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A Search for Quality: Avoid the Due Diligence Quagmire

Business owners beware; do not underestimate the exhaustive financial due diligence process by a prospective buyer when selling your business.

by Mark D. Working

Perhaps it is the overhang of Sarbanes-Oxley, the lessons of the late 1990's buy-out boom, or the legal exposure that can ensue with litigious investors, but one thing is certain-no buyer wants to risk learning of some material detail to the acquired business post-closing. As a consequence, we have found that both financial and strategic buyers have ramped up their due diligence efforts to look at business operations, performance, and systems at a very granular level. Prospective business sellers should expect to endure an exhaustive due diligence process. Preparation is a keystone to success in achieving the optimum value and the highest probability of closing a sale of the company.

Virtually every business owner we have known has underestimated the challenge of financial due diligence. Two common and sincere refrains are that "the CFO has all the information at his finger tips and can handle it" and "our accounting system is pristine." At the outset, the process is akin to an audit, but quickly expands beyond GAAP compliance into a free-ranging investigation into cost accounting, product line and customer profitability, revenue concentration, breakeven analysis, earnings sensitivity, and business / financial risk assessment. The unsuspecting CFO will likely find the process to be far more intrusive than any financial audit.

QUALITY / CONSISTENCY

Due diligence starts with a financial review, with buyer inquiries directed toward determining the quality both of the data collected and the reporting of information. In this regard, "quality" is an assessment of the reliability and consistency of underlying data-collection practices. A financial statement review is simply a launching point into the evaluation of data-collection practices. It extends into the verification of how both financial and operating data is collected and finds its way to the company's management information system and financial statements. Effort focuses on reviewing systems, financial statements, and audit workpapers, together with staff interviews that delve into procedures for collecting, processing, reporting, and reconciling information.

The inquiry moves on to test the degree to which financial reports adhere with generally accepted accounting principles ("GAAP"). Here, the buyer is seeking to gain comfort with the consistency and integrity of the information presented in financial reports. A common misconception among business owners is that their financial statements are fully GAAP compliant. Often private company financial statements are presented in "material compliance" based on judgments that minor variances from GAAP do not give rise to a material misstatement of results. That can leave room for debate regarding the methodologies for revenue and expense recognition, and establishment of reserves for warranty, product liability, bad debt, and inventory obsolescence. Surprises can largely be avoided with the preparation of audited financial statements by a reputable accounting firm for at least several years preceding the sale. Although a review may suffice, a full audit is preferable, as it serves as independent confirmation of consistency in accounting practices. It is important that the CFO pays close attention to auditors' suggestions for reducing the reliance on "materiality."

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EARNINGS QUALITY

In many cases, the most challenging aspect of due diligence is the buyer's effort to accurately quantify the intricacies of business operations and profit generation. That means an examination of data that explains business unit, customer and product profitability, and measures asset quality and utilization. This level of analysis requires an ability to integrate financial and operating data and then "slice and dice" it in a multitude of ways.

Buyers are seeking to develop a detailed grasp of the economics of the business to determine the impact of accounting policies on smoothing performance and to understand exactly how and from whom its profits are earned, the factors that affect the ability to sustain those earnings, and the requirements for capital to maintain and grow each aspect of the business. A static analysis of the business will not suffice. Only a robust database of financial and operating data that can be

DUE DILIGENCE CHALLENGES	COUNTER MEASURES
Accounting practices will be challenged; no firm is exempt from improvements, but the list can be shortened.	Engage a reputable CPA firm and competent staff as part of the transaction team to review all procedures in advance. If challenges are anticipated, financial presentations can be adjusted in the beginning of the process to avoid "misunderstanding" about performance.
Alternative accounting treatments are commonly used as a rationale for restating business performance, fostering a renegotiation of price.	Disagreements regarding GAAP can spawn heated negotiation deep in the process. These differences often do not actually have any economic significance and therefore should not be the basis for an adjustment. Separate economics from accounting.
Financial statements rarely explain business economics in detail.	The ability to effectively articulate business economics with data has a major bearing on value and due diligence efficiency. As part of our preparation, we have often remapped the entire accounting general ledger of a company to create a customized presentation of income statement and balance sheet items to illustrate critical economic aspects of the business.

(continued p.2)

arranged in a variety of formats enables the seller to fully address the buyer's questions.

PREPARATION IS THE EFFECTIVE COUNTERMEASURE

Anticipation is essential. Know that methods and results may be challenged at a deeper level than management normally requires or has seen. Although not a complete list of potential challenges, the table above highlights areas of potential conflict.

As the keeper of data and master of the systems, the CFO is the central player in the due diligence effort. Answering questions on the fly, while meeting day-to-day business demands, is difficult. On occasion, we encounter some reluctance on the part of a financial officer to cede control of a portion of the process. But, if the CFO has not recently been through a full due diligence process and does not have sufficient internal resources, the process will bog down, usually to the detriment of the seller.

Anticipate, get some help, and avoid a perpetual due diligence quagmire that is likely to sow uncertainty among employees, and ultimately increase transaction costs and diminish sale proceeds. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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