CGMA TOOL

M&A due diligence for CFOs part II – seller: Guidance for small- and mid-sized organisations

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About the tool

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INTRODUCTION

The process of due diligence typically involves a thorough investigation of the business from many vantage points. The understanding of due diligence is best summarised by *Black's Law Dictionary* as "the diligence reasonably expected from, and ordinarily exercised by, a person who seeks to satisfy a legal requirement or discharge an obligation."

Due diligence is usually thought of as the long list of items the buyer must consider and verify prior to purchasing a business. It's true that the buyer has a special and enduring duty to thoroughly examine the target company because he or she will have to live with the purchase decision if the deal is completed. The seller has a much lighter due diligence load from a purely technical or legal viewpoint. Most sellers enter into negotiations and possible transactions woefully unprepared to discuss the deal with an experienced buyer.

SELLER'S DUE DILIGENCE

Examination of the seller's side of a transaction begins with an overview of the reasons the business is available for purchase. Once the decision to sell has been made, thoughts often focus on such things as optimising the transaction price, minimising negative terms and being as tax efficient as possible.

This examination of the seller's due diligence is intended to be proactive and geared to optimising negotiating strength. It seems logical that the typical seller would desire optimal negotiating position but, as you will see, such a position often entails actions antithetical to many business owners.

DEVELOP AN EXIT PLAN

The first topic regarding seller due diligence, developing an exit plan, is something that few business owners ever adequately address. Absent a sudden or unanticipated event that compels the sale of a business, most owners will have a reasonable amount of time to ponder the transaction. There are many reasons for selling a company, but few of them require a fire sale environment.

With forethought, the sale of a business to the seller can be substantially less stressful and more financially rewarding. Often, the owner of a closely held business is so identified with the company that it's unimaginable for him or her not to be in a position to control the organisation. Particularly if the business is prospering financially, the enjoyment of leading a successful entity provides significant psychic remuneration in addition to an enviable material standard of living.

The astute business owner realises that staying in the business forever is not an option. Every owner will leave the business. The important question to ask is, how will the owner leave? Will the owner be in control of the succession process, or will he or she merely react to events? Our overwhelming experience is that owners electing to take control of the process will become students of best practices and begin the process of selling the business years before the actual transaction date.

Following are two examples of exit plan outlines.

Example: Succession exit plan

In this example, the business owner has made the strategic decision to begin the process of transition planning. Several decisions must be made to formulate an appropriate exit plan:

1. The owner needs to determine what standard of living should be maintained following the sale of the business. This is a classic "work the math backwards" exercise in which the business owner estimates what living expenses will be incurred moving forward and if sufficient resources exist to provide for those costs.

2. Goals should be addressed. One goal frequently cited is maximising the transaction price, but this is often too simplistic. There are a limitless number of goals tailored to each owner, but a few more common goals we have experienced are to:

   - Maximise the after-tax proceeds from the sale (not the gross price)
   - Provide security to key employees who helped grow the business
   - Give something back to the community
   - Give something back to the industry
   - Keep the business independent
   - Sell to the employees
   - Ensure a legacy for successor owners and employees

3. The owner needs to fully understand the various options available regarding the sale of the business. There are really a limited number of buying groups. These groups are listed here and considered in greater detail shortly:

- Sell to family members
- Sell to management or an employee stock ownership plan (ESOP)
- Sell to a third-party financial buyer
- Sell to a third-party strategic buyer
- Exit through an initial public offering
- Liquidate the business
- Remain in control of the process until the decision to leave is finalised

Each of the preceding options has relative benefits and costs based on the goals of the seller. If selling to family members or employees is desirable, for example, such a transaction requires seller financial assistance and a generous amount of time. Be pragmatic about the timeline to exit.

4. Assemble a team of trusted advisers to accomplish the exit plan.

   This outline is very abbreviated and virtually all of the key items could be greatly expanded. For proactive owners interested in optimising their negotiation position, this first step in building a succession plan is a lynchpin in the process of success.

Example: Competitive pressure exit plan

This next example is offered as an illustration of circumstances that suddenly emerge, dictating a consideration of dramatic actions:

1. Quickly assess the risk to the business due to changing circumstances. The changes may range from longer term risks or sudden catastrophic circumstances:

- If the risks to the business are longer term, there would seem to be time for the transition process to evolve. This often is a mistake because the longer term atrophy typically is well known to the pool of buyers and they will discount the business for the compromised future. One example of this application is the sheet-fed printing industry. Many industry participants failed to understand that competition is not only other printers but also competing technologies like the internet.
- If the risks are more imminent, then something must be done with a true sense of urgency. One example of this is the U.S. domestic textile industry that is faced with sudden international competition.

2. If the risk environment is severe and the longer term prospects are in serious doubt, it is best to quickly face reality and search for a larger strategic partner. A larger partner may have an interest in the business and also have the financial strength to remain viable:

- The owners may well be advised to quickly adjust to the likelihood of an environment in which they will have to make many concessions just to survive. The compromises are almost certainly preferable to liquidating the company or prolonging the inevitable with a financial decline.

3. Quickly identify a team of advisers. In this case, industry specific authorities will have worthwhile insights.
4. Develop a “damage control” outlook and try to negotiate the best deal possible.
5. Having multiple contingency plans in dire circumstances is a recommended procedure. Implementing a plan quickly is the best guide to controlling financial losses.

Even in difficult market circumstances, with the correct preparation business owners may reduce financial damage with advanced planning. Failure to heed market conditions is most often a prescription for a financial disaster and a shattered future.

IDENTIFY YOUR ADVISORY TEAM

Key advisers to the seller in the form of finding and selecting an advisory team is an integral part of the process.

PLAN TO OPTIMISE THE VALUE OF THE BUSINESS

It is possible to argue that this point is closely related to developing an overall exit plan, but the intent is to specifically isolate this point under a major heading. Most business owners of successful companies will likely only sell one time. There are a number of proactive measures that the business owner may initiate as part of the process of being in control of the transaction environment. Optimising the financial value of the business is clearly one of the more easily understood goals.

This section focuses on a number of key initiatives that the seller may undertake. These initiatives will have a significant favourable impact on the total consideration to be received for the company:

- Financial statement presentation. If the seller is serious about optimising the value of the company, consider having the past year or two audited or, at the minimum, reviewed by a public accounting firm. This step is easily accomplished with some advanced planning and with some anticipated cost. The advantage of having an independent third party, the CPA/Chartered Accounting firm, prepare financial statements typically at the end of a fiscal year is clear: the financial statements are far more credible and believable if this financial standard is offered to a prospective buyer.
- End commingling personal and business activities. The temptation is great to convert as many personal living costs as justifiable to business expenses. The tax savings are significant. The savvy business owner wishing to sell the business on favourable terms will take appropriate steps to eliminate such items so that the operations of the entity are most accurately evidenced in professionally prepared financial statements.
- Ensure effective reporting controls. Install effective internal reporting controls and make sure they are working. Reporting requirements, for example, are far more complex in manufacturing companies than in service operations. If the operational environment is more complex, the seller will strengthen bargaining leverage by addressing this potential profit hole.

PLACE THE BUSINESS IN A POSITION TO BE EASILY SOLD

The seller should anticipate the concerns a potential buyer will have regarding the business. Anticipating the more common questions helps with negotiating leverage because defensible answers may be crafted to alleviate buyer concerns. This factor helps justify the seller assembling an advisory team to make the process far less stressful.

Review of legal issues

Prior to the close of a transaction, it is a best practice to review applicable legal issues. Unanticipated and material surprises late in negotiations are a leading reason for killing deals. The following non-comprehensive list is a reference for major legal issues to be addressed:

- Decide what is legally being transitioned. For example, decide if it is the stock of the business or the assets that are being sold. Even if the assets are being sold, if the company name is one of the assets this suggests that certain legal liabilities are being assumed by the buyer.
- Make sure that the company stock or equity records are up to date along with other applicable legal documents such as corporate minutes and state/other jurisdictional filings.
- Identify and disclose all litigation affecting the business.
- Identify and disclose all known material liabilities such as government regulatory investigations, workman's compensation reviews and other investigations.
- Determine if there are any outstanding environment-related issues. Such matters may relate specifically to land and buildings owned or leased by the business.
- Do a thorough review of all applicable compensation and benefit plans to determine if there are any liabilities, such as unpaid vacation and retirement obligations.
- Make sure you have clear title to the assets you wish to transfer.

- Verify compliance with all applicable federal, state, provincial and local regulations. For example, if the seller is married and is a resident in a marital property state/jurisdiction, there may be disclosure requirements to a spouse with a property interest in the business.
- Talk with knowledgeable lawyers experienced in transaction to develop a comprehensive checklist of potential matters that may apply.

Preparation of an offering memorandum (Recommended but not required)

Preparation of an offering memorandum is a best practice if selling the business to a third party is the likely outcome. Clearly, if selling to groups such as family members, key employees, or an ESOP is the goal, this step is not necessary. It is assumed for this point that selling to a third party is desirable.

The memorandum is a promotional report that casts the operations of the business in their most favorable but accurate light. The preparation of an offering memorandum assumes that the business will be marketed to an outside buyer. The memorandum is intended to educate potential investors about the operations of the business. Such memorandums discuss the business in realistic terms because it serves as an introduction to the company.

The memorandum is largely regarded as a promotional piece by potential buyers, and they reasonably assume that the company is portrayed in a more favourable light. Regardless, the credibility of the seller is being examined, and so the memorandum should be factual, particularly with regard to facts that are independently verifiable such as industry information and competitors.

The memorandum largely reflects the elements that you expect to find in a comprehensive business valuation report. Nonbinding guidance for such a report is found in the IRS Revenue Ruling 59–60, Valuation of Non-Traded Assets, which details the requirements for determining fair market value of corporate stock.

Key benefit of offering memorandum is value analysis

It has been indicated that preparing the offering memorandum is elective. One strong aspect of the process is the development of a defensible assessment of the value of the target company. Many business owners do not have an informed understanding regarding determining the value for their company. The exercise of preparing an offering memorandum will focus attention on the strengths and weaknesses of the business. Accordingly, some attempt to quantify the value of the business through an analysis of the risks is a worthwhile activity.

Typical offering memorandum table of contents

Following is a recommended table of contents to provide an outline of important information to include in this document:

Executive summary	
Strengths and opportunities	
Business description	• History • Industry overview • Products • Sales and marketing • Customers • Manufacturing and distribution • Suppliers • Manaagement and employees • Information systems • Real estate
Financial information	• Discussion of historical results • Summary historical and projected financial results • Other applicable exhibits
Appendices	• Company and product brochures • Management biographies • Audited or reviewed historical financial statements

FINANCIAL STATEMENT PRESENTATION AND ANALYSIS

One of the first impressions that a potential buyer will get of the target company comes from the quality and presentation of the financial information. For example, if the financial statements are unambiguous, audited and agree with a business plan prepared by the senior management, this is a compelling strength in negotiations. Clearly the message to a prospect is that the owner is focused on managing a successful enterprise and such organisations typically command a stronger sale price:

1. Does the target company have a chief financial officer capable of assembling reliable internal data?
2. Are annual financial statements comparable?
   - If the financial statements are prepared consistently by a professional accounting firm in accordance with generally accepted accounting principles (GAAP), the likelihood is that the statements are comparable. This is a decided advantage in negotiations for the seller, particularly if the business is financially successful. It is best to have three to five years of comparable financial statements.
   - If the financial statements are casually prepared by internal management representing multiple accounting systems in recent years, the statements will not be comparable. This compromises the ability of a candidate buyer to assess the financial prospects for the business. Buyer uncertainty increases risk, which can negatively affect the offering price.
   - One of the worst scenarios is that the seller only has tax returns to offer a prospective buyer. Tax returns are not financial statements; they are a mechanism for the government to assess and collect revenue. If the best the seller can do is offer tax returns then the seller should prepare for substandard offers, if any at all.
   - Finally, the absolute worst situation is being presented with a trial balance from the seller. No attempt is made to organise the financial data in any useful format.
3. Have the financial statements been prepared by a CPA firm?
   - This is related to the issue of comparable statements from the preceding list. Independent preparation of the financial statements is a clear sign to the buyer that the seller likely has nothing material to hide.
   - Audited financial statements provide the best assurance that the information is accurate and in full compliance with GAAP. Due to the cost of audits, many companies do not develop financial information to this standard unless required by regulatory bodies or loan covenants.
   - Reviewed financial statements, a lesser form of assurance, are more often prepared, typically in response to loan covenants. The advantage to reviewed financial statements is that they contain footnote disclosure regarding additional information relating to the operations of the business. The CPA firm also does some analysis to verify the integrity of the financial information but will not test as extensively as an audit. Reviewed financial statements are usually much less expensive than an audit but convey a professional image.
   - Compiled financial statements are prepared by the CPA firm and accompanied by a disclaimer report stating the restrictions on the reliability of the information. The statements may be prepared in a similar reporting template between years, but without reassurance that the work was completed by the CPA firm such statements are of limited value to the prospective buyer.
4. Is the information system software current?
   - Current computer software and hardware are some of the most overt signs that the business is well managed. It is a silent message that the owners recognise the importance of providing their employees with the best information tools to accomplish company objectives.
   - Obsolete accounting and systems software is an indication that other aspects of the candidate business may be out of date.

- Dated hardware is another warning sign that the operations of the candidate company may not be current and will likely need a significant upgrade soon after the transaction is completed.

This section is intended to emphasise that first appearances say a lot to a potential buyer. One of the first opportunities the seller has to make an impression is the presentation of the financial statements and other financial data.

CONSIDERATION OF KEY EMPLOYEES

More and more, today's economy is dominated by service businesses, and many of those service entities are populated by associates with high levels of education and skills. In fact, most businesses have at least a few key employees that possess integral knowledge of the operations of the target firm. In the case of businesses that are professional service providers such as engineering firms, CPA firms, law offices and consulting firms, highly portable skills among associates are common. The point in emphasising this is that many times a few key employees are disproportionately responsible for the financial success of the target company.

To lessen the likelihood that one or more of those key employees leaves at an inopportune time, the owner should proactively develop a retention strategy. Although having a retention programme for key employees is typically a best practice, it may be more pronounced during the process of selling the business. Most key employees will know if the business is being sold because such analytical skills are likely a major reason the employees are integral to the company.

There are no absolutely correct strategies that will ensure the retention of key employees in all instances, but there are a number of better practices to consider. First, the business owner should accept the fact that it may take a considerable period of time to successfully sell the company. During this period, the key employees may become legitimately concerned about their futures if the business is sold. The new owner may have replacement personnel on its staff to assume many of the duties of the current key associates. For example, the senior officer at highest risk in our experience is the chief financial officer, who is likely to be replaced immediately following the transaction.

Retention of the most senior employees

Consider bringing these senior-level associates into the confidence of the owner and reassure them that their continued efforts are integral to the success of the business. Often, these individuals have the most developed and portable skills. Losing a key associate could be adverse to the selling process. For example, if the top business development and marketing associates sense there is no future with the current company, they may jump to another company. Even worse, they may go to a direct competitor.

The more common retention strategies include the following:

- Retention bonus – The bonus will be paid upon the sale of the business but will be forfeited if the executive leaves prior to the sale.

- Deferred compensation – Similar to a retention bonus in tax treatment to the recipient, the deferred compensation programme is typically earnt over time and is often subject to a vesting schedule.

- Stock option granted if change in control – This technique permits the key employee to participate in the liquidity event if the company is sold. The stock options are exercised when the company is sold.

INVESTIGATION OF BUYER

The prepared business owner must anticipate that it is unlikely that the buyer will make an all-cash offer for the business. It is a near statistical certainty that the seller will be contingently liable for a percentage of the transaction, and, depending on the negotiations, the percentage may be substantial. Once the business is sold, the former owner is now a candidate creditor to the new owner, and the amount at risk could be significant. Thus, it is in the financial best interest of the seller to complete a thorough investigation into the financial wherewithal and business ethics of the buyer.

Verify the ability of the buyer to finance the transaction

- Verify the financial ability of the buyer to acquire the business. Determine the source of funding.

- If the buyer is reluctant to disclose financial information, this is at once a cautionary flag because you should anticipate carrying some seller finance paper. There are many alternative methods to determine some level of financial ability that should be considered:
  – Authorise a credit report on relevant parties.
  – Search the internet for credit verifying resources

- Ask for banking or industry referrals.

- If the seller is compelled to offer some form of contingent terms such as seller financing or providing a hold-back amount, verify that the contingent payment is provided with appropriate security. Virtually all transactions will require the seller to be contingently liable for a percentage of the transaction price as a form of insurance for the buyer against seller misrepresentations. The extent to which contingency terms are mandated, the seller must ensure that such terms will be honoured by the buyer without collection problems.

Determine the purchase history of the buyer

- Research the reputation and history of the buyer. What motives does the buyer have for buying the company? Is there a reasonable explanation for the acquisition, such as the elimination of a competitor or the expansion of territory and products?

- Determine if the buyer intends to retain the current employees. This is particularly important if there are significant contingent payments due the seller. The same is true regarding the retention of good customers, a lynchpin regarding the ability of the company to honor its contingency obligations to the seller.

- We are in the era of the Internet, and there is substantial information available on most companies. Research specialists may be contacted to discover the information that is in the public domain.

Always engage the services of experienced professionals to assist with the due diligence process.

SELLER'S DUE DILIGENCE CHECKLIST

Develop an exit plan	• Understand that everyone eventually will leave the business. • Be in control of the succession process and develop a plan of exit. Successful succession plans typically take two to five years to complete. A significant amount of the time is dedicated to getting the business ready for sale from a financial standpoint. • Document primary goals for selling the business. Goals include quantifiable amounts, but often qualitative issues are important, such as the continued employment of key employees and keeping the business operating in the same locale. • Anticipate your living requirements post transaction. Ask yourself: "What will you do one week, one month, and one year following the sale of the business?" Making a healthy behavioural adjustment following the sale is important. • Estimate your (and your family's) financial requirements in retirement and ensure there are sufficient assets to maintain living standards. • Maximise the cash payment for the business at the closing date and agree to deferred payments only with adequate security. Remember that once the business is sold, control of the company is surrendered to the new buyer. Ensure you have enough cash at the closing date to adequately cover such items as taxes, professional fees and broker fees (if applicable). • Clarify who is responsible for all applicable closing costs in the purchase agreement. • Clarify negotiation points such as noncompetition agreement, consulting or employment agreement and contingent payment agreement.
Identify key members of the transition team	• Family members, often a spouse or children. The support of family members can be crucial to a healthy behavioural departure from the business. • Partners or key employees. • Board of directors. • CPA/Chartered Accountant. Make sure you understand the tax- and cash-flow implications of the transaction. Make sure you have enough for retirement. • Lawyer. Find a lawyer with successful transaction experience because your legal interests will be in his or her hands. • Business valuation adviser. Negotiate from an informed position of strength and retain a business valuation professional who is independent and can offer objective advice. Many deals never close because of unrealistic valuation expectations by the seller. • Personal financial adviser. • Business intermediary or business broker. Experienced business brokers are generally focused and professional, but remember that they are success-fee dependent and are oriented to earning the success fee. Find a business broker with specific success within your industry for optimal results.

Optimise the value of the business	• Decide that optimising the value of the company is a primary goal. This often requires managing the business to be successful and profitable, which may be different from the company culture of surviving and minimising tax liability. • Talk to or engage a business valuation professional. Do not exclusively rely on a business broker to value the business due to obvious conflict of interest. • Research transactions in your industry. • Do not commingle personal and business activities. • Demonstrate the profitability and financial returns possible in the business. If profitability is possible only by a wide range of adjustments and add-back amounts, lower your negotiating stance with potential buyers
Financial statements	• Consider having financial statements prepared by an independent CPA or Chartered Accountant, reviewed or audited with applicable footnotes. • Anticipate that buyers prefer CPA/Chartered Accountant prepared financial statements. Financial statements prepared by an independent CPA or Chartered Accountant will increase negotiating strength. • Ensure that historical financial statements are comparable between years. • Remove personal activities from the business. • Insist on having a strong operating computer system for operations supported by appropriate internal controls.
Documents	• Have articles of incorporation or other founding documents. • Update company bylaws • Verify title to all assets. • Update all applicable company resolutions and authorisations to proceed with the transaction.
Offering memorandum	• This is not always required but is a good sales tool if the business is marketed to third parties. • If selling to a third party, this is a useful sales tool to communicate the business to candidate buyers. • Make sure information in the memorandum is accurate. • If the memorandum is prepared by a business broker, verify the responsibility for all the costs associated with the business broker's efforts.

Key employees	• Identify key employees who are essential to operations of the business. • Consider a key employee retention programme during the succession process. • Consider including key employees in transaction proceeds if they stay during the sale process. • Key employees will typically know the business is for sale and will often feel betrayed or disappointed if you have not confided in them.
Investigate the buyer	• Once a candidate buyer is identified, investigate buyer background and reputation. Employ the full spectrum of resources including newspaper or media articles, business associates, banks, professionals, industry authorities, and any other reliable sources. • Investigate the financial resources of the buyer. Complete credit check using appropriate resources such as Dunn & Bradstreet. Verify buyer's banking relationships and ask for references. • Ensure that all prior loan defaults and bankruptcies have been disclosed, especially if seller-deferred payments are part of the transaction. • Research public records for litigation involving the buyer as plaintiff or defendant. • Review the business plan of the buyer following the sale if deferred payments are required.
Anticipate seller financing	• Although seller financing is not an absolute requirement, the overwhelming percentage of transactions have some seller financing as a requirement. • Anticipate seller financing and how best to collateralise the note. Collateral will include the assets of the business being sold, but consider additional security such as the assignment of specific assets or a personal or corporate guarantee. • Negotiate an interest rate commensurate with the risk, especially if seller is required to subordinate to a bank.

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