

Bank Loan

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REPORT

Due Diligence Challenges in Today's Financial Market

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In today's precarious financial market, it is no surprise that the number of mergers and acquisitions has significantly declined. Understandably, buyers and lenders have become more cautious, patient and selective, but most would readily admit that opportunities and "good deals" still exist. Therefore, now more than ever, buyers and lenders should rely on thorough financial due diligence for answers and guidance.

Effective financial due diligence has always been a key component of a successful merger or acquisition. Financial records are not always as they appear. Accounting principles can be exploited, earnings misstated, and books "cooked" in order to conceal an entity's true financial condition. Buyers utilize due diligence to identify problems associated with both financial and operational issues that could impair the value of a given deal, or even preclude proceeding with the transaction in the first place. In addition to the financial aspects of due diligence, buyers rely on the due diligence process to identify key controls and operational factors that could influence both the pre and post acquisition phases.

Buyers experience unjustified optimism and receive very little benefit from a "cookie cutter" approach to financial due diligence. Risks or concerns will vary from transaction to transaction. Therefore, the financial due diligence program should be designed to address the specific concerns of the buyer and to assess the target's ability to cope with current and future challenges.

Financial due diligence has traditionally focused on various quantitative and qualitative aspects of the target's economic drivers. These economic drivers can take

many forms, including "earnings before interest, taxes, depreciation and amortization" (Ebitda). The financial due diligence process includes an assessment of the target's historic Ebitda and an understanding of the significant unusual and non-recurring events affecting it.

Buyers typically view a target in light of current and anticipated conditions. Unfortunately, as a target engages in and adapts to the challenges of today's economic market, its historic performance may not be an ideal indicator of current, or, more importantly, future value. Understanding the relationship among past, present, and future financial performance is a critical challenge to buyers. In addition to the traditional focus on Ebitda, today's financial due diligence must be expanded to address these variables and metrics, as well as other contemporary challenges. It is essential to assess whether a plausible financial and operational bridge can be built to meet the future metrics the seller asserts will be achieved.

Financial projections are often a critical tool for assessing the value of a target. Buyers look to the financial due diligence process to vet a target's financial projections, which should always include a section containing key assumptions. As a predictive model, financial projections can be based on a wide array of key assumptions, from conservative to radical.

By applying a traditional due diligence program, historic financial performance can be examined to help understand and evaluate key assumptions. However, given today's economic market and changing financial pressures, it has become increasingly difficult to make accurate predictions. Any key assumption that varies from

historic performance should be carefully assessed, particularly assumptions that are aggressive, radical or have a substantial impact on the target's value.

Stay Skeptical

It is important for buyers to generally maintain a level of professional skepticism, resist the seduction of the all too common "financial comb-over," and strike at the financial heart of the target and the ultimate financial deal. This is particularly the case when assessing changes in accounting policies or methods and accounting estimates.

With changes in accounting policies or methods, both historic and future financial trends become much more difficult to assess, particularly when a target modifies key accounting policies or practices. Such changes may make the situation as difficult as "comparing apples to oranges."

Mind The GAAP

Under Generally Accepted Accounting Principles (GAAP), a change in accounting principle is "a change from one generally accepted accounting principle to another... when there are two or more generally accepted accounting principles that apply or when the accounting principle formerly used is no longer generally accepted. A change in the method of applying an accounting principle also is considered a change in accounting principle."

It is important for the buyer to request that the seller identify and disclose all changes in accounting principles and methods. The due diligence

professional should carefully consider the rationale for the changes, and their financial impact. GAAP also requires “retrospective application of changes in accounting principle to prior period financial statements, unless it is impracticable to determine the period-specific effects.” Therefore, all financial statements presented by a target (both historic and prospective) should be presented using the same accounting principles or methods.

In accordance with GAAP, an accounting estimate is another important consideration in today’s economic environment. An accounting estimate is an approximation of a financial statement element, item or account. The estimate is often included in financial statements because the measurement of some amounts or the valuation of some accounts is uncertain, pending the outcome of future events, or because relevant data concerning events that have

already occurred cannot be accumulated on a timely, cost-effective basis.

Since estimates are based on subjective as well as objective factors, judgment is required. Management’s judgment is normally based on its knowledge and experience with respect to past and current events, and its assumptions regarding conditions it anticipates will occur and/or courses of action it expects to undertake. Examples of accounting estimates include:

- Net realizable value of inventory
- Net realizable value of accounts receivable
- Revenues from certain contracts
- Various expense accruals
- Contingencies

Today more than ever, buyers and lenders should work to gain a complete understanding of a target’s key accounting estimates. For a host of reasons, the target’s expectations may be completely different

from the buyer’s. Targets in struggling or declining markets should recognize fair and appropriate estimates, while buyers, equipped with their overall industry and economic knowledge, should carefully scrutinize and assess the judgment of the target’s management.

In the end, thorough and transaction-specific due diligence should be leveraged to aid a buyer or lender in developing accurate, reliable and meaningful information through the M&A process in today’s turbulent financial environment. Cutting corners in the world of due diligence is always a “sucker’s bet,” especially in an unpredictable financial market. Accordingly, one must be ever mindful of the Latin doctrine, “Caveat Emptor” (Let the Buyer Beware).

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