

Accounting, Analysis and Governance in Complex Deals

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Due Diligence

BMME303

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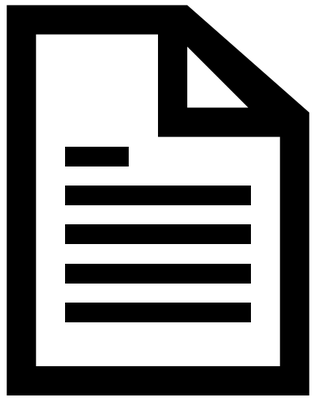
Roadmap

Due Diligence

1. **Motivation** for and basics of Due Diligence (DD)
2. Applying DD-Frameworks with focus on **Risk Assessment**
    i. Tax DD incl. tax basics
    ii. EBITDA Adjustments in Financial DD
    iii. Advanced DD in Guest Lecture: Commercial/Strategic DD & Synergies
3. Economic **Effects** of DD

Starting at the End

Due Diligence



Let’s start asking questions:

- **What** are we reading?
- **Who** reads it (when)?
- **Why** was it written?

Due Diligence

Definition

> **Systematic (i.e., appropriate & required) analysis of a transaction**

Purpose and Objectives

- Reduce **information asymmetries**: understand business (of target)
- Risk identification / risk reduction
- Establish liability framework & document evidence
- Shape structure of transaction

See Dreher and Ernst (2022) for additional details

Analysis of a Transaction?

Due Diligence

Due Diligence Streams

- Financial
- Tax
- Commercial/Strategy
- Legal
- IT
- HR
- […]

Who Cares?

Due Diligence Streams

Example: Bayer acquires Monsanto

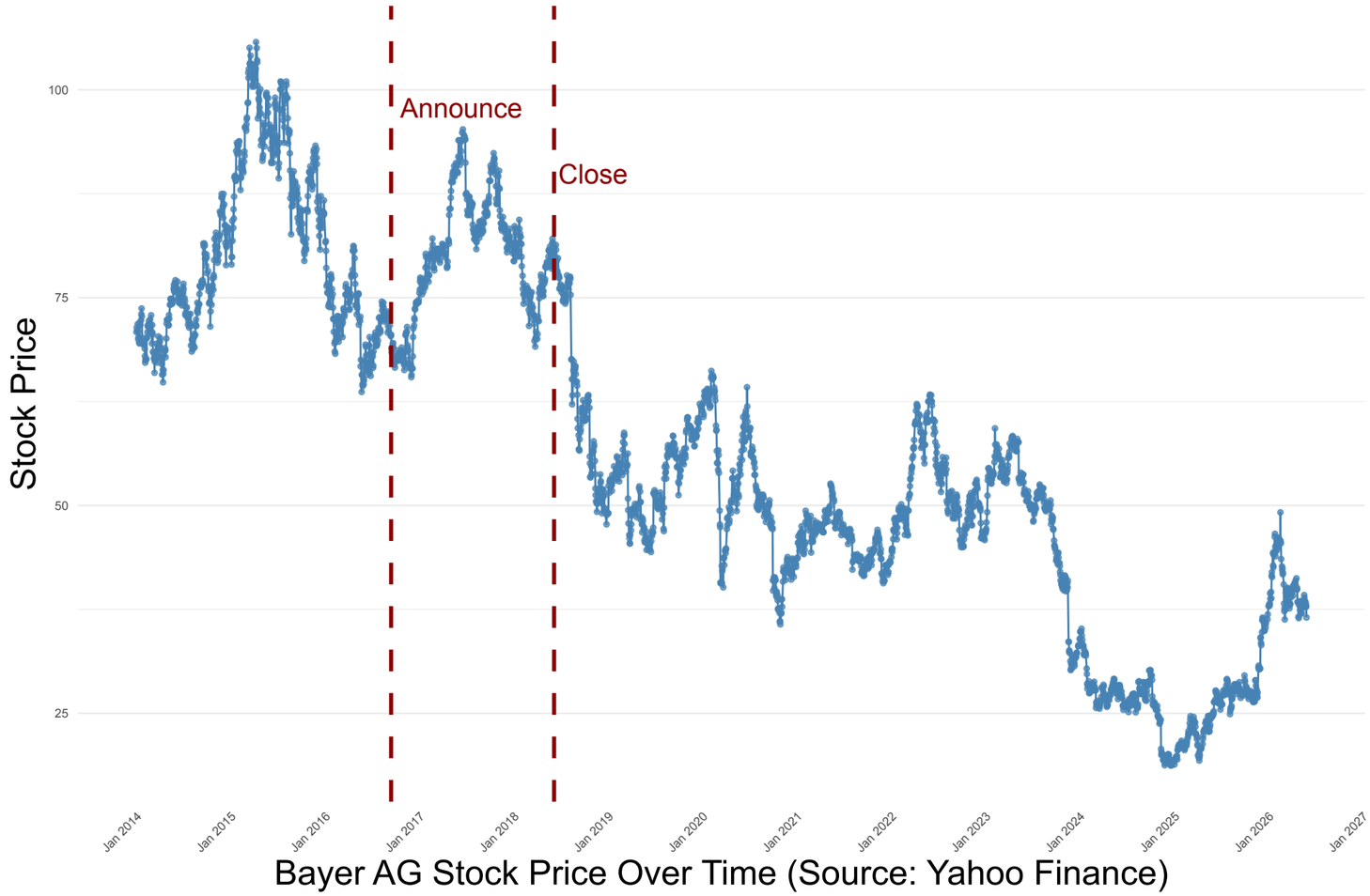
- 2016 for > USD 60bn
- The deal **led to major financial and legal troubles**, especially due to lawsuits over Monsanto's Roundup weedkiller
- **USD 10bn - 20bn** to settle claims/proposed settlements/provisions set aside
- Acquisition heavily strained Bayer's finances

See also this *Ask FT* summary

→ we can only speculate about the diligence in the acquirer's legal due diligence

Who Cares?

Bayer acquires Monsanto



Asking Better Questions?

Our Approach

Develop questions & answers along a specific DD stream: Tax Due Diligence

→ Tax issues/efficient tax planning matters in any transaction: always among DD streams

→ Add: understand **basic tax** triggers in transactions

→ Easy to apply concepts to streams with other focus, such as Financial DD

Tax Due Diligence

Selected DD Streams

Throwback

Menti: What Factors Lead Firms To Acquire a Firm in Another Country?



Tax Complexity & Relevance in Complex Deals



NETHERLANDS

	2016	2018	2020	2022	2024
Overall Tax Complexity	0.32	0.35	0.36	0.35	0.33
Tax Code Complexity	0.49	0.49	0.52	0.52	0.46
Additional Taxes	0.12	0.24	0.18	0.00	0.26
(Alternative) Minimum Tax	0.05	0.12	0.10	0.33	0.49
Capital Gains	0.41	0.37	0.48	0.41	0.40
CFC-Rules	0.49	0.60	0.59	0.59	0.48
Corporate Reorganization	0.56	0.54	0.57	0.50	0.47
Depreciation	0.46	0.46	0.47	0.48	0.40
Dividends	0.46	0.52	0.53	0.53	0.47
General Anti-Avoidance	0.68	0.58	0.66	0.66	0.61
Group Treatment	0.60	0.63	0.66	0.61	0.47
Interest	0.60	0.55	0.58	0.67	0.48
Investment Incentives	0.49	0.50	0.51	0.55	0.49
Loss Offset	0.54	0.48	0.54	0.54	0.50
Royalties	0.36	0.38	0.46	0.47	0.40
Statutory Tax Rate	0.32	0.36	0.32	0.30	0.27
Transfer Pricing	0.71	0.67	0.66	0.70	0.60

Tax Complexity & Relevance in Complex Deals

Selected DD Streams

Tax Complexity

- Significant driver of deal complexity
- Ability to better assess the after-tax cash flows resulting from a transaction offers strategic and financial value
- Tax complexity can impact economic decisions (e.g., on (structure of) transaction)

But why are taxes that important?

Step Aside: Taxes

Why are taxes that important in complex deals?

Tax

A tax is a **levy** by a public entity which does not constitute an entitlement to something in return and is imposed on everyone who meets the criteria of a tax act

Who is Taxed?

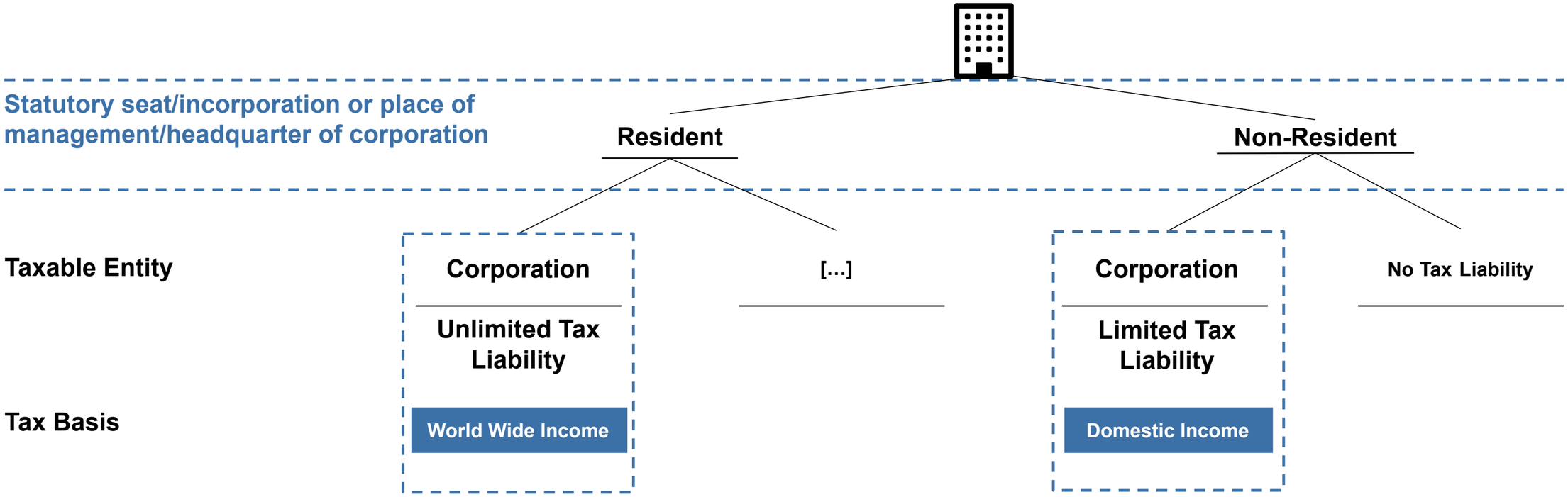
Taxable entity is the entity deemed liable to taxation by a tax act. In the case of corporate income tax, the taxable entity is the corporation

What is Taxed?

Tax basis is the factual situation to which the respective tax act links a tax liability. In case of the corporate income tax, tax basis is the taxable income

Corporate Income Taxation

Overview Taxes



Note: tax law is country-specific. This overview is *not* country-specific but captures the essence of many tax systems around the world.

Corporate Income Taxation

Overview Taxes

Tax basis/taxable income of a business (e.g., corporation) is its **profit**

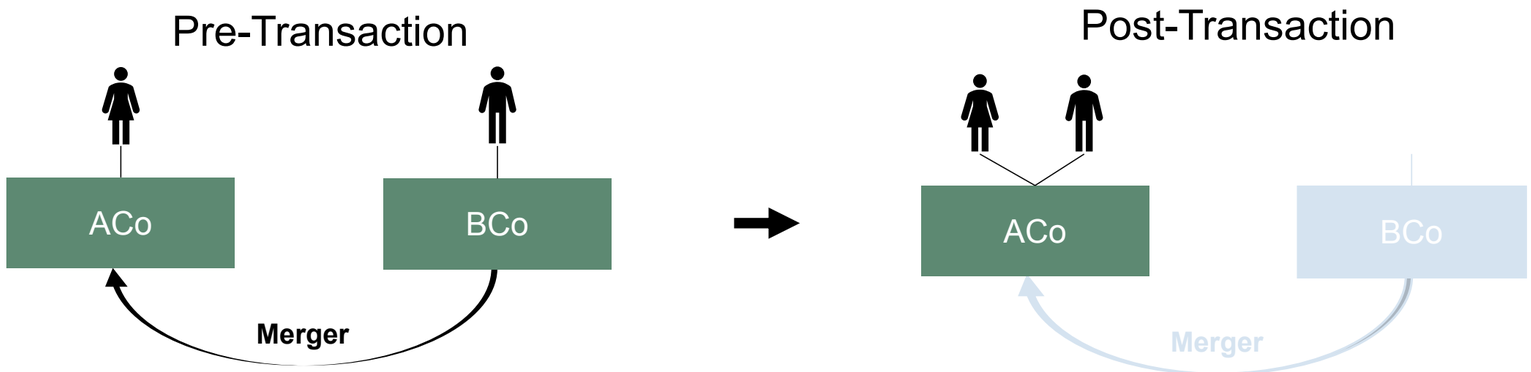
- Profit is determined by measuring a change in net assets from t_{-1} to t
- **Profit = net assets$_t$ – net assets$_{t-1}$ + withdrawals – injections**

Net Assets		**Withdrawal**		**Injection**
Difference between total assets and total liabilities: change from t_{-1} to t	+	Assets which are withdrawn from the business during t	–	Assets which are injected to the business during t

Profit in Transactions?

Overview Taxes

Example: Merger



- Assets are “moved” from transferring to receiving entity
- BCo: all assets/liabilities are **withdrawn** and net assets decrease to zero
- How does tax law value such transfers? Impact on Profit?

Hidden Reserves

Overview Taxes

Profit in Transactions?

- Withdrawals (e.g., all assets in a merger) are generally considered to take place at **Fair Value**
- **Book Value** of assets are based on historical costs & adjustments (GAAP & Tax Acc.)
- If fair value exceeds book value, this **Hidden Reserve** causes an increase in profit
- If BCo's assets contain hidden reserves (e.g., from IP) → **merger causes profit**

▶ Add. Details

Taxes & Transactions

Overview Taxes

Taxable Events

- Rule of thumb: consider transactions as a disposal of *what is transferred* at fair value
- Hidden reserves in *what is transferred* cause taxable gain from transaction
- Applies to any transaction (e.g., acquisition, reorganization) and any level (e.g., shareholders of target)

What is the underlying economic problem when transactions (e.g., mergers) are deemed as taxable events?

Taxes & Transactions

Overview Taxes

What is the underlying economic problem when transactions (e.g., mergers) are deemed as taxable events?

Liquidity Effect

- Transactions/withdrawals trigger taxes (outflow of liquidity) but do not generate liquidity
- Companies might refrain from economically viable transactions
- Taxation locks business in current state of the world

→ *Solution?*

Tax Free Transactions

Overview Taxes

Carryover Basis

> **Implement selected exemptions in tax law that allow transactions to take place in a tax-neutral manner: tax-free transactions at carryover basis**

Example cont'd

- Upon approved request: consider withdrawal at BCo from merger at book value
- Book values of assets are **carried over** to receiving ACo

Tax is effectively **deferred**, not free. Carryover exemptions apply often to reorganizations and stock-paid acquisitions.

▶ Tax Free/Taxable Transactions

Efficient Tax Planning

Tying Things Back to Tax DD

→ Consider the role of taxes when maximizing after-tax returns in transactions

- All Taxes
  - Explicit Taxes (taxes payable to taxing authorities)
  - Implicit Taxes (taxes that are paid indirectly)
- All Parties (consider tax implications for all parties: global/multilateral, rather than unilateral approach)
- All Costs (consider all costs of the transaction (e.g., restructuring costs))
- Tax Minimization Strategies ≠ Effective Tax Planning!

Implicit Taxes

Tying Things Back to Tax DD

> **Implicit Tax on a tax-preferred/free investment is the tax rate that, if applied explicitly to a fully taxable investment, would leave a return equal to the before-tax rate of return on the alternative investment**

- Since taxes might influence deal structure, parties to the transaction might be inframarginal
- **Mechanism?** Minimum- and maximum-prices demanded and offered can diverge → **taxes have a valuation implication**

▶ Implicit Taxes Example

Tax Due Diligence

Stepping back

Tax Due Diligence

Selected DD Streams

Where are we?

Due Diligence is a systematic analysis of the transaction

→ Transaction can trigger taxes: Recommend Actions to be taken in tax DD report?

→ Tax DD goes beyond as it (always) is a Tax Impact Analysis: conclusions from this anticipated tax audit?

Step #1: By whom am I mandated for what?

Information Requirements Differ

Tax DD

By whom am I mandated?

- Financial Buyer: participation only for limited time and scope → tax cash effects
- Strategic Buyer: long-term tax effects → tax optimized integration

Scope of Work

Tax DD

By whom am I mandated for what?

- Tax Due Diligence under tight deadlines
  - Timely evaluation of available information: **efficiency** is key
  - Scope of Work of tax due diligence: restricted by time and content/subjects
- Add: different requirements for **buy side** and **sell side** clients

Scope of Work

Tax DD

By whom am I mandated for what?

Buy Side	Sell Side
Focus on protecting the acquirer from inheriting/creating tax issues	Tax Fact Book or **Vendor Due Diligence**
Identification of (pre & post-acquisition) **tax risks**	Creating a clean tax narrative to maximize selling price
Identification of (post-acquisition) effective tax planning	Preparation of information for potential acquirers to support negotiation

Step #2: Where do/don't I find relevant information?

Internal Information

Sources of Information

> **Target provides information (but hostile takeovers exist!) that is needed to perform (tax) due diligence.**

Always ask for

- Financial Statements incl. Management Report and P&L of past five financial years
- Tax Balance Sheets of past three assessment periods
- Tax Assessment Notices of past three assessment periods
- […]

External Information

Sources of Information

Acquirer can employ information from external sources (e.g. commercial register)

Advantages of limiting information to external sources first?

External Information

Sources of Information

Advantages of limiting information to external sources first?

Notes

- Internal information may be classified as trade secrets
- Often employee representatives must be involved: speculations among employees

Data Room

Sources of Information

> **Required information for examination can be made available to prospective buyers by means of a virtual or physical (on-site) data room**

How to protect sensitive data?

- Establish data room rules
- Personalize access & accounts
- Document (by way of implemented protocol) access
- Restrictions to multiplication of information (e.g., restrict downloads)

Virtual Data Room (VDR) service provider example dataroomx.de

Tax Due Diligence

Tax Risks

Step #3: How do I identify Tax Risks?



- How to identify ***effective post-acquisition tax planning?***
- How and why identify ***historical tax risks?***

Check this guide by Bain & Company on important steps in DD

Ex Post Perspective

Tax Risks

> **Tax effects & risks that are determined and predominantly influenced by economic decisions that take place at/ex post the transaction**

Efficient Tax Planning

- Structure of the transaction
  - Carryover possible/beneficial?
  - Financing strategy (e.g., debt push down)?
- Integration & eventual disposal of the target?

Tax Impact Analysis

Tax Risks

Historical Perspective

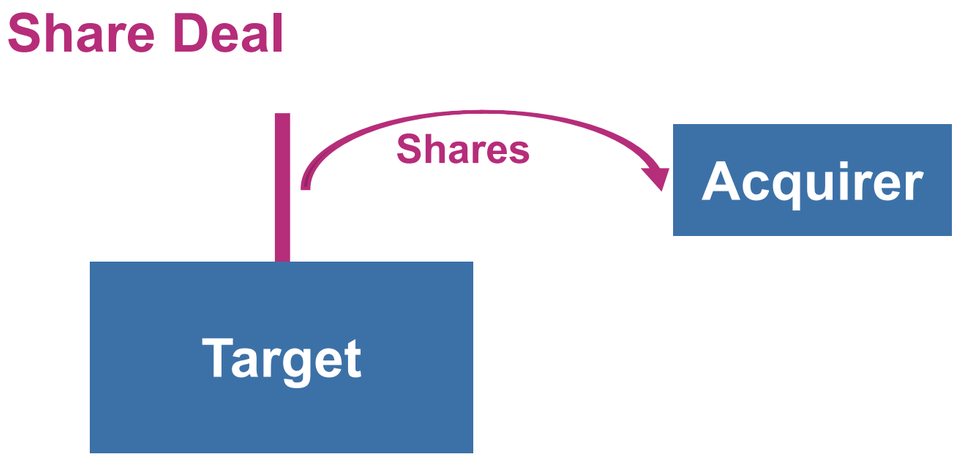
> **Tax effects & risks that are determined and predominantly influenced by economic decisions that take place ex ante the transaction**

→ **determined by a third party (target)**

→ *why relevant for acquirer?*

Acquisitions & Tax Risks

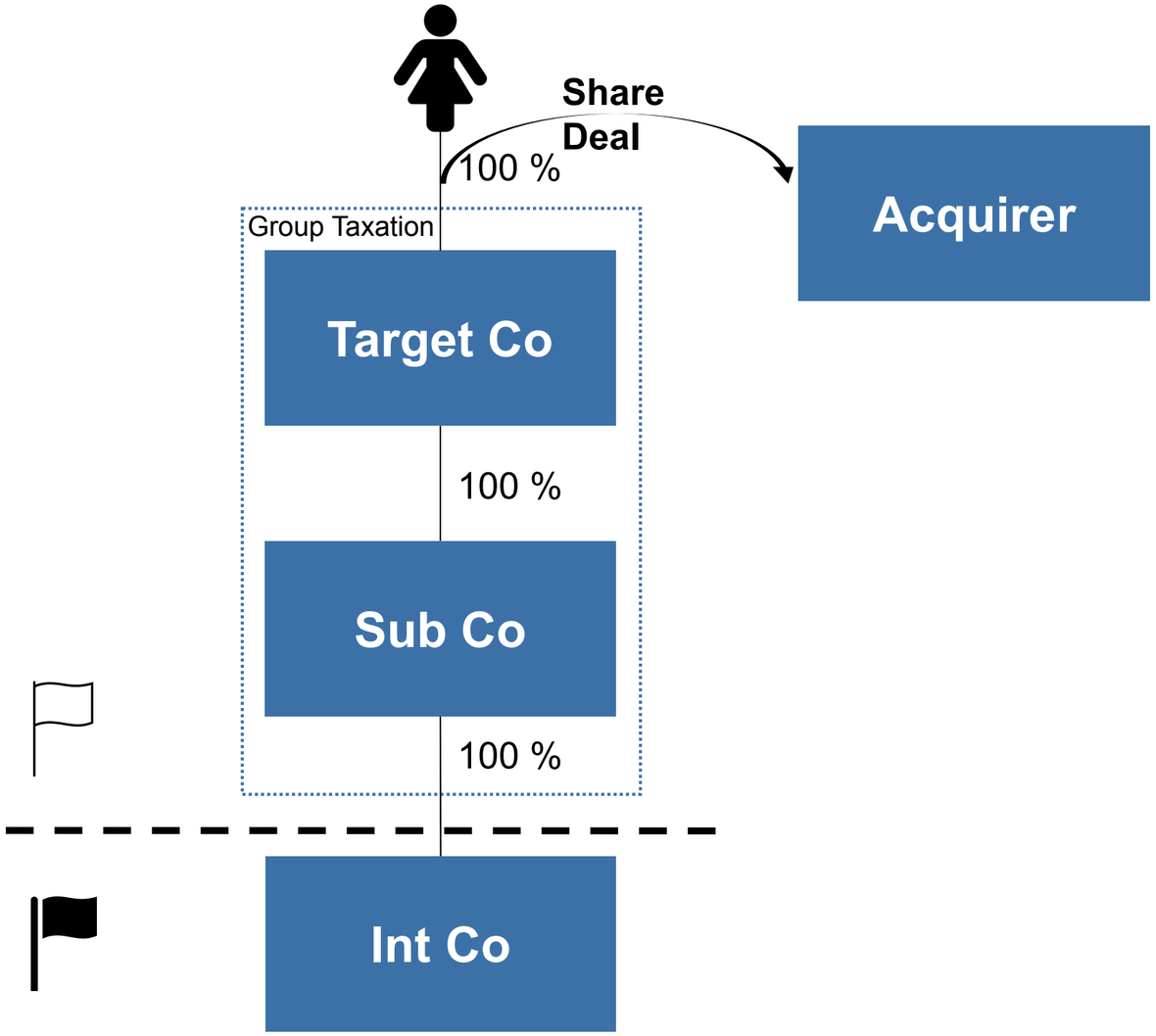
Tax Impact Analysis



Share Deal

- **Scope** of tax DD covers **entire target**
- b/c **tax risks transferred (!) to acquirer** as a whole:
  - Determine Magnitude
  - Determine Propensity to Materialize
  - Determine Timing

Selected Tax Risks



Selected Tax Risks

Tax Impact Analysis

Broad

- Non-compliance with tax regulation by target / its management
  - Misdeclaration
  - Pending Payments
- Compliance with tax regulation by target / its management
  - Tax treatment assets/liabilities
  - Target’s structure
- Changes in the underlying facts and circumstances with tax effects
- Misjudgment of facts and circumstances for tax purposes

Selected Tax Risks

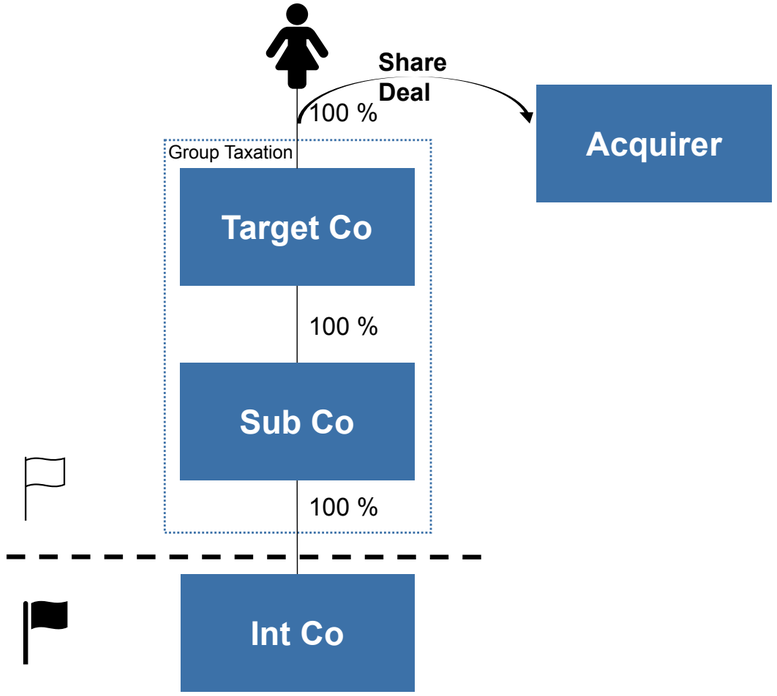
Tax Impact Analysis

All Time Favs

- Tax Loss Carryforwards / Change of Ownership
- Group Tax Regime(s)
- **Transfer Pricing**
- Vesting Periods from prior reorganizations
- Interest Deduction Limitations
- Real Estate Transfer Tax
- Value Added Tax Compliance

Selected Tax Risks

Magnitude, Propensity, Timing



Example

You are mandated with the tax due diligence (buy side) of the target and recognize the following facts: target has received an interest-bearing loan in the amount of EUR 10m from its sole shareholder, which is not secured. The interest rate for the loan is 20%. Under the same conditions, a bank would have granted the loan with an interest rate of 10%.

(i) identify a material tax risk, (ii) determine propensity to materialize, (iii) timing?

Selected Tax Risks

Magnitude, Propensity, Timing

- **Arm's length Principle:** an arm's length interest rate (loan agreement with bank) would have been 10%. In this case, the interest would have amounted to EUR 1m (arm's length portion). However, the actual interest amounts to EUR 2m and is therefore EUR 1m too high (non-arm's length portion)
- The portion of the interest payments that does not meet the arm's length principle constitutes a "hidden profit distribution" → may not reduce the income of the target **but did!**
- Taxable income of target needs to be upward adjusted by EUR 1m (→ material tax risk)
- Tax audits (→ timing) with heavy focus on transfer pricing (→ very high likelihood of detection)

Tax Check List

Sources of Information

- Tax balance sheets or tax reconciliation accounts for the last three to five years of the target and its subsidiaries
- Last tax audit report of the fiscal authorities, including wage tax external audit/sales tax special audit reports
- Tax returns and tax assessment notices (including loss assessment notices) for the last three to five years
- Shareholder resolutions and minutes of shareholder meetings, in particular profit distribution resolutions of the last three to five years
- Organizational chart of the group structure with complete name designation (shareholders in the target company, subsidiaries, sub-subsidiaries) with details of the participation quotas and excerpts from the commercial register
- List of all branch offices and other offices or places of business
- Contracts, agreements and arrangements between the company and its affiliated companies (such as control agreements, profit and loss transfer agreements, transfer pricing documentation, loan agreements)
- Documents on intra-group transactions (disposals), restructuring or acquisitions (contributions) within the last seven years
- Contracts between shareholder-managing director and company
- List of the company’s real estate, including the relevant purchase agreements, stating: a brief description of the respective real estate, the respective address, the land registry office and the land registry number, the last determined market value
- Annual financial statements of the company (balance sheet, profit and loss statement and notes to the financial statement) together with the management report and the auditor’s report for the last three to five financial years
- Information on independent auditors appointed by the company
- List of outstanding tax liabilities
- List of tax benefits/rulings
- Disputed tax claims/List of disputes with the fiscal authorities and proceedings in front of tax courts
- List of current or pending criminal tax proceedings

Due Diligence Report

Magnitude, Propensity, Timing

Step #4: How do I document the tax risks that I could (not) identify?

Due Diligence Report serves documentation purposes

- Timing (**deadlines & scope!**) and addressees must be considered
- Issuing the report in time allows for (necessary) adjustments to the scope of the tax due diligence

A *Full Scope Due Diligence* requires a DD report; a ***Red Flag Report*** instead highlights material tax risks only.

Due Diligence Report

Magnitude, Propensity, Timing

Step #4: How do I document the tax risks that I could (not) identify?

- Executive Summary with most material insights, often in keywords
- Comprehensive presentation of the analysis:
  - reviewed documents
  - identification and quantification of the resulting tax risks (?)
  - proposals for risk mitigation and recommendations for further action (?)

→ ***tax risk assessment follows a staircase design***

Staircase Design

First Stage

May material tax risks be mitigated/avoided/triggered by designing the structure of the transaction?

Second Stage

Quantification of material tax risks per period

Third Stage

Guarantee for identifiable tax risks

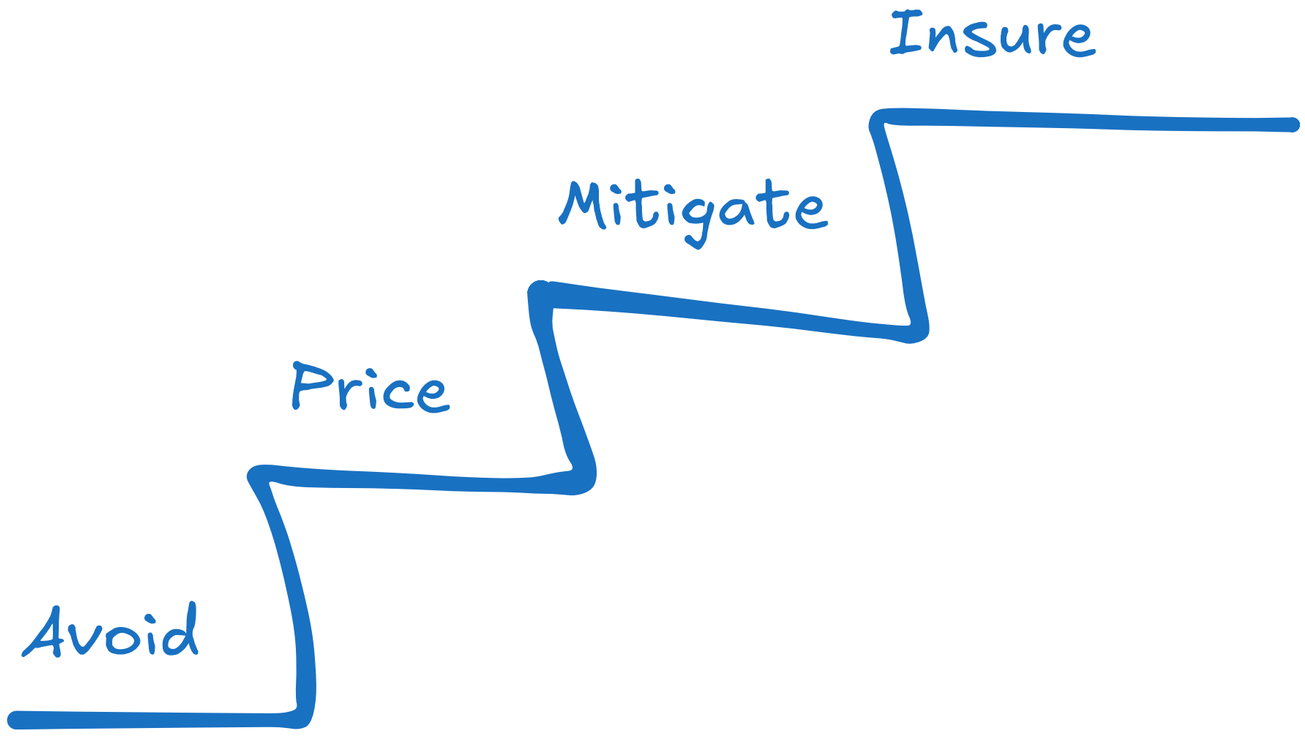
Fourth Stage

Abstract Guarantee for presumed tax risks

Staircase Design

DD Outcomes

1. **Efficient Tax Planning**
2. **h, p and t known**
   → Purchase Price Reduction
   → **Quantification**
3. **h, p or t unknown**
   → Guarantees
   → **Contract Design**
4. **h, p and t unknown**
   → Abstract Guarantees
   → **Contract Design**



Contract Design

DD Outcomes

Acquirer and Seller must (?) agree on who carries tax risks economically

Acquirer is usually subject to material tax risks of target. If caused by seller, acquirer wants to protect by means of a corresponding guarantee. Material tax risks of a target are therefore usually reflected in tax clauses

Tax Clauses

Contract Design

Tax Indemnity

- Relate to identifiable tax risks of target ex-ante to the transaction
- Usually, seller is obliged with respective payments

Abstract Guarantees

- Aim at unknown/not-identifiable tax risks of target
- Contain assumptions about the target's tax risk profile that are priced into the acquisition
- Tax clause settles payments if assumptions are violated

Financial Due Diligence

Selected DD Streams

Financial Due Diligence

Why?

> ***"[…] we've seen experienced acquirers take a blank-sheet approach to foster creativity, rather than anchor the exercise in a financial due-diligence model, which often leads to incremental synergies."***
>
> Koller, Goedhart, and Wessels (2025)

Financial Due Diligence

What?

> ***"The function of financial due diligence is to provide the potential buyer with an accurate and objective picture of the target company's net assets, financial position, and results of operations"***
>
> Dreher and Ernst (2022)

Financial Due Diligence

What?

- **Balance Sheet Verification:** Confirm existence and valuation of assets, equity, liabilities, and provisions
- **Performance Assessment:** Determine sustainable profit and cash flows based on historical financial data

Scope

Financial Due Diligence



→ **Focus on historical, current, and planned goes well beyond a financial audit (i.e., one year of historical information)**

EBITDA Adjustments

Selected (Historical) Topic in FDD

Profitability as Key Valuation Metric

- Widely used in transaction **multiples** (EV/EBITDA)
- Enables **comparability** across companies and industries

Adjust (historical) EBITDA by: (i) normalizing for one-time, anomalous, or non-recurring items, and (ii) incorporating forward-looking or deal-driven adjustments ("pro forma") ⇒ assess the sustainability and quality of earnings

EBITDA Adjustments

Selected (Historical) Topic in FDD

Adjustments as Drivers of Dispute?

- No standardized methodology exists for EBITDA adjustments
- Calculations are inherently subjective in nature
- Adjustments must be case-specific to target company circumstances
- Requires careful professional judgment in financial due diligence

Example

EBITDA Adjustments

Description	FY t_{-3}	FY t_{-2}	FY t_{-1}
EBITDA as per Financial Statements	**205.0**	**220.0**	**230.0**
Normalizations			
Restructuring Expenses	10.0	-	2.0
Gains from Asset Sales	(3.0)	-	(8.0)
Release of Provisions	-	1.0	(1.0)
Warranty Costs	6.0	-	-
Bad Debt Losses	-	1.0	-
Payment Received from Written-Off Receivable	-	1.0	(1.0)
Repair Costs	4.0	-	-
Consulting Costs	-	1.0	-
Legal Costs	4.0	-	-
Transaction Costs	0.5	-	1.0
Non-Recurring Income	-	1.0	(1.0)
Non-Recurring Expenses	(2.0)	2.0	-
Non-Operating Income	(2.0)	(2.1)	(2.2)
Total Normalizations	17.5	4.9	(10.2)
Normalized EBITDA	**222.5**	**224.9**	**219.8**
…	…	…	…

Example

EBITDA Adjustments

Description	FY t_{-3}	FY t_{-2}	FY t_{-1}
…	…	…	…
Pro Forma Adjustments			
Acquisition of Company A	1.0	1.0	0.5
Discontinuation of Business Unit B	1.0	1.0	0.2
Ramp-Up Losses	6.0	-	-
Synergy Effects	0.8	0.9	1.0
Carve-Out Effects	(4.0)	-	(4.0)
Currency Effects (Translation Effects)	(1.0)	(3.3)	(0.1)
Total Pro Forma Adjustments	3.8	(1.4)	(2.4)
Pro Forma Adjusted Normalized EBITDA	**226.3**	**223.5**	**217.4**

Example

EBITDA Adjustments

Notes

Example shows the presentation of a normalized pro forma adjusted EBITDA for the historical period under review. The starting point is EBITDA, which was derived from the audited annual financial statements. In the EBITDA adjustments, a distinction is made between normalizations and pro forma adjustments.

Based on the annual financial statements, EBITDA improved continuously between FY t_{-3} (EUR 205m) and FY t_{-1} (EUR 230m). However, the quality of earnings analysis reveals that adjusted EBITDA has fallen rather than risen over the historical period under review. Normalized pro forma adjusted EBITDA decreased from EUR 226.3m to EUR 217.4m.

Wrap Up

Due Diligence

Due Diligence

Wrap Up

> **Due diligence is ultimately about enabling better decisions with imperfect information under time pressure**

- *What we did:* frameworks and techniques that help you approach these challenges systematically
- *What you add:* judgment, creativity (?), and clear thinking about complex deals

Thank You!

RSM Ezafus

Appendix

Definitions

Tax Value Concepts

- Book Value: value of an asset as recorded on a company's balance sheet
- Fair Value: The amount of money for which it is assumed an asset or liability could be exchanged in an arm's length transaction between informed and willing parties.
- Partial Value: pro rata amount of a fictitious purchase price for the entire business that an acquirer would allocate to an individual asset.

Hidden Reserve

- Difference between book value and partial/fair value.
- Hidden reserves stem from an undervaluation of assets, an overvaluation of liabilities, the unjustified formation of provisions, or from the omission of step-ups in the event of an increase in the value of an asset.

▶ Back

Tax Free & Taxable Transactions

Tax Free Transaction

In a tax free transaction, there is no immediate tax event, and hence, there is no immediate taxable gain or deductible loss at the completion of the transaction. Instead, the tax consequences are deferred until taxable gain/loss is realized.

Taxable Transaction

In a taxable transaction, a taxable gain (or deductible loss) is realized at the completion of the transaction. The gain is equal to the difference between the partial/fair value of the consideration received and the tax basis (book value) of what is transferred → **basis step up**

▶ Back

Implicit Taxes

Example in Scholes et al. (2020)

Consider two types of bonds. Type B (benchmark) is a corporate bond that is fully taxable (i.e. interest income is taxable income and taxed by applying a (specific) tax rate, e.g. 30%). Type A (alternative) is a tax-exempt bond (e.g. a tax-favored municipal bond in the US).

Implicit Taxes

Example in Scholes et al. (2020)

cont'd

The implicit tax rate, t_{Ia} on a particular investment, a, is that tax rate that, if applied explicitly to fully taxable bonds, b, would leave a return equal to the before-tax rate of return on the alternative investment:

- R_b risk-adjusted before-tax return on fully taxable bond
- R_a risk-adjusted before-tax return on the alternative investment

$$R_b \times (1 - t_{Ia}) = R_a$$

$$t_{Ia} = (R_b - R_a)/R_b$$

Implicit Taxes

Example in Scholes et al. (2020)

cont'd

With $R_b = 10\%$ and $R_a = 7\%$: although investors do not pay any explicit tax on the interest earned from holding municipal bonds, they pay the tax implicitly (here to the issuer of the tax-exempt bond) at a tax rate of 30% through a lower before-tax return.

▶ Back

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