

# FINANCIAL DUE-DILIGENCE

*August 26, 2010*



Nitin Arora || *Associate Director* ||

Corporate Catalyst India [www.cci.in](http://www.cci.in)

# Financial Due Diligence (FDD)

- Financial Due Diligence is a reasonable level of enquiry into the financial affairs having a **material impact** on the prospects of the business
- A FDD review may not only look at the **historical** financial performance of a business but will generally consider the **forecast** financial performance also
- The objective is to ensure that prospective investors make an **informed investment decision**
- Its a fact gathering exercise with a focused analysis of information. The main **sources of information** for a FDD review include:
  - Historical financial data including statutory accounts, detailed management accounts and reports and income tax returns
  - Current financial data such as year-to-date management accounts
  - Minutes of Directors' Meetings and Management Meetings
- FDD is about: **Evaluation, Interpretation and Communication**

# FDD – When Needed ?

Mostly sought for the following **transactions**:

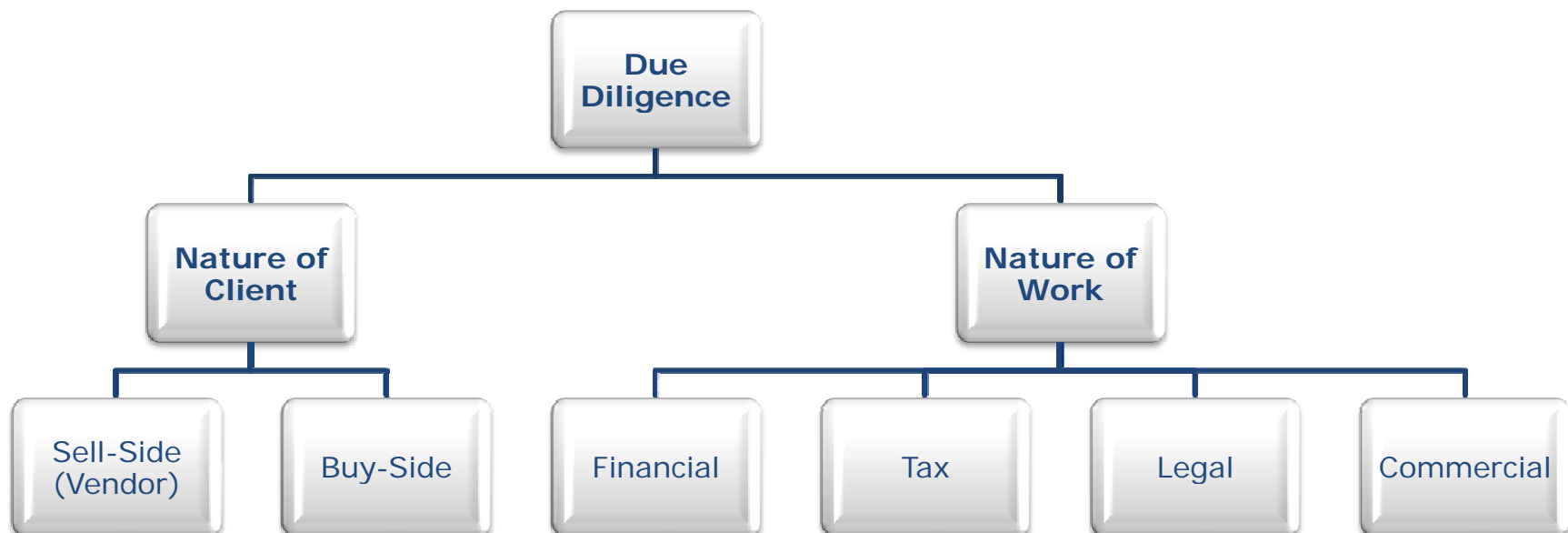
- Disinvestments
- Strategic investments or a PE investment
- Acquisition of an undertaking / business
- Inbound and overseas investments
- Listing of securities in Indian or overseas market





*Building Business  
Partnerships*

# Types of Due Diligence



# Purpose of FDD

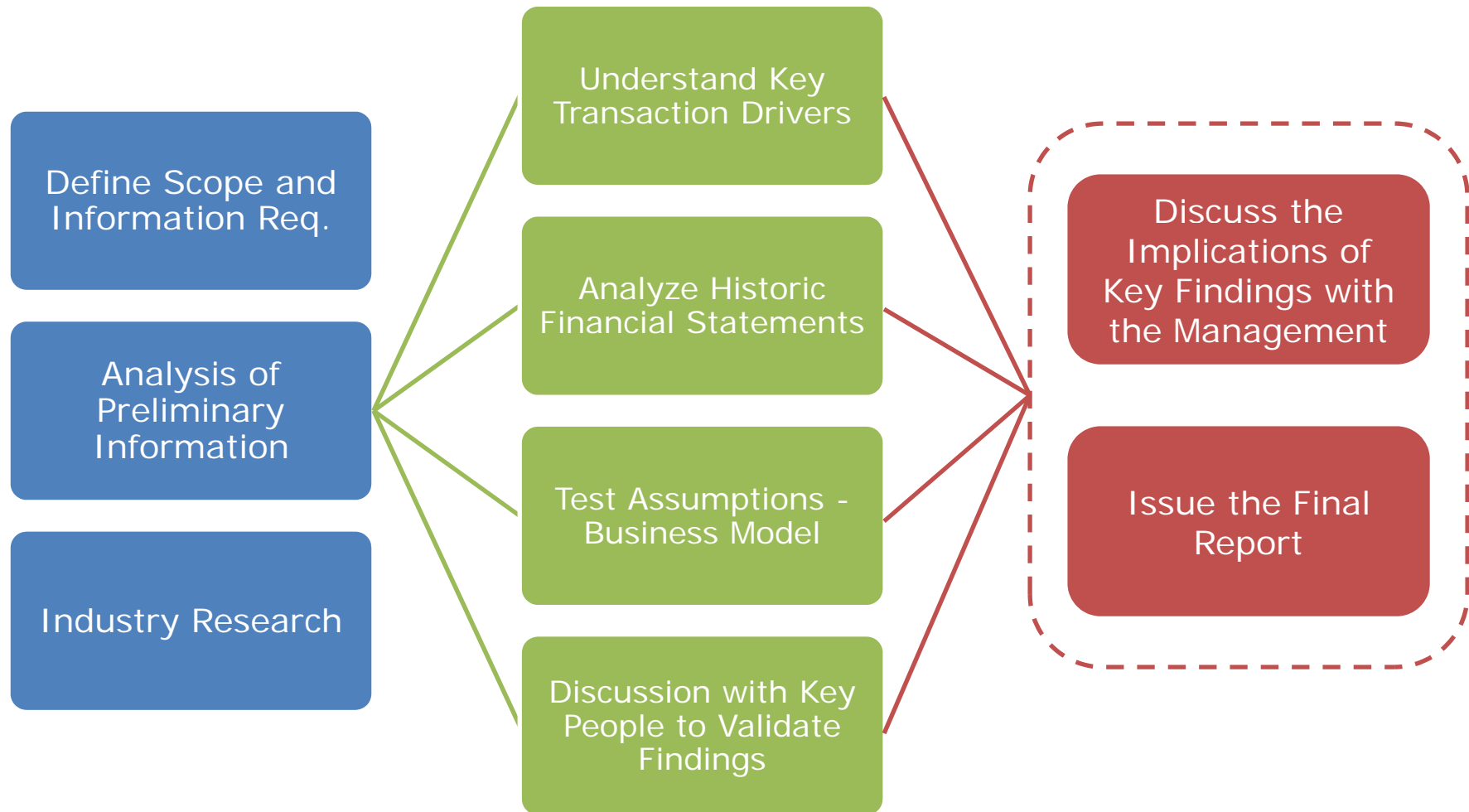
- Identify **potential risks for the buyer** in its investment decision
- Evaluate quality of reported earnings and **identify value drivers** critical to the transaction
- **Corroborate buyer assertions** regarding target's financial position
- Identify issues to be addressed in **purchase agreements**
- **Assess strengths** of financial personnel and systems
- Improve **transaction structure**
- Identify areas for **post-acquisition attention**
- It helps in **better negotiation** with the discovered information





Building Business  
Partnerships

# Due Diligence Process



# Due Diligence vs. Audit

## Due Diligence

- Scope and Procedures agreed with client
- Does not test the underlying accuracy of information
- Can cover future periods
- Focuses mainly on quality of earnings
- No defined form for deliverables
- Limited access and timetable
- Uses audit output
- Level of materiality may be adjusted to meet client needs

## Audit

- Procedures defined by GAAS in each country
- Tests underlying accuracy of the information
- Mainly backwards looking; does not cover forecast period
- Typically balance sheet focused
- Financial statements (report) prepared as per GAAP
- Scheduled timetables

# Financial Statements

## What Do They Tell Us?

- 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 and their development over time, provide good measures for the reasons behind positive or negative performance of a business:
  - Gross margin
  - Operating margin
  - Working capital days
  - Debt Equity ratio



# Financial Statements

## Why Do We Analyze Them?

- Financial statements are typically the basis for **determining valuation**
- Identify inconsistent accounting policies and **one off items**
- Understand the **estimates and judgments** used in reported numbers
- Historical results are used to **challenge forecasts** / projections
- Identify matters that impact valuation and **transaction documents** i.e. SPA / SHA etc.
- To advise on the level of **recurring EBITDA/EBIT** (Quality of Earnings Analysis)

# What to analyse in FDD? Income Statement (P&L)

- Sales by region/ customer/ product...
  - Volumes
  - 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



# What to analyse in FDD ?

## Balance Sheet

- **Current assets**
  - Inventory valuation
  - Debtors ageing and provisioning
  - Nature of long and short term advances
- **Liabilities**
  - Payment terms
  - Provisioning policy
- **Fixed assets**
  - Degree of depreciation
  - Capital expenditure
- **Working capital** items impact purchase price consideration
  - Cash flow impacts
  - Seasonality
- **Net debt** – Debt and Debt like items



# Key issues in FDD

- Revenue drivers and recognition issues
- Cost drivers and accrual issues
- Depreciation policies adopted
- Valuation of current assets - Non-provisioning for obsolete inventory and doubtful debts
- Adequacy of accruals
- Advance Tax / Provision for Taxation
- Contingent liabilities and off balance sheet items
- Change in control clauses

Period	Total number of shares purchased	Average price paid per share
April 1, 2006 - April 30, 2006	38,541,415	8,818,096
May 1, 2006 - May 31, 2006		136,945,025
June 1, 2006 - June 30, 2006		175,558,592



Building Business  
Partnerships

## FDD's Relation with Other DD's

- Framework of Due Diligence is designed for “**Client Success**”
- **Commercial due diligence** compares future business plan and revenue potential with the industry trends
- Cost assumptions may be tested through **technical and operational due diligence**
- Various costs impact profitability e.g. employee related matters could be tested through **HR due diligence**
- **Legal due diligence** helps in spotting various hidden issues like arrangements with associates and stakeholders
- Financial Due Diligence overlaps with all other areas of Due Diligence and **should not be conducted in isolation**



*Building Business  
Partnerships*



**Questions?**



*Building Business  
Partnerships*

A collection of chess pieces in red and blue, including pawns, a knight, and a king, are arranged on a light-colored board. The board is overlaid with a faint map of the United States and several US dollar bills. The text 'Thank You' is centered over the pieces.

**Thank You**