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DUE DILIGENCE ENGAGEMENTS

Due diligence engagements or due diligence investigations as they are also called, can be described as the investigation and evaluation of a business. The term "due diligence" describes a general duty to exercise care in any transaction. As such, past and present transactions are investigated in order to predict the future of the business.

Due diligence engagements are generally performed to:

- Confirm that the business is what it appears to be;
- Identify potential "deal killers" in order to avoid a bad business transaction;
- Gain information that will be usefull for valuing assets, defining representations and warranties, and/or negotiating price concessions.

Initial data collection and the evaluation thereof commences when a business opportunity first arises and continues throughout the talks. Thorough detailed due diligence is typically conducted after the parties involved in a proposed transaction have agreed in principle that a deal should be pursued and after a preliminary understanding has been reached, but prior to the signing of a binding contract.

Financial statements, business plans and other documents are reviewed. In addition, interviews and site visits are conducted. Finally, thorough research is conducted with external sources including customers, suppliers, industry experts, trade organizations, market research firms, and others.

The amount of due diligence is based on many factors such as the size of the transaction, the likelihood of closing a transaction, tolerance for risk, time constraints, cost factors, and resource availability. The time allocated for completion of the due diligence engagement can therefore vary widely with each situation.

Due diligence costs are based on the scope and duration of the effort, which in turn are dependent on the complexity of the target business and other factors. Costs are typically viewed as an essential expense far outweighed by the anticipated benefits and the downside risks of failing to conduct adequate due diligence. The involved parties determine who will bear due diligence expense.

A due diligence program cannot guarantee that a business transaction will be successful. It can only improve the odds. Risk cannot be totally eliminated through due diligence and success can never be guaranteed.

THERE ARE VARIOUS TYPES OF DUE DILIGENCE ENGAGEMENTS

1. Commercial Due Diligence

Commercial due diligence looks to understand the market the target business is operating in. The due diligence will look at the forecast level of future market growth and the target's competitive position within that market. Part of commercial due diligence often involves phoning customers of the target business to assess their opinion of the business. This can provide extremely valuable insights into how the target business is perceived.

Commercial due diligence can be extremely valuable when an acquirer is using an acquisition to expand into a new market though may be of limited value where the target is in the acquirer's existing market.

Typical areas of interest are:

- Financial records and projections of revenues;
- Profits and cash flows;

- Lists of assets and liabilities;
- Analyses of customer lists;
- Review of supplier agreements and purchasing practices; and
- Review of bank accounts and tax records.

Key considerations in commercial due diligence include determining the true financial position of the Target, especially in regard to:

- Inventory obsolescence;
- Research and development expenditures;
- Excessive fixed costs;
- Off-balance sheet liabilities;
- Uncollectable accounts receivable; and
- Tax contingencies.

2. Intellectual Property Due Diligence

IP due diligence is focused on establishing what rights the company may have in various intellectual property and where it might rely on the intellectual property of another entity. Intellectual property consists of patents, copyrights, trade secrets, trademarks, service marks and trade names. Patents, copyrights and trade secrets tend to be the most important types of intellectual property.

The key consideration in IP due diligence is establishing the ownership rights that the Target holds in a given piece of IP. The discovery of a "cloud" in the ownership of an IP asset may significantly decrease the value of the Target.

3. Legal Due Diligence

Legal due diligence aims to ensure that there are no legal impediments to buying a business. Solicitors will typically review all the key legal documents of the target business such as employment contracts, board minutes, confidentiality agreements, articles and memorandum of association and any patents, copyrights or other intellectual property-related documents. It is likely that the same legal team that perform the legal due diligence will help with drafting the Share Purchase Agreement (SPA).

Key considerations in legal due diligence include the establishment of clear title to assets, obtaining a clear view of potential employee-related matters (e.g. wage and hour law violations, discrimination claims, health and safety violations), and uncovering possible environmental liabilities.

4. Financial Due Diligence

Financial due diligence aims to verify the factual accuracy of claims made by the sellers. This is different to an audit. A financial due diligence is not so much about are the accounts correct but what the accounts tell the buyer. What are the trends of the business is it growing or declining? Are profits being supported by one-off events or the result of accounting trickery? Is there any evidence to support the sales forecasts?

On the balance sheet side financial due diligence should aim to identify any previously unknown liabilities and advise on the level of working capital the business requires. The due diligence findings should then feed into warranties and indemnities within the SPA, to mitigate any risks identified. See more about financial due diligence.

5. Tax Due Diligence

Tax due diligence is often performed at the same time as the financial due diligence. Tax due diligence aims to ensure that there are no historical tax liabilities that have materialised due to mistakes or deception that the acquirer will become liable for. The tax due diligence team should also be able to help with acquisition structuring to minimise the future tax bill of the enlarged group.

6. IT Due Diligence

IT due diligence aims to identify any IT issues in the target business. It will look at matters such as the scalability of systems, the robustness of processes (eg backups), the level of documentation of processes and code, compliance with legislation and the ability to integrate various systems.

7. HR Due Diligence

HR due diligence will consider the impact of human capital on the proposed deal. This will involve looking at employment records, compensation schemes (including pensions), HR processes, ongoing HR related litigation, sales force effectiveness, cultural factors and legal compliance. If any restructuring is likely to be required post-completion the HR due diligence team working alongside the financial due diligence team should be able to forecast the likely costs involved.

Why should a Forensic Accountant be Involved in a Due Diligence Engagement?

Historically, forensic accountants were not retained until after an acquisition closed and problems began to emerge. Pre-acquisition financial due diligence was conducted before the fact by traditional accountants, either in-house or external. Nowadays forensic accountants are often brought in as soon as the term sheet is signed, usually at the same time as the lawyers. The analysis conducted by the forensic accountant generally includes, but is not limited to, the following:

- Financial Analysis

  Analyse whether the financial statements of a business represent actual performance and assess the reasonableness of future projections.

- Operational Analysis

  Analyse revenue and cost levels, supplier contracts and customer relationships to determine efficiency issues and potential cost reductions.

- Cash Flow Review

  Analyse the projections in light of historical results, competitors, market share and industry trends.

- Tax Structuring:

  Analyse tax structure to minimise tax burden.

- Background Investigations into Key Employees

  When conducted properly, a background investigation is a relatively small cost item that can save a client from dire consequences and uncover facts not apparent on the face of the financials or discoverable through traditional audit methodologies.

- Acquisition Disputes

  Analyze the issues relating to the financial framework (GAAP or IFRS) or changes to the consistent application accounting practices and policies. Determine the effect on the closing balance sheet and historical profit and loss statements. Determine how these GAAP/IFRS issues may affect the purchase price and closing balance sheet.

Analyses provided by the Forensic Accountant may often lead to purchase price adjustments both before and after the closing of the transaction. Sometimes the biggest adjustments come after the transaction closes and a more complete review is performed by the buyer and their internal and external accountants.

Avoiding Post-Acquisition Disputes

By identifying and focusing on risk areas, forensic accountants can identify deal-breaking, price and financial exposure issues, including:

Misrepresentation or non-disclosure of material facts:

- Unrealistic financial projections;
- Unrecorded/understated liabilities;
- Overstated revenues and/or understated expenses;
- Overstated assets;
- Hidden ownership interests;
- Related party transactions; and
- Managerial deficiencies and other business issues.

The work of the forensic accountant on due diligence matters generates information that allows the buyer (and the seller) to make more informed decisions and create a meeting of the minds, ensuring transparency and thereby limiting potential pitfalls and conflicts.