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Due Diligence Exercise: Materiality Thresholds

Contact Persons:

Chia Loong Thye
Partner☎ +603 370 1122
✉ ltchia@rdslawpartners.com**Mohd Farizal Farhan**
Partner☎ +603 6206 0400
✉ farizal@rdslawpartners.com**Ong Eu Jin**
Partner☎ +603 6209 5488
✉ eujin@rdslawpartners.com**Ooi Bee Hong**
Partner☎ +603 6209 5401
✉ beehong@rdslawpartners.com**Tan Gek Im**
Partner☎ +04 370 1122
✉ gekim@rdslawpartners.com**Annabel Kok Keng Yen**
Senior Associate☎ +603 6209 5400
✉ annabel@rdslawpartners.com**Lily Lee Zai-Lii**
Senior Associate☎ +603 6209 5400
✉ lily@rdslawpartners.com

When a company (Applicant) undertakes a corporate exercise and due diligence is involved, not every aspect of the Applicant's affair is required for due diligence to be conducted on. Judgement would be exercised by the due diligence working group (DDWG) on whether the matter or issue at hand is sufficiently material to require further due diligence or disclosure in the relevant offer documents.

This alert provides an overview on the concept of materiality based on the Malaysia Equity Capital Markets Due Diligence Guide issued by the Malaysian Investment Banking Association (MIBA Guide) which considers both the quantitative and qualitative limbs when determining the materiality.

Quantitative Limb

Paragraph 2.5.3(b)(ii) of the MIBA Guide provides that, materiality in terms of monetary value depends on the current and future financial performance of the Applicant and its related companies (collectively, the Group) and how the Group would be impacted by the transaction or matter. This can be assessed based on the Group's past and current financial performance.

In most instances, the DDWG would determine the quantitative threshold by reviewing the Group's latest consolidated or comprehensive financial statement and set the materiality thresholds based on certain percentage of (i.e: 5%) the profit after tax or net asset of the Group.

Thus, most transactions or matters would generally be material if its value exceeds such quantitative threshold agreed by the DDWG.

Qualitative Limb

Paragraph 2.5.3(b)(i) of the MIBA Guide considers the subjective aspects, which includes the nature of the

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corporate exercise undertaken together with the parties involved and other relevant factors made known to the advisers or experts, that are likely to have a material impact on the business, assets or operations of the Group.

The relevant factors provided under the MIBA Guide are as follows:

- (a) any material impact on the reputation of the Group;
- (b) any breach of legislation which involves substantial monetary penalty, imprisonment or which may result in the cessation of business;
- (c) any material impact on the ability of the applicant to carry out the corporate proposal;
- (d) in relation to contracts or agreements, whether they involve or are likely to involve:
 - obligations and liabilities which by their nature and magnitude are unusual,
 - are of an onerous or long-term nature,
 - are otherwise material to the business or relates to another material contract, asset or subsidiary, or
 - are contracts, agreements, licences or permits upon which any company within the Group is materially dependent, including contracts which are material to the business or profitability of the Group;
- (e) in relation to litigation, whether it has a material effect on the financial position of the Group or might materially and adversely affect the position or business of the Group; and
- (f) in relation to any related party transaction, whether existing or proposed, a transaction which is unusual in nature or condition or not carried out on an arm's length basis.

In addition, contracts that have been entered into by the Group within the period covered by the historical financial

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Contact Persons:

Chia Loong Thye
Partner

+603 70 1122
lthia@rdslawpartners.com

Mohd Farizal Farhan
Partner

+603 6206 0400
farizal@rdslawpartners.com

Ong Eu Jin
Partner

+603 6209 5488
eujin@rdslawpartners.com

Ooi Bee Hong
Partner

+603 6209 5401
beehong@rdslawpartners.com

Tan Gek Im
Partner

+603 70 1122
gekim@rdslawpartners.com

Annabel Kok Keng Yen
Senior Associate

+603 6209 5400
annabel@rdslawpartners.com

Lily Lee Zai-Lii
Senior Associate

+603 6209 5400
lily@rdslawpartners.com



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information would be considered as material contracts if they fall within the following criteria:

- the contracts meet the quantitative limb and are not made within the ordinary course of business; or
- if the Applicant was a listed company would require an announcement under the Listing Requirements.

Conclusion

However, the list of relevant factors provided under the MIBA Guide is not an exhaustive list or a minimum standard to be achieved. As there is no hard and fast rule in a due diligence process, constant exercise of judgment by the DDWG is required to ensure the compliance and disclosure obligations are reasonably met. Such exercise of judgment on the grounds for materiality should also be documented pursuant to paragraph 2.5.3(a) of the MIBA Guide.

While it is vital to have a comprehensive due diligence, but it is never intended to be an exercise in boiling the ocean. That being said, prior to conducting a legal due diligence, the DDWG would come to a unanimous consensus on the materiality thresholds involving both qualitative and quantitative limbs, designed to elicit material information and to discard immaterial information as early as possible.

It is also of paramount importance for the Applicant, being the primary source of providing such information, to ensure all information and documents made available in the course of the due diligence exercise are complete and are not false or misleading to prevent liability(ies) arising from all relevant laws and regulations.

Authored by Lee Zai-Lii (Lily), a Senior Associate and Lau Sherley, a Paralegal with the firm's Capital Markets and M&A practice group.

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