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How To Conduct A Thorough Acquisition Due Diligence

The acquisitions that end up not being successful can some times be the result of mediocre due diligence on the front end. The buyout history has horror stories of missing critical information until after the closing such as finding contingent lawsuits, toxic waste dumps on the property, loss of a major customer, financial misrepresentation, loss of government licenses to operate, shifts in competitor advantage and numerous others.

The purpose of the acquirer's due diligence investigation is to scrutinize the target company the acquirer is about to purchase. The result of due diligence is the detailed analysis and risk assessment that provides the acquirer with an ability to make an intelligent and informed decision regarding the acquisition. The acquirer also is interested in confirming both his assumptions regarding the target's business and value together with avoidance of post transaction liabilities or surprises. It is really a common sense look at the company's historical and existing status to reasonably predict its future.

Due Diligence Preparation. As the acquirer, your successful due diligence results will depend on how well you prepare for the process and who will do what during the process. Normally, you will have a defined amount of time and realistically, more time will not yield a better result. Each due diligence is different depending on the target, your assumptions and what needs to be determined. As such, you should prepare accordingly:

1. Determine the specific due diligence steps that your team needs to complete.
2. Determine who will do what.
3. Create a detailed list of everything you need, information and documents, in each focus area. A checklist works well here.
4. Communicate with the seller the list of materials you need in the process.
5. Determine a reasonable amount of time required to complete, then get agreement from the seller.

Due Diligence Focus Areas. Due diligence is conducted by interviewing owners and management and reviewing documentation. The following are the kinds of documentation the due diligence team will want and that the seller should have ready:

1. **Management.** Biography or resume' for each key member of the management team, a strategic plan that focuses on the next five years, forecasts (include previous plans to compare how the company performed against plan), management employment agreements, confidentiality agreements, an organization chart. Understand management's business model and key drivers of the business. Background checks may be appropriate.

2. **Financial.** Published financial statements for the past five years, income tax returns for at least three years, internally prepared interim financial statements and analyses, financial projections in summary form, auditor's work papers, financial ratios, appraisals, real estate details including appraisals or market value estimates. Off balance sheet items, revenue recognition practices, earnings management and overall accounting practices might be reviewed here. Get all state, local, employee and withholding tax payment documentation.

3. **Marketing and Sales.** Product brochures and sales materials, list of key customers, sales analysis by customer, by product, by market or whatever makes the most sense, historical and projected sales data, customer contracts and agreements, historical and current order backlog, competitive analysis with strengths and weaknesses of each key competitor, and industry association studies.

4. **Operations.** Process flows, quality assurance programs, product or service delivery methods/processes, warranty information and historical experience, workforce information, subcontract agreements and information, and list of suppliers. Detailed information on all locations including purpose, people ownership, etc. Environmental, EEOC, immigration compliance, operating authorities and permits.

5. **Legal**. Corporate documents including minute books, articles of incorporation, bylaws, summary of all current and pending litigation and if significant then legal opinions from law firm regarding expected outcomes, summary list and copies of all contracts and agreements with lenders, employees, shareholders, unions, etc., patents, insurance policies, leases, and product liability summary.

6. **Technical**. Description of computing systems, website details, software used and release versions, people and outside resources, and evaluation of IT integration if it is to be integrated.

Due Diligence Performance and Execution. The due diligence process is best accomplished by the acquirer's management, independent of whether the acquirer is a financial or strategic buyer. Outside resources may be used where appropriate. Regardless of who performs, it must be done to a plan with specific results to be achieved. It can be a sensitive and anxious activity so the principals must be careful to not let it become a deal killer for the wrong reason.

Due Diligence and the Seller's Role. It is in the seller's best interest to go above and beyond in helpfulness for this process. Any reluctance may cause red flags. So it is best to have ready those documents that will surely be requested in an orderly way. Provide good, clear copies. Assign someone to assist the due diligence team.

Due Diligence Resources. The Internet offers descriptions and checklists for fee and sometimes for free. CPA and law firms and investment bankers provide due diligence services. If the target company is public then there is a wealth of information at the Edgar website called Livedgar where one can ask a list of due diligence questions about a public

company and the answers are returned in a professionally formatted presentation. There is quite comprehensive industry information here and at numerous other sites as well.

Due Diligence Factoids. Due diligence usually occurs after the acquirer and seller have agreed in principal on a transaction, often after a letter of intent is executed, but before the binding definitive agreement is executed. Due diligence is to confirm the value and risk with the expectation that there will be no significant surprises found. As such, only if there is something discovered that is material in nature, would the principals re-trade the deal. Due diligence costs are normally paid by the acquirer except that the seller may pay his preparation expenses, i.e. copies, CPA and employees. Unless there is unusual size or complexity, more than three weeks for due diligence is not reasonable.

Due Diligence Issues and Problems. Time pressures, Short closing periods, Competition for the deal, Auctions with due diligence materials locked in a room with some lawyer watching the process, Sellers that are not forthcoming or seem adversarial, Acquirers lolligagging through the process or not prepared. Confidentiality during the process is consistently a source of concern for the seller. Finding ways to solve the problem and get the information required can sometimes be challenging. But it can almost always be accomplished

Reverse Due Diligence. If you are the seller there are situations where it is important for you to know about the acquirer. If you are taking the acquirer's stock; if you are taking back a seller note; if you are staying with the company; if you have concerns about your employees; if your look for a compatible cultural fit, then you may want to conduct your own due diligence to ensure that the post-closing vision unfolds the way you expect. There is nothing wrong or offensive in checking out the acquirer. Lift some ideas from above to conduct your own due diligence. Are the acquirers what and who they say they are? Have they made other acquisitions? Can you talk to other sellers of companies they have acquired? Do they have the financial resources they say they have? How will they run or conduct the business post transaction?

Conclusion. In the good words of Ronald Reagan regarding the Soviet Union's commitment to dismantle their nuclear weapons "Trust but verify."

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