



Financial Due Diligence CA Aadish Jagawat

Topics to be Covered

- What is Due Diligence
- Objective of Due Diligence
- Due Diligence Process
- Types of Due Diligence
- Buy Side v/s Sell Side
- Major Aspects to be Covered in DD Report
- Important Financial Matters
- Examples of Acquisitions Went Wrong
- Career in FDD: Pros and Cons



What is Due Diligence and Role of a Finance Professional

Due diligence is a process by which all the relevant **information** to **making a decision** on a **particular transaction** comes to light!

We as accountants take up the **accounting, tax and financial** due diligence process and **closely work** with the **law firms** and **information system audit firms, environmental audit firms, HR specialists** to take up the other aspects.



Objectives of Due Diligence

- Investigate into the **affairs of business** as a prudent business person
- Assess the **risks and opportunities** of a proposed transaction
- Reduce the **risk of post-transaction** unpleasant surprises
- To **create a trust** between two unrelated parties
- To **identify potential Synergies**



Due Diligence Process

- Define **scope** of the engagement and relevant information requirement
- Analysis of **preliminary information**
- Analysis of **historic financial** information
- Industry research
- **Benchmark** forecasts and proposed deal multiples with market and industry data
- **Discussion with key management** personnel to validate findings
- Discuss the implications of **key findings**
- Issue of **final report**

Types of Due Diligence

Accounting due diligence

- Review of financial statements and management accounts
- Review of significant accounting policies and compliance with relevant Generally Accepted Accounting Principles (GAAP)
- Historical revenue and cost trends
- Consistency between historical results, versus budget and forecast
- Historical and anticipated capital expenditure and working capital levels
- Review of debt covenants and terms of other debt-like instruments

Financial due diligence

- Basis for future business plan
- Valuation
- Deal financing
- Market dynamics and customer attractiveness
- Industry structure and dynamics
- Distribution channel dynamics
- Business plan review
- Quality of assets

Types of Due Diligence

Tax due diligence

- Assessment of tax impact
- arising from “change in control”
- Assessment of historical tax exposures
- Identifying tax saving opportunities
- Assessment of current tax position
- Assessment of various modes of tax neutral deal structuring

Legal due diligence

- Liabilities and potential risks
- Competition authority implications
- Transaction mechanics,
- execution and closing



Buy Side v/s Sell Side Due Diligence

Buy side due diligence

- **Problem Statement:** Are you buying what you think you are buying?
- **Objective:** Assist the buyer maximize his return on the deal

Sell side due diligence

- **Problem Statement:** Do you know the issues a potential buyer may negotiate on?
- **Objective:** Assist the Vendor / Seller get the best value on the deal



Major Aspects to be Covered in DD report

- **Deal breakers** - Issues which would impede the consummation of the proposed transaction
- **Negotiation points** - Issues which would be necessary to consider in the valuation of business/ negotiation of bid price
- **Commercial override** - Risks and issues which are knowingly, taken over as a calculated commercial decision.
- **Issues for agreements** - Issues which would warrant indemnities and identify conditions precedent for happening of the transaction
- Possible business reductions and cannibalism.

Key Financial Matters

The buyer will be concerned with all of the target company's **historical financial statements** and **related financial metrics**, as well as the **reasonableness** of the target's projections of its **future performance**. Therefore, topics of inquiry or concern for FDD will include the following:

- 1. Look at history
- 2. To predict the future
- 3. Related party transactions
- 4. Valuations



FDD - Look at History

- What do the **historical financial statements** for the **last three years** reveal about its financial performance and condition?
- Are **all liabilities**, both current and contingent **set forth** in the financial statements?
- Are the **margins** for the business **growing or deteriorating**?
- Are there any **unusual revenue recognition issues** for the company or the industry in which it operates?
- What is the **aging of accounts receivable**, and are there any other accounts receivable issues?
- Has **EBITDA** and any **adjustments to EBITDA** been appropriately calculated?

FDD - To Predict the Future

- Are the company's **projections** for the future and underlying assumptions **reasonable and believable**?
- How do the **company's projections for the current year** compare to the **board-approved budget for the same period**?
- What **normalized working capital** will be necessary to continue running the business?
- What **capital expenditures and other investments** will need to be made to continue growing the business?

FDD- Related Party Transactions

The buyer will be interested in understanding the extent of any “related party” transactions, such as agreements or arrangements between the target company and any current or former officer, director, stockholder, or employee, including the following:

- Any **direct or indirect interest** of any officer, director, stockholder, or employee of the company **in any business that competes with or does business with the company.**
- Any **agreements** where any officer, director, stockholder, or employee has **an interest in any asset (real estate, intellectual property, personal property, etc.) of the company**

FDD-Valuations Approaches

- **Income approach:** Reviewing future earnings and valuation through growth model. Use appropriate income factor like dividend, free operating cash flow, free cash flow to equity.
- **Market approach:** Use appropriate multiplier like EPS, EBIDTA, EPS etc. to compare it with industry standards.
- **Asset approach:** Identification of risks relating to assets which may have an impact on the value of the assets

Examples of Acquisitions Went Wrong



Merger	Failure reason
eBay and Skype	Overestimating of demand by eBay
Daimler-Benz and Chrysler	Cultural changes in 2 companies
Bank of America and Merrill Lynch	Lack of communication of key decisions to stakeholders
Volvo and Renault	Problems of combining an investor-owned entity with a government-owned company
HP and Autonomy	Due to accounting irregularities

Career in FDD

Pros:

- Higher compensation
- Work directly with the executive team of large Companies
- Growth at a tremendous pace in your firm
- Better options for cross-selling within firm

Cons:

- Deadlines are extremely tight
- Nauseating and unpredictable work hours
- Lot of travel

