



# *Investigating Due Diligence*

*Proper research and investigation play a vital role in merger and acquisition transactions*

*By Thomas M. Edens*

**D**ue diligence is the process of investigation conducted by parties involved in a business transaction. It can be viewed as an essential exploratory journey that begins with the first conversation between the parties and may end as much as a year after the transaction closes. Due diligence in a merger and acquisition transaction is not a finite event or period of time. There are varying intensities and rigor in the execution of this important investigative process. The most intense reviews usually occur between the signing of the letter of intent and the execution of the definitive purchase and sale documents.

There are a number of ways that buyers attempt to protect themselves from unforeseen negative attributes of the company they are buying. The core of their risk management efforts centers on a thorough due diligence effort. Other risk management techniques include escrowing a

certain percentage of the purchase price for a time-certain period after closing. This allows time for previously undiscovered items to surface. Lastly, there will be numerous representations and warranties in the definitive purchase documents that will allow recovery from the seller through offsets, or otherwise, if the matters were not previously disclosed to the buyer.

The operative mind-set in any due diligence process should be full disclosure by both parties. The more open the parties are throughout the process, the sooner the due diligence can be completed and the determination made to conclude the transaction or part ways.

Due diligence may unfold similar to the following scenario. The shareholders of a company have reviewed their succession planning options and have made the decision to sell the company. Merger and acquisition (M&A) advisors have been engaged to market the company and

negotiate with potential acquirers. The M&A advisors have prepared a marketing memorandum, which typically includes substantial information that acquirers will need in order to determine their interest level regarding making an offer to purchase the company. The acquirers have performed limited due diligence prior to making an offer. It is typically after the letter of intent is signed that substantial and thorough due diligence is conducted.

It is important to note that due diligence is two-way street. The sellers of a closely held business have an important obligation to themselves to investigate the buyers of their business. However, it is usually much less intense and more limited in scope than the acquirers' investigation. The buyers typically have more uncertainties to address as they are acquiring a complex operating entity with numerous moving parts, whereas the sellers are often receiving a known quantity—cash or near-cash consideration.

The letter of intent will effectively charge each party to begin their investigations and will typically specify that each party bear the cost of their own due diligence efforts.

The purpose of due diligence is not to find “deal breakers,” but to provide an opportunity for all parties to verify the facts and circumstances as they understand them. Due diligence is expensive in terms of cost to the acquirers and of professional opportunity cost expended by executives during the transaction process.

### **Typical steps**

There are numerous components of your business that a typical acquirer will want to examine. Expect that examination to be extremely thorough. A team usually conducts the examination. The due diligence team can be made up exclusively of employees of the acquirer, or the acquirer can outsource much of the investigation to outside professionals. There is often a correlation between the size of the transaction and the use of outside professionals to conduct the due diligence. The main reason, of course, is cost. The smaller the transaction, the less the transaction can bear the cost of expensive outside service professionals.

Many of the most active acquirers will use a large accounting firm to perform a material portion of the investigation, which will be further supported by a significant contribution from the legal team. Other professionals that may be utilized are computer and software consultants, quality control consultants, private investigation firms and environmental consultants (if real estate is involved).

A due diligence questionnaire (or data request list) submitted to the selling shareholders is the most typical way that the

due diligence process begins. It is often at this point that the shareholders disclose to another trusted employee (or two) that the owners have agreed to sell the company. The preparation of the reply to the questionnaire

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is often accomplished by a team approach led by the owner, his outside CPA firm, the company's chief financial person or some other administrative manager. This will entail a substantial time-consuming effort. It is often during this process that business owners learn things about their own company that they did not know before.

Once the information has been gathered to comply with the questionnaire, the buyer's team will often be invited to visit the seller's offices. The team may work for several days at the seller's offices, the seller's CPA's conference room, or alternately at a local hotel's conference facilities.

The most common aspects examined by the acquirers' team are as follows:

**Legal Matters:** Legal due diligence may include the examination of all material contracts of the target company. These contracts often include client contracts, office and equipment leases, software contracts and licenses, employment agreements, bank loan documents, and shareholder agreements. A public lien records and UCC filing search will more than likely be conducted. The company's corporate records will be examined, which include the articles of incorporation, bylaws

and minutes of shareholder and board of director meetings. Certificates of good standing will usually be required to be obtained from the Secretary of State.

Of primary concern to an acquirer will be the company's history of lawsuits. FDCPA violations (or often purported violations) will be reviewed for determination whether there is to a pattern of continual violations or isolated suits of a frivolous nature. Employee lawsuits must be satisfactorily explained as well as legal suits with your clients, vendors or various governmental agencies. The acquirer's perception of the risk of contingent liabilities will affect the amount of escrowed purchase price and timing of its release (especially if the transaction is structured as a stock sale).

**Financial, Accounting and Tax Matters:** More than likely, the purchase price will be determined by using a multiple of adjusted earnings. The most common benchmark utilized by most acquirers is EBITDA, which is an acronym for Earnings Before Interest, Taxes, Depreciation and Amortization. The acquirer's due diligence team will spend considerable time verifying the different components of the financial statements. There will be an attempt to identify and quantify all commitments and contingencies of the target company. Trust cash accounts will be examined for accurate reconciliations and the corresponding obligation reflected as a current liability on the balance sheet. Accounts receivable, and related bad debt reserves, will be scrutinized for collectability. Depending on how the transaction was structured, current liabilities and related accruals will be tested for reasonability.

Tax returns will be examined and verified as to compliance with filing requirements of various taxing authorities. It would not be uncommon for the buyer to request “as filed”

tax returns directly from the Internal Revenue Service. Any recent tax audits (federal, state or local municipality) will be reviewed, and discussions will more than likely take place with the tax professional that prepared your tax returns.

**Clients, Placements, Recoveries and Fees:** The business you are selling and the acquirers are buying is an accounts receivable management service company whose clients generate cashflow resulting from accounts placed with the business. Accordingly, placement patterns will be examined closely to verify trends in the amount of business you are receiving. The seller's trend of dollar placement inventory accompanied by liquidation rates will provide an acquirer data to make projections of near-term fees.

Depending on the nature of your business, this analysis may need to be prepared by product lines or classes of paper (early-outs, prime paper, seconds, tertiary, etc.). Any negative trends in dollar amounts placed or quality (collectability) will be reviewed and analyzed. Placement trends are often an early indicator of near-term recoveries, fees and cashflow. The downward trending of commission rates and fee structures has been a factor affecting the industry for a while now. The impact of this trend on your business and its relationships with your clients will be a significant concern.

The stability of your clients will be investigated. One of the most fearsome techniques utilized in the due diligence process is the direct contact with your clients by the acquirer's team prior to closing. The purpose of this communication is to inquire about the satisfaction of service levels that the seller has been providing and the likelihood that the client will be retained after a change of control event. This contact

usually occurs immediately prior to closing and under the specific supervision of the selling shareholders.

Sellers will want to edit and approve the script to be used in the dialogue with their

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clients. It is not uncommon for acquirers to utilize a quality assurance consultant (or market research firm) to contact the clients under the guise of a quality control survey initiated by the seller. What is not common is for the potential acquirer to be allowed to contact the clients before the seller is reasonably assured that the transaction will close and the definitive agreement is negotiated.

**Management & Personnel:** During the due diligence period, there are many personnel issues that are required to be addressed. Most acquirers will determine which key employees will be requested to sign an employment agreement and/or a non-compete agreement. Almost always, the selling shareholders will be required to execute a non-compete agreement. Unusual patterns of employee turnover will need to be explained to the acquirer. The principals of the selling company may additionally be subjected to a background check (criminal, credit, litigation and otherwise).

Another factor is the cultural compatibility of the selling the company with the buyer's organization. If the selling company has had more of a "maintain the current clients" mentality and the acquirer has a company-wide mantra of "growth,

growth, growth," there could be an intangible issue that needs to be reconciled. This issue compresses down to a feasibility of a successful integration.

**System:** During the last two years, great emphasis has been placed on the Y2K software issues dealing with the use of dates in software programs. Among the non-Y2K issues that will be addressed will be the status of updates from the software vendor and the ability to download business from the clients.

If the company is using a proprietary system (versus one of the widely utilized system platforms), the level of system due diligence will probably increase due to the unknown territory that must be charted. If the acquirer is going to convert from the proprietary system to one of the platforms it utilizes, the result will be minimized system due diligence. If an acquirer is going to utilize your proprietary system and plans on growing your company, a primary concern will be the scalability and stability of your system.

**External Factors:** Besides thoroughly examining the target company, an acquirer will usually examine a number of non-economic factors that affect your company. This may include performing an analysis of your competitors and the general market conditions of your geographic marketing area as well as the specific industry niches that you serve. It is important for an acquirer to understand the external trends that are taking place which could have an impact on your business in the future.

External factors also include the employment climate in your city—specifically, within your hiring radius. Turnover of collection staff is a challenge facing most agencies, and some companies have a greater challenge than others. An acquirer anticipating rapid growth post-acquisition must be satisfied that a trained

work staff can be maintained and expanded.

**Re-Negotiation of Purchase Price:** Just when you think the stressful negotiations that took place and culminated in the signing of the letter of intent are over, due diligence uncovers issues to be resolved. The most common occurrence is that the re-cast earnings (EBITDA) you submitted to the buyer ultimately do not hold-up under the rigorous scrutiny of the buyer's financial due diligence team. If there is a material difference between the EBITDA the buyer thought he was acquiring and the EBITDA computed by his team, more than likely the result will be a downward adjustment of the purchase price. Sellers expect an increase if the re-computed EBITDA amount comes in materially higher after review.

Other discoveries resulting from due diligence that could result in changes in either the purchase price or a re-structuring of payments (or worse yet, the deal fails) are:

1. Client concentration is greater than originally perceived.
2. Management is not as strong as originally perceived (or is leaving or will not sign a non-compete).
3. Placements are trending in a negative way.
4. Fee structures are determined to be under greater pressure than originally projected.
5. Reference checks with clients indicate that relations and client satisfaction levels are unstable.

Any re-negotiation of the purchase price or terms is almost always one of the most tenuous parts of the transaction process.

**Seller Consideration:** Now it's your turn. There are a number of important attributes that a seller will want to verify about the acquirer before he turns over the reins to him. It has long been assumed that you (as the

seller) are thoroughly and specifically satisfied that the acquirer has the financial resources to close the transaction.

Part of your due diligence regarding the buyer will include discussions with the

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owners of other companies that he has acquired. You will want to satisfy yourself as to how he treats his employees, his reputation in the industry and the likelihood that he will pay your note (providing that a seller note was part of the transaction structure). Another reason for investigating the buyer is that you may have elected to accept a portion of the purchase price in the form of common stock of the acquirer. Don't ignore your instincts if something does not feel right as you do your investigations.

It is suggested that you make an extra copy of the due diligence materials that you are supplying to the buyer. Some of the material will be asked for again by other members of the acquirer's team, and a material portion of the data will be used as a foundation for the disclosure schedules integral to the definitive purchase agreements.

### **Summary**

Due diligence is a vital part of the acquisition process. The better the parties are prepared, the sooner the process will be concluded. The buyer will probably spend considerable funds to perform due diligence (and the seller will spend an enormous amount of time).

Following is a list of the top attributes of successful due diligence in a merger and acquisition transaction, courtesy of Marion Financial Corp.

1. Seller is prepared.
2. Buyer is prepared.
3. Buyer's team is coordinated in their efforts so as to reduce redundant data gathering requests.
4. Confidentiality is maintained by the buyer's due diligence team.
5. Seller disclosures are kept current with changes in the business as the transaction progresses.
6. The process proceeds on a pre-determined schedule and efforts are made to minimize delays.
7. Renegotiation of economic points resulting from due diligence findings are handled fairly and in good faith by both parties.
8. Seller has a competent financial person to assist in the due diligence process.
9. Policy of "full disclosure" is practiced by both parties.
10. Due diligence efforts have enabled the transaction to end with a win-win conclusion. CM

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