THOUGHT LEADERSHIP
DUE DILIGENCE: HOW TO AVOID SURPRISES WHEN ACQUIRING A MANUFACTURING COMPANY
By Joanna Brumsey, CPA
Due Diligence is one of the most critical stages in the process of purchasing a business. Some buyers incorrectly assume that due diligence means simply performing a financial review, but in actuality it encompasses significantly more and can be a lengthy and sometimes complex process. Proper due diligence entails a thorough investigation into the intimate details of the business being purchased in order to identify its strengths, weaknesses, growth opportunities, threats and strategic assets. Facts must be validated, assumptions eliminated, and risks mitigated.

In today’s economy, manufacturers will weigh the pros and cons of buying vs. building before researching potential acquisition targets. When an acquisition is determined, enter due diligence. While acquisition due diligence may seem obvious to some purchasers, many transactions take place without adequately completing this process. Given the current economic conditions, thorough due diligence is crucial in evaluating the risks related to the manufacturing industry.

A basic manufacturing-specific checklist will consist of managerial, operational, financial and economic due diligence. Your research should include interviews of key management staff such as the company’s Vice President of Manufacturing, VP of Sales, head of Human Resources and CFO at a minimum. You should cover the manufacturing and operations processes, the machinery used, its age and average useful life cycle and owner occupied real estate.

Beyond the general overview of due diligence pertaining to the purchase of a manufacturing business, there are some key scenarios to consider, such as the following.

**Normalizing earnings as reported by the seller**
Net income provided by the seller often includes the results of related party transactions, owner-related activities or significant non-recurring events or circumstances. Your goal in this process should be to see how the manufacturer will operate post-transfer. How the business has operated in the past may not be reflective of its operations under new ownership.

Related party transactions may include favorable leases, foreign currency rate management, administrative support or customer / vendor relationships, and are often not “arms length” transactions. These related party transactions may not operate in the same manner post-acquisition. For example, an owner may receive favorable lease terms from a related real estate entity, manage foreign currency fluctuations through a separately held foreign entity, utilize shared administrative or management support functions, or have special terms with customers or vendors.

Owner-related activities may include personal vehicles, club memberships or charitable contributions. Non-recurring events may refer to a one-time significant sale, lease or debt termination penalties, weather related incidences or major repair.

Other events could also potentially skew trend information and should be carefully analyzed, such as a new product line introduction, acquisition of a new business or new customer. All of these items need to be identified and quantified in order to normalize the potential future earnings of the business.

**Concentrations of customers or suppliers**
Many manufacturing businesses have significant purchases concentrated between a few key vendors. Alternate sources of supply must be identified up front, in the event that a transaction changes the nature of the relationship or because of potential unforeseen events. Relationships with key customers may require special attention on the part of the new owner in order to maintain that business. These concentrations may result in favorable pricing or payment terms that should be understood by the buyer.

**Gross margin by product line or location**
Many buyers purchase a company with the intent of changing the product mix or discontinuing under performing lines. Many companies report gross margin for the total company, but rarely is an accurate margin presented by product line or location. Without this information, it can be very difficult for a potential buyer to determine whether to continue or discontinue certain product lines or to close certain locations.

When evaluating the actual profitability of a particular product line, all costs should be considered, including materials costs, royalty fees and commissions, as well as special warehousing, packaging or customer service requirements to maintain that product line. For evaluating a particular location, this analysis should take into consideration overhead allocations. In other words, the profitability of a particular location, division or subsidiary should be evaluated prior to overhead allocations, unless that overhead would be eliminated upon closure.

**Credit memos issued to customers**
The volume and root cause of credit memos issued to customers can be an indicator of quality issues in the production, delivery or service processes in the target company. Analyzing trends of credit memos and investigating reason codes for returns may lead you to other inquiries or analysis in your due diligence process. This investigation should go beyond the accounting department into the warehouse and / or production departments into the warehouse and / or production.
THOUGHT LEADERSHIP
How to Avoid Surprises When Acquiring a Manufacturing Company

Due diligence in the purchase of a manufacturing business – or any business for that matter – is essentially a structured method for a buyer to

facility. Credit memo analysis may also uncover otherwise undisclosed customer terms, such as guaranteed buy-back provisions or sell-through requirements.

Working capital needs
Understanding the terms for accounts receivable and accounts payable is crucial for cash flow planning purposes. There may be significantly extended customer payment terms of 90 to 120 days, especially involving overseas shipments, versus vendor payment terms of 30 days, increasing the potential need for working capital lines of credit. The seasonality of the business may also impact working capital needs; understanding these trends will allow for you to obtain flexible, but adequate, line of credit arrangements.

Salability of on-hand inventory
Inventory can be classified into three main buckets: raw materials, work-in-process and finished goods. In many cases, management does a good job of evaluating potentially obsolete finished goods inventory using a typical days on hand analysis. However, rarely does that analysis consider obsolete raw materials inventory based upon the usage as stipulated in the bill of materials and the ultimate sale of the related finished goods.

Depending on the particular business, this analysis may become very complex and without a sophisticated Enterprise Resource Planning (ERP) system may require the use of data analysis software to combine information available in multiple databases. An effective analysis of the quality of inventory being acquired may have a substantial impact on the overall purchase price of the target company. In one recent instance obsolete inventory in excess of $3.5 million was identified by utilizing data analysis software to analyze the salability of all components of inventory.

Consignment inventory
Some large retailers utilize “scan based trading” for dealing with their suppliers. This requires suppliers to maintain ownership of the inventory within retailers’ warehouses or stores until sold to the end user. As a result of this relationship, the supplier will now have property in multiple locations, possibly multiple states, creating state tax exposure. Being aware of these relationships prior to acquisition will allow for adequate tax management, avoiding back end surprises.

Temporarily idle or non-operational equipment
Operational reviews include learning the individual manufacturer production process, as well as any supporting departments. A simple inventory of the fixed assets may lead to identification of assets temporarily not placed in service, assets that were disposed of in prior years but never removed from the fixed asset listing or assets that are non-operational and require significant investments or maintenance to become operational. Inquiries alone may not tell the whole story. A thorough review of historical repairs and maintenance expenses may also aid you in your identification of deferred maintenance and required replacements.

Employee agreements
Most often, lower level employees are offered continued employment with the buyer. However, successful transitions require a thorough understanding of all agreements currently in place, including bonus plans, commission structures, deferred compensation plans and benefit plans. Not fully understanding or appreciating these plans may prove to be disastrous down the road, either because the new buyer’s compensation structure may not mesh well with the historical payments, or because there may be a significant contingent liability on the improved operational results following a change in ownership.

Unrecorded liabilities
How would you know if a target company left millions of dollars in disputed A/P off their books? If it’s not recorded, it may be missed, unless you perform procedures specifically targeted towards identifying these undisclosed liabilities. These liabilities could include environmental issues, such as hazardous waste or underground storage tanks, product liability claims, OSHA claims or other regulatory claims.

Contract assumption
Careful review of contracts prior to assumption will identify potential termination penalties, price guarantees, geographic limitations, purchase commitments, warranty obligations or opportunities to achieve synergies with existing arrangements post-acquisition.

Performing due diligence prior to an acquisition is as important as adequately inspecting and insuring your home. Although due diligence can be a lengthy and difficult process that takes considerable resources and time, it is critical to acknowledge what the report tells you and then be prepared to walk away if the findings indicate you should.

Due diligence is time consuming and can be costly. However, acquiring a company that is not the right fit could cost much more in the long run.

Conclusion
Due diligence in the purchase of a manufacturing business – or any business for that matter – is essentially a structured method for a buyer to
"prove" that an acquisition is worth the price being paid. A thorough due diligence process should include involvement from tax and legal professionals, human resources, insurance and risk, and sales and operations.

It takes a professionally experienced team to perform proper due diligence. While physical investigation of fixed assets, production equipment or inventory is relatively straight-forward for a knowledgeable buyer, involving an expert in the industry of the target company can be essential during the investigation of the more subjective matters. Digging into customer satisfaction, market assumptions and future projected revenue sources goes beyond the historical past and peers into the future.

Ultimately, the prudent choice is to avoid overlooked potential problems associated with unasked questions. It is important to remember that it is also a part of the negotiation process because the final purchase price is often adjusted based on findings. The process should be structured and checklist-driven to ensure that nothing is missed.

about the author:
Joanna Brumsey, CPA

Joanna Brumsey has over eighteen years of accounting experience, including six years with a national accounting firm. She provides assurance and advisory services to public and private companies in the manufacturing, distribution, retail, franchise, and real estate industries. She is the leader of Wall, Einhorn & Chernitzer’s Manufacturing & Wholesale Distribution and Retail Service Teams. Joanna also has extensive experience with budgeting and forecasting, financial modeling, insolvency and restructuring consulting, due diligence investigation of target, and post-acquisition integration services.

Connect with Joanna: [LinkedIn Profile](http://www.linkedin.com/pub/Joanna-Brumsey/5/672/b6)

about the firm:
Wall, Einhorn & Chernitzer, P.C.

Wall, Einhorn & Chernitzer (WEC) offers a local touch with regional scope and national resources. Serving clients since 1989, we are today the largest public accounting firm headquartered in Norfolk, Virginia and the third largest in the Hampton Roads region. WEC is an independently owned and operated member firm of CPAmerica International, one of the largest associations of CPA firms in the United States. Through our affiliation, we have instant access to the expertise and resources of more than 2,500 professionals across America.

In addition to our Assurance and Tax services, we offer a variety of Advisory services, including: Entrepreneurial Services; Restructuring & Turnaround; Wealth Management; Business Valuation; Litigation & Dispute Consulting; and Succession Planning. Our professionals offer expertise and experience to organizations in a broad range of business sectors. Our seasoned accountants and consultants deliver exceptional service and solutions to the specialized needs of our clients in the following industries: real estate; manufacturing & wholesale distribution; retail; franchise; government contracting; construction; and not-for-profit.

Circular 230 Disclosure: This analysis is not tax advice and is not intended or written to be used, and cannot be used, for purposes of avoiding tax penalties that may be imposed on any taxpayer.