Top financial challenges in selling a business

For sellers, exercising proper due diligence can pay off handsomely

By William H. Wiersema, CPA, *EA* Contributing Editor

Business owners who are planning to sell their businesses have much to do. Enhancing a business's value, planning personal finances, and considering tax implications are often top priorities. However, many sellers overlook the financial challenges that may arise once they've signed a letter of intent with a buyer. Unprepared sellers are often blindsided and disappointed, even to the point of withdrawing from the transaction. Most letters of intent do not close, causing significant wasted time and resources for everyone involved.

On the other hand, once under a letter of intent, buyers focus on due diligence. The financial portion entails a thorough review of the target company's financial statements, accounting policies, tax aspects, proposed adjustments, and operational performance, among other things. Unlike sellers, many buyers have extensive experience in evaluating businesses. Buyers seek reassurance that the financial representations made by the seller are accurate and that they are not overpaying for the business. For buyers, the target's earnings before interest, income taxes, depreciation, and amortization (EBITDA), as adjusted, is a key metric.

To forestall problems, sellers and their advisors should stay informed about the latest developments in due diligence. That way, sellers can identify potential issues and optimize their responses. Investment bankers note that these efforts can pay off handsomely, leading to an increase in the business's selling multiple by one-half to a full turn. For instance, for a business generating $1 million in EBITDA, this could result in an additional $500,000 to $1 million in the selling price.

Let's consider today's top accounting, tax, and add-back concerns.

Apply accounting rules

Companies book sales at different times, often improperly. For instance, to incentivize its sales team, a kitchen remodeler recorded revenue when the company received a final order, even before scheduling the work or purchasing materials. This practice significantly inflated the company's financial

— Illustration by Bing generative AI

performance. More commonly, middle-market companies recognize revenue at the time they invoice customers, following most accounting software.

However, since 2019, the new default method for revenue recognition is "Over Time" (OT). It resembles the percentage of completion method, which was used traditionally by contractors. Now, OT applies to almost every industry, including consulting, software, and custom manufacturing, promoting consistency.

OT recognizes revenue based on the ratio of costs incurred to the total budget. Because this method aligns with project progress, it is theoretically sound, although not in line with billing. For example, customer advance billings are regarded as liabilities and considered unearned until work is performed under OT. In contrast, if revenue were recognized solely based on billing, a company could record a deposit as revenue without incurring any costs, which would be misleading. Other examples where billing does not align with earned revenue include annual billing, retainer or progress billing, and time-and-materials work billed a month in arrears.

OT relies on estimates, making budgeted remaining costs a crucial element. Unfortunately, budgets are rarely accurate and always contain some degree of error. Budgeting can also be subjective. Inflating budgeted costs results in reduced revenue, whereas understating budgets can accelerate revenue. Additionally, OT can lead to increased revenue and profit in unexpected ways. For example, by adding payables to ongoing jobs, revenue is recognized with a budgeted margin added.

Inventory is the second top issue. For companies in trouble, a classic way to turn losses into profits is to raise inventory levels. This can be as simple as creating fictional inventory in the records, as happened in the Phar-Mor fraud case during the 1990s. Other ways of misstating inventory, whether intentionally or not, include practices such as capitalizing more overhead into inventory cost, failing to write off old inventory (or marking it back on), and even just adjusting upward to current costs in inflationary times.

The equation for computing cost of goods sold illustrates how. Ending inventory is deducted from purchases (or production) plus beginning inventory, meaning that overstating ending inventory leads to more income. Unfortunately for the fraud-minded, ending inventory this period is beginning inventory for the next. Inventory must continue to be overstated by the prior amount just to run in place.

Buyers are also wary of reserves mandated by accounting rules for excess and obsolete inventory. For example, an item costing $1,000 might be reserved to $750 down to a net realizable value of $250. Oftentimes, middle-market companies do not book reserves. Additionally, where reserves exist, buyers may suspect manipulation.

In one situation, buyers insisted on a deduction from EBITDA for a reduction in an inventory reserve, which caused ending inventory to increase. The seller became distrustful of the buyer and terminated the deal. When investigated subsequently, the decrease in reserve was actually reasonable and could be traced to negative margin sales, charitable donations of product, and disposals. Once documented, it became a non-issue in the next deal, which successfully closed.

Check on tax compliance

In its 2018 Wayfair decision, the U.S. Supreme Court ruled that sales of $100,000 or 200 transactions over twelve months was enough for a state to obligate an out-of-state business to register, collect, and remit sales tax. As a result, many companies are facing unexpected consequences. For instance, an Illinois distributor of repair parts for manufacturing equipment had no tax liability before Wayfair. However, about one-quarter of states do not provide exemptions for manufacturing, meaning the distributor now becomes liable for sales tax when shipping to those states.

Buyers are often hesitant to assume state tax liabilities due to the risk of successor liability, even in asset acquisitions rather than stock purchases. This often leads to complex negotiations, structures, and financial protections, such as voluntary disclosure filings, which can become an ongoing burden for sellers after the business is sold.

The Wayfair decision extends beyond sales tax, potentially affecting any non-income tax compliance. The landscape is complicated by politics, as there are 10,000 state and local taxing jurisdictions in the U.S., each with varying rules and timelines. Out-of-state businesses lack voting power, so their concerns tend to receive lower priority.

Payroll also presents due diligence concerns. Recent changes to the income tax law regarding the qualified business income deduction greatly impact owner compensation. In many industries, owners can deduct 20% of pass-through income, giving them a considerable tax advantage over their W-2 income, causing owners to revisit their compensation.

Owners influence related party transactions in ways that are not solely market-driven. For example, when a business rents a facility owned by its owner, the arrangements may reflect personal financial objectives. Complications may arise further when a company sells to an affiliate, who might purchase more than necessary to boost profits.

Compliance remains a critical issue. Early-stage businesses often misclassify workers as contractors to save on payroll taxes and benefits. However, the IRS and other government agencies apply complex and strict tests to determine worker classification. Employers who violate the rules face penalties and personal liability.

Adjust for non-recurring items

Sellers often take the time to identify nonrecurring items to add to reported EBITDA. Examples include failed products, nonproductive advertising, recruiting fees, severance pay, and employee bonuses. However, buyers are likely to challenge these items, arguing that they are standard parts of business operations. Additionally, buyers may analyze historical data to exclude any anomalies related to the post-pandemic period, such as government pandemic subsidies, abnormal revenue fluctuations or temporarily elevated profit margins caused by lags in changes in sale and purchase prices.

For sellers to effectively present their add-backs and defend against buyer deductions, the items must be quantifiable, justifiable, and supportable. For instance, an examination of historical data reveals that ocean transport costs peaked in 2021 but have since returned to pre-pandemic levels. Consequently, the costs that impacted profit margins were temporary and can be justifiably considered as add-backs to EBITDA.

Sometimes, measuring a company's value requires more than just historical data. For example, when Encyclopedia Britannica published its last print edition in 2010, many believed this marked the end of its 240-year history. However, *Crain's Chicago Business* reported recently that the company has undergone a technological turnaround through digital products, resulting in a current valuation of $1 billion. **EA**

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