DEZAN SHIRA & ASSOCIATES

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Case Study

Adjusting Inaccuracies in Financial Statements via Due Diligence

In the process of acquiring a Chinese company, an overseas health and wellness firm was unsure of the accuracy the target company's financial statements and profitability status. A comprehensive due diligence provided a clear understanding of the target company to successfully negotiate an acquisition.

Challenges

The target company's accounting practices created uncertainty regarding the true profitability status presented in their financial statements. Our client required a clearer picture to proceed with the negotiation process and close the deal.

Solutions

We conducted an in-depth investigation of the target company' financial documents and rectified any inaccuracies to reflect the company's true financial position.

Impacts

With an accurate financial assessment, our client was able to negotiate a new acquisition price that was 40 percent lower and mitigate previously unknown operational risks that our team uncovered during the investigation.

CHALLENGE: Inaccurate accounting resulting in skewed financial assessments

A US client considering the acquisition of a China based company in the health and wellness sector needed to better understand the financial situation of the target company to submit an appropriate offer price. Poor accounting and bookkeeping practices by the target company led our client to be concerned about the true profitability status presented by the company's financial statements.

While the target company's income statement showed that they were running at a profit, the suspected inaccuracy of their accounting and bookkeeping practices concealed the target company's true financial situation.

Our services were engaged to conduct in-depth due diligence of the target company's current financial situation, with particular attention to their sales and profits. Although a tentative acquisition price was discussed between the two parties, our client felt that with professional insight and analysis of the company's profitability status, they could confidently proceed with the negotiations and acquisition.

SOLUTION: Investigation of financial documents, rectification of statements

Our team conducted a detailed investigation into the target company's financial documents. During this time, we found that the company's sales records unreliable. Payments for services were only based on the VAT invoices - the company collected these payments in advance and recorded them as revenue. Many of these services had not been provided in full, which resulted in high revenues in their books.

To gain an accurate understanding of the target company's actual profits, it was crucial for our team to distinguish between services fully provided and those yet to be fulfilled.

An IT system used by the company's operations team for daily management allowed our team to compare the accounting data with the original accounting records and data.

During our investigation, we also discovered that the company did not recognize employee salaries as expenses, and this was paid separately. Our team performed a review of contracts, bank slips, and other supporting materials to identify the nature of each recorded transaction. Thereafter, a series of necessary adjustments were made to the target company's financial statements to reflect the target company's true financial position. After the appropriate alterations, the target company's revenue decreased by 40 percent while its expenses increased by 30 percent.

IMPACT: Accurate company finances, mitigated risks, and a fair acquisition price

After the investigation, our team prepared new financial statement that gave our client an accurate assessment of the target company's business operations and profit status. This clarity of the target company's current business affairs proved invaluable for our client.

We found that that the company was running at a loss and the tentative acquisition price originally discussed was grossly overpriced. Based on the new financial statement complied by our team, our client was able to re-negotiate a price that was 40 percent less than the original acquisition value.

Not only did our client avoid overpaying for this acquisition, but they were also able to prepare for and address potential operational risks which were masked in their initial assessment of the target company. When the services that were recorded as advance revenue by the target company was clearly assessed, it allowed our client to distinguish who to continue providing services to after taking operational control.

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