A Story of Diligence

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At Lucas Horsfall we have had a busy 2017 working on Quality of Earnings (Q of E) engagements and helping our clients prepare for an exit. Following is a summary of one of our Q of E engagements this year. To protect the identity of the client I have changed names of people and places, everything else is factual.

National Payroll Company

Getting Hired

A banker who I have known for three years gave our name to a Search Fund started by Steve. Steve had graduated from Stanford and worked for several international investment banks before deciding to start his own fund. This was a big decision for Steve to leave the security of a job and dedicate 100% of his efforts to find a target for acquisition. Coincidently I had known two investors in Steve's Search Fund for at least a decade. These investors are directors at a national Private Equity (PE) firm with whom we have a long working history. When Steve was looking for an accounting firm he got our name from a banker in Los Angeles and a PE firm in Boston. We were ahead of the competition right out of the gate. Steve wanted us to jump on the job right away and get it done in the space of two weeks. This would be tough because Steve was acquiring two Companies. One in Montana and the other in Texas. We gave a range of fees with the assumption that everything would go smoothly. We were hired. Things hardly ever go smooth in a M&A transaction. To make things interesting a third party had made a crazy offer to buy the business in Texas? This put extra pressure on us to get our work done quickly. Our buyer wanted to get to the finish line first.

The Business

Before I go any further I should describe the business. Both companies are engaged in payroll related services for businesses. However, they operate very differently. The Company in Texas has created software which allows them to automate the process, while the Company in Montana was calculating the taxes manually. Steve's objective was to acquire the business in Texas for the software. The software then could be used to improve the billing processes in Montana. Efficiency would be found, thereby increasing profitability of the combined operation. This is an oversimplification, but you get the point.

Montana & Texas

We started by setting up the data room, reviewing available financials and strategizing the best way forward with Steve. Neither one of the Companies had ever been audited. This can be an issue, because we operate in the middle market and we know how to design procedures to get over this hurdle. We had just finished working on a project where the books reflected $250,000 in inventory while the physical inventory was close to $4 Million. Compared to that transaction this would technically be much easier.

After reviewing the financials and speaking to the management our assessment was that the books in Montana were messy. Texas would be more manageable.

Montana

A week later we landed in Montana. The Company was not fully prepared for us. We were not surprised. What did surprise us was the amount of unrecorded liabilities. Without a lot of effort, we found a million dollars of unrecorded liabilities. This was a potential deal killer because this could adjust the purchase price by $5-$6 Million. The business in Montana had been profitable but lacked working capital. In addition, the owners were not spending a lot of time at the office. In hindsight, we should not have been surprised by the amount of unrecorded liabilities, cash strapped businesses don't do a good job of recording liabilities. They are concerned with the basics of making payroll and keeping the lights on.

Given the lack of accounting sophistication at the Company it became our job to see if we could find transactions which went in the Company's favor. I felt that we were in the twilight zone of diligence. Usually our role is to find transactions which knock down the value of the business, now we had to find transactions which were going in the other direction. Fortunately for all parties we found something big. I can say that this was the first critical moment of this engagement. Working with Steve we saved the deal.

What we found was this. The Company had a major mismatch between expense and revenue recognition. The Company performed the work but did not recognize revenue until several months after. This was the case in both Montana and Texas. We did our research and determined that the Company was understating revenue by approximately $3 Million. We established a new method for revenue recognition which was accepted by all sides. We were far from being done. There was still Texas.

Texas

We arrived at a no-frills office with a 'bring your own coffee from home' kind of vibe. This was a big contrast to the office in Montana which was professionally decorated and smelled of fresh flowers. The accounting in Texas was just as different. The owner was deeply involved in the day to day operations, and believed paying all bills in advance because the taxes were filed on a cash basis. This company had no accounts payable. The Company was not capitalizing software development costs which made our work easy. We applied the new revenue recognition model to Texas and we were done.

Our Report

I must say that I feel very proud of the reports we produce. Every report is as unique as the engagement we perform. We know who will read our reports- the lender and the PE firm. We anticipate the questions and we answer them in the report.

Not only did we report our findings, but we also presented consolidated historical and projected financials considering efficiencies that would be achieved from the merger. Cash flows are important to lenders. They want to make sure that the borrower will be able to pay them back. Therefore, we also presented historical and projected Free Cash Flow calculations.

Lastly, the report must look professional. It should be pleasing to the eye. Why? This is because the report must reflect the love and care which has gone into the work we have done. M&A work is hard, my team and I spend hundreds of hours away from home. The only tangible evidence of our work is our report. It must look good.

Lessons

- Relationships: There was no investment banker in this deal so it meant that we had to get the information directly from the seller. This can become difficult because after a while deal fatigue sets in and the seller can become touchy to data requests. We worked hard on establishing a good relationship with the sellers which allowed us to get our work done at a good pace.
- Background Checks: There was a hiccup before closing. Customary background check on a seller's personnel turned up a questionable past. While we were not charged with performing the background checks a quick google search could have altered us to the matter on day one.
- Liabilities: Expect large sums of unrecorded liabilities in companies that are strapped for cash.
- Add Value: I can say that we were instrumental in getting the deal done. We worked closely with Steve and the PE firm.
- Working Hours: This work is deadline driven. You must commit to working around the clock until the task is finished.

The deal got done. Steve moved his family to Texas to run the business. He is happy. We did a great job which makes us happy. We are also happy because Steve has engaged us to do ongoing tax and audit work.

Based in Pasadena, Los Angeles, Gaurav heads Lucas Horsfall's audit department as well as spending time consulting on M&A Transactions. To contact Gaurav, please do so at GMalhotra@lhmp.com.