FINANCIAL DUE DILIGENCE

ICAEW CORPORATE FINANCE FACULTY
BEST-PRACTICE GUIDELINE 71

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FOREWORD AND ACKNOWLEDGEMENTS

An accurate assessment of the financial performance of a business has always been an essential element of any deal or investment process. This is unlikely to change, but the way in which it is carried out, and the nature of insight that can come from a high-quality financial due diligence report, have changed dramatically, even over the past couple of years.

The use of artificial intelligence (AI) and data analytics combined, critically, with human oversight enables a significantly greater level of insight and better informed forecasting than had previously been possible.

The days when due diligence teams were surrounded by lever-arch files in airless, and sometimes windowless rooms, are fading into distant memory. Gone too are the days of agreeing the scope of an engagement and then (hopefully, a few weeks later) the submission of a finished report. The sharing and interactive analysis of datasets with clients has become commonplace.

However, changes bring not only opportunities but also a raft of additional considerations and risks for preparers, providers and users.

Sell-side advisers must consider carefully what information goes into a virtual data room, and at what stage. Preparers of reports must ensure that they have sufficient information, both to support reported historical financial performance and to accurately and comprehensively evaluate the deliverability of future financial performance.

The Corporate Finance Faculty is most grateful to Mark Binney, James Orr, Toby Popplewell, Jack Beard and other colleagues at PricewaterhouseCoopers LLP, UK for the expert commentary in this publication for faculty members.

The faculty's best-practice guidelines are subject to rigorous peer review by our Technical Committee, which includes experts from many leading firms of advisers and principal investors (see icaew.com/cff). Thanks are due to the committee members and other member firms, as well as to ICAEW colleagues, for their considered input. Sincere thanks to my colleague at ICAEW, Katerina Joannou, who collated and carefully balanced suggestions and amendments from our expert review panel.

David Petrie
Head of Corporate Finance, ICAEW

INTRODUCTION

An organisation considering an acquisition or divestment needs to have a clear understanding of the financial performance of the business being bought or sold and the implications for the deal. For the deal to be agreed, it is also important that issues that may concern potential purchasers and the vendor are addressed.

The financial due diligence (FDD) process can help:

- identify red flags and risks so that purchasers and funders can make an informed decision;
- provide peace of mind by analysing financial performance to test the deal hypothesis and investigating financial areas of particular focus or concern; and
- support the overall valuation of the target business being acquired.

In this guideline, we explore the what, why, who and how of performing effective FDD and the outcomes it should achieve. We touch on how today's rapidly evolving technology landscape, including the use of AI, is reshaping the FDD process and its related deliverables. We also comment on how FDD interacts with other areas of due diligence.

The guideline has been prepared by experienced FDD specialists, setting out best practice for FDD on both sell-side and buy-side transactions.

It is primarily focused on FDD in the context of a merger and acquisition (M&A) or debt financing transaction, although many of the principles apply to FDD in the context of a public market transaction. It mainly focuses on deals in the UK and continental Europe, but touches on how practice varies in the US and emerging markets.

FDD EXPLAINED

DUE DILIGENCE AND FDD

A simple definition of due diligence is that it is a robust, objective enquiry. In addition to FDD, there are other areas a stakeholder might want to investigate through due diligence, including:

- commercial;
- operational;
- IT;
- legal;
- tax;
- HR/pensions; and
- environmental, social and governance (ESG).

The various types of due diligence will cross over and inform other areas. See pages 10–11 for more detail on these types of due diligence.

In a significant transaction (such as an acquisition, divestment, flotation, refinancing or restructuring), FDD practitioners will undertake an agreed scope of work to analyse and scrutinise the target (or subject matter). This could be a standalone company, group of companies or carved-out division. The aim is to provide sufficient information to help an investor or finance provider make a more informed decision about their potential involvement in the transaction.

Stakeholders, such as company directors or private capital investors, are duty bound to act prudently and exercise due diligence in their decision-making. To meet these responsibilities, they need to be able to demonstrate that they took sufficient steps to undertake and/or commission an appropriate level of enquiry (ie, due diligence) to enter into the transaction.

The depth and scope of the due diligence will depend on the type and materiality of the transaction, the user's needs and the level of access to be provided, both to information and the target's management. Some elements of the due diligence process may be undertaken in-house, depending on the skills and capacity available. This will influence the depth and scope of any outsourced elements.

Due diligence is typically performed during the execution phase of a transaction, although it also forms an important part of the pre-deal evaluation (for example, commercial due diligence on market potential). Its findings are often used to inform key post-deal areas of focus, such as potential operational improvements that have been identified.

FDD covers areas affecting the financial position and performance of a target, including its earnings, cash flows, assets and liabilities. The target's financial position and performance is usually informed at least to some degree by each of the other categories of due diligence. A transaction would therefore often require close alignment and coordination between the various due diligence areas to ensure key issues are identified and considered.

The scope, depth and breadth of the FDD process are not generally prescribed. What is covered and in what depth is up to the commissioning client, be they on the sell-side or buy-side. The commissioning client will seek advice and input from the FDD advisers on the appropriate level of coverage. In the case of vendor due diligence (VDD) and refinancing, if the transaction completes, the FDD advisers will typically give a duty of care (reliance) allowing the purchaser and/or finance provider to rely on the contents of the report.

FDD is not an audit or assurance opinion

FDD does not constitute an audit or review under assurance standards. Given the time and expense involved, FDD practitioners tend not to refer to underlying evidence (such as invoices and bank statements) to provide documentary support for aspects of the financial performance. Unlike an audit, they do not provide a formal opinion over the accuracy or completeness of the information covered as part of an FDD engagement.

FDD typically focuses on management information, which is often more detailed than that presented in the audited financial statements and therefore tends to enable greater insight. The practitioner will

seek to reconcile such management information to the audited financial statements to give comfort that the management accounts are an accurate source of financial information to use. They will identify audit adjustments that are missing in the management accounts and will then reflect these in the management information to enhance their accuracy as a source of information. FDD often also considers other non-GAAP financial information (such as transactional-level volume and price data), which is not subject to audit.

FORMS OF FDD AND VENDOR ASSISTANCE

The form FDD takes depends on the nature of the transaction, the requirements of the party commissioning the work, the intentions of the user and the information available. These forms include:

Vendor due diligence (VDD)
This is where a vendor commissions objective due diligence to help inform potential investors. The VDD report is therefore ultimately for the benefit of the actual purchasers and/or funders of the transaction and should have the needs of potential purchasers at the fore. Therefore the scope of VDD needs to be broad and deep. The process reduces management distraction, with one sell-side commissioned team undertaking the initial due diligence rather than multiple buy-side commissioned teams. It also gives vendors more control over the sale timeline and a more common understanding of the key issues for both vendors and purchasers.

If the transaction completes, the VDD team typically extends a duty of care to the successful purchaser.

VDD does not eliminate the need for potential investors to undertake additional top-up due diligence to meet their particular requirements, but it should reduce the scope and depth of such work.

Vendor assistance report (VA report)
This is also known as a data pack or factbook. If vendors want to present the target's financial performance but not commission a due diligence report over which purchasers receive a duty of care, they will typically request a VA report or factbook.

The decision to commission a VA report rather than VDD depends on a range of factors including the deal dynamics, investor expectations and target readiness.

Within the UK and continental Europe, a VA report is most commonly used for carve-outs. This reflects the more complex nature of carve-out transactions compared to a stand-alone business. The key areas of increased complexity include determining the transaction perimeter (reflecting the assets, liabilities and legal entities being sold as part of a proposed transaction), identifying separation issues and value creation levers (areas that are expected to enhance future performance), and preparing financial evaluations.

While the areas covered are similar to a VDD, a VA report is designed to help vendors understand and facilitate the purchaser FDD process. It is not an independent view and purchasers therefore need to undertake their own due diligence.

Purchaser or buy-side due diligence
Due diligence commissioned by potential purchasers can take various forms and is usually dependent on whether the vendor has commissioned a VDD report. Where there is no VDD report, purchasers will generally commission extensive due diligence work from scratch.

Top-up due diligence is designed to consider, augment and sometimes update a VDD with the latest data. It involves a review of the VDD report, along with additional information to form a view on the areas the user considers fundamental.

Refinancing
If a business wants to raise finance (debt or equity), the potential funders (banks, credit funds, private equity or sovereign wealth fund investors) will often request that it commissions a due diligence report over which the potential funders will receive a duty of care. This requires FDD practitioners to maintain their objectivity and professional competence – which are among the fundamental principles of ICAEW's Code of Ethics – given the potential conflict that arises. The scope is typically dictated by the amount being raised and expectations of the financing entities, which can differ depending on the nature of the institution and the funding being provided (for example, private equity or lending banks).

Initial public offering (IPO)
If a business wants to list its shares on the public markets it may, depending on market practice, commission due diligence.

The extent and scope of the due diligence – alongside other requirements such as assurance over the financial track record – vary by jurisdiction and are subject to relevant capital market regulations, market practice and the needs of sponsoring banks.

PURPOSE OF FDD

Carrying out due diligence is accepted market practice for significant transactions. There are many reasons why some form of due diligence, and FDD in particular, would be undertaken or commissioned.

The primary purposes of FDD are to help:

- satisfy an investor's/director's duties to shareholders and stakeholders and serve as a record of proper process;
- enhance a user's understanding of the financial performance, assets and liabilities of the target;
- inform the decision on whether to proceed with a transaction;
- inform the overall valuation assessment and assist in negotiating a price and funding requirements;
- highlight information relevant for structuring a potential transaction;
- identify risks that may require additional protection, such as through the use of warranties, indemnities or pass-through mechanisms (whereby future costs and income associated with a particular item are transferred between the purchaser and vendor) in the sale and purchase agreements;
- assist with a funder's decision to provide finance; and
- inform post-acquisition strategy (for example, for synergies, the carve-out or the integration) and understand the sustainability and growth prospects of the target.

While due diligence is commissioned by investors and directors for their purposes, it often provides benefits to third parties either on a reliance basis (usually only for providers of equity/debt financing) or on a non-reliance basis (for other users). For example, access to due diligence undertaken by a potential purchaser may also be sought by and made available to providers of financing or warranty and indemnity (W&I) insurance for the acquisition. Depending on the circumstances, the due diligence practitioner may consent to the report being provided to other parties under non-reliance arrangements. See the section on how FDD findings are used on page 19 for more details.

The scope, nature and depth of the due diligence will depend on the transaction and the user's needs. Key considerations include, among others, the size and complexity of the target, an investor's risk appetite and their familiarity with the target's market and sector. As mentioned, in some cases, due diligence will be carried out in-house by the acquiring business or investor. For example, this might be because the target is small or well-known to the client, and if the investor has the capability and bandwidth to perform the due diligence. Often, however, professional practitioners are brought in to perform the due diligence and report to the investor.

When external practitioners are hired to perform the due diligence, the timing and extent of their involvement will depend on the deal dynamics. A corporate finance adviser is often hired to advise directors and investors (either sell-side or buy-side) and to manage the process.

The timing and extent of external due diligence in a typical M&A process are as follows:

Sell-side due diligence
Professional practitioners are typically engaged to undertake VDD at an early stage in the deal cycle. This is often before marketing materials are released, with aspects of the due diligence findings then incorporated into 'teaser' documents, information memorandums and management presentations.

Buy-side due diligence
Due diligence is often undertaken in phases. It typically starts with pre-deal vetting. This is often carried out in-house, with the involvement of a limited circle of professional advisers. The aim is to find out whether there is sufficient appetite to pursue a transaction.

If the pre-deal vetting concludes that there is, it would be followed by buy-side due diligence. This might be in the form of either top-up due diligence on VDD materials (if available), or a red flags exercise on key focus areas, followed by a fuller scope phase if no deal breakers were identified. This phase can include discussions between sell-side and buy-side due diligence practitioners (known as expert sessions) where there is a VDD, and access to management and management information.

Some buy-side investors may choose to pre-empt a typical auction process, resulting in accelerated buy-side due diligence.

Proprietary (exclusive) deals and public to private processes typically have different dynamics to the M&A auction process. For example, exclusive deals may include extensive access to information and the target management team whereas public to private processes typically involve more limited information, which can often be restricted to publicly available data.

USERS OF FDD AND THEIR REQUIREMENTS

COMMISSIONERS

FDD is usually commissioned by an M&A team, a CFO at a corporate client or the investment team at a financial investor (such as private equity and sovereign wealth funds). These commissioners are likely to require detailed FDD so that they can assess the findings and identify negotiation areas and risks that need to be mitigated or further investigated.

Key areas of focus are likely to include:

- the current and historical trading trends and, often, forecasts of the various divisions and operating territories;
- the underlying performance of the target; and
- historical budgeting accuracy.

The findings help those commissioning the FDD to assess whether the key forecast assumptions and, therefore, the target's business plan are a reasonable basis for decisions about the acquisition and valuation.

Fundamental priorities generally include identifying the cash generation and funding requirements and ensuring that the balance sheet composition and liabilities that will be inherited are factored into the valuation. The commissioners will likely also want to gain a detailed understanding of the cost base, staffing and potential areas of synergy to help their post-acquisition 100-day planning and beyond.

Private equity investors will often use leveraged finance structures to fund the acquisition. Therefore, they are likely to request that the sustainability of cash flows to support debt servicing is investigated as an additional key focus area.

Given that private equity ownership periods are typically four to six years to meet their fund investing and harvesting cycle, the envisaged exit route will also be a primary consideration. Private equity investors will want to know about issues, opportunities and risks that may crystallise within that timeframe, typically in conjunction with other workstreams such as commercial, operational and ESG due diligence.

For venture capital and start-up investors, understanding the current cash cost base of the business and expected negative cash flows over the near term are among key areas of focus. These areas, alongside details about the proposed cash funding to be received as part of a transaction, provide clarity on the length of time the business will be able to operate before seeking additional financing (or, if earlier, generating positive cash flows).

When valuing early-stage targets, venture capital and start-up investors are also likely to want the due diligence to hone in on factors such as the revenue growth rate, revenue recognition policies and cost allocations between gross profit and operating expenses. Further focus areas may include information that would help them to understand the trail between the numbers in the marketing materials shared about the target and the accounting records.

Given the relative cost of external advisers for smaller investments, the FDD scope may include limited information, with more emphasis on legal and tax due diligence (for example on share scheme structures) and less information to subject to due diligence.

OTHER PARTIES

Other users of FDD, such as the wider team at the commissioning client, management of the business that is the subject of due diligence, and third parties who may also be allowed access to the FDD, have varying needs.

Wider executive teams

A summary of the FDD findings is likely to be more suitable for the wider executive team, who may only want to focus on particular areas relating to their individual roles, such as HR matters, property issues or specific trading divisions. This is why it is so important for the FDD practitioner to ensure that the findings are clearly and logically structured. The key aims are making the high-level summary findings easy to digest and simplifying navigation to specific matters of interest.

Non-executive directors on a corporate board and investment committee members at financial investors
These stakeholders often receive a synopsis of the FDD findings as part of a client-prepared investment paper. It is important for the FDD practitioner to ensure that the client understands that the full FDD findings represent the deliverable, as important matters will not be fully reflected in the synopsis.

Management teams
The target company's management team can also benefit from the FDD process. While the report is not usually shared with them during a buy-side process (except for redacted reports and extracts that may be shared as part of confirming factual accuracy), they are likely to see the full report post-deal. In the case of VDD, they will often be expected to review and comment on a draft of the report. The external view on their areas of operation and focus can provide valuable insights.

Other users
Other parties may also receive aspects of the report under non-reliance arrangements and, in some cases, with a duty of care being provided as well. See the section on third-party access on page 21 for more details.

SETTING THE SCOPE

The FDD practitioner can advise the client on the recommended scope, but the client is ultimately responsible for it, including areas that are left out. This should be clearly set out in the engagement letter.

The starting point for determining the scope is a clear understanding of the client's motivation and hypothesis for the deal, key assumptions that need testing, and the client's concerns about issues that they want to have addressed.

The (sub)sector and location of the target business will also impact what work will be appropriate. Different key performance indicators (KPIs) apply to different (sub)sectors, which can drive business valuations such as annual recurring revenue and net retention rates in a software business or like-for-like sales in multisite operations. The FDD practitioner will therefore need to draw on the experience of sector specialists to make sure that the relevant value drivers are identified and included in the tailored scope.

The core areas that an FDD practitioner would be expected to cover as a minimum in most scenarios are:

- analysis and commentary on the trading trends in the current and historical management accounts, performed at a suitable level of detail in relation to services, products, divisions and operating territories including KPIs and non-GAAP measures (for example, earnings before interest, tax, depreciation and amortisation (EBITDA), annual recurring revenue, net retention rate and like-for-like sales growth);
- details of the current cost base;
- an assessment of earnings (quality of earnings) to present the underlying performance, excluding the effect of one-off items or fundamental changes (ie, accounting policies or acquisitions);
- cash generation, capital expenditure and net working capital trends, and 'normalised' requirements;
- balance sheet composition, net debt and other liabilities that will need to be funded to ensure that any future cash outflow or inflow not included within underlying earnings is identified for consideration within price negotiations;
- accounting policies for judgement areas, any changes made and differences to the client's own policies; and
- material contracts and agreements, to understand key financial terms that relate to pricing, payment terms, duration etc, in conjunction with the legal due diligence practitioner.

The timetable for a transaction process can influence decisions about the scope of work proposed, given the constraints on what can reasonably be achieved in the timeframe, as will the extent and quality of the available management information.

In many cases, the client may choose to cover certain areas of buy-side due diligence internally, using their own team or by engaging other professional advisers. It is therefore important to ensure clear delineation of responsibility for each aspect of the due diligence, along with agreement on how the workstreams will interact.

The scope of the FDD can be adapted during the process as issues are identified for further follow-up and as the level of access to information and

management becomes evident. Changes to the scope will be documented in an addendum to the engagement letter.

Forecast assumptions

The scope of the FDD might also include commentary on the assumptions applied in the business plan, in particular key risks and divergences from recent performance. This is often performed in conjunction with the commercial due diligence practitioner, or the client's own team, although the FDD practitioner remains responsible for their own conclusions. It is important to clarify which business plan will be used as, in a buy-side scenario, the client may have prepared their own projections, factoring in different assumptions than those applied by the target's management team. There may also be separate equity case and financing case scenarios.

VDD versus top-up

A VDD's scope will often be much broader and deeper than an exercise commissioned by a buy-side party, as the specific needs of the eventual purchaser and their focus areas will not be known at the outset. A VDD report will usually include a business overview describing the operating model, the range of products and services provided by the target, operating territories, key customers and suppliers, locations and employees. It will also include more granularity on revenue KPIs, costs and working capital.

Conversely, a top-up due diligence in a deal where there is already a VDD report will often be narrower in scope. The main focus will be areas of particular concern to the client rather than reperforming analyses and looking at issues adequately covered in the VDD report.

Different regional market practices

There are differences in the FDD practice, focus areas and contracting frameworks that are commonly seen in the US, European and emerging markets, especially in relation to private equity clients. Across Europe, sell-side due diligence, and in particular VDDs (whereby a duty of care is extended to purchasers), is more common. VDD reports are typically comprehensive, covering key transaction-related matters such as a view of underlying earnings, net debt and adjusted working capital, alongside trading trends. Private equity investors in Europe also tend to include forecast data in the scope of the due diligence, especially in relation to nearer-term forecasts (such as the budget for the next year or current year outturn).

In the US, commissioning clients place greater emphasis on the work performed by buy-side due diligence teams. The scope tends to be more detailed in nature, with the buy-side team often performing analysis on information at the trial balance level and reconciliations of this to audited financial statements. The scope and emphasis of sell-side FDD in the US is much less standardised than in Europe. Where sell-side work is performed in the US, it is usually on a non-reliance basis to the purchaser and the purchaser's investing syndicate, with VA reports often referred to as quality of earnings reports in the US market. However, there is a duty of care (ie, reliance) to the sell-side client. The outputs also tend to be summarised, covering quality of earnings and net debt, with less focus on trading trends or forecast performance. Unlike in Europe, however, sell-side teams tend to have more access to the target's auditor and opportunities to review their working papers.

Investors in emerging markets will often focus on specific risks related to the ownership structures of the target companies. There may be a high level of related-party transactions, especially if a promoter (founder) owned business is being sold. The FDD's scope often includes testing transactions, for example, tracing sales and purchases to invoices and bank statements. A lack of readily available reconciling datasets can impact the depth of work performed. Where a target business does not have a finance function that aligns with the client's usual expectations, it is important for inbound investors to ensure that they commission a due diligence practitioner with an appropriate level of local experience.

BRINGING TOGETHER THE RIGHT TEAM

FDD requires people with specialist expertise and experience. To ensure the right blend of professional scepticism and commercial awareness, the ideal attributes include a solid understanding of how financial statements are prepared and strong analytical skills, alongside the ability to step back and see the bigger picture and understand the key drivers for a business. These skills should be applied consistently with the fundamental principles in ICAEW's Code of Ethics. This will help to identify relevant risks and ensure that inconsistencies and other areas in need of further scrutiny are followed up.

Many teams now include a combination of sector specialists and people on the ground in local markets, with the resulting insights helping to focus the analysis and discussions with management teams. If the FDD practitioner does not have the necessary expertise in-house, they can bring in independent consultants and subject matter experts to supplement their capabilities.

OTHER TYPES OF DUE DILIGENCE

OPERATIONAL AND IT (INCLUDING CYBER) DUE DILIGENCE

This process helps the vendor/purchaser to understand the key operational levers in the business. It can help to identify key risks and opportunities for improving a target company's performance and potential operational synergies, as well as determining whether the IT systems are fit for purpose, scalable for anticipated growth and resilient against cyber attacks.

In addition, this kind of due diligence increasingly focuses on identifying potential operational value creation opportunities to support the purchaser's investment thesis. In the case of a carve-out, the operational due diligence team will support the vendor/bidder to assess the operational dependencies and separation complexity. This can help them to develop plans that would allow the carved-out entity to operate as a standalone business or be integrated into the purchaser's existing business. Typically, the standalone assessment made as part of the operational due diligence would feature in the FDD's quality of earnings analysis in order to reflect the standalone earnings of the target entity.

MARKET AND SECTOR-RELATED DUE DILIGENCE

Other specific matters are also often covered within certain markets and sectors, such as regulatory due diligence (for example, for the financial services and utilities industries) or technical due diligence (such as mineral reserves within the oil and gas or mining sector).

TAX DUE DILIGENCE

This process assesses the target company's tax health. The main focus is identifying potential tax risks and liabilities that the purchaser in a shares sale will inherit from the target company. Tax due diligence has become progressively more important as tax authorities step up scrutiny and investigation, and due to the growing prominence of W&I insurance within transactions.

ESG DUE DILIGENCE

This due diligence has become increasingly prevalent as the expectations of investors and regulatory stakeholders have increased. A comprehensive agenda encompasses a variety of issues, including carbon management, energy efficiency, ethical procurement and employee welfare. While the scope of ESG due diligence will vary depending on each target, it is grounded in the concept of materiality for its financial impact.

COMMERCIAL DUE DILIGENCE

This provides investors with the information needed to help them assess a company's growth potential, identify opportunities for commercial synergies and/or validate the assumptions that underpin their investment thesis. This is achieved by building an understanding of the market in which the company operates and its prospects within that.

HR AND PENSIONS DUE DILIGENCE

This process provides a comprehensive overview of the employee base, compensation, potential HR issues and the current pension and incentive arrangements and suggests how these could be captured in the deal valuation. This is particularly relevant if defined benefit pension and share options and management incentive plans are in place.

LEGAL DUE DILIGENCE

This consists of a legal review of documents and information in relation to a transaction and target company to identify potential liabilities and to understand legal risks, such as potential exposures due to ongoing litigations or non-compliance issues.

ACCESS TO INFORMATION AND MANAGEMENT

Due diligence, including FDD, requires a significant time commitment from the target's management. It is therefore important to factor management capacity into the process timelines from the outset.

At the beginning of the process, and as a starting point for gathering information from the target, the FDD practitioner usually issues an information request list, tailored to reflect the circumstances of the deal.

For professional advisers and investors, the level of access to information and the management team will vary depending on the extent of FDD being performed and broader deal dynamics. While each transaction differs, a typical level of access to information and management would be as follows:

SELL-SIDE DUE DILIGENCE

With sell-side due diligence, full access will be granted to both information and management, including detailed supporting financial information and regular dialogue with relevant management team members.

Information is typically provided at a granular level, including detailed management accounts supplemented with relevant analysis. It is increasingly common for large volumes of data to be analysed as part of due diligence. For example, for an online direct-to-consumer retail business, this could involve data at an individual transactional level.

Before starting the detailed analysis, it is important to consider the underlying source and reliability of this transactional data, including how it reconciles through to headline management and statutory accounts.

In situations where financial information is more limited or unclear (for example, where a transaction involves a carve-out), a VA team will often be brought in to help management prepare the necessary financial information for the transaction. VDD will therefore be performed with reference to the VA materials, and with the benefit of access to the VA team that helped prepare them, alongside management. As the VDD team needs to maintain its independence, it cannot help prepare information that it will be performing due diligence on.

The sell-side process also allows commercially sensitive information to be shared with the VDD practitioner, to analyse and present on an anonymised or redacted basis. Full details are only shared with the eventual purchaser.

BUY-SIDE DUE DILIGENCE

The vendors and their corporate finance advisers will ultimately decide how much access they grant to potential purchasers, although this will be influenced by the strength of the negotiating positions of the purchaser versus the vendor. In some instances, they may only provide information and access to a small number of individuals on a buy-side team. This is particularly relevant when a potential purchaser is a competitor of the target.

In such cases, access to certain sensitive information is often provided under a clean team agreement, whereby both parties agree that a limited number of personnel from the buy-side advisory team will be able to access information and report on conclusions without disclosing the underlying commercially sensitive detail. This protects competitively sensitive and confidential information.

The main buy-side scenarios include:

Proprietary/exclusive process
Typically, limited or no sell-side due diligence will have been performed. Access to both information and management on the buy-side is therefore generally more comprehensive and the timetable would need to reflect this.

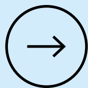
Public to private deals
Typically, no VDD or sell-side work will have been prepared. Information and access to management is often more limited, with buy-side FDD typically performed according to an accelerated timeframe.

Public companies are generally subject to different disclosure requirements compared to private entities, although this will vary by jurisdiction. For example, in the UK, Rule 21.3 of the Takeover Code requires public companies subject to an offer by one bidder to provide the same due diligence information to other potential bidders who may be direct competitors. This means due diligence is often focused on publicly available data for public to private deals, as there is no obligation for the target company to share any private information with potential bidders. Practitioners are also required to consider market abuse regulations given the likelihood of inside information being received. See the section on regulatory matters on page 23 for more details.

AUCTION PROCESS

In an auction process with many bidders, sell-side due diligence would have typically been performed. As a result, buy-side due diligence will be focused on top-up areas. Access to information and management during the auction process is depicted below.

ACCESS DURING PHASES OF AN AUCTION

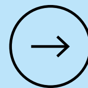


ROUND ONE

Corporate finance advisers notify potentially interested investors, sharing limited materials such as teasers and confidential information memorandums. The seller then sets up a virtual data room (VDR), with limited information included.

Buy-side due diligence is generally high level, covering areas such as key commercial hypotheses and reviews of the information shared in the sell-side materials. Access to management is generally more limited at this stage.

A non-binding indicative offer is submitted at the end of round one, from which the seller and their advisers select a shortlist of potential investors to progress into round two.

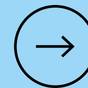


ROUND TWO

Sellers provide shortlisted investors with access to further information, usually via a VDR, which has been populated by the target and their corporate finance advisers. Sellers may also share the VDD report on a non-reliance basis, such as via the VDR or directly from the VDD practitioner. Other approaches may be used, for example, use of a separate portal for downloading reports.

Access to management tends to be closely supervised by the lead adviser. It generally takes the form of a presentation from the management team, along with further ad hoc sessions with key executives such as the CFO, or written questions and answers (Q&A) as deemed necessary. This information and access, alongside meetings with sell-side due diligence teams, form the basis of top-up due diligence.

At the end of round two, investors submit final offers, typically alongside a mark-up of the proposed sale and purchase agreement (SPA).



AFTER ROUND TWO

Sellers select one or more potential buyers to enter a limited period of exclusivity or a final stage. This allows them to work through any residual due diligence matters (if relevant), with a view to executing a definitive SPA. Commercially sensitive information and redacted elements of the sell-side due diligence report are shared during this phase.

Upon completion of the transaction, and if a VDD has been performed, the VDD team signs over a duty of care to the final purchaser (and financing banks, if relevant).

The auction process can vary. For instance, extracts from the VDD report can be shared with bidders earlier on in the process, or a selected bidder may be fast tracked or pre-empt the process with earlier access to materials.

The VDR process also includes a record of documents shared, which is important for the disclosure letter. The disclosure letter sets out information relating to warranties and indemnities in the SPA to ensure that the purchaser is aware of them before signing the deal. This serves to limit the purchaser's ability to claim damages subsequently. It is also important for managing the FDD practitioner's liability, and to satisfy the practitioner's professional requirement to keep adequate records and sufficient evidence of key VDR files used to support the conclusions shared.

USE OF DIGITAL TOOLS, AI AND TECHNOLOGY PLATFORMS

The scope of the FDD process, and insights available from it, are being enhanced by the growing availability and quality of data, as well as by digital tools and platforms that are easy to access and deploy.

DIGITAL TOOLS

Slice and dice

Key aids for FDD include tools that enable practitioners to 'slice and dice' millions of data points to help boost understanding of the drivers of the revenue or profit of a division. Where a sufficient depth of data is available, splitting this by market, product and/or customer allows users to gain faster and deeper insights into performance trends. This tech-enabled analysis also improves the quality and value of FDD by bringing issues to the surface faster and more effectively.

The necessary professional scepticism demonstrated by practitioners performing FDD comes to the fore when analysing data. The data should be compared with the management information that is being used as the source of financial performance for the overall FDD process, and rigorously tested, reviewed and understood. This should help prevent unsupported conclusions being drawn about a business from inaccurate data.

Easier visualisation and interpretation

In a transaction, sellers often load their data into a platform early in the deal preparation process to ensure all parties are using the latest, most accurate data for their analysis.

If VDD is being commissioned, a data platform or visualisation tool can be used to illustrate how the vendor views the business and its potential once the due diligence reports and analysis are ready to share with purchasers.

Despite the curation of the information made available, purchasers will often want to get to grips with the raw data themselves, so that they can explore their own hypotheses and more clearly understand the business they are thinking of buying. The depth of data that a seller is willing to share with the potential purchaser(s) will depend on the individual process dynamics.

Analysis of third-party data

Digital tools allow due diligence practitioners to analyse third-party data, such as web traffic, Internet of Things devices, mobile footfall, bank transactions or social media posts. Purchasers can use this data to understand a business from the outside-in, which can be especially useful in instances where the seller will only share limited information, for example in public to private transactions and demergers.

IMPACT OF AI AND ADVANCED ANALYTICS

Note: AI is evolving rapidly and while the authors comment on its expected impact on FDD as at the time of publication, there is uncertainty about how AI technologies will develop in the future and the timeframes involved.

FDD practitioners are increasingly using AI capabilities to extend the boundaries of traditional due diligence as they look to gain a deeper understanding of the potential investments, mitigate risks and uncover opportunities that could provide a competitive edge. The impact of AI and advanced analytics on due diligence can be broken down into three outcomes: faster, broader and deeper.

Faster

Incorporating AI into FDD can speed up and enhance the efficiency of investigations and reporting. This includes automating the analysis of large datasets using natural language processing and machine learning to swiftly navigate complex documents, financial records and other relevant data. This in turn helps to shift the human focus from data collection to insight analysis, saving time and allowing for higher-value activities such as strategic planning and negotiation.

Broader
AI opens up opportunities to analyse a larger pool of information than was previously feasible. Traditionally, the FDD process was constrained by human limitations in processing and analysing data. However, AI's ability to sift through and interpret complex datasets can allow the due diligence process to consider a broader spectrum of data.

Deeper
The demand for data extends beyond the quantitative. Those commissioning FDD now seek rich, qualitative insights to inform their strategic decisions. AI has the potential to meet this demand by extracting patterns and trends from unstructured data such as news articles, social media posts, customer reviews, industry reports, market analyses, competitive intelligence, internal communications and employee feedback in support of FDD and the wider due diligence process.

These capabilities open up opportunities to develop a more nuanced understanding of a target company's performance, prospects, market position, reputation and potential risks that may not be evident from financial data alone. However, these capabilities also give rise to additional ethical and practical factors, which should be considered in the context of the work being completed. By harnessing both qualitative and quantitative information, AI improves the quality of insights during the FDD process. The enhanced analytical power can help pave the way for more accurate assessments of a company's value and prospects. The results help clients to make more informed decisions faster, which is crucial in the dynamic environment of M&A.

MINDSET SHIFT

Harnessing the full potential of AI and advanced analytics in FDD requires a mindset shift as well as new technology and the skills needed to deploy it.

Ensuring accuracy of AI outputs and context
Human oversight remains critical. Reviewing the output ensures that the interpretations and recommendations made by AI are accurate, contextually relevant and aligned with strategic objectives. Human experts can pick out nuances and contextual subtleties that AI might overlook, particularly in complex or ambiguous scenarios. Moreover, human judgement is essential in validating AI outputs (for example, to identify incorrect responses generated by AI that contain false or misleading information, often referred to as hallucinations), as well as mitigating potential biases and making final decisions that incorporate ethical and strategic considerations.

Shoring up data
The analysis and insights generated by AI depend on the quality and depth of data used. Comprehensive data storage enables AI systems to perform in-depth analyses, uncover hidden patterns and generate actionable insights that might otherwise be missed. Making the most of the potential and ensuring that the data is accurate and robust is likely to require an upgrade of knowledge management frameworks and how data is used, reconciled and presented right through the deal, including data uploaded in the VDR.

Embracing data-driven decision-making
It is important to foster a culture that embraces data-driven decision-making and is receptive to the insights generated by AI and advanced analytics. The shift includes developing an ethos of continuous learning and adaptation in response to the ongoing evolution of AI technologies. It is also important to ensure that all stakeholders are aware of both the benefits and limitations of AI within the FDD process.

Adapting to an evolving due diligence landscape
The FDD and wider due diligence landscape has the potential to be transformed by the increasing prevalence of AI and advanced analytics. It is therefore important to keep abreast of the AI developments that could influence the execution of due diligence and adapt strategies and processes to integrate new AI-driven insights.

For the vendor, AI's ability to rapidly work through huge amounts of structured and unstructured data will have a strong bearing on the setting up and management of the VDR (including decisions about the volume of documents to include). AI tools are more likely to be able to draw connections between references in large documents that may be overlooked by practitioners working in silos and under time constraints.

REPORTING FORMATS

A variety of reporting formats can be used for FDD. The style of reporting will ultimately be determined by the purpose, intended audiences, client needs and scope of work. Often, multiple reporting formats are used throughout a process, but the final deliverable will generally be in one format which reflects the reliance that goes with the final deliverable.

Presentation formats include:

Oral presentations
FDD teams generally use oral presentations with select discrete financial analysis when findings are needed quickly, or to share initial views in the early stages of the investigation. As the FDD progresses, other reporting formats are also used (such as slide-based reports), although these are often supported by oral presentations to summarise the headline messages and direct the user's attention to the key areas. However, these do not form part of the formal deliverable under an FDD engagement. The engagement contract should make clear what is and is not an engagement deliverable.

Briefing notes and emails
Briefing notes and emails are often used to communicate initial thoughts and red flag deal risks. The FDD team should be careful to reference these as draft perspectives and clarify that they do not form part of the formal deliverable under the engagement contract.

Slide-based reports
The standard approach is to use traditional presentation formats (PowerPoint, Word or PDF), particularly for final deliverables. While the structure and content of these reports will vary depending on the transaction and scope of work, they generally open with an executive summary, highlighting the key areas of focus (which often include a view on adjusted EBITDA and net debt). This is then followed by more detailed analysis, commentary and appendices (used for supporting detail etc). The final report represents the FDD practitioner's definitive record of advice and supersedes any previously shared briefing notes, emails, interim reports, oral presentations and data visualisation tools.

Extracts from detailed slide-based reports may sometimes be shared with other parties, although market practice in this area varies. Within an auction process, for example, potential investors may receive selected analysis from the VDD report at an early stage. The full report would then be shared in a subsequent phase, although it is important to highlight the nature of items excluded from the extract to ensure readers are aware of the wider scope of work performed.

Spreadsheet datapacks
Sharing spreadsheet datapacks is a common buy-side option. Turnaround is faster than full slide presentations. They also allow users to deep dive into the data and change inputs to understand the associated impacts on the analysis provided.

Live visualisation and pivot tools
As data collection and analytics advance, there is growing use of dynamic visualisation tools that allow users to interact with analysis and data. This includes slicing and dicing data to explore results by product, division and operating territory. While these options require time to use and absorb, they can provide richer, more insightful and more usable outputs than static conventional reports. See the section on the use of digital tools, AI and technology platforms on page 15 for more details.

Online-hosted platforms
Presentation on online platforms is also becoming increasingly common. These platforms are generally cloud-based, allowing users to access them from multiple devices. They allow information to be updated and shared right through the FDD process and are often supplemented by linked live visualisation and pivot tools.

HOW FDD FINDINGS ARE USED

The results of FDD are used to inform decisions across a range of areas. The main deal-related uses are outlined first, followed by examples of wider uses.

It is important to note that FDD reports are commissioned and prepared for a specific purpose, which will be reflected within the scope of work and engagement contract. Other parties might request access to the findings, but the report will not be prepared for them and will not meet their precise requirements.

MAIN USES IN A DEAL

Identification of red flags
Users want to be able to see and assess the red flags that could make or break the deal (material issues).

Insight on valuation and negotiation points
Potential purchasers want to know about the issues that could affect:

- the valuation (enterprise value);
- net debt (consisting of cash, debt, cash-like and debt-like items); and
- the net working capital adjustment to enterprise value to arrive at a final equity value. The net working capital adjustment is defined as the difference between the level of net working capital delivered to a purchaser at a specific point in time versus a normal level of net working capital.

Insights from the FDD are also used to inform the equity ticker calculation, a concept used as part of a 'locked box' completion mechanism, which is commonly used across UK and European M&A transactions to capture the impact of cash profits generated by a target business between the 'locked box' date and completion.

Identification of areas to be covered in the SPA
The FDD findings are often instrumental in shaping the SPA. The objective of the SPA is to ensure that the agreement between the parties in the transaction is accurately recorded and both the purchaser and the seller are adequately protected. By addressing FDD insights in the SPA, both the purchaser and seller can achieve a fair and equitable transaction, with risks and rewards appropriately allocated between them. As well as capturing the final outcome on valuation and negotiation points, the SPA may also include specific W&I insurance, protecting the purchaser from financial exposures post-acquisition. The areas covered could include earn-out clauses, or provision for contingent liabilities or litigation that have not been fully priced into the deal.

Raising finance
Lenders providing private financing for a transaction often seek access to, and may receive, a duty of care over the FDD findings. Practice varies between markets, however, lenders typically receive a duty of care for specific deal finance in Europe but not in the US and some developing markets. The FDD provides finance providers with a view on the target's financial performance (such as leverageable free cash flow), which can help them to determine what the appropriate level of financing should be.

Other third parties (including W&I providers and rating agencies)
A range of other parties may also request access to the FDD findings. This includes potential providers of W&I insurance for a transaction. They will often use the FDD (alongside other areas of due diligence, including tax) as a source of background information on key risks and to help judge whether to offer W&I coverage and any coverage restrictions. Due diligence is not performed for the purpose of pricing a W&I insurance policy, nor for rating listed debt. Access is typically only provided on a non-reliance basis. See the third-party access section on page 21 to find out more.

INPUT INTO OTHER AREAS OF DUE DILIGENCE

In addition to the core FDD, a potential investor will typically perform other due diligence on broader matters. Such due diligence may require input from and interaction with the FDD workstream. However, the FDD practitioner would not owe a duty of care to the client on how their work was used by other due diligence practitioners.

A range of non-financial matters can crossover with the FDD, depending on the transaction. The following four areas are likely to require the greatest level of coordination.

Value creation hypotheses

Insights from due diligence will shape and have input into an investor's value creation plans. These are typically driven by commercial and operational areas, such as expansion into new markets and products, and operational efficiencies or synergies. This operational and commercial work is often conducted by industry experts. They often refer to the FDD for insights in areas such as the target's existing cost base, profitability and geographical reach to understand the scope and scale of potential value creation opportunities.

Tax structuring

The insights gained from tax due diligence can help to structure the acquisition in the most efficient way. This often requires input from the FDD workstream in areas such as historical profitability and the risks and vulnerabilities to the financial forecasts. Key structuring considerations include:

- how to fund the acquisition between debt and equity given debt capacity and interest deductibility;
- potential opportunities post-acquisition, such as the centralisation of functions, rationalisation of legal entities and adjustments to transfer pricing strategy;
- use of the target's tax losses, tax credits or capital allowances to set against its taxable income; and
- asset purchase rather than a share purchase.

Regulation

Regulatory due diligence reports are often commissioned in highly regulated industries such as utilities and financial services. The regulatory due diligence practitioner often draws on the FDD to provide information about areas such as the extent of the regulated asset base or potential restrictions on cash extraction.

ESG

ESG evaluations are typically wide-ranging, but often require input from FDD teams to understand:

- the financial impact of regulations (for example, the EU's Corporate Sustainability Reporting Directive);
- the extent of climate-related provisions held on the balance sheet;
- potential incremental costs associated with enhanced ESG reporting (to the extent not fully reflected in the cost base); and
- the basis of calculation of liabilities for remediation/decommissioning costs in extractive industries.

LEVELS OF VERIFICATION

FDD does not involve audit-style procedures to verify financial information. FDD practitioners will state in their engagement letter and report that the content does not represent an audit. However, the FDD practitioner should exercise professional scepticism when considering information and explanations supplied by management and seek suitable corroboration.

While the level of information considered as part of FDD will ultimately be determined by the nature of the process and scope of work, the process largely relies on the factual accuracy of management information, Q&A responses and audited financial statements (if available) as the basis for the findings.

If ad hoc breakdowns and additional supporting information (such as transactional-level data to understand the drivers of revenue and gross margin performance) are used as part of FDD, they will generally be reconciled back to either the summary management accounts or statutory financials to establish their reliability.

To improve a user's understanding of the depth of the work performed and help identify potential gaps, the outputs from FDD should:

- clearly set out the scope of work performed and any limitations to completing this;
- clarify the key sources of information that were used and the level of access to both information and management that was received;
- perform internal consistency checks between data sources used to identify inconsistencies and set out the reasons for such differences; and
- comment by exception, because the FDD practitioner cannot confirm the reliability of the data used, and any associated impacts on the analysis performed and resulting insights.

Additional cross-checking
In some cases, underlying records may be considered as part of the FDD process. This often occurs when there is a higher risk of accounting misstatements – for example, where accounting profit does not correlate with cash generation or where an audit may not have been performed (in particular, in emerging markets). However, these steps should be discussed at the outset of an engagement and the level of access agreed with the target.

As part of a VDD process, management teams provide confirmation of the accuracy of the information included in the FDD through a representation letter from senior management to the FDD practitioner. While target management teams do not generally review or have access to the findings of buy-side due diligence, they might comment on certain areas in proprietary and exclusive deals, particularly where no sell-side due diligence has been carried out, and provide confirmation of factual accuracy.

THIRD-PARTY ACCESS

Non-reliance arrangements
With the agreement of the party that commissioned the due diligence, the FDD practitioner may consent to provide access to and sight of the FDD deliverables to a third party that has requested it under a non-reliance arrangement. The FDD outputs or deliverables are commissioned solely to meet the commissioning party's specific needs and the non-reliance terms will make that clear. However, during scoping, clients may have other users in mind. Examples include private equity purchasers, who may tailor the scope to help provide information for the financing bank.

The terms of access are usually set out in a non-reliance letter, which the recipient must sign. Non-reliance arrangements can also be established implicitly. For example, the engagement letter may include terms allowing the client to share the FDD report with their other advisers as long as they state that it is on a confidential and non-reliance basis. On occasion, particularly in relation to a VDD report, the non-reliance terms may also be agreed to via a click-through mechanism in a VDR. However, market practice varies in this respect.

Duty of care
The FDD practitioner, with the agreement of the commissioner of the due diligence, may consent to extending a duty of care to certain third parties as part of the FDD process through an assumption of duty letter. Typically, this is limited to providers of new finance (debt and co-equity investors) to fund the transaction, so long as their interests are aligned with those of the client and the party that commissioned the due diligence agrees. In the US, it is market practice that no extensions of the duty of care are given beyond the client.

Limitations on access to audit working papers
If the FDD practitioner carries out a review of the audit working papers during the FDD process, this will have implications for third-party access to the report. For the due diligence team to have access to the working papers and hold discussions with the target's auditors, the audit firm is likely to require a hold-harmless letter with both the client and the FDD practitioner. This letter can include indemnity clauses. While not always the case, in the UK (and some other jurisdictions), the auditor's hold-harmless letter may contain clauses requiring anyone accessing the FDD report to agree to the terms of the letter.

It can be impractical for the FDD practitioner to ensure third parties sign up to these arrangements. Therefore, increasingly, audit working papers are not reviewed at all, or audit working paper access often comes late in the FDD process. By this time, the number of third parties requiring access to the final FDD report is more limited, for example when the selection of financing bank(s) has been completed.

THIRD PARTIES TYPICALLY REQUESTING ACCESS INCLUDE:

Providers of finance (usually on a reliance basis)
- Equity co-investors, who are not addressees of the FDD engagement letter, as they only become involved in the transaction and known to the FDD practitioner after the diligence work has been undertaken. This is a common feature of private equity deals, for example where a limited partner (co-investor) also takes a direct stake in the deal. Such investors are likely to have similar requirements and aligned interests with the original client and may therefore not want to commission any supplementary work themselves. Instead, they will send a representative to key meetings with the target company and the FDD practitioner. It is therefore important for practitioners to remain objective, as defined by the fundamental principles, to ensure the work done is appropriate for all stakeholders.
- Financing banks, which are likely to focus on the underlying cash generation of the business and the downside risks identified in the FDD materials. They will often request an opportunity to discuss the FDD findings with the practitioner preparing the report to clarify matters of particular interest to them.
- Credit funds, which have become an increasing source of finance for private equity deals and invest in both the senior debt and preferred equity instruments. Their requirements are likely to be closely aligned with those of the private equity client and financing banks, including their due diligence requirements.

The client's other advisers acting on the same transaction and for the same purpose (non-reliance basis)
- Lawyers, to ensure that relevant issues identified are addressed in the SPA.
- The lead adviser, to support negotiations (for example, valuation, enterprise value (EV) to equity bridge items and earn-out structures).
- Operational, commercial and ESG due diligence practitioners, to ensure the findings of these other workstreams align with the findings in the FDD report. There may also be reciprocal arrangements to access the other advisers' materials.

Other parties (non-reliance basis)
- W&I insurers, who will be looking at whether to provide protection for the vendor against claims and ensure that there will be funds available for the purchaser if they subsequently make a claim. The W&I insurers (brokers and underwriters) are likely to request access to the FDD report and may request an opportunity to discuss the findings.
- Rating agencies may also request access when providing credit ratings for debt instruments used within the transaction.

REGULATORY MATTERS AND PROFESSIONAL OBLIGATIONS

Several regulatory requirements may apply – although not specifically about the FDD process – and managing these can be complex. Such requirements also change over time. Each transaction is likely to involve a number of such requirements, some of which will be relevant to practitioners, their clients, potential investors, the target or a combination thereof.

Potential investors and targets typically engage legal advisers to assist in managing their regulatory requirements and disclosures for a transaction. This guideline does not cover these obligations. Rather, the commentary here focuses on the key auditor independence and regulatory considerations for FDD practitioners and their clients.

Anti-money laundering and know your customer checks
Practitioners are required to verify the identity of clients and their ultimate beneficial owners. They also need to obtain information on the intended purpose and nature of each proposed engagement (including the source of funds). Once the engagement is underway, it is important to keep looking out for any warning signs that funds for a transaction are not of legitimate origin.

Sanctions
International sanctions are subject to frequent changes. Both practitioners and clients should carry out and document enquiries to make sure they are comfortable that an engagement or a particular transaction would not result in a breach of sanctions restrictions.

Ethical guidelines
Practitioners should identify and manage conflicts of interest and have the necessary competence to undertake an engagement. This includes:

- **Auditor restrictions:** Practitioners should consider the implications of providing due diligence services alongside both existing and prospective audit engagements. Firms must avoid conflicts of interest that could arise from acting in both capacities, ensuring that the audit remains impartial and preventing any self-review threats. Practitioners should also be aware of all applicable regulatory frameworks that apply to the audit relationship and follow each framework's specific rules (for example, not providing prohibited services to audit clients, and adhering to fee caps for non-audit services). Applicable regulatory frameworks will vary by jurisdiction. Under the Financial Reporting Council's (FRC's) Ethical Standard, due diligence is prohibited for audit clients that are public interest entities (PIEs).
- **Other conflicts of interest:** In addition to auditor restrictions, practitioners should ensure that there are no other potential conflicts that would prevent them from accepting an engagement. A typical example would be a buy-side team reviewing a VDD performed by a different team at their organisation, or where a firm is working with more than one bidder. Another example would be a buy-side team performing FDD on a listed client audited by the same firm, where consent for the buy-side team to act may be required from the target company. If conflicts of interest are identified, appropriate safeguards should be put in place to maintain appropriate levels of confidentiality and objectivity. These might include separating the staff working on the different engagements as part of an 'ethical wall' arrangement. However, if the required levels of confidentiality and objectivity, as defined by the fundamental principles in ICAEW's Code of Ethics, cannot be maintained, then practitioners should decline the engagement.

Contingent fee arrangements
Contingent fee arrangements are not appropriate in any due diligence engagement as they could compromise objectivity. Differential fee arrangements may be acceptable in other scenarios such as buy-side transactions provided the differential is at a level that does not compromise objectivity and reflects the additional risk of providing an FDD report on a completed transaction. FDD practitioners should refer to the supplementary guidance to ICAEW's Code of Ethics. Note also that some jurisdictions limit this. For example, they are prohibited in connection with US Securities and Exchange Commission (SEC) restricted clients.

Competence
It is clearly important to ensure that the team undertaking the work has the capabilities to cover all areas of the scope, as defined within the ICAEW Code of Ethics fundamental principles. If not, firms may choose to supplement their expertise with independent contractors or exclude certain aspects of the scope.

Additional notification and reporting requirements
An M&A transaction is often a significant event for a target and potential investor or purchaser. It can therefore trigger additional reporting requirements or elevated risks for both clients and practitioners who are dependent on the financial reporting requirements under which they operate. Examples include requirements in relation to cross-border tax matters or the business's ability to fund a defined benefit pension scheme. Potentially impacted parties typically seek legal advice on the relevant requirements to ensure they are compliant.

It is important to ensure that practitioners appropriately consider, document and, where relevant, disclose such notification and reporting matters as part of an FDD engagement. Where applicable, practitioners should satisfy themselves that their client is taking appropriate advice – for example, in relation to potential M&A or refinancing transactions involving a party with a UK defined benefit pension scheme.

The notification and reporting requirements will depend on the nature of the transaction. Specific additional independence and ethical guidelines may also apply to certain types of work or clients. For example, transactions involving public companies often require practitioners and clients to put in place additional measures under Market Abuse Regulations (MAR), such as an insider list.

CLOSING REMARKS

Financial due diligence is key to enabling informed decisions about proposed transactions. Whether undertaken in-house or with the support of professional advisers, it supports sellers, purchasers and providers of finance by enhancing knowledge about the financial performance of a business.

The scope and phasing of the work needs to be tailored to the circumstances of the transaction, deal process, local market practice and the specific needs of the users of the deliverables. The rapidly evolving landscape in data analytics and AI technology provides exciting new opportunities for the depth and breadth of work that can be performed and, therefore, the level of insight generated.

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The Corporate Finance Faculty is ICAEW's centre of professional expertise in corporate finance. It contributes to policy development and responds to consultations by international organisations, governments, regulators and other professional bodies. It provides a wide range of services, information, guidance, events and media to its members, including its highly regarded magazine Corporate Financier and its popular series of best-practice guidelines.

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ICAEW is working towards becoming net zero

* includes parent companies. Source: ICAEW member data February 2024, Interbrand, Best Global Brands 2023

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