

Don't ignore due diligence

How to be adequately prepared before you sign a purchase contract **Interviewed by Kristen Hampshire**

Buyers who purchase companies without doing due diligence often find themselves saying: "If only I had known." If only they had known about those payroll tax penalties. If only they had known about a burdensome pension plan. If only they had known that a majority customer would leave after the business transferred.

"The purpose of due diligence is threefold," says Patricia Rubin, CPA, a director in the assurance services department for SS&G Financial Services, Inc. "First, we find information about prospective companies that will help buyers run the business after the deal closes. Second, we identify problems that could delay closing. Third, we determine issues that could impact the purchase price."

Due diligence answers common-sense questions about a business being considered for purchase. In the heat of negotiations and drafting letters of intent, many business owners neglect to ask the basics. Due diligence exposes all the numbers, human resource issues and key factors a buyer must know about a business before buying it.

Smart Business spoke with Rubin about the due diligence process and what to watch for during the process.

What are the stages of a business purchase, and when should due diligence begin?

It all begins with the search process and seeking out a viable business for purchase. From there, you determine a reasonable purchase price and make an offer. Once a price consensus is reached, a letter of intent is drafted and signed by both parties. At this point, you should contact a professional to perform due diligence. Generally, you have a 30- to 45-day window for this process, during which a purchase contract is drafted and negotiated. Once due diligence is complete, the purchase contract may be renegotiated to reflect any findings, and then financing is finalized and the deal closes. Due diligence is a critical part of the purchase process. Once you own the business, you own its mistakes.

How will a hired professional begin the due diligence process?

First, the professional you hire will gather information about the business for sale and its industry. We start with a general list of pro-



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cedures and customize this process to fit the business, always asking the question: What is important to the deal? That varies from business to business. Where revenue may be critical to one deal, expenses may be more important to another. We determine what items require more investigation — where do we need to dig deeper so you will understand the business better once you own it? Due diligence often gets started after-hours or on weekends because many company owners do not reveal to employees that the business is for sale. The due diligence process also requires working with the seller to determine the following: Who manages accounting at the business, is quality financial reporting in place and what customers are important to retaining sales levels? Other questions we ask include: Has inventory been consistently valued? What is included in accounts receivable and payable agings? How up to date is the equipment? The list continues and varies depending on the type of business.

Can due diligence findings affect purchase contract negotiations?

We may learn that a seller's attractive financial results are the result of inconsistent accounting practices, such as deferring

expenses to make the company look more profitable on a continued basis or pooling revenue into one year to the detriment of another year. These practices can affect the value of the company and, therefore, what you should pay for it. Or, we may learn that a company is dependent on a particular customer. In that case, the buyer should confirm that the customer will stay with the company when the business changes hands. We try to identify issues during due diligence so you do not find out about them after the sale.

How can due diligence provide buyers with important post-sale knowledge?

We often identify integration issues. In other words, we consider everything you should know about the business after you own it. For instance, are the accounting personnel competent and will they be dedicated to the new owners? In instances when a division of a company is for sale, that division may have always relied on the parent company to do its accounting. In that case, it may require additional assistance to manage banking, accounting systems and payroll processing after the sale. Also, a division may not have any tax reporting responsibilities.

Are there any deal-breakers that buyers should avoid?

Warning signs often light up during due diligence — that is the point of the process. One major red flag is if a seller cannot answer routine questions about the business. The seller should know how the company reconciles its accounts and how much inventory it has at any given time. Review the seller's financial records. They should be concise and up-to-date. Find out if the company has payroll tax problems. Ask whether the company has lost any customers in recent years and why. Check accounts payable agings to learn whether bills are paid on time. Examine the condition of equipment. Ask yourself every what-if question possible, and bring these inquiries to the table before signing the purchase contract. Due diligence is a learning experience and if what you discover is bad news, you will be glad you didn't skip it. <<

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