CERTIFIED PUBLIC ACCOUNTANTS & CONSULTANTS SINCE 1939

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3 Types of Due Diligence to Consider Prior to Buying a Business

There is no single process that everybody follows when purchasing a business, and there are many factors that determine whether a business, once bought, will fulfill its desired purpose. But if there is one thing that will mitigate the chances of failure, and increase the chances of success, it is conducting detailed due diligence on the company you intend to buy - before making the purchase permanent and irreversible.

In the early stages of a transaction, buyers and sellers rightly focus on the financial terms of a transaction, with the key element being the valuation of the seller's business. Once this is agreed, it is often customary for both parties to sign a Letter of Intent ("LOI"). Although the LOI is primarily non-binding and contains purchase price, method of payment etc., it typically also includes an exclusivity period during which the seller agrees to not talk to any alternative buyers – often referred to as the 'no-shop' provision. The rationale for this exclusivity period is that time and money will now be spent on (a) the buyer conducting due diligence on the target business, and (b) legal counsel for one party drafting the legal documents that are required to close the transaction.

But what exactly is due diligence, and why is it such a crucial part of a successful transaction and a subsequent productive operation?

The main purpose of due diligence is to test the veracity of the information received from the seller and its representatives, regarding the financial, operational and legal status of the business. In addition, due diligence presents an opportunity to dig deeper into certain topics – to get beyond the 'spin' of the sellers initial set of documentation.

Financial Due Diligence
Buyers will have formed a view on the financial impact of an acquisition and may well have created post-transaction projections. But what if the financial information provided by the seller and their representatives is not accurate? Rarely is this because the seller wishes to deceive anyone, but the accuracy of financial statements is determined by the application of correct accounting principles. Are the seller's accounts GAAP compliant? Has revenue been correctly recognized? Have expenses been suitably assigned? Is the Balance Sheet, as well as the P&L, accurate?

The accuracy of the financials is even more important if the buyer has valued the seller's business as a multiple of EBITDA. If the underlying data is inaccurate, then the valuation may be overstated.

To determine whether there are accounting anomalies, we recommend that all buyers conduct a Quality of Earnings ("QoE") review. A QoE is similar to, but less in-depth, than an audit of the seller's financials. The emphasis is on the "quality," or sustainability, of the company's earnings. One typically area of focus is the so-called "addbacks." These are pro-forma adjustments to the company's standard P&L that include personal, non-operational and one-off expenses. Testing the veracity of addbacks is an important part of a QoE.

If you don't have the skills or experience to conduct a QoE, hire an accounting firm with experience in M&A transactions. They will produce a QoE report that highlights issues, and re-calculates the seller's financials to account for applicable and necessary adjustments.

Operational Due Diligence
A business's financial performance is not the only aspect of the business that needs to be tested. What is the quality and sustainably of its customers? Does the seller have the right personnel in terms of skills and experience? Is management available to run the operation post-transaction? How much has the company invested in sales and marketing? Do you have a full listing of products and services? Pricelists? How much information do you have about the competitive landscape?

We recommend visiting the seller's premises and talking to managers, executives, and employees. Examine the org chart and ask questions. Ask for short resumes of the key managers. If applicable, check out the factory floor – what is the state of equipment and infrastructure? A seller that has put off necessary repairs and maintenance, is not being frank about the cost of operations. Also crucial is the company's IT infrastructure and maintenance.

Again, if you don't have skill-set internally, hire an M&A advisor. The money spent will be worth the assurance that you are buying an effective and sustainable business.

Legal Due Diligence
Whether the planned transaction is an asset agreement or a stock agreement, evidence of the company's corporate and commercial legal documents is crucial. The seller needs to give copies of incorporation and formations documents, by-laws, and minutes of board meetings, plus operating agreements, partnership and shareholder agreements, if they exist. Details of the ownership of the firm need to be furnished, including stock certificates, if applicable. Make sure you have seen up-to-date certificates of good standing in the states in which you the seller operates. Ask if all relevant state and city licenses have been obtained.

As well as corporate agreement, review all commercial agreements with customers and vendors. Look at all documents which might incur liability for the company, including sales agreements and purchase agreements. If the seller has borrowed money, review all debt agreements and check on liens and encumbrances.

Review intellectual property relating to company patents, copyrights, and trademarks, as well as licenses owned by the company.

Ask for and examine documents relating to any ongoing or potential lawsuits, and recent litigation that has concluded.

Finally, check on employment matters. This includes reviewing employment agreements and employee handbooks, plus any relationships with regulatory agencies such as OSHA. Check the status of independent contractors to make sure they are correctly classified.

It is vital that you hire a law firm with experience in M&A transactions to help you with legal due diligence. The same firm will draft and comment on the all the legal and closing documents of the transaction.

Document Management
Virtually all the documents that you will be reviewing will be confidential in nature. You will need to return or destroy these documents if the transaction does not close. We recommend a virtual "deal room" is used to store and upload/download documents. That way there is a clear audit trail of who has uploaded, reviewed and downloaded documents. This will provide legal assurances to both buyer and seller.

Be diligent, hire experienced professionals, and good luck with your transaction!