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M&A Success

How Professional Due Diligence Reduces Risks

Half of all business mergers and acquisitions fail because things just don't turn out as executives planned. Acquisition value is often based upon a business's past performance, and many executives rely on in-house personnel to conduct historical financial analysis only to be surprised later because the past isn't always indicative of future earnings.

An acquired company may not sustain growth if market conditions change, key employees leave or the company's expense levels are too high compared to industry norms. An external financial due diligence review will uncover many of these hidden risks so executives can appropriately determine the acquired company's true value.

Projecting future earnings

Several questions come to mind when businesses traverse M&A transactions. For example, how can financial due diligence project future earnings quality? To answer this, it is vital to understand how the target company earns its profits to know if it will continue. Sometimes a highly profitable division may have been sold or a competitor may have gained the upper hand in the marketplace with new technology. If margins or revenues will be impacted in the future, you won't know that by looking at past or current financial statements, which are typically backward looking. Executives also need to know if the target has a consistent, stable customer base or if there have been large one-time orders that will not repeat, or non-operational gains. It's important for the due diligence team to assess the marketplace and the target's position to know if the acquisition price is right. Often an external review of these positions is the most effective measure.

Identifying hidden risk

There often is hidden risk associated with M&A activity. Back taxes, IRS liens, and EEO lawsuits can be disruptive or even catastrophic if CEOs have to deal with them after the acquisition; a solid external due diligence review can uncover the potential of any of these events occurring. Also, it is essential to secure clear title to the assets being purchased, to ensure that the company has effective accounting controls and processes in place, and that the business has been adequately insured. The likelihood of a lawsuit or claim surfacing after the acquisition increases if the business hasn't practiced sound management or risk management fundamentals in the past.

Setting parameters for due diligence review

Most importantly, setting parameters for a proper external financial due diligence review is critical. The due diligence professional should sit with management in the preliminary stages to gain an understanding of the proposed deal, including the upside and potential downside, allowing them to calibrate the due diligence procedures to assess the potential risks in a variety of financial and nonfinancial areas. A customized plan should be prepared to perform investigative procedures around those risks and determine if there are real or perceived risks and any potential mitigating factors.

With the help of a quality external audit partner, the due diligence process can help eliminate potential post-acquisition problems. The key is to understand if the deal is likely to look just as attractive in a few years as it does today.

For more information, please contact Haskell & White LLP, phone (949) 450-6200 or visit the website at www.hwcpa.com.