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“The Role of Financial Due Diligence in Evaluating Target Companies for Mergers and Acquisitions: A Sectoral Analysis”

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ABSTRACT

Mergers and Acquisitions (M&A) have become a key tool for growth, consolidation, and creating value in today's changing business environment. However, the success of these transactions depends on making informed decisions. This is where Financial Due Diligence (FDD) is essential. This research paper looks at the role and importance of FDD in evaluating target companies during M&A, focusing on how specific industry factors affect the thoroughness and nature of the diligence process. Using both secondary research and practical insights gained from a two-month internship, the study presents a step-by-step analysis of how FDD is carried out, particularly in the Fast-Moving Consumer Goods (FMCG) sector. The findings show how FDD helps reveal financial problems, evaluate working capital and cash flow situations, and support negotiations through accurate EBITDA adjustments and identifying risks. The paper concludes that FDD is not just a way to validate finances but also a strategic tool that ensures M&A outcomes are more secure and focused on creating value.

Key Words

Core Concepts	Financial Components & Techniques	Processes & Tools
Financial Due Diligence (FDD)	Income Statement Analysis	Data Request List (DRL)
Mergers and Acquisitions (M&A)	Balance Sheet Examination	Quality of Earnings (QoE)
Target Company Evaluation	Cash Flow Analysis	Forecasting
Valuation	Working Capital	Financial Modelling
Risk Assessment	EBITDA Normalization	Vertical and Horizontal

		Analysis
Strategic Decision-Making	Net Debt Adjustment	Ratio Analysis
Deal Negotiation	Tax Exposures	Document Review
Post-Merger Integration	Contingent Liabilities	Management Discussions
	Red Flag Reports	

INTRODUCTION

What is Financial Due Diligence?

Fundamentally, financial due diligence is a thorough examination of the performance, potential risks, and financial health of a target company. It involves more than just going over financial statements. Rather, it examines the key facets of a business's financial operations and prospects. A thorough investigation known as "due diligence" reveals the facets of a target company's performance, financial standing, and possible hazards. This in-depth analysis uncovers latent dangers that could significantly impact the post-merger scenario.

Business and Financial Due Diligence Process

The financial due diligence process combines skill and method. It starts with gathering evidence, including financial documents like historical statements, tax returns, contracts, and management reports. Collecting this data is just the beginning. The real effort occurs when financial experts analyse this information, searching for trends, anomalies, and potential issues.

This analysis phase reveals the true value of financial due diligence. Experts perform vertical and horizontal analyses of financial statements, conduct ratio analyses, and examine trends in revenue, costs, and profitability.

They focus not only on what the numbers show but also on what they mean. Is that spike in revenue sustainable or merely a one-time event? Does that drop in profitability indicate a temporary issue or something more serious?

Here's a typical roadmap:

1. Gather the evidence: Collect financial statements, tax returns, contracts, and other relevant documents.
2. Analyse the data: Look for trends, anomalies, and potential issues.
3. Ask the tough questions: Dig deeper into areas that seem unclear or concerning.
4. Assess the risks: Identify potential financial, operational, and legal risks.
5. Project the future: Use historical data to create financial forecasts.

The focus of the investigation shifts to risk assessment as it moves forward. Financial due diligence isn't just about knowing where a company has been; it's also about figuring out where it might go. Experts look for possible financial risks, such as having too many customers in one area or relying on cyclical business. They assess operational risks, like weaknesses in the supply chain. They also consider legal and regulatory

risks that could affect how well the company performs in the future,

What Financial Due Diligence Does in M&A Deals Financial due diligence is vital in mergers and acquisitions (M&A). First and foremost, it is essential for determining value. Checking the target company's financial claims and looking for possible synergies help find a fair price to pay for the company. It can also provide information that might lead to adjusting the price up or down. Financial due diligence is a valuable way to assess risk in addition to valuing an asset. It uncovers hidden risks or debts that may not be obvious from just reviewing financial statements. It considers how long past earnings are likely to last and how reliable financial forecasts are. This information is incredibly helpful for potential buyers because it reveals issues that could arise before finalizing a deal.

RESEARCH OBJECTIVE

The main goal of this research paper is to explore the significant role that financial due diligence (FDD) has in assessing target companies during mergers and acquisitions (M&A). The objectives seek to provide a clear and detailed understanding of different aspects of the FDD process, highlighting the differences between sectors. Each objective assists in evaluating how FDD helps stakeholders make informed, data-driven decisions.

1. To understand the role of financial due diligence in M&A transactions

Financial due diligence is an essential part of the M&A process. This objective examines how FDD helps identify financial strengths, weaknesses, and risks before finalizing a deal. It assesses how FDD acts as a validation tool that provides transparency to buyers. This transparency helps them decide if the target company's financials really justify its valuation. The process uncovers inconsistencies in accounting practices, overstatements in revenue or profit, and potential hidden liabilities.

2. To identify key financial components assessed during due diligence

A key goal of this study is to outline the financial areas examined during the FDD process. These usually include income statements, balance sheets, cash flow statements, working capital trends, off-balance sheet items, contingent liabilities, and tax exposures. Each of these components reveals different aspects of a company's financial health and sustainability. Understanding how each part contributes to the overall assessment of the target business is central to the research.

3. To analyse how sector-specific factors influence FDD procedures

Different sectors have unique business models, regulatory rules, and financial structures. This makes a one-size-fits-all approach to due diligence ineffective. This goal examines how FDD professionals change their strategies based on the sector being analyzed. For example, in the FMCG sector, inventory turnover and distributor risk might be prioritized. In a tech startup, recurring revenue, burn rate, and intellectual property are major concerns. The research aims to show how these sector differences affect the scope, depth, and

focus of due diligence activities.

4. To examine how FDD supports strategic decision-making in M&A

FDD findings extend beyond just financial checks and can guide broader strategic decisions. This goal analyses how FDD helps buyers find chances for value creation, negotiate better terms, or even rethink a deal altogether. It looks at how insights from FDD reports are used in business models, integration plans after a deal, and forecasts of synergies. The aim is to demonstrate that FDD is not just a compliance step; it is a strategic tool that can change the course of a transaction.

5. To evaluate post-transaction effects of FDD findings

The final goal focuses on how FDD findings impact the post-merger or post-acquisition phase. It examines how changes to the purchase price, earn-out clauses, or escrow arrangements are based on issues raised during due diligence. It also assesses how post-deal integration—such as financial reporting, restructuring, or legal compliance—is shaped by the FDD completed before the deal. The research discusses the ongoing role of FDD advisors in monitoring the deal's performance and the realization of synergies after the transaction is completed.

LITERATURE REVIEW

Due diligence has emerged as a critical component in mergers and acquisitions (M&A), guiding valuation, risk assessment, and post-transaction outcomes. The existing literature emphasizes that due diligence is no longer confined to routine financial checks; instead, it operates as a strategic tool that shapes decision-making throughout the M&A process.

Howson (2017) presents due diligence as a forward-looking and value-driven exercise. He explains that effective due diligence extends beyond legal and financial verification to include operational systems, commercial viability, environmental obligations, and intellectual property considerations. His work outlines a structured approach for planning and executing due diligence, supported by practical checklists and real-world examples. Howson's findings reinforce that detailed financial assessments—particularly of maintainable profits and cash flows—play a crucial role in determining accurate valuation and ensuring deal feasibility.

Dwiyanti and Wondabio (2023) examine the role of financial due diligence (FDD) in banking mergers and acquisitions during the volatility of the COVID-19 pandemic. Their study highlights that robust FDD became essential in managing liquidity pressures, regulatory shifts, and increased credit risks. Key elements such as loan portfolio quality, non-performing assets, capital adequacy, and tax exposures were found to significantly influence valuation outcomes. The authors conclude that comprehensive FDD not only reduces financial uncertainty but also supports smoother post-merger integration and maintains stakeholder

confidence during crisis periods.

Ceill (2013) provides a foundational perspective by emphasizing due diligence as a comprehensive investigative process that evaluates legal compliance, financial health, tax positions, operational efficiency, and strategic alignment. The study argues that inadequate due diligence can lead to overvaluation, legal disputes, and integration challenges, ultimately reducing transaction value. Ceill also notes that due diligence enables firms to renegotiate deal terms, implement risk-mitigation measures, and involve multidisciplinary experts for a more complete evaluation. His work aligns with Howson's view of due diligence as a proactive, value-enhancing activity that should be embedded within all stages of M&A planning and execution.

Together, these studies underscore that due diligence functions as a strategic mechanism for risk identification, valuation accuracy, regulatory compliance, and long-term value creation within M&A transactions.

RESEARCH METHODOLOGY

This study takes a qualitative research approach based on:

- Secondary data from industry reports, FDD case studies, and academic journals.
- Sector insights gained through an internship at a leading FDD firm, EY.
- A comparison of due diligence practices across sectors, including FMCG, tech, and infra.

The research uses descriptive and analytical methods to interpret how financial variables are assessed and modified according to sector-specific needs.

DATA ANALYSIS

This analysis reflects my hands-on experience during my internship, where I took part in two live M&A financial due diligence (FDD) engagements in the Fast-Moving Consumer Goods (FMCG) sector. The goal was to learn how FDD is performed in real-time, covering data collection, financial analysis, identifying red flags, and assisting clients in negotiations.

The process began by understanding the deal context, whether buy-side or sell-side. I reviewed the Confidential Information Memorandum and financial statements. FMCG targets usually operate on thin margins, so the early analysis focused on expense trends and revenue reliability. We shared a structured data request list (DRL) with clients. This list included audited financials, GST filings, inventory reports, and sales ledgers, paying special attention to product-wise and channel-wise sales data.

The Quality of Earnings (QoE) analysis aimed to normalize EBITDA by removing non-recurring items and adjusting for underreported expenses, particularly trade promotions that distorted true earnings. Revenue

and margin analysis included year-over-year (YoY) and month-over-month (MoM) trends, reconciled against GST data to spot inconsistencies. Often, secondary sales were recorded before cash was collected, needing timing adjustments.

The working capital assessment uncovered extended credit periods given to distributors, with receivables being a significant part. The inventory analysis pointed out risks related to slow-moving or seasonal products, frequently lacking adequate provisioning. Debt analysis covered short-term working capital loans and unrecorded trade promotion liabilities.

The tax checks focused on mismatches in GST input tax credit claims and unfiled reconciliations, which could lead to contingent liabilities. In the final reporting stage, we compiled red flag reports and summary memos that clearly showed EBITDA adjustments and working capital trends, which were crucial during deal negotiations.

Through participation in internal calls and client presentations, I saw how FDD insights influenced pricing discussions, escrows, and purchase price adjustments. This entire process reaffirmed the important role of financial due diligence in reducing risks in transactions and supporting informed decision-making, particularly in sector-specific contexts like FMCG.

FINDING/DISCUSSION

- Financial Due Diligence is not a one-size-fits-all process. The depth, focus, and techniques vary by sector.
- FDD helps uncover hidden risks and gives the acquirer negotiation leverage.
- Sector-specific factors—like distributor risks in FMCG or revenue recurrence in tech—can drastically alter valuation and deal feasibility.
- FDD firms bring value not only pre-deal but also post-transaction through integration support and financial clean-ups.
- Findings from real-life FMCG due diligence highlight how adjusted EBITDA and working capital findings can influence pricing or even lead to renegotiation.

CONCLUSION

Financial Due Diligence (FDD) plays a pivotal role in the M&A process by ensuring that decisions are grounded in accurate financial insights, realistic projections, and a clear understanding of potential risks. It goes beyond surface-level financial reviews and dives into the core elements of a company's operations—uncovering hidden liabilities, normalizing earnings, and validating working capital positions. This research has demonstrated that FDD is not a uniform process; it varies significantly across sectors, with FMCG companies requiring a focus on distributor margins, inventory turnover, and promotional adjustments, while

sectors like technology or infrastructure present entirely different challenges.

Through my internship experience at EY, I gained practical exposure to the application of FDD in real-world M&A scenarios. From preparing data request lists and analyzing financials to contributing to red flag reports, I observed how FDD findings directly impacted deal negotiations and valuations. Sectoral knowledge, combined with analytical tools, helped refine our understanding of target companies' financial health and strategic fit. Ultimately, financial due diligence serves as a critical safeguard in M&A—protecting buyers from hidden pitfalls and empowering them to make more confident, informed investment decisions.

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