FINANCIAL DUE DILIGENCE IN M&A: HISTORICAL FINANCIAL STATEMENTS – IS IT ALL REALLY BEHIND US?

Comprehensive due diligence is an essential part of acquiring a business. Financial due diligence, in particular, can be a daunting task, especially for inexperienced buyers and sellers. Fortunately, financial and accounting professionals can help evaluate past and future financial statements, spot hidden liabilities, uncover management missteps and ensure earnings are accurate. This crucial information shapes deal terms, purchase prices, and validates key financial information related to your investment decision.

Reviewing the Past and Future

To set the right offer price, buyers must look at both historical and prospective financial statements. It's important to review a complete business cycle, covering both peaks and troughs. Relying only on peak-year financials can lead to overpayment based on unusually strong performance. For example, an HVAC company that records peak revenues in May through August (when air conditioners are running 24/7) consistently every year over a three-to-five-year period offers a reliable pattern. But if a clothing retailer suddenly shows peak revenues in May through August after years of winter peaks, further due

diligence is needed. Is the May through August bump a one-time anomaly or could it be considered the new normal?

Typically, examining five years of financial statements helps identify trends. Standard practice includes reviewing the last two calendar or fiscal years and the last twelve months (LTM) of financial results.

Financial due diligence also involves normalizing earnings—removing non-recurring items and correcting misreported figures. This ensures the purchase price reflects true earnings, not inflated ones. Items to adjust may include owner expenses, compensation, non-recurring expenses, and related-party transactions.

It is also worth analyzing prospective financial statements, statements based on management's expectations for the future. Likewise, a buyer's offer likely factors in how much return the business is expected to generate. Fair market value is a good starting point; however, buyers may be willing to pay more (or less) depending on the dynamics of the situation.

KEY AREAS TO REVIEW:

Historical Financial StatementsFuture Financial StatementsAdjusting Financials

- Examine a complete business cycle, including peaks and troughs.
- Avoid basing decisions on peak-year performance alone to prevent overpayment.
- Example: An HVAC company with consistent summer revenues over several years is reliable, unlike a clothing retailer with a sudden revenue spike outside of their historical high season.
    - Scrutinize growth assumptions and resource needs.
    - Ensure projections include necessary investments in equipment and staff.
    - Verify who prepared the forecasts—external reports are preferable, but still, hire your own expert for validation.
        - Remove non-recurring or non-operational items from earnings.
        - Correct misreported figures to reflect true earnings.

- Common adjustments: Owner expenses, compensation, non-recurring expenses, related-party transactions.

Devil's Advocate - Future Projections: What to Watch

When looking at future financial statements, scrutinize the assumptions behind growth projections. If management forecasts 20% annual growth, consider whether the business has the resources to support this. Additional investments in equipment and staff might be necessary—have these incremental costs been included in the projections?

It's also important to know who prepared these forecasts. Reports by external accountants may follow AICPA standards, but it's wise to hire your own expert for independent analysis. An external advisor can validate assumptions and provide a realistic outlook.

Overall, a buyer should keep in mind that prospective financial statements, projections, pro formas or forecasts are just that – these results have yet to be realized.

Uncovering Hidden Liabilities

Historical balance sheets reveal a company's assets and debts, but some liabilities might not be obvious. Examples include off-balance sheet bonuses, deferred compensation, customer deposits, extended vendor payables, pending lawsuits, and more. These hidden liabilities can directly affect the purchase price.

Additional issues, such as broken equipment or obsolete/slow-moving inventory, can be discovered during financial or operational due diligence. In stock sales, where all shares transfer to the buyer, uncovering these liabilities is crucial to avoid future legal issues.

Buyers should also verify the seller's claims to prevent post-closing disputes. Misrepresentations found later can lead to legal battles.

Earnout provisions or escrow accounts can protect buyers if the deal doesn't turn out as expected.

KEY AREAS TO REVIEW:

Off Balance Sheet ItemsOperational Due DiligenceVerify Seller's Claims

- Look for liabilities not listed on balance sheets, such as:
  - Off-balance sheet bonuses
  - Deferred compensation
  - Customer deposits
  - Extended vendor payables
  - Pending lawsuits
- Recognize the impact of these items on the purchase price.
  - Inspect for issues like broken equipment or obsolete inventory.
  - In stock sales, ensure all liabilities are uncovered to avoid future legal issues.
    - Misrepresentations can lead to legal disputes post-closing.
    - Use earnout provisions or escrow accounts to mitigate risk if the deal doesn't meet expectations.

Mitigating Mistakes

Inexperience in M&A diligence can lead to overpaying, causing future financial issues. It's common to hire external Transaction Advisory Services or Business Valuation Services professionals, as they provide tailored due diligence and valuation scopes, helping buyers understand the target's assets, earnings, and value. This insight is essential for negotiations and refining your financial models and investment strategy.

KEY AREAS TO REVIEW:

Seek Professional Help

Tailored due diligence and valuation scopes provide clarity on:

- Quality of assets
- Historical and future earnings
- Perceived value

By focusing on these areas and leveraging professional guidance, you can navigate the complexities of financial due diligence with confidence, ensuring a sound investment.