

THE ACCOUNTANT'S ROLE IN THE DUE DILIGENCE PROCESS

PURCHASE OF A BUSINESS

By: Stuart M. Bordman, Esq.



MEMORANDUM

TO: ALAN, THE ACCOUNTANT

FROM: STUART M. BORDMAN

RE: DUE DILIGENCE WITH RESPECT TO PURCHASE OF PRODUCE BUSINESS

DATE: NOVEMBER 11, 2017

One of my long term clients has been in the wholesale produce business for many years. He has an opportunity to purchase a competitor. His accountant is good at counting oranges and bananas, but is not up to the task of due diligence with respect to a business purchase. Accordingly, he has requested me to retain an accountant on his behalf to perform due diligence with respect to the target and based upon our years of working together. I thought of you.

BACKGROUND ON THE TARGET

The target has been in business for many years and has grown organically. Annual sales are in excess of \$10 Million. The target is a corporation with one shareholder. The shareholder started the company as a proprietorship many years ago and about ten years ago incorporated the business. The shareholder is no longer competent. The shareholder transferred his stock to a revocable living trust for estate planning purposes and appointed his accountant as successor trustee. The successor trustee elected a long term employee as the president of the company and gave him broad discretionary powers. The president is overworked. He handles purchasing, marketing, distribution, warehousing, equipment repairs, equipment purchase, building maintenance, pays the bills, etc.

The accountant for the target was a sole practitioner who passed away unexpectedly. He operated out of his home without an assistant.

The Probate Court appointed a bank to be successor trustee after the accountant. The Bank wants to sell and my client, now our mutual client wants to buy.

THE TRANSACTION

The problem is that our client knows very little about the target other than its annual sales. The decision to purchase stock or assets is open.

Your task is to:

- A. Perform due diligence regarding accounting and tax matters;
- B. Learn about the target;
- C. Identify problems; and
- D. Analyze the target.

DUE DILIGENCE STEPS

1. Obtain and review income tax returns and financial statements. Determine if the income tax returns, in all material respects, reflect the income and financial condition of the target;
2. Determine if all state and local returns have been filed.
3. Analyze internal controls, i.e., can the books and records which lead to preparation of the 1120 and any financial statement be relied upon;
4. Identify tax issues.
5. Identify areas for potential undisclosed liabilities.
6. Find out if there are any related entities that are essential for business operations, i.e., real estate leased to the business by a related party. (Are payments to related parties at arm's length?)
7. Spend some time at the target's warehouse so you can meet the office and accounting personnel. Determine their competency. Should they be replaced upon closing of the acquisition?
8. Is the computer hardware and software adequate for the business or should it be replaced upon closing the transaction?
9. Can the information on the target's computer system be transferred to other computer systems, if necessary?

10. Prepare a proforma financial statement, adding back shareholder compensation, dividends and any expenses such as travel, entertainment and auto that are really not business expenses.

11. Assuming a purchase price of \$2 Million Dollars, how would you allocate under Section 1060 of the IRC so if assets are acquired, we can complete the form 8594.

Please send an engagement letter as soon as possible. I have a stand-still agreement pursuant to which the trustee will not sell the stock or assets or invite other offers or negotiate with others until December 31, 2017. Accordingly, I need a report by December 15, 2017 so our client can decide if he wants to make an offer and the terms and conditions upon which he will make an offer to acquire the target.

DUE DILIGENCE CHECKLIST*
(Tasks to be Divided Between Attorney and Accountant)

- Limited liability company
 - Certified copy of articles of organization
 - Annual statement
 - Operating agreement
 - List of current members and their addresses
 - List of managers, if any, and other key employees and their titles
- Corporation
 - Certified copy of articles of incorporation
 - Bylaws
 - Profit corporation annual reports for last three years
 - List of all subsidiaries and affiliates
 - List of current directors and officers and other key employees and their titles

Financial Condition

- Most recent financial statements, with comparable statements for prior year
- Description of material contingent liabilities
- Revenue recognition policy
- Accounts receivable reports (aging, quality and special problems)
- Inventory valuation, turnover and obsolescence

Tax Matters

- Federal income tax returns for last three years
- State and local income and/or gross receipts tax returns for last three years
- Audit and revenue agents' reports (federal, state and local) for last three years

- Correspondence regarding any audit or investigation inquires
- Settlement documents and correspondence for last three years
- Sales and use tax returns for last three years
- Evidence that all payroll, withholding and real and personal property taxes are paid
- All tax elections filed (and related correspondence) for last three years (including Subchapter S, if applicable)
- Unemployment tax rate, payment status (UIA Form 1027)

Assets

- Real Property
 - Address and legal description for each owned or leased real property that the Company owns or as which it conducts operations
 - Mortgages
 - Leases and subleases
 - Surveys
 - Most recent title insurance policies
- Personal Property
 - Fixed-asset list indicating which assets are subject to capital or operating leases
 - Confirmation all assets are at the facility
 - Most recent personal property appraisal
 - Maintenance contracts
 - Service records
 - Documents of title
 - Copyrights
 - Patents
 - Trademarks/registration/application

- Trade names and trade dress
- Trade secrets (nature of trade secrets; procedures for protecting; third-party claims)

Contracts and Commitments

- Credit, loan and security agreements
 - Credit or loan agreements
 - Promissory notes
 - Security agreements
 - Guarantees
 - Indemnification agreements
 - Balance due and interest rates
 - Any financing agreements with or for suppliers/customers
- List of bank accounts
- Contracts involving expenditures above \$_____
- Contracts outside ordinary course of business
- Summary of all material oral contracts
- Equipment leases
- Insurance
 - Comprehensive public general liability coverage
 - Comprehensive public general liability coverage
 - Unemployment compensation
 - Commercial fire and extended coverage
 - Business interruption insurance
 - Comprehensive motor vehicle coverage
 - Product liability coverage and information regarding claims over past five years
 - Workers' compensation coverage and loss runs past three years

- Key-person insurance and present-value calculation
- Directors' and officers' coverage

Employees

- List of current employees, including name, department, date of hire, position, hour rate/salary, Fair Labor Standards Act exempt status
- Union matters
 - Collective bargaining agreement and local agreements and work rules
 - Pending and recent arbitration awards under contract
 - Unfair labor practices (pending and potential charges)
- Employee size, turnover (including any work force reductions during preceding 90 days) absentee history and distribution
- Agreements
 - Employment contracts
 - Noncompetition agreements/confidentiality agreements
- Employee handbook/personnel policies/posters
- List of fringe benefits, perquisites, holidays, vacation

Employee Benefit Plans

- Tax-qualified pension and profit-sharing plans maintained or contributed to by the business or any member of the controlled group, including terminated and frozen plans
- Welfare plans maintained or contributed to by any member of the controlled group to medical, medical reimbursements, disability, accident, dental, vision, life insurance, financial assistance, substance abuse, counseling, prepaid legal services and formal or informal severance arrangements) for active or retired employees

*This list is abbreviated and is for illustration only