How to Do Due Diligence

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As an entrepreneur, VC, or investor (which can include private equity), you are continually faced with the challenge of performing due diligence in the most efficient, effective, and parsimonious manner possible, with the overall goal of determining whether or not to make an investment. You will perform due diligence many, many times over your career, any time, in fact, when you are contemplating an economic relationship with another business. While this article will focus on due diligence from the viewpoint of a purchaser or investor, it can be done by a potential supplier, customer, business partner, or more.

My aim, through this brief post, to give an overview of what due diligence looks like.

Generally the potential investor's goal when performing due diligence is to answer the following questions:

1. What is the underlying business model of the entity? This includes how revenues are generated, what expenses are incurred to generate the revenue, as well as the underlying projected demand for the goods or services offered by the business.
2. What assets are owned by the business? Many of the assets should be listed on the business' balance sheet, pursuant to Generally Accepted Accounting Principles (GAAP). Some examples include cash, receivables, inventory, equipment, copyrights, and patents. But other "assets" such as a skilled employee base, relationships with suppliers, customers, and employees, and the "know-how" to operate the business will not be listed on the balance sheet.
3. What are the business' liabilities? This includes the liabilities that are traditionally listed, or should be listed, on the business' balance sheet such as payables, accruals, loans, and mortgages as well as contingent liabilities. Contingent liabilities are obligations that will only occur based on the happening of an event in the future.
4. What will change at the business? The world is constantly evolving and this has an ongoing effect on every business. Items which are demanded by customers today may become forgotten relics tomorrow. New processes, technological changes, and inventions can make a business obsolete. Demographic, environmental, pricing, and a host of other factors can have a profound effect on an enterprise.
5. What will change after the investor purchases the business? Maybe as a result of a change in the business' ownership new opportunities will arise and existing relationships will evaporate. These factors should always be considered.
6. What improvements can the new ownership group implement to the business? A new investor/owner may have additional insight, expertise, relationships, or views that will help or hurt the business.

In addition to reviewing the business' webpage, the initial items that I typically request from the business are:

1. Financial statements,
2. Tax Returns,
3. Organizational chart, job descriptions of key employees,
4. Business Plan and projections, and
5. Marketing materials.

An online search, utilizing different search engines, of the business, products, key people, and economic sector will usually provide valuable insight into the business. Utilizing social media including Facebook, LinkedIn, and Twitter to learn more about the owners, executives, business, and sector may bolster the investor's understanding of the business and viability of the investment, and should not be overlooked.

Another valuable source of information are your friends, relatives, colleagues, and associates who may have some familiarity with business or whose judgment and advice you respect for additional intelligence and an overall reality check. These individuals may be able to introduce you to people who have expertise in relevant areas.

A salient component of the process is meeting with the management of the business. A candid and forthright exchange about the business during the meeting(s) is an extremely valuable and vital component of the due diligence process. While email exchanges, telephone calls, and video conferences such as Skype or Facetime are helpful and serve a valuable purpose, they do not replace the information that can be gleaned from a face to face meeting.

There is no universal source or document that can provide all of the information that will be needed to properly evaluate a business. Healthy, but practical, doses of understanding, skepticism, and pragmatism will assist in the process. Ultimately it is important to perform the necessary analyses, carefully review all of the data, develop and utilize a strong team of advisors, and always trust your gut.

Bio: Robert J. Chalfin is a lecturer at The Wharton School where he teaches courses to MBA candidates on business acquisition. An attorney and a CPA, he is an entrepreneur and has invested in numerous businesses. His book *Selling Your IT Business: Valuation, Finding the Right Buyer, and Negotiating the Deal* provides more detail about due diligence. He can be reached at bob@chalfin.com, 732/321-1099, or www.chalfin.com.

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