

The Complete Startup Due Diligence Checklist

A comprehensive, data-driven guide to navigating legal, financial, and tax due diligence for early-stage Indian startups raising venture capital.

Overview

Due diligence is the rigorous process through which prospective institutional investors verify the financial, legal, and operational claims of a startup before finalizing an investment. In the Indian venture ecosystem, this exercise acts as the bridge between a signed term sheet and the actual remittance of capital into the company's bank account. Understanding this process systematically allows early-stage founders to prepare their data rooms proactively, minimizing transaction timelines and preventing deal fatigue.

The Architecture of Indian Startup Due Diligence

Due diligence in India is not a mere formality but a highly structured investigation conducted by independent legal and financial audit firms on behalf of incoming investors. The process typically spans four to eight weeks, depending on the stage of the company and the orderliness of its records. For pre-seed and seed rounds, the focus remains primarily on basic legal compliance, founder cap table integrity, and intellectual property ownership. By the time a startup reaches Series A, the scrutiny expands to comprehensive historical financial audits, detailed tax reconciliations, and strict regulatory adherence under Indian corporate laws.

Founders often underestimate the operational drag of this phase, which can divert management attention away from core business operations. Incoming venture capital funds, SEBI-registered Alternative Investment Funds (AIFs), and institutional angel networks use this process to identify liabilities that could impair their investment or expose them to regulatory penalties post-transaction. Resolving discrepancies during the diligence phase is invariably more expensive and time-consuming than addressing them systematically beforehand.

Corporate Structure and ROC Compliance

The foundation of legal due diligence lies in verifying the corporate existence and capital structure of the company. Investors will examine all records filed with the Registrar of Companies (ROC) under the Ministry of Corporate Affairs (MCA). Any gaps in filings, delayed annual returns (such as Form MGT-7 and Form AOC-4), or un-updated registers of members can stall a transaction. The diligence team will trace every equity share, Compulsorily Convertible Preference Share (CCPS), and option granted under the Employee Stock Option Scheme (ESOP) to ensure absolute alignment with the

capitalization table.

- Certificate of Incorporation and Memorandum & Articles of Association (MoA and AoA) reflecting current share capital.
- All ROC filings for the past three financial years or since incorporation, including proof of payment of filing fees.
- Proof of active DPIIT startup recognition to validate tax exemptions and regulatory relaxations.
- Complete capitalization table detailing equity, CCPS, warrants, and ESOP pools with corresponding board resolutions.
- Share subscription and shareholders agreements (SSHAs) from previous funding rounds, including waiver of pre-emptive rights.
- Form FCGPR filings with the Reserve Bank of India (RBI) if the startup has previously received foreign investments.

Additionally, startups claiming benefits under the Department for Promotion of Industry and Internal Trade (DPIIT) must prove their recognition status is active and compliant. The valuation reports issued by Registered Valuers or Merchant Bankers for historical share issuances are cross-referenced to ensure compliance with the Companies Act, 2013, and FEMA regulations where foreign direct investment is involved.

Financial Audits and Accounting Integrity

Financial due diligence involves a thorough forensic review of the startup's books of accounts, ledger balances, bank statements, and historical financial performance. Auditors look for consistency between internal Management Information Systems (MIS) reported to existing investors and the audited financial statements. Revenue recognition policies are scrutinized closely to ensure compliance with Indian Accounting Standards (Ind AS) or standard Indian GAAP. Discrepancies between cash flows and reported revenues are immediate red flags that invite deeper transaction testing.

- Audited financial statements for the past three financial years along with the statutory auditor reports.
- Month-on-month provisional financial statements for the current ongoing financial year.
- Bank reconciliation statements for all active corporate bank accounts covering the last 24 months.
- Detailed breakdown of capital expenditure and operating expenses categorized by vendor and department.
- Documentation of all related party transactions with corresponding invoices, agreements, and board approvals.

For early-stage companies, cash burn, working capital cycles, and capital expenditure are mapped meticulously. Auditors will analyze bank statements for the preceding 12 to 24 months to verify that all major payments match valid invoices and contracts. Related party transactions—such as payments to founders, their relatives, or sister concerns—are isolated and evaluated for market-rate arms-length pricing and appropriate board approvals.

Direct and Indirect Tax Compliance

The Indian tax landscape is complex, and non-compliance can lead to severe financial penalties and litigation, which investors are highly averse to inheriting. Tax due diligence covers both direct taxes under the Income Tax Act, 1961, and indirect taxes under the Goods and Services Tax (GST) framework. Investigators will review income tax returns, tax audit reports (Form 3CB-3CD), and trace any outstanding tax demands or ongoing assessment proceedings. They will also verify if the startup has utilized any Section 56(2)(viib) angel tax exemptions and if the conditions for such exemptions continue to be met.

- Income tax returns (ITR-6) and tax audit reports for all active financial years since incorporation.
- GST registration certificates, monthly and annual GST returns (GSTR-1, GSTR-3B, GSTR-9) along with payment challans.
- Withholding tax (TDS/TCS) deposit receipts and quarterly filings (Form 24Q, 26Q, 27Q) along with Form 16A issuances.
- Details of any ongoing tax assessments, appeals, disputes, or notices received from direct or indirect tax authorities.
- Proof of compliance with Professional Tax (PT) and Equalisation Levy regulations if applicable to foreign SaaS expenditures.

Under the GST regime, auditors check for timely filing of GSTR-1 and GSTR-3B forms. They will perform a reconciliation between GSTR-2B (input tax credit available) and the purchase registers of the startup to ensure that no inadmissible Input Tax Credit (ITC) has been claimed. Any mismatch between these figures can lead to demands from the tax department, which will be deducted from the startup's valuation or held in escrow during the transaction.

Intellectual Property and Technology Integrity

For technology-driven startups, the valuation is heavily anchored in proprietary intellectual property. Diligence teams require clear, unambiguous proof of IP ownership. The primary risk in early-stage startups is that the core code or technology was developed by founders or third-party contractors before the formal incorporation of the private limited company. If explicit, written IP assignment agreements are not in place transferring all rights from the individuals to the corporate entity, the startup does not legally own its product.

Legal audits will review all software licenses, open-source software (OSS) usage, and registered trademarks, patents, or copyrights. The use of open-source components with restrictive copyleft licenses (such as GPL v3) can compromise the proprietary nature of the startup's codebase. The diligence team will run code analysis tools to verify the software architecture and check for potential vulnerabilities or licensing violations that could restrict commercialization.

Employment Laws and Human Resources

Startups must comply with a range of central and state-level labor regulations in India. Financial and legal risks often arise from improper classification of contract workers versus full-time employees. If a startup utilizes independent consultants but treats them operationally as employees, it faces exposure to retroactive claims for benefits. The diligence process will examine all employment contracts, non-disclosure agreements, and non-compete clauses to ensure they protect the company's business interests.

- Standard employment agreement templates containing intellectual property assignment, confidentiality, and non-solicit clauses.
- Registration certificates and monthly deposit challans for Provident Fund (PF) and Employee State Insurance (ESI).
- Details of the Gratuity liability calculation and provisions made in the balance sheet if employee count exceeds ten.
- Comprehensive list of all consultants, freelancers, and independent contractors with executed service agreements.
- Internal policies and compliance documentation relating to the Prevention of Sexual Harassment (POSH) Act, including committee formation.

Compliance with social security statutes is also verified. Startups crossing specified employee thresholds must prove registration and regular contributions under the Employees Provident Funds and Miscellaneous Provisions Act (EPF), the Employees State Insurance Act (ESI), and the Payment of Gratuity Act, 1972. Gaps in these statutory contributions can result in heavy interest and penalty liabilities.

Material Contracts and Commercial Relationships

The commercial viability of a startup is assessed through its material contracts with customers, distributors, suppliers, and strategic partners. Diligence teams review these agreements to identify any change-of-control clauses, which might require written consent from the counterparty before an investment round can close. They also look for unusually restrictive clauses, such as exclusivity commitments, uncapped liability, or severe liquidated damages that could threaten the startup's survival in a downside scenario.

For B2B startups, the actual pricing, Service Level Agreements (SLAs), and termination clauses of major customer contracts are analyzed. Any customer representing more than

10% to 15% of the company's total revenue is classified as a material relationship. The loss of such a client due to a contract dispute or termination-at-convenience clause is flagged as a key concentration risk for incoming investors.

The Practical Due Diligence Checklist

Preparing for due diligence before signing a term sheet is the single most effective way to shorten the time-to-close from months to weeks. This checklist serves as an operational guide for founders to structure their cloud-based virtual data room (VDR). Documents must be organized in folders matching the key diligence domains, with clear, standardized file names and indexing.

- Incorporate and maintain updated statutory registers (Register of Members, Register of Directors, Register of Share Transfers).
- Consolidate all historical and current board meeting minutes and shareholder general meeting minutes.
- Compile executed IP assignment agreements for all current and former founders, employees, and external developers.
- Obtain a clean, updated tax ledger (Form 26AS and AIS) matching internal TDS receivables and tax payments.
- Map all customer and vendor contracts exceeding Rs 5 lakh in annual value into an organized, executed contracts folder.
- Maintain clear records of hardware asset allocations, software subscriptions, and cloud infrastructure invoices.
- Ensure all commercial leases, rental agreements, or utility bills for registered office verification are legally executed.
- Prepare a formal ESOP plan document along with individual grant letters and proof of board approvals.

Founders should assign a dedicated internal compliance lead, typically the finance head or company secretary, to manage document flow and address follow-up queries. Keeping these documents updated continuously ensures that when an investor initiates the diligence phase, the data room can be populated within 48 hours, signaling institutional maturity and reducing deal drop-out risk.

Common Due Diligence Mistakes for Indian Founders

Many early-stage founders approach due diligence as a reactive administrative task rather than a strategic exercise. This often leads to critical oversights that can derail transactions or lead to unfavorable valuation adjustments. The most frequent errors stem from informal arrangements made during the early, pre-funding stages of the startup. Verbal agreements regarding equity splits, unrecorded loans from friends or family, and delayed statutory registrations are common occurrences that become major

bottlenecks during institutional diligence.

- Failing to execute formal IP assignment agreements with founders and early developers, leaving ownership unclear.
- Delaying statutory filings such as ROC annual returns, GST returns, and TDS deposits, leading to accrued penalties.
- Issuing equity or options to advisors, employees, or vendors via simple email agreements without formal board or shareholder approval.
- Mixing personal and business expenses through corporate bank accounts without appropriate accounting treatment or reimbursement documentation.
- Neglecting to register for mandatory state-level compliance certificates, such as Shops and Establishment Licenses, in operating offices.
- Underestimating the time and resource commitment required to respond to diligence queries, leading to operational delays.

Another significant pitfall is failing to audit the company's compliance health internally prior to the investor's diligence team arriving. Discovering a compliance gap, such as unpaid TDS or missing board resolutions for historical share issuances, during the diligence process damages founder credibility. It is far better to proactively discover these issues, disclose them to the incoming investor upfront, and present a clear, documented plan for rectification.

Frequently asked questions

- How long does the startup due diligence process typically take in India? — The entire due diligence process from term sheet signature to transaction closing usually takes between 4 to 8 weeks. Legal and financial audits consume approximately 3 to 4 weeks of this window, while drafting and negotiating final definitive agreements accounts for the remaining period.
- Can a startup raise funds without a completed due diligence process? — Institutional venture capital funds, SEBI-registered AIFs, and organized angel networks will almost never disburse capital without completing due diligence. Only very early-stage angel investments or simple convertible note rounds may proceed with a simplified, limited legal review instead of full financial and legal diligence.
- What happens if the diligence team finds a compliance gap during the process? — Minor gaps like delayed filings or small unpaid taxes are usually rectified prior to the transaction closing, or included as Conditions Precedent that must be met before capital is disbursed. Major issues like disputed IP ownership or large tax litigation can lead to a renegotiation of valuation or deal termination.
- Is a Virtual Data Room mandatory, and how should it be structured? — While not legally mandatory, using a secure Virtual Data Room is standard industry practice for institutional rounds. It should be structured logically with separate folders for

Corporate Legal, Financials, Tax, Intellectual Property, HR Employment, and Commercial Contracts, ensuring access levels are controlled.

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