



**Faculty of Business, Law and the Built Environment**

**Managing Investments**

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**Assignment:**

*Explain the differences between a financial audit and financial 'due diligence' in the merger and acquisition process. Giving examples of key metrics, trends to be identified, etc.*

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In the following text I will try to define and contrast financial audit and financial due diligence amongst their use in a merger and acquisition (M&A) process. Whether it is horizontal or conglomerate, main evaluation of an M&A performance will be financial at the end. This can be listed as profit, or revenue, or share prices of the company for following years. Hence it is important for an M&A to financially make sense. To understand if it financially makes sense, a crude analysis of historic revenue or profit figures may seem enough to make the decision. But in order to achieve the value sought from M&A thorough analysis is needed. That is the point where audit and due diligence breaks apart.

Financial audit is defined as ‘...professional examination and verification of a company’s accounting documents and supporting data for the purpose of rendering an opinion as to their fairness, consistency, and conformity with generally accepted accounting principles’(DePamphilis 2003 p464). Financial audit is crucial in an M&A to perform the most accurate valuation of the target company (Clemente and Greenspan 1998 p2). Further ‘financial audit provides the platform for the acquisition team to project future growth/profit scenarios for the company’ (Harvey and Lusch 1995). In other words, financial audit is only a part of long and detailed financial due diligence list.

Current definition of due diligence is ‘purposeful, systematic, professional, investigation of business opportunity and risk during on-going sale negotiation’ (Picot 2002 p156). If we spread “financial” word in this definition we get a financial due diligence definition of “financially purposeful, systematic and professional, financial investigation of business opportunity and financial risk during on-going sale negotiations”. To achieve this bidder companies forms internally and/or externally sourced due diligence teams to perform financial due diligence.

According to Borgese and Borghese (2002 p34), financial due diligence covers ensuring target financial statement accuracy, performing sanity check projections by trend based ratios, understanding tax issues, valuing target, and recommending appropriate financing. And “finance team” must perform following four key activities during the acquisition process: ‘corporate finance, tax strategy, audit, and cash management’ (Borgese and Borghese 2002 p35)

So, financial due diligence process starts with financial audit by ensuring target financial statement accuracy and goes further by standing on them. Financial due diligence will rely on target company’s balance sheet and statement of income. Also at audit step of due diligence the audit procedures and the adequacy of audit procedures or internal auditing of target firm can be monitored and understood too.

Understanding the audit procedures can be important for the finance team especially if the acquirer company is not familiar with the target's industry.

Understanding internal auditing can point material errors in accounting or a weakness in cost accounting, which can be a potential value or a problem has to be solved after M&A. "This information is generally contained in the "management letter" or "internal control letter" provided by the independent auditor' (Harvey and Lusch 1995) "...statements and notes from the auditors...may be of decisive significance in this respect.' (Picot 2002 p163) Discovering underlying facts about financial statements will be possible from auditor's reports. "Valuation and/or allocation of assets and liabilities and disclosure of potential liabilities that have not been determined at the time of the audit (e.g. pending lawsuit, regulatory investigation)' (Harvey and Lusch 1995) will again be processed during financial audit.

By definition, audit is involved with the past and the present status of company's accounts. Therefore most important difference between financial audit and financial due diligence is in the coverage. While financial audit cover past and present, financial due diligence make projections for the value sought based upon audited financial statements.

There is a certain asymmetry between the so called seller and purchaser parties of mergers and acquisitions. 'The buyer tends to lack a wide range of information required in order to determine, for example, an appropriate purchase price, to ascertain synergies, or to minimize risk. The seller party, on the other hand, either has all such information readily at to hand, or has the ability to obtain such information without undue difficulty' (Picot 2002 p154). The purchaser tries to overcome this obstacle by making financial audit and financial due diligence through the process. In order to make the best decision possible the purchaser will need the best data possible due to all aspects sought. But the seller party may need to look after an internal audit because of warranty after M&A. With warranty and liability system a material defect caused to purchaser party by seller may result a liability to seller and/or also the management. Internal audit is gaining importance in this sense. Seller party should also make an auditing on its self during the negotiation process in order to avoid facing heavy risks in the future. (Picot 2002 pp90-91)

After sound figures have obtained to make projections the procedure continues by running the numbers. “Finance team” will use numbers obtained from financial statements in valuation of the target company and in ratio analysis. Ratio analysis of the target company should be compared with its industry ratios to understand the performance. “A successful competitor’s performance ratios may be used if the industry average data is not available’ (DePamphilis 2003 p401). Analyzing trends in various ratios is important to understand characteristics of the business and to estimate a scope for the business. Ratio analysis helps to pinpoint strengths and weaknesses of the target firm, which may help all over due diligence process. Combining the result of ratio analysis with the strategic goals of the bidder company is important in success of M&A.

Finance team should analyze the target company and its industry with profitability, liquidity, activity, and leverage ratios. Ratios should be studied in trends to achieve a sound understanding.

Profitability ratios:

- |                           |  |
|---------------------------|--|
| • Net profit margin (%)   | <b>(Net profit after taxes)/(Net sales)</b>            |
| • Gross profit margin (%) | <b>(Net sales – Cost of sales)/(Net sales)</b>         |
| • Return on investment    | <b>(Net profit after taxes)/(Total assets)</b>         |
| • Return on equity (%)    | <b>(Net profit after taxes)/(Shareholders’ equity)</b> |

(DePamphilis 2003 pp457-458)

Liquidity ratios

- |                           |   |
|---------------------------|---|
| • Current ratio           | <b>(Current assets)/(Current liabilities)</b>             |
| • Acid-test (Quick) ratio | <b>(Current assets – Inventory)/(Current liabilities)</b> |

(DePamphilis 2003 pp457-458)

#### Activity ratios

- Inventory turnover  $(\text{Net sales})/(\text{Inventory})$
- Days in inventory (days)  $(\text{Inventory})/(\text{Cost of goods sold}/365)$
- Asset turnover  $(\text{Net sales})/(\text{Total assets})$
- Average collection period (days)  $(\text{Accounts receivable})/(\text{Annual sale}/365)$
- Accounts payable (days)  $(\text{Accounts payable})/(\text{Annual purchases}/365)$

(DePamphilis 2003 pp457-458)

#### Leverage ratios

- Debt-to-equity ratio (%)  
 $(\text{Total debt})/(\text{Shareholders' equity})$
- Long term debt to total capital (%)  
 $(\text{Long term debt})/(\text{Shareholder's equity} + \text{Long term debt})$

(DePamphilis 2003 pp457-458)

During ratio analysis it is important to understand the fluctuations in the ratios and the causes. The trends must be compared with the industry to reveal macro or micro causes. Profitability and activity ratios can tell so much about characteristics of the business, such as competition, market opportunities and how mature the market is. If there is slack in the industry enhancing management and planning better marketing techniques may get things better but these kinds of opportunities has to be considered with other departments such as marketing.

Liquidity and leverage ratios can be enhanced by injecting capital or restructuring debt but still it changes from one industry to another. These ratios have to be compared with the acquirer company's ratios too. It is important to understand if capital structure of the company is strong enough to support the target company or visa versa.

After studying financial statements and financial ratios of the target next step in financial due diligence will be tax before valuation. In order to understand incumbents of M&A before deciding about the value of target tax due diligence has to be applied.

'The tax due diligence exercise primarily concerned with two completely independent tasks: a) Ensuring fiscally optimised acquisition arrangement for purchaser and seller b) Protection of the purchaser against tax-related financial risks arising from the past' (Picot 2002 p175).

Agreements covering the followings may be necessary to include in the contract of sale: Who is responsible for the business related tax amounts? Who is responsible for unexpected tax payments or refunds? Who bears liability for additional tax payments arising from constructive dividends/ disguised profit distribution/ previously non-deductable dividends? (Picot 2002 p176)

Apart from tax, unrecorded liabilities have to be specified before valuation. Such as 'pension liabilities, employment benefits, customer allowances/discounts, and product and service warranties.' (Borgese and Borghese 2001 p57)

Consolidating above variables; cash flow projections, asset and liability values, tax liabilities, and unrecorded liabilities finance team will have a sound base to make valuation calculations. Valuation can be done in various ways:

'Enterprise (free cash flow to the firm) and equity (free cash flow to equity investor) discounted cash – flow methods' -- The projection of cash flow has to be considered with other teams such as marketing to make a sound valuation. While the historic data might shed some light, there are so many variables determining future prospects. Future prospects are important to decide about the growth rate of cash flows. It can be zero, constant, or volatile with respect to market structure. (DePamphilis 2003 pp346-348)

Market-based valuation methods can be applicable if the target company is open to public and bears the assumption the market has fairly priced the company and/or the others in the industry. (DePamphilis 2003 pp346-348)

Asset-oriented and replacement cost methods: Much more reliable after financial audit. But can not be applicable in every situation as the value lies on the future prospects of the target much more than the current position. (DePamphilis 2003 pp346-348)

Weighted average method is finding an average value for the target by giving a weight to each valuation method. (DePamphilis 2003 pp346-348)

After a value for the target has been attained financing of M&A takes place. If the acquirer company will give its own share for some or all of the target company, valuing the bidder is next step. Afterwards, if payment occurs, the bidder company has to uncover its own strengths and weaknesses

through internal auditing and ratio analysis too. This will render a picture for finance team before contacting financial institutions if needed.

Finance team has to review current capital structure, match it with the strategic objectives, evaluate cash requirements of the deal, and assess need of external financing (Borgese and Borghese 2002 p35). To avoid any short comings of the path followed the capital needs after closing the deal has to be considered too. So after learning how much cash will be paid; finance team must learn how much cash we have? How much cash will come? And how much cash can we have by liquidating some of our assets in short term?

Again at this point financial ratios should be studied and they should be studied in trends to understand fitness of capital and need of financing. These ratios includes 'leverage ratios', 'liquidity ratios' but this time it is interpreted as not for performance or enhancement but health and sustainability. Asset and liability quality assessment is assessed to understand its own leverage capacity and bargaining power. And solvency ratios come into picture as the acquirer might need to go very end of its financing options.

Asset and liability quality assessment ratios

- Cash - How much cash is available?
- Accounts receivable turnover - When will be the next cash flow and what is the financial burden of sales activity?  
**(Credit sales)/(Average accounts receivable)**
- Inventory turnover: When we will buy extra stock?  
**(Cost of goods sold)/(Average inventory)**
- Fixed assets – 'Is there sufficient maintenance of productive assets to ensure the current and future earnings power?'
- **(Current liabilities)/(Total liabilities)**  
Can we find extra debt in a short time or did we stick on short term debt?
- **(Current liabilities)/(Shareholder equity)**  
Low leverage or high leveraged already?
- **(Current liabilities)/(Sales)**  
How long does it take to cover the current liability?

(Borgese and Borghese 2002 pp35-38)

Solvency assessment ratios – are useful to assess the bidder company with the view point of financial institutions and test it on worst case scenario in case of maximum debt situation.

- **(Long term debt)/(Net worth)**
- **(Cash flow from operations)/(Long term debt)**
- Interest coverage: What amount of interest can be paid at most?  
**(Net income + Interest + Taxes)/(Interest)**

(Borgese and Borghese 2002 pp35-38)

Financial due diligence process will therefore start with financial audit, which supplies sound data to be dealt along the financial due diligence process, and ends with suitable financing of merger and acquisition activity. Financial due diligence should aim the maximum reliability with optimal solutions for both parties of merger in order to help to achieve the value sought in M&A. Financial due diligence is a part of whole due diligence process and finance team always have to be interactive with other team to form right projections and assess trends in company history, which shed light future prospects of the deal.

## References

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