect of the aforesaid period:

1. The management of the Company is carried out by the Board

of Directors comprising of as listed in Annexure …., and the Board was duly constituted. During the period under review the following changes that took place in the Board of Directors of the Company are listed in the Annexure …., and such changes were carried out in due compliance with the provisions of the Companies Act, 1956.

2. The shareholding pattern of the company as on .... was as detailed in Annexure .... During the period under review the changes that took place in the shareholding pattern of the Company are detailed in Annexure……. .

3. The company has altered the following provisions of (i) The Memorandum of Association during the period under review and has complied with the provisions of the Companies Act, 1956 for this purpose. (ii) The Articles of Association during the period under review and has complied with the provisions of the Companies Act, 1956 for this purpose.

4. The company has entered into transactions with business entities in which directors of the company were interested as detailed in Annexure…............

5. The company has advanced loans, given guarantees and provided securities amounting to Rs. .... to its directors and/or persons or firms or companies in which directors were interested, and has complied with Section — 295 of the Companies Act, 1956.

6. The Company has made loans and investments; or given guarantees or provided securities to other business entities as detailed in Annexure…. and has complied with the provisions of the Companies Act, 1956.

7. The amount borrowed by the Company from its directors, members, financial institutions, banks and others were within the borrowing limits of the Company. Such borrowings were made by the Company in compliance with applicable laws. The breakup of the Company's domestic borrowings were as detailed in Annexure …. .

8. The Company has not defaulted in the repayment of public deposits, unsecured loans, debentures, facilities granted by banks, financial institutions and non-banking financial companies.

9. The Company has created, modified or satisfied charges on the assets of the company as detailed in Annexure…. Investments in wholly owned Subsidiaries and/or Joint Ventures abroad made by the company are as detailed in Annexure ....

10. Principal value of the forex exposure and Overseas Borrowings of the company as on are as detailed in the Annexure under.

11. The Company has issued and allotted the securities to the person sent titled thereto and has also issued letters, coupons, warrants and certificates thereof as applicable to the concerned persons and also redeemed its preference shares/debentures and bought back its shares within the stipulated time in compliance with the provisions of the Companies Act,1956 and other relevant statutes.

12. The Company has insured all its secured assets.

13. The Company has complied with the terms and conditions, set forth by the lending bank/financial institutions at the time of availing any facility and also during the currency of the facility.

14. The Company has declared and paid dividends to its shareholders as per the provisions of the Companies Act, 1956.

15. The Company has insured fully all its assets. 16. The name of the Company and or any of its Directors does not appear in the defaulters' list of Reserve Bank of India.

17. The name of the Company and or any of its Directors does not appear in the Specific Approval List of Export Credit Guarantee Corporation.

18. The Company has paid all its Statutory dues and satisfactory

arrangements had been made for arrears of any such dues.

19. The funds borrowed from banks/financial institutions have been used by the company for the purpose for which they were borrowed. 20. The Company has complied with the provisions stipulated in Section 372A of the Companies Act in respect of its Inter Corporate loans and investments.

21. It has been observed from the Reports of the Directors and the Auditors that the Company has complied with the applicable Accounting Standards issued by the Institute of Chartered Accountants in India.

22. The Company has credited and paid to the Investor Education and Protection Fund within the stipulated time, all the unpaid dividends and other amounts required to be so credited.

23. Prosecutions initiated against or show cause notices received by the Company for alleged defaults/offences under various statutory provisions and also fines and penalties imposed on the Company and or any other action initiated against the Company and /or its directors in such cases are detailed in Annexure…..

24. The Company has (being a listed entity) complied with the provisions of the Listing Agreement. 25. The Company has deposited within the stipulated time both Employees' and Employer's contribution to Provident Fund with the prescribed authorities.

Note: The qualification, reservation or adverse remarks, if any, are explicitly stated may be stated at the relevant paragraphs above place(s)

Place: Signature :

Date :

Name of Company Secretary/Firm :

C.P. No.

Let’s sum up

A due diligence report provides a comprehensive assessment of a company or asset that is being considered for acquisition, investment, or partnership. It typically covers various aspects including financial performance, operational efficiency, legal and regulatory compliance, market position, intellectual property, and potential risks. The report aims to provide the acquiring party with a detailed understanding of the target's strengths, weaknesses, opportunities, and threats, enabling informed decision-making. It involves thorough analysis of documents, interviews with key personnel, site visits, and sometimes, input from external experts. The due diligence report serves as a crucial tool in evaluating the feasibility and potential synergies of a transaction, ensuring transparency and reducing the likelihood of unforeseen issues post-acquisition.

CHECK YOUR POGRESS – Quiz_1

Which of the following is NOT typically included in financial due diligence for a takeover?

A) Review of historical financial statements

B) Assessment of operational workflows

C) Analysis of key financial ratios

D) Evaluation of assets and liabilities

What is the primary purpose of conducting legal due diligence in a takeover?

A) To assess the operational efficiency of the target company

B) To evaluate the cultural fit between the acquiring and target companies

C) To identify any legal risks, obligations, or liabilities associated with the target company

D) To determine potential cost synergies post-

acquisition What does operational due diligence

primarily assess?

A) Market trends and competitive analysis

B) Customer retention rates and supplier relationships

C) IT infrastructure and cybersecurity measures

D) Financial performance and profitability ratios

Which of the following is a key consideration in strategic due diligence for a takeover?

A) Analysis of financial statements

B) Assessment of cultural alignment

C) Calculation of key financial ratios

D) Review of legal contracts

What is typically included in the due diligence report following a takeover assessment?

A) Detailed analysis of customer demographics

B) Calculation of projected revenue growth

C) Summary of findings across financial, legal, operational, and strategic aspects

D) Overview of IT infrastructure security measures

5.3 UNIT SUMMARY

This unit covers due diligence for takeover and due diligence report. The process of due diligence is a prerequisite for merger and acquisition

(M&A) deals. It is a type of legal audit and research activity that offers the investor a precedent guarantee and contentment with the entity they are acquiring or merging. Before beginning to structure the deal, **M&A lawyers** organize this material by researching and developing a thorough M&A due diligence checklist. The investor, their consultants and accountants, must perform extensive due diligence to protect them from unexpected risks. Additionally, the target company must be ready for these due diligence tasks and make sure that everything goes smoothly and provide all relevant documents, efficiently, and in the best interests of all parties involved in the transaction. A scheme of amalgamation is a structured legal framework under which the process of amalgamation is executed, detailing the terms, conditions, and procedures for consolidation, ensuring regulatory compliance and fairness to stakeholders involved in the merger. A due diligence report provides a comprehensive assessment of a company or asset that is being considered for acquisition, investment, or partnership. This unit helps to the student to get knowledge of due diligence for take over and its report.

5.4 Glossary

Takeover	The acquisition of a company by another through purchasing its shares or assets, thereby gaining control over its operations and assets.
Due Diligence Report	A comprehensive document that outlines the findings, analysis, and conclusions from the due diligence process. It typically includes assessments of financial statements, operational efficiencies, legal and regulatory compliance, market positioning, risks, and potential synergies.
Risk Assessment	The process of identifying and evaluating potential risks associated with the target company, such as financial risks, legal risks, operational risks, market risks, and strategic risks.
Site Visit	An on-site inspection conducted as part of due diligence to physically assess the facilities, operations, and infrastructure of the target company.
Management Interviews	Meetings or discussions with key executives and management personnel of the target company to gain insights into its strategic direction, management style, corporate culture, and future plans.

5.5 Self-Assessment Questions Short Answers: (5 Marks)

1. Write about Due diligence for Mergers and Amalgamation.

2. Write about takeover.

3. what are the a**spects covered in a due diligence report?**

4. Write about types of due diligence report.

5. Describe Disqualifications of Secretary in Whole-Time Practice.

Essay Type Answer: (10 Marks)

1. Explain process of Due diligence for Mergers and Amalgamation.

2. Explain Preparation of scheme of amalgamation.
3. Describe Guidance on diligence reporting.

4. Explain benefits of Due Diligence Report.

5. Explain Format of diligence report.

5.6 Activities:

1. Evaluate the value and condition of the company's assets (both tangible and intangible) and liabilities to identify any potential discrepancies or hidden risks.

2. Examine all material contracts, agreements (including with employees, suppliers, and customers), leases, and other legal documents to identify any obligations, liabilities, or potential legal disputes.

3. Analysis of synergy opportunities, integration challenges, and potential cost savings.

5.7 Topics for Discussion

1. Discuss the value and condition of assets (tangible and intangible) and liabilities, including any contingent liabilities or risks.

2. Review of operational workflows, efficiency metrics, supply chain management, and manufacturing processes

Recommendations for stakeholders, including whether to proceed with the acquisition, renegotiate terms, adjust valuation, or consider alternative strategies.

5.8 Suggested Readings / References

1. Mergers, Acquisitions, and Corporate Restructurings" by Patrick A. Gaughan

2. "Due Diligence Techniques and Analysis: Critical Questions for Business Decisions" by George S. Constantinides, Milton Harris, and Rene
M. Stulz

3. Due Diligence in Mergers and Acquisitions" by Richard G. Vanden Bergh and Martha L. Maznevski (The Academy of Management Perspectives, 2006)

"Strategic Due Diligence: A Foundation for Mergers and Acquisitions" by Robert L. Brown (Strategic Finance, 2016)