



Financial Due Diligence

This toolkit includes:

- How Frog conducts Financial Due Diligence (Financial DD)
- What is covered
- The typical scope of the external Financial DD
- Risk and opportunity identification and management
- Dataroom checklist

Our approach to Due Diligence

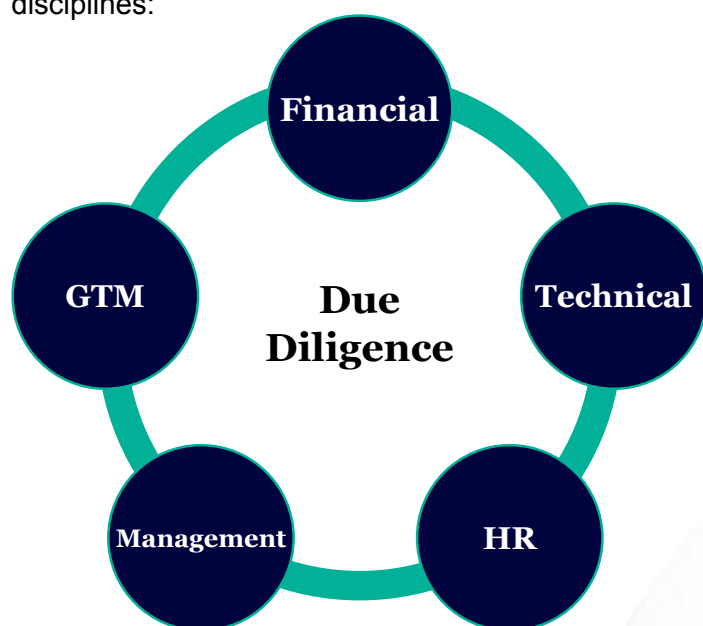


At Frog, due diligence (DD) is an integral part of our investment process. It is led by our team of Operating Partners, who are part of the Frog team (participating in IC meetings) and provide consistent functional support throughout the life-cycle of our investments:

- 1 Deal assessment**
- 2 Due diligence**
- 3 Ongoing portfolio support**

Our approach to DD is designed to add value in its own right; it is conducted not in isolation but as part of an end-to-end process of collaborative added value.

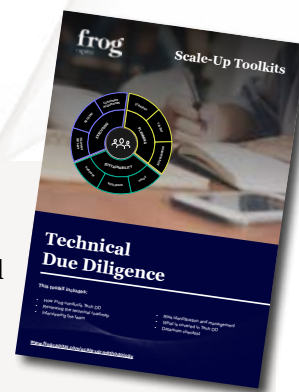
Our Operating Partners work across the following disciplines:



[Click above to find out more about Frog's approach to Due Diligence](#)

Download the How to Scale toolkit for **Technical Due Diligence**

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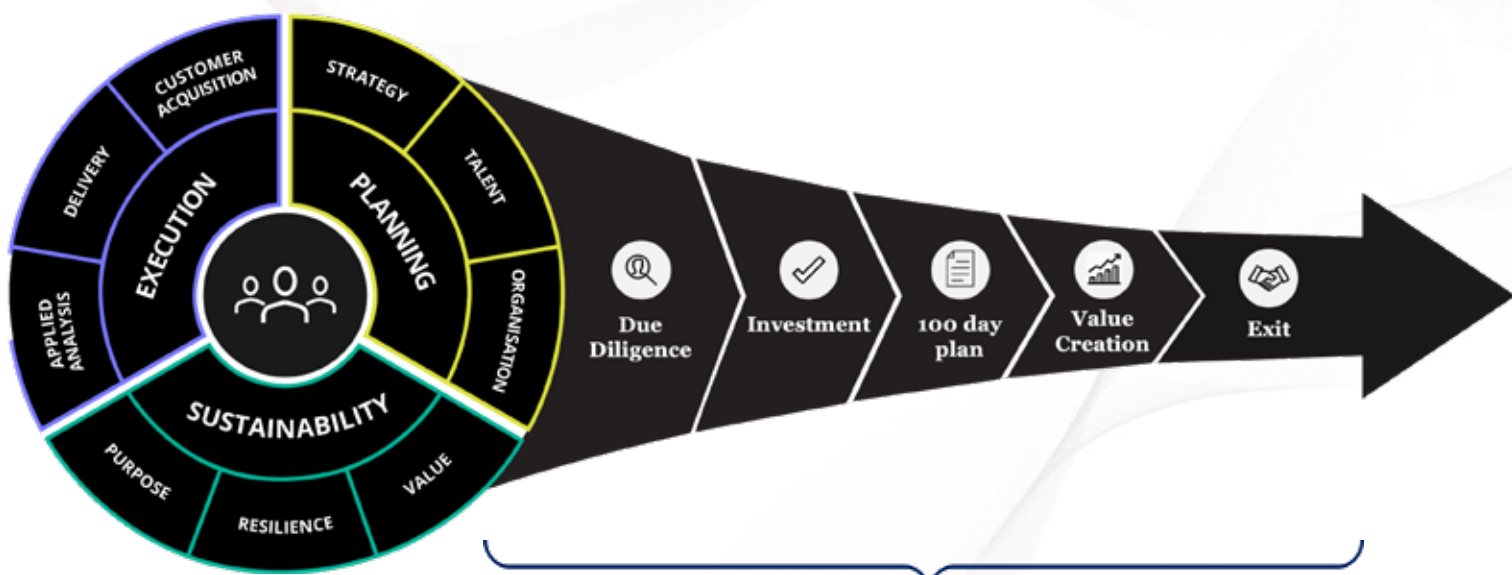
As part of deal assessment our Operating Partners meet leadership teams to develop deeper understanding of the business, at the same time as demonstrating how we can add value.

The due diligence process itself then goes into far greater detail across the different key functions of each business focusing on the key areas determined by understanding that business, rather than applying a template approach. At the same time as serving its traditional purpose of ensuring a business is performing as expected across departments, it also facilitates relationship building between our Operating Partners and senior leadership teams and alignment around future scaling developments. The immediate outcome of this is a robust 100 day plan to follow

after investment, laying the foundations to a successful ongoing partnership.

One of the additional benefits of our approach is that our Operating Partners not only continue working as part of the portfolio company teams post investment, but also that they work closely with each other. This multiplies the value we can add because our work is both end to end, and inter-connected across what can otherwise be separate work streams.

In this toolkit we outline how we execute Financial Due Diligence, what is covered, the work we do internally and how we manage external partners, what to include in the data room and how we identify risks and opportunity.



The same Operating Partners are involved before we invest right through to exit



01 Introduction



Financial due diligence (Financial DD) is a core part of the assessment that we undertake at Frog during an investment process to ascertain if the company is ready to scale. Finance functions will be at different levels of maturity when we start talking with them and it is important that the assessment is appropriate for the size and scale of the company, the business model and market specific risks.

At Frog, the Financial DD is the opportunity for us to evaluate both current position and ability to evolve to support scale-up.

More specifically, we are looking to gain a good comfort level to the following:

1 Resources in finance and key responsibilities

2 Current level of board reporting

3 Other management information reporting by finance

4 Other management reporting outside finance

5 Revenue recognition policy



About the author Steven Dunne, Frog Senior Partner

Steven is a Senior Partner, CFO and Head of Portfolio of Frog Capital, with over 20 years of PE experience gained both within PE firms, and as a senior executive of PE backed companies.

Steven spent eight years as a CFO in two VC/ PE backed businesses, both successfully exited. In addition to his operational experience, Steven spent four years as a portfolio director at Livingbridge.

Although one of three senior partners at Frog with executive responsibilities, Steven's experience in operational roles in VC backed companies qualifies him to act as the Finance Operating Partner. Having been on the receiving end of Financial DD, he is very conscious of making it an efficient and value add process for the target company.

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Systems, controls, processes and external dependencies

7

Subjective areas review
(provisions, accruals, contingent liabilities)

8

Budgeting and forecasting process

9

Management accounts to statutory accounts reconciliation items

10

Month end and year end procedures

11

Priorities for finance as the company scales

- Potential resource bottlenecks
- System upgrades
- Reporting Integration into sales and ops

Many companies will get to the scale-up phase with a reactive approach to finance that means it is in need of a thorough, and maybe first ever, review of what evolution is required for the next five years not just managing the current activity level.



Financial Due Diligence



How do we conduct a Financial DD?

We are very conscious of making Financial DD an efficient and value add process for the target company. This means it needs to be very tailored to the company and not following an accountancy firm checklist approach.

A typical Financial DD project at Frog tends to follow the following sequence:

1 Deal Organisation

If finance function development is a key part of our value proposition for a company then even before term sheets have been agreed I will have meetings with the members of the leadership team and the functional lead for finance. This helps to scope out both the current state of the function and the appetite for change.

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2 Documentation and Dataroom

Before the formal interviews begin, we will read through all financial and non-financial information that the company provides. It is important the Financial DD is not conducted in isolation from the overall assessment and that the DD streams work harmoniously to improve the overall decision making.

3

3 CFO/Head of Finance Kick off call

The purpose of the kick off call is to understand the specific business model risk areas that Financial DD should focus on and the possible finance function capacity issues (people, processes and systems) that need to be investigated. It is also revealing to understand the current state of integration of finance into the rest of the business; it is not uncommon for finance professionals to feel quite peripheral, and this is a real risk to its ability to add value and scale if not addressed. This call is the start of the relationship building that is essential for the post transaction implementation phase.

4

Interviews

This will be very different according to the situation but is likely to include the founder or C-Level person who oversees finance, if there is no CFO, and the outsourced accountancy and/or tax advisor. Sometimes there might be founder reluctance to allow the most senior finance person to be interviewed alone if they are not considered to be at leadership level, in itself this is quite revealing.

The exercise is not designed to expose anyone or to hold the finance team to account for the current state of the finance function as it will be a result of Board level decisions (or often omissions). Rather it is to establish base camp from which a credible plan can be built to support the future growth of the company.

Of course, Financial DD also has to establish the credibility of the financials on which our investment is based which will combine historical financial information with sales pipeline analysis, product roadmaps and market information. All are equally important in assessing prospects.

Ultimately we expect our portfolio finance functions to be adding value by providing high quality insight for better decision making and building forecasts based on a broad range of evidence-based sales lead indicators and cost relationships, but we don't expect that to be in place at the point of investment.



Follow-up



After the formal interviews are complete, I will instruct an outsourced Financial DD provider to do the detailed work to cover the risk areas I have identified.

These are usually smaller, transaction focused accountancy firms that are better at taking a brief and working to it that the larger

firms that are encumbered by internal standardisation requirements that can result in unnecessary checklist-based review.

Typically the scope of the External Financial DD will be:

Financials	<p>Historical Cash flow track record (two years plus YTD)</p> <ul style="list-style-type: none"> • Comparison to prior year and budget <p>Historical P&L track record (two years plus YTD)</p> <ul style="list-style-type: none"> • Comparison to prior year and budget • Headcount by department <p>Last year-end balance sheet</p> <ul style="list-style-type: none"> • Detail on accruals and provisions and support information • Year-end outstanding debtor balance and bad and doubtful debts <p>Monthly KPIs management reporting – Dec 2019, Dec 2020 and each month in 2021</p> <p>Last year end management account and Statutory accounts and reconciling items.</p> <p>Prior year end management account and Statutory accounts and reconciling items.</p> <p>Current year Budget detail</p> <p>Revenue recognition</p> <p>Accruals and provisions</p>
Tax	<p>Details of any recent tax audits</p> <p>Known disputes/contentious items.</p> <p>Past reorganizations, tax rulings, or clearances</p>
Employee Costs	<p>Discuss pension and long-term employee benefits.</p> <p>Share-based payments (including board-members)</p> <p>Management and key employees - reward and retention - detailed table of salary, bonus and options (with details) for key employees</p>
Documented Policies & Procedures	<p>Revenue recognition</p> <p>Accruals and provisions</p>

Risks, recommendations and planning



The diligence concludes with a report summarising all the areas previously described. Most importantly though, the Financial DD report will include an overview of the risks that the company faces together with a longer list of actionable recommendations. I will also ask the Financial DD provider to comment on the development needs of the individuals in finance so this can also be part of the recommendations alongside identified systems, policies and procedures required.



Over the course of data analysis and the formal interviews we can assess the level of importance and resource attached to finance to date and therefore assess the journey it needs to go on through the scale-up journey. The outsourced Financial DD will identify areas of current risk and provide suggestions for improvement. It provides data points on which to assess the financial forecasts however, the subjective assessment of the business plan sits within Frog and is not outsourced.

The financial plan is reviewed taking into account the input from all the DD streams but clearly the first check is whether it is connected to the historical financial information and the evolution can be tracked both financially and in articulated operational change plans. We have experience of the fundraising business model being outsourced to an advisor and this can result in a plan disconnected from what we see in the Financial DD and the operations of the business which is a big red flag.

The ideal situation is that we have a collaborative approach to the Financial DD with the finance function, both sides seeing it as a chance to plan what needs to change to deliver the scale-up ambitions of the company and as an opportunity to benefit from the expertise available to help on this journey.



Checklist



Preparation checklist for dataroom content

Reporting Overview

- What is produced, how frequently and for whom?

Organisational Chart

- Detail showing all reporting lines including at board level.
- Show how many staff are in each role group and make it explicitly clear how many are currently in position and how many are open or vacant positions.

Systems and Processes Overview to include:

- Outsourced accountant relationship and flow of information
- Accountancy software
- Payroll software/outsourcing
- Sales recording process (CRM or other and links to accounts)
- Billing process
- Purchasing process including authorisations

Policy Documents

- Revenue recognition
- Accruals and provisions

Cash Management

- Monitoring responsibility
- Forecasting process and frequency of update
- Treasury management (including diversification)

Suppliers

- Key suppliers and terms (inc. office)



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See more at www.frogcapital.com/scale-up-methodology

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