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Financial Due Diligence: Critical Success Factor for Mergers & Acquisitions

Manish Sharma[1]*
*Assistant Professor (SAMA) & Research Scholar,
University of Lucknow
Uttar Pradesh, India – India

Dr. V.B. Singh[2]
Addl. Director
Aryakul Group of Colleges,
Lucknow – India

***Abstract:** Mergers & Acquisitions, popularly termed as M&A, are most crucial economic activities happening across globe in the corporate world. Corporations, worldwide resorts to M&A to restructure, realign and reorganize their functionalities to equip themselves to face tough times ahead or to move ahead time to kill competition. Apart from liquidity, dividend decisions, financing decisions, M&A are critical investment decisions a CEO makes for her firm.*

It is imperative for a mergers & acquisition decision to be financially viable and make sense. A critical and crude analysis of past records of revenue or profit figures may first seems enough to make the decision. But, the fact is, in order to achieve the value out of decision to initiate M&A, a comprehensive analysis is needed. It is at this juncture, where Financial Due Diligence comes into picture in M&A. Financial due diligence (FDD) is all about thorough enquiry by the corporate or financial buyer into the financial matters of the prospective capital investment (target company in case of M&A) by analyzing and validating all the financial, commercial, operational & strategic assumptions being made.

This work is an attempt to emphasize on adopting while highlighting the pivotal role a financial due diligence process plays in the correct valuation of prospective target and success of mergers and acquisitions..

***Keywords:** due diligence, mergers and acquisitions, operating performance.*

Financial Due Diligence is a purposeful, systematic & reasonable level of professional enquiry into the financial affairs of a business opportunity during an ongoing sales negotiation having a material implications on the prospects of business #

 # Definition by author

Financial Due Diligence: Introduction

It is imperative for a mergers & acquisition decision to be financially viable and make sense. A critical and crude analysis of past records of revenue or profit figures may first seems enough to make the decision. But the fact is in order to achieve the value out of decision to initiate M&A, a comprehensive analysis is needed. It is at this juncture, where Financial Due Diligence comes into picture in M&A

Financial due diligence (FDD) is all about thorough enquiry by the corporate or financial buyer into the financial matters of the prospective capital investment (target company in case of M&A) by analyzing and validating all the financial, commercial, operational & strategic assumptions being made.

Financial Due Diligence is a fact gathering exercise with a focused analysis of information.

The objective of financial due diligence is to ensure that the prospective investors makes an informed investment decision. To achieve this bidder companies forms internally and/or externally sourced due diligence teams to perform financial due diligence.

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There is a certain asymmetry between the so called seller and purchaser parties of mergers and acquisitions. The buyer tends to lack a wide range of information required in order to determine, for example, an appropriate purchase price, to ascertain synergies, or to minimize risk. The seller party, on the other hand, either has all such information readily at hand, or has the ability to obtain such information without undue difficulty (Picot 2002 p154).

The purchaser tries to overcome this obstacle by making financial audit and financial due diligence through the process. In order to make the best decision possible the purchaser will need the best data possible due to all aspects sought.

For conducting FDD review following sources of information may be tapped.

- Minutes of management and director's meetings
- Current financial data
- Historical financial data, detailed managements reports and accounts, income tax return, statutory accounts etc

Financial Due Diligence is about *Evaluation, Interpretation & Communication.* It overlaps with all other areas of Due Diligence and should not be conducted in isolation.

According to Borgese and Borghese (2002 p34), financial due diligence covers ensuring target financial statement accuracy, performing sanity checks, projections by trend based ratios, understanding tax issues, valuing target, and recommending appropriate financing. According to them finance team must perform following four key activities during the acquisition process: *corporate finance, tax strategy, audit, and cash management.*

So, financial due diligence process starts with financial audit by ensuring target financial statement's accuracy and goes further by standing on them. Financial due diligence will rely on target company's balance sheet and statement of income. Also at audit step of due diligence the audit procedures and the adequacy of audit procedures or internal auditing of target firm can be monitored and understood too.

Understanding the audit procedures while doing FDD, can be important for the finance team especially if the acquirer company is not familiar with the target's industry.

It is to be noted here that financial due diligence is distinct from financial audit in terms of coverage. While financial audit cover past and present, financial due diligence make projections for the value sought based upon audited financial statements.

Financial Due Diligence: Purpose

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Financial Due Diligence: Purpose

Financial due diligence should be undertaken whenever a company is considering acquiring new business (whether it be by acquiring share capital of an existing company or purchasing the business operations and assets only).

However the benefits of financial due diligence reviews are not limited to merger and acquisition decisions. They can also be useful in assessing the merits of disposing of certain existing business divisions within an organisation. A financial due diligence review is also an essential component of assessing investment requirements for venture capital arrangements.

Purposes of conducting Financial Due Diligence are-

- *Evaluating the quality of reported earnings*
- *Identification of potential risk for the buyer before making actual investment*
- *To identify value drivers critical to the transaction*
- *Identification of areas for post acquisition attention*
- *To improve transaction structure*

- *Identify issues to be addressed in purchase agreement*
- *To assess strength of financial personnel and systems*
- *FDD corroborate buyer's assertions regarding target's financial position.*
- *FDD helps in better negotiation with the discovered information.*

Financial Due Diligence: Types

- **FDD Commissioned By Buyer**

Buy side financial due diligence in M&A is conducted by the acquirer which covers analyzing general issues involving risks related with investment in target firm. It focuses on financial or strategic areas.

- **FDD Commissioned By Seller**

FDD commissioned by the vendor identifies potential 'show stoppers' allowing and effective mitigation strategy to be devised. It is too focused on areas of interest to potential buyers. The main objective of sell side commissioned FDD is to work it as a key tool for maximizing success of the transaction in a reduced timetable through maintaining competitive tension.

- **Limited Level FDD**

Limited level financial due diligence focus on certain key areas based on level of comfort desired by client. Its one variation is *Carve Out* which is strictly limited to the part of business proposed to be sold.

- **Full Scale FDD**

Full scale financial due diligence focuses on all the major aspects of financial statement and the extent of focus & coverage is more comprehensive.

Financial Due Diligence: The Process

The scope of each financial due diligence will be unique depending upon the nature of the transaction and the size of the company or business operations being acquired. In general a financial due diligence would typically involve a review of the following areas: historical financial results; current financial position; forecast financial results; working capital requirements; employee entitlements provisions; valuation implications; risks and opportunities; and taxation implications.

The key to determining an appropriate scope for financial due diligence is clear identification of the risks surrounding the potential acquisition.

The financial due diligence process should commence as soon as practical when negotiating to acquire a company or business. Generally, once a heads of agreement has been drafted setting out the structure for the deal, financial due diligence should begin.

Importantly, sufficient time should be allocated to the financial due diligence process as the outcome of the review may provide valuable information required to ensure a fair purchase price is agreed upon and, where necessary, the appropriate guarantees and provisions are put in place.

Focus Areas

All businesses involved in an acquisition, as buyers or sellers, need to ensure that the financial information they hold is as accurate as possible, not only to prevent paying too much (or in a seller's case receiving too little) but also to ensure that their

governance and risk management objectives are met. To ensure an efficient sales process, vendors need to present their financial information to potential buyers as transparently as possible. From the buyer's perspective the quality of financial information available about a potential acquisition determines the ultimate success of a transaction.

Analyzing historical financial statements may unravel the detailed facts crucial to the acquirer to make decision to go or not to go with the investment in target. Using past trading experience, FDD forms a view of the future and makes sure there are no 'black holes' through services that include:

- *Synergy validation*
- *Maintainable earnings and future cash flow assessments*
- *The determination of a normalized working capital and indebtedness position*

Financial statements commonly consist of the following items

- Income Statement
- Balance Sheet
- Cash Flow Statement
- Notes to the Financial Statements

Key performance indicators (KPI's) based on financial statements like *Gross Margin, Operating Margin, Debt Equity Ratio, Working Capital etc* and their development over time, provide good measures for the reasons behind positive or negative performance of a business. Financial statements as basis of valuation helps in identifying inconsistent accounting policies and also facilitates understanding of estimates and judgements used in reported numbers. Scrutiny of financial statements reveals levels of recurring EBITDA/EBIT.

Income statement of target company (Profit & Loss Account) throws light on

- *Sales by region/ customer/ product...in terms of (volume, prices)*
- *Cost of sales*
- *Raw materials (such as volumes, prices, supplier dependency)*
- *Manufacturing costs (costs per unit, headcount ...)*
- *Margins by region/ customer/ product*
- *Overhead costs - fixed vs. variable*
- *EBITDA/EBIT development over a number of periods*

Position statement (Balance Sheet) of target would help acquirer in analyzing the facts about targets

- *Current Assets (inventory valuation, debtors ageing, provisions, short term advances*
- *Liabilities (payment terms, provision policies, provision of tax)*
- *Fixed Assets (degree of depreciation, capital expenditure)*
- *Working Capital (cash flow impacts, seasonality)*
- *Net Debt (maturity, off balance sheet items, contingent liabilities)*

Before the final stage of the investigation, an analysis of the target business's capital, reserves, and financial investments must be done with attention paid to cash flow.

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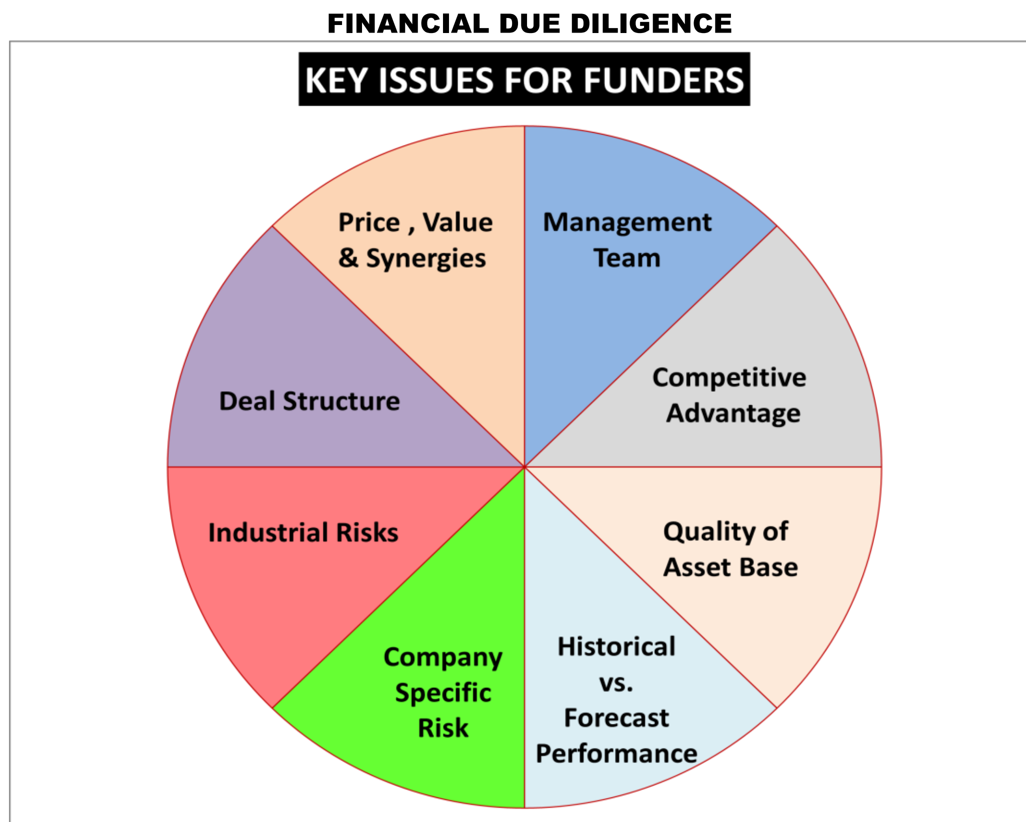
The final stage of the financial due diligence is to calculate EBIT (Earnings before Interest and Taxes) and EBITDA (Earnings before Interest, Taxes, Depreciation and Amortization). Short-term and long-term debt must be considered in light of the company's working capital.



Stages in FDD Process

After obtaining sound figures in way of making projections, the procedure continues by running the numbers. Numbers obtained from financial statements will be utilized by the financial experts of acquirer in valuing the target company and during ratio analysis. Ratios so derived will be compared with industry standards to understand the performance of the target. A study by DePamphilis (2003, p401) suggest that ratio of successful competitor may be used for comparison in absence of average industry standards.

Analysis of trends in the ratios is crucial for understanding the characteristics of the target and to estimate the scope for the merged entity. Ratio analysis will help in pin pointing weakness and strength of the target firm and this will further the due diligence process. Results of ratio analysis in combination with the strategic goals of the bidder company are important in the success of M&A.

Finance team of bidder should analyze the target and its industry (must in case of conglomerate merger) in terms of activity, liquidity, profitability and also in term of solvency ratios. During the analysis any fluctuations in ratios and their causes must be studied and trends must be compared with the industry to reveal macro or micro causes.

Nature of competition, market opportunities and market maturity can be easily revealed by studying profitability and activity ratios. On comparing target's liquidity and leverage ratios with that of acquirer company's ratios one can found out if capital structure of acquirer is strong enough to support the target company or vice versa.

After studying financial ratios and financial statements of the target, next big step in FDD is to evaluate tax positions. Tax due diligence must be applied in order to understand incumbents of M&A and that too before deciding about the value of target.

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Tax due diligence in financial due diligence comprises of two completely independent task. First one is to ensure fiscally optimised acquisition arrangement for both purchaser and seller. Second involved protection of the purchaser against tax related financial risk arising from the past liabilities (Picot 2002 p175).

Besides tax, liabilities like employment benefits, customer allowances/ discounts, products and service warranties and any other unrecorded liabilities like pension liabilities have to be specified before valuation. (Borgese and Borghese 2001 p57)

On consolidating above variables; cash flow projections, assets and liabilities values, tax liabilities and unrecorded liabilities, financial experts of the acquirer will be able to get a solid foundation to start valuation calculations. (*Refer to Chapter 3 of this thesis for details of methods used for valuing a target*)

In valuation of target, *Equity discounted cash flow* method (*free cash flow to equity investor*) and *Enterprise discounted free cash flow* method (*free cash flow to the firm*) may be used.

Market based valuation technique can be utilized if target is open to public and bears the assumption that the market has fairly priced the company or the other similar company in the industry.

Asset based valuation method and *Replacement* cost methods are much more reliable after financial audit but are not suitable in every situation as the future value of target lays in the future prospects of the target may be drastically different from its current positions.

By giving due weight to each valuation method, a weighted average value of target can be found out. This technique is known is *Weighted Average Method.*

Financing of M&A initiates after valuation of target is done. Valuing the bidder is the next stage if the M&A deal is going to be all share swap deal i.e. if the acquirer company will give its own share for some or all of the target company.

At this very stage i.e. before payment commences, it is vital to uncover the strength and weaknesses of acquirer by conducting internal auditing and ratio analysis. This will clear the picture for finance team of acquirer to assess the need of financing required for M&A if any.

Financial experts need to review current capital structure, evaluate cash requirement if any, and in the light of strategic goals and objectives of the company assess the need of external financing and its impact on prospective capital structure (Borgese and Borghese 2002 p35). The capital requirement after closing the deal has to be considered too.

At this juncture, again financial ratios should be studied and they should be studied in trend to understand fitness of capital structure and need of financing. Leverage ratios and liquidity ratios are studied and interpreted with health and sustainability view point. Assessing the assets liability quality of bidder is also required to understand its own leverage capacity and bargaining power. Studying solvency ratios will help acquirer determining the need to go to every end of its financing options.

After giving due consideration to each and every stage FDD acquirer can then make a final informed decision on a potential merger and acquisition.

The Way Forward

Financial due diligence initiates with the financial audit that provides solid financial data about both the parties to M&A which will be utilized along the entire financial due diligence process and it ends with selection of suitable financing option for merger and acquisition activity.

Financial due diligence process is much more than simply following through a standard check list of procedure in order to provide a *tick* for proposed acquisition. In fact, financial due diligence being a crucial part of whole due diligence process

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should aim at the maximum reliability along with providing optimal solutions for both the parties of M&A, in order to help them achieve value sought in M&A.

The finance teams involved in financial due diligence always have to be interactive with other teams of due diligence process to form right projections and assessing trends in companies history which sheds light on future prospects of the deal.

There have been numerous high profile examples that have proven the cost of performing expert financial due diligence far outweighs the cost of a bad acquisition. When done properly a financial due diligence review provides valuable information to support the proposed acquisition and identify early the issues that need to be addressed to combine companies and businesses successfully.

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