

# **FINANCIAL DUE DILIGENCE & REPORT WRITING**

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<b>Sr. No.</b>	<b>Particulars</b>
1	Transmitted / Covering Letter
2	Brief Overview of the Transaction
3	Company Background including Financial Overview
4	Executive Summary
5	Adjustment Tables
6	Summary Financials – Analysis of Balance Sheet, Profit & Loss Account and Cash Flow Statements
7	Key Observations
8	Contingent Liabilities
9	Related Party Transactions
10	Human Resources
11	Tax Matters
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## **KEY ELEMENTS OF FINANCIAL DUE DILIGENCE REPORT**

1.

## Transmitted / Cover Letter:



Give brief about the Client appointed the Firm to carry out a Financial Due Diligence (“FDD”) exercise



Write in brief about the Scope of work and period to be covered



Exclusions and Limitations – Usage of Report, Hold Harmless, this is neither an audit nor an investigation, etc.



Abbreviations used in the Report



Details about major data received for due diligence exercise



Talk about the meetings carried out with the Target Management, access to the data room such as Physical or Virtual Data Room, Plant visit, work carried out from the Target office, WFO, WFH, etc.

2.

## Brief Overview of the Transaction:

- Nature of transaction
- Transaction Perimeter
- Type of transaction – Share Purchase / Business Transfer / Asset Purchase / Debt Funding
- Any business which is not forming a part of the Transaction
- Any Assets or Liabilities which are to be carved out from the Target Company Financial Statements

### 3. Company Background including Financial Overview:

- Overview of the Target Company
- Group Structure
- Major Shareholding Pattern
- Management / Directors / Key Personnel
- Financial Snapshot
- Key Performance Indicators (“KPI”)

## 4. Executive Summary:

- Mentioned major observations along with the brief details about the issue and provide recommendations for the same.
- Deal breaker issues – Hidden liabilities or overbooking of revenue
- Major dependency on Customer / Supplier / Employees/ Related Parties
- Sustainability of the Business Model – Growth in Revenue and EBITDA
- Current pandemic situation – Covid 19 impact on the overall business
- Target Company is Promoter or Personnel driven
- Significant non recoverable/ realisable assets
- Significant liabilities not provided for in the books of account
- Borrowings - Highly geared or leveraged
- Key negative/ restrictive covenants of Borrowing Agreements
- Tax Exposure (Direct and Indirect taxes)
- Quality of Information

## 4. Executive Summary: (Contd.)

### Impact and Mitigation Strategy for Executive Summary Points:

- There are certain points will have an impact on Valuation of the Company/ Business.
- Risk involved in few points will get mitigated by way of obtaining Representations and Warranties and Indemnities from the Seller.
- There are certain points where risks will get mitigated by way of putting condition precedents or condition subsequent in the Transaction Documents.
- There are specific points where other expert view is required – Legal/ Technical/ Commercial Due Diligence

# 5. Adjustment Tables: EBITDA and Net Worth - Examples

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**Sales overbooked/ Subsequent sales returns**

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**Expenses not provided for e.g. year end provisions, audit adjustments, discount, commission, etc.**

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**Employee retirement benefits not provided for – Gratuity, Leave Encashment, etc.**

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**Prior period adjustments – EBITDA impact only**

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**One off / Non-recurring income or expenses – EBITDA impact only**

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**Normalized adjustments – Rent expenses, Management cost, etc.**

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**Provision for doubtful debts based on FDD exercise**

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**Provision for slow / non-moving inventories based on FDD exercise**

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**Significant potential tax liabilities – Net Worth adjustment only**

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**Significant disputed legal liabilities – Net Worth adjustment only**



# 5. Adjustment Tables: EBITDA and Net Worth - Example

INR Million

Particulars	Note	Revenue/ EBITDA			Net Worth
		FY18	FY19	FY20	31-Mar-20
<b>Reported Revenue/ Net Worth as per the financials</b>		314.02	443.22	505.48	874.81
Less: One time Consultancy income from LLC	1	(53.90)	-	-	-
Less: One time trading revenue	1	(77.90)	-	-	-
<b>Adjusted EBITDA</b>	<b>A</b>	<b>182.22</b>	<b>443.22</b>	<b>505.48</b>	<b>874.81</b>
<b>Adjustments:</b>					
Deferred revenue expenditure	2	-	-	13.07	(65.33)
Bank Charges	3	-	-	(0.85)	-
Donation	4	-	-	0.07	-
RM overvaluation	5	-	-	(1.97)	(1.97)
Revised FG valuation	6	-	-	(8.83)	(8.83)
Production overheads	7	(NQ)	(NQ)	(NQ)	(NQ)
Non-Moving inventory	8	-	-	(28.04)	(28.04)
Provision for Gratuity	9	-	-	2.50	2.50
Provision for Leave encashment	10	-	-	NQ	NQ
Potential Direct and Indirect tax litigation	11	(NQ)	(NQ)	(NQ)	(NQ)
Non-current investment in one entity	12	-	-	-	(322.00)
Delays in payment of statutory dues	13	-	-	-	(NQ)
Prior period expenses of FY18 and FY19	14	(NQ)	(NQ)	0.24	-
Audit Fees	15	-	-	(1.05)	(1.05)
Advance to vendors	16	-	-	(1.76)	(1.76)
Directors remuneration	17	(NQ)	(NQ)	(NQ)	(NQ)
Differences in books and provisional financials	18	-	-	0.13	(1.53)
Loss on sale of asset	19	0.05	0.45	-	-
Short provision of PF and ESIC	20	-	-	(0.73)	-
Potential audit adjustment	21	-	-	NQ	NQ
Adjustments (to the extent quantifiable)	<b>B</b>	<b>0.05</b>	<b>0.45</b>	<b>(27.22)</b>	<b>(428.01)</b>
<b>Adjusted EBITDA/ Net worth (to the extent quantifiable)</b>	<b>(A+B)</b>	<b>182.27</b>	<b>443.67</b>	<b>478.25</b>	<b>446.80</b>
<b>EBITDA as a % to Adjusted Revenue</b>		<b>0%</b>	<b>0%</b>	<b>-5%</b>	

Source: DH&Co. Analysis

# 5. Adjustment Tables: Net Debt - Examples

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**Debt less Cash and Cash equivalents**

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**Long term employee related liabilities – Gratuity and Leave encashment**

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**Capital creditors**

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**Non-provision for interest liabilities on loans**

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**Stretched liabilities e.g. creditors outstanding for more 12 months**

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**Liquid investments – positive adjustments**

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**Financial support received from/ given to Group companies**

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**Significant potential disputed tax liabilities**

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**Impact of contingent liabilities (other than tax liabilities)**

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**Capital commitments**

## 5. Adjustment Tables: Net Debt - Example

		INR Million
Particulars	Note	31-Mar-20
Long Term Borrowings		528.74
Short Term Borrowings		8.44
<b>Total</b>		<b>537.18</b>
Less: Cash and Cash Equivalents		(2.72)
<b>Reported Net Debt (A)</b>		<b>534.46</b>
<b><u>Potential adjustments to reported Net Debt</u></b>		
Overdue trade payables	1	14.47
Potential direct and indirect tax liabilities	2	NQ
TDS default liability	3	0.02
Unprovided Interest liability	4	NQ
Interest accrued but not due on borrowings	5	11.29
Deferred tax asset/liability	6	NQ
Provision for Leave encashment - Unfunded	7	3.62
Provision for Gratuity - Unfunded	8	4.95
<b>Total adjustments (to the extent quantifiable) (B)</b>		<b>34.35</b>
<b>Grand total (A+B)</b>		<b>568.81</b>

Source: Management Information & DH&Co. Analysis

## 5. Adjustment Tables: Net Working Capital - Examples

- Provision for slow / non-moving inventories based on FDD exercise
- Provision for doubtful debts
- Excludes - Trading related stock, debtors and creditors
- Exclusion of stretched liabilities and capital creditors considered as a Net Debt
- Excludes long term advances and deposits given/ received
- Operating income and expenses related adjustments from Adjusted EBITDA table

Working Capital Analysis

Cash Conversion Cycle ("CCC") = DSO + DIO - DPO

# 5. Adjustment Tables: Net Working Capital – Quarterly Trend

Working Capital excluding bank balance and cash and bank borrowings - INR Million									
Particulars	31-Dec-19				31-Dec-20				31-Mar-20
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
As on last day of quarter	16.97	17.32	17.84	18.02	18.02	18.38	18.13	18.51	17.66
3 months average	16.94	17.26	17.69	17.94	18.38	18.21	18.22	18.36	18.23
<b>Current Assets</b>									
Trade receivables (net)	1,256.78	1,191.76	1,544.42	2,068.13	2,047.82	2,011.45	2,052.40	2,272.37	2,276.05
Due from a related party	288.56	328.48	407.67	534.14	717.40	747.85	602.28	687.01	720.43
<b>Total trade receivables</b>	<b>1,545.34</b>	<b>1,520.23</b>	<b>1,952.09</b>	<b>2,602.27</b>	<b>2,765.22</b>	<b>2,759.31</b>	<b>2,654.68</b>	<b>2,959.39</b>	<b>2,996.49</b>
Other receivables	377.41	350.64	511.60	208.29	210.74	277.69	258.99	218.56	273.13
Inventories	2,419.93	2,053.06	2,237.63	2,261.06	1,879.17	2,365.56	2,172.16	2,206.54	2,048.43
<b>Sub total (A)</b>	<b>4,342.68</b>	<b>3,923.94</b>	<b>4,701.32</b>	<b>5,071.62</b>	<b>4,855.13</b>	<b>5,402.56</b>	<b>5,085.84</b>	<b>5,384.49</b>	<b>5,318.05</b>
<b>Current Liabilities</b>									
Trade and other payables (exclu dividend payable) (B)	(1,603.42)	(1,320.99)	(1,288.11)	(1,651.80)	(365.64)	(1,859.26)	(1,805.68)	(1,956.48)	(1,666.02)
<b>Working Capital (A-B)</b>	<b>2,739.26</b>	<b>2,602.95</b>	<b>3,413.22</b>	<b>3,419.82</b>	<b>4,489.49</b>	<b>3,543.30</b>	<b>3,280.16</b>	<b>3,428.01</b>	<b>3,652.03</b>
Revenue	2,548.11	2,834.61	2,681.19	2,835.71	2,348.68	2,352.46	2,725.72	2,880.02	2,713.17
Cost of sales	1,873.75	2,152.45	2,038.39	2,327.48	1,933.16	1,753.64	2,110.52	1,287.53	2,239.87
Days Sales Outstanding (in days) - DSO	67.91	59.40	82.70	89.20	114.04	116.19	96.21	99.31	108.46
Days Payable Outstanding (in days) - DPO	77.02	55.23	56.87	63.87	17.02	95.42	77.00	136.76	66.94
Days Inventory Outstanding (in days) - DIO	116.23	85.84	98.80	87.43	87.49	121.40	92.63	154.24	82.31
Cash conversion cycle (in days) CCC	107.13	90.01	124.62	112.76	184.50	142.17	111.83	116.79	123.82

Source: Financial Statements and DH&Co Analysis

# 6. Summary Financials

- **Variation analysis for minimum period of three years and the latest period (depending upon the scope period)**
  - Balance Sheet
  - Profit & Loss Account
  - Cash Flow Statements
  - Notes to Accounts
  - Complete Annual Report
  - Management Discussion & Analysis

7.

## Key Observations: Revenue and other income



Overall revenue growth/ de-growth  
Manufacturing v/s Trading Revenue



Seasonality impact - Trend analysis of sales - Monthly/ Quarterly/ Yearly



Volume and Value analysis of major products



Customer concentration – Top 10/ 20 customers

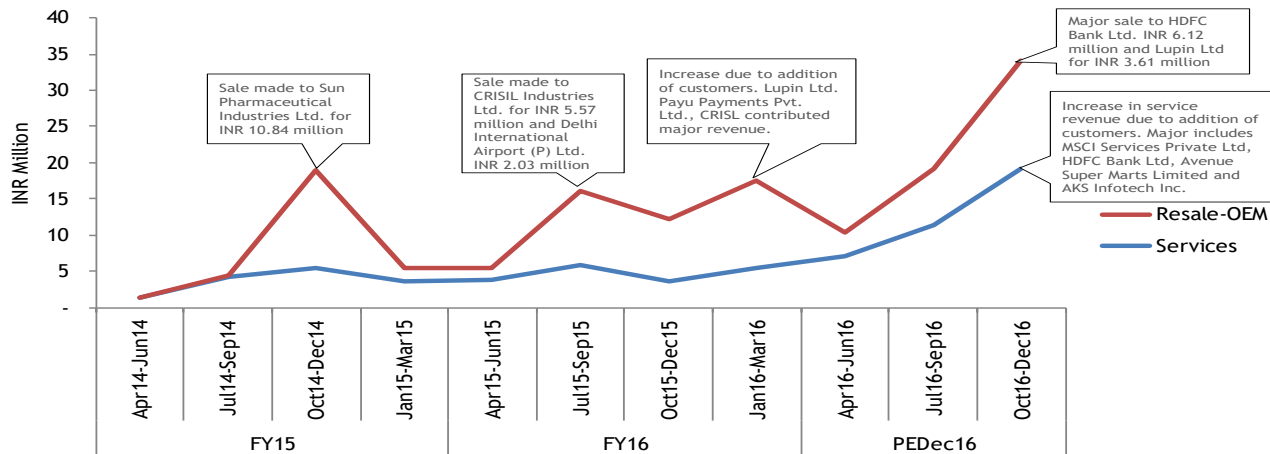
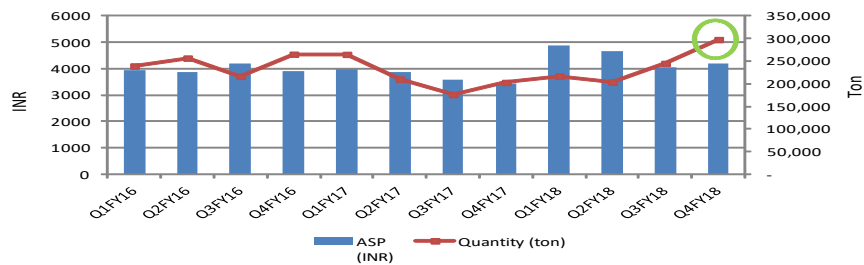


Key terms of sales contract – Minimum supply, price escalation, payment terms, etc.



Accrual of rental, interest and dividend income

# 7. Key Observations: Revenue related graph





7.

## Key Observations: Production analysis



Capacity Utilisation



Installed vs Actual Production



Constraints/ Bottlenecks in capacity utilisation



Future capex required for enhancement of capacity



Possible Synergies post acquisition

# 7. Key Observations:

## Overall expense growth/de-growth

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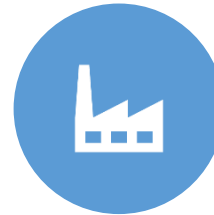
Material & Other Expenses



Seasonality impact -  
Trend analysis of  
purchases – Monthly/  
Quarterly/ Yearly



Volume and Value  
analysis of major  
materials purchased



Supplier concentration –  
Top 10/ 20 suppliers

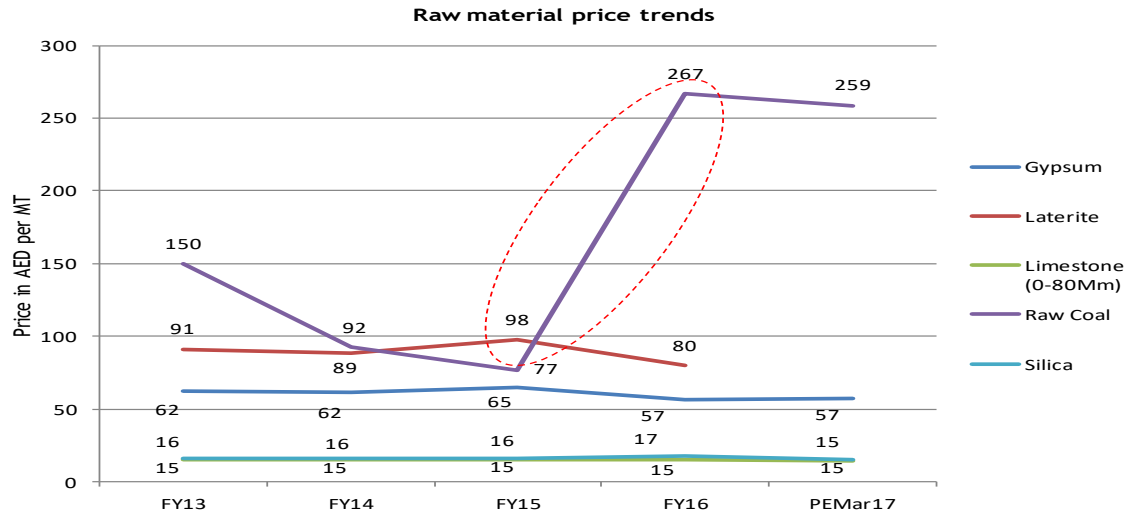


Key terms of purchase  
contract – Minimum  
offtake, price escalation,  
payment terms, etc.

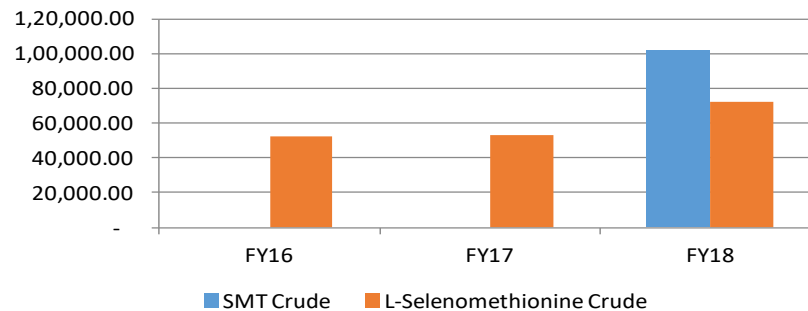


Accrual of expenses –  
Employee cost, SGA  
expenses, rental charges,  
depreciation and interest  
expenses

# 7. Key Observations: Expenses related graph



**Price Movement of Major RM**



7.

## Key Observations: Fixed Assets

Overall Tangible and Intangible assets - Gross block v/s Net block

Impaired Assets

Potential capital expenditure required due to highly depreciated assets

Future capex and financial closure

Land – Owned vs Leased

Leasehold land – Negative and restrictive clauses in the leasehold agreement

7.

## Key Observations: Investments



Assessment of net worth of the Investee Company

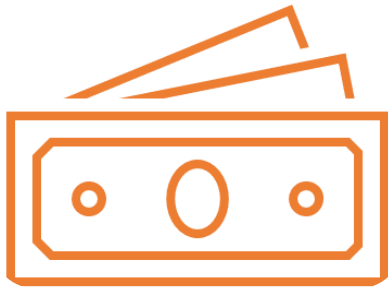


Impairment provision for permanent diminution in value of investments



In case of Joint Venture – Key terms of the agreement including restrictive clauses in the JV agreement and compliances of the same

# 7. Key Observations: Sundry Debtors



Debtors ageing



Days Sales Outstanding



Subsequent collection from the customers



Legal and disputed debtors



Provision for doubtful debts



Confirmation from high value debtors

# 7. Key Observations: Inventory

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**INVENTORIES  
AGEING**



**METHODOLOGY  
USED FOR  
VALUATION OF  
INVENTORIES,  
COMPLIANCES  
WITH THE  
ACCOUNTING  
STANDARD OR  
IND AS**



**IMPACT ON  
ACCOUNT OF  
PHYSICAL  
VERIFICATION  
OF  
INVENTORIES**



**CRITICAL AND  
INSURED SPARES  
SHOULD BE FORM  
A PART OF THE  
INVENTORIES OF  
THE TARGET  
COMPANY  
OTHERWISE IT WILL  
HAVE AN IMPACT  
ON IMMEDIATE  
FUTURE CASH  
FLOW**



**PROVISION  
FOR SLOW  
MOVING AND  
NON MOVING  
INVENTORIES**



7.

## Key Observations: Other current assets

Overall assessment of other current assets such as loans and advances given, deposits given, etc.

Ageing of loans and deposits given

Accrual of interest, dividend and other income

Assessment of recoverability and realisability of loans and advances given, deposits given, etc.



# 7. Key Observations: Debt/ Borrowings

- Overall borrowing summary
- Provision for interest and average cost of borrowings
- Delays in repayment of loans and interest, penal interest, etc.
- Loan agreements – Negative and restrictive clauses in the agreements, compliances of key terms of the agreement, etc.
- Future repayment schedule and its impact on the future cash flow position e.g. Bullet Payment at one go
- Note on Debt Restructuring Scheme (“DRS”) of loans or One Time Settlement (“OTS”) and compliances of key terms of DRS / OTS

7.

**Key  
Observations:  
Trade  
Payables**



Creditors ageing



Days Payable Outstanding



Subsequent payments made  
to the suppliers



Legal and disputed suppliers  
liabilities

# 7. Key Observations:

## Other current liabilities

- Overall assessment of other current liabilities
- Completeness of provision for expenses
- Delays in payment of statutory dues – TDS, GST, PF, ESIC, etc.
- Provision for employee related liabilities – Gratuity, Leave Encashment, Bonus, Medical benefits, etc.

**8.**

## **Contingent Liabilities:**

Disputed liabilities and claims against the Target Company

Open Letter of Credits

Corporate and Bank Guarantees given for Target Company and on behalf of their Group entities

Performance Bank Guarantee given as per the terms of contract with the customers

9.

## Related Party Transactions:

Financial Support  
– Interest free or  
interest bearing

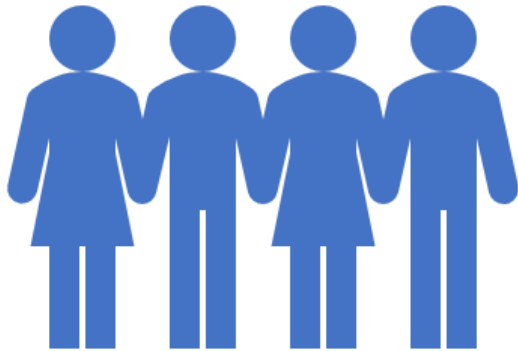
Management  
Support –  
Chargeable or  
non chargeable

Infrastructure  
provided at free of  
cost/ below  
market price/ at  
arms' length price

In future potential  
cost for the  
services/ facilities  
provided free cost  
and its impact on  
future EBITDA,  
Net Worth and Net  
Debt

## 10. Human Resources:

- Overall employee strength and cost analysis
- Attrition Rate
- Provision for retirement benefits w.r.t. Gratuity and Leave Encashment – Funded/ Unfunded
- Shortfall in fund position as compared to the Acturial Valuation Report
- Compliances – Payment and provisions for of PF, ESIC and Bonus
- Key vacant position – Potential cost for the same and its impact on future EBITDA



# 11. Tax Matters – Direct Tax:

- Complete summary of assessment chart of Direct Tax for last 8 years
- Details of ongoing litigations and its impact on the Valuation of the Target Company
- Give weightage to the ongoing litigations from the risk point view – High / Medium / Low
- Compliances:
  - Payment of Corporate Tax and TDS as per stipulated timelines provided in the Income Tax Act, 1961
  - Filing of Returns – Corporate Tax and TDS Returns

# 11. Tax Matters – Direct Tax: (contd.)

- Transfer Pricing matters
- Sunset clause of certain tax benefits and its impact on future tax liabilities
- Impact of section 79 of the Income Tax Act – Carried Forward of Business Losses
- Recommendation after analysing the Tax disputes w.r.t. structuring of the Transaction - SPA vs BTA



# 11. Tax Matters – Indirect Taxes:

- Complete summary of assessment of Indirect Taxes
- Details of ongoing litigations of Indirect Taxes and its impact on the Valuation of the Target Company
- Give weightage to the ongoing litigations from the risk point view – High / Medium / Low
- Sunset clause of certain tax benefits and its impact on future tax liabilities
- Compliances:
  - Payment of Indirect Taxes as per stipulated timelines provided in the respective act.
  - Filing of Indirect Tax Returns

**12.**

**Annexures:**

Scope of work as  
agreed in the  
Engagement Letter

Key terms of  
customer contracts

Key terms of  
supplier contracts

Key terms of loan/  
borrowing  
agreements

Key terms of  
leasehold land  
agreement

Key terms of rental  
agreements

Detailed workings  
of certain key  
observation  
summary

# Consideration to be given for soft skills while drafting the FDD report

- Report should be crystal clear – No anomaly
- Sanity checking of numbers and % used across the report
- Usage of graphs and tables
- Key points to be explained properly – Significant variations or major events took place during the period under exercise
- Executive Summary and Adjustment Tables are very critical aspects of the report
- Disclaimer – This is neither a certificate nor an opinion, Covid 19 impact on the business operations, etc.

**Thank You**