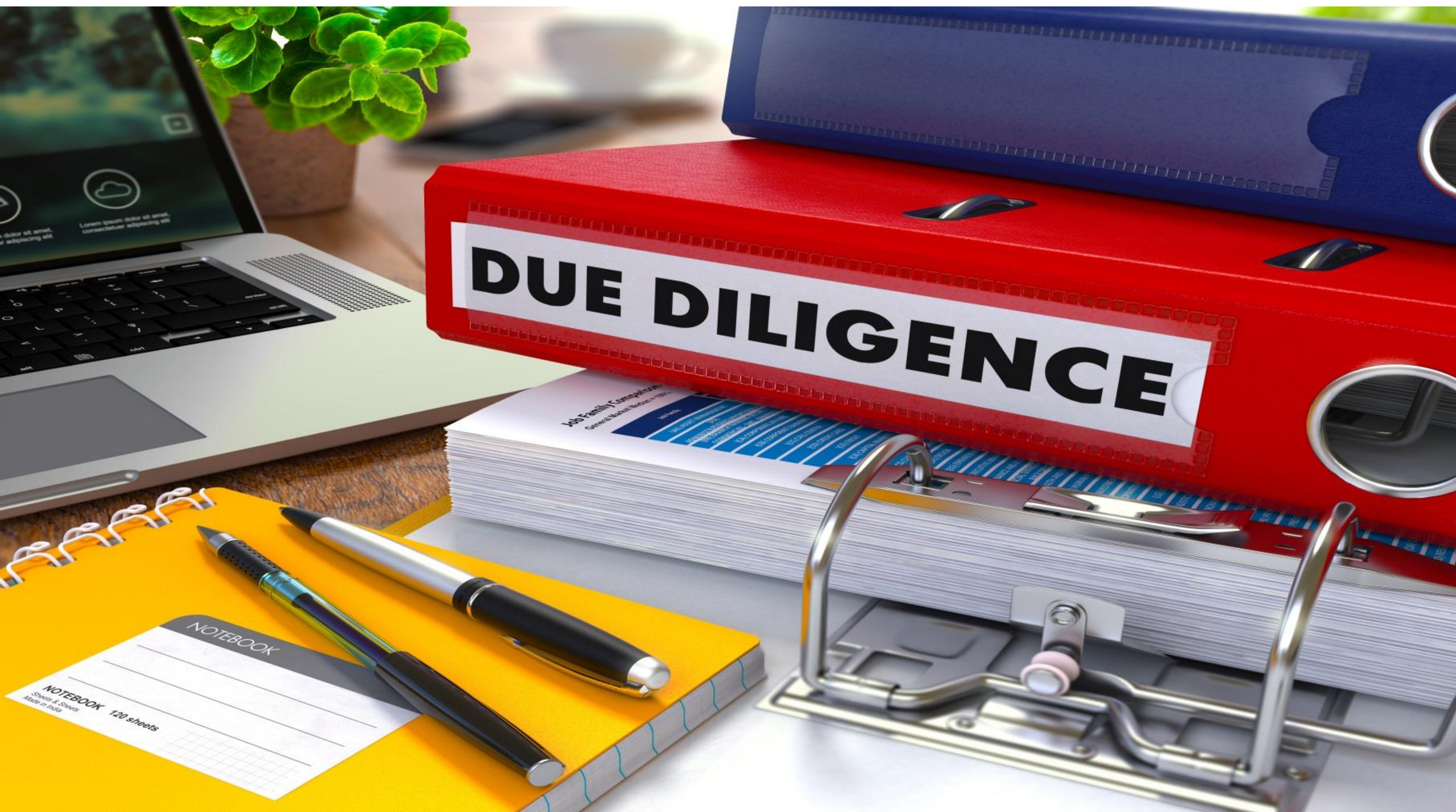

PREPARING FOR DUE DILIGENCE

Time and again, business owners may plan to seek working capital or additional funding in order to expand their business. In doing so, a pertinent question that will be inevitably raised is, “Will my funding proposal represent an attractive proposition to lenders or equity investors”?

Offering your books for due diligence may be a different experience as compared to running a business. When running a business day-to-day, the attention of a business owner tends to focus more on its immediate priorities. Issues such as winning new customers accounts, managing staff expectations and most or all dealing with accounts receivables are pertinent in seeing to the basic needs. Owners of businesses have practically no time to see or imagine what their businesses would look like from an outsider perspective until such time when there are plans for the business to seek external funding or offering of shares to potential investors. Under such circumstances, you will then begin to see the company as how an investor sees it, in terms of what they are looking for.

A due diligence process plays an integral role in ensuring that investors have all the relevant information they need to determine their risk as well as opportunities. For banks and private debts platforms working towards providing working capital, they would require to satisfy themselves that the business will be able to meet the repayment requirements. On the other hand, equity investors will be looking for their returns of investments and growth. Hence, any business seeking funding must be prepared to undergo an extensive and comprehensive due diligence in order to achieve its objectives. So, what should businesses expect and how can they be prepared for it?

Background Preparation

In preparing for a due diligence, business owners must ensure that they have all the information that a potential investor requires.

First and foremost, a due diligence engagement are usually carried out in two parts, a legal due diligence to be performed by lawyers and a financial due diligence which encumbers accountants to review the accounting and financial aspect of the company.

In a legal due diligence, lawyers appointed will usually carry out checks on the legal ownership of the company, titles of assets including intellectual properties owned by the company, legal contracts in which the company had entered into with its suppliers, customers, landlords, hire-purchase creditors, banks & financial institutions and most pertinent of all, independent searches in Courts to confirm if the company is engaged in any legal suits whether as plaintiff or as defendant. In instances where the company is a defendant, the merit of the matter in Court and other information giving rise to the suit would require disclosure in order to evaluate if there is an element of contingent liability.

On the accounting aspect, it would be necessary to present an accurate set of financial statements which may usually encumber the past three financial years. Financial information such as future projected turnover and profitability forecast, cashflow forecast and some less obvious information such as the key aspects of customers information, business vulnerabilities information, details on intellectual properties owned as well as contracts that the company had entered into with key personnel's within the organisation would also be necessary.

Other than determining the accuracy and completeness of the financial information provided, accountants conducting the due diligence will also review and scrutinise past debts obligations, turnaround period for accounts receivable. Legal documents relating to the company's ownership of assets, hire-purchase and leasing agreements. Intellectual property ownership will be reviewed and where necessary a valuation will be carried out to determine the fair value of these assets. A formal valuation would also be necessary for instances where certain assets will be utilised as security to lenders.

It would be helpful to get this key information prepared in advance before seeking funding as most investors would use these information to formulate investment decision.

Using assumptions

The use of assumptions plays a critical role in due diligence. It is a common methodology used by business owners to determine the viability of a business and investors rely on these information to make investment or funding decisions. It is therefore not unusual for management assumptions to be scrutinised in great depth.

The prospect of a due diligence process would prompt business owners to take a cold hard look at the assumptions on which the current business is based. From the inside looking out, it can be tempting to view things optimistically, such as the size of market segment which will translate to potential sales, expected growth and other opportunities. On the other hand, from the lenders or investors perspectives, an overly-optimistic sales projection that proves to be unfounded is likely to impact the company's ability to either repay its debts or generating the expected returns.

Hence, before approaching a financier or investor, the company should be mindful to evaluate its assumption carefully not only at its optimistic level but also caters for situation on a worst-case scenario. An accurate set of financial statements combined with realistic assumptions will provide certainty and credibility in the eyes of an investor.

Clarity of purpose

There must be clarity as to why the additional capital is needed and how it will be utilised. It is vital that these information are clearly stated in the business plan. Business owners must be mindful that these information will often relate back to your earlier projections and it has to be consistence. For instance, if the money is to be used to bring a new product to market or provide equipment that will increase production capacity, then the business must be able to make a strong case that the market exists and that the return will justify the investment. Consequently, the information contained in the cashflow and sales projections will co-relate to demonstrate when the capital expenditure (in the case of equipment) is incurred and when the increase sales is expected.

Business owners should also be prepared to answer questions in relation to past years' performances. It is particularly venerable in situation where the prior year's results may not be as attractive as what the current projections are. For instance, there may be setback due to poor economic condition where sales are down resulting in redundancies, temporary struggles to pay suppliers etc. There should be true and clear disclosures of all these issues. Historic problems are not necessarily deal breakers, and for some investors, it may be evidence that management has successfully overcome these difficulties and as a result of this, the disadvantages may indeed be an advantage having survived such crises.

With this said, it is important for business owners to be honest, transparent and open as it is likely that the past issues will come out of the woodwork in the course of the due diligence.

Taxation

Indentifying tax risks is another significant area that is crucial to an investor. Identified tax risks can have a significant impact on the market value of the business and might constitute a crucial consideration in the pricing process. The objectives of a tax due diligence is not purely confined to ascertaining the tax liabilities of a business at a particular point in time. It will also involve analysing the various tax treatment adopted by the company to ensure that they are consistent and in compliance to the jurisdiction where the business operates. In any event of uncertainty, due diligence professionals are also expected to work within certain assumptions in order to establish a provision for contingent tax liabilities.

Under these circumstances, it will be prudent that owners of businesses should take the necessary steps to initiate any reasonable provision (where necessary) prior to any due diligence. In doing so, it will certainly demonstrate better credibility with investors.

Conclusion

Based on the synopsis presented above, business owners should be mindful that before formulating a business plan for fund raising purposes. There is indeed a full load of preparatory work to be done at its forefront. The preparation process requires rigorous focus and it is sometime impossible for a company to depend solely on its internal resources to collate and compile these information. Under these circumstances, it will be prudent to engage the help of an accountant who process the knowledge and expertise in this area of work.

As discussed earlier, it will be necessary to see the company from outside perspectives, and not from an inside-out perspective. Otherwise, one will naturally have a tendency of being over optimistic.

If you wish to understand more on the preparing for Due Diligence, please feel free to approach:

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