The Advisor – Fall 2012

Due Diligence

A key component of any business acquisition is the performance of due diligence on the target company. Due diligence has many definitions but in corporate finance it can be defined as *"the process by which a buyer of a company attempts to mitigate acquisition risk by an examination of financial records and other operational documentation to support valuations and verify company representations and warranties."*

Detailed due diligence usually occurs once a letter of intent (discussed in our Spring 2012 Newsletter) is signed between the buyer and seller.

A buyer can execute diligence on its own, especially if the target is small, is in the same industry and its operations are not complex. In this case, the business risks should be well known so outside assistance may not be required.

In more complex cases however, using a corporate finance advisor, accountant or other specialist with proficiency in executing due diligence is a good idea. The specialist will have experience in uncovering undisclosed liabilities and other inherent risks not normally considered by a buyer.

There are a number of approaches that a buyer can take to execute due diligence. An overriding principal however is that the due diligence team (the "Team") should "think like an investor" rather than as an auditor ticking boxes on a checklist.

Questions to consider throughout the process include:

1. Is the target worth buying at the negotiated price?
2. What are the inherent business risks that should be reviewed and mitigated if possible?
3. If the acquisition contemplates a merger of offices or employees, are the two cultures compatible?; and
4. Five years from now, will the acquisition be deemed a success?

The Team should commence with a generic due diligence checklist and tailor it in order to focus on the target's specific business issues and risks as discussed above. Reviewing of prior years' financial statements is a good place to start. This will provide a basis for which assets are subject to valuation issues and which liabilities may be underestimated.

It is imperative that the Team's conclusions be clearly set out in a report including the appropriate paper trail to support the findings. This is crucial if the findings cause the buyer to reopen negotiations with respect to the purchase price or other key terms of the agreement of purchase and sale.

The seller will expect an opportunity to review the findings and how they were arrived at before considering renegotiating any key items.

The report should include a SWOT analysis (strengths, weaknesses, opportunities and threats) along with recommendations to exploit the strengths and opportunities and to minimize the weaknesses and threats. An overall conclusion on whether to complete or terminate the acquisition should also be provided.

For larger transactions, the target may set up a “data room” with all of the required information. In recent years, data rooms have become “virtual” so that the Team can access the information online via a password. This allows the Team to complete the majority of diligence without being onsite and unduly affecting the target’s operations and employees.

At some point however, the buyer will want to meet with key employees it expects to retain after the acquisition is complete.

As a final step and prior to closing, it is prudent for the buyer to communicate with the target’s key customers and suppliers about the existing relationships and to ensure that there won’t be any issues as a result of a change in ownership.

Aries Advisory Group has significant experience in executing due diligence mandates. We focus on the key areas of risk inherent in the target. We will prepare a comprehensive report with all of our key findings and conclusions. And we will “think like an investor” throughout the process. If you require assistance in executing due diligence as part of an acquisition, please contact us at info@ariesag.com or at (416) 467-7878 to see how we can help.