CAPFORGE™
ACQUISITION ACCOUNTING

1. What is the difference between due diligence, quality of earnings and quality of earnings light?

Financial due diligence and quality of earnings are basically the same thing: an investigation of the financials of the business that you're looking to acquire. People often use these words interchangeably and there is no specific definition of one or the other that covers more or less. The main difference between a quality of earnings and a quality of earnings light is that the light version generally costs significantly less and takes less time but doesn't come with the sign off of a CPA auditor and the legal liability that goes with that opinion.

Typically, a quality of earnings report will be used for deals with a price tag of at least 10 million and up. These reports will often cost at least $25,000 and can take 6 to 8 or even more weeks of time to produce. On the other hand, a quality of earnings light or due diligence project is typically completed in just two to three weeks and will cost a third or less of what the full quality of earnings report will cost. The way we do them at CapForge is no different than the level of investigation or in depth review that you would get with a full quality of earnings report but it will cost much less and be done much sooner.

2. How small a deal still needs due diligence?

There really is no smallest size. Even a deal with a price of 50,000 or $100,000 probably is worth investigating beyond just a cursory review of the financial documents provided by the seller. When a deal is small in size it generally means there are fewer things to look at and the looking can be done much faster and so the project price should be commensurately smaller.

Unless the deal size is a non material amount to put at risk for the buyer then some level of due diligence nearly always makes sense to perform to ensure that the purchase is going to be worthwhile.

3. Can I do my own due diligence?

Anyone can do their own due diligence if they feel sufficiently qualified to review the material that they're getting and be able to judge the accuracy and completeness of what they're seeing.

In my experience however buyers often are looking at deals with a more optimistic view then they should be. They are going into the deal expecting that it will be completed and with faith that not only is everything as presented but that they will then in turn be able to make it even better. The benefit of having a third party due diligence review is that the reviewer has no stake in the outcome and will not have their opinion colored by their personal feelings about the seller or their optimism for the future potential of the business. Beyond that the due diligence team doing their review should have the experience of having done dozens or even hundreds of reviews and will be much better positioned to know what to look for and how to spot things that may be missing that they should be seeing.

Finding problems with what you can see is not nearly as hard as discovering things that aren't there that should be and this generally only comes with a lot of experience that the typical business buyer simply doesn't have because they've only done one or two deals in their lifetime, if any at all.

4. What’s the difference between the bank appraisal and due diligence?

The bank appraisal for a business acquisition is generally focused on the tax return and the requirements of underwriting which revolve around the anticipated cash flow versus the anticipated debt service. The problem is the bank is not really investigating the accuracy of the tax return and so if the tax return was prepared using faulty numbers then all of the banks assumptions are now based on inaccurate data.

A due diligence review on the other hand is looking at not just the tax return but also the bank statements and the financial statements and all the other documents related to the preparation of those financial statements that in turn generally drove the preparation of the tax return. We discover incorrect values on the tax return with provable errors and misstatements more than 75% of the time.

Relying solely on the bank's appraisal for the business does very little to mitigate risk or demonstrate value in the deal. I have seen literally hundreds of examples of deals or the bank was willing to loan money based on inaccurate data. So while having the bank sign off may be a requirement for the doing the deal it is in no way sufficient for feeling confident to move ahead.

5. What’s the right time to do due diligence?

Normally due diligence is done immediately after the letter of intent is signed for deals that use a letter of intent. If it's a deal that uses an APA then it would be immediately after that is signed.

You want to verify that the financials are accurate and that you have a good handle on what the actual financial results are from the business before investing any additional money into legal services or bank fees or any other costs. If it turns out the financials don't live up to expectations then money spent on any other aspect of due diligence or transaction completion become wasted dollars.

6. How long should due diligence take?

In most cases two weeks is sufficient to thoroughly investigate a business of anywhere up to $10 million in revenue. This time frame assumes that all of the available documentation required is available.

Obviously if some things are missing this will push the time to completion but in general the work itself shouldn't take more than a couple of weeks. This time frame also allows for sufficient time to do other forms of due diligence and reach a decision point within the time frame normally allowed for due diligence which is typically 30 to 45 days.

7. What happens if we run into the due diligence deadline?

I can say that I've never seen a deal that was otherwise on track in all respects be shut down simply because a deadline date was reached. If both sides are working cooperatively towards a close then if a deadline is reached but one side or the other hasn't had sufficient time to complete their work for that part of the deal then inevitably the deadline will be extended without penalty or consequence.

On the other hand, if the deal already has problems and one side or the other is reluctant to move forward or otherwise not engaged in getting to the close then reaching a deadline may in fact invoke a cancellation of the deal but you can be confident that that deal wasn't going to make it to the finish line anyway. The deadline was just an excuse for a reason to stop working on it but it was not the real cause of a deal not getting to close.

8. What are red flags as far as a seller not providing certain items?

Some sellers are more skittish than others about what they're willing to provide even after an LOI or APA has been signed. What you have to decide is whether or not their caution is reasonable or whether they are truly hampering your ability to evaluate the business by what they are holding back.

The less they're willing to give you or the longer they take to produce documents that should be readily available is definitely a red flag. Blocking out customer names is reasonable but they should be willing to share the percent of revenue that each customer is producing. Blocking out vendor names is OK but they should be willing to share how much they're spending with each vendor and the general category of that vendor. Blocking out employee names is OK but they have to be willing to share the amount they're paying those employees their tenure with the company and their role with the company.

Not providing tax returns, bank statements or financial statements for a sufficient period of time and with the pertinent information redacted is a problem. The seller you want is one who freely gives all the information in a timely manner and without reservation. The farther you get from that standard the more you should be nervous about the deal in general.

9. How many years of documents do you look back at?

We generally look at the last three years plus the year to date information. Some people go back farther and if they provide that information you can certainly take a look at it. The last three years trends however are the most relevant to the current market and economic conditions you'll be in when you acquire the business and so those are the most relevant ones to look at.

A seller who wants to talk about their glory days five or six years ago is most likely trying to compensate for what's happening currently. Of course, if the business has only been around for a couple of years then you're going to want to see everything from inception however buying a business with only a year or two track record is its own added risk.

10. When is it too much to ask for and what is deal fatigue?

It depends on the size of the deal but sometimes buyers go overboard with what they request and this can cause problems for the seller simply for the sheer amount of work you're asking them to do to provide you with information. For example it's fine to ask for payroll summary reports to see who the employees are and how much they're being paid.

But it doesn't make much sense to also ask that the seller also provide the timecards or timesheets for all the employees for the last several years. It's fine to ask for financials and sales by customer and air aging reports but you probably don't need to see every single invoice for the last three years.

It's OK to ask for the mileage of each vehicle and maybe the date of the last oil change for each one but you don't need to see every single receipt for every single maintenance job for every vehicle for the last five years. The question to ask yourself is whether or not the information you're requiring is going to help you materially determined the risk and value of the business you're acquiring.

If finding out that they may have skipped an oil change three years ago on one of the five trucks in the fleet is going to cause you to not buy the business then you probably shouldn't be looking at it in the first place.

11. Should due diligence go through the broker, the seller, or the seller's accountant?

There is no right answer to this. We generally say that we're happy to work with whoever the best source of information is to make the process as easy as possible. In some cases the broker wants to be the control for all information.

In other cases, the buyer is happy to hand off direct communication to the seller and the seller may in turn hand off direct communication to the accountant. I don't think it matters too much who you get the information from as long as the information you get is what you asked for and if there are any questions you're getting answers from the person in the best position to know the actual correct answer.

12. How much of a problem is it if the seller has several businesses co-mingled into the tax return or financials?

It's not a problem at all if they've done a good job of accurately separating the businesses. Unfortunately this is often not the case and you have to do a fair amount of work to untangle what expenses and sometimes even what revenue goes with what business. To the extent that there are Gray areas because of shared expenses and sloppy record keeping it is fair to make some adjustment to the price you're willing to pay to help mitigate this risk.

If the seller wanted you to know exactly how much the actual business you're looking at acquiring produced in revenue and had as expenses then they should have done a much better job proactively of separating all that information out. To the extent that they didn't they're going to have to recognize that their lack of attention to detail is going to cost them some amount of value in their sale.

13. Should the bank get a copy of the due diligence report?

That is entirely up to the buyer but I would generally recommend against it. At least in our case we create our due diligence reports to give the buyer an honest assessment of the business they are looking to acquire and their personal chances in our opinion of the likelihood of a successful outcome.

While the opinion may be mixed the buyer may decide they want to proceed with the deal and so giving the bank a copy of the review may be counterproductive for them to achieving that end. On the other hand if the bank is on the fence about the deal and the report is overwhelmingly positive about the prospects for the acquisition then sharing it with the bank may help. There's also nothing that says you have to share the entire report with the bank you are welcome to selectively share only the portions that you as the buyer decide you want other people to see.

14. Should the seller get a copy of the due diligence report?

Sometimes buyers feel that giving the seller a copy of a report that suggests the value for the business is currently higher then it should be we'll help the seller understand why they should accept a lower offer.

This rarely works out. While the deal may in fact be overpriced in my experience it's better to just focus on a few reasons backed up by facts as to why a lower offer is the right one than to hand over the entire report to the seller who may take issue with other things in the report that really have nothing to do with why they should consider a lower offer.

15. Are the tax returns the most important part of the financial due diligence?

If you ask the bank then the answer is yes because they generally base their lending decision on the tax returns. The problem is very, very often the tax returns contain mistakes and are not an accurate representation of the true performance of the business.

So, while you certainly want to see what the seller has been reporting to the government the tax returns alone are far from sufficient to really understand exactly what's been going on with the business. If you were to rely solely on the tax returns to evaluate a potential acquisition you are far more likely to end up in a bad deal than it few did a complete and thorough due diligence review of the entirety of the financials for the business.

16. Why do you want to see monthly reports?

Very often sellers and brokers are providing just yearly totals for the business for the last several years and using these as the basis for the price. The problem is many businesses have ups and downs even if they aren't specifically seasonal period of course seasonal businesses are even more prone to ups and downs and it's even more important to see that monthly activity versus just what it totals to at the end of the year.

A business may be profitable over a 12 month period but still manage to have a loss 8 months out of 12. If you are financing the deal with that and we'll have a monthly debt service obligation then you need to know how many months out of 12 you will have to have capital in reserve to cover your obligations if the business is losing money even before that debt service on a regular basis in many of the months of the year.

You also want to see the month over month performance in order to be able to better spot trends in both rising expenses and falling revenues which may be muted or completely hidden by just looking at yearly totals.

17. Why do you want to see both cash and accrual reports?

Some businesses only report cash basis results in which case that's all you need to see. On the other hand if you are looking at a business that uses invoicing to record revenue then you absolutely would want to see both cash and accrual basis reports. A business can look fantastically profitable on an accrual basis and yet be on the verge of insolvency on a cash basis at the same time.

If you only evaluate the business on an accrual basis then you may very well walk into a situation where there is virtually no cash to support the business itself never mind the debt service you'd be taking on to acquire it. I can't count the number of times I have seen businesses listed at healthy multiples that looked fantastically profitable at first pass only to discover that on a cash basis they were a fraction of the same results. Had a buyer moved forward based only on the financials they were presented and had they not investigated the cash basis results the deal would have been an unmitigated disaster. If you fail to evaluate the cash flow and the cash basis financials then you only have yourself to blame if you get into a bad deal where the business looked great but you only looked at the accrual results.

18. Why do you want to see the general ledger report?

The general Ledger gives you the detail behind the transaction totals that appear on the monthly and annual financials. Without looking at this level of transaction detail it is impossible to know for sure if the revenue you're looking at was coded correctly and is truly sales or if in some cases there were transfers or loans or investments that may have been accidentally coded to income that shouldn't have been income.

The same goes for any of the other totals that you are seeing if you aren't looking at this level of detail then you're only assuming that things like payroll, office expenses, rent, cost of goods sold and any other category of account you may be looking at are yeah truly those things and not some combination of other things as well. If you aren't looking at this level of transaction detail then you haven't done a very thorough due diligence investigation.

19. What does the cash flow report tell you?

The cash flow report is a great document to review if you can get it (not all businesses are doing their books well enough to produce one!) because it shows you how much cash is actually being generated from the business after accounting for things like A/P, buying assets, paying down loans and all kinds of other activities that aren't accounted for by the P&L. You can get a good sense of how much cash there will actually be to pay for debt service and give you a decent ROI on the acquisition.

20. What can you tell from a payroll report?

Quite a few things! The amount of turnover, the rates being paid, how much may be overtime, who is taking advantage of health insurance or 401K plans, how long people have been with the business, the last time people got raises and if there are family members on the payroll. This is definitely something to ask for and review carefully and for more than just the totals of wages and payroll taxes.

21. Why do you need a list of assets with current fair market values?

There are a lot of reasons to get this. You want to know what they are including in the sale (which may not be everything they own!) and the book value vs what they are saying it's worth now. The current fair market value gives you an idea of how much of the purchase price is going to be Goodwill vs actual fixed assets.

It also tells you how much you can plan to depreciate when you take over and give you sense of the collateral you are getting and the tax savings available. You also want to determine if any of these assets are going to need replacement soon and if they are sufficient for the current level of business and how much additional capacity you'll have before you need to invest in more to grow.

22. How do the assets of a business impact the price?

Business values are largely based on a multiple of their discretionary cash flow but when the fixed asset value is significant it can play a role in the price. For one thing, it provides collateral and mitigates some of the risk. For another, it provides a tax break and serves as an offset to the buy or build question. Imagine two businesses, each with $1M in sales, $250K in discretionary profit.

One of them is a digital business with no fixed assets, the other is a printing business that owns a printing press with a current fair market value of $750K. The digital business might sell at a 3X multiple ($750K) and that would be a fair price. The printing business however, simply by selling the press, would collect $750K. Which means a 3X multiple would be the same as valuing the business at zero and simply selling the asset. A buyer buying it a $750K would incur no risk because they could flip the press and essentially recover 100% of their investment.

They also would be able to claim $750K in depreciation and have no taxes owed for three years (assuming the same SDE value going forward). So a more equitable price for the printing business might be $1M or $1.1M even though the cash flow is the same as the digital business. It wouldn't be $1.5M because the cash flow simply won't support a price like that, but selling for the price of the assets also doesn't make sense. Every deal is different but when there are a large amount of fixed assets in a deal it definitely can impact the price.

23. How does purchase price allocation come into play in a deal?

It depends on how much there is to allocate. For a business that is all or nearly all goodwill there just isn't much impact because the goodwill gets amortized over 15 years and there really isn't anything to adjust or negotiate there. On the other hand if the business is transferring with a fair amount of fixed assets then those fixed assets will be beneficial from a tax standpoint because they can be depreciated in year 1 and that does have an impact on the financial picture of the deal overall. In those cases as the buyer you'd like to negotiate a higher value for the fixed assets in most cases because that is more beneficial to your situation although it is the opposite for the seller.

Understanding the tax implications and the pros and cons of purchase price allocation does play a role and is a topic that often comes up in deals when there is a good amount of fixed assets to consider.

24. What should you look at in the A/R aging report?

AR aging is super important because you want to know what amount of the total invoices that are out there are old and potentially uncollectible. Old invoices are effectively propping up the SDE and artificially inflating the value of the business if they haven't been cleared off the books.

My general assumption unless I have proof to the contrary is that anything older than 90 days is no longer a valid, collectible amount. If you don't review the AR aging report and the business you're evaluating does invoice customers then it's very possible that you're looking at an overstated SDE which is another reason that you should also always investigate the cash basis results of a business as discussed in an earlier question.

25. What level of customer concentration is risky in a typical deal?

With no other context or information than having a customer whose value to the business is equal to or greater than the SDE is concerning. In the event this customer, or any customers the size of this customer or larger, were to leave then the assumption is the business would become at least for a period of time unprofitable. But usually some context is helpful.

There is a single customer who represents a good portion of the total revenue but they have been a long time customer and have increased their orders each year and there is no good viable alternative for them to switch to then that may be less concerning. Or another case may be that there is one single customer who represents a good chunk of the business but in fact this single named customer actually represents many different departments or divisions or projects each with its own decision maker who has independently chosen to work with this particular company and so the loss of one of these smaller units could happen without actually jeopardizing the loss of the entire business of that customer.

So while in general a high level of customer concentration is not a good thing it really depends on the situation and everything has to be looked at on a case by case basis.

26. What kinds of add backs are normal and what ones are not?

A legitimate and acceptable add back is any expense that can be clearly shown to be not required for the business to have achieved the level of a success that it has currently gotten to whether that cost was incurred or not.

Typical add backs include the primary owner's compensation, owner's health insurance, donations, non-business meals, non-business required travel, owner cell phone, owner's vehicle expenses and one time non-recurring events such as legal claims or one time capital investments. Addbacks that require additional documentation or proof are ones that are round numbers and lumped into things like office supplies where it's not clear how much was actually spent to benefit the owner and how much may have been required for the business.

Another area that gets tricky is when there are multiple owners in which case normally only the primary owners compensation is added back and the other owners salaries are adjusted to reflect market rate replacement cost for a similar position. Non working family members compensation is normally an add back but you have to be sure that they are truly not working.

One time expenses may be added back but you have to be sure that they aren't actually periodic expenses that a new owner will have to bear in the future. There is no single set of rules to determine what is and isn't a fair add back for any given deal but common sense is usually a good guide for a lot of the questions that come up.

27. What is the difference between profit, EBITDA, SDE and Net Operating Income?

Profit is all income minus all expenses. EBITDA is profit plus interest, taxes, depreciation and amortization. SDE is EBITDA plus any expenses that are deemed discretionary and not required to operate the business. Net operating income is income minus regular expenses but excluding other income and other expenses which may or may not be similar to EBITDA.

For most business transactions SDE is the most accurate number to use as an assessment of what a new owner would be able to generate from the business assuming it operates in the same manner and at the same level as it is being operated by the current owner.

28. What metric should I use to evaluate the business?

There are many ways to evaluate a business but the things that we tend to weigh most heavily in evaluating the businesses we look at are growth over time, percentage of recurring or repeat business out of the total income, the SDE as a percent of income over time.

A business showing steady year over year growth at a good rate with a good amount of recurring or repeat business at a high SD margin as a percent of income is a very good business to own particularly if the price asked is at or below the average for similar businesses.

29. What is the value of looking at comps?

We always look at what similar businesses are doing in terms of their total sales profit margin and asking multiple. At a glance this quickly tells you how the business you are looking at compares in terms of size, profitability and asking price. In this context you can determine whether or not the business you are looking at is at, above or below average revenue size, average profitability and asking price multiple.

A deal that looks expensive may actually turn out to be a bargain in comparison and likewise a deal that looks attractive may suddenly seem overpriced in comparison with its peers.

30. Is there a "right" multiple to pay when buying a business?

The general across the board average for businesses under 5 million in revenue is 3 times the SDE. But some businesses may not even be worth one times SDE while other businesses may justifiably ask and get five times SDE. In some industries for whatever reason there are certain expected multiples that may be higher or lower than typical or what you would expect based on the revenue and profitability in general. In these cases there often isn't much you can do about it.

If all the buyers are conditioned to expect prices between 4X and 5X for a particular type of business (for example, coin laundries) then as the buyer you are likely going to be stuck paying this. The only mitigating factor is that you will presumably experience the same beneficial inflation when you eventually go to sell your business into this same industry.

How much you pay also has to do with how you finance the business because at a certain point the loan repayment requirements simply won't allow you to pay more than a certain multiple and still be able to make the business cash flow. On the other hand purchasing a business with cash allows you to pay more but that doesn't necessarily make it a better investment.

31. How does price relate to risk in valuing a business?

If you think of price as a proxy for risk then this should help you determine what the right price is regardless of what a seller may be asking. The higher the price you pay relative to the cash flow produced by the asset you are acquiring then the more certain you should be of this future cash flow continuing.

When a business is risky, for example it has declining sales or shrinking margins, then the price you should be willing to pay would be much lower than a similar business with growing sales and improving margins, simply because in the first business you presumably have a much lower chance of making your investment back with a good return.

Each buyer has to work out the level of risk they are comfortable with and in many ways this depends a lot on what the buyer individually would be able to do with the business that they are considering and this in turn should drive their decision as to how much they will be willing to pay.

A buyer with the experience and ability to take a business on a strong growth trajectory maybe we're going to pay more than a buyer who's uncertain about their ability to grow the business they are considering. All of these elements factor in.

32. How does a stock sale vs an asset sale impact the value?

In a stock sale the buyer generally takes on additional risk because if there are any liabilities lingering from the previous ownership the new owner will now be responsible for handling those. This could include things like legal action against the company or unpaid taxes or insurance or other liabilities.

While there is usually some indemnification agreement signed this is by no means full proof and ultimately the new owner of the stock will be held responsible for making good on whatever these obligations may be. The other downside of a stock sale from a buyer standpoint is that if the current owner has claimed full depreciation for any assets the new owner will not be able to benefit from further depreciation. The new owner will also not get the benefit of being able to amortize the goodwill.

So for the new owner there are significant tax downsides to a stock sale. In some cases, however, the benefit of a stock sale will still outweigh these downsides because by retaining the same corporate structure they may be able to be grandfathered into certain accounts or customers or exceptions or other benefits that they would lose if they created a new entity in order to do an asset sale.

There are also ways in which a stock sale for tax purposes can be treated as an asset sale bringing back some of the advantages of an asset sale to the new owner as far as the tax treatment goes. Both sides however must agree to this treatment and since it is generally less favorable to the seller from a tax standpoint this negotiation may require some concessions on the part of the buyer.

33. What's the difference between a seller note and an earnout?

A seller note is simply a portion of the purchase price that the seller agrees to take in payments over time rather than at the time of the close. The amount is predetermined and unchanging under normal circumstances.

An earn out on the other hand is an agreement for the seller to take a portion of the purchase price over time however, the specific amount that the seller will get is determined by some performance metrics the business must meet in order for the seller to get the full amount.

In some cases, an earnout is used to allow a seller to participate in upside that they would otherwise be giving up when they sell and in other cases the earn out is there to encourage the seller to help the new owner continue to be successful and if failing to do so will in turn cut down the amount they will receive as a result.

34. What's the relationship between the LOI and the APA?

Most transactions today start with an LOI or letter of intent which gives the buyer a period of exclusive review and an anticipated but not binding purchase offer price. The APA or asset purchase agreement is a more formal and comprehensive document that outlines all the details of the sale including the price to be paid, the specific assets to be transferred and other details such as the training period and non-compete that the seller will agree to.

Sometimes these things are also spelled out in the LOI but they must be detailed in the APA. There are still some brokers and some jurisdictions where only the APA is used and in that case although it is technically binding on the buyer to complete the sale in those cases there is always an out via the due diligence where a buyer may cancel the deal based on their investigation of the business information.

There are many prewritten fill-in-the-blank template forms available for both LOI and APA's and why you can certainly use a lawyer to draft one from scratch, it is generally much more cost effective and expeditious to use a prewritten form and modify it as needed.