Chapter 14: Buyer/Seller Due Diligence

Due diligence is conducting an investigation in order to support the purchase price of the business. From the standpoint of the buyer, he wants to be assured that he is not paying too much and that there are no surprises. The seller wants to know whether the buyer will perform and repay debt and understands the tax consequences of the transaction.

Introduction

Due diligence can vary depending upon whether the target company keeps records based upon a cash or accrual basis. In cash basis accounting, all transactions and taxes paid are according to one's real-time cash flow. Cash income begins when you receive it, and expenses are paid as they occur. The accrual accounting method charges income and expenses to the period to which they apply, regardless of whether the cash has been received. Accrual accounting must always be used if the business involves nonperishable inventory.

Buyer Due Diligence

Buyers want to accomplish the following during due diligence:

- understanding how the business works
- whether the seller is accurately representing the assets, liabilities and financial statements
- whether there are any surprises in the near future such as a downturn in the industry, major customers going bankrupt, top sales persons leaving, etc.

Obviously, if due diligence does not support the valuation, then there would be a disconnect between the buyer and seller and there needs to be a reduction in the price of the business.

This section will discuss the business operations and financial impact of these operations through a review of the balance sheet and income statements (profit/loss statement). This review is not intended to be comprehensive. As always, one would be better served by retaining a great CPA who has previously done due diligence of small companies and is possibly a forensics expert.

Due Diligence Stages

There are generally three different stages to performing due diligence:

- an initial walk-through and interview with key personnel
- gathering data
- a final walk-through and review of things that have changed since the initial walk through.

Obviously these stages depend upon the size and complexity of the business.

Like most things in life, intuition can be valuable in gathering information. Buying a business is no different. Data revealed during one of three stages may terminate any further investigation.

During the first stage, the owner would release some financial information and give an overview of the operation. Obviously the buyer wants to receive all of the information upfront. However, many business owners may not relinquish certain information, believing that such guarded information would give them an edge over their competition.

When walking through the plant or office, a close eye should be kept on the employees and the real estate facility. Do the number of employees stated show up on the floor? Are they busy at work or are idle? Is there a sense of productivity? Do a mental headcount on employees. Is garbage being piled up. Sometimes a large number of the work force will get terminated prior to a sale, in order to reduce expenses and thereby show increased earnings. Sometimes, a walk-through can be more informative than weeks of reviewing financial statements. Many business owners are reticent to allow an interview with their key employees. The buyer should suggest that the owner be present in order to reduce any apprehension by the seller.

The second stage is a hard review of the financial statements and some of the information described in the business checklist seen earlier in See “Checklist of Important Items for Valuation” on page 38. The last stage is simply tying up the loose ends. Finally, personnel and management should be interviewed.

Operations

Line of Business

In many cases it is difficult for the buyer to figure out exactly what the company does, who are its customers, and why this company is different from other competitors in the same industry. The seller typically speaks about the company business in an industry in a broad way rather than in a more exact manner. It is important to have the seller break out both the specific service or product provided, and also the area of specialty and any related areas in which