

ORIGINATION OF DUE DILIGENCE AND SCOPE OF ITS APPLICATION

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Abstract

Companies that develop in international public space, with traditional financial analysis, where various financial coefficients from the balance sheet, profit and loss account and cash flow statement are analysed, remain less and less. In order to assess a financial condition and results of economic activities and its development trends, it is necessary to use different methods of analysis. By using the methods of analysis of due diligence, a wide range of sources of information is used and from the result of the analysis one can obtain both qualitative and quantitative indicators, which are the basis for creditors and potential investors in decision-making.

The aim of the article is to explore the theoretical aspects of due diligence and develop proposals for its use in business environment. The article explores the essence of due diligence and origination of its history, forms of due diligence and major components that are significant for each group of users of analysis. The author examines in detail the procedures of due diligence and reveals the differences from audit procedures. The article is prepared on the basis of foreign scientific and economic literature, publications of scientists and materials of international conferences.

Keywords: due diligence, financial analysts, auditors, lawyers.

Introduction

Currently, for an enterprise, which develops internationally, simple financial analysis consisting of financial indices only is not sufficient. To find out the real situation of enterprise, an analysis from various angles is required, not only from the financial one. Therefore the author offers to use due diligence analysis, which gives information about the enterprise from various angles and multiple sources.

Many of us have been asked to perform due diligence assignments late in the acquisition cycle. The most important objective is to identify potential risks not apparent from the offering and to verify information provided by sellers or their representatives.

Executives sponsoring potential acquisitions face an uphill battle with their board, shareholders and peers. Merger and acquisition risks include: paying too much, the inability of the companies to combine in a positive manner, inability to manage the combined company, and surprises. Due diligence assignment is to quantify risks and minimise its consequences. One major challenge is managing buyers' expectations [1].

What is due diligence and history of its origin?

Due diligence – (literally it means assurance of adequate good faith, diligence), is a versatile investigation and inspection of the financial operation of a company and inspection of its situation in a market. This procedure allows finding legal, commercial, financial and operational risks in business.

The term appeared in the USA in 1930s of the previous century and it was related to the requirement for adjustment of relationships between investor and issuer in the securities market.

It should be noted that an issuer is a company, which has issued its securities in circulation. It means that development of a company needs funding. For implementation of the planned one, the fixed capital is increased and new shares or stocks are sold, what also means issue of securities in circulation. However, not all business plans are successful, sometimes losses occur. In such cases, investors who have invested money, i.e., bought securities issued in circulation, began to search for the perpetrator. It would not be correct to shift the blame to the merchant, because any business contains elements of success and risk. Therefore many issues, which defend investors' rights, have emerged:

- Was the investor provided with all required information for assessment of investment risks?

- Was this information correct?
- Was there all the most important information provided?
- Was no information hidden and was no investor deceived?

From these questions it can be established that only from questions, which are posed to parties: issuer and investor, a wide area for disputes and legal proceedings arises [2].

Therefore, to decrease and prevent potential conflict situations between a person, who gave money, and a person, who received it, in Article 11 of the USA Law on Securities of 1933 protection from investors' money requirements against those issuers, who performed independent inspection and reflected information in issue prospect, was determined. From the time, when the respective article in the Law was approved, the identified investigation process in the USA has obtained the title "due diligence", until then the term was not explicitly determined.

According to the decision of the Terminology Commission of the Latvian Academy of Sciences, appropriate translation for the English term due diligence into Latvian was made. The English term has received double translation in Latvian – *pienācīgā uzmanība* (due attention), *uzticamības pārbaude* (inspection of reliability). The respective terms are intended for joint practical usage in official Latvian language, for which agreement was reached between specialists of Legal Bureau of Parliament of the Republic of Latvia, European Integration Bureau, the State Chancellery, the Ministry of Justice of the Republic of Latvia, LU Faculty of Law, Translation and Terminology Centre of the Latvian Academy of Sciences [3].

From the examination of the opinions of several authors it can be concluded that due diligence is directed to versatile inspection of legality and commercial attraction of planned transaction or investment project.

Completeness of information, which arises in the way of *due diligence* inspection, allows investors and business partners to assess all advantages and shortages of cooperation in a more detailed manner.

Due diligence is based on interview data, which is obtained as a result of investigation of internal documents, operative and financial report data, sector specifics and legislation of appropriate field. By analysing the enterprise, it is possible to determine risk zones and to increase attractiveness in the eyes of an investor or potential customer.

In most cases the term is being used in finances and law. Abbreviated forms are **DueD** and **DDG**. Basically the method consists of totality of information analysis, taken decisions and their usefulness, when getting involved in mutual relationships of business partners [4].

Any kind of information is taken into account while collecting information, regardless of origin of sources. Investigation of obtained information is performed by various specialists separately; afterwards the summary analysis is performed.

Several arguments for the performance of due diligence analysis can be mentioned.

Firstly, information that is disclosed by the seller to establish warranties will be the only officially available material for a customer that can be taken into account when making a decision on acquisition of an enterprise.

However, to rely only on warranties and bails is not a good practice. Firstly, the offered protection can be limited or impractical for implementation. Also, in case a seller is openly dishonest, which is not completely known only by accepting warranties and bails without additional investigation, it will be difficult to disclose fraud or other illegalities. Due diligence sometimes can identify suspicious actions.

The second true value of due diligence is what is best characterized with its comfort factor. Everything in this universe is relative. Services of accountants and lawyers can be expensive, but not in comparison with costs of proceedings. In comparison, in terms of costs the application of due diligence is cheaper than legal proceedings, which are implemented in practice. Because of this reason, the majority of customers feel more comfortable by knowing about problems in advance, rather than remaining with an opportunity, although small one, to issue claims of warranty or bail or to start proceedings against a seller after completion of a project.

Due diligence is not simply a tool for discovering black holes, not only for provision of useful information in negotiations. It ensures both, but it also should be used as a tool for longer term [5].

Finally, knowledge is power. *Due diligence* provides an armament for negotiations with potential seller in both ways, physically and psychologically.

Where and for what purposes due diligence method is used nowadays

Generally, a due diligence procedure means performance of comprehensive analysis of a company based on financial analysts, conclusions of auditors and lawyers. In addition, each group of specialists prepares a detailed report on situation in an enterprise for a customer.

The aim of the due diligence procedure is to avoid and minimise the respective business risks (economical, juridical, tax, political, marketing risks). Among the most important risks are:

- risk of enterprise acquisition (shareholdings) on increased price;
- risk of non-execution of enterprise debtor's liabilities;
- risk of property loss;
- risk of creating losses, incl. intangible assets such as reputation;
- risk of legal proceedings and negative consequences;
- risks of seizure and implementation of other security enforcement measures;
- risk of acknowledgement of transaction as invalid;
- risk of application of recovery mark on property, securities (shares);
- risk of prosecution of tax, administrative and criminal liability;
- risk of occurrence of corporative conflicts (occupation, negative undertaking, legal proceedings);
- risk of intellectual property loss (trademarks, industrial samples, inventions, know-how, commercial ideas, business plan, etc.);
- political risks and risk of loss of administrative resource (amendments of legislation, change of officials, on whom the success of project depends on, prosecution);
- risk of unfair competitors' activity (secret agreement with counterparties, initiated inspection of taxes, operative inspection, pricing policy, lobbying etc.);
- risk of non-obtaining respective permissions, licences, agreements, things, from which the project or transaction depends on [6].

Both parties involved in a transaction (customer and seller) are interested in objective and competent performance of these procedures.

As the most typical situations, which characterise *due diligence*, the following can be mentioned:

- purchase of operating business;
- restructuring of company;
- optimisation of costs;
- increase of a company's legal protection;
- expected tax inspection;
- reducing the risks of litigation;
- loss of financial management;
- Involvement of company in new markets [6].

Due diligence allows:

- *For a proprietor*: to check reliability of data provided by management; to ensure on existence/ non-existence of personal responsibility in company operation; to determine value of his/her business;
- *For an investor*: to find weak sides, about which the seller has not been informed; to assess further risks of business operation; to obtain protection from possible negative financial events;
- *For management*: to assess operation of their own accountancy and financial office; to involve tax and financial planning schemes; to obtain recommendations for decrease of financial risks; to improve manageability and transparency of financial risks [7].

The *due diligence* procedure begins in a moment, when a customer starts to plan a purchase of investment object.

The *due diligence* procedure takes from few weeks to a year, depending on structure and amount of business.

Due diligence is obviously only one part of an acquisition or investment exercise. In order to understand where it fits into the overall acquisition process, for convenience, assume the process falls neatly into the four generic categories shown in Figure 1.

Stage one is about identifying an acquisition target and making an approach. This can only be done by sensibly following a proper strategic review in which the acquisition has been identified as a logical strategic tool. If the approach leads to an agreement to take things further, the deal enters the second stage.

The two parties sketch out the broad terms of the deal and the buyer will begin due diligence. Successful due diligence leads to negotiations and, in case of a positive outcome, to completion of a deal. Then the

buyer enters stage four, in many ways the most important stage of all, where the acquisition must be bedded in and made to pay its way [6].

Stage 1.	Stage 2.	Stage 3	Stage 4
1. Strategic review	1. Heads of terms	1. Sale and purchase	1. Post-completion.
2. Systematic search	2. Due diligence	2. Completion	
3. Approach			

Figure 1. The acquisition process [6]

If an approach leads to mutual interest, both parties will want to begin serious negotiations. Heads of Agreement/Heads of Terms/Letter of Intent is the document which records an agreement to negotiate the purchase of a business. It is a non-binding agreement which sets out the main points on which the parties to a transaction have agreed and the basis on which they are prepared to proceed.

As far as the *due diligence* is concerned, the critical thing about signing Heads of Agreement is that there is a deal underway. Drawing up the document usually focuses minds of both parties. The buyer will now have assured the seller of its seriousness, both parties will have decided that there is sufficient agreement between them to continue and both can draw comfort that the deal will proceed, because they can indicate a document setting out the fundamental issues. Due diligence can therefore begin.

Due diligence is not simply a tool to unearth black holes. Nor is it just to provide ammunition for negotiations. It reaches both of these aims, but should also be used as a tool for the longer term.

Due diligence components

Due diligence consists of many components, but it would be good to separate the most important of them: commercial, financial and legal due diligence. These are the three main types, which will most often be addressed prior to making an acquisition, but other areas may be covered as well.

The first group consists of financial analysts (**Financial Due Diligence**), their task is to determine fair value of investment object, to determine range of value for customer in different variants of its future usage [7].

There can be determined value of market, investments and liquidation depending on whether there is bought functioning enterprise for complete re-profiling or for being merged with the client. Financial analysts offer the client several value standards, operating with definite range of prices, for taking decision on enterprise acquisition.

Because the majority of enterprises use audited reports, it can seem a little bit surprising that so much time, efforts, concerns and costs are intended for financial *due diligence* (FDD). It has two reasons. Firstly, opposite to common opinion, the accountancy is not a science. It means that even in audited reports there are a lot of uncertainties, how far the customer is involved:

- all reports are subject to several assessments. Some of them, such as assessment of stocks and depreciation policy, can create large differences in the rate of profitability. Also, the time, when incomes are acknowledged, can differ, depending on accounting policy or assessments. As a result, the tendencies of income can be distorted.
- reports can possibly contain several extraordinary incomes of costs, which distorts profitability of a business, and which should be excluded from calculations [8].

So, one of the main meanings of audited reports is confirmation of what is done by accountants.

According to historical information, financial *due diligence* is tended to future. In the framework of financial *due diligence* various methods of economic analysis are applied. As the main ones can be mentioned:

- analysis of dynamics and structure;
- analysis of creditor and debtor debts;
- structural analysis of income;
- analysis of actual costs and operational costs of structure;
- profitability analysis;
- factor analysis
 - cash flow analysis;
 - analysis of standard registry payments;
 - compliance analysis of financial reports.

A report on the complex assessment of analysed company is the result made by a given group of specialists.

Financial *due diligence* also includes detailed analysis on business specifics, which is obtained from interviews with main specialists of sectors. It is important to emphasise that access to *due diligence* is rather different from procedures of common audit. Because the aim of financial *due diligence* is to explain why the results are what they are, and the analyst has more to do with finding reasons which seem to have negative changes, not like the financial results.

The second group – they are auditors (**Commercial due diligence**) **CDD**, their aim is performance of financial inspection, expertise of company's operation, as well as determination of possible risks [3].

- An enterprise gains benefit not from past achievements, but from ability to create a profit in future. Commercial *due diligence* CDD is intended for assessment of future achievements. CDD receives information from published sources, but, what is more important, from speaking with leading specialists in the same market as the target market is. Traditionally, the commercial *due diligence* has three aims:
- Reduction of risk. A price of enterprise is the ratio of current profit, but, in case further profit can be endangered, if the enterprise is ready to decline from its aims, then customer should know it, and they should agree on lower price correspondingly.
- Helps determine the actual value. Business planning for future ten years is complicated; it is required for prediction of cash flows. Of course, it cannot be done by using previous financial reports only.
- Allows for better planned integration. Weak integration is the main reason why the benefits cannot be obtained. Commercial *due diligence* checks the target markets and trade activities. In doing so, one can establish strong and weak sides which should be taken as the part of integration process [5].

The income and cost analysis of enterprise structure should be completed at this stage, as well as assessment of internal control system, assessment of fixed assets, financial investments, debts of creditors and debtors, reserves; as well as there is performed analysis of credit contracts and liabilities, terms and provisions of liabilities, amount and reliability analysis for assets and liabilities. The final stage of work – determination of potential risks and benefits, as well as disclosure expression of company's taxes, and liabilities in numerical form.

The result of auditors' work is a report of financial expertise.

Commercial *due diligence* is an investigative process of audit markets of companies. The relation between legal and financial *due diligence* is generally poor. As a discipline, which can give the best available forward-looking information on business to the rights hands, it is required for appropriate *due diligence* process. It depends highly on primary sources to obtain the most of new facts on markets and their participants. In ideal case it should search for immediate transactions for future of competition in merged enterprise [6].

Table 1

Essential distinctions between terms audit and due diligence

	<i>Audit</i>	<i>Due diligence</i>
Aim	To check and show true data	To determine the basic profit, to eliminate doubts on controversial points
Focused on	Past. Independent inspection of data to allow providing warranties in relation to fairness and authenticity of financial information.	Past and Future. To analyse and understand why the data is what they are, and to analyse them. To point attention to the main moments.
Sector	Determined by articles of association	Very often is limited only with main issues.
Availability of information	Unlimited	Can be limited
Data	Testing and verification of original data.	On the base of interview data

Table 1 shows the main differences between *audit* and *due diligence*. They have differences in aims, sectors and availability of information, as well as data analysed and performable procedures.

The third group of specialists – lawyers (Legal Due Diligence). Their task is performance of juridical and legal expertise of company with the aim to determine maximal risks, related with acquisition [5].

Lawyers perform investigation of establishment documents, corporative management documents, the main powers and collegial decisions of management organs. They analyse the main transactions with shares, data on shareholders, their property and non-property rights. They also investigated state regulation in operation of company, the main contracts and property rights of company, labour relations and operation of claims-petitions.

For history of company or group establishment the main aspect is focused on such issues as:

- legal purity of transactions with shares/stocks;
- corporative management;
- kinds of business which correspond to special state regulations;
- justification of property rights to fixed assets, unfinished construction, intangible assets, financial investments;
- rights on intellectual property and other intangible assets;
- debtors' and creditors' debt structure;
- security liabilities;
- personnel management, including relationships with trade union bodies.
- juridical disputes and petitions of counterparties, including analysis of possible prosecution [6].

Legal *due diligence* includes many specialisations, as well as several obvious juridical forms, for example, property rights, acceptance to liabilities and discharge from them, and normative issues. The legal firm itself is able to ensure some or all of them. If there are involved also other specialists, lawyers should act in close cooperation with them because it could make important contribution in final agreement. Because of the same reason, even if lawyers ensure all “legal” disciplines, they should cooperate also with other advisors and foreign lawyers where their local consultation is required in cross-border issues. When it comes to reporting, you should ensure they maintain contacts with you during whole time of operation and you should ensure they give summary where the main commercial issues are emphasised. Demand also to show conclusions. Mainly, you should ask and receive opinions.

The result of lawyers' work is report on juridical expertise of company.

The recommendation for the use a due diligence programme is likely to involve a number of different advisers. Even when the target is a business the acquirer knows well, perhaps competing in the same industry and sharing the same distributors, external advice can add a lot of value to a transaction. How much value they add will be heavily influenced by how well due diligence is managed. Planning, coordination and communication are as important as any other input and project management should be given top priority.

Conclusions

1. Initially, the *due diligence* was related to the arrangement requirement of relationships between investor and issuer in security market.
2. Completeness of information, which occurs in the form of *due diligence*, allows investors and business partners to assess all advantages and shortages of cooperation in a more detailed way.
3. *Due diligence* does not have unambiguous translation in Latvian. LZA TK (Terminology Commission of the Latvian Academy of Sciences) accepted the terms – “*pieņācīga uzmanība*” (due attention), “*uzticamības pārbaude*” (inspection of reliability).
4. By investigating *due diligence* from theoretical viewpoint, it can be concluded that it is a tool, which allows:
 - *For proprietor*: to check reliability of data provided by management; to ensure existence/ non-existence of personal responsibility in a company's operation; to determine value of his/her business;
 - *For investor*: to find weak sides, on which the seller has not informed; to assess further risks of business operation; to obtain protection from possible negative financial events.

5. *For management*: to assess operation of their own accountancy and financial office; to involve tax and financial planning schemes; to obtain recommendations to decrease financial risks; to improve manageability and transparency of financial risks.
6. *Due diligence* it is a compliance verification of prepared information. It is a process, which is important for potential investors, company owners and management.
8. The task of financial analysts (**Financial Due Diligence, FDD**) is to determine a fair value of investment object, to determine the value range for customers in different variants of its future usage.
9. The task of auditors (**Commercial due diligence, CDD**) is performance of financial inspection, expertise of company's operation, as well as determination of possible risks.
10. The task of lawyers (**Legal Due Diligence, LDD**) is performance of juridical and legal expertise of a company with the aim to determine maximal risks, related to acquisition.
11. It is useful to investigate the elements of *Due diligence* and opportunities of their application to the analysis of economic activity of a company more precisely.

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