APPENDIX 1

Typical areas that may be covered in a financial due diligence report

1 **Key findings and executive summary**

- This will contain a brief summary of the contents of the report and details of principal matters arising.

2 **History and description of business**

- Key events in the recent history of the target.
- Brief description of business activities and milestones in the development of the target business.
- Company structure, including capital structure, details of ownership and recent changes therein, any minority interests in subsidiaries, investments and joint ventures.
- Review of the strategy and objectives of the target business.
- Contracts and transactions involving directors.
- Details of the key legal agreements influencing the nature of the business or structure of the target business.

3 **Markets and sales**

- Markets, and competition (particularly in the light of recent and planned changes), including market growth and changes in market share (this can be on the borderline with the work of commercial due diligence specialists — see later comments).
- Sales (including strategy, sales organisation and control, dependence on individual customers, contracts, pricing, terms of trade, dependency on agency agreements, etc). Assessment of seasonality.
- Services provided (including range, description, development, revenue and contribution).
- Exposure to foreign exchange fluctuations (including extent of any hedging).
- Details of post-sales obligations, including product guarantees and servicing arrangements.
- Customer service and quality policy.

4 **Purchasing**

- Purchasing and supplies (including strategy, purchasing organisation, relationships and principal suppliers and associated purchases and relevant agreements. Exposure to raw material price movements. Details of alternative supply sources).
- Exposure to foreign exchange fluctuations (including extent of any hedging).
- Use of sub-contractors.
- Information on distribution systems.
- Review of stock control disciplines.
- Overview of research and development programmes.

5 **Premises**

- Description of premises, including location, locality, site area, current usage, date of acquisition, subsequent expenditure, analysis between freehold and leasehold. In the case of leased properties, details of terms of lease, any onerous covenants, any planning restrictions or planned development (comment on space constraints or the availability of spare space). Details of any impending or deferred repairs if significant, and any ongoing programme of maintenance.
- Any recent independent or internal valuations or insurance reports.
- The suitability and adequacy of plant and premises (based on discussion with management as non-experts). Present and future production capacity/requirements.

6 **Organisational structure, management and personnel**

- Management structure, reporting lines and division of responsibility.
- Outline of directors' and senior executives' biographies (including their age, qualifications, experience, length of service, responsibilities during the period under review, service contracts, benefits and remuneration and the role of non executives).
- Details of former directors and senior executives who have left the business over a specified period.
- Details of any relatives/friends of directors/sellers on the payroll or otherwise engaged by the target business.
- Management style, succession planning and current gaps or weaknesses in the management team (particularly in relation to the finance team).
- Analysis of employees (including total number of staff at the date of the report, analysis between full-time and part-time employment and by function, movement in numbers over the recent past, length of service and age profile).
- Basis of remuneration of employees (including salary/wages structure, comparison with industry average rates, and dates of salary reviews). Overtime and sickness levels. Holiday pay arrangements.
- Current state of labour relations and any past disputes together with details of any trade union membership.
- The use of agency or temporary staff (has PAYE/NI been correctly dealt with?).
- Pensions (including current status of the fund, existence of unfunded liabilities, level of contributions and security of assets, details of any Pensions Regulator's clearance letters) and other employment and post-employment benefits. If applicable, the financial impact of withdrawing from current seller group arrangements (this will almost certainly require specialist advice).
- Details of share incentive, share option and profit sharing schemes.
- Recruitment policy and training.
- Ability of staff to meet development plans.

7 **Financial control environment**

- Description and assessment of the key financial systems and internal controls, including estimating and forecasting, credit control and cash management procedures.
- Details of key financial (and other) information used to manage the business, including accuracy, timeliness and sufficiency (including the level of adjustment required to management accounts to produce the annual statutory accounts).

- Summaries of past budgets compared with actual results for a specified period, together with comments on the main reasons for deviations from budgets to assess past budgeting accuracy.
- Details of key computer systems (including IT strategy, systems development to date and proposed enhancements, security and disaster recovery plans, extent and effectiveness of use).
- Organisation and effectiveness of the finance function (including credit control).
- Weaknesses identified by the auditors and significant matters arising from the audit work in respect of past periods.

8 **Accounting policies**

- Details of historic accounting policies (including detailed practices and procedures adopted). Income and cost recognition policies in some businesses can be highly subjective. Imprudent revenue recognition or the excessive deferral of costs in fixed assets or stocks can be important areas for review. The mechanism for elimination of unrealised inter company profits can also be an area requiring detailed assessment.
- Impact of any changes (or of any proposed changes) in policies, methodologies and practices over a defined period (typically three years).
- Comparison with industry and "best practice", and potentially with International Financial Reporting Standards.
- When an acquisition involves a significant overseas business, a restatement of the target's accounts to UK GAAP (or the buyer's GAAP as relevant) is often required.
- A comparison of the target company's accounting policies with those of the buyer.

9 **Historic trading results**

- Summary of the profit and loss accounts over a specified period (typically three years) and the principal reasons for significant fluctuations.
- Analysis of revenues, direct costs and gross margins by relevant business segment or product category (including key operational statistics, comparison with competitors, impact of seasonality etc). Identify any low margin or loss making product groups.
- Assessment of the target's dependence upon any individual customers by reviewing an analysis of historic revenue by customer.
- Review of historic order book levels identifying key trends.
- Details of overheads together with commentary on significant fluctuations.
- Analysis of and commentary on "exceptional" and "extraordinary" items, and any significant transactions not on an "arm's length" basis.
- Analysis of interest and taxation charges.
- Details of any prior period adjustments considered by the investigating accountant to be necessary.
- Assessment of the "underlying" profitability of the target business. This can involve determining the necessary adjustments for any significant "one off" costs or revenue, or "non-arm's length" transactions. Where relevant, it may also require making allowance for the costs of operating the target business on a "stand alone" basis separate from the rest of the seller operations. This can include the loss of lower prices (for both direct costs and overheads) secured on a group wide basis by the seller's group, and the need to replace services provided by the seller group (for example, for group treasury and HR services).

10 **Historic net assets**

- Summary of historic balance sheets and an explanation of significant trends (typically up to the last three year ends and the latest available balance sheet per the management accounts are reviewed).
- Detailed analysis of each significant balance sheet heading including:
  - Comment on details of fixed assets and depreciation rates/asset lives (is there an asset register which adequately allows individual assets to be identified? When was the asset register last checked by physical verification of assets?). Provide details of leased assets. Identify any significant element of own labour capitalised. Review proposed capital expenditure programme and current commitments as well as past grants (and potential obligations to repay).
  - Stock verification (any stocks at third party locations or held on consignment; is all stock regularly verified; is there a history of large differences between book records and physical quantities?).
  - Stock valuation/provisioning methodologies.
  - Analysis of debtors, including sales ledger ageing, bad debt history and provisions.
  - Analysis of creditors including ageing of purchase ledger balances, accruals and basis of provisioning (provision accounting particularly for long-term liabilities can be often highly judgmental and therefore require detailed assessment as part of the due diligence review).
  - Details of banking arrangements and loan facilities (including terms, covenants and details of security granted to third parties).
  - Details of contingent liabilities.
  - Summary and implication of any off balance sheet financing arrangements.
  - Details of any material long term and/or onerous contracts.

11 **Historic cash flows**

- Summary of historic cash flows (again typically for up to three years and current year to date).
- Details of seasonality in working capital requirements, and also intra month patterns.
- Details of evidence of current or historic cash pressures in the target business.

12 **Taxation**

- Summary of the current corporation tax position of the target business with regard to the agreement of taxation computations, highlighting any important outstanding issues.
- Summary of the taxation charge within the accounts and the basis of provisioning (including an assessment of the deferred tax position).
- Summary of any available corporation tax losses.
- Impact of the acquisition on the taxation position of the target business.
- Compliance with PAYE/NI regulations and VAT regulations. In respect of these matters, work is often restricted to enquiry as to compliance with submission of returns and normal procedures and the status of any outstanding queries or issues. Has income tax/national insurance been properly accounted for on payments to employees—in instances where employees have been wrongly paid without deduction of tax, it can be very difficult for the buyer to recover the tax due from the employee. If deemed a particular risk area, a detailed review by VAT and PAYE specialists can be commissioned.

13 Financial forecasts

- Review and commentary on the profit and loss, balance sheet and cash flow forecasts, a comparison with historic trading and recent experience and budget, and commentary on the assumptions underlying the forecasts. Specific consideration is typically be given to:
  - sales volume and pricing assumptions, often taking into account inter alia order book levels/level of contracted income and reliance on key customers as well as any capacity or supply issues;
  - forecast margins;
  - adequacy of forecast overhead expenditure (particularly taking into account the buyer's post acquisition planning for the target business and any anticipated step change in activity levels);
  - interest charges — the accounting for debt raising costs on acquisitions can be complex;
  - forecast tax charges — dependent on the profile of the target business and the buyer, simply applying the standard tax rate to forecast profits may not be sufficiently accurate;
  - capital expenditure forecasts;
  - forecast working capital levels (stocks, debtors and creditors); and
  - the potential impact of seasonality on the business.
- Assess forecast compliance with debt covenant requirements.
- Identify the key sensitivities and areas of vulnerability in the trading forecasts and cash flows.
- Model the impact of appropriate sensitivities on the forecast model.

14 Other matters

- Provide a summary of insurances (particularly where not currently on a "stand alone" basis, existing insurance cover and premiums may not remain post acquisition).
- Summarise any current, pending or threatened significant litigation by or against any member of the target business or its directors and the adequacy of provisions associated therewith.