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March 2003

BOWNE Review for CFOs & Investment Bankers

ABSTRACTS OF CURRENT ARTICLES IN BUSINESS AND FINANCIAL PERIODICALS

Due Diligence Should Precede Every Deal

Abstracted from: *Quantitative Due Diligence: The Check Before The Check*
By: Howard Silverstone and Peter McFarlane, Kroll Inc., Philadelphia, PA
M&A Lawyer - Vol. 6, No. 6, Pgs. 16-19

Thorough investigation crucial to success. Despite the volume and value of recent M&A failures, too many acquirors fail to complete an independent due diligence investigation before they sign on the dotted line. The asset writedowns—amounting to hundreds of millions of dollars—are the best evidence of these failures by companies that made acquisitions during the late 1990s. Pre-closing due diligence must go beyond the financial statements, urge risk consultants Howard Silverstone and Peter McFarlane. For thorough due diligence, the buyer must study the company's markets, review the asset and liability values (whether on the balance sheet or not), scrutinize the synergy that will develop between the two companies, determine what the working relationship will be among the management teams, and establish that the acquisition is consistent with long-term strategy and goals. The answers may lead the acquiror to reprice the deal and, at the least, will protect against deception.

Look to independent sources beyond the financials. Remembering Enron and WorldCom, acquirors must understand that just perusing the prospective target's financial statements is not adequate for due diligence. The authors remind us that large companies have falsified financials to make earnings projections and smaller outfits have stretched the truth for higher bonuses and stock option values. Even if the financials are perfectly stated, a buyer needs more information about the prospective partner before proceeding with an acquisition. Those performing the due diligence should be free of bias and not married to the deal ahead of time. Talk to customers and vendors, then look at the company's market position. Pay attention to the company's governance policies, and analyze whether the board includes financially savvy and independent directors.

Red flags to highlight. Be on the lookout for telltale danger signs, which might point to a potentially unsuccessful merger. The authors list several factors to examine, including whether the target has a headstrong CEO or chair who micromanages every decision in the company; whether the target shows positive earnings but less positive operating cashflow; and if the executive compensation seems too hefty for the circumstances. To illustrate, the authors use a hypothetical study with red flags such as the controller whose mortgage payments equal 80% of his yearly salary, the customer base largely owned by an international parent undergoing financial difficulties, and a manufacturing process that relies on an expiring patent.

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Abstracted from ***M&A Lawyer**,* published by Glasser LegalWorks, 150 Clove Road, Little Falls, NJ 07424. To subscribe, call (973) 890-0008; or visit www.legalwks.com.

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