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Do your homework! What to look for in the due diligence process.

Most people would not buy a home without a thorough inspection. The same general principles of due diligence also applies to the merger of CPA firms. Due diligence will be one of the last stages before each firm signs on the dotted line. So prior to a deep dive, each firm must have a clear vision of what post-merger success should look like.

We're often asked about the items the buyer and seller should request during the due diligence process and how to spot red flags that signal when you should walk away from a deal. Most due diligence items to be reviewed are finance-centric in nature, while others may reflect the culture of each firm such as the employee manual, perks and benefits, the type of software programs and technology platforms or employment agreements. But during the process it's critical that both firms should assess whether the affiliation will meet their respective financial and business goals.

What Our Clients Are Telling Us

Sadly, we have seen far too many cases where firms attempted to shortcut the due diligence process or circumvent it completely. As an example, we recently helped a firm in the Midwest unwind a merger, where the due diligence process was at best, superficial. Not surprisingly, post-closing it was discovered that the seller firm had been hit with a number of violations and had its license suspended by the state board. Had even a cursory investigative process been put in place it could have saved hundreds of hours of aggravation and perhaps more importantly, thousands in legal and consulting fees. In another case, a sole practitioner with no succession plan appeared to have found the ideal merger partner. But during the due diligence process, the owner discovered that the successor firm's partners were so inundated with their own work, they had no practical transition plan to take over his clients.

When Should the Process Start?

There are technically two steps in the due diligence process. During the initial meetings, both firms usually have signed mutual non-disclosure agreements and have exchanged enough financial information to make a clear determination if they should, or shouldn't, move forward. This information is detailed but generic with regards to confidentiality. After the second meeting, we usually help draft a non-binding agreement on how we see the affiliation going forward both philosophically and financially. Once the principles of the deal have been agreed to by both parties, then it's time to begin what's called "field due diligence." Field due diligence is often a time consuming and lengthy process in an attempt to retrieve all the requested information. But here's a critical caveat – do not begin field due diligence until the terms are agreed to. Can you imagine the frustration, not to mention the colossal waste of time completing an exhaustive document request only to discover that the terms of the deal are unfavorable? Secondly, since it will require several visits to the seller firm, news of a merger may leak out prematurely to the staff and some panic may ensue. So it's critical to have an understanding in place.

Beginning the Process

A thorough due diligence should be broken down into three distinct categories:

1. **Things that are readily available and can be easily delivered**. An example can be last year's financial statements, bank statements and tax returns, or, if requested, the employee handbook.
2. **Information that requires some effort to help pull together.** This would include a client list, sorted by revenue, industry and partner or accounts receivable and work in process.
3. **Information that must be gathered in the field**. This would include checking out the software platforms for compatibility, quality control processes and samples of workpapers.

As a rule, the acquiring firms will be reviewing historical financial data, details on owners and employees, client categories and specific material clients,

service methodologies, benefit plans, policies, procedures, the quality-control system, legal matters such as litigation and licensing, and the condition of assets being acquired.
But the seller firms also have a right to specific information, such as a credit report, the latest peer review opinion if applicable and requesting to speak with someone who has previously merged into the firm.

A key thing to remember is as a successor firm, you should be picturing how their metrics will look when run by your firm, not just how they appear in their firm. For example, if you can leverage the work to lower level staff or take less time and effort to derive the fees because of your technology, ask yourself how would that impact your profitability and billing rates? What if your QC process is more robust and it will take your firm longer to do the work? A key to effective due diligence is transposing what they do into what you do.

Sometimes the Unexpected Happens

It's rare the something completely unexpected emerges during due diligence because firms have already exchanged reams of information upfront. But it occasionally does happen. There are at least two avenues in which you can deal with it. If it's so egregious such as a large pending malpractice lawsuit, that closing the deal is impossible, simply walk away. If it's somewhat more workable such as the loss of a larger client, then you can modify the terms of the deal to mitigate your risk.

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