Looking beyond financial statements

By Russell Long

The concept of due diligence is as varied as its applications in the business world. To a business owner looking to expand through acquisition, due diligence will identify whether a target company's financial condition is sound, the management team is competent, the underlying business practices are proven and the disparate cultures will mesh in a way that will achieve the growth desired. To business owners looking to sell, utilizing a professional to perform the due diligence prior to marketing a company will assist in anticipating any matters that may affect the transaction and thus maximize the value of the business.

In last quarter's Forefront, Susan Koss discussed the importance of understanding the "Quality of Earnings," which is a key component of the due diligence process. A business seller can engage a firm to prepare an independent Quality of Earnings report, a much more thorough analysis than revenue and expenses, that can be utilized by management to prepare themselves for the questions that will come during the sale process.

Traditional accountants and auditors are trained to prepare, evaluate and validate financial statements but are restricted by materiality thresholds. Boiler-plate audit programs executed by staff with limited or no business experience can miss critical red flags in financial or operational performance. Due diligence engagements must be performed by seasoned professionals, experienced in multiple industries, who have the ability to look beyond the financial statements and identify potential risks buried in the details. Additionally, due diligence engagements should all be done in a dynamic fashion that will vary significantly by engagement. At O'Keefe, a unique due diligence plan is designed specifically for each engagement and is tailored to the needs of the acquirer or in the case of a sell-side engagement, will focus on the areas management deems the most vulnerable.

In addition to a comprehensive Quality of Earnings analysis, a due diligence plan should include:

- Validation of purchase price – No two deals are structured alike and the due diligence team will want to ensure the client is getting the best deal possible.
- Analysis of Working Capital Requirements – A coordinated analysis of the working capital needs of the consolidated entity during the due diligence is essential to ensure working capital needs increase during the integration period and management needs to be prepared for the new environment.
- Assessment of Management – Assessment of the quality of management is part of the Quality of Earnings review. However, consideration must be given to whether management styles will mesh with the acquiring company's key leaders. Identification of key managers and their roles is essential.

A comprehensive due diligence plan performed by a seasoned professional is essential to ensure the buyer doesn't overpay and the seller does not leave money on the table. Because there is no single approach to a due diligence engagement, hiring the right firm is critical to a successful acquisition or sale.

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