Reprinted from:

November 10 - December 7, 2012 Volume 12 Issue 12

COMMERCIAL INVESTOR

INCORPORATING FRANCHISE AND BUSINESS OPPORTUNITIES

dollarsandsense

What to expect in due diligence

Buying or selling a small business means asking the right questions, and getting the right answers

By: Hartley Cohen, C.F.P., C.P.A., C.A.

Congratulations, you've found a small business to buy, or found a buyer for your small business. It's an exciting time in your financial and professional journey. But before the i's are dotted and t's are crossed for good, the final step in the process is still ahead – due diligence.

Due diligence is simply the research and analysis of the company in question prior to sale, in order to confirm all material facts involved in the sale. In reality, it's a time-consuming and occasionally overwhelming process, but a critical component of any small business transaction that helps avoid potentially costly surprises. For a small business purchase, due diligence can take a couple of weeks and sometimes up to nearly a month or longer, depending on the complexity of the transaction and the reliability of accounting and other records.

The entire due diligence process is comprehensive, involving legal, accounting, and general business practices. It starts with synergies and the identification of where cost reduction opportunities and revenue increase opportunities exist, as well as how the product, personnel, and geographic coverage of the acquirer/acquiree fit together.

Next comes a market overview, including the size of the market; how it's segmented; projected growth and profitability and what factors might affect those; trends in the number of competitors, their size, product innovation, distribution, finances, regulations and product liability.

A SWOT analysis (Strengths, Weaknesses/ Limitations, Opportunities and Threats) starts with an analysis of the aspects of the business likely to give it a competitive advantage, such as patents, strong brand names, positive reputation, proprietary know-how, and good access to distribution and resources.

Weaknesses could simply be an absence of such strengths, or the flip side of those strengths; a large manufacturing capacity in the strengths column can mean a corresponding item in the weaknesses column if it prevents the company from reacting quickly to market changes. Opportunities for growth and profit should also be revealed during due diligence, including the imminence of new technologies, loosening of regulations, or changes to barriers to international trade; likewise, these things may also reveal threats to the business.

The next stage of the due diligence process is a corporate overview The essentials include the company's core competencies, strategic alliances, history of product development, and a history of the management team. The corporate overview is broad spectrum analysis that will examine corporate culture, including command structure, employee retention, promotion policies, internal information dissemination, and the physical environment; personnel information including compensation agreements, payroll, terminations, organization charts, employee manuals and benefits; marketing and advertising expenditures, risk management, and insurance premium adjustments, to cite a mere few examples.

Products, intellectual property and brands will be extensively reviewed, including historical and projected growth rates, marketshare, and profitability, as well as the legal minutiae of ownership, such as clear title to branded names, legal fees involved in brand encroachment, pending patent applications, copy right registrations, and registered designs. Legal matters also include pending lawsuits against the company and any initiated by the company, and environmental and employee safety issues and liabilities.

Research and development matters including strategies, key personnel and major activities will be reviewed also. What's the status and timing of new products, and their cost of development? What critical technologies are necessary for implementation? And, what are the risks?

Of course, financial due diligence is a huge part of the process. Assets and liabilities, equity and profitability play major roles. Annual and quarterly financial information for the past three years will be reviewed, as well as financial projections, capital structure, and other financial information such as general accounting policies and tax positions.

While they're poring over the huge volume of information involved in the process, your lawyer, accountant and business advisors will be looking for red flags, such as: is there evidence of numerous changes to accounting practices? Are there complex arrangements in place that don't appear to have a sound business purpose? Have other acquisition attempts fallen through? Are a large percentage of monthly sales regularly achieved in the last few days of the month? Have sales and/or profits been stagnant or are they declining?

It's important to note, too, that even information revealed in due diligence that is technically "accurate" may not reliably represent the business's true performance; for example, a seller might have a relationship with a cargo company that keeps shipping costs well below the industry average, but the buyer would not have the same relationship. A professional due diligence review is essential to ensuring that information disclosed is not just accurate, but reliable as well. The reliability of the historical financial statements will be key. Generally reviewed or audited financial statements will add that much more creditability for reliance and in the end may reduce the cost of financial due diligence.

Hartley Cohen is a Partner at KRP (Kestenberg Rabinowicz Partners LLP, Chartered Accountants) in Markham, Ontario.

Accountants For Entrepreneurs

Kestenberg • Rabinowicz • Partners LLP

Chartered Accountants

krp

2797 John Street, Markham, Ontario, Canada L3R 2Y8 T (905) 946-1300 F (905) 946-9797 www.krp.ca

Russell Bedford

MEMBER OF THE FORUM OF FIRMS