**UDC 336.7** **DOI: 10.37332/2309-1533.2024.1.12**
**JEL Classification: G340**

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# FINANCIAL DUE DILIGENCE IN MERGERS AND ACQUISITIONS TRANSACTIONS

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# ФІНАНСОВИЙ ДЬЮ ДІЛІДЖЕНС В ТРАНЗАКЦІЯХ ЗЛИТТЯ ТА ПОГЛИНАННЯ

***Formulation of the problem.*** The development of companies and the increase of shareholder value are strategic goals of managers, and mergers and acquisitions have become a key instrument of inorganic business growth, involving the purchase of a company or a significant part of it with the transfer of corporate control. A merger is the combination of two or more companies in which the assets and liabilities of the seller are absorbed by the buyer [1]. Although the structure of the buyer's company may change significantly after the merger, it still retains its initial identity. Acquisition is the purchase of an asset, such as a plant, a division, or even the entire company [2]. According to P. Gaughan, despite their differences, the terms "merger" and "acquisition" are used interchangeably in practice.

Despite the lack of clear evidence of shareholder value creation for the acquiring company [3; 4] and the presence of studies confirming value destruction due to M&A [5], globally, there are about 40,000 transactions annually [6], and this level mostly continues to rise, experiencing some fluctuations only during crisis periods. P. Haspeslagh and D. Jemison note that the failure of some transactions can be traced back to mistakes made during the pre-deal phase [7]. During the planning stage of M&A transactions, the investor is interested in obtaining objective and unbiased information about the actual financial position of the enterprise, as well as all risks associated with the purchase (acquisition) of the investment object. The most effective tool for investigating a company's activities is due diligence – an independent assessment procedure of the investment object, aimed at reducing risks in acquiring companies. Therefore, further development of approaches and tools of the pre-investment stage of the M&A process is important both theoretically and practically.

***Analysis of recent research and publications.*** An important stage of the merger and acquisition process is the pre-investment phase, within which the Analytical stage is separately distinguished. Within this stage, either only the due diligence process is included or (more often) also the business valuation process, although the company valuation may start before due diligence and continue and conclude after it. During the pre-deal phase, both the due diligence process and valuation take place. X. Welch et al., as a result of their study, argue that compared to processes related to company valuation, the number of published studies on the due diligence process is very limited [8]. For example, M. Harvey and R. Lusch in their work state that companies make significant efforts and form internal teams supplemented with specialized advisors to conduct due diligence [9]. However, P. Povel and R. Singh argue that during due diligence, negative information about the object is often not identified [10].

Researchers who have published works on the financial due diligence process, including G. Bing [11], M. Vochozka [12], I. Tomashivska [13], O. Yermolenko [14], I. Nazarenko [15], N. Karmazina [16] and others, primarily conduct scientific inquiries in such directions: defining the concept, functions, and tasks of financial due diligence, the impact of financial due diligence on the success of transactions, and the process of financial due diligence.

A. Kasych and Ya. Yakovenko note that the financial due diligence procedure involves a comprehensive diagnosis of the business as an object of sale, the components of which include collecting, processing, summarizing, and analyzing information about the company's activities in all areas to ensure the reliability of the data provided for analysis, their compliance with legislation, and the absence of inaccuracies and distortions. It regulates the main tasks of comprehensive verification, the structure of the report based on

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them, user groups, and areas of analysis. Additionally, the authors note that due diligence allows verifying the reliability of financial information provided by sellers [17].

D. Angwin understands the term due diligence within the merger and acquisition process as the investigation of the acquired company from various aspects that have been previously defined by the parties. This term is widely used in merger and acquisition processes. In other words, it is the process of discovering and finding information that may be important for deciding whether to continue or terminate the merger and acquisition process. Additionally, D. Angwin notes that since the concept of due diligence often varies among different experts involved in the process, there may be different definitions of the term that affect their own role in the process. According to W. Schmitz's definition, due diligence encompasses all the investigations and checks conducted by a potential buyer before acquiring a company to determine whether the acquisition should proceed and under what conditions [18]. Due diligence is conducted by a team of people because all elements of the company may be involved in the process [19].

We have found that Financial Due Diligence (FDD) is often equated with the audit of financial statements, and the role of a specialist advisor in "due diligence" is equated with the role of an auditor. This is one of the most common mistakes made by investors because the essence and scope of financial "due diligence" are not identical to the translation of auditing financial statements of the Target company. While the financial statements and other documentation may be the same, the scope, directions, and methods of analysis in due diligence are typically different [20].

Based on the analysis of scientific research, several directions have been identified that, in our opinion, require further development: 1) there are different approaches to defining the term Financial Due Diligence (FDD), with a key issue being the conflation of the concepts of financial due diligence and auditing by certain authors; 2) in some studies, one of the functions of due diligence is defined as "confirmation of the accuracy of financial information; 3) at present, the scientific literature does not devote sufficient attention to adjustments made during financial due diligence. We have not found works that identify and analyze clear examples of adjustments that can be made during financial pre-investment research.

***Setting objectives.*** The purpose of the article is to distinguish between existing approaches to differentiating the concepts of financial due diligence and auditing; improving methodological approaches to company analysis within the pre-investment stage based on systematizing possible adjustments to financial indicators.

***Presentation of the main research material.*** Analysis of Target companies during the pre-investment stage of the merger and acquisition process, in our opinion, should be based on the principles of an ecosystem approach, whereby the Target company is considered as an element of an ecosystem that includes various entities and their interactions. Such an approach allows for a better analysis of synergies that arise from their interactions and identifies risks arising from the diversity of their interests. The due diligence process, and specifically financial due diligence (FDD), is a tool that helps reduce the level of information asymmetry between the parties to the deal. The aforementioned ecosystem approach should also be utilized in conducting financial due diligence. The analysis of literary sources has revealed that some authors equate the concept of financial due diligence with auditing, although there is a fundamental difference between these two processes. We have identified key characteristics for comparison and demonstrated the differences between FDD and auditing (see Table 1).

***Table 1***

**Comparative Characteristics of FDD and Audit**

| Characteristics | FDD | Audit |
|---|---|---|
| Goal | Identification of potential risks for the client, adjustment of key indicators, depending on the scope of providing expanded information about the business activities | The auditor's statement on whether the financial statements comply in all material respects with the instructions governing the preparation and presentation of financial statements |
| Data | Financial statements, accounting and management accounting data, contracts, additional company documents, and, if necessary, interviews with company management | Accounting data, contracts |
| Scope of work | There is no predefined scope; it all depends on the client's request and needs. The final scope is documented in the contract | There is a clearly defined set of procedures that must be carried out |
| Result | Financial due diligence report | Audit opinion |
| Users | Limited user scope | If there are legislative requirements, the reporting is available to a wide range of users |
| Executors | Consultants | Auditors |
| Time line | It can vary, but on average, it takes up to 2 months | Clearly regulated and limited by legislative requirements for submission of reports by the client company |
| Materiality | Not applicable | Approaches to calculation are clearly defined |

*Source: compiled by the author using [20; 21]*

Financial due diligence can be conducted either by the internal resources of the acquiring company or by external consultants. However, it is important to note that when additional parties are involved in the transaction, such as financial organizations, and may require access to the financial due diligence report, an independent analysis is necessary, meaning the engagement of external consultants.

However, for small transactions, companies may conduct pre-investment analysis independently. Obviously, not all companies, especially small ones, have significant experience in conducting transactions, so it is important to deepen scientific research in the direction of approaches to analyzing companies during mergers and acquisitions transactions. Engaging external consultants for small transactions is often impractical or impossible given the cost of such services on the market.

The key objectives of the financial due diligence process are to reduce information asymmetry, identify potential transaction risks, and calculate three adjusted indicators. It is important to note that the analysis during financial due diligence is based on the information provided by the Target company. That is, the Target is responsible for the accuracy of the data provided. Based on the results of the analysis, three key indicators are calculated: EBITDA, Net Working Capital, and Net Debt/Net Cash. These indicators have a significant impact on the valuation of the company in most transactions. However, attention should be paid to the prior conditions agreed upon by the parties regarding the valuation method, as it is possible to evaluate the business using a multiples method, for example, using revenue rather than EBITDA.

The purpose of making adjustments is to reflect only the revenues, expenses, assets, and liabilities that are related to the ongoing operations of the business, which will continue after the change of ownership (sale of the business). During the company's operations, there may be transactions that are not related to normal operational activities, distorting its financial results and financial position indicators. Changes in the direction or scale of the company's activities may also occur, in which case adjustments need to be made to objectively reflect the impact of such changes retrospectively on the company's results and financial position. When analyzing a company for merger and acquisition purposes, it is necessary to clean/adjust the indicators in such a way that they reflect its normal operational activities, as revenues and expenses that distort the normal level will affect the price of the company formed using this information, leading either to an overpricing and losses on the part of the buyer or to its underestimation and losses on the part of the seller (however, the latter option is less likely, as the seller always has more complete information about their own business). Of course, other factors also affect the deal price, such as forecasts of the company's further development, the buyer's interest in acquisition, and the seller's interest in selling (whose negotiating position is stronger), subjective factors in decision-making, etc.

Sources of information during due diligence may include public data such as company's annual reports, financial statements, government databases regarding owners and related parties, court cases, and seized assets. However, analysis primarily occurs based on sources with limited access, including data extracts from the company's accounting system, management reports, contracts with suppliers, customers, financial institutions, company's forecasting models, access to other internal calculations and documents of the Target company, discussions with the company's management, etc.

Identification of potential adjustments is based on the analysis of available information, interviews with management and key employees of the company. It is also advisable to request information from the management of the Target company regarding potential adjustments they identify. Since the management always has a deeper understanding and obviously greater access to information, their list of adjustments can become a valuable additional source.

EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization) is a measure that reflects a company's financial performance before deducting interest expenses, taxes, depreciation, and amortization. The calculation of EBITDA involves starting from net profit/loss and adding back interest expenses/income, depreciation, and taxes. Adjustments can be categorized into several groups: one-time expenses or income; changes in accounting policies, misrepresentation in the reporting period, pro forma adjustments, and other adjustments. Figures 1 and 2 provide examples of adjustments that may be made during financial due diligence.

Companies in different industries have their own specific operational characteristics, some of which are reflected in the adjustments particular to them. Specific adjustments that may arise when analyzing companies in the agricultural industry are often related to the valuation requirements of agricultural products and biological assets, accounting for operations with land plots and shareholders, seasonality of the business, and risks inherent in the industry.

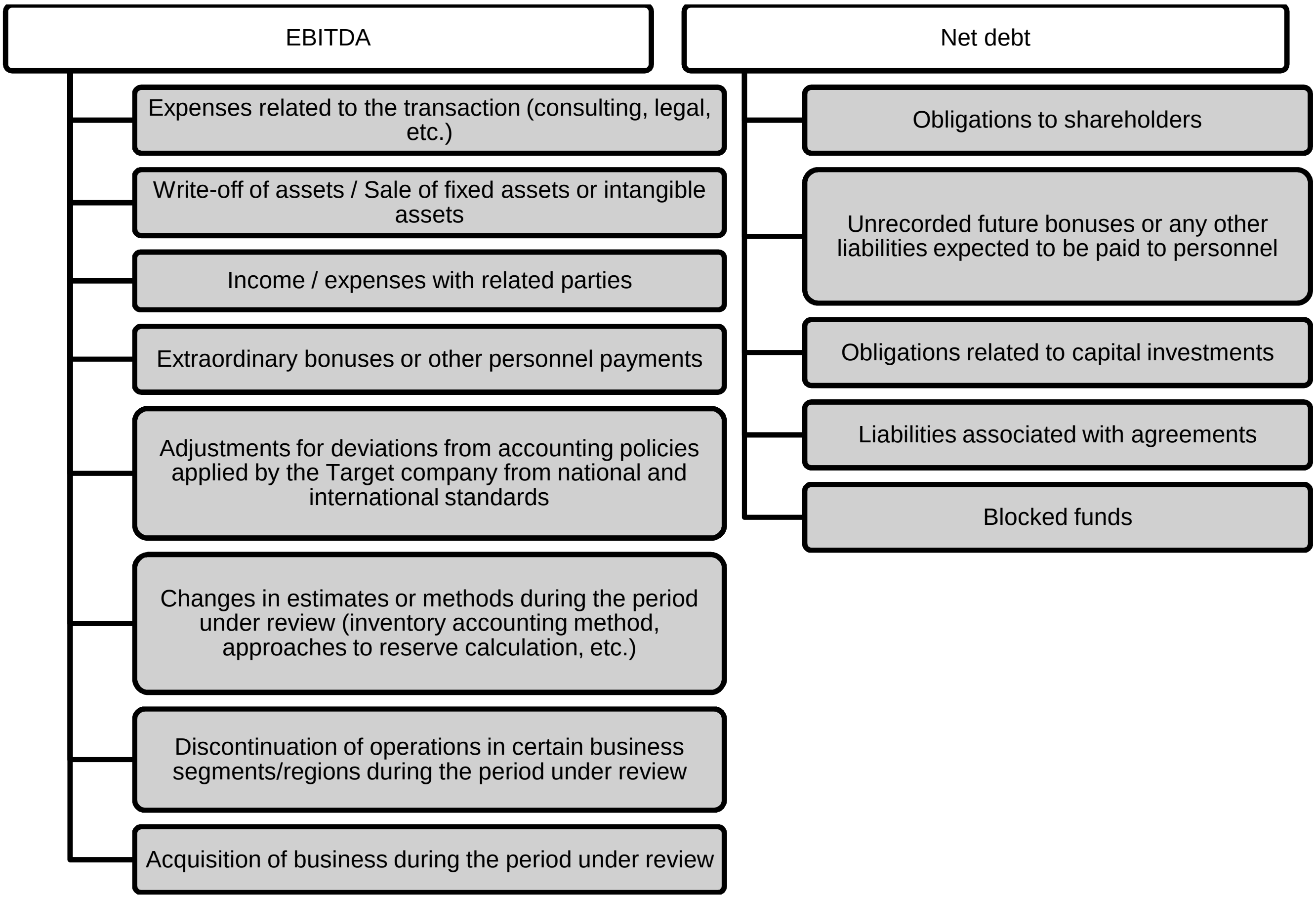


**Figure 1. Examples of adjustments to key financial indicators (EBITDA and Net debt)**
*Source: compiled by the author based on conducted research*

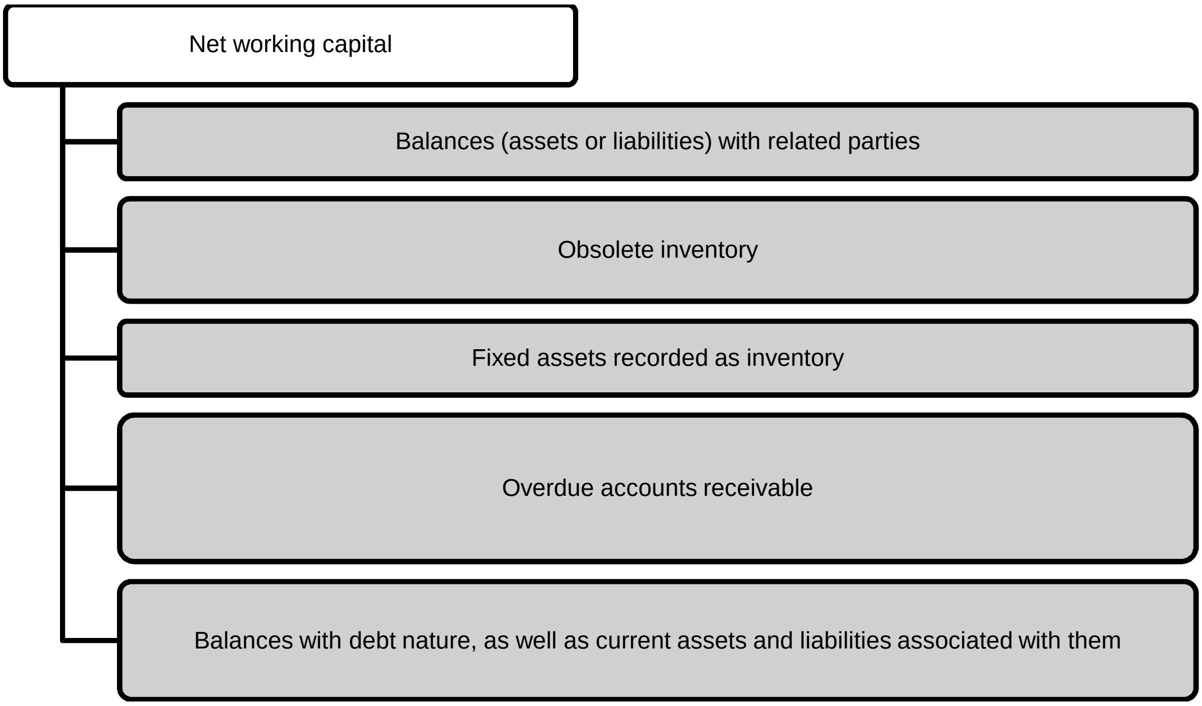


**Figure 2. Examples of adjustments to key financial indicators (Net working capital)**
*Source: compiled by the author based on conducted research*

Table 2 illustrates the impact of adjustments on the EBITDA indicator of the Ukrainian agro-company Astarta. The adjustments were made based on publicly available information, mainly the company's annual reports. The identified adjustments increased EBITDA by 139 million UAH in 2022. Importantly, with access to internal company data, a more precise analysis is possible, potentially leading to a reduction in the EBITDA indicator.

***Table 2***

**Example of adjusted EBITDA for 2021–2022, kUAH**

| Indicators | 2022 | 2021 |
|---|---|---|
| **EBITDA** | **5 271 272** | **6 542 883** |
| ***Potential adjustments*** | | |
| Transactions with related parties (net) | 44 397 | 37 597 |
| Spending on charity and social projects | 79 882 | - |
| Result from the sale of fixed assets | -15 327 | 43 018 |
| Expenses for payment of fines | 19 777 | 53 498 |
| Operational FOREX | {...} | {...} |
| Additional personnel payments are related to the war | 6 300 | - |
| Destroyed equipment as a result of hostilities | 4 200 | - |
| Expenses related to the sale of companies | | {...} |
| **Total potential adjustments** | **139 229** | **134 113** |
| ***Pro-forma adjustments*** | | |
| Results of the companies sold in 2021 | **-** | {...} |
| The result of the activity of the acquired company in February 2022 | {...} | {...} |
| **EBITDA after adjustments** | **5 410 501** | **6 676 996** |
| ***Other areas*** | | |
| Increase in logistics costs due to the war | {...} | {...} |
| Payments to personnel serving in the ranks of the Armed Forces | 67 200 | 0 |

*Source: compiled by the author using publicly available company data [22]*

Net working capital reflects the amount of current assets necessary for a company to operate within one operating cycle. The classical formula for calculating net working capital is current assets minus current liabilities. However, there is no clear approach to calculating working capital, so the structure of working capital can vary for different companies. To accurately determine the components of working capital within each transaction, it is important to understand the specifics of the Target's business, events that occurred during the analyzed period and affected working capital, and analyze all balance sheet items, not just those traditionally attributed to net working capital (inventory, accounts receivable, and accounts payable), as elements of working capital can also be reflected in other items.

When analyzing agricultural companies, it is also advisable to include current biological assets in the calculation of working capital. When analyzing working capital, it is important to consider seasonality, as different periods of the operating cycle may require different levels of working capital, and in some industries, these fluctuations can be significant (such as retail, agriculture, construction). Therefore, without understanding these fluctuations, it is impossible to form an adequate understanding of the maximum, minimum, and "normal" levels of working capital.

Table 3 examines the impact of adjustments on the Net Working Capital of the Ukrainian agro-company Astarta. The proposed adjustments reduce the level of working capital by 31 million UAH in 2022.

***Table 3***

**Adjustments to Net Working Capital 2021–2022, kUAH**

| Indicators | 31 December 2022 | 31 December 2021 |
|---|---|---|
| 1 | **2** | **3** |
| **Net working capital** | **12 873 870** | **9 553 008** |
| ***Potential adjustments*** | | |
| Bonds | -60 906 | -20 427 |
| Overdue receivables | -36 201 | -28 830 |
| Financial assistance received | 52 840 | - |

***continuation of table 3***

| 1 | 2 | 3 |
|---|---|---|
| Accounts payable for fixed assets | 5 956 | 2 586 |
| Balances with related parties (none) | 7 218 | 3 355 |
| **Total potential adjustments** | **-31 093** | **-43 316** |
| ***Pro-forma adjustments*** | | |
| Net working capital of the acquired company in February 2022 | - | {...} |
| **Net working capital after adjustments** | **12 842 777** | **9 509 692** |
| ***Other areas*** | | |
| Potential write-off of biological assets as a result of hostilities | {...} | {...} |

*Source: compiled by the author using publicly available company data [22]*

Net Debt or Net Cash is an indicator that shows the level of a company's financial debt obligations/assets. Net debt includes cash and cash equivalents, bank loan liabilities and related interest payments, financial leasing, factoring, liabilities to shareholders, etc.

In Table 4, the impact of adjustments on the Net Debt metric of the Ukrainian agro-company Astarta is considered. Adjustments were made based on public information, primarily annual reports of the companies. As a result of the analysis, adjustments were identified that increase the amount of net debt by 14 million UAH.

***Table 4***

**Adjustments to Net Debt 2021–2022, kUAH**

| Indicators | 31 December 2022 | 31 December 2021 |
|---|---|---|
| **Net debt** | **-2 155 534** | **-1 092 842** |
| **Potential adjustments** | | |
| Accounts payable for fixed assets | -5 956 | -2 586 |
| Bonds | -60 906 | -20 427 |
| Financial assistance received | 52 840 | - |
| Obligations under the employee assistance program | {...} | {...} |
| Costs for restoration of lands and property damaged as a result of hostilities | {...} | {...} |
| **Total potential adjustments** | **-14 022** | **-23 013** |
| ***Pro-forma adjustments*** | | |
| Net debt of the acquired company in February 2022 | - | {...} |
| **Net debt after adjustments** | **-2 169 556** | **-1 115 855** |
| ***Other areas*** | | |
| Obligations to related parties | 180 643 | 95 413 |
| Lease of office premises from related parties | {...} | {...} |
| Participation of the company's management in business ownership | {...} | {...} |

*Source: compiled by the author using publicly available company data [22]*

It is important to note that some of the adjustments to the above-mentioned metrics are interrelated. For example, making an adjustment to Net Working Capital regarding the removal of balances with debt nature entails reflecting this balance as an adjustment to net debt. Adjustments related to the creation and release of provisions in EBITDA should also be reflected in adjustments to Net Working Capital or debt.

***Conclusions from the conducted research.*** The merger and acquisition process is characterized by a high level of complexity and risk. A clear understanding among the participants of the process of the essence of concepts and approaches to analysis is a necessary condition for the successful outcome of the transaction, although it does not guarantee it due to other influencing factors (subjective assessments of decision-makers, strength of negotiating positions of different parties, realization of risks at the integration stage, etc.).

The proposed research findings add important details to existing scholarly works in aspects of defining the concepts of financial due diligence and auditing, as well as specific aspects to consider in financial analysis of potential investment Targets.

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**Гончаренко О.Е.**

**ФІНАНСОВИЙ ДЬЮ ДІЛІДЖЕНС В ТРАНЗАКЦІЯХ ЗЛИТТЯ ТА ПОГЛИНАННЯ**

**Мета.** Виділення ключових характеристик, за якими відрізняються процеси фінансового дью ділідженсу та аудиту; удосконалення методичних підходів до аналізу компаній в рамках передінвестиційного етапу на основі систематизації можливих коригувань до фінансових показників.

**Методика дослідження.** Для досягнення мети дослідження були використані такі методи дослідження: теоретичного синтезу, аналізу, інтерпретації та порівняння – для визначення впливу коригувань на показники; табличний – для наочного представлення результатів коригувань.

**Результати дослідження.** Виділено ключові характеристики, за якими відрізняються поняття фінансового дью ділідженсу та аудиту, серед іншого зроблено фокус на понятті матеріальності. Систематизовано та наведено приклади можливих коригуваннь до фінансових показників в ході фінансового дью ділідженсу в рамках передінвестиційного етапу угод злиття та поглинання. Розраховано скориговані показники для української агрокомпанії на основі публічної інформації.

**Наукова новизна результатів дослідження.** Дістали подальшого розвитку методичні підходи до аналізу бізнесу в рамках передінвестиційного етапу процесу злиття та поглинання, в частині систематизації потенційних коригувань фінансових показників в рамках фінансового дью ділідженсу. Було систематизовано результати попередніх досліджень та розширено перелік характеристик, за якими доцільно аналізувати поняття фінансового дью ділідженсу та аудиту, зокрема виділено поняття матеріальності.

**Практична значущість результатів дослідження.** Запропоновані результати дослідження додають важливі деталі до існуючих наукових праць в аспектах визначення понять фінансового дью ділідженсу та аудиту в частині їх розмежування, а також ключових моментів, на які варто звертати увагу при фінансовому аналізі потенційних об’єктів інвестування на передінвестиційному етапі процесу злиття та поглинання компаній. Результати проведеного дослідження можуть використовуватися для покращення ефективності транзакцій через удосконалення підходів до аналізу, поглиблення розуміння процесу учасниками угоди злиття та поглинання.

**Ключові слова:** угоди злиття та поглинання, фінансовий дью ділідженс, інформаційна асиметрія.

**Honcharenko O.E.**

**FINANCIAL DUE DILIGENCE IN MERGERS AND ACQUISITIONS TRANSACTIONS**

**Purpose.** The purpose of the article is to distinguish between existing approaches to differentiating the concepts of financial due diligence and auditing; improving methodological approaches to company analysis within the pre-investment stage based on systematizing possible adjustments to financial indicators.

**Methodology of research.** To achieve the goal of the research, the following research methods were used: theoretical synthesis, analysis; interpretations and comparisons – to determine the impact of adjustments on indicators; tabular – for a visual representation of the results of adjustments.

**Findings.** Key characteristics distinguishing the concepts of financial due diligence and auditing have been highlighted, with a focus on the concept of materiality. Systematized and provided examples of possible adjustments to financial indicators during financial due diligence in the pre-investment stage of merger and acquisition deals. Calculated adjusted indicators for a Ukrainian agricultural company based on publicly available information.

**Originality.** Methodological approaches to business analysis in the pre-investment stage of the merger and acquisition process have been further developed, particularly in terms of systematizing potential adjustments to financial indicators within financial due diligence. The results of previous research have been systematized, and the list of characteristics suitable for analyzing the concepts of financial due diligence and auditing has been expanded, with a specific focus on the concept of materiality.

**Practical value.** The proposed research findings contribute valuable insights to existing scientific works regarding the definition of financial due diligence and auditing, particularly in terms of their differentiation, as well as key aspects to consider in the financial analysis of potential investment targets at the pre-investment stage of the merger and acquisition process. The results of the study can be utilized to enhance transaction efficiency by improving analytical approaches and deepening the understanding of the merger and acquisition process among participants.

**Key words:** merger and acquisition, financial due diligence, information asymmetry.