Understanding the Importance of Due Diligence

Thinking of buying or selling a business? Perhaps counter-intuitively we urge you to pause and take a step back. Sadly, we have seen examples of management continuing to try and "make it work" 12 - 24 months after the date of acquisition - and all too often attributable to inadequate due diligence being performed.

Why due diligence is critical:

1. The significant value involved in buying a business both in time and money
2. The quality of financial information can vary significantly
3. The brevity of information provided in the negotiation phase of the sale & purchase transaction

These factors put a reasonable amount of pressure on parties to the transaction to quickly make a decision, to either:

a.) Continue with the purchase
b.) Go back to the negotiation table
c.) Walk away completely

In this article we look to improve the general understanding of why financial due diligence is important from the perspective of the buyer.

What is Due Diligence?

The meaning of due diligence is to 'have a measure of prudence' or to 'perform a prudent review'. In an acquisition context due diligence will generally be described as a mixture of legal due diligence (review of legal impediments, high level review of key legal documents relevant to the business i.e. employee and supply contracts) and financial due diligence which aims to verify the factual accuracy of financial claims made by the seller.

What is important to clarify is that a due diligence review is not an audit. Nor is it a valuation of the target company. Due diligence does have common procedures and has overlaps with audit in purpose and procedure. However, the difference is that it is a thorough investigation that focuses specifically on key information that has been asserted to the buyer, often largely via the financial statements.

Financial due diligence in particular allows the buyer to assess all financial aspects of a potential acquisition to determine what the benefits, liabilities, risks and opportunities are. In conjunction with other forms of due diligence it is generally the best way to ensure what you pay is justified. It should also give you confidence that you as the buyer will be able to fulfil the value proposition a new acquisition presents.

What are the types of due diligence?

Common due diligence reviews will take a 'triangular' review approach which has a focus on legal, financial and tax due diligence review. However due diligence reviews can look at much more than this. Other forms of due diligence may be of importance / relevance to your decision making and your objectives as a party to the sale and purchase agreement.

A list of other due diligence reviews includes:

- Carve out due diligence (i.e. focuses on one only one aspect of the target)
- Commercial / Operational
- Customer
- Human resources

- Information Technology
- Seller due diligence

The main thing to remember when scoping your requirements with the team performing the due diligence is that you are integrally involved in setting the parameters for your review. Put simply; get involved and stay involved and up to date as you will ultimately be the best judge on what the numbers tell you.

What should be looked at?

We recently received a call where the simple question of "what should be looked at?" came up in the initial engagement scope. It's a valid question, particularly where the acquirer is unfamiliar with the business sector (a speculative/try something different investor) or where the acquirer does not have a strong financial background (lifetime industry/time to do it on my own investor). Our simple response? To try for as much and as in depth as allowed for under the sale and purchase agreement will allow you within the allocated due diligence period.

A broad brush approach we know. But remember a business is not just one thing, it is generally a complex collection of moving parts which come together to provide outputs to your customers and returns for its stakeholders.

At a minimum the financial due diligence process should look at:

→ Company history and background

→ Key deal considerations

→ The financial performance – Operating effectiveness and earnings quality

→ Employee strengths/ weaknesses & commitments

→ The strength of the financial position

→ Cash flow assessment – now and going forward

→ Tax due diligence*

→ Close off / cut off review*

* Traditional financial due diligence will not look at this in detail. We do however recommend this be included as we have come across recent examples where these areas were scoped out of the engagement only to hear subsequently of issues. Two separate instances resulted in a significant adverse impact to the buyer subsequent to the completion of an acquisition. This also resulted in additional consultancy on a complex accounting transaction by accountants and auditors.

Highly recommended but commonly viewed as 'optional'

→ IT Environment review

→ Lease assessment review

→ Related party transaction review

→ Foreign currency exposure review

→ Acquisition accounting

As you can see above, the financial due diligence process is a full 360° review of the target company. Not only looking at a 'snapshot' of the target, but looking at the past, the present and the future. This provides the benefit of enhancing the decision making process by allowing the purchaser to fully assess the accuracy of information presented in the negotiation process.

Common errors / pitfalls

Although generic in nature, no two sale or purchase transactions are the same. Here is a list of 'common' points to watch out for / consider when planning for your due diligence:

- → Short changing the due diligence process
- → Not including information flow expectations as part of the terms of the sale and purchase agreement
- → Doing it autonomously and not involving the experts
- → Reliance on unaudited or management information
- → Short term forecast requirements are not assessed.

The last point is important when, as part of the transaction you are not assuming rights to working capital assets as part of an acquisition. This of course creates an upfront cash gap which will require funding by contributed funding - either through loans or shareholder equity.

The suggested approach

To ensure you give yourself the best opportunity to fully understand the impact of an acquisition to your existing business or to your current plans we suggest you use the following as a guide.

- → Understand the reason for, and the expected impacts from the acquisition
- → Do your homework and get as much 'free' information as you can
- → Get involved in the scoping procedures
- → Request that you are updated on a weekly basis (or more) if needed
- → Be aware of the open items, key deal issues

Conclusion

Obtaining astute and timely feedback on the quality and accuracy of financial information is the foundation of a good decision making process. Here at RSM we provide our clients with the information they need to understand the business being acquired. Using a globally backed process with your interests in mind, we ensure you maximise the value for money ratio and gain a solid understanding of the acquisition process.

A cornerstone of our processes is the ability to look beyond the numbers. This, combined with our extensive knowledge and experience over a breadth of industries ensures answers to all your questions.

If you would like to discuss how we can help you through the acquisition process, please contact us.

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