

Business Due Diligence Process

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Due Diligence Considerations, Process & Timing

Buyer Due Diligence (DD) on a business (going concern) acquisition is the process of verifying that a prospective buyer is purchasing what he THINKS he is purchasing, and that the information he has been provided thus far by brokers and sellers is accurate within a reasonable degree of tolerance to the buyer. Due to serious concerns about confidentiality, disruption of current and future business, and time and expense, in depth DD is generally conducted after a binding agreement is in place and earnest money has been provided. Earnest money is refunded only if specific contingencies cited in the agreement are not met, (such as financing) or if due diligence uncovers material facts in dispute with the prior representations on which an Offer, or at least an LOI (letter of intent) was based.

Some degree of exploration and analysis of the business, its viability, its fit with the buyer prospect's experience, skills, and financial resources should begin the minute a buyer starts considering the opportunity. No one in the process wants to waste time, money and energy on a deal that cannot or will not happen. Many times the exploration process will not get past the first look at the offering prospectus or first meeting, as one side or the other recognizes this deal is not mutually beneficial. If there are brokers or alternative advisors representing the buyer and seller, he or she will understand the buyer's need for information to make a decision, and also the need to respect the seller's confidentiality. So, the process will go step by step with additional information provided as a buyer is apparently more qualified and serious. This article focuses on the DD that will occur when a buyer gets past the initial stages and has come to some terms with the seller.

Once there is an agreement in place, DD is a mandatory step in purchasing any business. Put simply, a buyer must do his homework, and know precisely what he is buying. This may be relatively painless with an honest seller and well organized business, presented by a professional broker. But, it can be a trying process, especially if a business is not well organized, the seller has something to hide, and/or a buyer is not both reasonable and prepared for the investigation. Buyers are encouraged to engage the assistance of a CPA with some small business experience to make the process far more efficient and productive. In depth due diligence is not a 'free look period' in which a buyer can decide if he likes or does not like "anything at all" about the business. Extensive DD simply cannot occur with every prospect on a business. The seller cannot be asked to commit the kind of time and energy, and expense for advisors, potential exposure to employees, vendors and customers required for due diligence of his ongoing business unless a buyer is committed to the purchase. Measurable contingencies and due diligence requests should be precisely listed at the outset of the process, often in the LOI or Offer document, or through the provision of a DD list.

The objective is to ensure the buyer gets all the material facts required to make a fully informed decision and assessment of the true condition of the business while not disrupting the seller's business unduly. To this end, timing is critical. Generally, a buyer has 2-3 weeks to accomplish this process while working around the schedules of the seller, the seller's accountant, and their own accountant. It is best to work out some type of planned schedule in advance so everyone's expectations are met and we do not have disagreements or unnecessary delays.

Pre-Offer or LOI, most buyers will already have obtained and reviewed financial statements and tax returns in order to define the price and terms that will work for the deal. If not, this is step one. Many businesses require outside financing, and no deal will take place without this, so at least a loan proposal is commonly required before any other DD that involves the seller's time begins. If a lender is providing financing, the buyer essentially has a secondary DD partner; the lender will be conducting their own DD, and they generally have a lot of experience with this. Financials will be analyzed, and the fact that the tax returns were indeed filed and accepted by the IRS will be verified by the lender.

Once a buyer has a loan proposal, or even better, a loan commitment, the parts of due diligence that open the seller up to exposure and potential business damage, can begin. If there are any other major contingencies, these should be tackled next. For example, insurance is an issue for many businesses—workers' comp, liability, fleet, contractors'. It is often best to start with the current providers, but only with the seller's permission and even an introduction. Financial DD should be scheduled during this time, as it will generally entail coordinating meetings with several people. Often the best route is to have the seller's CPA meet with the buyer's CPA, with any information not available at the CPA's office to be provided by the seller. If the seller's accounting records are available via QuickBooks or Peachtree Accounting, and do not contain the type of proprietary info that should not be handed over until closing, the buyer will have the luxury of looking at the accounting records at their own leisure. Otherwise, this may be done with some restrictions in the accountant's or seller's office. If any reports, customer or vendor accounts appear unusual in any way, a paper trail

can be followed to track orders, billings, deposits, etc. Financial DD on most small businesses can be accomplished in 1-2 days of focused work if everyone co-operates.

The closing attorney or buyer's attorney will do a lien and law suit search, and work with the seller to clear any old liens that may be incorrectly showing as active. Other liens will generally be cleared at Closing with payments made directly to lenders or creditors by the Closing attorney with funds from the transaction. If any problems are uncovered, the buyer will be informed.

Employment, asset, and operations questions not answered prior to DD should be addressed to the seller and/or their broker for responses. This is sometimes done in an interview session, or simply via e-mail, fax, etc. If the business has sellable inventory, this will need to be counted or the final amount being purchased somehow agreed-upon. The method needs to be decided ASAP so that an outside firm can be retained if needed. The inventory value should be finalized the night before closing. Often a "last minute" adjustment cannot be made within the third party loan amount, so the parties need to decide how adjustments to the estimated inventory will be handled.

If there are key employees or customers that must be interviewed prior to closing, these meetings will only take place when all other contingencies have been met, unless the seller has already informed these people in advance of his intentions. The seller does not want the potential of a major change to disrupt his business unless the deal is virtually certain to close. The seller does not want to have to present a new person as the next owner of his business, only to have to "take it back" next week. Generally, employees find out that a business has a new owner after closing at a meeting, with refreshments. The new owners and the seller reassure the employees that THEY are the reason for the success of the business, and are very much wanted and needed by the new owners. If the new owner treads slowly in making major changes, most often all employees will stay on, as they have no reason to leave a job that they need and like, and lose their source of income. Buyers should have time to evaluate all employees in the working environment before deciding to terminate existing staff, especially since often times the new owner does not know how to run the business without those employees.

Customers of a business are typically only concerned about one thing: are their needs being met? They do not care if Joe or Sam owns the business, so long as your plans do not upset their prior working relationship with the business. Quality, service, on-time, at the price they were quoted, etc. is why they deal with the business in question. If there is an existing written contract, it may or may not be invalidated by a sale. Buyers should have their attorneys advise them as to the nature of the contract, with input from the seller. Many times, the contract will continue under new owners; or it may be assumable, or the buyer may need a new contract. If a new contract is required, the buyer clearly needs assurance that they can obtain a contract that can be signed "subject to" closing on the new business. Most businesses do not inform any of their customers about a change in ownership until after a sale. In fact, in order to ensure a continuity of relationships and a smooth transition, many sellers introduce their buyers as a "partner" who has begun working with them so that they can grow the business and better serve that customer's needs. The seller remains in the background in case of any questions, and soon the customers are just as comfortable with the new owner as they were with the old owner . . . because their needs are being met!

The buyer also has many "transitional" tasks that are not so much DD on the business as set-up requirements to ensure that the business will run smoothly the day after closing. These often involve an accountant and/or attorney who assists with the establishment of a new legal entity to purchase and hold the business assets, and all related tax ID's, licenses, bank accounts, etc. The seller and broker will also be a good resource for what accounts need to be contacted to ensure continuity of services, utilities, and purchases for the going concern.

During due diligence, buyers may find some inconsistencies with what they previously were told or understood, or perhaps some anomalies in the business records. Naturally, these must be questioned, but a buyer should not over-react and assume this is fatal to a deal. Communication errors can and do occur with many parties to a deal, and small businesses often have "do it yourself" bookkeeping, which can lead to some interesting issues. However, many of these can be resolved. Neither principal should over-react to a DD hurdle or there will be no deal, and neither party gets what they want. Buyers and their advisors should speak with the seller and their advisors about their concerns so that the problems can hopefully be addressed. If a business turns out not to be as originally presented in terms of revenue, profits, personnel, contracts with customers, or assets—factors which affect the value of a business—then a renegotiation of price and terms will often be called for. On the other hand, no business is perfect (as the cliché goes) and a buyer cannot expect to renegotiate based on a non-material difference. Normally, both sides of the deal will have spent a lot of time, energy and money getting to this point, and will have a true desire to make the deal work.

Two different sample due diligence lists are attached for your consideration. As a buyer, you and your advisors should come up with a list that will satisfy your concerns, at a level appropriate to you and to the specific business. Take into consideration the systems in the business and the reasonableness of your requests. The seller and broker will need to be consulted as to when and how your list will be addressed. The parties should devise an actual schedule of meetings

to meet the DD deadlines defined in the purchase agreement. If all goes well, and everyone's expectations are fairly met, you should have a deal!

NOTE: BROKERS DO NOT WARRANT ACCURACY OR COMPLETENESS OF FINANCIAL OR BUSINESS INFO PROVIDED BY SELLERS. CONSULTKAP RECOMMENDS THAT ALL PARTIES TO BUSINESS TRANSACTIONS SEEK APPROPRIATE FINANCIAL, LEGAL, ACCOUNTING, AND TAX ADVICE FROM PROFESSIONALS IN THESE FIELDS. PROSPECTIVE BUYERS OR USERS OF INFORMATION PRESENTED BY BROKERS ARE RESPONSIBLE FOR THE PERFORMANCE AND THE EXPENSE OF DUE DILIGENCE REVIEW PRIOR TO ANY FINANCING, MERGER OR ACQUISITION CONSIDERATIONS.

IF YOU NEED REFERENCES FOR PROFESSIONALS TO ASSIST YOU, WE ARE HAPPY TO PROVIDE THEM.

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Buyer's Due Diligence Checklist #1 (asset sale)

1. Verify income tax returns have been filed and accurately reflect previously analyzed financial statements. Verify that there are sensible explanations for any material differences in income and expense categories between the tax return & financials.
2. Review A/P & A/R aging reports for unusual accounts or patterns. Review status of any customers with large balances due.
3. Verify State Sales Tax payments are up-to-date. Ensure buyer has Federal EIN & GA Taxpayer ID number, plus sales tax account if needed.
4. Verify Workmen's Comp payments and any other insurance plans are up-to-date. Ensure buyer obtains Workmen's Comp and all other necessary insurance—fleet, liability, property, fire, etc.
5. Determine physical inventory to establish existence & condition of inventory—you count, you hire counters? (Just before Closing) Funds need to pay for positive adjustment?
6. Review equipment & maintenance records to ensure that required maintenance has not been put off to dress up earnings pre-sale.
7. Obtain seller assurances that all liabilities secured by equipment have been fully disclosed. Verify with lien search.
8. Obtain seller assurance that obligations under any contracts of the company have been disclosed. Review any company contracts for potential liabilities or future payments.
9. Check employee vacation accruals and scheduled pay increases for future. Determine who is liable for any bonuses or vacations and how compensation occurs. Any employee contracts required?
10. Contact administrators of any company payroll, health insurance, or retirement plans to establish new accounts. Other vendor accounts that need transfer or set up?
11. Assess the likelihood of undisclosed miscellaneous liabilities, and obtain general representations & warranties by the Seller in

that there are no known undisclosed or contingent liabilities.

12. Conduct a UCC Filing Search under the official name of the **business** and all DBA's. (Closing Atty generally does this)

13. Conduct a public records search in the local county court records to uncover undisclosed liens or litigation. (Closing Atty generally does this)

14. Review, assume, obtain new Lease for premises. Meet with Landlord & get Lease executed.

15. Obtain new bank account(s) –requires Corp. Entity docs- and credit card processing, plus **business** license(s).

*This is just a basic list with those items most commonly done. Buyer is responsible for assuring their own **due diligence** is done to their satisfaction, and at their expense. Broker is not able to give legal or accounting advice.*

Due Diligence Checklist # 2

Following is a common list of the information needed for a more thorough Due Diligence. Some of the information may not be applicable to a specific **business**. Some of the information will be obtained through examination of the data on-site, through the **business** accountant, or it could be provided directly by the seller via interview or written response. Buyers should always take into consideration the capabilities and systems of the **business** and its owners when requesting information.

Personnel

1. Methods and levels of pay for employees
2. Bonus and incentive pay plans
3. Pension and deferred compensation plans-Contact info for administrators
4. Vacations entitlements
5. Benefits programs – automobiles, personal loans, insurance, ...
6. Recent payroll report—payroll company or employee leasing? Contact info
7. Resume or job description of each employee and reporting structure

Operations

8. Agreements with insurance companies, suppliers, customers, vendors, service providers, and others.
9. Description of procedures or functions... operations manual, copy of any forms used available?
10. Systems/reports used to manage the **business** Marketing & Sales
11. Competition -advantages and disadvantages
12. Pricing policies
13. Copy of any agreements with major customers
14. Trade names held
15. Forecast of market growth and company sales growth

16. Details or advertising and promotions campaigns

17. Warranty /guarantee provisions for past sales

Accounting Records

18. Financial statements for last three FY's

19. Quick Books/Peachtree company file available?

20. Copy of Bank statements and copy of checks— only if need to verify items.

21. Tax return for last three years

22. History of changes in accounting policies

23. Current accounts receivables & accounts payable aging

24. History of bad debts

25. Details of any unusual payment arrangements with anyone-vendors, employees

26. Asset lists and records for fixed assets & inventory—counting and valuation methods.

27. Dates and results of any federal, state, and local tax audits.

General

28. Listing and assessment of past, pending, and potential litigation

29. Details on insurance coverage and history of losses covered by insurance

30. Banking relationships Land, Building, & Assets

31. Any description and valuation data on building if being sold

32. Information on any environmental issues, recent Phase I?

33. List of all vehicles – year and model, market value, current mileage

34. Equipment list w/ market value—any leased equipment? Can it be paid off or assumed?

35. Any assets need to be replaced soon? Are any assets used in the **business** not owned by the **business**? (owned by you personally, by employees)

36. Capital expenses/major maintenance –capital expenses and major maintenance expenses currently needed or reasonably expected to be needed in the next year

37. List of all website URL's, e-mail addresses owned/used by **business**

38. List of all patents, licenses, other intangibles

39. Lease on premises—assumable or new lease required. Landlord contact OK? Contact info.

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