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PRE-DEAL PREPARATION:

The role of audits, financial due diligence, and M&A forensic risk services

Floyd Advisory

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Imagine this scenario: An established company contemplates acquiring a target. The company ensures that the purchase agreement includes a representation that the target's financial statements are audited and presented in accordance with U.S. GAAP. The company hires a well-regarded accounting firm to perform the financial due diligence ("FDD"), including a detailed quality of earnings ("QofE") analysis. Yet, weeks after the deal closes, the company finds itself entangled in a post-acquisition dispute over multiple items on the balance sheet. With all the careful preparation put in prior to the closing of the transaction, how could this happen?

Unfortunately, this scenario happens frequently. While financial statement audits and FDD are not required to complete an acquisition, they can be, and often are, critical services in the pre-deal period. However, neither of these services are specifically designed to mitigate the risk of post-closing disputes. That service is commonly referred to as M&A Forensic Risk Services ("FRS").

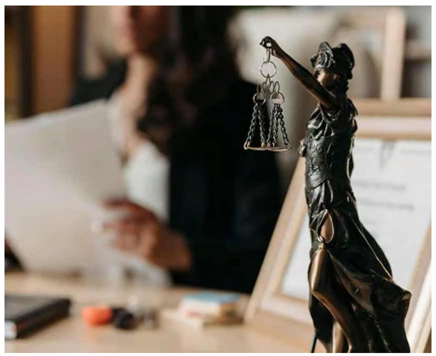
Audits, FDD and FRS

<u>What are they designed to do?</u>

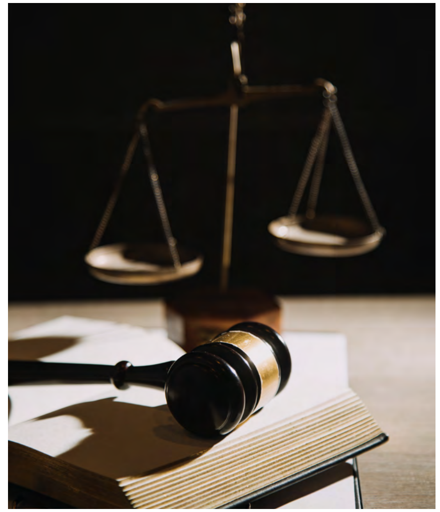
While audits, FDD, and FRS are all services that can be performed in the pre-transaction period to promote success post-transaction, the objective of each service can vary widely.

The objective of an audit is to obtain reasonable assurance that a set of financial statements, taken as a whole, are free of material misstatement. By nature, audits are historically focused rather than forward looking. Financial statement audits are likely to provide a starting point for FDD, and while they may boost stakeholder confidence, they alone are unlikely to uncover the most significant issues relevant to a prospective buyer.

FDD, on the other hand, is designed to inform forward-looking deal decisions. It typically, though not always, utilises fiscal year or trailing-12-months ("TTM") data. FDD evaluates a target's financial health and identifies risks that could affect the deal value such as aggressive revenue recognition practices or revenue tied to contracts nearing expiration, high customer concentration, seasonality, or margin compression. An FDD report usually includes a QofE analysis and provides



a picture of the company's sustainability and profitability. It also may highlight non-recurring items such as one-time legal settlements, gains or losses on asset sales, or temporary cost reductions. FDD may also help in the understanding of the target company's revenue and profitability forecasts, as the identified risks can distort normalised earnings and affect future performance.



FRS is designed to limit the risk of post-transaction disputes and to manage areas of accounting judgment. These services often involve a detailed review of the FDD report, an assessment of proposed contractual language in the purchase agreement, and the identification and evaluation of any line items on the balance sheet or income statement that are particularly subjective or judgment based. This analysis often includes reviewing key contractual provisions for ambiguity and replacing generic language with precise definitions to avoid conflicting contract interpretations. FRS advisors often work with legal counsel and can draft or refine purchase agreement language to help prevent or mitigate net working capital or earnout disputes. They may also prepare illustrative schedules and example calculations to demonstrate how the contractual provisions will operate in practice and compare proposed definitions to the target's historical accounting policies to make sure they are aligned.

Characteristic	Audit	FDD	FRS
Evaluation of specific balance sheet and income statement accounts	X	X	X
Provide opinion & reasonable assurance	X		
Assess internal control environment	X		
Forward-looking focus		X	X
Identify non-recurring items & adjust EBITDA		X	
Advise on contract language and mitigate risk of post- deal disputes			X
Historical focus	X		

What are the blind spots?

It is also important to understand the limitations of audits, FDD, and FRS. This can help ensure that a buyer isn't under the impression that their service providers have provided more assurance than they have.

Audits are not built to detect fraud or manipulation unless such items are material. Something immaterial in an audit context can still trigger a post-acquisition dispute. For example, a small difference in how bonuses are recorded could significantly affect a net working capital true-up or earnout calculation, even if the auditors viewed it as immaterial to the financial statements as a whole. Due to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements may not be detected.

FDD relies on management-provided information. If the underlying data is flawed, so is the analysis. While FDD professionals can flag issues in the income statement, they often place less emphasis on the balance sheet. They typically do not investigate company policies, off-balance sheet liabilities, or changes in accounting standards that could impact the buyer. FDD teams may also lack experience in post-acquisition disputes, and therefore may miss areas where accounting judgment can be contested.

FRS is most effective after an audit or FDD report is available, but it is not dependent on them. Additionally, while forensic advisors have the expertise to identify areas of judgment that could trigger future disagreement, they cannot eliminate the possibility of post-acquisition disputes entirely. Instead, their goal is to reduce risk and ensure clear, unmistakable contractual language.

Mind the "Gap"

Buyers should avoid relying on any single pre-deal tool. Each has limitations. The best approach is to combine multiple assessments. Where possible and practicable, audited financials should be obtained. Audits help validate the financial baseline, but they are not sufficient to assess transaction-specific risks. An audit is a complement to the FDD process, not a substitute. Additionally, an audit may be helpful to the FDD process by offering a point of comparison for historical treatment and the consistency of accounting policies. The FDD process itself would also help to flush out differences in year-end closing practices versus interim practices. If an audit is not available, buyers do not always need to commission one. Instead, the FDD should be scoped more broadly to fill that gap.

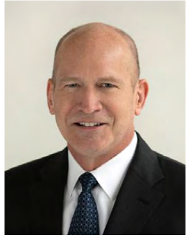
FDD reports often focus on QofE and emphasize income statement results and profitability. This can leave balance sheet items under-examined. As a result, buyers may face post-closing disputes tied to working capital or find that the target lacks enough capital to operate.

To address these risks, buyers should engage FRS advisors early in the deal process. These professionals build on the audit and FDD results, test areas of judgment and subjectivity, and align financial findings with contractual language. This can help refine definitions for critical balance sheet line items such as indebtedness, reserves, or deferred revenue.

Conclusion

Let's return to our buyer. They took prudent steps: they obtained audited financial statements as well as a full FDD report, including a QofE. But they still ended up in a post-acquisition dispute. Why? Because these tools, while valuable, may not be enough on their own. Each has blind spots. A clearer understanding of these limitations, along with early involvement from FRS advisors might have helped them avoid the conflict altogether.

Understanding the connection between audits, FDD, and FRS is key to executing a smooth acquisition. The best protection against post-acquisition disputes is not a single service, but a coordinated strategy that identifies risk, probes assumptions, and clarifies obligations before the deal closes.



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