# Thinking Strategically

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## Middle Market Due Diligence

Given the outlook for M&A, it is a good time to review how strategic advisers can aid the entrepreneur and the buyer with the financial due diligence process. Generally, TTM (latest 12 months) financial results and the 3-5 year outlook is where the buyer and seller come together on price.

Entrepreneurs grow their business by allocating limited resources to business processes with the goal of expanding cash flow. Unfortunately that may mean less investment in financial management since most entrepreneurs run their business utilizing their detailed hands-on knowledge of the business. Financial investors however need information to evaluate the opportunity and set a price. The quality of this information varies from business to business.
How can the seller's team help the entrepreneur with this process? Propose performing due diligence on the seller for the seller. Performing due diligence prior to locating a buyer should surface issues allowing the seller to convert issues into opportunities in order to present the best possible Company to potential investors.

Here's a list of telltale signs that the financials need some work to prepare for the financial investors.

1. **Overuse of tax orientation to the financials.** Cash basis financials generally fail to properly match periods with revenues and expenses. Are the company's sales subject to returns, allowances, bad debt, and warranties? If so how has the company accounted for these expenses? Accrual basis financials can be prepared easily but addressing tax strategies for the deal to benefit the seller can be more complex.

2. **Revenue Recognition.** If the company isn't simply selling a simple product then review the approach used to record the sale. It is important to note that the accounting standards on revenue recognition are presently being reviewed and a new pronouncement should be forthcoming. A sophisticated financial buyer will be aware of these changes and how future revenue recognition may be affected.

3. **Related entities and unconsolidated financials.** Many entrepreneurs have separate legal entities that may be part of the business units included in the sale but have never been consolidated. If these entities are truly a part of the business, preparation of a consolidation will help the buyer evaluate the business.

4. **Inventory.** Businesses with significant inventories have numerous opportunities to manage financial results through the valuation of the inventory. Sellers may manage inventories to avoid income taxes but create situations where realizing the value in a sale is difficult. Also inventory valuation can be complicated and require someone with an understanding of cost accounting to ensure appropriate valuation.

5. **Historic results by customer, vendor, or stores.** Buyers look to history to forecast possible future results. Historic detailed trends are essential in due diligence. Is the data available to present a comprehensive analysis of the key revenue drivers of the business? This analysis must include comparative by year/season/period of revenue, returns, allowances, bad debts and cost of sale to provide the buyer with the right data to build the future financially to pay top dollar for the business. The buyer won't pay for what can't be quantified.

Recent projects have included a variety of situations involving businesses for sale and illustrate these issues. In working with one seller, numerous accounting issues were uncovered and preparation of a consolidation of entities enabled the buyer to see the entire business included in the sale. This sellers had legal and accounting advisors whose advice did not support presentation of the financial results to a buyer or enable good financial management of the company. Fortunately the company for sale was high growth and enjoyed a good valuation resulting in a successful sale. There are endless stories of deals fraught with issues that could have been avoided. Recently a high level review of a company with significant inventory uncovered issues involving both quantities on hand and valuation of the inventory. The proposed buyer could not become comfortable with the financials in order to present them to investors and lenders. The deal couldn't be done.

To avoid deals falling apart or unnecessary last minute price adjustments, perform due diligence on the seller's business long before the buyer's team. The buyer's due diligence team must uncover issues to perform professionally and to reduce the purchase price to add value. At that point the seller has fewer options to get the deal back on track.

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