Financial Due Diligence

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X. The Importance of Financial Due Diligence for Target Firms
Due diligence, often known by the acronym ‘DD’, usually refers to within the context of mergers and acquisitions when after reaching an initial agreement of cooperation with the target firm (in addition to the signing of a letter of intent, generally both parties will also sign a confidentiality agreement), the acquiring party is permitted through mutual agreement to conduct an investigation into the operational situation of the target firm. Due diligence ordinarily incorporates investigative measures directed against all relevant matters pertaining to merger and acquisition, a series of operations including data analysis and field surveys amongst others, these operations can be subdivided into the following:

1. Financial Due Diligence - Determining whether or not company accounts are consistent, evaluating the real situation of assets, liabilities and tax risks;

2. Legal Due Diligence – Analysis of contracts and other documents, evaluating whether or not any hidden legal hazards or lawsuits exist.

3. Human Resources due diligence – Identifying the qualifications, technical ability and working initiative of the target firm’s senior management personnel and key staff;

4. Operational Due Diligence – Evaluating a target firm’s business model and prospects, including identifying the existence of a market, whether or not the firm has an attractive force, and assessing their competitive situation.

Financial, legal, and human resources due diligence focus upon establishing a historical and factual foundation, especially as a means to discovering issues of supervision and compliance. Even if these measures seem essentially retrospective, these tasks offer a background and framework for evaluation of any target firm’s future yield and for ascertaining whether or not a sufficient potential for sustainable development exists. Operational due diligence acts as an effective means of assessing growth prospects and developmental potential. Operational due diligence has an important focus upon business and industry fundamentals, and on delivering an evaluation of the whole operating strategy of the firm in question, ascertaining the firms competitive position as well as revealing the ultimate viability of bringing about the expected synergistic effect of merger and acquisition.

It must be emphasised that that within processes of merger and acquisition, conducting a due diligence investigation of a target firm is not a compulsory legal requirement. However, on the basis of the fact that a vast majority of modern firms are managed and operated by professional managers and that these professional managers hold a responsibility to explain and illustrate for shareholders the necessity and feasibility of any merger or acquisition program, as well as the reasonableness of prices, due diligence becomes a necessary and indispensable part of merger and acquisition processes.

We will in this text expand upon some of the important facets of financial due diligence.
Financial due diligence refers to financial professionals, according to the acquiring party’s objectives and commissioned scope, conducting investigation into the target firm’s financial circumstances and various other related factors. Financial due diligence ordinarily employs methods such as document review, conducting discussion and interviews with senior management and key employees, comparing historical financial data and trend analysis, and finally the reporting of financial and tax risks along with the actual operational situation of the target firm in written form to the acquiring party.

Conducting financial due diligence is not only related to proposed acquisitions or mergers, it can also be directed against joint ventures, financing or other deals and transactions. Principal work usually centres on people related or interest related business activities and relevant financial data, the ultimate goal being to provide assistance to the acquiring party in eliminating asymmetric information, and allowing the acquiring party to obtain a greater depth of understanding with regards to the target firm. Due to the differing characteristics of various industries, the knowledge and understanding of a certain industry on the side of an acquiring party might also differ from an equitable level with that of the target firm. Therefore financial due diligence process should be modified or adjusted so as to meet the acquiring party’s specific needs and expectations. Generally speaking, the most important usage of financial due diligence is to realise the following functions:

1. To sufficiently reveal financial and tax risks
2. To analyse a firm’s past profitability and cash flow, and according to this forecast the firm’s future operational prospects
3. To understand the target firm’s assets and liabilities (including contingent liabilities), internal control, and the actual situation of operations management, providing a suitable foundation for follow-up negotiations, strategic investment decisions and the formulation of a post-acquisition business plan and integration program.
4. When compiled with other due diligence results such as legal and operational due diligence, to determine whether the item of investment in question is in keeping with the acquiring party’s general strategic targets and investment principles.

Financial due diligence has the primary objective of establishing and understanding a target firm’s actual financial situation in the recent few years (in most cases around three years), and subsequently forecasting its future financial situation. This is the basis for the acquiring party’s current valuation of the target firm. For strategic investment decisions, as well as for providing a necessary foundation for formulating a post-acquisition business plan and integration program, the target firm’s internal control and actual situation of operational managements must be initially understood.
III. Fundamental Principles of Financial Due Diligence

Even though financial due diligence differs from general audit work, staff participating in a due diligence investigation, acting as third party independent financial consultants in the merger and acquisition group, must adhere to the following principles:

1. Independence Principle

- The independence principle typically covers two elements, the first is that of the financial consultancy firm, the second is the group of financial professionals that work on an investigation. For instance, before the aforementioned financial consultancy firm accepts the engagement it must not have provided the target firm in question with any service that could possibly conflict with that project of financial due diligence, and any financial professionals concerned with the project must not hold any direct or indirect economic interest concerning the firms involved, in order to guarantee said financial consultancy and project group members’ independence.

- Upholding an objective approach, establishing that any determination should be devised rationally and only according to already acquired and well understood information.

2. Prudence Principle

The prudence principle manifests itself in the following elements:

- Upholding a prudent and professionally skeptical approach, from beginning to end, through the process of due diligence.

- Review of work plans, staff allocation, working papers and financial due diligence report.

3. Comprehensiveness Principle

Financial due diligence should cover all aspects of the target firm’s relevant financial management and accounting.

4. Materiality

In light of differing industries and differing firms, investigations must be conducted according to levels of risk after sufficiently considering client requirements.
Financial due diligence operations belong amongst related services, in comparison to assurance services (for instance the familiar service of auditing) they do not provide any level of assurance (they do not have an audit report or opinion paragraph). However, the ultimate result of this form of service, the financial due diligence report, possesses the characteristic of verifiability. From the thorough conduct of the merger and acquisition related activities, to the final transaction accomplishment and post-acquisition integration, the due diligence report undergoes examination and appraisal. Therefore, a financial due diligence engagement is really a challenge to the professional competency of the accounting or consulting firm.

China’s current system of practicing standards for certified public accountants has yet to establish any specialised standards pertaining to financial due diligence. Completing this engagement efficiently and to a high standard, displaying a firm’s professional competency, and promoting a high level of customer satisfaction are a firm’s predominant concerns when receiving requests for financial due diligence engagement. Through a comparison with the auditing of financial statements within assurance services, and through analysing the differences and similarities, suitable working methods and procedures can be identified and referenced.

1. The differences between financial due diligence and the auditing of financial statements

(1) Differing Nature

Financial due diligence is a non-assurance service and consequently not included in the statutory services of certified public accountants, therefore the role of the financial professionals reflects a role of management consultant and financial advisor. Financial due diligence can be conducted by individuals and institutions that possess the appropriate capability.

The audit of financial statements is one of the statutory operations of certified public accountants and a crucial component of assurance services.

(2) Differing Objectives

The objectives of financial due diligence are:

(a) Through the analysis of related financial data, granting the acquiring party a greater understanding of the target firm’s actual operational situation, helping the acquiring party to decide whether to proceed with the acquisition procedures and creating a suitable investment strategy;

(b) When there is clear intention for merger and acquisition, this would assist the acquiring party as far as possible be wary of and avoiding investment risk.

(b) When there is clear intention for merger and acquisition, financial due diligence would assist the acquiring party to ensure that they were wary of avoiding investment risk.

The objective of auditing financial statements is that certified accountants, through implementing auditing work for financial statements, form an audit opinion on the basis of the following aspects:

(a) Whether or not financial statements are prepared in accordance to the applicable accounting standards and complied with the relevant accounting system provisions; and

(b) Whether or not financial statements present fairly, in all material aspects, the target firm’s financial position, financial performance and cash flows.
(3) Differing Focus of Attention

Financial due diligence, as well as analysing historical financial data, also at the same time is concerned with ascertaining industry and firm background, operating prospects, contingencies, earnings forecast, and other aspects, principally uncovering and reporting merger and acquisition risk points.

The foremost concern of financial statement auditing is the suitability of the audit opinion.

(4) Differing Methods

During the financial due diligence process, confirmations, physical inventory observation and other investigative methods are not extensively employed, these methods are substituted with more comprehensive methods of review, observation, interviews and analysis.

(5) Differing Levels of Cooperation

Although the target company signs a confidentiality agreement with the acquirer in advance, it is still a fact that the target company reveals financial information and even business or trade secrets to the acquirer in the financial due diligence process. Additionally, when the acquisition fails, these business or secrets could possibly be leaked to other competitors or even used by the acquiring party (who usually exists in the same sector as the target company). In view of this, on grounds of confidentiality amongst other reasons, the target company is often not willing to allow certified public accountants to be involved too deeply, hence the overall cooperation can be dissatisfactory.

In audit of financial statements, the management of the units being audited are the expected users of the audit report, they are therefore more likely to take a more cooperative approach with the auditing work. Nonetheless, CPAs must under no circumstances take this lightly. After all, the management of the units being audited might not tell everything fully and truthfully.

2. The relationship between financial due diligence and financial statement auditing

Overall, an audit of financial statements can be divided into six steps:

Step One - Implementation of initial engagement activities and determining whether or not to accept the audit engagement;

Step Two - Formulation of the audit plan;

Step Three – Implementation of procedures of inquiry, consultation, observation, inspection, analysis etc. Understanding the unit being audited and it’s background, perform risk assessments and identify the risk of material misstatements;

Step Four – On the level of financial statements, considering risk of material misstatements, designing and carrying out overall response measures. Also in line with assessment of risk of material misstatements, designing and carrying out additional audit procedures, whilst collecting and evaluating audit evidence to support the financial statement assertions.

Step Five- Determining the form of audit opinion to be issued, based on the audit evidences and the extent of the adjustments for material misstatements.
Step Six - Issue the audit report for submission to the client. Risk assessment procedures are of paramount importance, these procedures are geared towards identifying areas of material misstatement in financial statements, and towards designing and performing additional audit procedures, in order to reduce the audit risk to an acceptable level and to obtain audit evidences that provide sufficient and appropriate basis for the audit opinion.

During the process of merger and acquisition activity, the primary objective of a financial due diligence report is to offer support to the acquiring party's investment decision. The acquiring party can make use of the risk assessment procedures in a financial statement audit as assessment of risks associated with an acquisition. However, points of focus, methods and procedures should be adjusted in order to meet the special features of financial due diligence. If permitted under the conditions, combining with part of the substantive audit procedures, the areas of material misstatement identified can be further verified.

V. At What Stage Should Due Diligence be implemented?

Merger & Acquisition Sequence:

Merger and acquisition is one means by which a firm can realise its business strategy, therefore the acquiring party must carefully examine its own business strategy. Generally the reason for engaging in merger and acquisition is only for pursuing synergistic effects, adapting to competition and expanding the firm’s business scale, so once a firm is determined to employ the merger and acquisition method to realise its business strategy, it must establish an investment principle and formulate a merger and acquisition strategy, and then seek the most suitable investment opportunities accordingly.

After going through initial screening and establishing the project, the acquiring party can express its interest to the target firm, both parties may carry out preliminary negotiations on the purchase terms. Once investment intentions are determined, both parties may sign a letter of intent, as well as a confidentiality agreement. After signing the confidentiality agreement the target firm can then provide related materials to the acquiring party and its entrusted intermediaries, and allowing them to formally embark on due diligence work.
VI. Methods of Financial Due Diligence

During the investigative process, financial personnel usually will employ the following fundamental methods:

Review - through review of financial statements and other financial materials, identify critical and material financial factors;

Analytical procedures – includes procedures such as performance analysis, trend analysis, structural analysis etc. analysis of materials acquired through all channels then through collating the results of this analysis discovering abnormalities and important issues.

Interview - sufficient communication with every level of the internal hierarchy, employees of different positions and roles, as well as intermediary institutions.

Internal communication - due to investigative group personnel coming from different backgrounds and specialisations, mutual communication and timely sharing of work results creates an effective method of accomplishing investigative targets.

In this comparison we have indicated that there are some key differences in the objectives of financial due diligence and financial statement auditing. In addition, the duration of a financial due diligence is comparably short, and therefore in the place of auditing methods such as confirmations, physical inventory observation and the re-calculation of financial figures, methods such as trend analysis, structural analysis and other such analytical tools are more often utilised.

VII. Contents of Financial Due Diligence

Usually the acquiring party will employ an independent third party intermediary institution, typically a consulting firm or accountancy firm, to conduct financial due diligence on the target firm.

Financial due diligence engagement can be divided into the four stages of project preparation, project planning, project implementation and project completion.

1. Project Preparation Stage

The intermediary institution, before accepting the engagement, needs to carry out initial operational activities and decide whether or not to accept the engagement. At the time of carrying out these initial operations, the principal questions it must consider are:

First, the professional competence of personnel, ascertain whether or not the personnel are familiar with the related industry and client, whether they possess experience of carrying out similar engagements, whether they are equipped with the necessary technical capacity and knowledge, and if the occasion requires whether they are capable of obtaining specialist help.

Second, consider the objectives of the prospective clients, confirming that there are no misunderstandings in the terms of the engagement. Due to the special features of merger and acquisition projects, when accepting an engagement, the confidentiality agreement, the usage of the report and terms of the disclaimer are all areas which warrant particular emphasis and attention.
2. Project Planning Stage

(1) Initial Preparative Work

Includes explaining to the target firm the investigative objectives and the relationship with the client, compiling and issuing an investigation data manifest, and understanding the target firm’s historical evolution, organisational structure, primary operational scale, ownership and investment structure, as well as future development tendency etc. At the same time, estimating the target firm’s scale and degree of operations complexity, this would facilitate the determination of project personnel, work progress and key areas to focus on.

(2) Compiling an Investigative Plan

After the initial preparation of the investigation, the project leader ought to begin the compilation of an overall work plan for the project. The project plan should comprise of project objectives, investigation procedures, key areas to focus on during the investigation, project personnel composition, project time and location arrangements etc. At the same time, within the framework of the overall work plan, the project manager should also compile and revise a detailed work program for the financial due diligence.

(3) Risk Assessment Procedures

In financial due diligence, the following elements constitute risk assessment:

a) The state of affairs in the industry, and the legal and regulatory environment, amongst other external factors;
b) The nature of the target company;
c) The target company’s objectives, strategies and relevant operational risks;
d) The target company’s financial statements and primary financial issues.

3. Implementation Stage

(1) A few aspects that should be effectively grasped during investigative work:

a) Sustainable Operation

Operational cash flows are a useful indicator for understanding the sustainability of the target company’s operational situation. In comparison to accounting profits that can be subject to manipulation, cash flows can be more a more accurate representation of the going concern of the target company. Furthermore, taking into account the target company’s motives for accepting an acquisition, the difficulties it confronts relating to sustainable operation can be observed.

b) Internal Control

Documents related to internal control should be obtained and read through, and a walk-through test should be conducted, in an effort to understand and evaluate the rationality of the internal control design and its effectiveness in execution.

c) Financial Affairs

Information about the accounting policies, financial structure, credit worthiness, asset quality and profitability of the target company need to be obtained. The admissible degree of the target company’s financial standing is subject to the level of internal control, but procedures involving important issues must be conducted in a thorough manner, for instance the verification of the ownership of major assets and contingencies. For those cases already highlighted, for example mortgages and guarantees, contingencies, pending legal actions, etc. need to be followed up as they develop. For risk items not highlighted, they should become the major focus of the financial due diligence work.
d) Taxation Affairs
The current structure of the tax burden, tax treatment, and the fulfilment of paying and withholding tax in the target company should be studied. For enterprises enjoying tax preference, one should estimate their tax burdens after the end of the preferential period; for those who have not fulfilled their obligation to pay tax, one should perform a quantitative analysis of their tax risks.

e) Financial Forecasts
The forecasts involved in financial due diligence include: incomes, investment scales, capital requirement, changes in major accounting policies, etc. All these are finally reflected in the forecast of cash flows and earnings capacity. Certified public accountants must carry out appraisals of the industry outlook, policy orientation, interest rates, exchange rates, changes in taxation, etc. In addition, when dealing with primary facts involved in the forecasts, one must maintain a professionally sceptical attitude and verify them with utmost prudence.

(2) Contents of Investigative Work

a) Investigation of the overall financial data of the target company
In financial due diligence, some basic financial circumstances of the target company need to be understood. One can learn its time of establishment, history, registered capital, shareholders, modes of investing capital, properties and major businesses, etc. through obtaining the company’s business licence, capital verification report, constitution and organisational structure. A detailed understanding of the target company should also contain the head office and all the companies under its control, including the proper information of its related parties. Moreover, the target company’s tax policies should be covered, which comprise current tax types, tax rates, bases for calculation, the collecting departments, preferential tax policy, tax allowance and exemption, and settlement and payment of annual enterprise income tax.

b) Investigation of the Target Company’s Specific Financial Condition
The reliability of the financial statements of the target company, which is related to its own procedures of internal control, would affect that of financial due diligence. Consequently, when conducting financial due diligence, the internal control of the enterprise should be taken into account. After having developed an understanding of the system of the internal control of the company, one can probe into its financial position and profitability.

c) Investigation of Special Matters
Special matters refer to financial commitments, contingent liabilities, post balance sheet events, related party transactions, off-book assets and liabilities, etc. which exist in the target company. These items should be given high attention. More detailed primary source documents are needed in order to assess their legitimacy and fully disclose them in the financial due diligence report according to their materiality.

4. Completion Stage
The main contents of this stage are the preparation of work papers and drafting of the report.

Due to the particularity of the project and the uncertainty of information collection, it is not probable that the work papers of financial due diligence can be of the standards of financial statement audit. It is more likely to depend on the personal ability and the professional judgement of the executive staff. In terms of the preparation of the work papers, evidence for professional judgement is communicated in greater detail. (Is more emphasised).
In the financial due diligence report, findings should be stressed. The wording of the conclusion should be prudent and suggestive. Under the circumstances of inadequate basis, excessively positive conclusions should be minimised. The incompleteness of obtained information and work scope needs special emphasis. The disclaimer and the usage of the report should be expressed in an explicit way. When narrating the conclusion, firstly, one could make a general evaluation of the investment project, which is primarily a summary of the investment value of the company. Secondly, an overall estimation of the level of risk involved in the project should be given. Lastly, measures to avoid risk and suggestions regarding the steps of acquisition should be put forward to the acquiring party.

VIII. Common Issues Seen in Financial Due Diligence

1. Application of Accounting Standards

During due diligence investigations, it is frequently revealed that the target company fails to some extent, and for various reasons, to comply with accounting standards. A typical and recurring example being that the target company recognises income on cash basis in place of accrual basis with a view to underpaying or avoiding paying relevant taxes.

There can also be differences resulting from a need to use the accounting standards adopted by the acquirer other than that of Chinese accounting standards, for example United States accounting standards. An example is that China’s companies are not allowed to calculate income tax after offsetting profits and losses among different units under the same corporate group, but the US allows income tax to be paid on the level of corporate group after the compensation of profits and losses.

2. Contingent Liabilities

During the course of the due diligence process, target companies are often found to have contingent or improperly recorded liabilities. Examples of such are guarantees or assurances provided by a third party or an affiliated company, unused annual leave of employees, insufficient or non-payment of employee social insurance and taxes, and possible litigation risks caused by violation of the laws and regulations relating to the businesses of the target company.

3. Related Party Transactions

During the due diligence process, problems regarding related party transactions are often found. For instance, the terms of trade are not compatible with the principle of independence; the target company provides off balance sheet guarantees for the transactions or liabilities of its affiliated companies for the overall interests of the corporate body instead of business objectives.
4. Mortgaged or Defective Assets

Particular attention should be paid to the fact that assets of the target company may well have been mortgaged or used as guarantees for other liabilities, or its factory or office premises might not have valid planning or construction permits, or some premises might not provide certification of ownership for their operating and available properties, all of which could severely distort records of income and expenditure.

5. Income Tax Payments

Through understatement of turnover or overstatement of operating expenditure, the target company might (willfully or inadvertently) underpay or not paying corporate and individual income taxes.

IX. Follow-Up Work after Financial Due Diligence

1. Specialist Assistance for Investment Program

- Proposed resolutions for corporate financial risk (discovered in the course of financial investigation);
- Financial feasibility of investment model
- Financial forecast of investment returns;
- Financial risk evaluation of investment program.

2. Integration Program and Specialist Assistance

- Evaluation of the professional competency of the target firm’s financial personnel and internal audit personnel;
- Recommending financial and internal audit personnel
- Assistance for financial management system and internal control system perfection or establishment;

3. Pre-transaction Asset Valuation Review

- Cooperate with assets valuation work;
- Connecting with valuation firms, ensuring favourable asset evaluation results;
- Constructive suggestion regarding important issues of asset valuation

4. Post-transaction Financial Audit and Internal Audit
X. The Importance of Financial Due Diligence for Target Firms

Prior to this chapter, all that has been discussed pertaining to the importance of financial due diligence has been from the perspective of the acquiring party, yet is this the only party that requires the service of financial due diligence? The answer to this question is that it is not. Along with the steadily increasing number of merger and acquisition cases (some which are successful, and some which end in failure), firms on the selling side (target firms), are also conscious of the importance of conducting financial due diligence beforehand.

From the perspective of the selling side, the importance of financial due diligence is embodied in the following aspects;

1. Effectively Preparing for Impending Merger and Acquisition Negotiations

Financial report forms act as a mirror, what presents itself in this mirror is the overall capacity of the enterprise. Through financial due diligence the selling firm can take a step towards understanding its own key strengths and shortcomings. This lets the selling party whilst conducting negotiations with the acquiring party to have greater confidence, to be able to understand and play to its strengths. Even if confronted with unavoidable questions, because sufficient preparation has been carried out in advance, the selling side is more than capable of putting forward the appropriate responses.

2. Raising the Firms Value

A single good financial due diligence report can make known a firms various issues, for instance questions of operation and internal control. Constructive suggestions from relevant financial specialists can still assist the firm in further perfecting or correcting issues that are discovered. This contributes to the firm’s raising operational efficiency, and ultimately the value of the firm itself.
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