Importance of Financial and Tax Due Diligence in Company Acquisition

Once the deal value is agreed upon and the Letter of offer/intent is signed, it is imperative for an acquirer to verify the information shared by the target company which has been assumed as a basis for valuation.

Further, if there are any defaults, dues, risks or contingent liabilities, the same are quantified during the due diligence. Based on the same, the valuation is adjusted and agreed upon during re-negotiations. Financial and tax due diligence also helps in establishing profitability at operational level.

For this activity, a third-party consultant is often appointed to conduct an analysis of the financial records, quantify the liabilities and risks associated with the transaction for the acquirer. If there are any issues, the consultant also works on the practical solutions.

Some of the key areas which are checked during the financial and tax due diligence:

- **Revenue:** Verification of invoices against the accounting entries, policy for booking the revenue, customer contracts along with revenue composition are undertaken. Transactions with the related parties are especially put under the scanner.
- **Significant Expenses**: In terms of expenses, major expenses are identified based on the nature of the business with special focus on inconsistencies, ambiguities, and one-time expenses. It also entails comparison of the level of expenses of the target company with the industry standards. Amongst the expenses, manpower cost is thoroughly checked and verified with the actual salary slips, appointment letters/ employment contracts and the applicable Labour laws.
- **Ambiguities in Cash Flow**: Yearly cashflows are also analyzed in order to verify the primary source of funding for the business viz. operating profit or equity or debt. In addition, irregularities in the cash flow are also examined.
- **Land, Building, Plant & Machinery**: Most often, land, building, plant & machinery form a major part of the assets of the target company. In due diligence process, the consultant verifies the physical assets with the fixed assets register. The consultant also conducts discussion and understands about the capital work in progress and requirement of capacity additions envisaged for the short to medium term. Further, special attention is paid to the accounting entries and valuation related to intangible assets as well as overall policy of the depreciation being provided.
- **Sundry Debtors / Customers**: The consultant's team analyses the data with regard to customers such as contracts with the customers, contribution of major customers to the turnover, receivable to sales ratio, and ageing in order to establish quality of the existing customers and their relation with the target company. Special attention is given to the dues of the related parties.
- **Inventory**: Inventory is such an area which is always very important while acquiring a manufacturing or trading company. During due diligence, physical verification of the inventory is carried out vis-à-vis the books. It also entails inventory ageing, analysis of inventory write-offs, as well as inventory policies adapted by the target company.
- **Government Dues:** Since, in case of defaults, the Government has the first charge on the assets of the target company, even before the banks and the suppliers. Hence, quantification and verification of Government dues (including outstanding taxes, penalties, interest, any pending cases) needs to be undertaken. It involves scrutiny of the returns, tax audits, payroll taxation, international taxation, supporting data and e-filing accounts of the target company.
- **Sundry Creditors / Suppliers**: Another important area where a liability may arise in the future post takeover is the supplier's dues. In addition to analyzing the ageing, purchase orders, invoices; balance confirmations from the suppliers are also obtained as of the transaction cutoff date.

- **Unrecorded / Contingent Liabilities**: One of the key objectives of the financial and tax due diligence at the time of company acquisition to identify and quantify the unrecorded or contingent liabilities, for instance: written off dues of the suppliers, government dues, employee dues, litigations, liabilities of the performance guarantees given by the target company.

Before going ahead with the transaction, conducting due diligence of the target company in the most elaborate and efficient manner is of paramount importance. In case, you have any specific queries related to due diligence or company acquisition, please feel free to contact Ms Dipali Joshi (Head-Business Consulting) at dipali.joshi@uja.in