

Due diligence

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Section I: Concept

Meaning of Due Diligence

In lay terms, Due diligence is the effort made by an ordinarily prudent or reasonable party to avoid harm to another party or himself. The term “Due diligence” is used for a number of concepts involving either the performance of an investigation of a business or person, or the performance of an act with a certain standard of care.

In finance, due diligence is the process of research and analysis that takes place in advance of an acquisition, investment, business partnership or bank loan in order to determine the value of the subject of the due diligence or whether there are any “skeletons in the closet”.

In the banking industry it refers to the responsibility of bank directors and officers to act in a prudent manner in evaluating credit applications. In the securities market, it refers to the responsibility of underwriters to explain the details of new securities to interested purchasers.

In criminal law, due diligence is the only available defense to a crime that is one of strict liability (i.e. a person is responsible for the damage and loss caused by their acts and omissions regardless of culpability or fault). It is not enough to prove that the defendant did not commit the crime intentionally or knowingly, it must be proven that they did everything possible to prevent the act from happening. It is not enough that they took the normal standard of care in their industry - they must show that they took every reasonable precaution.

Due diligence can also refer to the ongoing activities of pension or investment fund managers who keep track of the operations and financial health of the corporations they invest in and the trustworthiness and ability of their managers, or those of the managers of an acquiring corporation toward a target corporation.

Thus, Due diligence involves investigation and evaluation of a management team’s characteristics, investment philosophy, and terms and conditions prior to committing

capital. Due diligence is undertaken in order to determine the value of the subject of the due diligence and unearth any issues or potential issues. It is expected to provide a realistic picture of how the business is performing now, and how it is likely to perform in the future.

The potential investor generally uses in-house resources or out sources the job to consultants who specialize in due diligence and corporate investigations to investigate the background and principals of the target company. The potential investor may also seek legal counsel and professional accountants to get expert advice in all areas.

In addition to identifying risks and implications of an investment, due diligence may include data on a company's solvency and assets

On completion of the exercise , one should know exactly what he is getting into, what needs to be fixed, what it will cost to fix them, and if he is the right person to take on the business.

While Due diligence is the responsibility one has to investigate and identify issues, due care is doing something about the findings from due diligence.

Difference from other assurance services

In audit, the Chartered Accountant's objective is to provide a high (but not absolute) level of assurance on the reliability of financial statements. The auditor provides a positive opinion which essentially states that based on the work performed; the financial statements comply with relevant accounting standards and principles. The level of testing procedures to obtain the evidence necessary to support such an opinion is high.

In contrast, a review provides a negative assurance report giving only a moderate level of assurance on the reliability of the financial information. The report essentially states that nothing has come to the reviewer's attention to indicate that the financial information is not presented fairly in accordance relevant accounting standards and principles. Review

engagements are designed as a limited review of financial statements; therefore the risk of mistakes, omissions or incorrect disclosures is considerably greater than with an audit.

An audit engagement involves a study and evaluation of internal accounting controls, detailed tests of accounting records, or corroborative evidence through inspection, observation and confirmation which is not usually required in a review engagement.

Due diligence goes far beyond the financial analysis. It differs from an audit in that the latter is concerned with the truth and fairness of historical financial statements only. The scope of a due diligence review is generally wider – it includes a review of historical figures as one of its elements and also involves analysing the sustainability of business, competition, business plan, future prospects, corporate & management structure, technology, synergy of target business to company's business apart from researching regulatory compliances , legal issues and other financial data.

Need for due diligence

Due diligence is necessary to limit reliance placed on vendor's warranties – it is better to discover a “skeleton in the closet” before the business is bought than afterwards. The costs of buying a business with unexpected difficulties can be disastrous.

Due diligence is necessary to allow the investigating party to find out everything that he needs to know about the subject of the due diligence. The objective is to allow the investigator to consider his options in light of the facts.

The investigator would then have the following options open:

- i. To withdraw from the deal - if the due diligence unearths information that makes the investment, loan or participation risky or undesirable and which cannot be adequately resolved then
- ii. To adjust 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, as positive information will have been made more publicly available by the target from the start.

- iii. To have the problem remedied - it may be possible for a problem uncovered by the due diligence to be remedied 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 firm to replace that individual. This will mean that the target is put into a state that the investigator is happier with before it deals with it.

Review of Information

The information reviewed will include:

- a) Historical Financial Data
- b) Current Financial Data
- c) Forecasted Financial Information
- d) Business Plans
- e) Minutes of Directors' Meetings and Management Meetings
- f) Audit work paper files (if available)
- g) Contracts with suppliers, customers and staff
- h) Confirmations/representations from financiers, debtors etc

However, due diligence review should not be limited to reviewing documentation. Much can be learnt about the target from discussion with the staff (formal and informal talks), and generally attending at the target's premises and observing the ongoing daily activities. It is for this very reason that it is recommended the review be conducted by high-level experienced staff.

Section II: Transactions requiring Due Diligence

2.1 Mergers and Acquisitions

The term “due diligence” is synonymous with “background check” and refers to the period during which buyers make sure they have all the information they need to proceed with the transaction.

The key objective of the purchaser or acquirer from the transaction is to get something better than whatever it is that they are presently doing. The prospective purchaser tries to minimize or unveil any post settlement “surprises” and reduce uncertainties. The cost of the preparation of a quality due diligence exercise fades into insignificance when compared to the cost of a bad acquisition

So, the prospective purchaser conducts extensive due diligence .He sends a questionnaire to the target company, requesting full details of the business’s financials, patents and patent applications, licenses and collaboration agreements, major systems, confidentiality agreements, employment contracts and a whole host of other information. The team doing the due diligence then reviews regulatory and press filings, media reports, etc. to find out whether there are any legal and regulatory issues, existing and pending lawsuits and other litigation involving the entity. The team may also look for conflicts of interest, insider trading and other problems.

Due diligence is both for the Buyer and the Seller.

However, it is not only the buyer who will carry out due diligence. The sale of a business will invariably include warranties given by the seller in relation to certain aspects of the business. For example, the seller will usually be asked to warrant that so far as it is aware, the activities of the business do not infringe any third-party intellectual rights, and that no third parties are infringing any of the company’s rights. There will also typically be warranties relating to the company’s licenses, IT systems and so on. Thus it is preferable that the seller must carry out a due diligence exercise of his own.

Similarly, business Sellers might conduct their own due diligence to be assured of the ability of the buyer to complete the sale, the track record of keeping complying with agreements etc. Specifically, they may look into:

- Whether the buyer has the resources to complete the sale
- Whether there is a past record of previous acquisitions
- Whether commitments made have been complied with in the past
- Whether Confidential and Non-Disclosure Agreements have been complied with

2.2 Partnership

Before entering into partnership, the concerned parties conduct negotiations and investigation into affairs of the entities. Some of the different types of partnerships where due diligence investigations are appropriate include:

- Strategic Alliances, Strategic Partnerships
- Business Partners and Alliances, Partnering Agreements, Business Coalitions
- Just In Time Suppliers and Relationships, Sole Suppliers, Outsourcing Arrangements, and Customers
- Technology and Product Licensing, Joint Development Agreements, Technology Sharing and Cross Licensing Agreements
- Business Partners, Affiliates, Franchisees and Franchisers
- Value Added Resellers, Value Added Dealers, Distribution Relationships

2.3. Joint venture and collaborations

Before entering into a major commercial agreement like a joint venture or other collaboration with a company, a collaboration partner will want to carry out a certain amount of due diligence. This is particularly likely to be the case where a large company is forming a relationship for the first time with a relatively small start-up company. The due diligence may not be as extensive as on an acquisition, but the larger company will be seeking comfort that its investment will be secure and the small company has the systems, personnel, expertise and resources to perform its obligations.

Section III: Things to keep in mind when conducting due diligence.

1. Objectives and focus

Expectations: Be clear about your expectations in terms of revenues and profits and whether the probability of the target company to provide you the same.

Commitment: 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

Strengths: Consider whether the business gives you the opportunity to put your skills and experience to good use

Business sector: Learn as much as you can about the business sector you are interested in form media reports, journals and people in the industry.

2. Preparation Is The Key!

To ensure thorough and detailed investigation your preparation should begin in advance of the due diligence process begins. Once you have decided that you are interested in particular business prepare

- Steps to be followed in due diligence process
- Areas to be checked
- Things to check in each area
- Information and other material to be requested from the seller

3. Negotiate adequate time

Most sellers want the process to get over as soon as possible and try to hurry the proceedings. Do not succumb to the pressure as you are trying to understand and learn about a business-its past working and its future prospects, which will take time. Also, when the seller gives a short financial review period; consider it as red flag which could mean that they have something to hide or some matter which they don't want you to

discover. It is in the best interest of the seller to give you adequate time so that you are certain to buy. You cannot move ahead with a deal simply because you ran out of time for due diligence.

4. Minimise your risk: Double-check all information financials, tax returns, patents, copyrights and customer base, and make sure the company does not face a lawsuit or criminal investigation. The financials are also 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. However do not look solely at numbers.

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

- the management team's past performance, roles and talent
- organizational strategy , business plans
- risk management structure
- technological superiority
- adequacy of infrastructure

5. Seek information from external sources:

The company's customers and vendors can be quite informative. Find out from the vendors whether the target company falls in their most favored clients list. Seek out customers who were not considered by the company for doing business.

6. Find the best help money can buy: It is always better to hire the best consultants that your budget will allow than to make a bad decision.

7. Prepare to haggle. You can and should use any flaws that the audit uncovers 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.

Section IV: Steps in due diligence

The due diligence exercise should reduce uncertainties, confirm assumptions and define scope and prioritize issues. The exercise should combine an understanding of organization, its operations, technologies, logistics, corporate strategy and finance and then summarize complex issues into concise, easily understandable terms.

The process would generally comprise of

- 1. Planning phase**
- 2. Data Collection Phase**
- 3. Data Analysis phase**
- 4. Report Finalization Phase**

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1. Planning phase: This stage includes the following processes:

- a) Defining the scope
- b) Deciding the focus areas
- c) Finalizing the team structure
- d) Clear definition of responsibilities
- e) Defining time schedules
- f) Timely communication of information requirements

a) **Defining the scope**

Prior to conducting an engagement, the due diligence team needs to learn about the specifics of the project. The due diligence team or the consultants should discuss the proposed transaction and the due diligence needs. After establishing and prioritizing clear objectives, the availability of resources should be studied and the areas on which the team has to focus on should be defined.

b) Deciding the focus areas

The first thing would be to decide on focus areas which normally include:

- i. Sustainability of the business: The team can understand the sustainability of the business by considering the target company's business plan, vision, strategic alliances, synergies, new products under development, new customers, order status and backlog, customer base
- ii. Financials : The key financial data to be reviewed are assets, liabilities, cash flow, Inventory turnovers, accounts receivable., accounts payable, ownership structure , revenues and accounting procedures and policies
- iii. Competition: It is essential to understand the market environment, and the significant competitors
- iv. Management team and organization culture: The prevailing culture and the outlook and capability of the management team are of prime importance in taking a decision about the target company.
- v. Organizational Infrastructure: The organization's facilities, quality systems, personnel talent and policies should also be considered.
- vi. Potential liabilities: It is important to understand the potential risks and liabilities which an organization would face. The issues to be considered would include intellectual property rights, pending regulatory issues, liens, lawsuits etc.
- vii. Technology: It is essential to explore the technological advantage, if any, which the target company has over its competitors
- viii. Existing market and potential. It is important to gather Information about sales, distribution, marketing channels and promotional methods.
- ix. Business to business fit: If there is a good fit between the two businesses, it would create corporate synergy. The synergy might arise due to complementary strategy, personnel, financial situation etc.

c) Finalizing the team structure

Ensure that the members who form the team are specifically chosen based on their skills and background so that the project is successful. The team members should know the relevant background information on the target company, the transaction, the industry, and due diligence objectives. The members should be clear about what information should be collected, what site visits should be conducted, what analyses should be performed, and what end products should be delivered at the end of the project.

d) Clear definition of responsibilities:

The due diligence effort requires integration of efforts and communication with multiple parties. It is therefore important that planning is done in such a manner that responsibilities and expected outputs are clearly defined so that the team is working collectively towards a common goal. Define the expectations from all sources like target company, internal parties, third party sources, database searches.

e) Defining time schedules

Before starting on the actual execution, it is best to define the scope, expectations and timing from each step. Scheduling the time of each key step helps achieving results in desired timeframe and helps the parties focus on the common goal.

f) Timely communication of information requirements :

The success of due diligence process depends upon complete, accurate and timely information. This can be made possible if the information providers are informed of the expectations from them and the timelines. Each party involved needs to provide as early and specifically as possible. For example, instead of making repeated information requests, if the target company is provided detailed information request list early, they can effectively manage the process and meet the communication timelines.

g) Finalize the template and tools required

Based on scope, needs and objectives, the due diligence team should decide on tools to be used like internet database search, regulatory database search , questionnaires, worksheets and other communication methods like conducting interviews, emails etc.

II. Data Collection Phase

This stage involves collecting existing business process data, key products, critical to quality services. The approach used for data collection depends on a number of factors including the desired precision and "projectability" of decision inputs, the nature of questions that need to be answered, and availability of time, money and access to information providers.

Information sources can be:

- a) Internet
- b) Regulatory organizations and databases
- c) Competitors
- d) Vendors
- e) Customers
- f) Industry associations
- g) Chambers of commerce

The research can be qualitative research which is conducted via in-depth interviews with information providers. The real answer to any problem is usually two or three questions deep and therefore requires a skilled interviewer adept at probing.

The quantitative research is conducted via surveys - among a sample of customers' information providers and the information from a sample is extrapolated to the entire population.

Initial Meeting Conduct a meeting with company management. In a merger, acquisition or investment scenario, consultants meet with the target company management in order to clarify the due diligence process, the issues that should be addressed, and the meetings and site visits that need to take place. The team makes the initial requests for information needed, such as business plans, forecasts, financial statements, sales and profit breakdown, market data, transportation records, customer lists, technology specifications, and supplier contacts.

Meetings, Site Visits, Analysis and Communication After the meeting, the team conducts the rest of the process that has been specifically designed for this transaction or analysis. Interviews are conducted. For example, suppliers and customers are discreetly interviewed as to their perceptions of the company's products and services and its position alongside competitors. Collect and examine relevant information. The team works through methodologies to identify issues that may need to be brought to attention and that require further investigation.

Adopt a unique methodology for collecting critical to quality data by preparing specific questionnaires and interviewing key customer Personnel.

Data Analysis phase:

This stage involves analysis of the collected data and arriving at a conclusion based on critical factors like business criticality, functional complexity, technical complexity, Infrastructure requirements etc.

In life, there are no clear cut solutions. Similarly once the due diligence team has been through the process of rigorously examining an organization and its leadership; it will realize that there are no consistent set of findings .In reviewing due diligence findings, the team may uncover some issues that lead to a favorable impression of the organization and others that cause concern. There might be few red flags too.

During the course of due diligence, the team will understand the organization's financial health, its capacity to deliver in future, its reputation and its approach to working. The team will get a perspective on the leadership of the organization.

The analysis of due diligence findings is generally a weighing of a variety of factors in order to determine whether team should give a positive recommendation. All the factors need to be considered and the organization should balance them to arrive at a decision.

IV. Report Finalization Phase

- Once all the interviews and site visits have been completed by the due diligence team and all of the accompanying analyses performed, formalize finding into final presentation and final deliverables.
- The due diligence team prepares due diligence report and presents its conclusion that becomes an integral component of the decision-making and negotiation processes.

Section V: How to Select a Due Diligence Consultant

Due diligence may be done by your house staff or can be outsourced to a consultant having expertise in due diligence and corporate investigations. One gets the benefit of experience, expertise and objectivity when work is outsourced. A good due diligence consultant can help you make better business decisions, protect you from liability, and increase your transaction success rate. But first you have to select a firm that understands your requirements and can handle the job right.

Objectives

The most important thing is to make sure that first the organization defines its expectations from the process of due diligence. Once the objectives are clear it will be easier to communicate it to a prospective consultant.

Size of the consulting firm

The size of the consulting firm doesn't matter. You should look into experience, ability, knowledge of specific industry and technology. And then decide whether the firm's staff is dedicated and passionate about your objective. The consultant who is on the same wavelength as you and does a good job at a reasonable price is the one for you.

Multi-Functional Expertise

Try to pick a firm which has expertise in multiple fields so that they can give you the big picture and unearth inter functional issues. If you use one firm for technical due diligence, another for logistics due diligence, and yet another for financial due diligence, then they will have a very narrow field of vision and greatly limit their ability to identify the most important issues.

Consider an End-to-End Provider

Post-transaction integration planning starts along with due diligence exercise. Given the intimate knowledge that the due diligence team gains from its work, it's a no-brainer to involve them in post-transaction integration planning, which is critical for success. Accordingly, pick a firm that not only does due diligence consulting but also can form, implement and accelerate a comprehensive post-transaction integration plan that will ensure your business goals are achieved.

Be Wary of Conflicts of Interest.

Certain firms may have a conflict of interest and you should be wary of this. An accounting firm that performs due diligence consulting work, for example, may want a transaction to proceed because they will get auditing work if it does. Pick a firm that is completely, totally and unequivocally objective.

Avoid "Casual" Due Diligence Consultants

Some firms may profess to do due diligence consulting but it isn't something they've dedicated their professional lives to mastering. For example, a law firm may review contracts for you but may not have the specific industry or business knowledge to

properly identify critical due diligence issues. A systems integration firm or research organization may opportunistically announce they have a due diligence practice to create a new revenue stream without ever really understanding what it takes to do due diligence well. Pick a firm that is dedicated to achieve operational excellence in the area of due diligence.

Secure Long-Term Relationships With Your Consultant.

The ultimate consulting relationship is a highly productive one, in which there are no inefficient communications between you and your consultant and there is an implicit understanding of and trust in each other. Hence, when you do find a good consultant, nurture that relationship for the long term so that the due diligence efforts are constantly excellent.

Prepare for the Meetings

Arrange for meetings with the due diligence consulting firms. Share your objectives with them before you meet with them. Then see how well they tailor their presentation to you. The best firms are always thinking about you, not about themselves. If they come in and generically toot their horns about themselves but never give any sign that they've researched your business and your transaction, with an eye to meeting your objectives, that's a very bad sign.

If you are evaluating multiple consulting firms at the same time, inform them of their competition. They often will give you some insights on their competition. Take those insights with a grain of salt, and give high marks to those who take the high road and don't disparage their competition.

Finally, some words of wisdom on soliciting firm presentations:

- Provide the firms with relevant background materials. If necessary, have the firms sign a non-disclosure agreement.

- Be sure to schedule the presentations within as short a timeframe as possible so you can compare and contrast them better.
- Let the firms know who the decision-makers are within your organization and be sure they attend all presentations.

How Can You Tell Who Will Perform Well For You?

Getting a sense for who will deliver the goods isn't rocket science. After you've met with the consulting firm, you get a sense for their breadth of practice areas, abilities, service levels, and professionalism.

In general, you want smart people working for you. The good ones will raise issues or ideas that you haven't even thought of yet.

Beyond that basic intelligence criteria, look for people with passion, who work around the clock, and who can communicate well.

How Formal Should the Evaluation Be?

This is a matter of personal preference. You may want to formally evaluate and score the consultants against a checklist or, if time is of the essence (which it usually is); you may want to go with your gut after thinking through a few key questions. Do their people seem to be of high quality? Is there a good cultural fit between the two organizations? Do they impress you? Have they done good work for other clients? Do they seem to have the right number of resources available to service you well?

Making the Decision

Talk it through and make a decision.

Avoid analysis paralysis. The longer you don't have a due diligence consulting firm up and running, the more you risk missing out on discovering important information that could affect whether you pursue the transaction or influence negotiations. In a perfect

world, when a new transaction materializes, you have the relationship in place already and start-up lead times are close to zero.

Documentation

Getting the most out of your due diligence consultant often hinges on the relationship you formally draft in the agreement.

It's tempting to do a one-off agreement. But the record indicates that you'll get best results with a longer-term contract. That's because the due diligence firm knows you'll be with them for a while and, frankly, that means a lot to them. They'll invest more resources and more effort if it's a long-term marriage rather than a short-term blind date. They'll assign their best people to your account on a dedicated basis.

Here's what we recommend. Commit to a certain number of consulting hours over the course of a year-long contract. Make sure that you get a better rate for having committed to giving the company some guaranteed work.

Section VI: Conclusion

The conclusion of the financial due diligence review should provide an overall evaluation of the viability of the target business following the proposed acquisition. The due diligence reports will form a valuable tool for the new owners of the business in providing an overview of the business and identification of areas of weaknesses and threats which will have to be addressed.

Each due diligence review is unique but the overall aim is to provide the investor with sufficient, relevant and timely information in order to assist in the investment decision. The due diligence exercise is not simply a number crunching exercise but involves collation of strategic non financial information which is likely to be crucial in the overall investment decision.

The successful performance of a due diligence investigation is dependent upon the scoping, co-ordination and planning of the review and the use of a highly skilled team. The cost of the preparation of a quality due diligence exercise is insignificant when compared to the cost of a bad acquisition.

Annexures

Annexure 1- Documents to be obtained from Target Company

I	<u>Corporate Records</u>	Checked by	Reviewed by	Observations
1.1	Certificate of Incorporation, Memorandum & Articles of Association, including any amendments.			
1.2	Bye-Laws, operating agreements, partnership deed, including any amendments thereto			
1.3	Minute Books, resolutions for Shareholders, Members, Board of Directors and any committees of the above			
1.4	Schedule of officers, directors and committees of the Board of Directors			
1.5	Stock Book and Stock Ledgers			
II	<u>Shares and securities</u>			
2.1	Shareholder agreements, proxies, and similar agreements			
2.2	Agreements to purchase or re-purchase any class of security			
2.3	Agreements relating to preemptive rights for any class of security			
2.4	As of the most current date, the following			

	<p>information:</p> <p>(a) Number of, and record ownership of, outstanding shares (common and preferred);</p> <p>(b) Number of shares held in treasury;</p> <p>(c) Options, warrants and other rights outstanding, including detail of holders, exercises, unexercised, vesting schedules, and</p> <p>(d) Ownership by officers, employees and directors.</p>			
2.5	Stock option plans and stock option, warrant and other similar stock purchase agreements			
2.6	All applications for issuance/transfer of securities,			
III	Location & property			
3.1	List of jurisdictions (domestic and foreign) where the Company is (or should be qualified) to do business.			
3.2	Schedule of locations (by address, city, state and country) at which the Company has offices, conducts business or stores inventory or equipment.			
3.3	Schedule of leases and subleases for property and facilities, including location, area, rent and lease term and renewal options.			
3.4	Schedule of material suppliers and other third party service providers.			
3.5	Schedule of property, key man, liability,			

	and worker's comp insurance policies (including current and pending insurance carrier, policy limits, deductibles, and other special arrangements), and copies of all such insurance policies and contracts.			
3.6	Schedule of owned property			
IV	<u>Intellectual Property</u>			
4.1	Schedule of owned or proprietary technology (including software, databases and systems).			
4.2	<p>Schedule and copies (if applicable) of the following :</p> <p>a) trade names, brand names, trademarks, logos and slogans;</p> <p>(b) patents, patent rights, innovations and designs;</p> <p>(d). copyrights;</p> <p>(e) trade secrets and other industrial property rights, including all processes, know-how, technical data; and</p> <p>(f) Registrations, applications, additions, and other filings related to the foregoing items.</p>			
4.3	Schedule of all material ongoing or planned software, databases and/or network development projects.			
4.4	Schedule of third party intellectual property sold, licensed or otherwise distributed by the Company.			
4.5	Product documentation and manuals for			

	the Company's software, databases and networks.			
4.6	Schedule of software authors and other creators of the Company's software products and other intellectual property.			
4.7	The name(s), address (es) and phone number(s) of person(s) responsible for application, maintenance and protection of trademarks, copyrights, patents and other intellectual property rights.			
V	Contracts & Agreements			
5.1	Agreements with customers and clients warranties and guaranties			
5.2	Consulting, development and work-for-hire agreements with, or for and on behalf of, customers and clients			
5.3	Marketing agreements -- distributorships, sales representatives, franchises and agreements.			
5.4	Agreements with employees, independent contractors or other third parties			
5.5	Leases with respect to tangible personal properties (including equipment).			
5.6	Non-competition, exclusivity and non-solicitation agreements, in favor of the Company or by which the Company is bound, or by which the Company's key employees or consultants may be bound to third parties			
5.7	Confidentiality and non-disclosure agreements, in favor of the Company or by which the Company is bound.			
5.8	Employment (including incentive and severance) agreements, agency and			

	independent contractor agreements.			
5.9	Indemnification agreements for the benefit of officers, directors and employees.			
5.10	Agreements or arrangements with management, employees, shareholders and other affiliates (including any loans or management fee arrangements), or with which any of them have a relationship			
5.11	Outstanding agreements or commitments for capital expenditures			
5.12	Agreements with investment bankers, brokers and similar advisors.			
5.13	Inter company agreements			
5.14	Leases and subleases			
5.15	Contracts, or options to purchase, sell or lease real property.			
5.16	Loan agreements, lines of credit, other debt instruments, including notes payable and guarantees (by or in favor of the Company), and any other agreements collateralized or secured by the assets			
5.17	Agreements relating to past, current or proposed mergers, acquisitions or dispositions, including transactions involving subsidiaries, divisions, product lines and other substantial assets.			
5.18	Powers of Attorney			
5.19	Other material agreements to which the Company is bound or which are necessary for the conduct of the Company's business			
VI	<u>Personnel and Employee Benefits</u>			
6.1	Schedule of officers, directors, employees, independent contractors and consultants, and their respective titles, length of service, current compensation and benefits, and			

	contractual severance obligations.			
6.2	Schedule of employee benefit plans, including pension, bonus, commission, profit-sharing, stock option, deferred compensation, incentive, retirement, medical, disability, salary continuation, executive benefit, fringe benefit, management perquisites or golden parachute			
6.3	Policy and personnel manuals, including policies and procedures with respect to vacation and sick time, harassment and equal opportunity.			
6.4	Management perquisites or arrangements, contracts or loans between the Company and any shareholder, officer, director, employee or consultant or any entities or persons with which such persons have a relationship			
7	<u>Regulatory Matters</u>			
7.1	Filings, registrations, reports and correspondence filed with local, state or central regulatory agencies and any reports issued by such agencies			
7.2	Governmental licenses, permits, approvals and authorizations necessary to conduct business			
7.3	Expert compliance procedures or manuals			
8	<u>Litigation and Other Disputes</u>			
	Schedule and details of pending or threatened litigation, claims and other disputes.			
	Schedule and details of government or regulatory proceedings, inquiries or			

	investigations			
	Judgments, injunctions or other orders			
	Settlements			
9	<u>General Financial Information</u>			
9.1	Previous (up to 3 years if available) annual audited / unaudited financial statements as well as interim period (monthly / quarterly) for current year			
9.2	.Current prospective financial data (i.e., budgets / forecasts) with detail of assumptions.			
9.3	External and internal auditors' reports (annual and quarterly), permanent files, management letters and regulatory examination reports received / issued in the last 3 years.			
9.4	Consolidating general ledger or trial balance for detailed accounts for the latest 2 fiscal years, current year quarters and current period.			
9.5	Schedule of prepaid expenses and other assets			

Annexure 2- Sample Engagement letter

CS RAO & CO.
 CHARTERED ACCOUNTANTS

CONFIDENTIAL

May 15, 2XXX

Mr. S. Krishnan
Navtrix Corporation
President, CEO and Director
117, SV Road.
Mumbai, 400025

Dear Mr. Krishnan,

This letter shall confirm the engagement of CS Rao &Co. ("Advisor") as the exclusive financial advisor to Navtrix Corporation ("Company") to perform due diligence and post acquisition/merger advisory services as the Company and the Advisor may agree upon in writing. The Company, as defined herein, shall include Navtrix Corporation, its subsidiaries, affiliates and any entities it may form, merge into, be acquired by, or investing.

The term of this agreement ("Agreement") shall run from the date of receipt by Advisor of the Company's signed acceptance of this letter, until two months thereafter, and may be extended by mutual written consent of the parties or cancelled pursuant to the terms hereof ("Term"). This Agreement may be cancelled by either party as provided in the paragraph entitled "Termination of Agreement".

TRANSACTION:

The due diligence services will be performed by the Advisor of the following types of Transactions with the target entity. The term "Transaction" shall include, but not be limited to:

- a strategic alliance (a "Strategic Alliance") that involves an agreement with the target company that may, either directly or indirectly, enter into any type of sales, marketing and/or management agreement with the Company;

- the sale of the target company (a "Sale" or "Merger"), whether by merger, stock sale or sale in one or more transactions, of all or substantially all of the assets of the target company to the Company;
- a strategic acquisition (an "Acquisition") pursuant to which the Company consummates a merger, consolidation or other business combination with the target company, where the Company is the surviving entity (or its shareholders own a majority of the equity in the surviving entity) in such business combination, or

The Company acquires a majority of the total equity ownership of a Covered Party, or all or substantially all of the assets of a Covered Party.

DESCRIPTION OF SERVICES:

The Advisor will, to the extent requested by the Company, assist the Company in analyzing potential Transactions according to the terms and conditions of this letter. In this regard, the Advisor may undertake certain activities on behalf of the Company, including the following:

- a) Develop greater depth of understanding of a target company in terms of current and expected business.
- b) Obtain requisite information from external and internal sources to meet the objectives of due diligence
- c) Review the financial criteria (e.g., years to payback, return on invested capital, the sales growth and internal rates of return).
- d) Comprehensive evaluation of potential risks (e.g., incompatible technology, financial liabilities and flight of key professionals).

- e) Determination of how the target company's customers /vendors view their experience with the target company.
 - f) Understanding how the customers and prospects are likely to react to the acquisition
 - g) analyzing Transaction options available to the Company;
 - h) Uncover any potential red flags with regard to internal control, compliance with laws and regulations, presentation of financial statements and expectations that could influence negotiated terms in an acquisition
 - i) counseling the Company as to strategy and tactics for effecting a potential Transaction;
- j) Calculating the actual cost of acquisition.

EXCLUSIVITY:

The Company agrees that no other financial advisor is or will be authorized by it during the Term of this Agreement to perform services on the Company's behalf of the type which Advisor is authorized to perform hereunder. No fee payable to any other financial advisor either by the Company or any other entity shall reduce or otherwise affect the fees payable hereunder to Advisor, except as otherwise agreed to in writing by Advisor.

CONFIDENTIALITY:

The Advisor agrees that, without prior written consent, it will not disclose, and will not include in any public announcement, the name or names of any investor, buyer, or strategic partner, unless and until such disclosure is required by law or applicable

regulation, and then only to the extent of such requirement, and that too after it has received approval from the other party.

CLOSING:

The Closing of a Transaction shall occur on the earlier of execution of all material legal documentation or the transfer (if applicable) of funds. The Company has no obligation to Advisor to accept or close any proposed Transaction.

INFORMATION FURNISHED BY THE COMPANY:

The Company will furnish Advisor with all financial and other information and data as Advisor believes appropriate in connection with its activities on the Company's behalf, and shall provide Advisor full access to its officers, directors, employees and professional advisors. The Company agrees that it and its counsel will be solely responsible for ensuring that the Transaction complies in all respects with applicable law.

The Company represents and warrants that any material delivered to Advisor at all times through Closing, will not contain any untrue statement of material fact or omit to state any material fact required to be stated therein or necessary to make the statements contained therein, in light of the circumstances under which they were made, not misleading.

The Company will promptly notify Advisor if it learns of any material inaccuracy or misstatement in, or material omission from, any information theretofore delivered to Advisor. The Company recognizes and confirms that Advisor, in connection with performing its services hereunder, will be relying without investigation upon all information that is available from public sources or supplied to it by or on behalf of the Company or its advisors, The Company will also cause to be furnished to Advisor at the Closing copies of such agreements, opinions, certificates and other documents delivered at the Closing as Advisor may reasonably request.

WAIVER OF CONFLICTS:

The Company recognizes that Advisor is being engaged hereunder to provide the services described above only to the Company and to all other parties, if any, who execute this Agreement in specified other capacities and is not acting as an agent or a fiduciary of, and shall have no duties or liability to, the equity holders of the Company or any third party in connection with its engagement hereunder, all of which are hereby expressly waived. No one other than the Company (and such other parties in such capacities, if any) is authorized to rely upon the engagement of Advisor hereunder or any statements, advice, opinions or conduct by Advisor.

FEES AND EXPENSES:

With respect to the services rendered hereunder, the following describes the fees and expense reimbursements that the Company agrees to pay the Advisor:

- a) A retainer fee of Rs.xxxxx per month, with the first installment payable upon the execution of this letter. The Company may credit the retainer amounts paid to the Advisor against any fees it becomes obligated to pay Advisor under this Agreement. This retainer may be cancelled by the Company, after giving the Advisor 30 day's written notice. In the event that the Company proceeds with the transaction during the Term, the Company will pay the Advisor, immediately upon Closing of any Acquisition, a Transaction fee according to SCHEDULE A attached.
- b) The Company agrees to immediately reimburse any out of pocket expenses incurred by the Advisor during the Term of the Agreement, whether or not a Transaction is consummated, including, but not limited to legal, consulting, travel, lodging and due diligence expenses. Individual Advisor expenses in excess of Rs. xxxx shall require the prior written approval of the Company. On a month to month basis, the Company will immediately reimburse the Advisor

for all expenses related to arranging a Transaction, or other services provided described.

- c) In the event that Advisor's fees, costs or other compensation, are not paid on the due date, or the date of Advisor's invoice, if any, there will be an additional charge at a monthly rate of x percent or such lesser rate mandated by law,.

TERMINATION OF AGREEMENT:

Except as otherwise provided for herein, this Agreement may be cancelled by either party at any time prior to the end of the Term, effective upon thirty (30) days prior written notice to either party.

JURISDICTION:

All lawsuits, hearings, arbitration or other proceedings be subject to jurisdiction in Mumbai. The parties irrevocably waive any objections they may have based on improper venue or inconvenient forum in Mumbai

MISCELLANEOUS:

All payments and reimbursements of expenses payable hereunder shall be made in Indian Rupees in immediately available funds. This Agreement contains all of the understandings between the parties hereto with reference to the subject matter hereof. No other understanding not specifically referred to herein, oral or otherwise, shall be deemed to exist or bind any of the parties hereto and any such understandings, oral or otherwise, not specifically referred to herein shall be merged into this Agreement and superseded by the provisions hereof. No officer or employee of any party has any authority to make any representation or promise not contained herein. This Agreement cannot be modified or changed except by a written instrument signed by each party hereto.

INDEMNIFICATION:

Recognizing that Advisor, in providing the services contemplated hereby, will be acting as representative of and relying on information provided by the Company, the Company agrees to the provisions of Attachment A hereto.

It is specifically understood and agreed that the indemnification provisions of Attachment A shall be binding on the successors and assigns of the parties hereto and of the indemnified parties, specifically including the continuing corporation after any Transaction and any successor thereto whether by subsequent merger, consolidation or transfer of all or substantial part of the assets or business of the Company or such continuing corporation.

If this meets with your approval, please indicate your acceptance of the above by signing where indicated below and returning this letter and the original by mail to the undersigned.

Thank you for the opportunity to be of service.

Sincerely,

/s/ G. S. Rao

Partner

CS Rao &Co

AGREED AND ACCEPTED:

The foregoing accurately sets forth our understanding and agreement with respect to the matters set forth herein.

Navtrix Corporation

By: /s/ S. Krishnan

Title: CEO

Date: 5-15-XX

SCHEDULE A

Transaction Fees schedule

INDEMNIFICATION - ATTACHMENT A

The Company shall indemnify and hold harmless the Advisor and its respective directors, officers, agents, employees, affiliates and representatives (collectively the "Indemnified Persons" and individually an "Indemnified Person"), to the full extent lawful, from and against any losses, liabilities, claims or damages, including reasonable fees and expenses of legal counsel, related to or arising out of the Advisor's engagement hereunder or the Advisor's role in the Transaction contemplated hereby, including any losses, liabilities, claims or damages arising out of any statements or omissions made in connection with the transaction contemplated hereby; provided, however, that such indemnity shall not apply to claims which are determined by a final judgment of a court of competent jurisdiction to have resulted directly from the fraud, gross negligence or willful misconduct of an Indemnified Person. No Indemnified Person shall have any liability to the Company for or in connection with this engagement, except for any which are determined by a final judgment of a court of competent jurisdiction to have resulted

directly from the fraud, willful misconduct or gross negligence of the Indemnified Person. Notwithstanding any other provisions hereunder, in no event shall the Indemnified Persons be liable to the Company for an amount greater, in the aggregate, than the cash fees actually received by the Advisor hereunder.

If any action is brought against any Indemnified Person in respect to which indemnity may be sought against the Company, or if any Indemnified Person receives notice from any potential litigant of a claim which such person reasonably believes will result in the commencement of any action or proceeding, such Indemnified Person shall promptly notify the Company in writing.

Failure to notify the Company of any such action or proceeding shall not, however, relieve the Company from any other obligation or liability, except to the extent that the Company demonstrates that defense of such action is materially prejudiced by this failure. In case any such action or proceeding shall be brought against any Indemnified Person, the Company shall be entitled (at its own expense) to participate in such action or proceeding with counsel of the Company's choice, or to compromise or settle the action or proceeding, at its expense

Notwithstanding the Company's election to assume the defense of any action or proceeding, the Indemnified Person shall have the right to employ separate counsel and the Company shall bear the reasonable fees, costs and expenses of this separate counsel.

Under no circumstances, however, will the Advisor be obliged to make any contribution to any expenses described in this paragraph which is greater than the amount of cash previously received by Advisor for its services to the Company.

These indemnification provisions shall (i) remain operative and in full force and effect regardless of any termination or completion of the engagement of the Advisor; (ii) inure to the benefit of any successors, assigns, heirs or personal representative of any Indemnified Person; and (iii) be in addition to any other rights that any Indemnified Person may have at common law or otherwise.

AGREED AND ACCEPTED:

The foregoing accurately sets forth our understanding and agreement as pertains to the Agreement dated May 15, 2XXX

NAVTRIX CORPORATION

By: /s/ S. Krishnan

Title: CEO

Date: 5-15-XX

Annexure 3: Sample due Diligence Report

ABC Limited

Due Diligence Report

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Letter to the Board of Director, Y Limited

Significant Findings

A. Review of Net Liabilities Statements

B. Share Capital

Appendix 1: Group Structure

Appendix 2: Organization Chart

Appendix 3: Profit and Loss Projection

STRICTLY PRIVATE AND CONFIDENTIAL

The Board of Directors

Y Limited

Mumbai

17 December 2XXX

ABC Limited (“ABC”)

Due Diligence Exercise

Dear Sirs,

In accordance with the engagement letter dated 26 October 2XXX, you engaged us to perform due diligence on ABC and its subsidiaries. The engagement is conducted in accordance with the terms mentioned in the engagement letter. We have performed the necessary work and hereby report our findings to you as follows.

Terms of Reference

Our report has been prepared solely for the use of the directors of the XY Limited. It is the property of the author. The report should not be otherwise referred to, in whole or in part, or quoted by expertise or reference in any manner, or distributed in whole or in part or published or copied to any third party without our prior written consent.

The scope of the work has been limited to the purpose of our engagement detailed in the engagement letter dated 26 October 2XXX

.

Places Visited and Sources of Information

We have visited the Group’s offices at Unit A & B, 41, SDF Bldg 4, SEEPZ, Andheri, Mumbai and 70 D, Hosur Road, Bangalore. We have held discussions with, and obtained information from Mr. M Bole, the Chief Executive Officer of ABC, Mr. G. Singh, the Director – Finance and Relationship Manager of State Bank of India, their principal banker. In addition, we have checked the regulatory filings with SEBI and ROC.

Verification

In completing our work we have relied on the integrity of the information and data supplied to us. We have not independently verified the information or documentation provided to us unless expressly stated in the report.

Projections

We have made the projections based on underlying assumptions provided by the management .we cannot or do not explore the technical aspects of business decisions and their calculations. The assumptions are the sole responsibility of the directors of the Group. We have reviewed some major contracts but some deals are still under negotiation, and we accept no responsibility for any of them, or the ultimate accuracy and realization of the projections. Furthermore, there is a high probability that there will be differences between projected and actual figures, due to changed circumstances, and those differences may be material.

Disclaimer

Since it s a part of our job to look for possible issues, we highlight the negative aspects. In spite of detailed research and analysis risks cannot be eliminated and all business and investment decisions contain some amount of risk.

We do not claim that we can or have uncovered all possible issues.

This report is issued on the understanding you have drawn our attention to all matters of which you are aware concerning the company's financial position or the proposed transaction which may have an impact on our report up to the date of signature of the finalized report. The fieldwork for this report was completed on November x, 2XXX and we accept no responsibility for events and circumstances occurring after that date or of updating the report.

Limited Review Report

This is only a limited review report, the scope of the work being confined to the areas specified in the engagement letter. Further, the scope of our work has been limited by the time available and you should not rely on our work as being comprehensive.

Accordingly, we do not, and cannot represent that the procedures have been sufficient for your purposes.

Matters Excluded

There are other areas, such as,

- 1 1. issues of law (including without prejudice to the foregoing, validity and effectiveness of contracts, licenses, title deeds including those for property, investments and stock, encumbrances, and all matter relation to product liability);
- 2 2. valuation of fixed assets both tangible and intangible
- 3 3. valuation of work-in-progress;
- 4 4. regulatory issues; and
- 5 5. Legal and other specialist areas where RS Associates do not have expertise which may be relevant and which are outside the scope of our review.
- 6
- 7 You should consider whether to obtain expert advice in relation to these areas.

Yours faithfully,

For and on behalf of

RS Associates

Mr. R. Laha, CA

Significant Findings

During our review of relevant documents and accounting records, we have noted the significant findings about the Group as follows:

1. Going Concern Consideration

ABC Limited is now incurring heavy losses. The company depends on borrowed funds to finance its funds. Bank overdraft facility is used to the maximum limit. According to the

profit and loss projection prepared by ABC the company is not expected to make any profits for the next two years.

Therefore, the continuity of the Company is heavily dependent on the immediate injection of capital and the continuous support from the bankers of the Company.

2. Intangible Assets

A major portion of the assets comprise of development cost incurred on <product name> which has not yet been released in the market. The potential economic benefit of the product is not known and we find the inclusion of such assets in the financial statements as questionable. A substantial portion of the development costs was paid to 'APR' company .However, no details have been provided on services provided by the company. The company is not a listed company and even after making some preliminary inquiries we have been unable to find any information on the company.

3. Competitive advantage:

The company stated that its key competitive advantage is being “first to market”. However, this does no indicate a lasting competitive advantage. Likewise, their statement that their <type of service> “cannot be duplicated” doesn't sound convincing .If there is a strong market, providers will emerge.

4. Banking Facilities

Banking facilities was granted by Bank of <name>. The bank has a floating charge on all accounts receivables, cash and bank deposits of the Company. The bankers have to be provided with the audited accounts of the Company within six months after the end of each financial year.

5. Founders and officers

In our limited review, we did not find any issues in this area. We did not find any conclusive evidence that any of the principal persons have any problematic records. We have no done thorough background checks .We have however, devoted fair amount of

time looking and have come up with nothing which gives a reasonable degree of comfort. If desired, we can do a thorough background check

6. License for the operation of <product PRO>

As represented by the management of the Company, the success of ABC depends on its market for its newly launched product PRO. Up to now, the Company has not registered any patent or copyrights for PRO. Also, the Company did not obtain any significant licenses or rights for the development. Any abnormal changes in the government policy on this area will likely hamper the business development of the Company.

ABC LIMITED

DUE DILIGENCE REPORT

A. Review of Net Liabilities Statement

We have reviewed the Net Liabilities statement of the Group as at 30 September 2XXX and 31 March 2XXX as follows:

	30 Sept Rs.(‘000)	31 March Rs.(‘000)
Fixed Assets	1,690	2,246
Intangible Assets	20,436	20,436
Current Assets		
Work-in-progress	2,528.00	2,737.00
Trade and other receivables	1,625.00	521.00
	4,153.00	3,258.00
Current Liabilities		
Bank overdraft	18,405.00	17,476.00
Trade and other payable	1,658.00	2,602.00
	20,063.00	20,078.00
Net Current Liabilities		
Long Term Liabilities		
Shareholders’ Loan	13,392.00	9,311.00
Net Liabilities	7,176.00	3,449.00

1. Fixed Assets

	30 Sept	31 March
	Rs.(‘000)	Rs.(‘000)
Leasehold assets	264	341
Plant & machinery	300	308
Furniture and fixture	201	220
Office equipment	279	352
Motor vehicle	149	175
Computer hardware & software	497	850
	1,690	2,246

As discussed with the directors, there were no material additions and disposals during the six month ended 30 Sept 2XXX. The only fluctuation in book value of the fixed assets represented the depreciation charges for that period.

2. Intangible Assets

	30 Sept	31 March
	Rs.(‘000)	Rs.(‘000)
Opening balance	20,436	17,236
Addition during the year or period	-	3,200
Closing balance	20,436	20,436

As represented by the Management, the intangible assets is mainly the capitalization of the development cost incurred on <product name> which has not yet been released in the market. An intangible asset arising from development should be recognized if and only if the company could demonstrate all of the following:

- 1 1. The technical feasibility of completing the intangible asset so that it will be available for use or sales;
- 2 2. Its intention to complete the intangible asset and use or sell it;
- 3 3. Its ability to use or sell the intangible asset;
- 4 4. How the intangible asset will generate probable future economic benefits. Among other things, the enterprise should demonstrate the existence of a market for the output of the intangible assets or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset; and
- 5 5. Its ability to measure the expenditure attributable to the intangible asset during its development reliably.

Basing on the above information, the recognition of the intangible assets will have the following potential problems:

- 1 1. Recognition of an intangible asset is highly depends on the generation of probable future economic benefits from this assets. According to the latest profit and loss projections, the company will have difficulties in generating such amount of future economic benefits in the foreseeable future. Amount to be capitalized should be limited to the benefits that can generated in the projections;
- 2 2. The intangible asset should not be carried at an amount permanently. The amount should be amortized to the profit and loss account as a cost against the revenue generated from the asset. Therefore, the company should amortize the cost of assets to the profit and loss account for a reasonable period;
3. During our visit to ABC, we found that a substantial portion of the development costs was paid to 'APR' company .However, no details have been provided on services provided by the company. The company is not a listed company and even after making some preliminary inquiries we have been unable to find any information on the company. We have asked the directors Mr. <> and Mr. <>. But up to the date of this report, they have not provided the details of these payments.

B. Share Capital

Number of ordinary shares of Re1.00 each issued and fully paid as at 30 Sept 2XXX	4,699,800,000
Nominal value	Rs.4,699,800,000
Share premium	Rs.23,057,040,000

1. List of Shareholders

As at 30 Sept 2XXX, the shareholders of the company are as follows:

	Number of shares	% holdings
SD	1,518,768	32.32%
FR	529,764	11.27%
Mr. Bole	225,200	4.79%
RT	1,760,320	37.46%
KL	665,748	14.16%
	4,699,800	100.00%

2. Pre-emptive rights

There are no provisions for pre-emptive rights under the Company's Articles of Association, which would oblige the Company to offer new shares on a pro-rata basis to existing shareholder(s).

3. Share option scheme

As at the date of this report, the Company did not enter into any agreement for granting options to subscribe any shares of the Company.

4. Directors

As at the date of this report, the lists of Directors are as follows:

Mr. <>

Ms. <>

Mr. <>

Mr. <>

Appendix 1: Group Structure

Appendix 2: Organisation Chart