Solid Due Diligence Reduces Investment Risk

Anytime a company considers an acquisition, it becomes an extremely risky venture. The acquiring company invests a significant amount of its cash at the beginning of the transaction and in many cases, the acquired company cannot generate any value from the original purchase price.

The person bringing the acquisition to the table usually has the most input into the final discussion. The due diligence process is a necessary evil and many senior executives, along with investment bankers, view due diligence as something that could slow down the deal, thus putting it in jeopardy. So, all too often, due diligence becomes a quick exercise in verifying the historical financial numbers of the acquired company rather than conducting a final analysis of the investment that will allow the acquired company to produce future value.

The management team must realize in the beginning that due diligence is time-consuming, but absolutely central for each acquisition.

A few items that we place on the top of our list during due diligence are:

- A thorough analysis of the CPA historical audited financial statements can get you some solid information from the footnote disclosures such as litigation, long-term contracts, environmental issues, pension or other employee issues, value of intangible assets, and disclosure of large customers, which go beyond the financial data normally found in the balance sheet or statement of income.

- When significant fixed assets (real estate, machinery or equipment, etc.) or significant intangibles (goodwill, patents, etc.) are being acquired, you should engage outside experts during due diligence to verify that the value of these assets being purchased agrees with the price you are paying. Your CPA will require a valuation of these assets for the opening balance sheet audit and will write off any amounts you paid in excess of the purchase price. The work of the experts used in due diligence can also be used by your CPA for the opening audit.

- As an acquirer, you are best suited by acquiring the assets of a business and not assuming any of its liabilities. Unfortunately, there may be instances where you will need to assume liabilities (i.e. environmental remediation associated with a building). In these cases, you need to determine an accurate assessment of the liability, possibly using an expert, and adjust the purchase price as necessary. If the liability can not be accurately determined at the time the acquisition closes, escrow money until that liability can be more accurately determined and make an adjustment at that time. You want to limit your exposure to your predecessor's liabilities.

- Often, the due diligence findings are not serious enough to kill a deal, but if you accumulate these findings, they can be added to the post-acquisition plan and these problems can be resolved as soon as the acquisition is completed.

Using a due diligence checklist can make the process orderly and speed up the time needed to complete the process. If you would like to review Downey & Company's due diligence checklist, or have any questions concerning the due diligence process, please e-mail jmdowney@downeycocopa.com, or call Jamie Downey at (800) 849-6022.