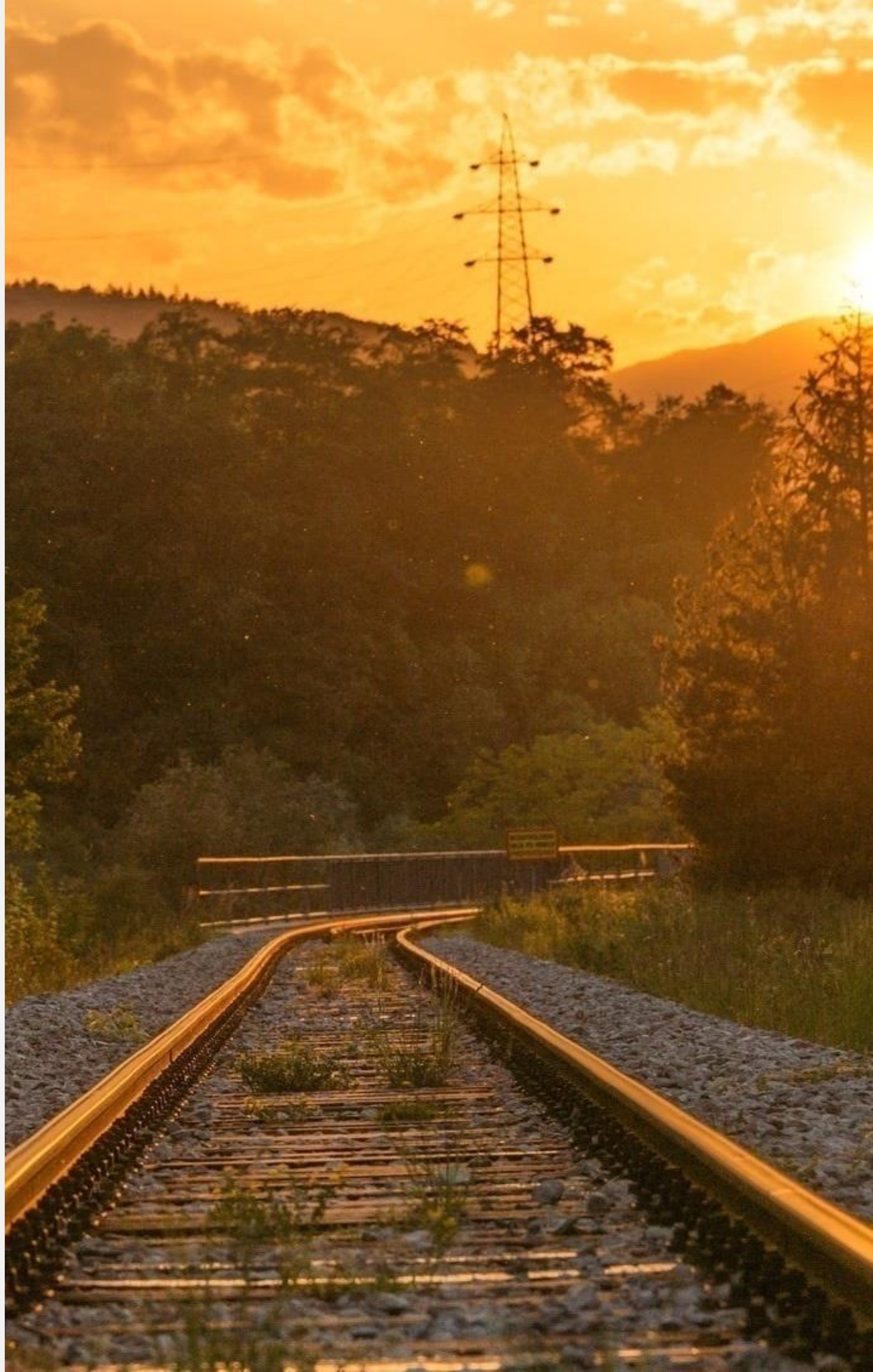
Crowe

Smart decisions. Lasting value.

Financial Due Diligence

Conducting an Effective Due Diligence

Contents



Introduction

In the mergers and acquisitions (M&A) environment, whether a person is undertaking an acquisition or an investment, a financial analysis on the potential target is important. Understanding the transaction and the risks involved enables the acquirer or investor to potentially mitigate the risks and make sound decisions.

The due diligence review looks at the Target's business, the key drivers, the product mix and the industry the Target is in. It also delves into historical performance trends, liquidity, forecasts and projections. In a nutshell, the exercise is directed at basically knowing your Target and scrutinizes the past, present and future from the financial aspect of the business.

However, a financial due diligence is not always foolproof in uncovering anomalies. Conducting a financial due diligence too hastily, or with limited scope and coverage may lead to issues not being identified. Certain questionable deals have arisen in the past even after a due diligence is done, such as Hewlett Packard's acquisition of Autonomy in the United States of America, or locally, Top Glove's acquisition of Aspion in which both had claimed fraudulent representation. As such, choosing the right team, scope and professional firm for your due diligence exercise is important.

In this publication, we are honored to share our knowledge and the issues to focus on when conducting a financial due diligence. **If you are currently in the midst of an M&A transaction and are considering a financial due diligence specialist, please feel free to talk to us.**

2. Who Needs Financial Due Diligence and Why

2.1 Who Needs Due Diligence?

When acquiring a company or investing into a company, we need to keep our eyes open and know what we are getting into. U-turns and regrets may be too late. We have to ensure that the transaction we are entering into is safe from critical financial issues and misrepresentations by the seller. A due diligence may also be needed for reasons unique to the acquirer. Often, an acquirer's concern is that they are paying an excessive price for overstated assets or understated liabilities. If the value of the target is below that as represented by the seller, the acquirer may wish to re-negotiate the acquisition price. Some may be concerned about whether their acquisition will reap synergies, competitive advantage, increase of market share and enhanced profits. The variety of users and their reasons for conducting due diligence exercises are:-

Acquirers
Main concerns are to minimize the purchase price and to reap synergies, increase in profits and increase in market share upon acquisition

Private Equity/Venture Cap
Interested in the upside potential of investments, and the ability of the target to pay interest or dividends

Others – lawyers, advisors and promoters
Use the due diligence findings as a support for negotiations and drafting of agreements.

Vendor/Seller
Reduce exposure in transaction risks and costs i.e. issues that are uncovered during the due diligence process which may introduce concerns on the certainty of closure of the acquisition

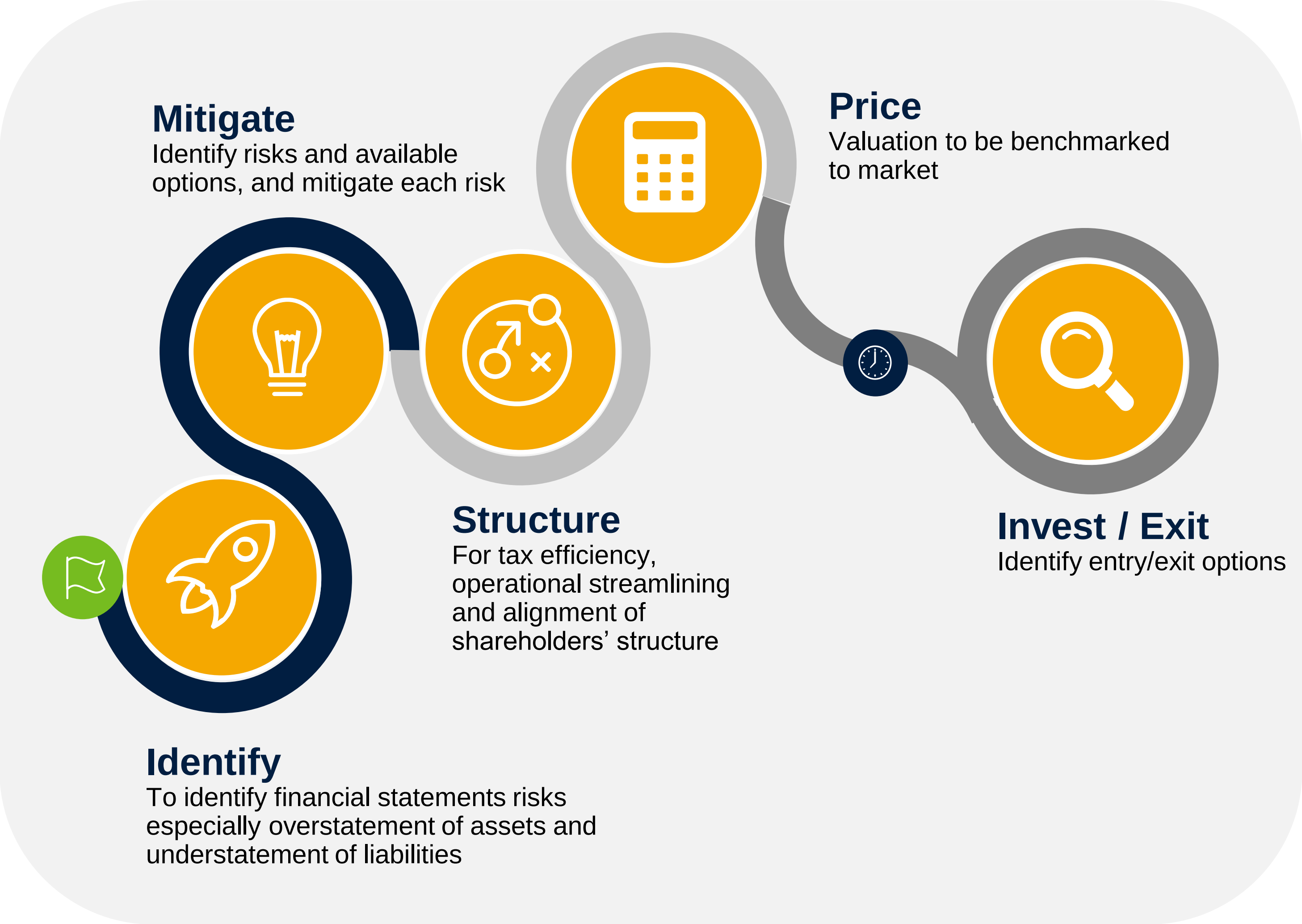
Financial Institutions or Lenders
Concerned about the acquirer's ability to repay loans and the veracity of assets as collateral

2.2 Why is Due Diligence Necessary?

A financial due diligence is an integral part of the M&A environment. Seldom do acquirers make acquisitions without undertaking either a limited or full due diligence exercise on the target. The key objective is to identify the risks arising from the transaction and thereafter to put in place a proper mitigation strategy.

Due diligence findings will also help the user to consider the most optimal structure for making the acquisition and to take advantage of potential tax savings. Options to invest or exit will always depend on the findings and the right pricing. There are times where due diligence findings have led to a lower pricing as a result of adjustments.

Acquirers or investors should not under-rate the necessity of these exercises because of past accounting improprieties in the financial statements of target companies such as those in the acquisition of Autonomy by Hewlett Packard in the United States of America.



2.3 How does a Due Diligence Differ from an Audit

The purpose of conducting a financial due diligence is simple - it is for “Fact Finding”. *It is not an audit.* Due to this mistaken impression, many acquirers are of the view that a due diligence is not needed if an audit had been conducted. Being a fact-finding mission, the due diligence deliverable comprises a comprehensive due diligence report that consists of details and the reasons behind the numbers that will help to alleviate the concerns of the user. The key differences between an audit and a due diligence exercise are:

Audit

- It is a statutory requirement.
- Specific opinion.
- Auditors inform the client on what are needed.
- Work directed at opinion.
- Based on auditing and accounting standards.
- Recurring services.

Due Diligence

- No regulatory requirement.
- Depends on assignment.
- Client informs the due diligence team on what are needed.
- Work directed by scope. Focus is on deal matrix and value to acquirer.
- Professional judgement, ethics and experience with guidance from accounting standards.
- Services as and when needed.

3. Due Diligence Scope and Key Focus Areas

3.1 Scoping a Due Diligence Engagement

Every due diligence assignment is different and requires a different approach with focus areas that are tailored to the requirements of the Client. The nature and scope of due diligence depends on the type of transaction, the size of the investment and the timeframe available to conduct the due diligence. A pre-consultation with the acquirer and other relevant parties will be done to understand the nature and scope required. Subsequently, after perusing the preliminary information received from the Client, a discussion will be held to highlight potential red flags following which a scope of work will be prepared for the Client. The scoping process is as follows:-

- Pre-consultation/ assessment of target company
- Full scope/high-level review of target company's financials – this depends on costs and risks
- Identify red flags and communicate
- Scope and focus on high risk areas

3.2 Key Areas to Focus

Focus areas for a financial due diligence depend on the transaction, the business of the target and the industry the target operates in. The Team conducting the due diligence will not only need to understand the financial information, but also the way that the business operates and the management in charge. The key areas to focus on in a financial due diligence are:-

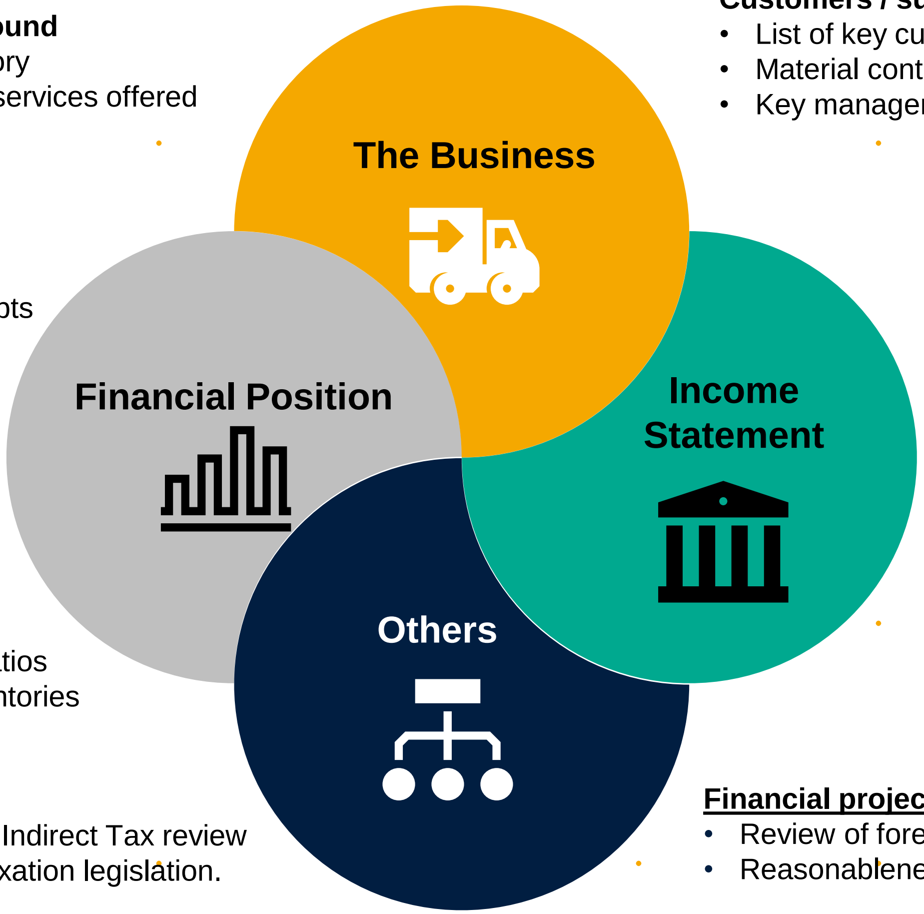
Business background
- The growth story
- Key products/services offered

Statement of financial position (Balance Sheet):
- Review on assets and liabilities
- Impairment of assets / restoration costs
- Recoverability issues - bad and doubtful debts
- Cash and borrowings
- Working capital analysis

Cash flows:
- Cash flow (net cash flow from operating, investing and financing activities)
- Cash conversion cycle

Ratios:
- Liquidity, profitability and other ratios
- Trade receivables/payables/inventories turnover days

Tax
- Corporate Tax and Indirect Tax review
- Compliance with taxation legislation.



Customers / suppliers / management
- List of key customers and suppliers, and terms
- Material contracts
- Key management personnel

Trading performance (Income Statement)
- Revenue / revenue by segment
- Gross profit margins
- Profit before tax / profit after tax
- Factors and trends analysis affecting financial conditions and results (economic situation, etc)
- Exceptional and extraordinary non-recurring items
- Related parties

Others (if any)
- Accounting policies
- Dividend policy
- Consolidated financial information
- Off-balance sheet items
- Material commitments
- Material litigation and contingent liabilities
- Undisclosed liabilities

Financial projections
- Review of forecasts and projections
- Reasonableness of the assumptions used

3.3 Financial Due Diligence Post Covid-19

The recent Covid-19 pandemic has shifted the way businesses operate. There is now a strong emphasis on providing an enhanced layer of security against health risks besides having to re-invent the way business is done especially by leveraging digital and online technology. With health being paramount, Governments of most countries have issued strict SOPs for partial or complete lockdowns that affect businesses. Consequently, some industries such as oil & gas, tourism, entertainment and food & beverage are affected as a result of depressed demand for their goods and services. Other industries have instead benefited such as the medical, pharmaceutical and e-commerce sectors. With this change in environmental and behavourial factors, most companies have shifted their strategies to overcome the implications of Covid-19 on their businesses.

In such an unfamiliar environment, due diligence exercises require ingenuity and insightfulness. Uncertainties lurking below the surface should be unearthed whilst gems should be identified. This will bring value to the acquirer who has to consider all the risks and benefits before embarking on the investment. The due diligence team can support the acquirer by using their work experience and professional judgment to identify potential issues and adjust or normalize numbers for the acquirer's consideration.

Trading Performance
- The revenue and gross profit trends before and after Covid-19
- The impact of Covid-19 on the product mix and value chain
- Effect of supply chain issues
- Repercussions due to unfulfilled commitments

Liquidity
- Subsidies/incentives/grants received from government accounted for?
- Ability of customers to repay debts and likely doubtful debts
- Any obsolete or slow-moving inventories as a result of Covid-19 that need impairment?
- Any indication of slower payments to creditors?
- Longer cash conversion cycle – identify changes in payment terms

Others (projections, tax, etc)
- Are forecasts adjusted based on current Covid-19 impact?
- How often are changes done to the projections - quarterly, semi-annually or annually; the shorter, the more reliable
- Have changes in customer base or suppliers been considered and new terms factored in?
- Moratorium on financing and tax repayments – whether factored into the forecast and the likely impact on profitability and cash flow
- Whether commitments and contractual obligations are recognised

4. Common Financial Due Diligence Issues

4.1 Common Financial Due Diligence Issues

From experience, various common issues may be encountered when conducting a financial due diligence exercise. For example, a review on assets may uncover overstatements of assets due to overvaluation of inventories, under-recognition of impairment of PPE (fixed assets), or even under-recognition of allowance for receivables due to recoverability issues. Some of the common issues or risks noted when conducting a due diligence exercise are:-

Statement of Financial position

- Overstatement of assets such as restoration costs, overvaluation of assets, impairments not adjusted for and doubtful debts
- Understatement of liabilities such as invoices not taken up, liabilities written back without waivers from creditors, and undisclosed liabilities
- Off balance sheet items such as contingent liabilities due to litigation or capital commitments on purchase of property, plant and equipment

Statement of Comprehensive income

- Appropriateness of revenue recognition
- One-off items / extraordinary items captured in the accounts which are not adjusted
- Non-adoption of approved accounting policies resulting in distorted trend analysis
- Related party transactions not taken up e.g interest charges and shared costs which affect profit margins

Business Background

- Reliance or concentration risk on key supplier or customer
- Key driver trends for the business on the downside
- Management team with special incentives in the contract, i.e special bonus, etc

Liquidity – cash flows / working capital

- Long inventory holding period resulting in significant cash flow issues
- Negative cash flow from operations, potential need for funding
- Fluctuations in monthly/quarterly cash flow and working capital trends

Financial projection review

- Overly optimistic assumptions used which are not in line with industry trends
- Actual results did not meet budgeted/projected figures leading to reliability issues
- Change in business direction with no track record or management to lead

Examples of Financial Due Diligence Issues

4.2 Property Plant and Equipment

Key Observations

Target X Sdn Bhd ("XSB") is in the entertainment industry. The list of fixed assets as at the review period is as follows:-

Details (Cost)	RM
Building	6,000,000
Land	13,000,000
Motor Vehicles	530,000

From the review of PPE, it was noted that XSB had paid only RM1.3m (representing 10% deposit of the total cost) to Yayasan ABC and had capitalized the land in the books of XSB.

Furthermore, from the purchase agreement, the title will only be transferred when full payment is made, and there is also a 3% interest chargeable on the amount outstanding, if settlement is not made within 6 months. As at the end of the review period, the estimated interest payable amounted to RM300,000, which had not been taken up in the books of XSB.

Salient Issues

- PPE overstated by RM13 million.
- Interest expense of RM300,000 not taken up
- Potential deposit written off in the event the outstanding balance is not paid

Examples of Financial Due Diligence Issues

4.2 Property Plant and Equipment (cont.)

Issue 1: Overstatement of Assets

XSB should not capitalize the land in the books since only a 10% deposit had been paid. XSB should only capitalize upon successful completion of the acquisition of land. Impact to the books:-

Details	Dr (RM)	Cr (RM)
Deposit - Land	1,300,000	
Amount owing to Yayasan ABC	11,700,000	
PPE – Land		13,000,000

Issue 2: Interest Payable Not Taken Up

Given that XSB had not settled the balance purchase price by the agreed date, there is an interest payable to be taken up.

The impact to the books are:-

Details	Dr (RM)	Cr (RM)
Interest on purchase of land – Income Statement	300,000	
Interest payable – Yayasan ABC		300,000

Recommendations

- To adjust the overstatement of assets and to take up the interest expense as it will affect the net assets and net working capital
- To ensure adjusted figures are used when valuation is done
- In the event the balance is not paid, the deposit is forfeited. The Client has to ensure that this amount is covered in the representations and warranties of the agreement

Examples of Financial Due Diligence Issues

4.3 Accounts Receivable

Key Observations

48% of the total accounts receivable of Target A Sdn Bhd ("ASB") are past due more than 120 days as follows:-

(RM'000)	Current	> 30 days	> 60 days	> 90 days	>120 days	Total
Customer A	550	200	500	800	3,300	5,350
Customer B	880	100	20	-	-	1,000
Customer C	220	55	10	3	-	288
Others	150	90	20	10	20	290
Total	1,800	445	550	813	3,320	6,928
%	**26%**	**6%**	**8%**	**12%**	**48%**	**100%**

The Management represented that Customer A is the key customer of ASB which contributed more than 50% of the total revenue in FY201X. The outstanding RM3.3 million was due and unpaid for more than 240 days. This has also affected the cash conversion cycle. However, no provision has been made by ASB as the customer had verbally agreed to pay in the near term.

From the due diligence review, it was noted that ASB lacked credit control procedures such as no customer credit check, debt collection procedures and impairment policy.

Salient Issues

- Accounts receivable overstated by RM3.3 million and if adjusted will affect EBITDA by RM3.3 million
- Operating cash flow issues / longer cash conversion cycle
- Exposure to customer concentration risk

Examples of Financial Due Diligence Issues

4.3 Accounts Receivable (cont.)

Issue 1: Overstatement of Accounts Receivable

ASB should consider to provide impairment of the debts outstanding for more than 180 days and when the recoverability of the debts is in doubt. Based on publicly available data, Customer A's revenue had been on a decline and it was having cash flow issues. As such, repayment in the near term is highly unlikely. In this case, the total of RM3.3 million for allowance for doubtful debts should be provided:-

Details	Dr (RM)	Cr(RM)
Allowance for doubtful debts – Income Statement	3,300,000	
Allowance for doubtful debts – Accounts Receivable (Balance sheet)		3,300,000

Recommendations

- ASB should adjust the allowance for doubtful debts for the said amount and accordingly, for the EBITDA
- For internal control purposes, it is recommended that ASB should:-
  - ➢ maintain the impairment policy to ensure the accuracy of accounts receivable
  - ➢ ensure credit control policies and credit management are rigorously applied and followed up on a regular basis to mitigate operating cash flow issues

Examples of Financial Due Diligence Issues

4.4 Inventory Control

Key Observations

Target C Sdn Bhd ("CSB") is engaged in manufacturing and trading of household products. During the due diligence review, it was noted that the inventories turnover period was on an increasing trend:-

(RM'000)	FYE 2017	FYE 2018	FYE 2019
Inventories	16,500	21,000	27,800
Purchases	65,800	64,500	65,600
Turnover period (days)	92	119	155

The closing inventories increased by RM11 million from FYE2017 to FYE2019 despite the revenue remaining stagnant over the due diligence review period. The management explained that the increasing trend of closing inventories was due to:-

- CSB purchased inventory to cover 2 months' buffer based on customer sales forecast figure. Yet, no sales orders were placed by the customer.
- Certain imported inventory require a longer delivery period and hence CSB purchased more stocks to avoid any delay or insufficiency of stocks.

We further noted that no inventory ageing was maintained by CSB.

Salient Issues

- Inventory may consist of slow-moving or obsolete stocks
- Weakness in inventory procurement procedures

Examples of Financial Due Diligence Issues

4.4 Inventory Control (cont.)

Issue 1: Overstatement of Inventory

CSB had not maintained the inventory ageing. The closing inventories value had been on an increasing trend over the review period which may indicate that there is a possibility of slow-moving or obsolete inventories. CSB has yet to perform an inventory count at the review period. No adjustment can be made as the inventory value cannot be quantified.

Recommendations

- To perform an inventory count before the deal can be finalized. Slow-moving / obsolete inventories are to be written off and the financials adjusted accordingly.
- To ensure that the inventory amount is extensively covered in the representations and warranties of the Sale & Purchase Agreement. Any impairment should be deducted from the purchase consideration
- For internal control purposes, it is recommended that CSB:-
  - ➢ invests in an inventory software application which is able to generate stock ageing reports
  - ➢ CSB to ensure a proper procurement policy to be in place and applied accordingly, for instance, CSB to enter into a sales agreement with the customer before purchase of any inventory

Examples of Financial Due Diligence Issues

4.5 Accounts Payable – Unrecorded Liabilities

Further to the unrecorded liability review, it was noted that:-

1. Certain purchase invoices amounting to RM5.8 million were received after the Cut-Off Date for the transactions made before the Cut-Off Date, but had not been recorded; and
2. Discrepancies between the actual purchase invoices and provision for raw materials purchased recorded in the books as of the Cut-Off Date amounting to RM800,000.

Key Observations

The main supplier of target J Sdn Bhd ("JSB") did not provide Empty Fruit Bunch ("EFB") invoices to JSB. JSB had taken up the provision for purchases of raw materials based on the daily weighing slip and no creditor statement had been provided by the supplier as at the review period.

Salient Issues

- Unrecorded liabilities amounted to RM6.6 million.
- Operating cash flow may be disrupted if the settlement of the unrecorded invoices are demanded by the supplier within a short period.

Examples of Financial Due Diligence Issues

4.5 Accounts Payable – Unrecorded Liabilities (cont.)

Issue 1: Understatement of accounts payable and cost of sales

Based on the unrecorded liabilities review, it was noted the total unrecorded liabilities as at the Cut-Off Date amounted to RM6.6 million. The potential adjustment to the books of JSB is as follows:-

Details	Dr (RM)	Cr(RM)
Cost of sales – Purchases	6,600,000	
Trade payables		6,600,000

Recommendations

- Adjustments should be made to unrecorded liabilities of RM6.6 million as these liabilities were incurred during the review period.
- The Potential Buyer should take note of the potential liabilities and should ensure they are extensively covered in the representations and warranties in the Sale & Purchase Agreement.
- For internal control purposes, it is recommended that JSB:-
  - ➢ Implements proper cut off procedures in order to comply with the accrual basis of accounting.
  - ➢ Obtain monthly statements from the supplier to avoid disruption of operating cash flow if the supplier requires payment for invoices not taken up.

5. Our Services

What can Crowe do for you?

5. What can Crowe do for you?

Crowe Malaysia is glad to be of service to you for financial due diligence exercises. We have the expertise to act in the following capacities:

a) Financial due diligence auditors

We can act as the Financial Due Diligence auditors for due diligence exercises. Our role is to advise on the transaction and to support the acquirer and his advisers on identifying issues in the financial statements of the target. We will also review matters of a financial nature that are important to investors such as financial risks.

b) Tax due diligence advisors

We can act as the tax due diligence advisors for due diligence exercises. Our role includes the review of tax compliance with corporate tax and indirect tax legislation such as those relating to Income Tax, Service Tax, Sales Tax and import duties. In particular, we will review the submission of tax returns, payment of taxes, accuracy of tax reporting, possibility of tax avoidance or tax evasion, eligibility to various tax claims, potential tax liabilities and tax disputes with the relevant tax authorities in Malaysia.

c) M&A transaction advisors

We can help to manage the M&A transaction by liaising with potential acquirers and sellers, including helping to prepare pitch documents and assisting in implementing the disposal or acquisition strategy. Our role can include assessing the needs and requirements of users to find the best fit and to maximize deal value.

5. What can Crowe do for you?

d) Post deal services

Post transaction, we are able to assist the acquirer with services such as:-

Post Financial Due Diligence (Completion Review)

When the due diligence is completed and the acquirer has executed the Sale and Purchase agreement, we will be able to assist the acquirer with the completion review.

Our role includes reviewing all conditions precedent in the SPA from the financial aspect and ensuring their satisfactory completion. We can also analyze the financials from the cut-off date to the completion date for performance trends that can be highlighted to the acquirer.

Post Tax Due Diligence (Completion Review)

We will review whether the issues highlighted during the due diligence exercise have been followed up upon with the tax agents and tax authorities, and liabilities quantified.

If necessary, we can act as the tax advisor to resolve all outstanding tax issues.

Purchase Price Allocation

Post acquisition, we will be able to assist the acquirer in performing a purchase price allocation for their financial reporting purposes. From our understanding of the business and the financials, we are able to allocate the purchase price into assets, liabilities and the corresponding goodwill or reserve on acquisition.

Performance Monitoring

We will be able to assist the acquirer in monitoring the performance of the companies as compared to forecasts and projections. Any deviations will be highlighted, and recommendations made for improvement.

Outsourced Services

If needed, we can provide outsourced services to enable the acquirer to quickly take control over all aspects of the target’s business including accounting services, consolidation of accounts, stocktakes, etc.

Our Professional Team

Suresh Thadani

Director,
Corporate Advisory

Onn Kien Hoe

Executive Director,
Corporate Advisory

Jessica Phoon

Director,
Corporate Advisory

Crowe

Our offices
(West Malaysia)

Kuala Lumpur
Level 16, Tower C,
Megan Avenue 2,
12 Jalan Yap Kwan Seng,
50450 Kuala Lumpur,
Malaysia

+603 2788 9898 Main
+603 2788 9899 Fax

Klang
Suite 50-3, Setia Avenue,
No. 2, Jalan Setia Prima
SU13/S,
Setia Alam, Seksyen U13,
40170 Shah Alam,
Selangor, Malaysia

+603 3343 0730 Main
+603 3344 3036 Fax

Ipoh
A-2-16, 2nd Floor, Wisma MFCB
1, Persiaran Greentown 2
Greentown Business Centre
30450 Ipoh, Perak Darul Ridzuan
Malaysia

+605 238 0411 Main

Penang
Level 6, Wisma Penang Garden,
42 Jalan Sultan Ahmad Shah,
10050 Penang, Malaysia

+604 227 7061 Main
+604 227 8011 Fax

Melaka
52 Jalan Kota Laksamana 2/15,
Taman Kota Laksamana, Seksyen 2,
75200 Melaka, Malaysia

+606 282 5995 Main
+606 283 6449 Fax

Johor Bahru
E-2-3 Pusat Komersial Bayu Tasek,
Persiaran Southkey 1,
Kota Southkey,
80150 Johor Bahru,
Johor, Malaysia

+607 288 6627 Main
+607 338 4627 Fax

Muar
8, Jalan Pesta 1/1,
Taman Tun Dr. Ismail 1,
Jalan Bakri, 84000 Muar,
Johor, Malaysia

+606 952 4328 Main
+606 952 7328 Fax

Our offices
(East Malaysia)

Kuching - iCom Square
2nd Floor, C378, Block C,
iCom Square,
Jalan Pending,
93450 Kuching,
Sarawak, Malaysia

+6082 552 688 Main
+6082 266 987 Fax

Kuching - Brighton Square
2nd Floor,
Lots 11994 - 11996,
Brighton Square,
Jalan Song,
93350 Kuching,
Sarawak, Malaysia

+6082 285 566 Main
+6082 285 533 Fax

Miri
Lot 2395, Block 4,
Bulatan Business Park,
Jalan Bulatan Park, 98000 Miri,
Sarawak, Malaysia

+6085 658 835 Main
+6085 655 001 Fax

Bintulu
1st floor, Lot 4542-4543,
Jalan Abang Galau Shophouse,
Kampung Masjid, 97000 Bintulu,
Sarawak, Malaysia

+6086 333 328 Main
+6086 334 802 Fax

Sibu
1st & 2nd Floor, No. 1 Lorong
Pahlawan 7A2, Jalan Pahlawan,
96000 Sibu, Sarawak, Malaysia

+6084 211 777 Main
+6084 216 622 Fax

Labuan
Lot 36, Block D, Lazenda Centre,
Jalan OKK Abdullah, P.O. Box
81599, 87025, Labuan, Malaysia

+6087 417 128 Main
+6087 417 129 Fax

Kota Kinabalu
Damai Plaza 3, 3rd Floor, C11, Jalan
Damai 88300, P.O. Box 11003,
88811 Kota Kinabalu, Sabah, Malaysia

+6088 233 733 Main
+6088 238 955 Fax

Contact us

Crowe Malaysia PLT
Level 16, Tower C,
Megan Avenue II,
12, Jalan Yap Kwan Seng
50450 Kuala Lumpur
Malaysia

Tel. +603 2788 9999
info@crowe.my

About Crowe Malaysia PLT

Crowe Malaysia PLT is the 5th largest accounting firm in Malaysia and an independent member of Crowe Global. The firm in Malaysia has 14 offices, employs over 1,300 staff, serves mid-to-large companies that are privately-owned, publicly-listed and multinational entities, and is registered with the Audit Oversight Board in Malaysia and the Public Company Accounting Oversight Board in the US.

About Crowe Global

Ranked the 8th largest accounting network in the world, Crowe Global has over 250 independent accounting and advisory firms in 130 countries. For almost 100 years, Crowe has made smart decisions for multinational clients working across borders. Our leaders work with governments, regulatory bodies and industry groups to shape the future of the profession worldwide. Their exceptional knowledge of business, local laws and customs provide lasting value to clients undertaking international projects.

www.crowe.my