A comparison between the audit and financial due diligence process in Belgium

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A comparison between the audit and financial due diligence process in Belgium

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Introduction

Merger and Acquisitions became a popular external growth strategy for companies in recent years (Frederiksen, 2020; Park & Jang, 2011; Garzella & Fiorentino, 2016). Research indicates that more than half of the M&A transactions do not achieve its initial objective (Angwin, 2007; Christensen et al., 2011; Uzelac et al., 2009), which raises several questions in the literature to encounter the problem. One way to decrease the M&A risk and support the valuation is an efficient due diligence process to reduce the information asymmetry between the buyer and the seller (Bruner, R., 2004). According to Berens and Strauch (2002), Due Diligence is applied in 74,1% of the acquisitions. Especially the financial due diligence is a famous tool used during the transaction to decrease the risks related to the financial statements of the company (Bhagwan, V., Grobbelaar, S., & Bam, W., 2018). The research about the financial due diligence usually includes comparison charts with the financial audit, for example, the articles of Pomp, T. (2015), or Brulard, Y. et al. (2008). These tables often highlight a few criteria to compare both processes but do not go into the details. This gap in the literature increased the curiosity to research differences and similarities between the financial due diligence and the audit process.

In this master thesis, the key concepts related to both processes are analyzed in detail to provide an efficient comparison. Therefore, a detailed literature review based on the approach of Keele (2007) is performed to give an overview of the current state of the research in both fields. In addition to this, the theoretical concepts are categorized into the different stages of both processes to design a standardized approach. The main findings of this literature review are used to develop a practical part of this master thesis. Based on the method suggested by Collis and Hussey, R. (2014), a qualitative survey was designed to address the specific needs of this research. Semi-structured interviews with experts of the domain were conducted to gain practical insights into both processes, discuss and challenge the critical concepts of the literature review. The findings of this qualitative approach showed that both processes have similarities as well as significant differences that characterized each concept.

In the first chapter, a detailed overview of the methodology employed in this master thesis is outlined. General keywords and search strings about both domains were used to set up a standardized approach. As there is an abundance of literature related to both concepts, specific inclusion and exclusion criteria were applied to diminish the number of pertinent articles. The second chapter starts with a detailed definition of the concept of audit in Belgium before providing an overview of the key stages of the process. Additional keywords and search strings were used at this point of the master thesis to categorize the available literature into the specific stage. The same methodology was applied in the third chapter related to the financial due diligence. This approach enabled us to compare both processes in detail and provide a solid foundation for the qualitative survey. Similar to the other chapters, the practical part of this master thesis starts with a detailed overview of the methodology applied. After that, the specific topics discussed with experts of both domains are presented to discuss and challenge the critical concepts of the literature review. The findings are categorized into the particular stages applied in the theoretical part to enable an efficient comparison. The conclusion of this master thesis contains a summary of the main findings of this research. Additionally, the limitations of this study are outlined, as well as recommendations for future research are presented.

Research Methodology – Literature Review

Based on the approach of Keele (2007), the objective of the literature review is to identify, evaluate, and interpret all available literature relevant to the research question. This methodology summarizes the existing literature, identifies current research gaps, and provides background information about the topic.

The main aim of this literature review is to establish a comprehensive overview of the process of audit and financial due diligence. Therefore, the literature review is divided into two parts. The first part summarizes the current state of literature in the field of audit. In the second part, the same methodology is applied to the area of financial due diligence. As both subjects are vast, different selection criteria were used to downsize the number of articles present in this research. An overview of the theoretical similarities and differences between both subjects has been established to provide a conclusion about the findings of the literature review.

Sources and Keywords

The databases provided by the university were used with specific keywords and search strings to cover a wide range of available literature. On Google Scholar and Google, the keywords used were applied in four different languages, French, English, German, and Dutch. The following table summarizes the databases, keywords, and, search strings which were used to establish the general structure of the master thesis:

Table 1: Initial keywords and search strings

Database	Academic Search Premier; Business Source Premier; Cairn.Info; Google Scholar; Google
Keywords	*"Financial Due Diligence"; "Financial Audit"; "Due Diligence Procedures; "Audit Procedures"; "Due Diligence Process"; "Audit Process"; "M&A Process"; "Audit Laws in Belgium"; "European Audit norms"; "Financial Due Diligence norms"; Independence of Auditor"; "Cost of Audit"; "Cost of Due Diligence"; "Audit Opinion"; "Due Diligence report"; "Audit Materiality."*
Search strings	*"Due Diligence AND Audit"; "Audit OR Due Diligence"; "Financial Due Diligence OR Audit"*

Source: Author

The results of the research based on the information above covered a large number of different articles. The selection steps were performed after the initial search to identify the relevant items for the literature review and restrain the number of results. Based on the selection approach of Keele (2007), the first inclusion/exclusion criteria were based on the title and the keywords of the article. In the second step, the applied standards were extended to the introduction and conclusion. In the third step, the analysis was based on the entire text, and the selection criteria were applied. This methodology facilitated the research as it downsized the number of relevant articles presented in the literature review.

Filtering

Different types of documents were used in the literature review: Academic papers, laws and regulations, published dissertations, working papers, best practices as well as books. The explained procedure above was based on the inclusion and exclusion criteria presented in the following table:

Table 2: Inclusion and exclusion criteria

Inclusion criteria	• Papers available on the different available sources • Papers which mention aspects related to the field of an audit or due diligence • Articles which mention essential elements of the financial audit process or the financial due diligence process • Papers which explain the different types of audits or due diligence • Webpages which contained reliable legal aspects about the field of audit and due diligence in Belgium • Webpages which mentioned the applicable norms and standards in the field of audit and due diligence • Recent books published by famous publishing companies which explained the financial due diligence process
Exclusion criteria	• Incomplete papers • Papers which addressed only the internal audit procedure • Webpages which addressed legal aspects in both fields in other countries • Webpages which contained legal information from 10 years ago

	• Papers which didn't address specifically the audit or due diligence process • Articles which contained technical inaccuracies or typographical mistakes

Source: Author

Structure of the literature review

After the selection process, the final structure of the literature review was established. The part dedicated to the financial audit process starts with a detailed definition of the financial audit profession in Belgium. After that, the audit process is divided into four main steps to categorize the findings. Each step includes the current state of the research regarding the topics discussed. This methodology enables us to present an overview of the main concepts of the audit process.

The part dedicated to the financial due diligence process also starts with a detailed definition of the concept. In addition to this, the difference between the Vendor Due Diligence, Vendor Assistance, and Buyer Due Diligence is explained to establish a clear overview of those concepts. Also, the different areas of due diligence are mentioned due to the high interconnections with financial due diligence. After this, the complex Merger & Acquisition process is explained in detail to identify the different stages and locate the due diligence procedures. The same methodology as for the audit process is applied to achieve the main objective of this master thesis, which is to compare both processes and analyze the main differences.

Literature review – Financial Audit

Definition of the theoretical concept

The literature offers a wide range of definitions for the word "financial audit" and "audit." The competent authority in issuing audit and assurance standards defines the concept as follow:

> The International Auditing and Assurance Standards Board (henceforth referred as IAASB) (2016) defined in the International Standard on Auditing (henceforth referred as ISA) 200 the audit objective as follows: "*The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general-purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework. An audit conducted in accordance with ISAs and relevant ethical requirements enables the auditor to form that opinion. (Ref: Para. A1) "*.

Different concepts mentioned in this definition, such as the opinion, materiality, reporting framework, and ethical requirements, are the pillar of the audit process and are therefore analyzed in detail in this literature review.

Important to mention is that in this definition, the IAASB defined the purpose of the financial audit, not the purpose of the concept of audit in general. In the financial audit, it is essential to differentiate between the external and internal audits. The internal audit is defined in the ISA- 610 as "the function of an entity that performs assurance and consulting activities designated to evaluate and improve the effectiveness of entity's governance, risk management, and internal control processes." (Ref. Para. A1-A4) "(International Auditing and Assurance Standards Board, 2016) This definition shows that the main differentiation between the internal and the external audit is that the performer and the stakeholders are part of the company in the internal audit. During this master thesis, the focus is on the process of the external audit, which can rely on the work of the internal audit function under certain conditions, as explained in the ISA-610. The cooperation between both types of audits is explained more in detail in the different steps of the audit process.

A wide range of other types of audit exists, such as the tax audit, Information System audit, forensic audit, compliance audit, or the environmental audit. Those concepts are not analyzed as it goes beyond the scope of this master thesis and the interconnections between the areas of audits are not usual as analyzed in the literature.

Audit Process

The focus of this master thesis is to analyze the audit process in detail to enable the comparison to the due diligence process afterward. Even if the consulted documentation offers different types of overviews about the audit process, it can be standardized into the following main steps:

1. Preliminary Engagement Activities
2. Understand and Plan
3. Perform and Evaluate
4. Conclude

Source: In Lecture notes of the course Francis, Y (2018)

This categorization enables the structure of the available literature regarding the four different steps. The following table shows the different keywords used in the different sections to cover the major part of the available literature.

Table 3: Specific keywords and search strings for the audit literature

Step	**Keywords**	**Search Strings**	**Number of pertinent references**
Preliminary Engagement Activities	*"Engagement Risk"; "Auditor Independence"; "Audit Engagement"; "Audit continuance"; "Audit mandate"; "Terms of engagement audit"; "ISA-Norms"; "Institut des réviseurs d'entreprises" ; »Duration of audit engagement »*	*"Audit AND Risk"; "Audit AND ISA-Norms"; "Audit AND Engagement*	12
Understand and Plan	« Audit Plan » ; « Legal environment audit » ; « Digital transformation audit » ; « Audit regulations Belgium » ; « European Audit Laws »	« Laws AND audit »; « Audit AND Environment"; Digital transformation AND	17

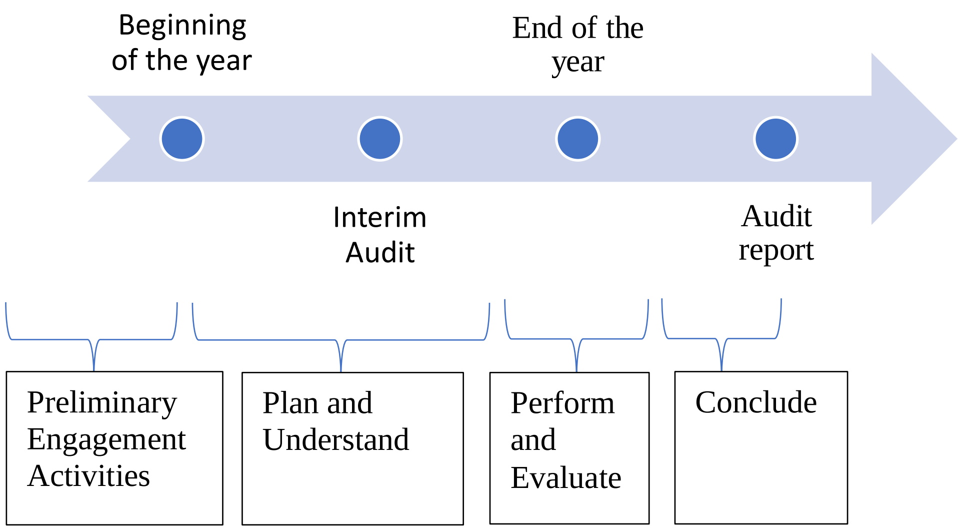
		Audit"; "Audit AND internal control"	
Perform and Evaluate	« Audit evidence » ; « Audit assertions » ; « Internal audit » ; « Audit documentation » ; « Audit review » ; « Audit procedures »	« Analytical procedures AND audit » ; « Internal audit AND external audit"; "Audit and evidence"	14
Conclude	« Subsequent events in audit » ; « Audit report » ; « Audit opinion »	« Audit AND subsequent events » ; « Audit AND Opinion »	8
Total of pertinent articles			51

Source: Author

This additional categorization of the audit process enabled to widen the range of covered literature of the Master thesis as it mainly focused on crucial audit components. A total of 51 articles were used to establish a detailed literature review about the essential elements of the audit process.

The following timeline presents the time specification of each step to provide an overview of the general duration of the process.

Table 4: Overview of audit process



Source: Author

Preliminary Engagement Activities

Audit Risk

In this step, one of the main aspects to consider is the engagement risk. According to Colbert, Luehlfing and Alderman (1996), the engagement risk of the auditors is the overall risk associated with an audit engagement. In this article, the audit risk is divided into three components: the client's business risk, the audit risk, and the auditor's business risk.

The client's business risk is that the going-concern principle of the client isn't fulfilled. In contrast, the audit risk is defined as the risk "that the auditor may unknowingly fail to appropriately modify the opinion on financial statements that are materially misstated." The auditor's business risk is the risk that auditors are exposed to "loss or injury to their professional practice from litigation, adverse publicity, or other events arising in connection with financial statements that they have examined and reported on." Colbert et al. (1996)

The different risks linked to the audit engagement are crucial to analyze for an audit company in all the different steps of the audit. Similar to these risks, the IAASB addresses in the ISA-200 an overview of the different risks linked to the audit engagement. A study from Ethridge et al. (2007) performed on the perception and strategies from audit partners on the engagement risk showed that the importance of the engagement risk changed only to a moderate degree after the different accounting scandals such as the famous Enron-Case. Kerr et al. (2007) offered a case-based approach to increase the assessment-quality when evaluating potential audit risk to reduce the risk linked to a new-client acceptance,

Duration of an audit engagement

The legislator fixes the general duration of an audit engagement in Belgium at three years. After three years, the mandate of an auditor is extensible up to nine years (Loi du 23 mars 2019a). This extension is heaty discussed in the literature, as the Sarbanes-Oxley Act (henceforth referred as SOX) of 2002, which is a federal law in the United States, stated that audit rotation improves the fairness of audit reports. Opposed to the SOX, auditors disagree with this statement as the engagement partner continuity improves the client familiarity, decreases information asymmetry and therefore enhances the audit quality (Litt, B. et al., 2014).

Auditor's independence

Next to the engagement risk and the duration, another important concept of the preliminary engagement activities is the auditor's independence and the ethical requirements, as stated in ISA 200 (IAASB, 2016). A concise definition of the independence of an auditor cannot be provided by the literature, as it continually evolves (Antle, 1984). The purpose of the independence principle is to assure the objectivity and integrity of the audit engagement, which are the main characteristics of the principle (Dunmore, P. & Falk, H., 2001). Especially after the accounting scandals of Enron and WorldCom, the laws handling the independence of an auditor became stricter. In Belgium, an auditor is allowed to perform non-audit services to audit clients under certain conditions, as long as the principle of independence is assured (Loi du 23 mars 2019b). A fee cap is fixed by the law to ensure this condition. (Deloitte, n.d)

An interesting study conducted by Craswel, Stokes, and Laughton (2002) investigated if fee dependence affects auditor's independence judgment. The results of this study showed that the level of auditor fee dependence didn't influence audit opinions. The same result had been observed by DeFond, Rughunandan, and Subramanyam (2002), who analyzed the effect of non-audit service fees on the auditor's independence. In contradiction to this conclusion, Beattie and Fearnley (2002) established a literature review about the relationship between auditor's independence and non-audit services. The conclusion of this literature review showed that there is a reasonable consensus in the literature that joint provision affects the auditor's independence adversely.

Ling and Nopmanee (2015) provided an interesting literature review about the auditor's independence and the auditor's quality. In this article, the authors highlighted the two main components to assess the audit quality: the auditor's capabilities and the auditor's independence. In addition to this, they presented the four main threats to audit quality. The conclusion was similar to the findings of the other articles presented in this part. There is no clear evidence that the client's importance, the non-audit services, the auditor's tenure, and the client's affiliation with the audit firm have a significant impact on the quality of the audit. The conclusions need to be interpreted with caution as the principle of independence is subjective.

Terms of Audit Engagement

The last essential concepts to highlight in the phase of the preliminary audit engagement are the terms of the audit engagement. As explained in the ISA-210, the auditor needs to fulfill certain preconditions before accepting the engagement and being appointed by the general assembly of the company. One example of a prerequisite is that the auditor needs to determine if the applied financial reporting framework is acceptable (ISA-210: Ref: Para A2-A10). Next to this, there needs to be a common understanding between the auditor and the company about the audit engagement.

The literature offers exciting investigations on the terms of an audit engagement. For example, one study analyzed the relationship between auditor's gender and audit fees. The result showed that audit companies with female audit engagement partners have higher audit fees. (Ittonen & Peni 2011)

As it is difficult to find supporting information for that, this result needs to be interpreted with caution. Next to this study, the literature reviewed the influence of the auditor's size on the audit fees, but no significant conclusion can be drawn.
Understand and Plan

Understand the legal aspect and environment

An essential aspect of an audit is the legal environment of the auditor's company and the client's company. As this master thesis handles the audit process in Belgium, a specific analysis of the legal environment in Belgium is required. In this country, the law (Loi du 23 mars 2019c) specifies the type of companies which are required to be audited, if they fulfill the following criteria in general (other specific criteria are mentioned in detail in the law):

- Number of people employed (on average per year): 50
- Turnover per year: 9.000.000 EUR
- Balance sheet total: 4.500.000 EUR

Source: Loi du 23 mars 2019c

The following table summarizes the main rules and their objective, which are applicable to audit companies in Belgium. In addition to this, it highlights the central supervision bodies of the audit profession in Belgium:

Table 5: Overview of the legal environment in Belgium

Law/Directive	**Objective**
Directive 2014/56/UE from the 16th April 2014 and the European rule n°537/2014	Requirements for the audit of public companies
Art. 4 to 30 of the Law of the 7th December 2016	Requirements for the audit profession
Art. 31 of the law of the 7th December 2016	Applicable norms and recommendations for the auditor
Art. 32 of the law of the 7th December 2016	Supervision of auditors by the "Collège de Supervision des Réviseurs d'Entreprises
Art. 44 and 45 of the law of the 7th December 2016	Confidentiality of information
Art. 59 of the law of the 7th December 2016	Supervision by the FSMA
Art. 64 to 81 of the law of the 7th December 2016	Responsabilities of the "Institut des Réviseurs d'Entreprises"

Source : Author

The rules applicable to auditors in Belgium are strict, as the table here above shows. The relationship between the audit markets and the legal environment has been investigated by Choi and Wong in 2002. The results of this study showed that the Big Five auditors charge higher risk premium if the legal environment is strong, and they reject more likely high-risk clients. From the client's business side, the study showed that the clients hire more likely Big Five auditors in strong legal environments.

The industry in which the company operates can also have a significant influence on the risk the auditor is exposed to. Industry differences in financial statement error characteristics showed implications on the risk assessment and the determination of the audit strategy (Maletta, M. & Wright, A., 1996). This result indicates that an auditor must be aware of the precise environment in which the client operates before accepting an engagement.

Digital Transformation

Another critical aspect in the category of understanding the entity and the environment is the emergence of digital technology. The landscapes of an audit changed entirely due to the way data is transformed. As a consequence, audit companies need to process the information of clients in a whole new way. The literature is full of articles addressing the influence of the new technologies on the profession of the audit. For example, Zhang, Yang, and Appelbaum (2015) analyzed in their paper the gaps between Big Data and the current capabilities of Big Data analysis in continuous auditing. Cao, Chychyla, and Trevor (2015) went a step further in their article and analyzed how Big Data analytics can improve the efficiency and effectiveness of the audit. The use of such techniques in audit companies is not as widespread, as argued in the article of Gepp and Smith (2018). A possible explanation, therefore, is that auditors refuse such types of technologies as they are far ahead of those adopted by the clients. An interesting overview of the need for future research in the digitalization of the audit profession was offered by Appelbaum, Kogan, and Vasarhelyi (2017). In their article, the authors emphasized the opportunities for advanced analytics to generate intelligent decision making. Six key research questions and a review of the main concerns of the audit community are presented to boost the research in this domain. Especially the synergy between IT-Audit and Financial Audit plays in this new era a vital role, as the IT-Audit improves the integrity of financial data.

Audit Plan

All the concepts discussed above are essential for the auditor to design an effective audit plan. The auditor documents in this step the overall audit strategy, including the nature and timing of the audit procedures. (IAASB, 2016)

Mock and Wright (1999) separated the audit plan in two steps: Risk assessment and planning. The risk assessment, already discussed above, is an essential step to design a risk-adjusted audit plan. The auditor needs to adapt its approach continuously if there are any risk changes (Hammersley, 2011; Vandervelde, 2006; Bechara & Kapoor, 2012).

An important and challenging component of the audit plan is the calculation of the materiality. In the ISA-320 Norm, all the crucial concepts linked to the materiality are highlighted. Qualitative, as well as quantitative aspects, need to be considered in the determination of the materiality (Bunjaku, n.d). Especially the qualitative part is difficult to determine, as it depends on the judgment of the auditor. This judgment can have a significant effect on the quality of the audit. The concept of materiality is an exciting topic in the literature, especially the relativism and subjectivity of materiality. Depending on the entity, the importance of the amount of the materiality of a financial position can vary, which enforces the relativism of materiality. (Grejadan, Joldos & Stanciu, 2010)

This aspect can hide some potential additional risks for the audit, as stressed by Paterson and Smith (2003). Also, the non-disclosure of the materiality level raises different questions in the literature. Houghton, K., Jubb, C. and Kend, M. (2011) investigated in a practical survey the consequences of the non-disclosure of materiality on the users of the financial statements. The paper of Messier, W., Martinov-Bennie, N. and Eilifsen, A. (2005) offered a detailed overview of the published literature about the concept of materiality since 1982.

Internal Control

An additional step performed during the planning phase of the audit is the evaluation of the internal control mechanism present in the client's business. In the literature, three types of controls can be identified: preventive controls, detective controls, and directive controls. (Bunjaku, n.d)

Important to mention is that the auditor communicates the deficiencies identified in the controls but does not express an opinion about the effectiveness of those (ISA-265). The objective of effective internal controls is to assure the reliability of financial reporting (Limsuwam & Wittayapoom, 2012). Nagaraja and Vijayakumur (2012) emphasized on the fact that internal control mechanisms enable the early detection of a fraud inside of the company. Also, audit fees can be influenced by the detection of internal control deficiencies (Vishal Munsif, K. et al. 2011).

Perform and Evaluate

Audit Assertions

The on-field work of an auditor is characterized by testing the audit assertions with professional skepticism and judgment supposed to be covered by the management of the company. The following table summarizes the audit assertions:

Table 6: Audit assertions

Assertions about classes of transactions and events for the period under audit	
Occurrence	Transactions and events that have been recorded have occurred and pertain to the entity.
Completeness	All transactions and events that should have been recorded.
Accuracy	Amounts and other data relating to recorded transactions and events have been recorded appropriately
Cut-Off	Transactions and events have been reported in the correct accounting period
Assertions about account balances at the period end	
Classification	Transactions and events have been recorded in the proper accounts.
Existence	Assets, liabilities, and equity interests exist
Rights and Obligations	The entity holds or controls the rights to assets, and liabilities are the obligations of the entity
Assertions about presentation and disclosure	
Completeness	All assets, liabilities, and equity interests that should have been recorded.
Valuation and Allocation	Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments are appropriately recorded
Occurrence & Rights and Obligations	Disclosed events and transactions have occurred and pertain to the entity
Completeness	All disclosures that should have been included in the financial statements have been included
Classification & Understandability	Financial information is appropriately presented and described, and disclosures are clearly expressed
Accuracy and Valuation	Financial and other information are disclosed fairly and at appropriate amounts.

Sources: Florea, R. & Florea, R. (2011)

The representation of the audit assertions above is essential to understand to work performed by the auditor. The management is supposed to fulfill the assertions during the preparation of the financial statement in accordance with the generally accepted accounting principles in Belgium. With the professional skepticism stated in the ISA-200 norm, the auditor needs to verify though the audit evidence if the assertions were fulfilled. (IAASB, 2016)

Obtaining Audit evidence

The ISA-500 norm states that sufficient and reliable audit evidence must be obtained to establish a reasonable audit opinion. The auditor can use different types of procedures to gain evidence about the categories of financial statements. Before highlighting two types of audit procedures, it is important to mention that the auditor often uses the sampling-approach to diminish the amount of evidence required (ISA-530). (IAASB, 2016)

External confirmation

The first type of procedure the auditor performs is the external confirmation request. The nature and the source of the external confirmations are crucial for the reliability of the evidence. As stated in the ISA-500 norm, the trustworthiness of the confirmations increases:

- If it is obtained by an independent source outside of the company
- If it is obtained directly by the auditor
- If it is available under the documentary form

The ISA-501 norm is complementary to the ISA-500 norm as it highlights the procedures which must be performed to obtain evidence for the inventory, litigations, and claims as well as the presentation and completeness of the applicable financial reporting framework. (IAASB, 2016)

Analytical procedures

The second type of procedure the auditor performs to obtain evidence about the financial statement relates to the analytical skills of an auditor. The ISA-520 norm highlights the importance of considering financial as well as non-financial data to prove the plausible relationships between the data. Therefore, the auditor must have a deep understanding of the entity and the environment to assess the risk. A field investigation by Hirst and Koonce (1996) highlighted the main practical issues of analytical procedures in the field of audit. One practical issue is addressed in the article of Anderson and Koonce (1998), which showed that the faulty risk interpretation of data is much higher if the auditor only relies on the plausibility check to perform the analytical procedures. In addition to the plausibility, the authors recommended performing a sufficiency check to evaluate numerous causes of fluctuations. The experience of the auditor is another factor that increases the reliability of the analysis performed. For example, research showed that audit managers are more effective than audit seniors in assessing the risk of fraud with analytical procedures. (Knapp & Knapp 2001)

The conclusion of this article can be discussed, as the audit environment changed a lot after 2001, mainly due to the accounting scandals and the emergence of technological advances (Trompeter & Wright 2010). To address the risk of the fast-changing environment, Yoon, Hoogduin, and Zhang (2015) mentioned the important role of Big Data Analysis to reduce the risk of material misstatements. The External Audit Analytics (EAA) framework developed by Appelbaum and Vasarhelyi (2018) can be an efficient tool to motivate future research to increase the efficiency of more complex and data-driven analytics.

Collaboration with the internal audit and experts

Especially in complex industries, an audit often requires a large amount of expertise to understand the financial statements of a company. Therefore, the ISA-norms 610 and 620 enables the auditor to rely on the work of the internal audit and experts.

The ISA-610 norm specifies the requirements, whether, in which areas, and to what extent the external auditor can use the work of the internal audit department. As the external auditor is solely responsible for the audit opinion expressed, he must evaluate precisely the quality of the internal audit as well as the scope and nature of work that can be used. (IAASB, 2016) The literature offers a wide range of articles about the relationship between the internal and external audit. A summary of the research on external auditor reliance on the internal audit function has been elaborated by Bame-Aldred et al. (2013). Felix, Gramling, and Maletta (2010) revealed that when significant non-audit services are not provided to a client, internal audit quality and the level of internal-external auditor coordination positively affect auditor's internal audit reliance decisions. A deeper analysis of the relationship between both types will not be provided in this master thesis as an internal audit department can just be found in some large corporations, which are not the central part of the Belgian economy (Trends Tendances, 2017).

The ISA-620 norm specifies the requirements when the auditor relies on the work of an expert to obtain sufficient appropriate evidence. Also, here, the concept of sole responsibility of the auditor is applicable, which requires the auditor to appropriately evaluate the work of the experts in conjunction with the ISA-200 norm. (IAASB, 2016)

Documentation and Review of work performed

"If it is not documented, it is not done" is a famous quote used by professionals of the audit. The ISA-230 norm addresses the different aspects of the documentation work, which has to be performed on a timely basis by the auditor in every step performed here above. The documentation must provide a sufficient and appropriate basis for the final audit report. Especially after 2001, the need for documentation evolved, and auditors are more and more under pressure to put their qualitative risk analysis into words. Indeed, this requirement increases the risk exposure of an auditor but also the overall quality of an audit, as the reviewer can perfectly understand each step.

Especially the review of the prepared work from subordinates is essential for the audit quality. The four-eyes principle decreases the judgment variance significantly, as proved by (Trotman, 1985) and increases the quality of the judgments (Trotman & Yeton, 1985). To improve the efficiency of the review process, the literature offers different articles about the potential use of specialization on specific kinds of errors depending on the level of seniority of the auditor. The study Bamber and Ramsay (2000) contradicted this literature advice, as they proved that specialization does not improve the quality of the review process automatically.

Tan and Jamal (2001) analyzed whether audit managers' assessment of the quality of work of their subordinates is influenced by the managers' initial impression of these subordinates. The study showed that average managers evaluate memos written by outstanding seniors more favorably than the ones written by moderate seniors, but not when the identity of the seniors is unknown. This result shows that the principle of objectivity stated in ISA-200 can be impaired depending on the preparer of the audit documentation.

Conclude

The last steps of the audit process developed in this part of the master thesis can be summarized under the category: Conclude.

Subsequent events review, Going Concern & Written Representations

Next to events that happened before the date of the financial statements, it is crucial that the auditors also consider events that occur between the date of the financial statements and the date of the auditor's report, especially those events that could have changed the opinion. The ISA-560 norm describes all the different aspects the auditor needs to perform during both dates. To limit the number of subsequent events that could influence the audit opinion, it is favorable for the auditor to shorten the period between both dates. Once the financial statements have been issued, the auditor doesn't need to perform additional procedures, as stated in ISA-720. (IAASB, 2016)

Another essential concept is the going concern assumption that comprises that a company is not expected to be liquidated in the foreseeable future. In the Belgian General Accepted Accounting Principles (henceforth referred as GAAP), the company is required to establish its financial statements under the going concern principle. Therefore, the ISA-570 norm specifies the requirements for the auditor to obtain enough audit evidence to reasonably assure the business's ability to continue. (IAASB, 2016)

After the evidence has been obtained, the auditor asks those in charge of the governance inside of the company to certify that the financial statement has been prepared under the Belgian GAAP. This written representation attests to the responsibilities of the company for the preparation of financial statements.

The penultimate step of the audit is to prepare the summary memorandum, which is presented to the management of the company. Important here is that the auditor clarifies his responsibilities towards the company and all the stakeholders. Even if the auditor forms and expresses an opinion about the financial statements, the company remains responsible for the financial statements. Therefore, the auditor highlights in the summary memorandum the scope and timing of the process, as well as significant findings during the audit (ISA-260) (IAASB, 2016)

Form & Communicate audit opinion

The ISA-700 norm elucidates the final objective of the audit, which is to form an audit opinion on the financial statement based on the professional judgment of the auditor and the evidence obtained. In addition to the audit opinion, the auditor can include in the audit report the key audit matters. This enables the reader of the financial statements to obtain greater transparency about the procedures performed. For the auditors, the key audit matters allow them to express the most significant aspects of the audit. Besides, the auditor can include an emphasis of matter paragraph or other matters paragraph in the audit report, as stated in the ISA-norm 706. In this paragraph, the auditor emphasizes crucial aspects that are fundamental for the understanding of the reader of the audit report. (IAASB, 2016)

In the following paragraph, the different types of audit opinions are explained, and their consequences:

Unmodified Opinion (ISA-700 norm)
For the company, the perfect conclusion of the audit is the unmodified opinion, also called a clean opinion. This result concludes that the financial statements have been prepared in all material respects in accordance with the applicable accounting framework.

Qualified Opinion (ISA-705)
Two types of circumstances can lead the auditor to express a modified opinion. The first circumstance is that the auditor obtained sufficient audit evidence to conclude that the financial statements as a whole include material misstatements. In the second circumstance, the auditor didn't get enough audit evidence to certify that the financial statements are free from material misstatements.

Adverse Opinion (ISA-705)
If the auditor obtained sufficient audit evidence, but he concludes that the misstatements are material and pervasive, he expressed that through an adverse opinion. For the stakeholders of the company, this type of opinion reflects that the financial statements of the company are not reliable.

Disclaimer of opinion (ISA-705)

The most tragic conclusion of an audit is the disclaimer of the audit opinion. In this circumstance, the auditor didn't obtain sufficient audit evidence to form an opinion. Due to this lack of evidence, the auditor concludes that the financial statements could contain possible misstatements that are pervasive and material. (IAASB, 2016)

The research about the audit opinion can be categorized into two parts. The first part analyzed the elements that could influence the audit opinion expressed. For example, Bao and Chen (1998) studied that the financial ratios of a company, as well as the region of the company, can influence the audit opinion. In addition to this, Yu, Zhang, and Lian (2013) showed that negative news in the media has a positive effect on the quality of the audit opinion. Ahadiat (2011) discovered that the provision of non-audit services could impair the audit opinion expressed. The freedom of the company to be able to choose their auditors also has a significant influence on the audit opinion expressed. Just by switching audit firms, the companies can obtain the desired audit opinion (Chen et al., 2016).

The second part of the literature researched the consequences of the audit opinion expressed. The results showed that the audit opinion could have dramatic implications for the company. For example, Buchman and Collins (1998) showed that a qualified audit opinion could increase the costs of the lawsuits of a company compared to the clean audit opinion. Also, the credit rating of a company can be influenced by the audit opinion express, as showed by Feldman and Read (2013). These results strengthen the fact that auditor needs to analyze the financial statements with professionalism and skepticism, as it is a powerful monitor tool that could influence investors' decisions and other stakeholders (Bo & Wu, 2011). Tian and Xin (2017) provided a detailed literature review about the audit opinion.

Literature Review - Financial Due Diligence

It is essential to establish a coherent structure in this part of the literature review to enable an efficient comparison between the audit and due diligence process. Therefore, the first step is to define the concept of due diligence precisely.

Definition of the concept

In opposition to the concept of financial audit, there is no legal definition available in Belgium for the concept of due diligence.

Crilly (1993) defined the concept of Due Diligence as a process whereby an individual, or an organization, seeks sufficient information about a business entity to reach an informed judgment as to its value for a specific purpose. Kozin and Young (1994) highlighted in their definition much more the financial aspects such as the target's revenue and cost structure, the search for contingent liabilities, and various legal aspects. In addition to this, they recommend sophisticated buyers to go beyond the fundamentals to identify the target's desirable core competencies, carefully analyze and value them, and creatively structure purchase-and-sale agreements to ensure that the skills and knowledge that comprise the core competencies are secured. (Referred in Berens et al. 2011)

Berens, Brauner, and Strauch (2002) analyzed the available definitions of the concept of due diligence as well as the history of the concept. Interesting is that the concept first appeared in the U.S. Security Act in 1933 concerning the issuing of securities. In their article, the authors also highlighted two similar characteristics in the available definitions of the concept nowadays:

- Due diligence means performing analyzes and examinations to generate information about the company. The interested party uses this information to plan the integration process.
- The objective of the due diligence to increase the quality of decisions by analyzing potential opportunities and risks.

The financial due diligence includes both characteristics to enable the expert to perform a detailed analysis of the current and future financial positions of the company. In most cases, the expert who performs the financial due diligence is an experienced auditor. (Pomp, T. 2015).

In this master thesis, the due diligence process analyzed is the review process in the context of an acquisition. The same method can be applied in practice to a whole range of other transactions, such as joint ventures, strategic alliances, or lendings. (Howson, 2003)

After having defined the concept, it is essential to emphasize on the two types of due diligence. The main difference is the issuer of the due diligence. If the buyer initiates the procedure, the due diligence is called Buy-Side-Due-Diligence. Sell-Due-Diligence is the concept that is used in the literature if the seller begins the procedures. In the following part, both types of due diligence are explained more in detail to cover the available literature regarding both concepts.

Types of Due Diligence

The literature already covers a wide range of articles regarding both concepts. Due to the limited scope of this master thesis, the following paragraphs explain the primary differentiation between both concepts briefly.

<u>Buy-Side-Due-Diligence</u>

As already explained above, the initiator of a Buy-Side-Side-Due-Diligence is the buyer. The objective of the buyer is to decrease the information asymmetry between both parties. The literature differentiates here between two types of buyers: the strategic investor and the financial investor. This differentiation is essential, as the objectives of both investor types are different. The primary goal of the financial investor is the pure maximization of the financial return (Eilers, Koffka & Mackensen, 2012; Kinzius, 2013). Next to the economic objective, the strategic investor seeks, for example, an optimization of the supply chain by creating synergy effects or other strategic motives (Wirtz, 2012; Weber & Hohaus, 2010).

Independently of the type of inventor, the kind of financing is also an element that influences the Buy-Side-Due-Diligence. If, for example, outside creditors finance the majority of the investment, the so-called Leveraged Buy-Out, they can require having insights into the findings of the due diligence. (Achleitner, 2002).

In the sub-chapter Financial Due Diligence in M&A Process, the timing of a Buy-Side-Due Diligence is explained more in detail.

Sell-Side-Due-Diligence

As Sell-Side-Due-Diligence, the literature defines the due diligence that is initiated by the seller. The primary objective of the seller is the optimal preparation for the possible transaction. Even if the management believes knowing everything about the business, it is crucial to conduct a thorough analysis of the own company to prepare the administration for possible questions during the selling process. The literature differentiates in the Sell-Side-Due-Diligence between the Vendor Assistance and the Vendor Due Diligence. The main difference between both concepts is that the performer of a Vendor Assistance does not need to disclose the findings in a report. Whereas in a Vendor Due Diligence, the performer reveals the main conclusions in a financial databook or a financial factbook. In the section Conclude, a more in-depth analysis between both types of reports is realized. (Pomp, 2015))

Besides the different types of due diligence, the research offers a vast number of articles about the different areas of due diligence. Even if in this master thesis, the main focus is the financial due diligence, it is essential to explain the other areas of due diligence due to the high interconnections between the areas. The following section provides a brief overview of the different areas as well as the current state of the literature.

Areas of Due Diligence

In 1999, Marten and Köhler revealed in empirical research in Germany that the most popular area is the financial due diligence, followed by the legal, tax, and market due diligence. The environmental due diligence was ranked in the last place. Due to the limited scope of this study and the fact it was analyzed 21 years ago, other articles need to be consulted to reveal the trends of recent years. In 2018, Bhagwan, Grobbelaar, and Bam examined in their research the different factors and concepts identified in the literature for each area of due diligence. On this basis, they established a breakdown of the different areas of due diligence.
Interestingly to observe was that the environmental due diligence has here been ranked in the second place. Additionally, the human resources and cultural due diligence, which were not even included in the empirical research of 1999, were here ranked in the third and fourth place. In both articles, the financial due diligence was in the firth place.

Contrarily to the research in the field of audit, the articles found on the databases about the financial due diligence were often so-called best practices or manuals but not often scientific papers. Few researchers examined the field of financial due diligence. Often, the financial due diligence is mentioned in articles that analyzed the reduction of the risks in the M&A-transaction through improved due diligence, such as the article Pery and Herd (2004). As this topic goes far beyond the scope of this master thesis, no further research about the current state of the literature in this field is provided. The findings of the best practices and manuals are presented in the chapters dedicated to the process of financial due diligence. The following table summarizes the other areas of due diligence mentioned in the article of Bhagwan, Grobbelaar, and Bam (2018). On top of that, a column highlights the main research conducted in those fields.

Table 7: Overview of the areas of due diligence and related literature

Area of Due Diligence	Description	Literature
Legal	The legal due diligence emphasizes five dimensions: the organization, the ownership of the assets, the exposure to associated liabilities, litigations, and	Bruner (2004); Horwitz et al. (2002); Makri et al. (2010) ; Shimizu et al. (2004) ; Beisel & Andreas (2010)

	regulation. It tries to identify and quantify potential legal risks.	
Tax	The focus of the tax due diligence is to identify tax risks or benefits. For example, the compliance with tax laws, the exposure to unpaid taxes or tax fraud, and the opportunities of tax reductions.	Bruner (2004); Peppitt (2009); Sinewe (2010); Brauer (2013); Trimborn (2013); Kneip & Jänisch (2010)
Environmental	The environmental due diligence investigates on the compliance of the business with the environmental laws and standards applicable.	Brancone-Capponi, Miller & Cecconi (2016) ; Roulac (1993); Bruner, R. (2004) ; Betko, Reiml, Schubert (2013)
Operational	The operational due diligence aims to understand the operating model of the company to identify the key operational drivers. Especially for potential synergy effects, this type of due diligence is essential as it allows us to see how the company fits into the current structure.	Porsgaard (2018); Morrison et al. (2008); Höhne (2013); Recardo & Toterhi(2013)
Market	Important in the market, due diligence is to analyze potential opportunities and risks of the different market segments in which the company operates.	Lebedow (1999); Bruner(2004)
Human Resources	Human Resources Due Diligence emphasizes a wide range of aspects related to the people inside of the organization. Potential areas of investigation are the exposure to union issues, the adequacy of leadership, or possible benefit claims.	Bruner (2004); Horwitz et al. (2002); Makri et al. (2010); Shimizu et al.(2004) ; Hitt et al. (2015); Harding & Rouse (2007); Latukha & Panibratov (2013)
Cultural	Especially for M&A transactions in foreign countries, it is essential to evaluate the cultural aspect. Therefore,	Bruner (2004); Horwitz et al. (2002); Makri et al. (2010) ;

	the cultural due diligence tries to identify different cultural levels of resemblances between buyer and seller.	Carleton & Lineberry (2004) ; Lovallo et al. (2007)
Strategic	The main purpose of the strategic due diligence is to evaluate if the price of the target is realistic. The literature investigates two questions: Is the deal commercially attractive? Is the company capable of realizing the targeted value?	Adolph, Gillies & Krings (2006)
Marketing	The marketing due diligence is part of the strategic due diligence as it evaluates the strategic fit between both companies. Mainly, it emphasizes on the deal through the eyes of the customer.	Gould (1998); Kumar & Hansted Blomqvist (2004);
Intellectual Property	The IP Due Diligence analyzes the risks related to the intellectual and intangible aspects of a company. For example, patents, trade secrets, or software. In addition to this, in this type of due diligence, the literature also categorizes the valuation of the intangible assets.	Bruner (2004); Reilly (2013); Lubit (2008)
Technology	The primary focus of technology due diligence is to analyze the infrastructure of the IT-Landscape. Mainly, the compatibility between the software of the companies and the general IT situation should be assessed.	Bruner (2004); Breitzman & Thomas (2002); Hornke & Menke (2008)
Research & Development	The R&D Due Diligence seeks to identify the capabilities of the R&D department and potential synergies between both companies.	Lemieux & Banks (2007); Merrifield (2006)

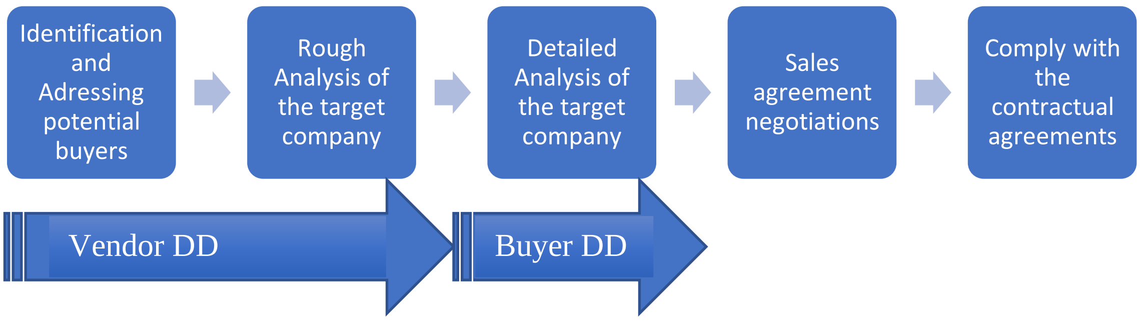
Source: Author

The interactions between the types of due diligence mentioned here above and the financial due diligence are explained more in detail in the chapter perform and evaluate.

Financial Due Diligence in the Merger and Acquisition Process

Before being able to analyze the different parts of the financial due diligence process, it is essential to take a step back and locate the process of due diligence in the complex M&A process. The following table highlights the main stages of a due diligence procedure.

Table 8: Overview of the financial due diligence process



Source: Pomp, T. (2015)

The table above highlights the different stages in a standardized M&A Process. Critical aspects of the different steps described here below are a summary of a standardized M&A Process (Seibt, 2011; Andreas, 2010; Dreher & Ernst, 2014). Indeed, in practice, this process can be completely different from the theory.

<u>Identification and addressing potential buyers</u>

In the first step of the M&A-Process, the seller establishes a shortlist with potential buyers before handing out a so-called Teaser about the company. In this document, he describes a few pieces of information about the business and the industry anonymously. If the potential buyers are interested, they have to sign a Non-Disclosure Agreement, often called Letter of Intent, before entering into the next stage of the process.

Rough Analysis of the target company

In the second step, more information about the seller's company is disclosed to the potential buyer. The seller provides the so-called Process Letter to the buyer, which contains crucial aspects of the whole process, such as key dates, documents, and contact persons. Often, the buyer meets in this stage of the process the seller's management and has to submit a so-called Non-binding Bid or Indicative Bid. The main content of this document is a non-binding purchase price. Alternatively, the potential buyer signs a Letter of Intent or a Memorandum of Understanding. At this stage, the Vendor Due Diligence is often completed, as the vendor desires to be efficiently prepared for the next stages of the M&A-Process.

Detailed Analysis of the target company

In the third step, the vendor discloses detailed information about the company to the potential buyer. Often, the vendor uses confidential data rooms to transmit the data. In addition to this, he discloses at this stage, the main findings of the vendor due diligence. The buyer submits to the seller a so-called info request list, which is the starting point of the buyer's due diligence. The findings of this due diligence are the basis for the binding offer submitted at the end of this stage. A deeper analysis of the content of the info request list and the due diligence is provided in the next chapter.

Sales agreement negotiations

In the fourth step, the negotiations about the selling conditions start. The buyer pursues the goal of reducing the price and the risks related to the transactions. Specific guarantees can be included in the selling contract to protect the buyer. In addition to this, the purchase price mechanism is determined at this stage. The literature differentiates here between two types of mechanisms: the completion account mechanism and the locked box mechanism. Further information about the differentiation and consequences between both are provided in the article of Pomp. Finally, after all, details of the contract are negotiated, the parties sign the sales agreement

Comply with the contractual agreements

In the last stage of the M&A process, the parties need to fulfill the closing agreements determined in the sales contract. After that, the parties surmounted every obstacle to the process, and the transaction is completed.

Overview of the different stages in the financial due diligence process

After having located the due diligence in the merger and acquisitions process, the following part addresses the literature about the different steps in the financial due diligence. Based on the approach of Lehmanbrown (n.d), the same structure as in the financial audit process is applied to enable the perfect comparison between both processes:

- Preliminary Engagement Activities
- Understand and Plan
- Perform and Evaluate
- Conclude

The following table provides an overview of the keywords and search strings used to cover the available literature.

Table 9: Specific keywords and search strings for the financial due diligence literature

Step	**Keywords**	**Search Strings**	**Number of pertinent references**
Preliminary Engagement Activities	*« Due Diligence engagement » ; « Scope of due diligence » ; « Due Diligence costs » ; « Due Diligence duration*	*"Due Diligence AND Independence"; "Due Diligence AND Confidentiality"; "Due Diligence AND cost"; "Due Diligence AND Duration"*	7
Understand and Plan	« Due Diligence Plan » ; « Due Diligence Information request list » ; « Due Diligence experts » ; « Due Diligence Team »	« Due Diligence AND Planning » ; « Due Diligence AND Information request list »; "Due Diligence AND Materiality"	4
Perform and Evaluate	« Due Diligence procedures » ; « Collaboration between auditor and	« Due Diligence AND Auditor » ; « Due	9

	performer of financial due diligence » ; « Due Diligence documentation”	Diligence AND Experts »	
Conclude	« Due Diligence report »		5
	Total		25

The type of literature found about financial due diligence was utterly different from the financial audit. Most articles analyzed included best practices for the profession. Therefore, the content of this part of the literature review is much more descriptive. The different tasks performed by the experts are highlighted in each stage to gain a detailed overview of the process.

Before entering into the details of each stage, it is essential to highlight that the legal environment is entirely different in this type of process. Contrarily to the audit, the financial due diligence is not directly required by the law. As the mission is on a contractual basis, the performer can be freely chosen by the company as well as the content of the mission. Nevertheless, the buyer, seller, and the performer of the due diligence have certain responsibilities during the process.

The buyer has to inspect the company before buying it. This requires him to consult the publicly available information about the company. In addition to this, he must keep the non-public information obtained during the due diligence confidential. This confidentiality requirement is often specified in the Non-Disclosure agreement discussed in the first step of the M&A-Process. The seller needs to assure the correctness and completeness of the information submitted to the buyer during the whole process. If the seller is aware of faulty details inside of the company, he must communicate it to the buyer. The withholding of information leads to the nullity of the sale agreement and can cause compensation payments. The seller commits, in this case, a *culpa in contrahendo* (Article 1116 of the Civil Code; Verleisdonk, Janssens & Wilkenhuysen., 2011)

The responsibilities of the expert, which is, in most cases, an experienced auditor in the financial due diligence (Pomp, 2015), are mostly covered in the contractual agreement with the parties mentioned above. Nevertheless, the professional auditor, which carries out a notification-obliged job under the Belgian law, must report to the legislator any detected information related to potential fraud or money laundering (Baeten et al. 2014; Law of 11th January 1993))

Preliminary Engagement Activities

Contractual Agreement

The timeline in the table 8 marks the beginning of the due diligence process. The vendor due diligence starts earlier than the buyer due diligence. Nevertheless, both types of missions begin with the same initial agreement between the performer of the due diligence and the company. As already explained before, the due diligence is based on a contractual basis. Therefore, the parties must define on their own the content of the work performed. This content varies, but Baeten et al. (2014) detailed in their article, the main content of the contractual agreement. The authors conducted interviews with several experts in the domain of due diligence. They highlighted five critical aspects of the mission letter to prevent misunderstandings between the client and the expert:

- The scope of the due diligence
- The responsibilities of the parties
- The confidentiality
- The remuneration agreement
- The duration

Scope

The scope of the due diligence varies from one engagement to another. Berens et al. (2011) emphasized in their article on two factors that influenced the scope of the due diligence: the amount and the complexity of the areas being tested. Therefore, the parties must be clear about the objectives of the due diligence. The experts must assess in this stage of the due diligence if they have enough professional competences to perform the mission (Lehman Brown, (n.d)). From the financial perspective, the objectives are to identify potential deal-breakers and the normalized cash flow of the company (Knauer, Hermann & Wagener, 2017). Both aspects are discussed more in detail in the chapter “Conclude” in this part of the literature review.

Independence

Important to highlight the responsibilities of the parties is the principle of independence. Contrarily to the audit engagement, the performer of the due diligence is not required to sign an independence agreement. The Belgian Law does not prohibit auditors from performing the financial due diligence of the same company. It specifies just that registered auditors must respect their deontological principles. (Baeten et al. 2014)

Confidentiality

In contrast to the principle of independence, confidentiality plays a vital role in the due diligence process. The main fear of the vendor is that in case of an abandonment of the M&A process, a competitor obtained precious insides about confidential information (Koch & Wegemann, 2001). On the other hand, the vendor has to provide enough information to the buyer to enable him to value the company correctly. Therefore, the Letter of Intent must clearly define the confidentiality of the data.

Costs and duration

Gösche (1991) analyzed that the costs and the duration of due diligence depend on the scope of the areas being tested and the qualifications of the experts involved. These elements vary from one engagement to another. Nevertheless, the author highlighted in his work that, generally, the process takes place under time and cost constraints. The experts must perfectly handle both constraints by setting up an efficient due diligence plan.

Understand & Plan

Understand the environment

Similarly to the audit engagement, the expert must understand the environment in which he operates. Next to the applicable accounting framework, the expert needs to assess if he has enough knowledge about the specifies of the industry to comply with the constraints imposed. In addition to this, the client and the expert have to determine which type of other expertise is required to improve the quality of the information obtained (See table 7). Three criteria can be used to assess the quality of the data: independence, clarity, and qualification.

Berens et al. (2011) differentiate here between two types of information. The first type of information is the internal information that can be obtained inside of the vendor's company. Often, this information is accessible in a so-called data room. The authors offer an overview of the information disclosed in this room, which is mainly the annual accounts, tax statements, shareholders agreement, as well as different types of contracts. Next to the data room, the expert conducts interviews with the management or the employees of the company. Important to mention is that the confidentiality of the process can limit the availability of interview partners. Also, company visits can be organized to inspect the company more in detail.

For the second type of information, the external data, the environment around the company needs to be analyzed. Therefore, the expert often contacts outside people such as the auditor, lawyer, banks, or the clients to verify the integrity of the information obtained. Due to confidentiality, the experts must be cautious about the pretenses of the contact request.

Information request list

After the initial scan of the environment, the experts set up at this stage an information request list, which highlights the focus of the expertise. An empirical study of Berens, Brauner & Strauch in 2002 showed that 82,5 % of the experts use checklists during expertise. The research offers different examples of the content of these checklists. Generally, the main information requested in the financial due diligence covers three main areas: general information about the company and the internal control, details of the income statement, and essential aspects of the balance sheet. (Berens et al. 2002; confidential document)

Additionally, the expert can request the business plan of the company (Pomp, 2015) Essential to mention is, that the research emphasizes on the fact that these information request list does not replace the critical judgment of the experts. Each due diligence process has its own specifies, and therefore, the experts cannot use a standardized approach during each engagement. (Harrer, 1993)

Composition of the team

Next to the information request list, the expert composes at this stage of the process, the due diligence team. In addition to the financial expertise, the client can require other experts to perform due diligence, as shown in the table 7. The conclusions of the other experts can influence the work of the financial expert significantly. These influences are discussed in more detail in the following section.

Perform and Evaluate

Procedures

After the plan and the team of the due diligence have been established, the fundamental stage of the process starts. Lehmanbrown (n.d) offers valuable insights about the difference between the audit and due diligence procedures at this stage of the process. They argue in their article, those typical audit methods such as confirmations, physical inventory observation, and the re-calculation of figures are not extensively employed. Therefore, the expert performs much more trend analysis, structural analysis, and other comprehensive methods.

- The historical and future revenue inclusive the sustainable financial results

Non-recurring events can primarily influence the historical profitability of a company presented in the financial statements. Therefore, the expert generally analyzes the financial statements of the last three years precisely and excludes the non-recurring events as well as structural changes to present the normalized and Pro-forma adjusted EBITDA. This EBITDA is essential for the valuation of the company and the validation of the submitted business plan. Additionally, the experts conduct sensitivity and scenario analysis to assess the plausibility of the numbers contained in the business plan.

- The historical and future asset positions inclusive the financial debt

The second key aspect of the financial due diligence mentioned in the literature is the identification and quantification of the net debt of a company, which is the difference between the debt and the cash positions of a company. Similarly to the adjusted EBITDA, the net debt significantly influences the valuation of the company and the validation of the business plan.

- The historical and future financial positions inclusive the working capital and investments

The last aspect put forward by the literature is the historical and future financial positions. Especially the development of the free cash flow of the company is analyzed in detail. Similar to the EBITDA, the experts adjust this cash flow by the non-recurring events to increase its predictive significance.

More details about the specific aspects analyzed during the financial due diligence are provided by Störk & Hummitzsch (2010), Strottmann &Pinkernelle (2010), and Bredy & Strack (2013) and Pomp (2015).

Collaboration with other experts

The three main findings of this stage mentioned hereabove can be significantly influenced by the findings of the other types of due diligence performed simultaneously. Therefore, the following table provides an overview of the influences on the financial due diligence of the different areas mentioned in the chapter. The findings are based on the references cited in table 2 regarding the different areas.

Table 10: Interconnections between the financial due diligence and the other areas

Area of Due Diligence	Influence on the financial due diligence	Expert type
Legal	Quantification of the net financial liabilities related to legal aspects such as contracts, patents, litigations, or warranty cases.	Experienced lawyers
Tax	Quantification of the accrued and income tax liabilities and the assessment of the related tax risk.	Experienced tax advisors
Environmental	Quantification of the net financial liabilities and provisions related to the environmental risks	Experienced environmental consultants

Operational	Assessment of the plausibility of the business plan, especially for the cost structure and the number of investments.	Experienced consultants in the specific industry
Market	Validation of the business plan by analyzing the market attractiveness.	Experienced
Human Resources	Quantification of the pension liabilities and the assessment of the personal cost development as well as the age structure of the employees.	Experienced human resource consultants
Strategic	Validation of the business plan by analyzing the distribution channels, the client structure, the Share-of-Wallet, the competitors.	Experienced strategic consultants of the specific industry
Intellectual Property	Valuation of the intangible asset value and the remaining useful life.	Experienced IP consultants
Technology	Assessment of the migration and integration costs of the software and hardware.	Experienced IT consultant
Research & Development	Validation of the business plan by analyzing the planned R&D costs.	Experts of the industry

Source: Author

Collaboration with the auditor and contact persons inside of the company

At this stage, Hölscher Nestler and Otto (2007) highlight the collaboration between the performer of the financial due diligence and the auditor of the company to ensure the integrity of the economic data. The authors mentioned that in both types of due diligence, the Sell-Side-Due-Diligence, and the Buy-Side Due Diligence, the experts conduct interviews with the auditors. Essential to note is that this type of interview can just be performed if the controlled company releases the auditors from their duty of secrecy. Next to the auditors, Pomp (2015) mentions that the experts mainly cooperate with the head of controlling and the management of the company. The accessibility of the contact persons inside of the company depends on the degree of confidentiality.

Documentation

Due to the massive amount of information obtained during the financial due diligence process, it is essential to have an efficient documentation process (Lück, 1991).
Berens et al. (2011) offered an overview of the seven functions which the documentation must fulfill as well as three main requirements. In addition to this, the authors highlight the three hierarchical layers of documentation:

Working Papers
The first layer is the working papers. Leffson (1988) defines the working papers as the written documents, which contain the planning, the type and scope of the performance as well as the results of the controls. These documents need to be structured logically to provide a transparent and understandable overview of the conclusions drawn. Especially for the identification of potential deal-breakers, efficient documentation is essential to prevent false findings. Lehmanbrown (n.d) emphasized on the fact that the working papers prepared during due diligence are not as standardized as in the financial audit. Also, the evidence for professional judgment is communicated in greater detail.

Due Diligence Memoranda
The second layer of the hierarchy is due diligence memoranda. In these reports, the expert summarizes the main information and conclusions obtained through the working papers, the interviews and, the other experts involved in the process. Lawrence (1995) precise that this information is essential for negotiations and follow-up decisions. Therefore, the experts must differentiate between essential and non-essential information to set up memoranda that are tightly organized, concise, and to the point.

Conclude

The last layer of the documentation hierarchy is the due diligence report. According to Berens et al. (2011), as well as Knauer, Herrmann, and Wagener (2017), the average length of a due diligence report amounts to 153 pages. Contrarily to the financial audit, the content of this report is not specified by law and not published. Therefore, the content, as well as the length, vary from one mission to another. Even if the recipients of the report are generally the board of the company, the formulations used should be adapted to the broader public (Berens et al., 2011; Laurence, 1995). Lehmanbrown (n.d.) added that excessively positive conclusions should be minimized. One reason for this is that the findings of the financial due diligence are essential for the integration program established at the end of the M&A Process.

Despite the lack of standardization, the literature offers insights into the main content of the report. Berens, Brauner & Strauch (2002) recommend including an abstract with the main facts of the company at the beginning of the report. Next to the abstract, the expert should include critical data about the three main aspects of the due diligence report, which are essential for the valuation of the company:

1) The historical and future asset positions inclusive the financial debt
2) The historical and future asset positions inclusive the financial debt
3) The historical and future financial positions inclusive the working capital and investments

Important here is to specify that the content and the form also vary according to the type of due diligence mentioned in the beginning of this chapter.

Differences in the reports depending of the types of Due Diligence

Especially in the Vendor Due Diligence the type of report varies between the Vendor Assistance and the Vendor Due Diligence.

Vendor Assistance

In the Vendor Assistance, the literature specifies that, in most cases, the experts set up a report, but this is not always the case as the experts are seen as support for the management. The authors differentiate between two types of reports: financial factbook and financial databook. Both types of reports offer the same type of financial information, but the main difference is that financial factbook also includes additional comments about the data. (Pomp, 2015)

Vendor Due Diligence

Contrarily to the Vendor Assistance, the mission of the Vendor Due Diligence always ends with a final report, and the experts are an independent third-party. The content of the report also varies in the Vendor Due Diligence. In addition to the comments included in the financial factbook, the report contains assessments about the appropriateness of the financial data. (Pomp, 2015)

In both cases, the report is handed out to the management of the vendor's company. Generally, the vendor hands out the findings of the report to the potential buyer at the beginning of the third stage of the M&A Process. The following table provides an overview of the main advantages and disadvantages of both types of engagements:

Table 11: Advantages and disadvantages of the types of report

	Factbook	**Vendor Due Diligence Report**
Advantages	Less time-consuming	Assessment about the appropriateness of the financial data
	Lower costs	Less Buy-Side-Due Diligence required
	Less management-ressources required	The expert can be held liable towards the buyer and the investors
	The expert does need to pount out detected weaknesses	
Disadvantages	No assessment about the appropriateness of the data	More time-consuming
	The expert cannot be held liable towards the buyer or investors	Higher costs
		Higher management-ressources required

Source: Pomp, 2015

Buyer Due Diligence

The content of the buyer due diligence report is similar to the content of the Vendor Due Diligence Report. Nevertheless, the authors suggest that the performer of the buy-side due diligence separates the reporting stage into two stages. In the first stage, the experts should present to the buyer the potential deal-breakers identified. Based on these findings, the buyer has to decide whether to proceed with the negotiations or not. In the second stage, the expert sets up the final report with all the findings. This breakdown into two stages has the advantage to identify early potential deal-breakers and save unnecessary costs. The final report is submitted to the management of the potential buyer or other specific interested parties. For example, in case of the use of external borrowings, the findings are presented to the financing bank.

Qualitative Survey

The objective of this master thesis is to offer a comparison between the process of audit and financial due diligence to analyze the similarities and differences. The literature review already offered essential insides into both field and enabled a first comparison with the main features of both processes. To complement the findings of the theory, a research method needed to be defined in order to provide practical insights into the field and challenge the aspects seen in theory. The features of the qualitative research approach discussed by Collis and Hussey (2014) offered the essential characteristics to reach this objective. The following part explains more in detail the different characteristics that defined the qualitative research conducted:

Method of data collection & Participants

The method of data collection used in this qualitative research were semi-structured interviews with experts having experience in both domains. Predetermined open-ended questions were asked to the participants while the rest of the questions were not planned in advance. This methodology allowed to compare the answers of the candidates as well as spontaneously explore topics not mentioned in the theoretical foundations. The survey of the interview included one general question about the main difference between both processes followed by different sub-questions. These sub-questions were categorized into main topics analyzed during the literature review:

Table 12: Overview of the main topics discussed

• Engagement • Team • Scope • Duration • Costs	• Procedures • Evidence • Confidentiality • Report • Evolvements

Source: Author

The theoretical foundation showed that process of financial due diligence varies from one company to another. Therefore, it was essential to interview experts inside of the same company to enable the comparison with the audit process. The method of purposive sampling by Freedman, Pisani and Purvey (2007), in which the sample members are selected according to their expertise and knowledge regarding the research subject, was used to construct the sample. A total of six people with different levels of experiences in both domains were interviewed to comply with the principle of variety. The following table provides an overview about the characteristics of the experts interviewed:

Table 13: Overview of the participants

Interview	Name	Function	Experience in audit	Experience in financial due diligence	Duration of the interviews
1	Benjamin Bataille	Supervisor in Corporate Finance BDO Namur	1,5 years	3 years	43 minutes
2	Justine Rodheudt	Supervisor in Corporate Finance BDO Liège	0 years	2 years	27 minutes
3	Christian Schmetz	Partner BDO Liège	15 years	Performs around 6 financial due diligence missions per year	36 minutes
4	Felix Fank	Partner BDO Liège	30 years	Performed many financial due diligence missions	37 minutes
5	Jean-François Bernard	Senior Manager in Audit BDO Liège	10 years	Performed around 10 financial due diligence missions	33 minutes
6	Arnaud Williquet	Manager in Corporate Finance BDO Namur	5 years	2 years	18 minutes

Source: Author

As the objective of the master thesis is to compare the due financial due diligence with the audit process, it was essential to set up the sample with experts from one company. The reason for that is, that the financial due diligence process differs from one company to another, which would increase the difficulty to compare both processes.

Due to the specific circumstances caused by the COVID-19, five interviews were conducted by phone call. The similar responses given by the interviewers justifies the number of interviews for the purpose of this research.

Method of Analysis

The method of analysis used in this master thesis is the content analysis developed by Moore & Cabe (2005). By transcribing the interviews, the data gathered through the research was categorized into the different sub-categories to enable the comparison between the data. In addition to the sub-sections mentioned in Table 1, the interviews leaded to interest other findings which can be useful for further research, which are discussed more in detail in the conclusion part of the Master thesis.

Limitations

As the study is conducted with experts working inside of one company, the general findings cannot be extended to the population with the same degree of certainty. In addition to this, the sample is relatively small to ensure the reliability of this research. Nevertheless, based on the assumptions of Baker and Edwards (2012), who analyzed the influencing factors on the number of participants in a qualitative approach, the sampling size allowed to draw general conclusions about the discussed aspects.

Findings and Discussion

In this chapter, the findings of the interviews with the experts are presented in detail and discussed with the current state of the research presented in the literature review. Therefore, the same comprehensive structure as in the literature review is applied to categorize the findings of the interviews.

This chapter is divided into five sub-chapters. The first sub-chapter presents the findings of the interviews regarding the main difference between the financial due diligence and the audit. In addition to this, the main types and areas of due diligence are presented with valuable insights offered by the experts. The second sub-chapter handles the aspects related to the preliminary engagement activities already discussed in the literature review, such as the duration of an engagement, the principle of independence, and the scope of both processes. In the third sub-chapter, the main findings regarding the understanding and planning phase are discussed. For example, the experts provided valuable insights into the influence of the legal context and the digital transformation of both professions.

Additionally, they offered an overview of the general composition of the teams and the related costs. In the perform and evaluate section, the fifth sub-chapter, the main findings regarding the audit assertions, the type of evidence, the documentation, and the confidentiality are discussed. Also, the experts explained more in detail the collaboration between the external audit, internal audit, and financial due diligence.

The last chapter highlights all the relevant findings regarding the audit and due diligence report submitted at the end of each engagement. To conclude the findings of the interviews and the literature review, a table is presented at the end of this chapter containing all the similarities and differences found between both processes.

Main Difference between Audit and Financial Due Diligence

The following table provides an overview of the answers given by the experts related to the main difference between the audit and the financial due diligence

Table 14: Overview of the main difference between both missions

Expert Name	**The main difference between the two missions**
Mr. Bataille	"The objective is the main difference between both missions. In the audit mission, the main objective is to deliver an opinion to reassure all the stakeholders about the financial statements. The main objective of the due diligence mission is to identify all the related risks to the company."
Mrs. Rodheudt	"The main difference between the due diligence and audit is the objective. The audit is a rule-based process to verify and correct the applied accounting rules. The main objective of the due diligence process is to find the normalized EBITDA."
Mr. Schmetz	"The objective is completely different, that's clear. In the audit, the objective is always the opinion about the financial statements. In due diligence, the objective depends on what the client wants to buy."
Mr. Fank	"The objective is the main difference. In the audit, you try to elaborate your opinion about the financial statement for all the stakeholders of the company. An auditor tries to validate the integrity of the financial statements at a specific point in time. The process is legally regulated, and the applicable standards are well-defined. The acquisition audit is based on a contract, and therefore, the content of each due diligence is different.
Mr. Bernard	"The objective of both missions is the main difference."
Mr. Williquet	"The main difference is that the audit is a legal mission, and the due diligence is a contractual mission."

Source: Interviews

All the experts agreed that the main difference between the audit and the due diligence is the objective. This result is similar to the findings of the literature review, which stated that both processes are entirely different since the objective differs between the missions. Mr. Williquet and Mr. Fank added that the legal basis is also different. The audit mission is legally defined and mandatory for some companies, while the due diligence mission is not legally defined and not mandatory during an M&A- process. The influence of this aspect on the work performed, already discussed in the literature review, is explained more in detail in the sub-chapter: Understand and Plan.

Types and areas of due diligence

Types of Due Diligence

The literature showed that in practice, it is essential to differentiate between the buy-side-due diligence and the vendor-side-due-diligence. In the vendor-due-diligence, the most common type of mission performed is the vendor due diligence in comparison to the vendor assistance, as analyzed by (Khaoula, 2018). The qualitative survey conducted in this master thesis spotlighted some interesting insights into the most common types of due diligence performed. Mr. Williquet revealed that in large corporations' vendors as well as the buyers perform due diligence. But for small companies, the most common due diligence mission accomplished is the buy-side-due-diligence. Also, Mr. Bataille agreed that the most common type of due diligence performed is the Buy-Side- Due Diligence. The other experts underlined this statement as they predominantly talked about the buy-side-due-diligence.

Areas of due diligence

The literature review offered valuable insights into the different areas of due diligence. Marten and Köhler conducted in 1999 a study to analyze the most widespread areas of due diligence performed during an M&A-transaction. The results showed that the three main types of due diligence performed in small, medium, and large companies are financial, tax, and legal, due diligence. Even if this aspect goes beyond the scope of this master thesis, it is interesting to highlight the answers provided by the experts as the other areas can have a significant influence on the financial due diligence as already analyzed in table 10.

Even if this study was conducted 21 years ago, the results of the answers provided by the experts are similar to the findings of the study. The following table highlights the main areas of due diligence mentioned by the experts

Table 15: Overview of the main areas mentioned

Area of due diligence	Mentionned by
Legal	Mr. Bataille ; Mr. Williquet; Mr. Fank; Mr. Schmetz
Tax	Mr. Bataille ; Mr. Williquet; Mr. Fank; Mr. Schmetz
Social	Mr. Bataille ; Mr. Williquet; Mr. Fank; Mr. Schmetz
Environmental	Mr. Bataille; Mr. Williquet
Operational	Mr. Fank
IT	Mr. Fank

Source: Interviews

The table shows that in addition to the findings of Marten and Köhler in 1999, social due diligence becomes more and more important nowadays. This finding is coherent with the conclusion of the research of Boussaguet (n.d), which emphasized the importance of social due diligence. The author highlighted in the article all the risks related to the employees during an M&A transaction. Mr. Schmetz provided an interesting example of the importance of the employees in an M&A transaction. He explained that, especially in Start-Ups, the relationship between the founder of the company and his employees is strong. The whole dynamic and success of the company are based on the massive motivation of the employees. In addition to this, people are often willing to give up some of their salary for the well-being of the company. These aspects are essential during the assessment of the costs related to the transaction because the acquiring company must often pay more to not lose the employees of the company. This change of the cost structure can have a significant influence on the business plan developed and is therefore essential to validate during the financial due diligence.

An interesting finding in the tax due diligence, which was not mentioned in the literature, is the differentiation between two types of due diligence in this area. All the participants mentioned the tax due diligence and differentiated between the value-added tax due diligence and the corporate income tax due diligence, which is performed by separate experts.

Performer of the due diligence

The literature stated that the usual performer of financial due diligence is an experienced auditor. Mr. Schmetz and Mr. Fank highlighted here that ten years ago, all the due diligence missions inside of their company were performed by the auditors. Nowadays, the assignments are completed by a specific department inside of the company. Usually, the experts working inside of this department have prior audit experience. According to Mr. Fank, this is caused by the quantitative evolution and leads to a qualitative improvement of the audit missions. Mr. Bernard also emphasized the fact that the due diligence missions inside of their company became much more professional since an own department performs the tasks.

Preliminary Engagement Activities

The scope

Especially in the due diligence engagement, the literature showed that the scope of due diligence varies from one mission to another depending on the amount and the complexity of the areas being tested (Berens et al. 2011). Mr. Fank agreed on the statement that each due diligence mission is different since the parties determine in the contract the scope of the engagement. According to him, the experts perform in most due diligence engagements a limited review. In cases of a full-scope review, the due diligence engagement can be compared to the audit engagement as this engagement is always a full-scope.

Mr. Schmetz emphasized on the fact that the first meeting with the client is the most essential one to determine the scope of the due diligence. In this meeting, the expert must understand why the client wants to buy the company. Once the objective is clear, the scope of the due diligence is defined. Examples of the importance of understanding the reason are provided in the section understand and plan.

Duration

Linked to the scope of the engagement, the mission letter also includes important comments about the duration of the due diligence engagement. In contrary to the audit engagement, the general duration of due diligence is not as structured. Therefore, the experts were asked to provide insights about the overall duration of the due diligence engagement.

Table 16: General duration of both missions

Name of the expert	General duration of the process
Mrs. Rodheudt	The duration of the due diligence depends on the size of the company. In small-size companies, the due diligence engagement can be performed in two weeks, while in big companies, it can last four to five months. Generally, the more companies and countries involved, the more time is required.
Mr. Bataille	The duration of the engagement is highly influenced by confidentiality as it takes more time to obtain the evidence if nobody knows about the transactions. Another aspect which affects the duration is the number of buyers interested in the company because it increases the pressure to perform the due diligence mission fast
Mr. Williquet	It depends on the efficiency of the information flow.

Source: Interviews

The duration of the due diligence engagement varies according to different factors. Therefore, it is not possible to determine the general duration. According to Mr. Williquet, the audit process takes in overall more time compared to the due diligence, as it requires an interim audit, as already seen on the timeline in the literature review. The literature often highlighted the fact that the due diligence procedure suffers under time pressure. This general statement cannot be confirmed in this qualitative survey, as the duration of the due diligence depends on different factors. Especially the efficiency of the information flow is crucial.

Principle of independence

The principle of independence of the auditors was an important concept developed in the literature review. Dunmore and Falk (2001) highlighted the objectivity and integrity as the main characteristics of the independence principle. Before accepting an audit engagement, the auditor is required to sign an independence agreement to confirm that the principle is respected. In the literature about the due diligence, the importance of this concept was not specified. Therefore, the experts were asked if the principle of independence plays a vital role in due diligence engagement.

The answers to the interviews confirmed that the independence principle does not play a significant role in due diligence engagement. According to Mr. Bernard, the principle of independence does not need to be respected as the due diligence is a contractual mission. Mr. Fank explained that it is the client's responsibility to assess the expert's independence during the engagement. He explained that the principle of independence is only crucial during the legal mission as the stakeholders are the wider public, and the auditors have a responsibility towards them. This is entirely different in the due diligence engagement, in which the experts are just responsible towards the contractual partner. In cases of conflicts of interest, another important concept in audit, the expert needs to inform the client before starting the due diligence engagement. Therefore, Mr. Bataille added that some clients require the experts to sign independence and conflict of interest letter before entering into the engagement.

Confidentiality

In the due diligence part, the literature highlighted that the confidentiality principle influenced a lot the work performed. Therefore, the experts were asked to evaluate the influence of the confidentiality principle on the due diligence process.

The results showed that the importance of confidentiality depends of the company and the competition. Mr. Williquet emphasized on the fact that the due diligence process is not always confidential. Some companies inform their employees about the future transaction and therefore the confidentiality does not impact the process, but in most cases the employees are not informed according to Mrs. Rodheudt. Therefore, the experts of the due diligence process perform a lot of work from the office, contrarily to the audit. Inside of the office, the colleagues use specific "codes" to hide the identity of the company. In addition to this, she explained that the rapidity of the data transmission is also impacted by the confidentiality. According to Mr. Bernard, the principle of confidentiality is highly linked with the competition. He explained that small businesses, which do not have a lot of competitors, are less prudent than companies exposed to huge competition. Especially in big companies, the confidentiality agreement and the securized datarooms are essential during the whole engagement. This finding is coherent with the research of Koch and Wegemann (2011).

Understand and Plan

The understanding and planning phase already developed in detail for both processes in the literature review offered interesting insights into the main aspects of this stage.

Legal Environment

The first aspect discussed in the literature review about the audit process was the legal environment which is very strong in Belgium. In the literature about the due diligence, the influence of the law was much less discussed. Therefore, the experts were asked to evaluate the legal environment for both processes in Belgium. The following table summarizes the statements of the experts

Table 17: Legal environment

Expert Name	Difference between the legal environment
Mr. Bataille	"The due diligence process is much less regulated than the audit."
Mrs. Rodheudt	"The audit process is a lot more regulated than the due diligence process."
Mr. Schmetz	"In the due diligence engagement, there are no specific standards and laws."
Mr. Fank	"The audit process is a highly regulated process by laws and standards. Whereas in the due diligence, there are no specific rules."
Mr. Williquet	"In the audit process, there are many more laws and formalities. It is much more procedural. In due diligence, you just have the mission letter, and then you enter into the work. Especially in the last years, the rules in the audit evolved a lot, but not in due diligence."

Source: Interviews

The statements of the experts confirmed the initial research conducted in this master thesis. The due diligence process is much less regulated nowadays than the audit mission. The main reason for that is, as already explained before, that the due diligence engagement is on a contractual basis, whereas the audit is mandatory under certain conditions. This difference in the legal framework has a significant influence on the main work performed during the engagement. According to Mr. Bataille, the difference in regulations has a significant impact on the quality of the work performed. From one company to another, the quality of the due diligence varies as there is no standardized approach, which is coherent with the findings of Harrer (1993). Whereas in the audit, the similar approach applied in every audit company increases the overall quality of the engagement. Another influence of the absence of regulations in the due diligence engagement is discussed more in detail in the sub-chapter: Perform and Evaluate.

Digital transformation

The second aspect discussed in the literature review was the influence of the digital transformation on the work performed. Especially the literature in the field of audit offered interesting insights about the digitalization of the audit process. In the field of due diligence, the research was not as developed. Therefore, the experts were asked to evaluate the potential of new technologies on the due diligence process.

The evolvement of digitalization impacts the work performed by the experts, according to Mrs. Rodheudt. She observed a general tendency that firms have much more digitalized data nowadays, which increases the overall efficiency of the process. Especially for technologies such as Blockchain and Artificial Intelligence, she recognizes a considerable potential to optimize the data preparation and analysis in the future.
Mr. Bataille shared the same opinion and added that automatization enables us to go much more into the details. According to him, the whole due diligence process changed in the last years. To transmit the data, the company uses secure data rooms and platforms on which the documents are encrypted. The buyer and the seller have access to this platform, and at the end of the engagement, all the information is stored on a secured USB-Stick.

The answers of the experts showed clearly that the focus of the digital transformation in the field of financial due diligence is on the security of the data. In the field of audit, the experts did not confirm the findings of Cao, M. et al. (2015). This result showed that Gepp, A. et al. (2018) are right in their conclusion that Big Data Analytics is not as widespread in the field of audit nowadays. For the future, the recommendations of Appelbaum, D. et al. (2017) can play a vital role in increasing the efficiency of the data analysis.

Contact person inside of the company

Another interesting practical aspect, which was not covered in the literature review, is the general contact person during both engagements inside of the reviewed company. Especially in due diligence, confidentiality can have an impact on the availability of the people contactable. Therefore, the experts were asked to clarify the general contact person in a due diligence engagement, as the audit engagement is not constrained by confidentiality. The findings of this qualitative study offered exciting insights into this practical aspect of the process of due diligence. The following table summarizes the statements of the experts.

Table 18: General contact person

Name of the Expert	General Contact person
Mr. Bataille	"It depends on two different factors: • The context: if the employees were informed, there is no problem to collaborate with the accountants inside of the company. If they were not informed, we would work a lot with the external accountants • The size and the roles: It is strategically important to identify the people who have the information. In general, it is the accountant and management. But in cases of strict confidentiality, we majorly work together with the CFO and CEO. "
Mrs. Rodheudt	"The general contact person inside of the company varies according to the size of the company. In small-size companies, it is often the CEO and the external accountant. In bigger companies, we cooperate a lot with the CFO or specific departments dedicated to the M&A. "
Mr. Williquet	"Generally, the accountants, the controlling, and the CEO. "
Mr. Bernard	"In small businesses, it is the external accountant and the CEO."

Source: Interviews

The answers provided by the experts show that the availability of the contact person is influenced by confidentiality. Generally, strategic people such as the CEO and the CFO are involved in the process as they have a deeper knowledge about the daily business. External accountants are also contacted in small companies as they have all the financial information regarding the target company. Due to personal experience and the discussions with the experts, the contact person in the audit process is different from the due diligence. Primarily, the auditors cooperate with the accountants and the controlling department. The CEO and the CFO are rarely contacted in large businesses.

General composition of the team and costs

Related to the people involved in both processes, the experts were asked to explain and compare the general composition of the teams involved in both processes.

Table 19: Composition of the team

Name of the expert	Composition of the team
Mrs. Rodheudt	"In depends of the size of the company and what the client wants. In financial due diligence, there are generally two or three people involved. For the corporate tax one or two experts and for the value-added tax also one or two people. Often, there are also two experts for the legal due diligence. "
Mr. Bataille	"It depends of the needs of the client."
Mr. Williquet	"In the due diligence, there are often other experts involved. "
Mr. Schmetz	"In the due diligence, there are generally more experienced people and more experts involved. In the audit, the average experience of the team is lower. "

Source: Author

The experts agree on the fact that in the due diligence engagement, the amount of people involved is higher than in the audit engagement, mainly due to the fact that often other experts are involved. Mr. Schmetz also highlighted that the average experience of the people involved in the financial due diligence is higher than for the audit. A reason for that is that the audit approach is much more standardized and includes a lot of repetitive work that can be performed by less experienced people. Often, as already stated by Pomp (2015), people working in the financial due diligence department have prior audit experience. This aspect also influences the average costs of due diligence engagement. According to Mr. Schmetz, the average costs of due diligence are higher than for an audit. In both missions, Mrs. Rodheudt clarified that the costs are not depending on the final result but are invoiced according to the hourly rate of the people involved.

Concept of Materiality

An important concept seen in the literature review of the audit planning phase is the materiality. This principle was not mentioned in the research about the due diligence process. Therefore, the experts were asked to clarify if the principle of materiality intervenes in the due diligence process. The following table summarizes the importance of the materiality in the due diligence.

Table 20: Concept of materiality

Name of the Expert	Materiality
Mr. Williquet	In due diligence, the principle of materiality is not often applicable
Mr. Fank	In the acquisition audit, there are no specific rules about the materiality, and the concept is not often used. Sometimes, we determine it in the contract with the client.
Mr. Bernard	The principle of materiality is not often applied as it can have a significant influence on the final value of the company.

Source: Interviews

The answers of the experts showed that the principle of materiality is not often applicable in due diligence, whereas in the audit, it is crucial. Mainly the response of Mr. Bernard highlights the main reason for this, which is that the materiality can influence the price of the company due to the multiple used in the valorization of the company afterward.

Perform and Evaluate

General Procedures

In the third stage of the process, the literature review offered valuable insights into the main work performed during an audit and a due diligence process. Lehmanbrown (n.d) stated in their work that the methods employed during the due diligence vary from the procedures performed during an audit. To analyze this statement, the experts were asked to compare the procedures performed in both processes. The following table presents the main conclusions given:

Table 21: Procedures

Expert Name	Comparison between the audit and due diligence procedures
Mr. Bataille	The aspect of the analysis is similar between the audit and the due diligence as you perform in both cases, an analytical review of the accounts. The difference is that in the due diligence, you analyze the effect on the normalized income statement or if it's recurrent or not. In the audit, you focus much more on the accuracy of the accountancy. Generally, we look if the data is consistent with the observations in due diligence. We do not perform as many tests as in the audit.

Mr. Fank	The procedures performed in full-scope due diligence can be compared to the financial audit.
Mr. Bernard	The procedures and the approach are similar between both processes. At first, you try to understand the financial statements, and based on the risks found, you adapt the approach. The starting point between the audit and the financial due diligence is the same, but the orientation after that is different
Mr. Williquet	The procedures performed are much more customized in the due diligence process.

Source: Interviews

Globally, the statements of the experts showed that the types of analytical procedures performed are similar in both processes. The main difference is that the audit procedures became much more standardized during the last years, while the due diligence procedures are much more adapted to the needs of the client. According to Mr. Schmetz, the procedures performed during the due diligence need to be adapted specifically to the objective of the client. The main question the expert needs to answer is: "What does the client want to buy?". Based on the answer, the expert must perform additional procedures. For example, he explained that if a company buys another business to obtain its clients, the expert must analyze the client structure in detail to identify all the risks.

On the contrary, if the company buys a business for its product, the expert must adapt its approach and focus, for example, on intellectual property rights. In this case, the collaboration with specific lawyers is the primary importance. These examples show that the procedures performed and experts involved in the due diligence strongly depend on the objective of the client. Another aspect that can influence the procedures performed is the type of business in which the client operates. For example, Mr. Bernard explained that cash verification in the gambling sector took much more time for due diligence than in an audit mission. Additionally, the experts also spend more time analyzing the on-going contracts and the tax. While in an audit, they just verify if the tax provisions are accurate, the experts collaborate in financial due diligence with the tax consultants to identify all the tax-related risks.

In addition to this, Mr. Bataille emphasized the fact that during due diligence, the experts analyze the financial data of the last three or five years while the auditor reviews the current year in comparison to the previous year. In this historical period, the experts analyze in detail all the elements that are not recurrent or transactions under the market price to present a normalized income statement. This finding confirms the statement of Lehmanbown (n.d.)), who mentioned that during due diligence, the expert performs much more trend analysis.

Another procedure often performed during the due diligence, which is not performed in an audit, is the validation of the business plan. As the company value depends on the historical financial data but also of future expectations, the experts are asked to review the business plan submitted by the company. According to Mrs. Rodheudt, the main job of the experts is to analyze if the numbers presented in the business plan are realistic based on past results. Mr. Bataille specified that the validation of the business plan is mostly performed in large businesses. In small and medium businesses, the experts only review the past but not the future. In the audit process, Mr. Schmetz highlighted that the auditors only look at the future to ascertain the going-concern principle. This statement is in accordance with the findings of Colbert, J, Luehlfing, M. and Alderman, W. (1996), who stated in their article that the auditor must ascertain the going-concern principle to diminish the client's business risk and the overall risk the auditor is exposed to.

Obtaining Evidence & Documentation

Related to the procedures performed is the evidence obtained and the documentation process. Especially in the audit process, the literature highlighted the importance of evidence and documentation to prove the procedures performed. The literature about the due diligence highlighted much more the documentation of the findings. Therefore, the experts were asked to analyze the amount of evidence required in both processes and the related documentation process. The following table summarizes the statements of the experts.

Table 22: Evidence required and documentation

Expert Name	Amount of evidence and documentation
Mr. Bataille	"The amount of evidence required in the audit is much larger. You have to find evidence for all the stakeholders of the company. In due diligence, the client does not require evidence for every step performed" "The major difference between the audit and due diligence process is that in the due diligence, you do not have the whole documentation process. You focus much more on the analytical aspect than on the documentation."
Mr. Schmetz	"During an audit, we focus much more on the documentation than in the due diligence."

Source: interviews

Both statements showed that the focus of the audit is much more on the documentation. The main reason for that is the evolvement of the legal environment in the audit profession, according to Mr. Schmetz. Mr. Bernard added that the audit sector had a bad reputation in the past because nobody controlled the auditors. Therefore the need for evidence and documentation was essential to prove the work performed and improve the image of the sector.

Internal and external audit

The last aspect analyzed in this part of the qualitative survey was the importance of the internal audit in both processes as well as the collaboration between the auditors and the experts of financial due diligence. The ISA- 610 standard describes in detail the collaboration between the external audit and the internal audit, but the due diligence literature did not mention the role of the internal audit. Therefore, the experts were asked to offer insights into the importance of the internal audit in a due diligence mission and compare it with the external audit.

Table 23: Role of internal audit

Name of the expert	Role of the internal audit
Mr. Bataille	The internal audit is a strength in the external audit as well as in the due diligence mission
Mrs. Rodheudt	In the due diligence mission, the internal audit is not important
Mr. Schmetz	The internal audit is much more important in the audit mission
Mr. Fank	It depends on the contract. In the due diligence, there is no structured work with the internal audit department, but it offers you confidence about the data.
Mr. Williquet	An internal audit is more helpful in the audit mission.

Source: Interviews

The answers of the experts showed that the work of the internal audit is much less used in the due diligence mission. This finding is consistent with the current state of the literature about the due diligence, as it did not mention the collaboration between the experts and the internal audit department. On the contrary, Pomp (2015) noted in their research that the experts highly collaborate with the external auditors of the company. The interviewees were asked to confirm this statement and to explain the typical collaboration between the experts of the due diligence and the external auditors.

Table 24: Collaboration with external audit

Name of the expert	Collaboration with the external audit
Mr. Bataille	"We consult the audit report during the due diligence engagement. If an external audit has been performed, we know that some risks have already been covered by the auditors."
Mrs. Rodheudt	"We don't collaborate directly with the external auditors. We just consult the audit report. A prior audit increases the integrity of the data, and we know that the company has applied the accounting rules. "
Mr. Schmetz	"A prior audit increases the integrity of the financial data, but we do not collaborate directly with the auditors."
Mr. Bernard	We use the audit report, but we do not base our judgments on it. One reason for that is that the audit report presents the financial statements at the end of the year. If the due diligence is performed before, we try to base our assumptions on the nearest date. Another reason already seen before is the concept of materiality in the audit, which is not always applicable in the due diligence mission.

Source: Interviews

This finding is interesting because it contradicts the statements of Pomp (2015) and Hölscher, Nestler, and Otto (2007), who stated that the experts highly collaborate with the auditors. In practice, the interviewees agreed that the work of the external auditor is used but that there is no direct collaboration between both parties.

Conclude

The last step of both processes is the report. The literature already showed that the content of both reports varies between the audit and the due diligence. In the audit, the central aspect of the report is the audit opinion, while in the due diligence, many more details are presented about the company. Another significant difference is that the content of the audit report is legally defined. The experts were asked to comment on both types of reports and precise the content of the due diligence report.

Table 25: Content of the report

Name of the expert	Report
Mr. Bataille	The most important aspects of the due diligence report are the normalized income statement, the net financial debt, and the normalized working capital. In addition to this, we try to present all the risks identified during the analysis. The due diligence report is much more detailed than the audit report. In the audit, you present briefly every aspect, but in the due diligence, you go into the details.
Mrs. Rodheudt	The main content of the due diligence report is the normalized EBITDA and the debt positions, as well as the main risks identified through the process.
Mr. Schmetz	The due diligence report contains the normalized EBITDA, the normalized financial debt, and the normalized working capital as these aspects have a significant influence on the valuation of the company. Even if we have much less documentation work during due

	diligence, the preparation of the report takes much more time than during the audit.
Mr. Fank	The central aspect of the audit report is the audit opinion. At the same time, in the due diligence, the focus is on the normalized EBITDA, the net financial debt, and the normalized working capital.
Mr. Williquet	The executive summary highlights the main aspects of the due diligence report. Especially the EBITDA, the net financial debt and the working capital is essential.

Source: Interviews

The findings showed that even if the content of the due diligence report is not legally defined, the practitioners have a common understanding of the main aspects of a due diligence report. Consistent with the findings of the literature review, the expert present in the report:

- Normalized income statement
- Normalized net financial debt
- Normalized working capital
- Risks related to the business

In comparison to the audit report, the content of the due diligence report is much more detailed and generally longer. The statement of Mr. Schmetz showed that even if the documentation effort during the due diligence is less, the drawing up of the report takes much more time.

Summarizing Table

The following table summarizes the main differentiations and similarities between both processes discovered during the literature review and the qualitative survey.

Table 26: Summarizing overview of the differences and similarities

	Audit	Financial Due Diligence
Objective	Decrease the information asymmetry by confirming the integrity of the financial statements	Decrease the information asymmetry by determining the normalized income statement, the net financial debt, and the normalized working capital for the valuation.
Type of mission	Legal mission	Contractual Mission
Performer	Auditors	Mostly experienced Auditors
Scope	Full-scope audit	Determined by contract
Period covered	Past: 1 year	Past: 3 – 5 years and future
Duration	Structured	Not structured
Principle of Independence	Applicable	Not applicable
Confidentiality of the process	Low	High/Medium/Low
Legal environment	Strong	Weak
Concept of Materiality	Applicable	Not applicable
General tendency	Standardization of the process	Customization of the process
Procedures performed	Similar to every audit	Depending on what the client wants to buy/sell
Obtaining evidence and documentation work	Huge amount of evidence and documentation	Low amount of evidence and documentation
Access to information	Not limited	Limited
Collaboration with internal audit	High	Medium/Low
Collaboration with other experts	Low	High/Medium
Report	Regulated by the law (Long or short form)	Not regulated, but much more detailed than the audit report

Source: Author

Stakeholders and users of the report	Inside and outside of the company	Mostly inside of the company

Conclusion

This qualitative research aimed to identify the similarities and differences between the financial due diligence and the audit process. Based on the results of the qualitative analysis and the literature review, it can be concluded that both processes have similarities as well as significant differences, as presented in table 26.

During the whole master thesis, we tried to establish a coherent and similar approach between both processes, as the major steps between the financial due diligence and the audit were similar. The rigorous research methodology used for the literature review enabled us to cover a wide range of available articles about critical topics in the field of audit and financial due diligence. The objective of the literature review has been fully fulfilled. Firstly, it enabled us to establish a concise and current definition of both concepts. Secondly, it helped us to discover the key concepts related to both processes to provide a solid foundation for qualitative research. Thirdly, and most importantly, it enabled us to set up a detailed overview of the current state of the research in both domains.

Already during the literature review, it was evident that one of the significant differences between both concepts was the objective. Through the financial due diligence process, the experts determine key financial figures about the company, which include mostly the normalized income statement, the net debt positions as well as the normalized working capital. In addition to this, the experts highlight the major risks the company is exposed to and validates the submitted business plan. In the audit process, the auditor certifies with the opinion that the financial statements of the company have been prepared, in all material aspects, in accordance with the applicable accounting framework. Nevertheless, both processes have a similar objective: decrease the information asymmetry about the financial statements.

Another key difference observed during the literature review was the legal environment of both professions. While the audit is a highly regulated national and supranational legal mission mandatory for specific types of companies, the financial due diligence is always on a contractual basis. This legal difference is justified, as the stakeholders of both missions are different. Even if, in both processes, the companies pay the fees, the stakeholders of the audit are mostly external. In contrast, the findings of the financial due diligence are specifically designed for the interesting parties inside of the company.

As the objective of this master thesis was to present a detailed overview of the differences and similarities of both processes, it was crucial to design efficient qualitative research. The findings of the literature review increased the number of questions related to both processes. For example, the literature didn’t emphasize the applicability of the principle of materiality in financial due diligence. Therefore, the experts were asked during semi-structured interviews to answer several questions related to key concepts of both processes.

The qualitative survey revealed several interesting new insights into the comparison between both processes. Generally, the experts agreed that the differences between both processes increased in the last years. Ten to twenty years ago, the central part of the due diligence missions was performed by the auditors. Nowadays, most of the experts work in specific departments dedicated to the financial due diligence as the process becomes much more customized to the client’s needs. In the audit, the increase in regulations leads to a standardization of the process.

In the preliminary engagement activities stage, the significant difference between both processes is the principle of independence. In the audit profession, the law requires the auditor to ascertain his independence towards the client. The main reason for that is that the stakeholders of the findings are outside of the company. As the due diligence mission is a contractual basis and the stakeholders of the report are inside of the company, this principle is much less critical. In contrast to the principle of independence, the literature highlighted in the financial due diligence the importance of the confidentiality of the process. The results of the qualitative survey showed that confidentiality does not impact all due diligence missions. It plays a vital role in some missions, depending on several factors, such as competition and size, which can affect the efficiency of the data transmissions.

In the understand and planning stage, other interesting new insights between both processes were revealed. The first aspect discussed during the qualitative research confirmed the findings of the literature review. The quality of the financial due diligence missions varies from one company to another as the process is barely regulated. This emphasized the importance that during this research, all the experts interviewed come from the same company to enable an efficient comparison. The second aspect discussed, the digital transformation, showed that in both professions, the potential for improvement is enormous. In the due diligence profession, the digitalization of the so-called data-room is the major development in recent years. The research revealed that the use of Big-Data Analytics, Blockchain as well as Artificial Intelligence, can improve the efficiency of both missions in the future enormously. The third aspect revealed that the overall experience of the due diligence team is higher than during an audit engagement. Generally, the experts working in the due diligence department have a prior audit experience, which directly impacts the costs of the appointment. The most interesting revelation in this stage is the applicability of the principle of materiality. While in the audit planning phase, the determination of the level of materiality is a crucial step, the principle is not applicable in the financial due diligence. The reason for that is that the materiality can have a significant influence on the final price of the company depending on the multiple used afterward

In the perform and evaluate stage, the qualitative study revealed the similarities between both processes. Generally, the experts agreed that the initial analytical procedures performed are similar in both processes. Afterward, due to the customization of the financial due diligence process, the expert must adapt its procedures according to what the client wants to buy. Therefore, a general explanation about the types of procedures performed during each due diligence process is not possible as it depends on the context. Depending on the client's objectives, the type of experts involved in the due diligence missions also varies from one engagement to another. Generally, the literature and the qualitative research showed that the number of other experts involved in the due diligence mission is much higher than during an audit due to the high interconnections between the areas. The role of the internal audit was also discussed during the interviews. The experts agreed that an efficient internal audit is helpful in both engagements as it increases the integrity of the financial data. Nevertheless, the collaboration with the internal audit is much more usual during an audit.

Another difference analyzed is the amount of evidence required from the client and the related documentation. All the procedures performed during an audit engagement must be proved by the corresponding piece of evidence, which significantly increases the need for sufficient evidence and efficient documentation. The experts considered this aspect as one of the main differences between both processes. Especially in the last years, the need for documentation increased due to the stricter rules applicable for the audit profession after the various accounting scandals. Even if the literature emphasized the three layers of documentation in the financial due diligence, the experts stated that the documentation work is much higher during an audit.

In the conclusion stage, the qualitative survey confirmed the findings of the literature review. The financial due diligence report is much more detailed than the audit report. The experts agreed that the work effort to establish a due diligence report is much higher. All the findings need to be presented in detail to enable the client to understand all the facts discovered. In the audit report, the auditor includes next to the audit opinion only a small conclusion about the main risks identified.

Some unexpected findings enabled to establish a small overview of the most popular areas of due diligence. Even if the study of Marten and Köhler was performed in 1999, this qualitative research presents similar findings. The only difference is the rise of social and human due diligence. All the experts mentioned the social due diligence as critical expertise performed in the due diligence missions. This finding is in accordance with the research of Bhagwan, Grobbelaar, and Bam (2018) and Boussaguet (n.d.).

As already explained in the methodology of the qualitative survey, the findings of this research must be interpreted with caution. The first reason for that is the complexity of both processes. Due to the limited scope, we tried to establish a standardized and comprehensive overview of both processes even if, in practice, the missions vary from one engagement to another. The second reason is that the variety of the sample does not allow us to draw general conclusions about the financial due diligence and audit. All the experts interviewed worked inside of the same company to facilitate the comparison between both processes.

The literature review, as well as the qualitative survey, revealed some gaps in the current literature, which could be interesting for future research needs. Ling, L. and Nopmanee, T. (2015) defined independence and the auditor’s capabilities as the two main components to assess the audit quality. As the independence principle is not applicable in the financial due diligence, future research could analyze the main components to evaluate the financial due diligence quality. Similar to this need, the research could analyze the main risks the professionals are exposed to. Another interesting subject for future research is the main areas of due diligence. Even if, during this study, the main areas of due diligence were similar to the findings of Bhagwan, Grobbelaar, and Bam (2018), a statistically significant sample size would increase the reliability of the study. Similarly, the overall efficiency of the areas of due diligence on the final result could be analyzed. Generally, the number of scientific articles published about financial due diligence is small in comparison to the audit, which increases the need for future research.

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Appendices

Appendix 1: Structure of the survey/interview

Objectives

- Establish a detailed definition of due diligence and audit. The literature offers a wide range of available definitions of both subjects. The goal is to establish a current and accurate definition of both. In addition to this, I will explain in this part the relationship between my topic and the broader subject area.
- Review the literature about due diligence and audit. The objective of this literature review is to establish a detailed theoretical framework about the current research regarding both subjects. This part will enable us to show the gap in the current research, which will be filled by this research thesis.
- Analyze the process of due diligence and audit in detail to highlight the main differences. The theoretical framework will help me to differentiate both subjects and establish an overview of the main differences. Moreover, it will provide me first insides of the difficulties during a due diligence process.
- We are conducting interviews with experts of both domains to gather information about the practical difficulties during the due diligence process and present the findings.
- Compare the data of the interviews with the theoretical framework and discuss the results. In this part, I will also show the limitations of my research thesis and future research needs.

Appendix 2 : Interviews

General Questions

a. What is your experience in both domains?

Justine Rodheudt

I work for two years now in the due diligence department at BDO. I worked for a Consulting company in supply chain management. During this job, I established a lot of financial reports, which included a lot of optimization calculations to present to the CEO. I found out that I liked to develop such financial reports. Then, I did an additional master's in Financial Analysis. Inside our company, we have different departments: The due diligence department, the department for the valuation of companies, and the M&A-Process department.

Benjamin Bataille

I work for three years now in the field of financial due diligence. Before, I worked one and a half years in the field of audit at EY.

Arnaud Williquet

I worked for five years as an auditor at KPMG. Then, I worked for seven years in the controlling department of a company before joining the due diligence department of BDO.

Felix Fank

I have 3o years of experience in both domains.

Jean-François Bernard

I have Ten years of experience in the field of audit. I performed around 20 different due diligence missions of small and medium entities in the gambling sector. All the people who moved to the due diligence department were auditors before. I performed due diligence before the due diligence department was born. It is interesting to perform the due diligence of small companies because there are more risks involved. As they are small, they are not aware of all the risks related to CISCO, social, legal. It was an exciting process, as the initial price fixed changed a lot, which influences the costs, the clauses and guarantees included in the transaction.

Christian Schmetz

I have fifteen years of experience in the field of audit. I worked for seven years at KPMG and now eight years at BDO. In the first seven years, I didn't perform a lot of due diligence missions. Since I've joined BDO, I performed around 5-6 due diligence missions per year.

b. What is for you the main difference between due diligence and an audit?

Justine Rodheudt

The main difference between the due diligence and audit is the goal of both processes. An audit is a rule-based process to verify and correct the applied accounting rules. In the due diligence department, they try to find out the normalized EBITDA of the company. The non-recurrent earnings, for example, need to be excluded, as also the debt of the company needs to be quantified. They do not adapt to the accounting entries of the company. When a client comes to our department, we look at the accountancy of the client. If, for example, it was the year of the Olympic games, in the due diligence process, they need to highlight these events to find out the normalized EBITDA. In an audit, you do not need to adjust the influence of such types of events. In due diligence, they will highlight this fact. The normalized EBITDA is the basis for the valuation of the company. The audit process is much more regulated than the due diligence process. We do not have to sign an independence letter at the beginning of the process. We just sign in most engagements a confidentiality agreement.

Benjamin Bataille

The objective is the main difference. The main aim of the audit is to deliver an opinion to reassure all the stakeholders about the financial statements, which is essential for all the stakeholders of the company. On the contrary, the objective of due diligence is to identify all the risks related to the company. Our final result is a normalized income statement. The EBITDA is used at 90% of the cases, but it depends on the sector in which the client operates. For example, in the industry of retirement homes, rent is an essential aspect of the income statement. Therefore, we verify that all the elements that are recurrent and we try to neutralize the non-recurrent events. In addition to this, we confirm, for example, if transactions are executed under the market price. We transform the historical income statement into normalized income statements. The historical period varies between three to five years that depend on the project, the risks, and the budget. We work together with the tax experts, for example, if we have a significant reduction in the value of an asset. They will evaluate the risk on the income tax and identify the associated risk. Therefore the final result of the due diligence is the entirety of risks identified, the normalized income statement, and the adjusted financial net debt (which is on the balance sheet). We try to identify on the balance sheet all the elements which can be related to cash to reduce the financial debt. For example, in the other receivables, there can be an amount associated with the value-added tax, which influences the working capital. Those elements are essential for the valorization of the company. For example, if we say we acquire five times the EBITDA of a company, for example, EBITDA 200.000 → 1 Million. We deduct from this the net debt 100.000 → Equity value 900.000. The expert, in this case, analyzes if the used EBITDA and the net debt is right. The ultimate goal is to assist the client, generally, buy-side that he buys the company at the right price. If we apply the formula of valorization Enterprise Value – Net financial debt = Equity value, we verify that both first amounts are correct.

Arnaud Williquet

The main difference is that the audit is a legal mission and the due diligence a contractual mission. In large corporations, we perform both. But for small and medium companies, we often do the buy-side due diligence. Another difference is that the audit is always financial. In due diligence, the number of other experts involved is much higher. In the main work of an audit, you define at the interim audit, the approach of the final audit. In addition to this, you fix materiality based on the turnover, for example. In due diligence, the concept of materiality is not often applicable very.

Felix Fank

The objective is the main difference. In the audit, we try to elaborate our opinion about the financial statements for all the stakeholders of the company. We try to validate the integrity of the financial statements at a specific point in time. It is legally regulated how the process and the standards used.

The acquisition audit is based on a contractual basis. Therefore the parties determine individually the type of procedures performed. Thus, the content of due diligence is different. The financial audit is always a full scope audit, while the acquisition audit is not. But a full scope due diligence can be compared to a financial audit. In due diligence, there are often other aspects that have to be considered. Therefore the starting point is different. Another difference is materiality. In the audit, this concept is essential and specific rules define the materiality principle. In the acquisition audit, there are no particular rules for materiality, and this concept is not often used.

Jean-François Bernard

The financial part of due diligence can be compared to the financial audit.

Christian Schmetz

The objective is entirely different. In the audit, the aim is always to establish an opinion about the financial statements. In due diligence, the focus varies according to what the client wants to buy. If we buy, for example, the customers, we need to be sure that when the deal happens, the risk is not there to lose the client. Imagine you buy a company because of the customers, and two months later, you lose the biggest client. If you buy, for example, a company for the building, the risk on the customers is not there. The focus of the due diligence determines the scope and the outcome of the due diligence.

The first meeting is essential to understand what we want to buy. For example, the company a client wanted to buy was tiny, but the price was high because they invented a new product. In this case, the focus of due diligence was on intellectual property. We highly collaborated with lawyers to determine the correct value.

In Start-Ups, specific risks can also be observed. Generally, such type of companies has a strong leader who motivates all the employees. The people are often willing to earn less because they are convinced of the project. If the company is sold and the leader leaves, the whole dynamic of the company disappears. This risk needs to be considered in the financial due diligence, as it can significantly influence the business plan. If we just buy a product, it is not important, but if you buy the know-how, it is much more important.

Another difference is the analyzed period. In an audit, we test to history without examining in detail the future of the company. The only aspect to consider is the going-concern principle. In due diligence, the client is much more interested in the future. To validate the future, we need to test the history, but the central aspect in the future.

In the due diligence, you try to find the normalized EBITDA or income, while in the audit, you just look if the classification is right. For example, if you have a small company and the CEO pays himself 500.000 euro. In an audit, we do not ask ourselves if the salary is correct or not. In due diligence, we ask what the regular payment would be. If it is, for example, 150.000, we know that 350.000 have to be normalized. (Normalized EBITDA; Normalized net financial debt and normalized working capital as it has a significant influence on the valuation of a company.

Sub-questions

1. **Due diligence engagement**

a. During a demand for a due diligence process from the client, who is the general contact person inside of the company?

Justine Rodheudt

The contact person inside of the company varies according to the size of the company. In small-size company, it is often the CEO, because external accountants do the accounting. They are not involved in the business operations and can, therefore, not explain in detail the usual business operations. In larger companies, it is the CFO. In big groups that acquire a lot of companies, there are specific departments just for the acquisition of companies.

Arnaud Williquet

Mainly the accounting and controlling department through the data-rooms as well as the CEO.

Benjamin Bataille

It depends on different factors:

The first factor is the context of the transactions. There is a difference between a transaction in which the management informed the employees and a management, which did not. If everyone is informed about the transaction, then there is no problem to contact the employees of the company. But if not, we work a lot with the external accountants, for example,

The second factor is the size and the roles inside of the company. We ask ourselves the question of who does what and who has the information. Generally, it is the accountant and the management. We try to find strategic people inside of the company who have a lot of information.

Jean-François Bernard

For the financial aspect, it is often the external accountant.

2. <u>Procedures</u>

a. In the literature, there is no typical procedure of a due diligence process, could you provide an overview of the general steps during a due diligence process?

Justine Rodheudt

In the due diligence process, there are no typical procedures. The process depends on the needs of the client. If the client wants a detailed analysis of the company, we perform a full-scope investigation. It also varies according to the risks the company faces. Therefore, due diligence does not enable standardized procedures.

Benjamin Bataille

In due diligence, you have much fewer constraints, as you do not have the documentation process. When we test, for example, the existence of the turnover, we do not need to justify it by documenting the invoices and the sales orders. You need to prove every step in the audit. In due diligence, you focus more on the analytical aspect. The objective is not to establish an entire folder with evidence. It is to justify, for example, why you have chosen to adjust the EBITDA. The client believes you and does not need a piece of evidence for everything. The aspect of the analysis is similar between the audit and due diligence if we do not consider the documentation aspect. In both cases, you perform an analytical review of the accounts. The difference is that in due diligence, you analyze the effect on the normalized income statement. In the audit, you look more on the accuracy of the accountancy.

Arnaud Williquet

The due diligence process is much more customized as the audit.

Jean-François Bernard

The procedures are similar in due diligence. The approach is identical as you try at first to understand the financial statements. Then based on the risks found, the approach differentiates.

In the gambling sector, there was a high risk that employees use company money to gamble. Therefore there were often considerable gaps in the cash of the company. It was a huge work to normalize the income statement. In addition to this, the buyer wanted to install their machines in the gaming rooms, which required us to quantify the costs precisely.

b. Can these steps be compared with the six steps during the audit process?

/

c. Which assertions would you highlight in both processes?

Justine Rodheudt

If we take, for example, the cut-off assertion, it is not dramatic if there are small movements between two years if you consider three years. But if the buyer bases the price on the income statement of 31/12/2019, it is essential to test the cut-off principle. Therefore, the assertions vary according to the context. Generally, it is vital to show the reality of the business because this determines the price.

Benjamin Bataille

No, because it depends on the business. You can have businesses with small margins where the existence of the turnover is critical. In this type of business, in which the volume is crucial, you have to have a closer look at the turnover. If, for example, you have high margins, you have a closer look at your costs.

d. What procedures are performed during a due diligence process, which does not exist in the audit process?

e. Which step/assertion is the most critical being tested?

f. As the due diligence process also requires to assess the future aspects of the company, how do you generally consider the future perspectives of the company (Type of *metrics, for example)?*

Justine Rodheudt

We consult the older financial/business plans and the planned budgets to validate the submitted business plan.

Benjamin Bataille

We do not establish predictions. We challenge the business plan and try to validate it. For example, if we know that the rent will increase next year, we try to see if this aspect is included in the business plan.

Arnaud Williquet

We validate the submitted business plan.

3. Pieces of evidence

a. What type of documents do you require from the client?

Justine Rodheudt

The financial statements in detail, the credit contracts, the margin analysis, the top 20 Clients/ Top 20 Suppliers, and much more.

Jean-François Bernard

In due diligence, we analyze the ongoing contracts to identify risks. We take more time for tax affairs. We ask the tax experts to examine in detail the tax calculations to ascertain that there is no risk. In the audit, we just verify if the tax provisions are accurate.

b. Would you say that the number of documents required during a due diligence is bigger than the amount during an audit?

Benjamin Bataille

In the audit, the amount of evidence required is much more considerable. In due diligence, we try to understand the business. Then we look if the data is consistent with the observations. We do not need to perform as many tests. We go not as far in the statistical testing.

c. Do you rely during the M&A Procedures on the work performed by the external auditor?

Justine Rodheudt

Not directly. We look at the reports made by the external auditor, but we do not have direct contact with the auditors. If we see that the company has been audited, we trust the audit reports more and know that the specific accounting rules have been applied.

Benjamin Bataille

We consult the audit report but do not collaborate directly with them. If an external audit has been performed, we know that the audit already covers some risks. For example, if the audit has tested a company for the cut-off assertion, we know that there is no significant risk about this. It is more comfortable if an audit has been performed.

Jean-François Bernard

We use the report but do not revise it. We verify the sections already tested if there is a risk, for example. In the due diligence, we try to base our assumptions on the nearest date. As the audit is done at the end of the year, we do not always base our findings on the report. Mainly because in the audit, they use the materiality. In due diligence, the principle of materiality is not applicable as it influences the price of the company. For the auditor, 100.000, for example, is not material, but in the due diligence, it will be multiplied by X. Due to the multiple, it can increase the risk.

d. In which process does the internal audit function inside of the company is more helpful? Is the internal audit department generally involved during the due diligence process?

Benjamin Bataille

It is a strength in both missions

Arnaud Williquet

It is more helpful during an audit

Felix Fank

It depends on the contract. There is no structured work with the internal audit in a due diligence department. It is helpful because it offers you confidence in the data.

Christian Schmetz

It has a bigger impact on the external audit.

4) Team

a. What is the general composition of a due diligence team, and do you work together with other experts outside of the company?

Justine Rodheudt

In Financial due diligence, I would say that there are 2-3 people involved, for the corporate tax 1-2, for the value-added tax 1-2, and the legal due diligence 1-2. Some clients hire all of our services, while other clients just take the financial due diligence from our company and the other services from other companies.

Christian Schmetz

In the audit, the overall experience of the team is lower than in due diligence as you have to perform some works which do not have a considerable added-value. In due diligence, you need a more experienced team, and you need more experts.

b. Would you say that there are more people involved in the due diligence process?

Benjamin Bataille

If there a concern about litigations, we ask a lawyer, for example. But just if the client accepts to pay for the expert.

Arnaud Williquet

Yes, we have experts for tax (corporate and value-added tax), social, legal, and environmental. Often, different companies perform simultaneously. At BDO, we often have financial and taxation, and for the social and legal, they often ask lawyers, for example. There are also cases in which we have to perform all the aspects.

5) Duration

a. If you compare the process of due diligence with the audit process, which process takes more time?

Justine Rodheudt

It depends on the size of the company. A small-size company due diligence can be performed in two weeks, while in a bigger company, it can last 4-5 months sometimes if you have, for example, a group with different companies in different companies. The bigger the companies and the more countries involved in the transaction, the more time is required.

Benjamin Bataille

It depends on the context. If nobody knows about the transactions, just the CFO, who can only work for the due diligence after his work, then it can take a lot of time. In the audit, you are planned, and everybody knows it. Another aspect is, for example, if there are many buyers, you have the pressure to complete the due diligence fast.

Arnaud Williquet

In depends on the scope in both cases. In the audit, the process takes more time as you have the interim audit also. The duration depends on the efficiency of the information flow in both processes.

7) Confidentiality & Emotional aspects

a. As the process of a due diligence is highly confidential, how much does it influence the work performed?

Justine Rodheudt

The factor of confidentiality influences the rapidity of transferred data. It is the reason why we perform a lot of work from our office. We cannot complete the job inside of the client's company. Otherwise, all the people would know that some unusual things happen. It is often the case that the employees are not informed about the transaction. Often, the CFO and CEO come to our offices, or we arrange issues by phone or mail. We try to limit the number of visits inside the company. All the projects have code names, to hinder that everyone knows which company we are talking about. All information is transferred through data rooms to increase confidentiality.

Arnaud Williquet

It depends on the context.

Felix Fank

It varies between Sell-Side and Buy-Side Due Diligence. If the employees are not informed, the performer of due diligence cannot always talk with all the strategic people. Therefore, we sometimes include in the final contract a clause, which states that we base our conclusions on the information available in the data room.

Jean-François Bernard

The influence of confidentiality varies depending on the context. The amount of competition is a factor that can influence the importance of the principle. In small businesses, which are not exposed to high competition, confidentiality isn't essential. In big transactions, we include non-disclosure agreement and secured data rooms as the secrecy is vital.

Christian Schmetz

Yes, the confidentiality influences the work performed in the due diligence.

b. How much influence does the emotional aspect have on a due diligence process?

Benjamin Bataille

During the due diligence, you are much less confronted with the emotional aspect. People involved in the M&A Process are much more confronted with such types of constraints.

8) Costs

a. Could you compare the prices of due diligence and an audit?

Christian Schmetz

The costs of due diligence are higher than for an audit.

9) Report

a. What types of information are disclosed during a due diligence report?

Justine Rodheudt

The normalized EBITDA is the central aspect of the due diligence report. If we take a step back, we establish the P&L, the balance sheet with explanations about the evolvements and the unusual aspects. The conclusion of the report is the normalized EBITDA and the debt positions, as also the principal risks of the company, which will be used by the vendor to establish the price of the transactions. The due diligence department does not determine the multiple, which will be used to determine the selling price; the department valuation performs this work inside of our company. They use databases to establish the multiple.

Benjamin Bataille

The due diligence report is much more detailed than the audit report. In the audit report, you present briefly every aspect and your findings. In due diligence, you analyze everything in detail and explain it in every step.

Arnaud Williquet

The main aspects are presented in the executive summary: the EBITDA, the net financial debt, and the working capital. In addition to this, we highlight the main risks.

10) Evolvements in due diligence

a. If you compared the due diligence process nowadays with the due diligence process 5/10 years ago, how much did the process of due diligence evolve?

Justine Rodheudt

Good question. As I work for two years inside of this department, I cannot highlight the main evolvement. The thing I can see is the tendency that firms have a lot more digitalized data. Blockchain and Artificial Intelligence are both technologies that can influence a lot of our work. The data preparations and analysis can be a lot more automated in the next years, but you will always need a person who comments on the figures. Nowadays, we "lose" two days just to prepare for Excel the data received by the clients. This loss of time can be improved in the next years.

Benjamin Bataille

The digitalization enables us to automatize and go much deeper in detail. We work together with a company that offers us a securitized platform where we can deposit our documents. The documents are encrypted. You have data rooms on both sides, sell and buy-side, both have access to the central data room. In the end, all the transactions on the platform are transferred on a securitized USB stick, and we receive all the information. If, for example, there are future litigations, you can use the stick to see the data. Inside of BDO, we also use a new system, where I can, for example, not see the folders of my colleagues. Also, when we talk about companies, we use "codes" to prevent colleagues from knowing of which company we talk about. Confidentiality is the key difference nowadays.

Arnaud Williquet

In due diligence, the main evolvement is the digitalization of the data rooms. In the audit, the laws evolved a lot in the last years.

Felix Fank

Quantitative, the number of due diligences evolved a lot. It also became more prominent to include professionals in the due diligence process. This led to the qualitative evolution of the due diligence process. Ten years ago, we as financial auditors performed the due diligence mission, nowadays not. Because we now have experts just handling these affairs, it became a new department in our company.

Jean-François Bernard

The field of due diligence changed a lot. Everything changed, as it became much more professional. Ten years ago, the auditors performed due diligence missions. Nowadays, we have a specific department. The audit procedures also changed a lot due to the standardization of the process. Especially the stricter rules led to professionalization. The sector had a bad image in the past, which increased the need for supervision by the competent authorities

Christian Schmetz

The due diligence missions changed a lot, as they were performed in the past by auditors. The difference between an audit and the due diligence increased in the last years. In the audit, the work also evolved a lot. The focus is now on the independence of the auditor and the documentation of the work performed. In the past, an experienced auditor was not controlled by the authorities. Nowadays, we are much more supervised, which increases the need for documentation.

<u>Other answers were given: Influence of the legal environment on the work performed.</u>

Benjamin Bataille

The due diligence sector is much less regulated than the audit sector. The quality of the work performed varies from one company to another in the due diligence. On the contrary, the approaches in the audit are similar in every company.

Arnaud Williquet

In the audit, you have many more laws, and it is more procedural. You need to complete different formalities before performing the work. In the due diligence, you directly start the engagement after obtaining the mission letter. You must not sign independence or conflict of interest agreement if the client does not require it.

Felix Fank

In due diligence, there are no specific rules. As it is a contractual mission, it is the responsibility of the client to assess your independence. In the audit, you have a responsibility towards the wider public, which influences the responsibilities massively.

Jean-François Bernard

The IRE does not supervise the due diligence missions. Also, the principle of independence is not essential as it is on a contractual basis.

Christian Schmetz

In the audit, we need to respect a lot of standards and laws, which influences the documentation efforts significantly. In due diligence, the report is, therefore, much more detailed. We must not sign independence or conflict of interest agreement, as we are working for one party. This is entirely different in the audit, as you are working for the stakeholders of the company

Abstract

The purpose of this master thesis was to establish a comparison between the financial due diligence and the audit process. Few papers outlined the significant differences between both processes but did not offer a detailed overview of the key concepts. Therefore, a thorough literature review was performed to provide a detailed overview of the differences and similarities. This methodology enabled to establish a solid foundation for the qualitative survey conducted with experts of the domain. Through semi-structured interviews, the findings of the literature review created a synergy with the answers of the experts to set up a detailed comparison table between both concepts. The findings showed that both processes have similarities but also major differences that were not addressed in the research before, for example, the principle of materiality. Generally, the differences between both processes increased in recent years. While due diligence became much more customized to the client's needs, the audit process emerged to a standardized process due to the evolvement of the legal environment.