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Quality In Everything We Do

Conducting Successful Investments in India

What Foreign Investors Need to Know About
Doing Deals in India

Dear Friends,

India in recent years has emerged as an important destination for foreign private equity and venture capital investors. The country's rapid economic growth, innovation, skilled workforce, use of English as the language of commerce, and well-established corporate legal system have all contributed to the creation of attractive investment opportunities.

Private equity investors are attracted by the growth available in such industries as manufacturing, construction, and outsourcing. Changes in government limits on foreign ownership in key sectors such as telecommunications, insurance, and retail have created further opportunities.

Venture capital investors come to India to leverage its low cost structure, tap its deep reservoir of engineering talent, and create companies to meet surging domestic demand for technology and mobile services. Many of the world's top venture capital firms have recently established a presence in India, whether through partnerships or India-dedicated funds.

While India offers many beneficial qualities to foreign investors, India is a unique market with its own set of local flavors and business practices. Ernst & Young has prepared this publication to help foreign investors become aware of some of the most important audit, tax, and transaction considerations to take into account when contemplating an investment in India. *Conducting Successful Investments* in India contains three topic areas:

- ◆ Answers to questions frequently asked by investors while evaluating opportunities in India
- ◆ What investors need to know about the differences between India GAAP and US GAAP
- ◆ Due diligence success factors in India

We hope that this publication will provide valuable insights into the Indian business environment for foreign investors. Ernst & Young's Transaction Advisory, Tax, and Assurance professionals in India stand ready to provide further insight and assistance to foreign investors conducting investments in this dynamic market.

Best regards,

Ernst & Young Global
Strategic Growth Markets



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If you are considering an investment in India with a view to an exit on a US stock exchange or via a trade sale to a large corporate buyer, it is important to understand the impact of converting Indian company financials from India GAAP to US GAAP. Find out what the key differences between India GAAP and US GAAP can mean for a Indian portfolio company’s reported financial performance.

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The due diligence process is usually where the business cultures of the foreign investor and the Indian management team meet for the first time. The appropriate cultural understanding, expectations, and process orientation are critical due diligence success factors for foreign investors. Learn more about due diligence best practices in India from Ernst & Young’s Transaction Advisory Services and Transaction Tax teams.

India FAQ: The Top 12 Questions for Foreign Investors

INDIA'S UNIQUE BUSINESS CULTURE AND ENVIRONMENT means that foreign investors face more uncertainties than in their more familiar home markets. While every deal is unique, foreign investors considering Indian opportunities typically ask similar questions related to the business culture, exits, taxes, government, corporate structuring, and corporate governance requirements. Drawing on the insights of our India-based Transaction Advisory Support and Tax teams, we have assembled a list of FAQs for foreign investors.

1. What are the investment routes foreign investors may utilize to acquire a stake in an Indian company?

A foreign entity may invest in India under any of the following routes:

- ◆ Foreign Direct Investment (FDI)
- ◆ Foreign Institutional Investor (FII)
- ◆ Foreign Venture Capital Investor (FVCI)

Investment under the FDI route and the FVCI route is discussed later in this article (see Questions 2 and 3). As regards the FII route, qualified foreign entities seeking investment opportunities in India are regarded as FIIs. FIIs can invest in Indian equities and debt subject to specified limits.

2. What is the Foreign Direct Investment (FDI) policy in India?

The FDI policy is relevant to foreign entities seeking to establish an Indian presence either by setting up an Indian company (either wholly owned or in joint venture with an Indian partner) or by acquiring a

stake in an existing Indian company. Over the last 15 years, the Government of India (GOI) has significantly liberalized the FDI policy for foreign investment in India. Currently, the FDI policy permits up to 100% foreign investment in most sectors, including the services sector. In sectors referred to as the “automatic route,” FDI does not require any prior approval from either the GOI or the Reserve Bank of India (RBI). In these situations, however, the Indian company is required to report certain details relating to the share issuance to the RBI. FDI through the automatic route is permitted in all activities and sectors except as listed below, which require prior approval of the GOI:

- ◆ Activities that require an industrial license
- ◆ Proposals in which the foreign investor has a previous or existing venture/arrangement in India in the same field
- ◆ All proposals falling outside notified sectoral policy or under sectors in which FDI is currently not permitted

Where FDI is not allowed under the automatic route, prior approval of the GOI is required.

The Foreign Investment Promotion Board (FIPB), an administrative body functioning under the Ministry of Finance, considers all proposals for foreign investment that require GOI approval. According to the FDI policy, an application made to the FIPB is disposed of within 30 days of submitting an application.

3. Are there any special investment vehicles required or useful in India?

The requirement for a special investment vehicle depends on an investor's objectives in India. If the investor is intending to make long-term investments (time horizon exceeding 12 months) in a listed Indian company, there is no requirement to structure the investment through a special investment vehicle. This happens because long-term capital gains are not subject to tax in India, provided the sale is entered into on a recognized Indian stock exchange and payment and securities transaction tax is

paid (currently 0.125% of the transaction value). On the other hand, investors seeking an exit within 12 months, or investors seeking to make investments in unlisted Indian companies that are not likely to list on an Indian stock exchange, should consider establishing an offshore investment holding vehicle before making the investment. A private equity or venture capital fund looking at making investments in India largely in unlisted companies could consider obtaining registration from the Securities and Exchange Board of India (SEBI) as a FVCI. The SEBI and the RBI have extended certain benefits to funds registered as FVCIs, which may make the registration more attractive from a commercial perspective.

Some of the key benefits of registration as a FVCI are:

- ◆ Normally, the price at which shares of an unlisted Indian company are sold by a non-resident is subject to RBI pricing guidelines — this may be a deterrent for an exit through a strategic sale or share buy-back. However, these pricing guidelines are not applicable for a registered FVCI, and such transactions can be executed at a negotiated price agreeable to the buyer and seller.
- ◆ Registered FVCIs are accorded the status of a Qualified Institutional Buyer (QIB) under the SEBI guidelines for disclosure and investor protection. QIBs have an allocation of 60% of the issue size of a public offer of a company.
- ◆ Transfer of shares by a FVCI in a listed company to promoters is exempt from the SEBI (Substantial Acquisition of Shares and Takeover) Regulations, 1997, which requires the promoters to

make a public offer under certain circumstances.

The Indian tax laws provide a pass-through status to SEBI-registered venture capital funds — accordingly, on registration, investors in a venture capital fund are taxed in the same manner as if the investment were made by the investors directly in the investee company.

4. Are there any restrictions on repatriation of capital invested and profits earned in India?

Capital and income arising from foreign investment in India can be freely repatriated (except for cases where the investment is made on non-repatriation basis). Repatriation is subject to the provisions of a no-objection certificate, which is obtained from the Indian revenue authorities or a certificate issued by a Chartered Accountant that confirms that taxes payable, if any, are deposited into the Indian government treasury.

5. Are there any regulatory approvals required for the transfer of shares in an Indian company?

The GOI and the RBI have recently liberalized the procedures relating to the transfer of shares between residents and non-residents. Currently, there is no requirement to seek approvals of the FIPB/RBI, subject to compliance with the following conditions:

- ◆ The transfer is in accordance with the pricing guidelines prescribed by the SEBI/RBI.

- ◆ The transfer is not subject to the provisions of the SEBI regulations governing acquisitions and takeovers.
- ◆ Activities of the Indian company are under the automatic route under the FDI policy.
- ◆ Non-resident shareholding after the transfer does not exceed the prescribed sectoral limits under the FDI policy.

All proposals relating to acquisition of shares in an existing Indian company by a foreign investor in the financial services sector requires prior approval of the RBI.

Transfer of shares between non-residents does not require approvals of the FIPB/RBI and pricing norms do not apply to such transfer of shares, subject to fulfillment of certain conditions.

6. What are the jurisdictions that have been typically used for structuring investments into India?

In recent years, structuring investments through tax-friendly jurisdictions has evolved as an effective tax-planning tool. In this regard, Mauritius has been a preferred destination for many foreign investors investing in India, because of the exemption from tax on capital gains provided by the India-Mauritius tax treaty, coupled with the favorable tax regime for taxation of offshore funds in Mauritius. A recently concluded Comprehensive Economic Cooperation Agreement between India and Singapore has provided an additional jurisdiction for structuring investments into India. Other jurisdictions with which India has a favorable tax treaty (for taxation of capital gains) include Cyprus and the United Arab Emirates,

From a foreign investor's perspective... it becomes critical to understand the company's level of compliance with various taxes affecting its business.

though transactions utilizing these jurisdictions are relatively untested.

Typically, the following parameters are considered by foreign investors when structuring investments through a special-purpose vehicle set up in a tax-friendly jurisdiction:

- ◆ Tax-friendly country having tax treaties with both host and home countries
- ◆ Lower or no withholding tax on payment of dividends, interest, royalties, etc.
- ◆ Low/nil incidence of tax in the tax-friendly country
- ◆ Availability of foreign tax credit
- ◆ Capital gains exemption
- ◆ Low set-up/compliance costs
- ◆ No or less stringent anti-avoidance rules (e.g, treaty shopping, controlled foreign corporation guidelines, transfer pricing guidelines, thin capitalization norms)

7. What domestic tax laws need to be factored into the early days of a company?

Under India's constitution, the power to levy taxes is divided between the central government and the state governments.

The central government levies direct taxes, such as income tax (personal and corporate), and indirect taxes, such as customs duty, excise duty, stamp duty, central sales tax, and service tax.

The state governments generally levy professional tax, stamp duty, entry tax, and state sales tax. Local authorities governing designated areas within a state also levy taxes, such as property tax, road tax, octroi, etc. Recently, the GOI has embarked on an initiative to integrate all indirect taxes (central and state) into a comprehensive goods and services tax regime.

From a foreign investor's perspective, especially where the investment is in an existing Indian company, it becomes critical to understand the company's level of compliance with various taxes affecting its business.

8. What are the key considerations that should go into finalizing the investment and operating structure for any private equity or venture capital fund intending to invest in Indian companies?

The ability to distribute returns with minimum tax leakage to the "ultimate" investors is a paramount consideration when identifying an investment structure for any private equity/venture capital fund. Typically, most investments

are structured through jurisdictions that afford a favorable domestic and cross-border taxation regime with the country where the investments are proposed to be made (see Question 6).

The operations (in India and overseas) of the private equity/venture capital fund with respect to its Indian investments have to be carefully structured to ensure that its operations do not constitute a permanent establishment (PE) in India (i.e., a place of business).

The implications of constituting a PE is that income/gains may be taxable in India to the extent that income is determined to be attributable to the activities carried on in India. The PE exposure can be minimized by implementing certain precautionary measures that should be adopted at the outset and followed throughout the fund's activities in India.

The tax consequence arising from employee participation in incentive plans should also be analyzed in the context of the overall structure. Innovative structures could be developed to achieve the twin objectives of mitigating the risk of taxation of the fund's returns, while at the same time making participation in stock programs tax-efficient for the employees.

Additionally, all transactions between associated enterprises should be at arm's length, in compliance with Indian transfer-pricing legislation.

In summary, investments by a private-equity/venture capital fund are of a longer duration, with gains being realized upon sale or dilution of ownership. To mitigate adverse Indian

tax consequences, it is preferable that the above considerations are addressed at the time of establishing a fund and

b) **Creeping Acquisition Limit:** An acquirer who holds 15% or more (but less than 55%) of shares or voting rights of a target company, can acquire

An acquiring company has to adhere to certain disclosure requirements in case the acquisition of shares in a company exceeds specified limits.

consistently observed during the entire life cycle of the investments in India.

9. What are the statutory obligations in case of a substantial acquisition of shares or takeovers of Indian companies?

SEBI regulates the substantial acquisition of shares in and takeovers of listed Indian companies. An acquirer has to adhere to certain disclosure requirements in case the acquisition of shares or voting rights in a company exceeds specified limits. Further, in the following instances, the acquirer is required to make an open offer to the public:

a) **15% Shares or Voting Rights:** An acquirer who intends to acquire shares or voting rights which, along with existing shares or voting rights, would entitle the acquirer to exercise 15% or more voting rights, can acquire such additional shares or voting rights only after making a public announcement to acquire at least an additional 20% of the voting capital of the target company from its shareholders through an open offer.

more than 5% additional voting rights in any financial year (ending March 31) only after making a public announcement to acquire at least an additional 20% of the voting capital of the target company from its shareholders through an open offer.

c) **Consolidation of Holding:** An acquirer who holds 55% or more (but less than 75% *) of shares or voting rights of a target company can acquire any further shares or voting rights only after making a public announcement to acquire at least an additional 20% of the voting capital of the target company from its shareholders through an open offer.

d) **Acquisition of Control:** Irrespective of whether there has been any acquisition of shares or voting rights in a company, an acquirer can acquire control over a target company (directly or indirectly) only after making a public announcement to acquire at least an additional 20% of the voting capital of the target company from its shareholders through an open offer.

* 90% in some cases

10. What are the pricing norms in the case of allotment of shares on a preferential basis by a company?

Pricing Norms Under SEBI Guidelines

Share issuance by a listed Indian company on a preferential basis should be at a price not less than the higher of the following:

- ◆ The average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange during the six months preceding the relevant date
- ◆ The average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange during the two weeks preceding the relevant date

Relevant date is defined as the date 30 days prior to the date on which the general meeting of the shareholders is held to consider the proposed issue.

Pricing Norms Under Foreign Exchange Management Act Guidelines

Share issuance by an unlisted Indian company to a non-resident (individual, company, etc.) should be at a price not less than the fair valuation of shares carried out by a chartered accountant in accordance with the guidelines issued by the erstwhile office of the Controller of Capital Issues.

11. What are tax rates on income from investments made in India?

Investors in Indian securities typically earn the following types of income/gains:

- ◆ Gains from transfer of Indian securities
- ◆ Dividend income
- ◆ Interest income

As per the Indian tax laws, non-residents (organized as a corporate entity) are taxed on their income arising from Indian investments at the following base rates (to be increased by appropriate surcharge and education assessment).

For SEBI-registered FIIs, interest on securities is taxable at the rate of 20%. Long-term capital gains and short-term capital gains on sale of shares, etc. (other than on a recognized stock exchange), are taxable at the rate of 10% and 30% respectively.

As mentioned earlier, the Indian tax laws provide a pass-through status to registered FVCIs; the investors in a FVCI are taxed in the same manner as if the investment were made by the investors directly in the investee company. The rate at which the investors are taxed would accordingly depend upon the status of the investors.

The rates mentioned in Table 1 are subject to relief under the applicable tax treaty provisions. To the extent that tax treaty provisions are beneficial, they override the provisions of the domestic tax laws.

Further, depending upon the applicable tax treaty provisions and the domestic tax rules, credit for taxes paid in India (including underlying tax credit for tax paid by

investee company) may be available against the taxes payable by the investor in its country of residence.

Table 1. Tax Rates

Nature of Income	Rate of Tax (%)
Dividends	Nil
Interest (debt incurred in Indian Rupees)	40
Interest (debt incurred in foreign currency)	20
Short-term capital gains (on sale on recognized stock exchange)	10
Short-term capital gains (others)	40
Long-term capital gains (on sale on recognized stock exchange)	Nil
Long-term capital gains (others)	20
Other income	40

12. What is the scenario for protection of intellectual property rights (IPRs) in India?

India is a signatory to the agreement of the Uruguay Round of GATT negotiations that established the World Trade Organization. The agreement, inter alia, contains an agreement on Trade-Related Intellectual Property Rights (TRIPS) that lays down minimum standards for protection and enforcement of IPRs in

member countries. The TRIPS agreement came into effect January 1, 1995.

The statutes in India for protection of TRIPS include:

- ◆ The Trade Marks Act, 1999
- ◆ The Copyright Act, 1957
- ◆ The Patents Act, 1970
- ◆ The Designs Act, 2000
- ◆ The Geographical Indications of Goods (Registration and Protection) Act, 1999
- ◆ The Semiconductor Integrated Circuits Layout-Design Act, 2000
- ◆ The Protection of Plants & Varieties and Farmers Rights Act, 2001
- ◆ The Biological Diversity Act, 2002

India has complied with its obligations under the TRIPS agreement, making the Indian IPR law regime almost at par with regimes of developed countries. ■

What Investors Need to Know About the Differences Between India GAAP and US GAAP

US VENTURE CAPITAL AND PRIVATE EQUITY INVESTORS are increasingly looking to India for investment opportunities with a view to exiting those investments through an IPO on a US exchange or a trade sale. One of the challenges of investing in India for US investors is being able to understand and compare investment opportunities from a familiar frame of reference: US GAAP. Moreover, an IPO on a US exchange or a sale to a US investor, requires the conversion of a company's financial statements from India GAAP to US GAAP. Knowing the likely impact of this conversion is therefore important in assessing both investment and exit opportunities.

Many changes have been made to India GAAP in the last five years as a result of India's rapid economic growth and the significant reforms made to its economic system. While business processes in India have historically not been as sophisticated as those in more developed economies, this situation is changing rapidly. Although India GAAP is increasingly getting convergent with US GAAP (and IFRS), differences remain in practice.

In general, US GAAP is more rules-based in a number of areas than India GAAP, particularly in areas such as revenue recognition and consolidation. Thus, there are more alternative accounting treatments under India GAAP, allowing a company greater latitude in the interpretation and application of accounting principles. The conversion of financial statements from India GAAP to US GAAP can often result in:

- ◆ Significantly lower reported revenues, and other revenue recognition issues
- ◆ Unexpected charges or income related to business combinations

- ◆ Reduced net income due to stock option accounting

Understanding the impact of India GAAP to US GAAP conversion will help US investors to calibrate their expectations correctly and—with the assistance of professional financial advice—better evaluate investment opportunities in India. The impact is even more important if a public offering is required on a US exchange or in an acquisition by a non-Indian company which has US GAAP statements as a closing condition. While each company's situation is unique, we briefly outline some of the key differences between the two comprehensive bases of accounting for US investors to be aware of as they consider investments and exits in India.

Assessing India-to-US GAAP Conversion: Where to Start

The first question to ask is whether the company's financial statements are audited by a reputable international accounting firm. In India, if a company is not audited

by a reputable international accounting firm with expertise in US GAAP, the quality of its US GAAP financial statements should be carefully examined because local accounting firms may not have exposure to international reporting requirements.

Bottom Line for US Investors

Preparation or examination of a reconciliation from India GAAP to US GAAP by a reputable firm is a good starting point in assessing the company's financial situation.

India-to-US GAAP Conversion: Significant Adjustment Areas

In converting from India GAAP to US GAAP, there are a number of areas that can have an impact on the bottom line and could consequently affect the attractiveness of a company as an investment. Some major areas for potential differences are

revenue recognition; accounting for business combinations; and stock options and other employee benefits. The differences discussed below are only illustrative and not intended to be exhaustive. There are several additional differences related to topics such as prior period items, defined benefit plans, variable interest entities, derivatives, impairment and foreign exchange gains and losses that would need to be considered by a potential investor.

Revenue Recognition

While revenue recognition rules (as described) for manufacturing companies are very similar in India GAAP and US GAAP, there may be differences in practice with respect to determination of when delivery occurs, price is fixed, what the contractual elements are, whether collection is probable and whether significant obligations remain. Additionally, rules related to revenue recognition for software, long-term contracts and services are often very different. US GAAP has specific guidance for revenue recognition in certain industries, such as software, whereas there is no similar specific and prescriptive guidance in India GAAP. Some of the key differences in revenue recognition between India GAAP and US GAAP include:

- ◆ **Recognition Timing:** US GAAP has certain rules regarding when revenue resulting from sales transactions involving rights of return, warranties, extended payment terms, installation clauses, or post-contract support services can be recognized. If requirements cannot be met in these cases, generally the revenue is deferred.

In converting from India GAAP to US GAAP, there are a number of areas that can have an impact on the bottom line and consequently affect the decision on a company's attractiveness as an investment.

In India GAAP, because there is no specific guidance, Indian companies may have recognized the revenue as soon as the first service component has been delivered. Converting from India GAAP to US GAAP could result in previously recognized revenues being deferred, because specific criteria and guidelines in US GAAP were not met.

- ◆ **Multiple-Element Contracts:**

US GAAP also has specific rules for recognizing revenue related to contracts that involve multiple elements, such as a systems integration project by a software, company that combines hardware, software, and integration services. Under US GAAP, revenue arrangements in such cases should be divided into separate units of accounting if certain criteria are met. Arrangement consideration is allocated to the separate units of accounting based on their relative fair values and applicable revenue recognition guidance is followed for each unit of accounting. If elements in an arrangement cannot be divided into separate units of accounting, revenue may, in certain circumstances, be deferred and recognized when remaining undelivered items are delivered. Under India GAAP, there

is no standard that deals with multiple element contracts, though there is an opinion from a committee of the standard setter, which requires the components to be fair valued and recognized as they are performed.

- ◆ Nevertheless in the absence of a clear-cut standard, the practice for accounting multiple element contracts may vary among companies and may not be in accordance with US GAAP principles. As a result, in converting from India GAAP to US GAAP, recognized revenue might have to be deferred.
- ◆ **Gross vs. Net Recognition:** Under US GAAP, a company that acts as an agent can often only recognize net revenue that might be a commission or a fee. An Indian company may have been determined revenue-based on invoiced amounts that include certain amounts paid to suppliers. While the net income may not be affected by such differences, it may result in differences in the top line. As a result, reported revenues may be higher than they would be under US GAAP.
- ◆ **Barter Transactions:** Under US GAAP, the fair value of goods or services exchanged in barter (non-cash) transactions is recorded as revenue only in

limited circumstances. For example, if a company receives a product in exchange for free advertising, certain criteria must be met prior to advertising revenue being recognized, including a determination of whether the fair value of the product or advertising can be made and whether there were similar cash transactions. Under India GAAP, companies may have recognized revenue if the value of the goods or services exchanged was considered determinable. Consequently, where companies have engaged in significant non-cash based transactions, revenues under US GAAP could be lower.

intangible assets such as customer lists or brand names, should be identified and valued. The difference between the consideration paid and the fair value of the net assets acquired is recorded as goodwill. Goodwill is not amortized but reviewed for impairment annually.

including goodwill, and consequently in net income as a result of differences in depreciation and amortization, among others. Note, however, that converting to US GAAP may cause net income to be higher as goodwill is not amortized under US GAAP.

Accounting for business combinations and merger and acquisitions represents another area where significant adjustments likely have to be made in an India-to-US GAAP conversion...

Bottom Line for US Investors

Be aware that revenues and/or net income will likely be significantly adjusted in the conversion from India to US GAAP, particularly in the case of software and service companies or companies that have engaged in substantial exchanges of goods and services.

Business Combinations

Accounting for business combinations and mergers and acquisitions represents another area where significant adjustments are likely to have to be made in an India-to-US GAAP conversion, most likely resulting in a change in net income.

Under US GAAP, when a company acquires another company that constitutes a business, only the purchase method can be used. Accordingly, the acquiring company must compare the consideration (the amount paid) to the fair value of the net assets acquired. Along with the tangible assets, the

In India GAAP, when the acquired entity loses identity either the pooling of interests method (when certain conditions are fulfilled) or purchase method can be used. In the purchase method, both fair value and carrying value can be used to value the net assets acquired. Goodwill is amortized over a period not exceeding five years. When the acquired entity does not lose its identity, the purchase method based on the carrying value of the net assets is applied to determine goodwill. Such goodwill may or may not be amortized but has to be tested for impairment.

Bottom Line for US Investors

If you are considering investing in an Indian company that has made an acquisition, or your Indian portfolio company is planning to make an acquisition, be aware that an India-to-US GAAP conversion could result in significant changes to recorded assets,

Stock Options

Stock options have been widely used in the United States for a long time. In India, it is relatively a recent phenomenon.

Under US GAAP, there is new accounting guidance for employee stock option grants that is applicable for fiscal years of public companies beginning after June 15, 2005 and beginning after December 15, 2006 for nonpublic companies. Under that guidance, when a company grants stock options, it must estimate the fair value of the options at the grant date using an option pricing model. As those options vest, the company recognizes that measured fair value as stock option compensation expense.

Additionally, options granted to non-employees are required to be re-measured at fair value over the performance period, with a final measurement at the conclusion of the performance period. Over the performance

period, the aggregate amount of compensation expense recognized is equal to the re-measured fair value at each reporting date multiplied by the portion of the performance period that has transpired as a percentage of the total performance period.

In India GAAP, the treatment of stock options is closer to the old rules under US GAAP. Stock compensation cost is generally recorded under the intrinsic value method (fair market value of the stock less the exercise price), although companies may choose to use the fair value model. Additionally, there are no standards under India GAAP with respect to options granted to non-employees. Under India GAAP, although there is no standard related to stock options granted to customers, there is an opinion from a committee of the standard setter that requires the options to be fair valued and recognized as a charge over the period revenues are received.

Bottom Line for US investors

Take a close look at the stock compensation plan of potential or current investee companies in India to understand what will happen to net income when stock options are accounted for according to US GAAP. Also, pay close attention to whether options have been granted to non-employees or customers.

India-to-US GAAP Conversion Success Factors

There are several straightforward steps that can be taken to make the conversion process go more smoothly:

- ◆ **Start Early.** Generally speaking, Indian companies should make the conversion to US GAAP at least two years before they list on a United States exchange. Additionally, Indian companies may need to become compliant with Sarbanes-Oxley. Putting the necessary business

processes and internal controls in place is a time-consuming exercise that could delay the IPO process if it is not started on a timely basis.

- ◆ **Hire the right accounting manager.** Hiring an accounting manager, whether controller or finance director, who has in-depth knowledge of US GAAP, is important for a successful transition. Since it is not easy to find someone with US GAAP knowledge in India, time to recruit or train the right individual must be factored in.
- ◆ **Involve an international accounting firm.** Involve an international accounting firm that can help management understand the key differences between India GAAP and US GAAP. ■

Due Diligence Success Factors in India

Foreign investment is flowing into India at a record pace as multinational corporations and private-equity investors cash in on the opportunities that India offers: a high-growth economy, political stability, an English-speaking and well-educated workforce, experienced management, and technological talent—and much more.

With increasing prospects for transactions in India, it is critical to understand what constitutes appropriate due diligence in this land of opportunity. M&A activity has soared in India since economic liberalization was introduced in the mid-1990s. Strong private-equity and venture capital interest has further spurred action. For US and European investors seeking to participate in Indian opportunities, due diligence is a critical step, not only to reduce risks, but also to understand the target company's business culture. Those familiar with India will agree that the country's business culture is very different from what Western investors are accustomed to. Understanding what this difference means for due diligence will help foreign investors approach this process with the appropriate expectations and may help to achieve greater transaction success.

Opening the Doors

For nearly four decades following its independence in 1947, India operated a traditional closed economy with stringent government regulations and high tax rates. Traditionally, a majority of Indian companies have been family-owned and were managed without strong management information systems and control procedures. In the last few years there have been significant enhancements to India GAAP



and an increase in corporate governance guidelines, but full implementation is not yet in force.

10 Tips for Successful Due Diligence

Based on Ernst & Young experience, here are 10 basic suggestions to help you to maximize your chances of deal success:

1. Know the mindset of the target company.

Small and medium-sized Indian companies typically lack prior M&A experience, and as a result, they take more time to prepare for due diligence when compared to their counterparts in the developed countries. Furthermore, the comprehensive information required for the due diligence process is not always readily available for Indian companies, due to lack of access to information

in a traditional management information system. For example, a detailed schedule of margins by product and by customer may not be easy to produce.

The forecasting methodologies of small and medium-sized Indian companies are not always robust, which can sometimes lead to relatively simplistic projections. These forecasts can be overly aggressive, in which case, it makes it difficult to evaluate properly the forecasted results.

2. Understand key differences in doing due diligence in the Western countries and in India.

Going into the due diligence process with the right expectations is another critical success factor. The quality of financial statements, financial infrastructure, and business processes will be lower and less explicit than overseas investors may be accustomed to. This results in the need to explore more risk areas and take more time in conducting due diligence. Some of the differences between due diligence in Western countries and India are set out in Table 1 and Table 2. (See pages 12 and 13.)

3. Listen for the word “no.”

Asian culture is less direct in some respects than Western culture, which often leads to

Table 1. Doing Due Diligence in Western Countries Versus India

	Western Countries	India	
		Large Companies with Prior M&A Experience	Others
1. Transparency in financial information	High	Medium	Low to medium
2. Normal duration of due diligence	1-8 weeks	1-8 weeks	3-12 weeks
3. Assistance required by target company to prepare for due diligence	Minimal	Minimal	Generally require assistance
4. Basis of financial information	US GAAP and IFRS	Generally India GAAP: some companies prepare according to US GAAP or IFRS	India GAAP
5. Audited financial information	Standards-driven	Standards-driven	May not be very reliable
6. Extent of related-party transaction	Varies; typically fully disclosed	Usually extensive; fully disclosed	Usually extensive; may not be fully disclosed
7. Disclosure of contingent liabilities	Usually transparent	Generally adequate disclosures	Usually extensive; may not be fully disclosed
8. Reliance of computerized systems	Typical	Typical	Evolving; dependence on manual process
9. Reliability on representations and warranties	Normally reliable	Untested	Untested
10. Enforceability of indemnification	Strongly enforced; backed by courts	Untested; may need to consider holdbacks or escrows	Untested; may need to consider holdbacks or escrows

Source: *Ernst & Young*.

misunderstanding. Western investors rarely hear their Indian counterparts say “no,” even though they do not mean “yes.” Do not be drawn into a false (and protracted) process of assuming cooperation by the other side without defined actions and deadlines. When discussing potentially contentious items, document key discussions and dates, as appropriate.

4. Be on the lookout for hidden skeletons.

Inadequate disclosures may impede the ability to access critical information. Environment issues and aggressive tax positions are some of the areas investors should look into. For example, due to historically high

tax rates, Indian companies may adopt aggressive tax positions that would have significant post-transaction consequences.

5. Evaluate corporate governance.

India is in the early days of stronger corporate governance guidelines and enforcement. Regulators are tightening the guidelines and pushing for greater accountability. Companies are slowly realizing the importance of corporate governance and some of the leading organizations developing these standards are benchmarking them to the global standards.

6. Keep an eye on related-party transactions.

Indian businesses are generally structured as conglomerates or group businesses, which creates extensive related-party transactions. Group companies may be structured in such a way that they would not be completely reflected in the disclosures as governed by the Indian accounting standards and India’s Company Law. A good understanding of informal practices and assumptions helps clarify the implications of transactions with related parties.

7. Avoid legal minefields.

Weak corporate governance is compounded by slow legal systems, in which dispute

Table 2. Due Diligence, Initial Information Review*

Tasks	Objective
1. Screening historical financial statements	Understanding key business drivers, quality of earnings and related issues, working capital requirements, etc.
2. Evaluate key accounting policies	Identify potential risky/sensitive areas that need additional attention in due diligence, valuation, and structuring
3. Perform high-level overall analytical review	Assess integrity and quality of financial data
4. Assess financial/accounting environment	Understand the limitations of the current accounting software; set expectations of the extent of financial data available for further analyses
5. Review internal management reports	Identify useful business statistics that are instrumental to in-depth analysis
6. Understand business and their financial impact	Determine impact on valuation and identify areas for further detailed due diligence
7. Develop comprehensive information request	Ensure that sufficient information and data are available to facilitate appropriate analyses

* Normally in Pre-LoI data-gathering stage

Source: Ernst & Young.

resolution often remains a distant goal. There are significant issues of enforceability of key contractual rights and statutory protection.

8. Communicate with care.

In any transaction, communication must be handled with the utmost care. Sensitivity to Indian culture with regard to dealing with owners who are also the entrepreneurs of the company will help to make the venture more rewarding.

9. Manage the controlling elements.

It is often observed that founding members of a start-up will refuse to give up control and settle for a minority ownership stake (a common condition for many start-ups in exchange for private-equity financing). Even in larger companies, founders generally prefer financing options that do not require them to give up “control” or “information rights.” To enhance a company’s governance systems, some Indian compa-

nies are actively seeking an institutional investor to participate on the board of directors. In some limited situations, entrepreneurs are recruiting experienced CEOs to run the business. It may take some time before this scenario becomes a more common practice.

10. Think global, act local.

With several success stories of private-equity firms in India, the country has become a favorite of many funds. In response to this competitive environment, investors often attempt to close deals in record time. Firms with a presence in India have a distinct edge, due to their wide networks of contacts and experience with the Indian business environment.

Investment in any foreign country can create anxieties for an investor. In India these anxieties are further exacerbated by cultural differences and unfamiliarity with local business rules. India’s economic policies are designed to attract significant

capital inflows into India on a sustained basis and to encourage technology partnership agreements between Indian and foreign firms. Policy initiatives taken over the last few years have resulted in significant inflows of foreign investment in all areas of the economy, except those reserved for the public sector.

Today, India is one of the most exciting emerging markets in the world. Skilled managerial and technical manpower match some of the best in the world. These experienced resources, coupled with a middle class whose size exceeds the population of the United States or the EU, provide the basis for considerable investing opportunities.

Understanding some of the main cultural differences, potential pitfalls, and due diligence success factors should help you to approach investing in India with greater confidence and also to determine when greater investigation and the assistance of a professional advisor is necessary. ■

Table 3. Due Diligence, Drill Down in Depth

Possible Tasks	Objective
Phase I	
1. Review audit workpapers	Identify risk areas that need special attention
2. Raise asset/liability questions	Validate book value of assets/liabilities and assess the impact on future earnings
3. Analyze income statement fluctuation	Understand the seasonality of the business, assess quality of earnings, etc.
4. Identify potential pro-forma adjustments	Ensure that historical profitability of the acquired business is appropriately reflected
5. Assess stand-alone matters	Evaluate stand-alone costs in case of carve-outs
6. Identify contingent liabilities	Determine impact on valuation and identify areas for detailed due diligence
Phase II	
1. Evaluate profitability by product/segment/geography	Develop in-depth understanding of the business, assess the quality of earnings
2. Analyze correlation between price and volume	Develop in-depth understanding of the business, assess the quality of earnings
3. Identify key cost drivers and expense variability	Develop in-depth understanding of the business, assess the quality of earnings
4. Review capital expenditure history	Determine impact on valuation
5. Analyze working capital sensitivity and seasonality	Determine impact on valuation and buyer's financing needs
6. Analyze projections versus history	Assess the practicability of the projections for profitability, working capital, and capex – determine impact on valuation
7. Evaluate the human resources and benefits issues	Determine impact on valuation
8. Quantify pro forma EBITDA	Determine impact on valuation
9. Discuss findings with target and finalize due-diligence report	Present the factual analysis to the target to ensure that facts are correct, and no facts are missed out – summarize key findings and observations; raise alerts, if any, to facilitate investment decision
10. Develop CPs, CSs, reps, warranties, and indemnities for purchase agreement from a financial perspective	Minimize the investment risk

Note: This phased approach is recommended only where there is concern on quality of financial information provided by target.

Source: Ernst & Young.

Contacts

Ernst & Young India Private Equity Group

For general enquiries, please contact Dilip Dusija at 91.22.6749.8000 or dilipi.dusija@in.ey.com.

To speak to one of our professionals, please contact the appropriate person below.

Rajiv Memani
CEO & Country Managing Partner
National Head of Private Equity
Ernst & Young Pvt. Ltd.
91.11.5159.4112
rajiv.memani@in.ey.com

Sameer Gupta
Global Tax Leader
91.22.5665.5520
sameer.gupta@in.ey.com

Srikant Nagraj
US GAAP Leader
91.80.5118.6004
srikant.nagraj@in.ey.com

Pankaj Dhandharia
Transaction Support Leader
91.22.5665.5676
pankaj.dhandharia@in.ey.com

Sunil Chandiramani
Risk & Business Solutions Leader
91.22.5665 5261
sunil.r.chandiramani@in.ey.com

Ranjan Biswas
Markets Leader
91.80.4114.6600
ranjan.biswas@in.ey.com

Ernst & Young Global Venture Capital Advisory Group

Global

Gil Forer	London	44.207.980.0170	gil.forer@ey.com
John de Yonge	New York	1.212.773.2541	john.de_yonge@ey.com

Americas

Joe Muscat	Americas	1.650.496.4517	joseph.muscat@ey.com
Joe King	Southeast	1.404.817.5439	joseph.king@ey.com
Rebecca Fitzgerald	Northeast	1.617.859.6524	rebecca.fitzgerald@ey.com
Jeff Fialko	Mid-Atlantic	1.703.747.0744	jeffrey.fialko@ey.com
Michael Schoenfeld	Southern California	1.213.977.3611	michael.schoenfeld@ey.com
Robert Browne	Silicon Valley	1.408.947.5430	robert.browne@ey.com
Mylene Levac-Wolfe	Canada	1.514.874.4697	mylene.levac-wolf@ca.ey.com

Asia

Dillip Dusija	Mumbai	91.22.6749.8000	dilip.dusija@in.ey.com
Robert Partridge	PRC/Hong Kong	852.28469973	robert.partridge@hk.ey.com
Joe Tsang	PRC/Hong Kong	852.2846.9902	joe.tsang@hk.ey.com

Europe

Remi Vermeir	Belgium	32.9.242.5143	remi.vermeir@be.ey.com
Petri Ojala	Finland	358.9.1727.7613	petri.ojala@fi.ey.com
Nick Powell	United Kingdom	44.118.928.1456	npowell@uk.ey.com
Julie Teigland	Germany	49.621.4208.11510	julie.teigland@de.ey.com
Philippe Grand	France	33.4.78.17.57.32	philippe.grand@fr.ey.com
Matt Keson-Lee	Switzerland	41.58.286.3336	matthew.kesonlee@ch.ey.com

Israel

Oren Bar-on	Tel Aviv	972.3.623.2524	oren.bar-on@il.ey.com
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SCORE Retrieval File No. CY0013
CSG NYC 0601-0705183