Why You Must Perform Due Diligence Before an Acquisition

Michael K. Menerey, Partner, CFO Edge, LLC

Buying another business is one way to grow your company. Growth by acquisition can lead to the realization of synergies between the merged businesses as well as rapid, exponential growth that could take years to achieve organically. One of the biggest keys to a successful business acquisition is performing proper due diligence on any company you're seriously considering buying.

Due diligence is *"an investigation of a business or person prior to signing a contract,"* according to Wikipedia. It goes on to state that *"performing this type of investigation contributes significantly to informed decision making by enhancing the amount and quality of information available to decision makers and by ensuring that this information is systematically used to deliberate in a reflexive manner on the decision at hand."* [1]

Avoiding Unpleasant Surprises

Sometimes, though, owners fall in love with another business and decide to buy it before performing due diligence. Maybe they have extensive experience in or knowledge of the industry, or the industry is "sexy" or "cool" right now (like the Internet and dot-coms were back in the late '90s). Or maybe they have a personal interest in the product or service. But whatever the reason, buying a business without performing proper due diligence can lead to some unpleasant surprises.

Following are a few critical questions that due diligence can help answer *before* you commit to signing an agreement to purchase another business:

- Why are the sellers selling? Are they retiring or is the industry declining and they're trying to get out before things get worse? Also, is the industry growing and providing you with potential upside?

- Are the historical financial statements GAAP-compliant or are they modified cash/accrual statements that have never been reviewed by a CPA? If they're not GAAP-compliant, it may take some effort to get them compliant so you can rely on the information — especially as it relates to unrecorded liabilities and revenue recognition.

- Assuming the financials are reliable, what trends do they show? Is profit growing or declining? If it's growing, has growth been consistent or was there a recent spike that may not be sustainable? If it's declining, why is this so and can it be fixed?

- What is the customer concentration like? Is the business too dependent on a few key customers? Have they recently added a lot of new customers? If so, are these customers sustainable going forward?

- Can the owner provide you with gross profit analysis by product or segment for different offerings?

- Will the current management team remain in place or will you need to build a new management team? And who will be responsible for new business development?

- How stable is the workforce? Are unique skills required that can make it difficult to hire new employees?
- What form will the acquisition take? Asset purchases are usually preferable because they minimize the unknown or under-accrued liabilities that can arise in a stock purchase.
- Are there lease, employment or other commitments in place that must be assumed or re-negotiated?
- Are there personal guarantees the sellers have provided to support debt, leases or other contracts? If so, how will you deal with them?
- What is the condition of the current IT and HR areas? These are both critical to the company's operations and may need improvements that must be factored into cash flow projections.
- How sound are the current internal controls, policies and procedures? If they're weak, this is another area of cost and effort that you'll have to address post-closing.
- What software systems are in use? Are they integrated and do they provide useful management reports?
- Are there any environmental issues that could arise later? These must be identified and addressed before closing or they could bury you later.
- If the company owns intellectual property, is it protected and will you continue to reap the benefits of it?

Performing proper due diligence can be exhaustive and time-consuming for those unfamiliar with the process. Therefore, it may be wise to engage an outsourced CFO services firm for assistance with due diligence on a prospective acquisition candidate. An outsourced CFO can help you analyze and quantify all the variables and risks involved and their potential impact going forward, as well as how to relate them to the purchase price.

Concluding Thoughts

One of the keys to a successful business acquisition is performing proper due diligence on any company you're seriously considering buying. Acquiring a business without performing proper due diligence can lead to some unpleasant surprises and financial outcomes. An outsourced CFO services firm can provide valuable assistance in the exhaustive and time-consuming process of conducting thorough due diligence on acquisition candidates.

1 en.wikipedia.org/wiki/Due_diligence

About CFO Edge

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