TRANSACTION ADVISORY SERVICES

THE IMPORTANCE OF FINANCIAL DUE DILIGENCE

A critical step in completing an M&A transaction

In the world of mergers and acquisitions, it is important for a purchaser to conduct its "due diligence" with respect to the historical and forecasted activities of a potential target company. Due diligence could include inquiries into the financial, tax, legal, commercial, human resources, regulatory and environmental affairs of the company. The following addresses the financial aspects of due diligence.

What is financial due diligence?

For starters, financial due diligence is not an audit. An audit provides an opinion on whether the historical financial statements present fairly the financial position of a company. Financial due diligence, on the other hand, goes deeper to understand the reasons for historical and forecasted trends, and reports on the relevancy of these trends to the purchaser.

The scope of financial due diligence differs from business to business depending on the size and industry of the target company. Typically, the scope would include an analysis of the historical quality of earnings (i.e. the sustainability of historical earnings before interest, taxes, depreciation and amortization or "EBITDA"), quality of net assets, working capital requirements, capital expenditure requirements, financial debt and liabilities, and forecasted financial results.

Based on the outcome of the due diligence a purchaser should be able to assess, based on their risk profile, whether there are any potential deal breakers, whether the structure and price of the acquisition is appropriate or whether appropriate warranties and representations are included in the purchase agreement.

When do I need to conduct financial due diligence?

Financial due diligence should be undertaken whenever a purchaser is considering acquiring a new business. Ideally, the financial due diligence process should commence as soon as possible when negotiating to acquire a business. Once an expression of interest or letter of intent (which lays out the structure of the transaction) has been agreed by both the purchaser and the vendor, the financial due diligence should begin.

Adequate time should be allocated to the financial due diligence process. Financial due diligence inquiries can range between two to four weeks depending on the size of the target company and scope of the work.

Who should complete the financial due diligence?

Financial due diligence can be conducted either internally, by the acquirers' own accounting and finance function, or by external independent due diligence professionals. The benefits of using external professionals include: 1) The diligence is based on an independent viewpoint from a party that has no direct interest in the outcome of the proposed transaction; 2) The diligence is completed by professionals who understand the dynamics of a transaction environment; and 3) Internal resources, which are likely already constrained, can be dedicated to integration and post transaction planning.

What information is required?

The information required to complete financial due diligence is dictated by the scope as well as the reporting capabilities of the target company. The main sources of information for

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financial due diligence include: historical financial statements, detailed trial balances, general ledgers, detailed management accounts and reports, current operating results, business plans / budgets and forecasted financial information.

What will I get out of a financial due diligence review?

Depending upon the scope of the procedures conducted, financial due diligence should provide answers to the following questions: Is the information provided by the vendor reliable? Are the historical earnings of the company sustainable? What are the potential future earnings of the company? What level of working capital should be included at transaction closing? Has the company sufficiently invested in capital expenditures? Are there any on or off balance sheet liabilities that should be considered? Does the company have any future commitments or contingencies?

When done properly, financial due diligence provides valuable information to support a fair purchase price and ensures the appropriate warranties and representations are included in the purchase agreement. It also identifies the issues the purchaser and vendor should address to complete a successful transaction. Finally, in today's markets, a third party due diligence report is increasingly becoming a requirement for lenders to provide financing to a transaction. In summary, the cost of performing professional financial due diligence far outweighs the cost of a bad acquisition.

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