

## The Importance of Due Diligence

**Pacific Veterinary Conference  
2010**

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## What does the term mean?

- An investigation or audit of a potential investment.
- For small businesses, serves to confirm all material facts in regards to a sale.
- Includes reviewing all financial records plus anything else deemed material to the sale.

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## What does the term mean?

- For sellers too!
  - Absolutely should perform your due diligence analysis on the buyer.
  - Save time and effort if you can determine early that buyer isn't qualified
  - Items that may be considered:
    - Buyer's ability to purchase (down payment, credit)
    - Other items that would impact the practice or the seller after the sale has been completed.

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## Another way to look at it...

- Due diligence is a way of preventing unnecessary harm to either party involved in a transaction.
- Like a marriage, all parties better off in long run if no stone is left unturned.

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## Is it that important?

- Buying (or selling) a veterinary practice – life altering decision!
- Usually largest financial decision of buyer's life
- Not monopoly money!

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## Is it that important?

- Look at it this way...
  - If you were buying a house, you would have an inspection done
  - Buying a used car – take to mechanic
  - Buying a veterinary practice – investigate and do your due diligence

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## Due Diligence

- Investigating all aspects of the “investment” you are buying:
  - Financial
  - Operational
  - Legal
  - Other

## Due Diligence

- Not relying on what you’ve been told
- Not relying on assumptions
- Not taking anyone’s word for it
- Pentagon: trust but verify

## Due Diligence

- Even though you’ve worked there...
- Even though they seem so nice...
- Even though you don’t want hard feelings...
- Too much at stake to just take their word for it
- Pentagon: trust but verify

## Do yourself or hire professionals?

- Probably a combination
- Operational – can do yourself
  - Medicine
  - Records
  - Equipment

## Do yourself or hire professionals?

- Legal Areas – Hire Attorney
  - Permits
  - Zoning
  - Pending lawsuits
- Financial Items – Hire CPA
  - Revenue
  - Payroll
  - Other financial items

## How much is too much?

- Depends on situation
- Buying a practice cold?
  - Never worked there?
  - Don’t know sellers
  - New area
  - Advise very thorough investigation

## How much is too much?

- Know the practice fairly well?
  - Worked there before
  - Know owners
  - Live in the area – know practice
  - Maybe you can skip some steps...maybe.

## If you find something suspicious...

- Ask – could be a reasonable explanation
- Not satisfied with answer, ask again. Ask his/her advisors
- Investigate deeper yourself
- Decide:
  - Simple mistake?
  - Intentionally misleading?

## If you find something suspicious...

- Simple mistake
  - Sometimes owners simply have no idea
    - Confused on ATC
    - Confused on associate production
  - How severe is the mistake?
  - Alter terms of deal?
  - Bail out?

## If you find something suspicious...

- Intentional mistake
  - Have you been misled?
  - How severe?
  - Trust shattered?
  - Can you believe anything?
  - Alter terms
  - Bail out of deal
  - Take action...

## Is Due Diligence only for buyer?

- No. Seller can and should also perform on buyer.
- Not as thorough or time-consuming
- Seller should be reasonably comfortable with buyer

## Is Due Diligence only for buyer?

- Why? Seller has financial vested interest in buyer's success
  - Seller carrying back paper?
  - Seller own the real estate and leasing to buyer?
  - Seller going to continue on as employee?
  - Seller going to have certain benefits paid by new practice owner?

## Is Due Diligence only for buyer?

- Why? Seller has non-financial vested interest in buyer's success
  - Seller feels obligation to employees?
  - Seller feels obligation to community?
  - Seller wants business – his/her baby – to succeed.
  - Legacy

Ok, let's investigate...

## General Areas

- Work at practice
  - At least five shifts – paid or unpaid
  - No better way to learn about:
    - Staff
    - Clients
    - Records
    - Medicine
    - Equipment
    - Vibe of the place

## General Areas

- Work at practice
  - Seller's don't like – confidential
  - Insist
  - Afterwards, ask yourself:
    - Can you work with these people?
    - Are these your type of clients?
    - Similar medicine to what you're practicing?
    - Does the practice have potential?
    - Can you see yourself here for the next five, ten, twenty years?

## General Areas

- Verify hours
- Look into nearby competition
  - How far?
  - How many?
  - Hours?
  - Threat?

## General Areas

- Complete demographics analysis for practice
- Economic analysis of area
  - Housing
  - Business
  - Population
- Check on status of phone book advertisements.
  - How much time remaining on current ad?
  - How many books are advertisements running in?

## Financial

- Verification of Revenue
  - Most important area.
  - Many transactions are based on gross revenue of practice.
  - Many loans are based on gross revenue
  - Can be overstated.
  - Blend of revenue

## Financial

How to verify revenue:

- Documents needed:
  - Tax returns last two years
  - Financial statements last two years
  - Sales tax returns (quarterly) last two years
  - Computer system revenue reports
  - Bank statements

## Verification of Revenue

- By month, cross check computer system with bank statements
- Cross check again with income statement
- Slight fluctuations ok.
- Timing differences possible.
- Check quarterly and annually with sales tax returns and income tax returns.

## Verification of Revenue

- Also review components of revenue:
  - Breakdown of revenue categories
  - Heavy on food/products/kennel?
  - Large unusual deposit (equipment sale) skewing numbers?
  - What you expected?

## Expenses

1. Review W-2s and 1099s. Match totals to expense items on tax returns. Staff costs what they appear to be?
2. Check on unpaid spouse. Large role in practice?
3. Review major vendor files – who, how much
4. Review general ledger to verify amounts paid for phone book, building maintenance, and other large .

## Personnel

Who are you hiring?

- One of the biggest components of your purchase.
- Working with them ahead of time is key

## Personnel

- Retrieve names, addresses and Social Security Numbers on all present employees
- Background checks? You don't have to hire.
- Request summary of payroll, by person, for the past year
- Request hourly rates currently paid to each employee, and last time raises were given
  - Important – what if raises haven't been given in three years?

## Personnel

- Review current benefits provided for employees: health insurance, education, auto, etc.
- Request accrued vacation and sick pay due to each current employee from the seller.
  - You won't be assuming accrued vacation, but you want to know what they're used to receiving

## Personnel

- Review current employee manuals
  - Any policies that you won't continue?
- Do key personnel analysis. Determine likelihood that they will leave once you take over. Determine how losing key personnel would hurt the practice. Associate?
- Review any existing personnel contracts.

## Assets

1. Match larger pieces of equipment in practice to equipment list
2. Test larger pieces of equipment for quality
3. Check computers and printers for quality
4. Verify veterinary software in use. Which version?
5. Verify the quality of client data on computer system

## Assets

6. Ask if service contracts are current
7. Do building inspection/construction review
8. If equipment leases are being assumed, verify terms and buy-out language
9. Verify quantity and quality of drugs and supplies on the shelves

## Title

1. Check how title is presently held to the veterinary practice
2. Check how title is presently held for real estate

## Zoning

1. Check that practice conforms to neighborhood zoning requirements, such as boarding limitations
2. Check that practice conforms to building and safety requirements

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## Other Areas

- Verify current Fictitious Business Name filing
- Request information on any lawsuits pending or settled in the last 10 years
- Request information on prior partners, if any
- Confirm practice conforms to OSHA requirements
- Have hazardous environmental study done
- Any employee issues?

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## Investigating the buyer

- Will this person succeed?
- Will he/she mesh with current staff and clients?
- What is his/her medicine like?
- What is his/her business acumen?

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## Investigating the buyer

- Specific Due Diligence:
  - Proof of down payment
  - Credit Report
  - Proof of license
  - Speak with prior employers?
  - Pre-approval letter from bank

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## Investigating the buyer

- Specific Due Diligence:
  - Hire him/her for a few shifts?
  - Meet
    - Plans for the practice?
    - Plans for the staff?
    - Get an overall "vibe"

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## Feasibility Analysis

- Is the Cash Flow you are Buying enough?
  - Once you are satisfied that the numbers are accurate, make sure you can:
    - Pay all bills of practice
    - Pay your salary – what you need to make
    - Pay your benefits
    - Pay practice loan payments

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### Feasibility Analysis

- Do feasibility analysis under three scenarios:
  - Conservative – results same as prior year
  - Optimistic – up 5%
  - Pessimistic – down 5%
  - What does it look like?
- Assume conservative financing
  - Rate
  - Term

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### Feasibility Analysis


- Excess cash flow? Too thin?
- Make sure cash flow is available AS IS. Don't factor in growth or potential or changes you might make.

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### Copy of slides and Due Diligence Checklist by email?

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### Questions?



### Answers