Due Diligence for Foreign Companies in India

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Introduction

Foreign companies looking to do business in India should perform a due diligence check.

During the due diligence examination, the financial, legal, and compliance aspects of the company or business are reviewed and documented. The purpose is to identify if there are any risks or concerns with the business.

Due diligence is usually conducted in cases of mergers and acquisitions, partnerships, joint ventures, and IPO.

It should also be noted that companies in India have to comply with different legal and regulatory compliances, and the tax regime can be difficult to navigate. Therefore, due diligence is required to ensure that the local company is in compliance with all the necessary laws and rules, and has been providing accurate information to the foreign company inquiring about its business.

Through this due diligence process, a foreign company gets access to all the information including the liabilities, reputation, and finances of the business. Once the risks, challenges, and potential opportunities are identified, the foreign entity can decide if it wants to be in business with the company in India.

In this issue of India Briefing, we outline key aspects that foreign companies must focus on when conducting due diligence on an entity operating in India. We analyze the different types of due diligence that foreign companies should consider important while investing in India. Lastly, we answer some frequently asked questions on this topic.

If you and your company are interested in conducting due diligence on a company or business set up in India, please contact Dezan Shira & Associates.

With kind regards,

Rohit Kapur

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Due Diligence for Foreign Companies in India

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Due Diligence in India: What Foreign Companies Need to Know

By Nishtha Yadav

Due diligence refers to the analysis done by investors before an acquisition, investment, or a partnership in order to identify if there are any risks or any concerns with the business.

Due diligence is usually conducted in the case of mergers and acquisitions, partnerships, joint ventures, or an IPO.

Due diligence provides the investors with a complete background information on a business, such as liabilities, discrepancies, reputation, and financial situation of the business that helps investors take an informed decision. There are several types of due diligence including financial, legal, tax, HR and environmental to name a few.

The purpose of due diligence is not to learn everything about the business, but to gather enough information to understand the business opportunity credibly.

Essentially, due diligence performs a Strengths-Weaknesses-Opportunities-Threats (SWOT) analysis to present a holistic view of the business to potential investing companies.

**Conducting due diligence in India**

Simply put, due diligence helps foreign companies decide if they should go ahead with their investment or financial deal, or negotiate terms and conditions further, or withdraw their interest from the deal.

Due diligence in India is recommended for all businesses especially in case of a joint venture.

Ideally, while conducting due diligence in India, companies should review the following points:

1. **Personnel**: The terms and conditions of employment as well as the experience of the staff should be reviewed. Also, review commercial management, including customer care, research and development, and marketing.

2. **Financial records**: This should be one of the focus areas for any foreign company looking to invest in a business, company, or a joint venture. Investors should study the company books and records, accounting, and bookkeeping methods. It is important to understand the debt on the business, and the relationships with banks and lenders, as well as the past and project cash flow of the company.

3. **Services**: Review the products and services offered by the business, with a focus on prices and how it compares to industry standards.

4. **Assets**: Following a thorough study of the financial records, a review of company assets is another important focus area for foreign companies looking to invest in an Indian business. The lease and deeds that company has signed, and the value of property and equipment should be verified while conducting due diligence. Review the company’s property and equipment, including IT systems and technology.

5. **Business operations**: Through due diligence, get an understanding of the company’s location, inventories, suppliers, management, customer relations, and insurance policies.

6. **Legal**: Pending or ongoing litigation can hamper a company’s value and reputation. Therefore, investors should review the company’s litigation, contracts, orders, and environmental issues.

Since India presents a complex economic, regulatory, and legal landscape for doing business, it is essential that foreign companies conduct due diligence when they plan to trade with an Indian company.
Due Diligence in India: What Foreign Companies Need to Know

Understanding the Due Diligence Process: An Example

**Purpose:** To conduct financial due diligence of a joint venture (JV) partner.

**Process time:** Varies as it depends on the scope of the due diligence process, usually it is between four to six weeks.

<table>
<thead>
<tr>
<th>Step</th>
<th>Description</th>
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</thead>
<tbody>
<tr>
<td>Step 1</td>
<td>An initial meeting with the JV partner about the proposed action plan, including meeting with key managerial personnel to start the due diligence process.</td>
</tr>
<tr>
<td>Step 2</td>
<td>Provide a list of requirements and documents to the JV partner that are needed to conduct due diligence.</td>
</tr>
<tr>
<td>Step 3</td>
<td>Visit the company site to understand the operations and processes within the company.</td>
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<tr>
<td>Step 4</td>
<td>Review of documents, such as financial statements for the last three years, balance sheets, accounting books, tax filings and returns, and assessments.</td>
</tr>
<tr>
<td>Step 5</td>
<td>Prepare a final report summarizing key findings, including the valuation of the JV partner and the financial risks of the deal, if any. Along with the report, a business plan is also presented to the client.</td>
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</table>

It should be verified that the business is what it appears to be. This is easily identifiable in the preliminary stage of due diligence; however, in some cases more in-depth due diligence may be needed.

**Scope of due diligence in India**

Scope of due diligence depends on the sector of the company. Like in case of a manufacturing company, the key focus of the due diligence will be around the licenses and approvals obtained by the business, and their operational and environmental compliances. While the due diligence might differ from sector to sector, every process includes evaluation of the company’s financial and legal situation.

Based on investor’s request, due diligence to check if the company was involved in bribery or corrupt practices can also be conducted.

Usually, scope of due diligence revolves around reviewing the following documents:

- Corporate records and filings with the Registrar of Companies (RoC) to check if the company is in compliance with the provisions of the Companies Act, 2013;
- Foreign exchange filings with the Reserve Bank of India (RBI) to ensure that any prior investment was in compliance with the applicable laws;
- Material contracts with customers, suppliers, and lenders to understand the key terms;
- Licenses, registrations, and permits obtained by the company for its operations, and to check their compliance with the applicable laws;
- Pending or ongoing litigations involving the company, including proceedings or investigations by regulator;
- Labor and employment documents such as agreement with employees to check if the company is in compliance with the applicable labor laws;
- Check if the intellectual property of the company is valid and registered; and
- Ancillary documents, including the ones related to information technology, and insurance policies obtained, among others.

**Due diligence process and checklist**

The following documents are needed while conducting due diligence for any business or company:

- Memorandum of Association;
- Articles of Association;
- Certificate of incorporation;
- Shareholding pattern;
- Financial statements;
- Income tax returns and balance sheets;
- Bank statements;
- Tax registration certificates;
- Tax payment receipts;
- Statutory registers;
- Property documents;
- Intellectual property registration or application documents;
- Utility bills;
- Employee records;

**Steps for Due Diligence Process**

<table>
<thead>
<tr>
<th>Step 1</th>
<th>Terms of due diligence</th>
</tr>
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<tbody>
<tr>
<td>Terms of the due diligence are decided between the two parties and a non-disclosure agreement is signed.</td>
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<tr>
<th>Step 2</th>
<th>Operational due diligence</th>
</tr>
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<tbody>
<tr>
<td>Operational information, such as cost structures and manufacturing activities is collected, validated, and documented.</td>
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<table>
<thead>
<tr>
<th>Step 3</th>
<th>Financial due diligence</th>
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<tbody>
<tr>
<td>Financial statements are collected, validated, and documented. This step includes analysis of the revenue, expenses, profitability, cash flow, assets, and liabilities.</td>
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</table>

<table>
<thead>
<tr>
<th>Step 4</th>
<th>Legal due diligence</th>
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<tbody>
<tr>
<td>Legal and regulatory information, such as tax payments, litigations, and intellectual property are collected, validated, and documented.</td>
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<tr>
<th>Step 5</th>
<th>Reporting Information</th>
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<tbody>
<tr>
<td>Results of the due diligence process are shared with the parties.</td>
<td></td>
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</tbody>
</table>
Due Diligence in India: What Foreign Companies Need to Know

• Operational records;
• Bank loans;
• Audit paperwork;
• Existing contracts with clients and staff;
• Lease agreements; and
• Partnership agreements.

Please note that these are only some of the documents that are needed during the due diligence process.

The due diligence process can be exhaustive and extensive.

To start, data can be downloaded from the Ministry of Corporate Affairs (MCA) website, including company's financial information and corporate filings with the ministry.

With a small fee, access to all documents filed by the company with the Registrar of Companies are also available.

Here are some of the documents that can be gathered from the ministry’s website:

• Details of incorporation of the company;
• Certificate of incorporation;
• Authorized and paid-up capital of the company;
• Date of last annual general meeting;
• Information about the directors of the company;
• Secured loans against the company;
• Memorandum of Association; and
• Articles of Association.

Due diligence is not restricted to understanding the finances of the company, but also includes assessment of its operations, intellectual property rights, tax and regulatory compliances, legal situation, and the company’s HR processes.

The process of conducting due diligence usually takes about four to six weeks, but the process might take longer if the investors have any specific requests.

Example for Due Diligence Methodology

1. Research
   - Data collection and review
   - Market research
   - Collect information on the company’s background

2. Interviews and discussions
   - Conduct interviews with employees
   - Conduct interviews with employees from competitive firms
   - Focused group discussions with customers

3. Assess market growth
   - Conduct external interviews
   - Understand customer behavior
   - Study the successful business models within the industry
   - Identify major trends in the industry

4. Summary and recommendations
   - Perception on the industry landscape
   - Suggestions for business plan and set up
   - Identification of risk
   - Risk mitigation strategies

5. Review business plan
   - Consensus on business plan
   - Discuss office set-up (e.g. liaison, LLP, branch, etc.)

6. Stress test corporate strategy
   - Assess the employee and organizational fit within the business strategy
   - Review if marketing and other financial strategies are in line with the company’s vision and mission

7. Further assessment
   - Conduct internal company analysis to check if it supports current strategy

Please note that this is just an example for due diligence methodology. The methodology will depend on industry and sector of the company and nature of the transaction, among other factors.
Navigating Through Different Types of Due Diligence in India

Author: Nishtha Yadav

When due diligence is being conducted, several aspects of the company are taken into consideration. The different categories of due diligence help evaluate every aspect of a business, in turn helping foreign companies make an informed decision about their business dealings.

Major types of due diligence are – legal, tax, HR, and financial. Usually, these four types of due diligence are most commonly conducted. However, depending on the company’s sector and the proposed business deal, due diligence on intellectual property, environment, real estate, valuation, forensic accounting, and vendors can also be conducted.

In this article, we will discuss financial, legal, tax, and HR due diligence.

**Financial due diligence**

Financial due diligence provides with the previous and current financial position of the business. Through this process, foreign companies get an idea about how the company’s finance will hold in the future. It also provides complete understanding of the company from the buying and selling point of view.

Financial due diligence includes reviewing the company’s debts at domestic and international levels, financial statements and audit reports, accounting policies, quality and sustainability of earnings and cash flow, condition and value of assets, potential liabilities, tax implications of deal structures, examination of information systems to establish the reliability of financial information, and internal control systems.

Usually for financial due diligence, the following information is reviewed and recorded by the due diligence team.

- Audited financial statements (cash flow, balance sheet, income statement, footnotes) for the last three years, including the auditor’s report as well as the quarterly and annual statements;
- Auditor’s correspondence to the management after finishing the audit report. This will help identify the strengths and weaknesses of the company;
- Auditor’s correspondence for the past five years. These are letters sent to management that outline areas to improve profits and efficiency;
- Company credit report;
- Schedule of accounts receivable and payable;
This due diligence process often covers various legalities, including corporate laws, loans and borrowings, real estate, intellectual property, secretarial due diligence, contracts and licenses, and competition law, among others.

In short, through legal due diligence a foreign company can determine if the company has any regulatory issues, verify the documents to check if it has any restrictions to undergo this particular business deal, check its corporate and environmental compliances as well as compliance with employment and industrial laws, licenses and regulatory approvals, and understanding existing and/or potential litigation against the business.

Usually, the following documents are reviewed while conducting legal due diligence for any business or company in India:

- Copy of Memorandum and Articles of Association;
- Minutes of board meetings for the last three years;
- Minutes of all the meetings of shareholders for the last three years;
- Copy of share certificate issued to key management personnel;
- Copy of all guarantees to which the company is a party;
- All corporate commercial contracts such as joint venture or partnership agreements, vendor agreements, license and franchise agreements; and
- Copy of loan agreements, bank financing agreements, and lines of credit details.

Please note that this list is not exhaustive, and that the due diligence team can ask for other documents or more information.

**Tax due diligence**

Apart from verification of information, tax due diligence also helps in identifying any tax upside to the business dealing, and assists in developing a suitable acquisition structure for the potential business deal.

Tax due diligence in India mostly comprises an analysis of tax compliance, tax contingencies transfer pricing, identification of risk areas, and tax planning and opportunities. This process reduces the risk of doing business with a company that has tax liabilities to risk exposures associated with the business transaction.
Navigating Through Different Types of Due Diligence in India

During this process, documents related to tax liability, company taxes, tax-related pending or ongoing cases, and tax audits of the company are reviewed and also verified with the tax authorities.

The following documents are reviewed and verified while conducting tax due diligence in India. This is a basic list, and more documents or information might be needed by the due diligence team.

- All tax returns including income tax, sales tax, and goods and services tax (GST) for the last three years;
- Tax audit reports of the company;
- Any tax settlement documents for the last three years;
- Tax registration certificates;
- Tax payment receipts;
- Balance sheets and profit and loss statements; and
- Financial statements as they disclose tax disputes, demands against the company, and contingent liabilities.

If the company has foreign investment, then compliance with annual return on foreign liabilities and assets (FLA Return) and its annual performance report should be checked to determine further liabilities of the company.

**Human resources due diligence**

HR due diligence is used to evaluate HR procedures, processes, and human capital of the company. This process helps in understanding the company’s employment contract, compliance with labor laws and regulatory policies, work culture, and industry standards.

Usually the following information is analyzed while conducting HR due diligence in India:

- Employee details – It includes number of employees, current positions taken, number of vacancies, notice period, and retirement dates;
- Salaries of all the employees including employees on a contract, bonuses paid to the employees during the last three years, and years of service;
- All employment contracts with non-disclosure, non-solicitation clause, and non-competitive agreements between the company and its employees;
- HR policies regarding annual leave, sick leave, and other forms of leave allowed by the company;
- Looking into employees’ concerns and safety such as wrongful termination, sexual harassment, gender and pay discrimination, and examining any pending legal cases with current or former employees;
- The potential financial impact of any ongoing labor cases, arbitration proceedings, or any other legal procedures; and
- Employees health benefits.

Apart from these HR processes, it is important that the due diligence team checks if the company has been adhering with the new wage code, including the provisions for minimum wage. The Code on Wages Act, 2019 prohibits employers from paying workers less than the stipulated minimum wage. The Code on Wages Act, 2019 has replaced four labor regulations – Minimum Wages Act, 1948; Payment of Wages Act 1948; Payment of Bonus Act, 1965; and Equal Remuneration Act, 1976.

Trade unions form an important part of an organization as it safeguards the rights of the workers. According to the law, if there are seven or more blue collar workers in an organization, they are entitled to form a union. Hence it is important to check on how the relationship is between the organization and the trade union – if such a relationship exists.

All unions in India are tracked by the Ministry of Labor, and are regulated under the Trade Union Act, 1926.

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**What is Reviewed Under HR Due Diligence?**

<table>
<thead>
<tr>
<th>Employee details</th>
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<tr>
<td>Number of employees, number of vacancies, notice period, and retirement dates.</td>
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<tr>
<th>Salary</th>
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<tr>
<td>Cost to company for each employee including bonuses.</td>
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<table>
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<tr>
<th>Contracts</th>
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<tbody>
<tr>
<td>Review non-disclosure, non-solicitation clause, and non competitive agreements between the company and employees.</td>
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<tr>
<th>Leaves</th>
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<td>Sick, casual, paternity, maternity, privilege, bereavement and other form of leaves to be reviewed.</td>
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<tr>
<th>Employee safety</th>
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<tr>
<td>Look into sexual harassment and gender and pay parity policies.</td>
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<tr>
<th>Lawsuits</th>
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<tr>
<td>Ongoing or potential legal cases between the employee and company.</td>
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</table>
Q + A: What You Need to Know About Conducting Due Diligence in India

When should a foreign company conduct due diligence?

Sunny Makhija: There are a couple of cases where a foreign company should conduct due diligence. If it is entering into a merger and acquisition (M&A), then due diligence should be conducted from the perspective of the buyer as well as the seller. It should also be conducted in case of a strategic alliance, business partnership, joint venture, or an IPO.

Due diligence is also conducted if the foreign company is interested in conducting background check of a personnel like a partner, supplier, or a country head.

Why should a foreign company conduct due diligence before entering into a business deal in India?

Sunny Makhija: It is important to conduct due diligence to avoid bad transaction, identify issues within the company, and verify that the business is what it appears to be. Further, through this process, information about the company’s value and assets is also revealed. It further helps in assessing the reputation and corporate governance of the company.

What are the types of due diligence that foreign companies should consider important while investing in India?

Sunny Makhija: Major types of due diligence in India are legal, financial, HR, and commercial.

Legal due diligence focuses on examining the legal basis of the transaction. It requires a thorough analysis of the documents, company’s existing contracts, agreements, ongoing and pending litigations, etc.

During the time of investment, it is important to understand the past financial statements, book of accounts, and compliance adherences. This helps to provide a thorough understanding of company’s financial health including any hidden liabilities and their future impact on business.

Typically considered a ‘soft’ concern, HR due diligence has an expanded scope in India. It constitutes understanding the country’s system of employment contracts, labor laws, labor relations, regulatory policies, work culture, and industry standards.

Commercial due diligence assists in understanding the market of the target company. It provides a full overview of the target’s internal and external environmental factors. It highlights the position of the target company in the market and its ability to reach the forecasted goals and objectives.

Other types of due diligence assist in understanding the areas such as operations, information technology, intellectual property, and vendor relationships, among others.
Pre-investment due diligence is a process to mitigate risks and to aid sound decision making. It helps in minimizing the extent of unknown risks or liabilities about a business.

It helps in raising the red flags before a deal goes through and consequently adjust the price and other important terms and conditions of a deal. It also assists in gaining a complete picture of the business and checking the synergy with existing business. Thus, giving practical insights on doing business in India.

Based on the result of due diligence process, parties can either go ahead with the deal, negotiate further, or walk away.

Should due diligence be limited to certain types of business dealings?

While due diligence is advisable in several cases, it is an important part of the joint venture process. As no two companies are same, it is important to obtain and unveil any information that can have an impact on the sale and purchase of a company or its assets.

However, the necessity to carry out a due diligence can at times be dependent on the structure of a joint venture. If two companies are merging to form a new third company for carrying out a new business activity, then due diligence may or may not be required.

On the other hand, if the joint venture results in acquisition of an existing company then a due diligence is always recommended.

What areas of tax and regulatory compliance come under a due diligence check? What should foreign companies prioritize in India?

Conducting tax due diligence during an M&A deal is important as it helps in uncovering tax issues and leakages. At times, tax due diligence may also help in unveiling potential tax benefits which the target company is not availing.

Understanding the tax nuances also helps in structuring the M&A deal in an overall tax efficient manner.

Balance sheet, related schedules, and profit and loss statements assist in capturing the relevant tax information of the target company. Such documents reveal aggregate taxes paid, current tax charge, and deferred tax charge for the relevant year. Financial statements also disclose tax disputes, demands against the company, contingent liabilities, among other important details.

It is also advisable to conduct analysis of effective tax rate, deferred tax rate, and review of MAT status.

Master data from the corporate affairs ministry is analyzed to review details of the target company established under the Companies Act, 2013. Information contained in certificate of incorporation, articles of association, memorandum of association, authorized capital, paid-up capital, quantum of secured loans can give a good overview of the status of the company during the due diligence process.

During the M&A, it is important to make sure that the target company is in compliance with the FDI policy of India. Investment in certain sectors and activities is prohibited or limited by the FDI policy. Compliance with Foreign Exchange Management Act (FEMA) is also mandatory. Compliance with annual return on foreign liabilities and assets (FLA Return), annual performance report helps in shedding light on assets and liabilities of the company and if any overseas direct investment has been made.

Why is it important for foreign companies to conduct HR due diligence?

It is important to conduct HR due diligence to correctly evaluate the overall HR procedures, processes, and human capital in a company. Such type of due diligence helps in understanding:

- HR policies, governance, and code of conduct guidelines;
- Any cultural differences between organizations which may result in a conflict in future;
- Payroll contractual obligations of the target company with its resources. Analyzing salary structures, cost to company details, lock in periods, no compete contracts, and severance package;
- Potential frauds in background details of employees;
- Labor issues, social security obligations and labor compliance status. Relationship with trade unions and bonding among the workmen; and
- Pending litigation against employees or company.

Why should foreign investors interested in investing in India employ a professional services firm for conducting due diligence?

If you are planning to invest in a business in India, then it is advisable to conduct a thorough due diligence of the target company to identify potential risks and opportunities well in advance.

A seasoned due diligence team assists in making the right decision and ensures no checkbox is left unticked.
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