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Financial Due Diligence:
A Crucial Factor in Small Business Acquisition

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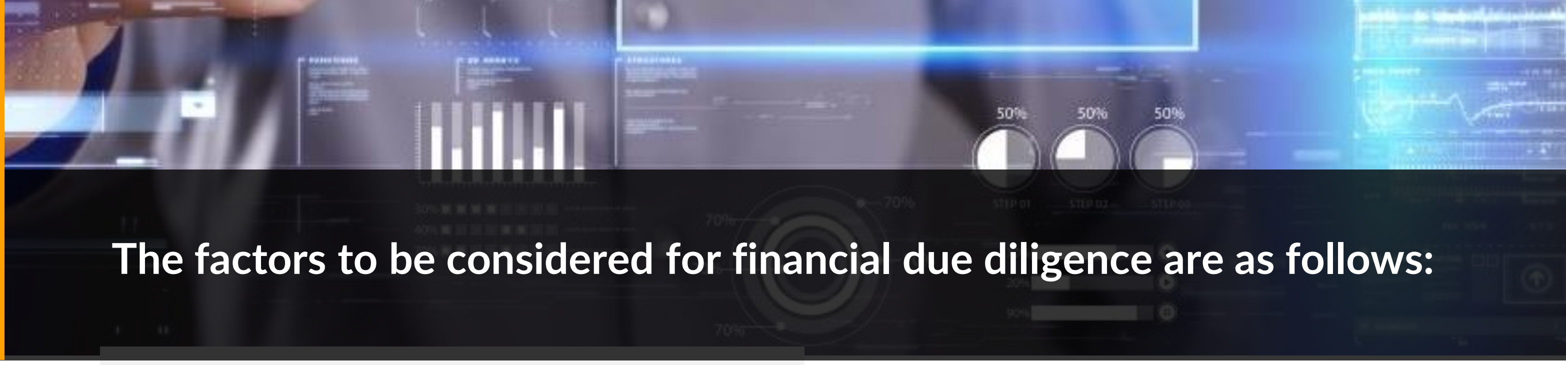
Financial Due Diligence is a rigorous process to determine financial health, assess the potential risks, and unearth the hidden liabilities of the target company. The findings of this process can be a deciding factor in the deal; hence, it is an inevitable process for acquisition of small and midsize Business (SMB).

Any buyer/investor always seeks answers to the following questions:

- What value is the good/service that is being bought?
- Is the price justified?
- Will the benefits mentioned at the time of buying hold good later on?
- Are there any inherent risks?

Along the same lines, when an investor acquires a business, financial due diligence aims to verify the financial soundness of the target company, the risks, and the financial forecast to determine the deal's viability.



The factors to be considered for financial due diligence are as follows:

What is the objective?

The objective of buy-side financial due diligence is checking the financial health, knowing the potential risks, and projecting Target's future performance. A Quality of Earnings analysis in a detailed diligence exercise provides reasonable assurance to the Buyer that the adjusted EBITDA at which the deal pricing is determined is fair and not trued up to the seller's benefit.

When should it be conducted?

Financial due diligence is generally conducted after the Letter of Intent (LOI) is signed but before the final purchase agreement. Usually, for SMBs, this process can last from 2-4 weeks, depending on the flow & quality of data being maintained by the Target.

Who should do it?

Financial due diligence is encouraged for every acquisition, regardless of size or industry. To avoid mistakes that can cost dearly, an M&A participant must get Financial Due diligence done. The errors caused by overlooking the potential risks or liabilities can result in post-acquisition pitfalls.

What is included in Financial Due Diligence

A detailed financial due diligence will typically involve

- In-depth quality of earnings analysis
- In-depth net working capital analysis
- In-depth Net Debt analysis
- Detailed income statement analysis
- Detailed balance sheet analysis
- Detailed cash flow analysis

In the SMB world, limited diligence is often referred to as "Quality of earnings" analysis, where only those aspects are scrutinized which can affect the deal value (mainly the EBITDA and Net Working Capital analysis)

- Quality of Earnings is a type of financial due diligence determining that the earnings are constant and sustainable, not just a result of one-off events or non-operational activities.

Need for Financial Due Diligence

Financial due diligence is needed to check the company's financial health for the Buyer. But there are more implications of financial diligence, which are as follows:

- It impacts the negotiation strategy of the deal.
- If revenue is cyclical and non-operational, it helps the Buyer adjust the offer price.
- It helps detect the cash pilferage.
- It brings to the surface internal controls and risk mitigation strategies.
- It shows the red flags and avoids post-acquisition obstacles.
- It prepares the Buyer for the acquisition.

Conclusion

Financial Due Diligence is a crucial step; hence, with the help of the right tools and professionals, buyers can make informed decisions that can ensure a successful and hassle-free transaction.

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