

Basic Practice of Financial Due Diligence

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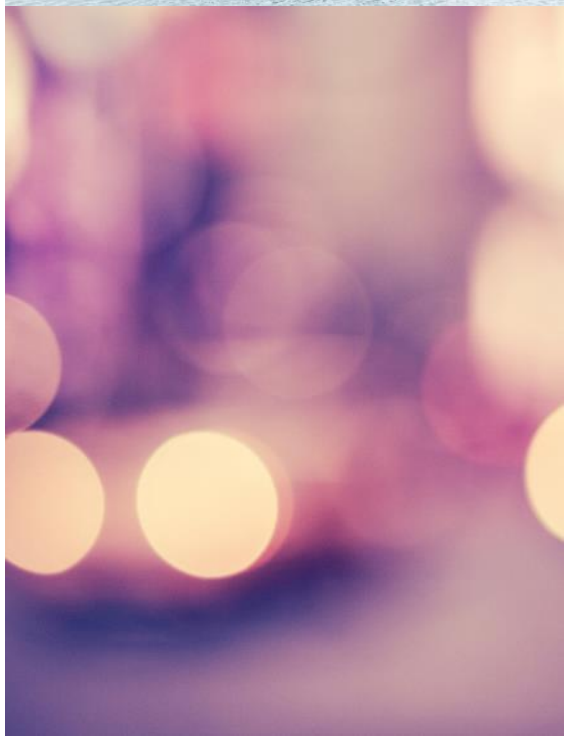


10. Basic Practice of Financial Due Diligence

🔍 Objectives of Financial Due Diligence (Part 1)

- FDD verifies a target's true financial health.
- It reveals the real story behind the numbers presented by the seller.

⚖️ Verifying the Balance Sheet

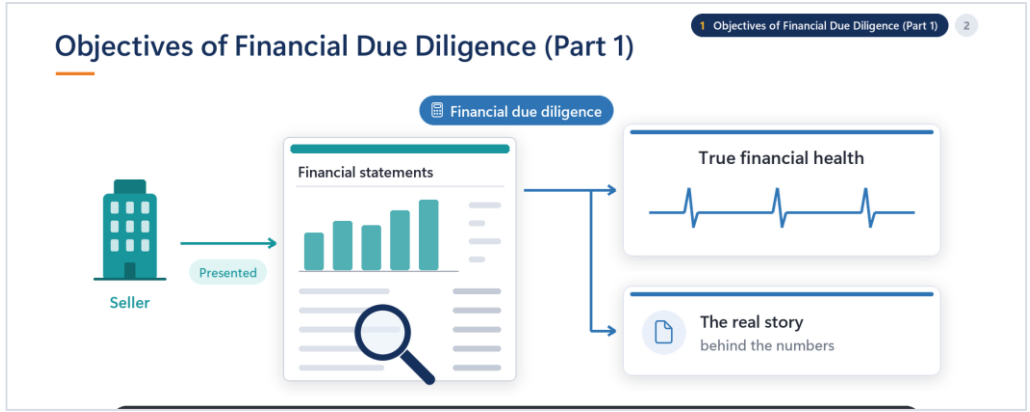
- The FDD team conducts a deep analysis of the target's assets and liabilities.
- Primary goal: uncover hidden or understated liabilities.
- Examples: pending legal settlements or unfunded pension obligations.
- Liabilities directly impact net debt, a key component of the final purchase price.

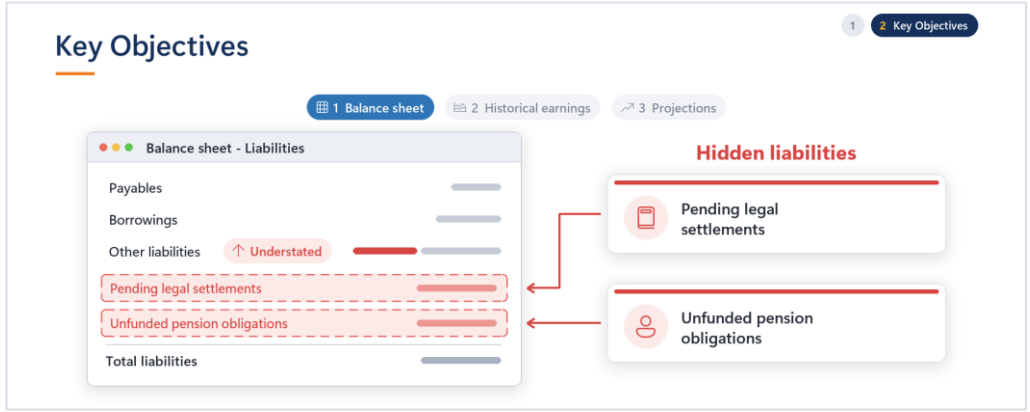
📊 Analyzing the Quality of Historical Earnings

- FDD scrutinizes the income statement for true, sustainable profitability.
- Key drivers of revenue and margins are analyzed for quality and stability.
- It identifies aggressive accounting policies or one-time revenue events.
- Such items may have artificially inflated past performance.

📈 Testing Future Performance Projections

- FDD stress-tests the seller's financial forecasts: are they realistic and achievable?
- Projections are compared with historical performance, market trends and operational capacity.
- Validation is essential for the buyer's valuation model.
- It is also essential for securing acquisition financing from lenders.





10. Basic Practice of Financial Due Diligence (Part 2)

🎯 Objectives of Financial Due Diligence (Part 2)

- FDD findings are categorized into actionable insights.
- These insights directly influence the deal's outcome.
- The most important output: the target's true, underlying profit.

🧮 Calculating Normalised Profit

- Central goal: the target's maintainable or "normalised" profit.
- It is often presented in a Quality of Earnings report.
- Reported profit (EBITDA) is adjusted to remove one-time, non-recurring or non-operating items.
- Example: remove a one-off gain from a factory sale; add back unusual legal costs.
- The result shows the true, repeatable earning power of the core business.

🚩 Identifying Red Flags

- FDD is designed to uncover red flags.
- Red flags are categorized as deal-breakers or negotiation points.

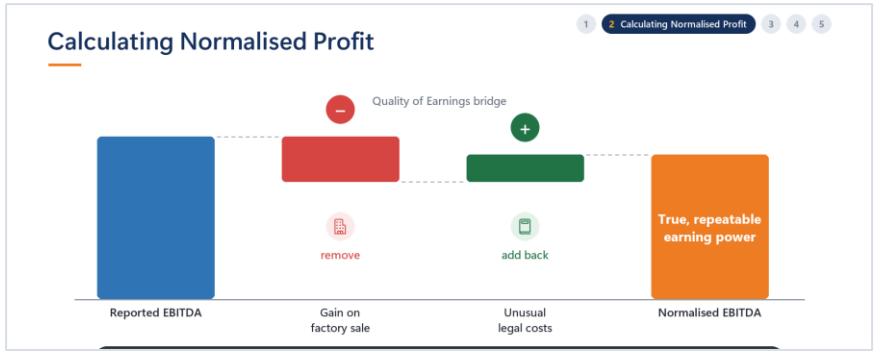
⛔ Deal Breakers

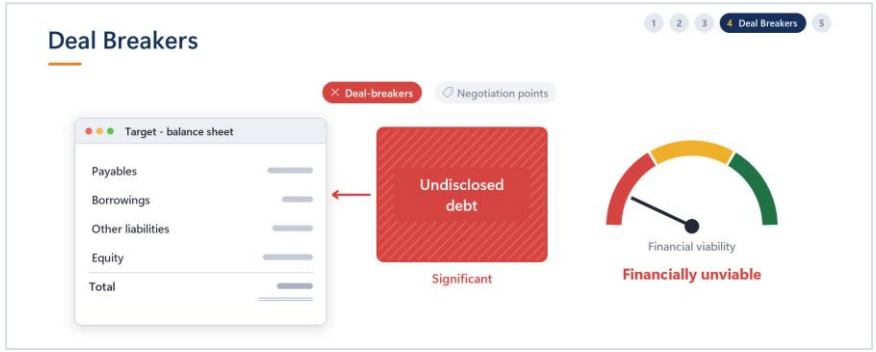
- Fatal flaws that typically cause the buyer to walk away.
- Example: significant, undisclosed debt that makes the company financially unviable.
- Example: fraudulent accounting, making all provided financial data unreliable.

🤝 Negotiation Points

- Significant issues that don't kill the deal.
- They give the buyer powerful leverage to renegotiate price or terms.
- Example: aggressive revenue recognition used to inflate sales figures.
- The buyer uses such findings to argue for a lower valuation.







10. Basic Practice of Financial Due Diligence (Part 3)

🗺️ Financial Due Diligence Procedure (Part 1)

- An effective FDD process is a structured, four-stage investigation.
- It is designed to uncover the financial reality of a target company.

👥 1. Assembling the Team and Defining the Scope

- The team combines external advisors, typically from an accounting firm, with key internal finance personnel.
- Together they define a precise scope of work.
- It is not a full audit but a targeted investigation of key risk areas.
- Focus: quality of earnings, balance sheet accuracy and achievability of financial forecasts.

🗂️ 2. Data Collection and Analysis

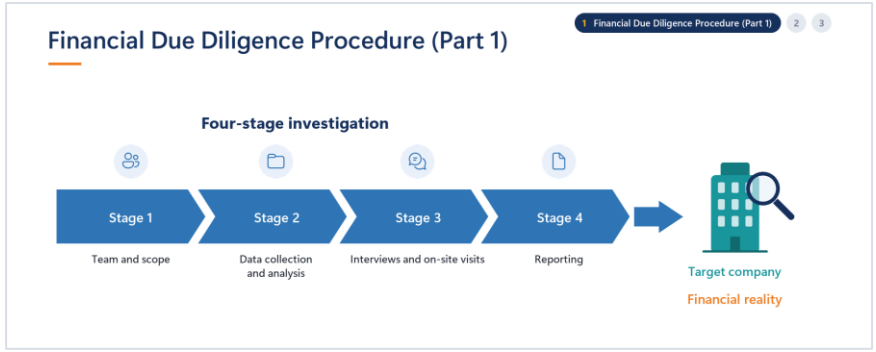
- Once the scope is set, the FDD team requests access to the target's virtual data room.
- Critical documents: at least three years of audited financial statements.
- Tax returns and internal management reports are also collected and analyzed.
- Core of this stage: the Quality of Earnings analysis of true, sustainable earning power.

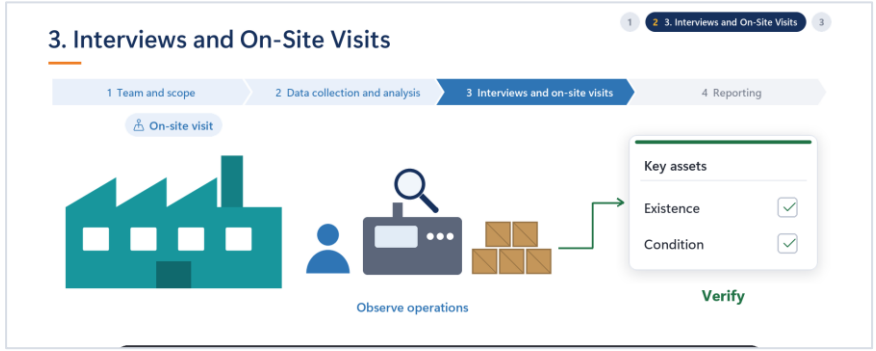
🔎 3. Interviews and On-Site Visits

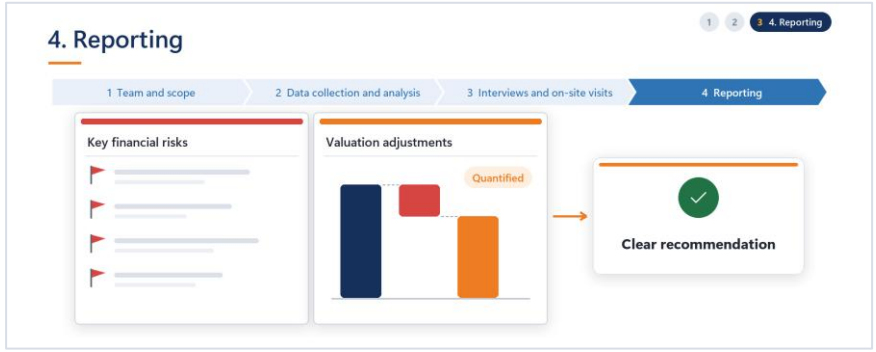
- In-depth interviews with the target's CFO and key finance personnel.
- Interviews reveal the story behind the numbers.
- On-site visits observe operations firsthand.
- They verify the existence and condition of key assets.

📑 4. Reporting

- All findings are compiled into a comprehensive FDD report.
- The report highlights all key financial risks.
- It quantifies the necessary valuation adjustments and gives a clear recommendation.







10. Basic Practice of Financial Due Diligence (Part 4)

📜 The Terms of Reference

- The Terms of Reference governs the entire FDD process.
- It acts as the formal project plan for the FDD work.
- The buyer and the advisory firm agree on it before any work begins.

🎯 Purpose of the Terms of Reference

- A foundational document that sets clear expectations.
- It prevents scope creep beyond the agreed work.
- All parties align on the objectives, timeline and deliverables of the FDD process.

🔍 Scope and Objectives

- Defines clearly what will be investigated.
- Just as importantly, states what will be excluded.
- Specifies the exact historical period to be analyzed.
- Names the key financial accounts to be scrutinized.

🗓️ Timeline and Milestones

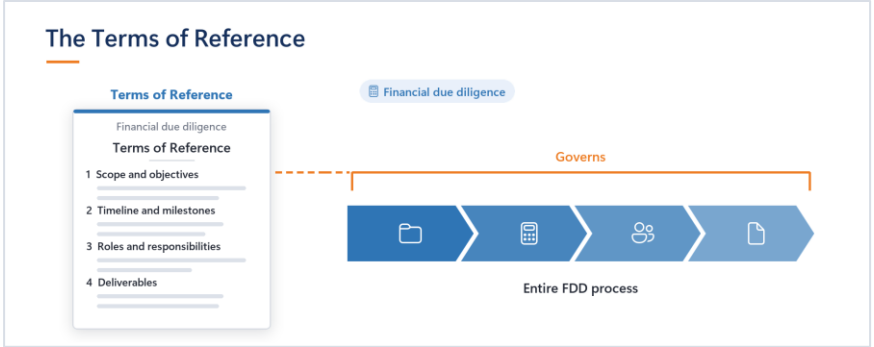
- A detailed timeline with key deadlines.
- Deadlines cover data requests and management interviews.
- Also sets delivery dates for the draft and final reports.

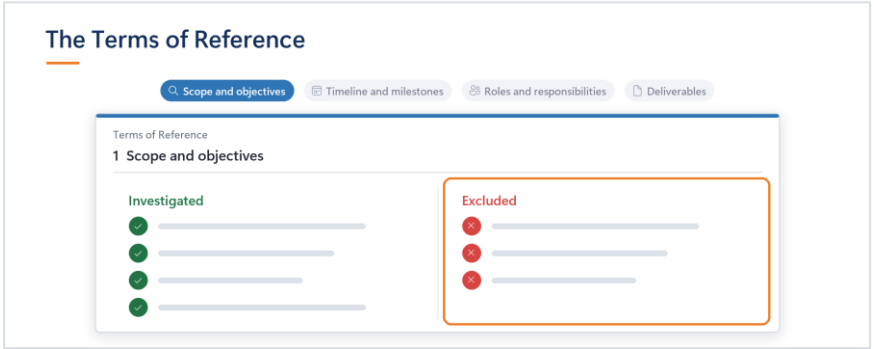
👥 Roles and Responsibilities

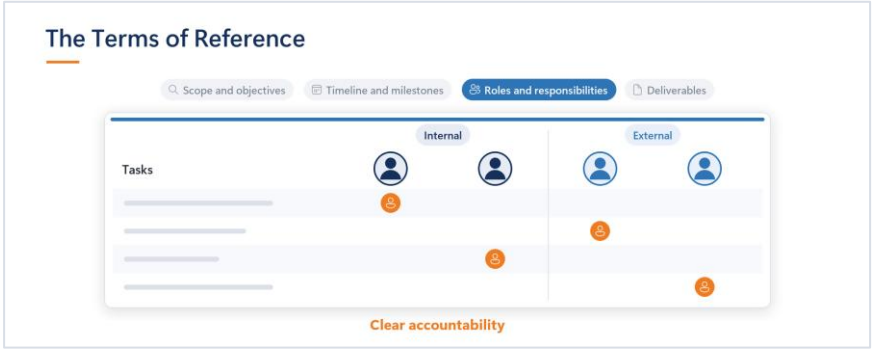
- Explicitly assigns tasks to each member of the FDD team.
- Covers both internal and external team members.
- Ensures clear accountability for every task.

📑 Deliverables

- Specifies the exact format of the final report.
- For example, the primary deliverable is a Quality of Earnings report.
- The report includes a detailed analysis of net debt and working capital.







10. Basic Practice of Financial Due Diligence (Part 5)

👥 Building a Financial Due Diligence Team

- Team size and composition depend on deal size and complexity.
- Most FDD teams include internal finance staff and external advisors.

🏢 Role of Internal Team Members

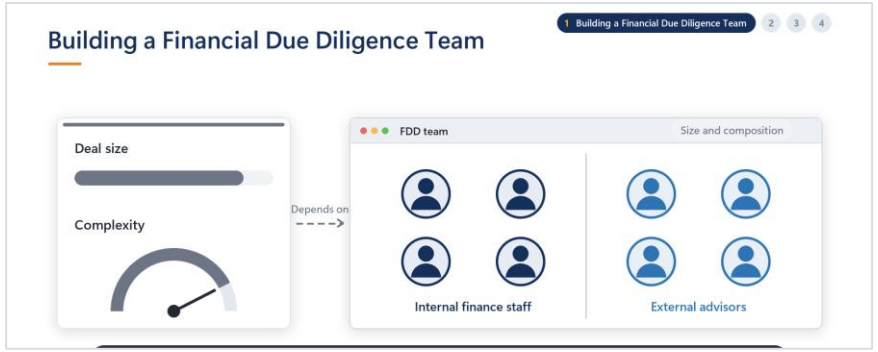
- Assign internal finance experts who know the company's goals and budget limits.
- They also understand the company's past M&A experiences.
- They align the FDD findings with the buyer's long-term strategy.
- They monitor external consultants and ensure outputs fit internal reporting standards.
- Involving internal staff builds internal capabilities for future deals.

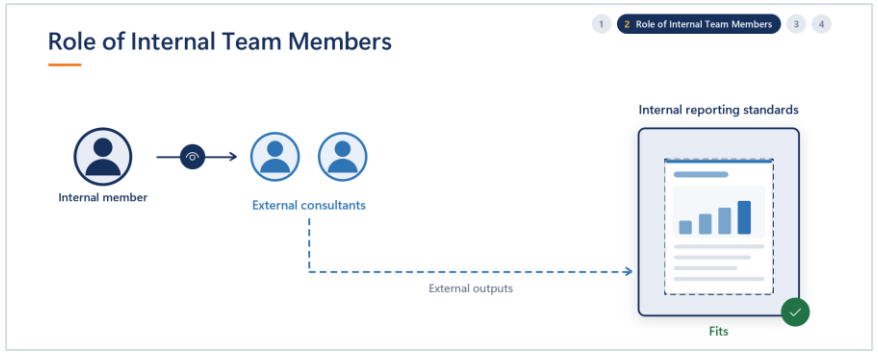
🧮 When to Bring in External Advisors

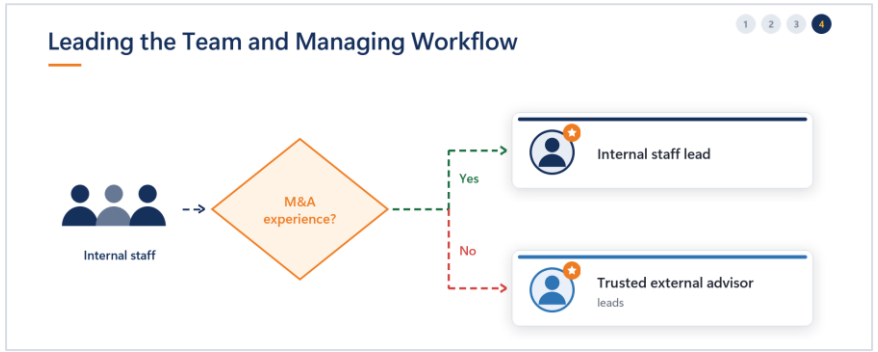
- Accounting firms are needed when the internal team lacks experience or capacity.
- They provide technical knowledge in tax and accounting policies.
- They also advise on compliance with local regulations.
- Weigh cost versus benefit, as advisory fees can be high.

🧭 Leading the Team and Managing Workflow

- A capable leader coordinates tasks and keeps the process on schedule.
- Internal staff with M&A experience should lead; otherwise a trusted external advisor.
- Assign clear responsibilities to avoid duplicated work or gaps.
- Run weekly meetings and use reporting templates to track progress.
- Review analysis quality before sharing final reports and respond quickly to delays.







10. Basic Practice of Financial Due Diligence (Part 6)

✅ Financial Due Diligence Checklist (Part 1)

- A thorough FDD process is built on a structured checklist.
- Part 1 covers historical performance, ownership and the credibility of future plans.

📊 Review of Historical Financial Statements

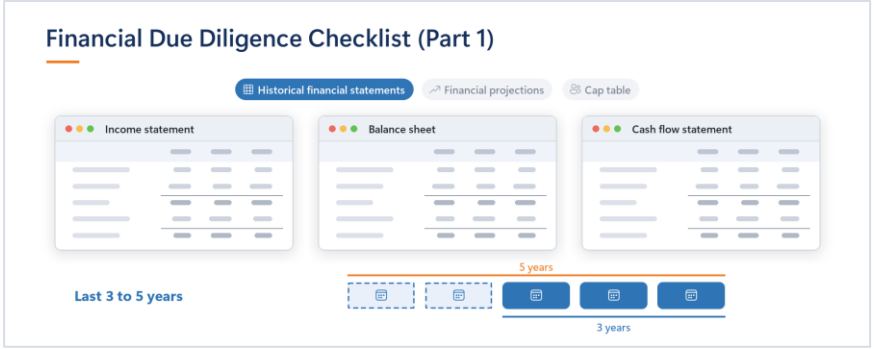
- Begin with a deep dive into the last three to five years.
- Scrutinize income statements for the true drivers of revenue growth and profitability.
- Use balance sheets to evaluate asset quality and uncover off-balance-sheet liabilities.
- Cash flow statements show liquidity and cash generated from core operations.

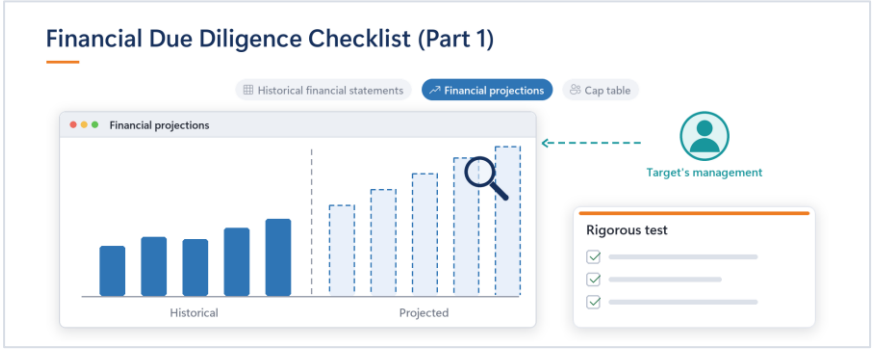
📈 Evaluation of Financial Projections

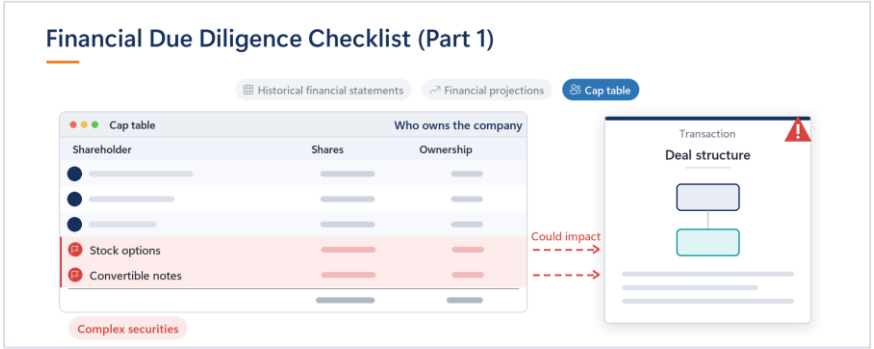
- Rigorously test the projections provided by the target's management.
- Check that revenue growth and margin assumptions are realistic.
- Compare the assumptions with historical performance and market trends.
- Decide whether the growth story is believable or overly optimistic.

📑 Analysis of the Capitalisation Table

- The cap table gives a complete breakdown of the ownership structure.
- Review it to understand who owns the company.
- Identify complex securities such as stock options or convertible notes.
- These securities could impact the deal structure.







10. Basic Practice of Financial Due Diligence (Part 7)

📋 Financial Due Diligence Checklist (Part 2)

- Part 2 moves from the core financials to operational and liability-focused aspects.
- Four checks: debt, customers and sales, working capital, tax compliance.

🏦 Debt Schedule and Liabilities Review

- Examine all of the company's debt agreements thoroughly.
- Identify interest rates, repayment schedules and restrictive covenants.
- Check which covenants could be triggered by the acquisition.
- Goal: no hidden or excessive debts that threaten stability post-acquisition.

👥 Customer and Sales Data Analysis

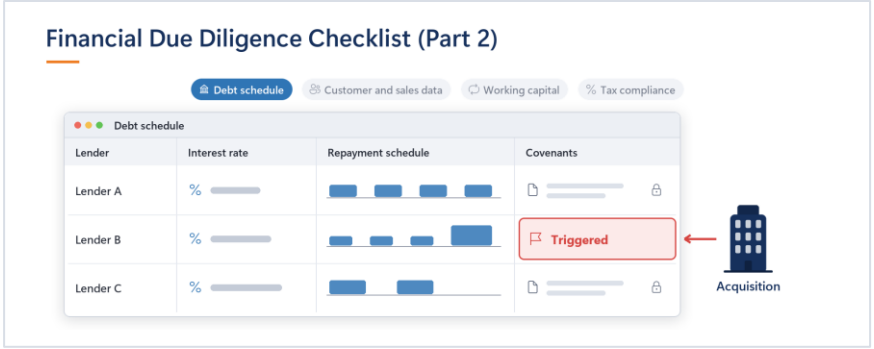
- Analysing the customer base is critical for assessing revenue stability.
- Calculate revenue concentration from the top 10 customers.
- Identify risky over-dependencies on individual customers.
- Analyse the historical churn rate to judge customer loyalty.

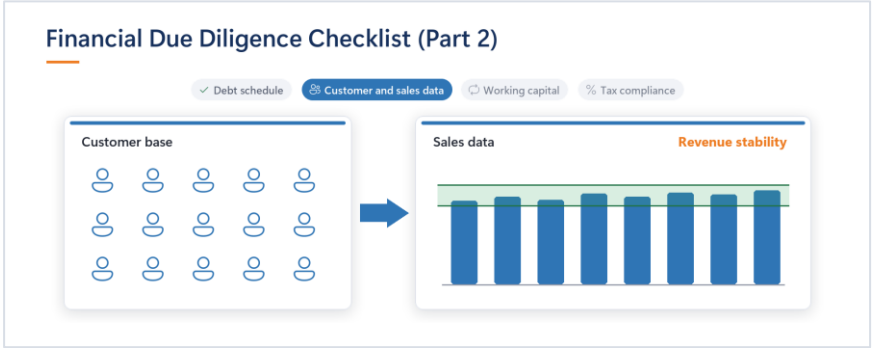
🔄 Working Capital Analysis

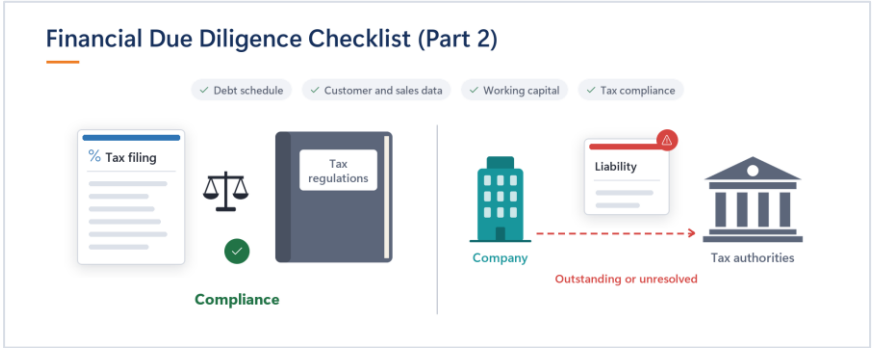
- Review the company's accounts receivable and accounts payable in detail.
- Analyse the aging of accounts receivable.
- Aging reveals potential issues with collecting cash from customers.

📜 Tax Compliance Review

- Review the company's historical tax filings.
- Ensure compliance with all tax regulations.
- Identify outstanding or unresolved liabilities with tax authorities.







10. Basic Practice of Financial Due Diligence (Part 8)

🌎 Cross-Border Financial Due Diligence

- FDD becomes more complex when buyers acquire a company overseas.
- Different accounting rules, tax laws and political risks affect the deal outcome.
- Examine several areas closely to avoid unexpected costs after the acquisition.

📘 1. Accounting Standards and Financial Comparability

- Many companies outside the US use a different accounting system.
- Some follow IFRS, while others use their national GAAP.
- Reconcile key items: revenue recognition, depreciation and lease accounting.
- Verify that reported earnings reflect the economic reality.

📃 2. Local Tax Exposure

- Each country has its own tax laws for income, VAT and transfer pricing.
- Check the target for unpaid taxes, aggressive tax structures or penalties.
- Post-acquisition tax surprises often lead to disputes or write-downs.

⚖️ 3. Legal and Regulatory Issues

- Confirm the target complies with local financial and corporate laws.
- Review litigation records, licensing requirements and audit history.
- In some countries, small compliance failures can delay or block the deal.

💱 4. Political and Currency Risks

- Evaluate currency volatility and inflation in the target's country.
- Political instability or capital controls can affect cash flow and value.
- If needed, hedge against exchange rate swings before closing.

