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A Due Diligence Review: Preparing Buyers and Sellers for the Best Outcome

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A thorough due diligence review is an extensive investigation of the seller's business that a buyer undertakes prior to the execution of the purchase transaction. The goal of due diligence is to confirm as much as possible of what you think you know about the seller's organization before you sign on the dotted line. The review can take many forms, from detailed legal, financial and operational examinations to assessment of the other agency's culture for compatibility purposes. No matter what steps are performed, the mission is to carefully peel back the layers of the seller's organization so the buyer knows exactly what they're buying.

The primary focus of this article is the financial and operational due diligence review. The legal and tax reviews should always be completed by your respective experts, internal or otherwise.

Asset vs. Stock Purchase Considerations

Purchase transactions between agencies can take two forms: as a stock purchase or as an asset purchase. A merger is simply a subset of a stock purchase whereby one party gives up their ownership in exchange for ownership of the other party. In a stock purchase transaction, the buyers acquire all of the known and unknown assets and liabilities of the seller when they acquire the stock of the firm. This means that any skeletons in the closet become the responsibility of the buyer. This financial exposure can be mitigated somewhat through contractual means, but it may never truly go away, and can disrupt or damage the reputation of the buyer's organization.

An asset purchase, on the other hand, is a more defined shopping list of assets and liabilities to be acquired by the buyer. In an asset purchase, the buyer is primarily focused on the book of business, the core operating fixed assets and perhaps the cash, customer receivables and company payables. The rest of the balance sheet, as well as any unknown obligations or liabilities of the firm, remains with the sellers.

The due diligence for a stock purchase transaction should be substantially greater in scope than the review for an asset-purchase transaction. This is due to the significantly higher risk assumed by the buyer, particularly as it relates to the accuracy, validity and completeness of the entire balance sheet. This additional review occurs not only on the accounting or financial side, but should be part of the legal and tax review as well. Buyers must complete a thorough investigation of all potential unrecorded liabilities. They must also validate the accuracy of known liabilities and asset values before finalizing the purchase price and terms.

Due Diligence Procedures — Financial Review

The most important component of a due diligence review is usually the seller's revenue, and should include the review and validation of:

- Supporting documentation of the premium and commission billing of the top accounts and other randomly selected accounts
- Revenue recognition of agency-

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billed items and identification of any collection problems

- Cash receipts and/or supporting billing information of direct-billed items (depending on the revenue recognition policy)

- Review of large accounts, lost accounts and new business to confirm the appropriate revenue is reflected in the pro forma.

A review of bank accounts, and in particular, the monitoring of the premium trust position and timeliness and thoroughness of bank reconciliations, needs to be part of any due diligence engagement. Bank reconciliations are some of the most basic of all accounting controls, and are often an indication of the quality of the financial controls existing within the organization. Without meaningful bank reconciliations, the financial information presented by the seller may not be transparent.

Generally, the next most important step in due diligence consideration should be a thorough review of the premiums receivable and payable. Customer receivables are generally reported in the aged receivable report, and should include the reconciliation to the financial statement balance. Buyers should also understand how customer credit balances are processed and reported within the receivable aging report and whether the credit balances are being addressed in a timely fashion. Finally, inquiries should be made regarding collection procedures and problems, any bad debt experience and related producer responsibilities.

Premiums payable can be an area rife with problems if the seller hasn't exercised proper financial controls and procedures. Situations such as stale payable items, debit-balance items or company balances that don't reconcile with insurance company records and financial statement balances are all indications of problems that a buyer needs to investigate.

Buyers should obtain a complete list of all personnel, salary levels and other information including employee benefits as part of the diligence information from the seller. The buyer should also prepare a reconciliation of salary and incentive compensation expense, by person if possible, through the due diligence date to the expense on the income statement to confirm its accuracy. Finally, the buyer should verify that all payroll filings and tax payments are current and properly reflected in the agency's financial statements.

Buyers should also review selected expense categories to identify any significant nonrecurring items, missing items or unusual disbursements (or receipts) to make sure the pro forma expense levels will be attainable going forward. Expenses such as outside consultants, technology-related purchases or upgrades, marketing campaigns, bulk-supply purchases and others can combine to create expense levels that may not be repeatable going forward.

There is generally a separate allocation of the purchase price to the fixed assets of the business. The buyer should obtain the summary and supporting schedules of fixed assets, consider confirming the existence of any individually material items, and review the reconciliation of the balances to the financial statements.

Insurance-agency sellers should be prepared to provide a comprehensive status report on their overall technology environment. The report should include:

- A detailed list of all equipment, software versions and required software licenses used in the office for normal desktop applications as well as agency management systems and overall network applications. For software products with maintenance contracts, include a description of the coverage and annual costs.

- A copy of all security policies and procedures, including back-up and disaster-recovery plans.

- Description of remote access capabilities, website client and/or employee portals and any other cloud based applications, including pending updates or changes in process.

- Anticipated capital expenditures for technology, and any other pertinent information.

If other asset or liability accounts are included in the purchase transaction, they should also be reviewed for propriety and supporting documentation during the due diligence period. Items for review may include direct-bill receivables, prepaid insurance, operating-accounts payable and various expense accruals.

In a stock-purchase transaction, the analyses discussed in this article should be conducted on all balance sheet accounts not specifically identified by the seller as ones they will remove prior to the sale. In addition, as mentioned earlier, a much more extensive review of legal, contractual, regulatory and other potential, unrecorded liability exposures is strongly recommended.

Due Diligence from the Seller's Perspective

For the seller, once the price and terms have been agreed upon, someone needs to come in and verify the information that has been presented about the business. While nothing can eliminate all the angst associated with the diligence process, there are a number of steps that can be taken to minimize it. The most prepared sellers don't wait until they're actually selling the business to start getting ready:

Establish a history of sound financial processes and controls well in advance of considering a sale of the business. In addition, consider an independent review or audit of your financial records, depending on the size of your business.

Take steps to eliminate unnecessary assets and liabilities so the business doesn't look or feel like an extension of your personal checkbook.

Review your internal processes within the finance and insurance operations of the business to ensure they correspond to any written or verbal descriptions to make sure what's supposed to be happening is in fact what's really going on. If written documentation does not exist, consider putting this on the "To do" list.

Conclusion

Both buyer and seller will be best served by preparing for the due diligence review, with the buyer knowing what to ask for and review in each particular situation, and the seller being aware of what to expect and being able to deliver it. Buyers require an extensive set of documents the seller needs to make available for due diligence review. The best way for sellers to prepare for due diligence is to have a strong foundation of financial and operational internal controls, policies and procedures within their agency developed over a period of years. When the time comes for outsiders to review, quantify and critique all of this information, surprises should be minimal — and results favorable — to both sides of the transaction. ■

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