



Due Diligence – Not As Scary As It Sounds

by John Gledhill

If you're at all like me (e.g. not a lawyer nor aspiring to be one), legal sounding words like "Due Diligence" go in one ear and out the other. You will, however, become intimately familiar with those dreaded words when you sell your company. Additionally, it makes sense to become familiar with them and incorporate them into your day to day business life – just in case you do have to sell your company when you least expect to. If something were to happen that would force a sale, you will want to have all your figurative ducks in a row.

Due diligence is one of the final steps in the process of transferring company ownership to a third party. Simply stated, it is the step in which the buyer makes sure that he is buying what he thinks he is buying. At this point in the sales process, a lot of energy has been expended by both parties and a lot of confidential information has been exchanged. Despite signed non-disclosure agreements, this information can seep into the marketplace should the deal be derailed during the due diligence process. And this is where most deals are derailed.

We recommend that our clients conduct a self-assessment due diligence prior to going to market. Most buyers will be looking for similar information, so it makes sense to organize the documents providing this information in a file which you can then hand to the buyer when they ask for it. This is perhaps the best way to combat the feeling of "buyer remorse" – an efficiently prepared documentation of all aspects of the company. It also makes sense to have a file like this even if you are not planning to sell your company in the foreseeable future; just make sure that you update it at least annually.

The buyer will want to review documents in the following general areas: legal, financial, human resources, and administrative. Legal documents include all those documents executed when your company was organized or incorporated, corporate records, financing documents (both bank debt and leases), property leases, intellectual property, and any regulatory matters. All details related to lawsuits past and present should also be included. Make sure that minutes of corporate meetings are documented so you aren't scrambling at the last minute to get them done. Finally, and most importantly, make sure that you have a corporate attorney review these documents for completeness and keep them in a safe and accessible location.

Financial documents to be reviewed include detailed income statements and balance sheets describing revenues, expenses, taxes, cash, accounts receivable (and payable), prepaid expenses, work-in-process, inventory, fixed assets, intangible assets, deferred revenue, debt, and shareholder equity. Obviously you will want your CPA involved in this process. Your financial statements should be prepared by your accountant (preferably with notes attached) and she should be able to assist you in preparing projected financial



statements. Projections should be realistic but aggressive enough to interest a potential buyer.

Human resources documents to be examined include: company policies, processes, and practices; group insurance; retirement plans; key employees; training policies; internal communications methods; 1099 contractors; and contracts. If you have employees you should have an employee handbook listing paid holidays, policies for sick time, personal time, vacation, etc. An HR Consultant can assist you in this increasingly complex area if you don't have the time or patience for it.

Administrative items to be reviewed include: descriptions of real estate, insurance paperwork, travel and entertainment policies, and contracts (including customer, vendor, and maintenance). This last item is of special importance because the value of the company is impacted by the transferability of the above listed contracts. Again, have your lawyer review these documents for completeness.

The majority of deals that fall apart do so because they failed due diligence. Some of these failures are due to misrepresentation of company facts. Some are due to the seller trying to hide company "skeletons". These errors are almost always discovered during due diligence. Consequently, it is always better to fix the problem before you go to market, or bring it to the attention of the buyer at the start of the sales process. Waiting for these problems to be discovered during due diligence is a tremendous waste of everyone's time, and can render a crippling blow to the future salability of the company. On the other hand, a smooth due diligence process verifying all the information presented to the buyer greatly improves the odds of a successful sale.