International Journal of Social Science and Business, Vol. 4 No 1; March 2019
ISSN: 2519-9161(Online), ISSN: 2519-9153(Print)
Published by Center for Academic Research (CAR)

Due Diligence in Small Business Acquisitions: A Cautionary Tale

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Abstract

When large corporations buy, sell or merge, the due diligence is a monstrous task, performed by accountants and attorneys, leaving no stone unturned. The valuation of the target company is performed using audited financial data and plenty of comparable market based values. But when small businesses are changing hands, the potential buyers are often counseled to obtain at least the past five years of tax returns, depreciation schedules and physical inventory records from the sellers, from which a fair value will be derived. The rule of thumb has been that tax returns will portray the most conservative view of the target company's results of operations, as owners are motivated to under-report earnings and over-report expenses to reduce taxable income. This article is a case study of an actual business purchase, subsequent forensic accounting and lawsuit, disguised for privacy, and demonstrates the risk in reliance on tax return information in the purchase of a small business. Further, practical strategies for additional due diligence that could have resulted in a stronger valuation are discussed.

Key Words: Small business acquisitions; due diligence; small business valuation

Introduction

When large corporations buy, sell or merge, the due diligence is a monstrous task, performed by accountants and attorneys, leaving no stone unturned. The valuation of the target company is performed using audited financial data and plenty of comparable market based values. But when small businesses are changing hands, the potential buyers are often counseled to obtain at least the past five years of tax returns, depreciation schedules and physical inventory records from the sellers, from which a fair value will be derived. Or, perhaps the business is listed with a business broker, who already had a valuation performed, probably using tax return data and information from the seller about owner perquisites embedded in the operating numbers.

Broadview Car Wash[1] was offered for sale and the Millers[2] were actively seeking a business to buy in the busy resort area. As the Millers contemplated their retirement, they realized they didn't want to be completely retired—they were hoping to find some kind of income-producing property that would allow them the freedom to enjoy a semi-retirement, but would offer a better return on their retirement funds than mutual funds. A car wash seemed like the best of both worlds, a cross between rental property and an active service business. The car wash could be left unattended for hours at a time, it required daily custodial and checking of the equipment in the bays.

[1] Fictitious name to protect privacy
[2] Fictitious name to protect privacy

Currency and coins needed to be removed and deposited, detergent and other solutions needed to be refilled in the bays, drives and bays needed to be hosed down—things that could easily be done by the owners, or they could occasionally be delegated to some hired help when the owners needed a longer break from the business.

1 The Millers' approach to buying the business

The Millers contacted the real estate agent representing the property to start the process of exploring the car wash as a viable option. The Broadview Car Wash was priced at $375,000, which included the land, building, paving and all equipment. The owners provided them with a cost summary of when they built the car wash and its actual cost was near the asking price. The Millers asked a local bank and the real estate agent for a recommendation for an appraiser.

1.1 The appraiser's approach to the car wash valuation

The appraisers asked the Millers to obtain tax returns and any financial statements available for the previous years of operation of the car wash, which were years 2009 through 2011. The previous owners had the car wash set up as an LLC (Limited liability Company) and reported the operations to the IRS via a Schedule C on their personal tax return. The appraisers also asked for the depreciation schedules. The Millers made the requests to the previous owners, who happily complied with their request, although they did not have financial statements to support their tax returns.

The appraisers used the Schedule C from Form 1040 of the Federal tax return for years 2010 and 2011, the most recent two years the car wash had operated. The appraisers were state certified real estate appraisers and they used a three pronged approach to the appraisal, which is typical in business and commercial real estate valuations. One approach was based on comparable sales, one was market based multiples of actual revenue and the final approach was capitalization of cash flows.

In their *comparable sales approach*, the appraisers looked at multiple other car wash sales and calculated the *price per bay* and applied an average of these sales prices, expressed as a price per bay, to the number of bays in Broadview. They attempted to find similar car washes based on volume given the revenue data provided by the owners. Using the comparable sales price per bay approach, the appraisers arrived at a value of $322,000 for the Broadview Car Wash.

In their second approach, the appraisers used a g*ross income multiplier* method, using the average of the national gross income multipliers for car wash sales transactions and the gross income multipliers in seven recent regional car wash sales transactions. Arriving at a gross income multiplier of 2.86, the appraisers applied the multiple to the gross revenue as taken from the tax returns and arrived at a value of $363,000.

Additionally, the appraisers employed a *capitalization of cash flow* approach using the 2010 results as reported, before depreciation, on the tax returns. They then created an annual reserve for replacement of equipment by assuming the equipment would have to be replaced in 15 years. They subtracted the reserve for replacement from the net income, resulting in a number approximating free cash flow from operations. They developed a capitalization rate by averaging a calculated expected investor return and the actual capitalization rates from actual car wash sales, using their sales prices and cash flow figures. They arrived at a capitalization rate of 11.68% resulting in an indicated value for the property of $535,000.

1.2 The Millers' purchase of the car wash

Based on the results of the appraisal, the Millers made an offer to the sellers, who countered, and they settled on a purchase price of $325,000. They made a down payment of $75,000 and borrowed $250,000 from the same bank that financed the original owner.

The Millers felt like this use for their savings was not risky for them because the car wash had been successful and nothing should change with the change in ownership. The name and the sign would remain the same, they were the only car wash in the area, they found no evidence that other car washes were planned for the area, the general public would see no change in the business. They were able to wrap up the transaction by the end of December, meaning they would start the new year with their new business.

2 The Millers' operating experience

The previous owners showed them around the property and demonstrated the work they do on a daily and weekly basis. They explained that people either put cash in the machines in the washing bays, or they swiped their credit card. One other source of income was a short list of fleet accounts that were billed each month. The fleet accounts' employees punched in a code on the keypads on the machines in the bays and then the owners billed the companies at the end of each month and the companies mailed checks to the owners. There were about a dozen companies on their fleet accounts list. Each time a customer enters the washing bays, they decide how long they want the car wash to last, making the car washes range from $3.00 minimum to about $8.00.

Three months into the Millers' tenure as car wash owners, they were very concerned about the revenue generated by the car wash. The expenses were running very true to what had been reported by the previous owners. However, the monthly revenue wasn't even close to what the monthly revenue had to be to match the annual amounts as reported on the tax returns provided by the previous owners. The Millers met with an attorney to discuss the possibility that they might have been misled someway by the previous owners. The attorney looked at their revenue and the annual revenue reported in the previous years. She was also very concerned, but advised the Millers to give it three more months to make sure there was not a seasonal component to the business, meaning the revenue could have picked up significantly in warmer weather. The Millers acknowledged that January, February and March could be the slowest months of the year, but emphasized to the attorney that the previous owners said that the revenue had very little fluctuation throughout the year. They did not believe that the remaining months of the year would bring the annual revenue up to anything even close to the revenue reported on the tax returns by the previous owners.

The Millers returned to the attorney's office to discuss their options and develop a strategy to determine if they were misled. The attorney explained that if the revenue was exaggerated by the previous owners, it was fraud. They needed to sue the previous owners to recover the difference between what the Millers paid for the car wash and what they should have paid for the business, given the actual revenue. The attorney explained that they must file a lawsuit and subpoena the bank account records so they could obtain the detail needed to figure out the true revenue. At that point, the attorney recommended utilizing a forensic accountant to ferret out the real revenue generated by the car wash.

2.1 The Forensic Accounting findings

The forensic accounting plan included an economic outlook review to determine that the appraisers and the Millers had been correct in their assumption that the car wash revenues would continue at similar levels as when operated by the sellers. The car wash industry outlook indicated that 2012 had growth in wash counts of 17% with average ticket growth of 2.6% (International 2013). Gross domestic product was up across 2012 both nationally and regionally (Real 2014). A well-known discount chain built a store next to the car wash after the Millers purchased the car wash, which they believed added to the traffic counts in the area. The Millers experienced very similar expense levels as the sellers had reported, except that they purposely increased spending on advertising and marketing.

Forensic accounting begins with developing an expectation of what a financial situation should look like. The economic outlook for the region and the car wash industry indicated that the Millers should have experienced similar revenues as was previously reported by the sellers.

The subpoena of the bank records for the car wash for years 2009 through 2011 allowed the forensic accountant (FA) the ability to gather evidence to support or refute the revenue numbers reported by the sellers across that time frame. Before looking at the deposits in the bank statements, the FA developed a profile of what the deposits were expected to look like:

--there should have been deposits of cash for nearly every banking day,

--there should have been many small credit cards charges for each time a bay was used. The expectation of the individual amounts fell between $3.00 and $8.00, depending on the length and features of the wash,

--and, lastly, there should have been a dozen or so checks deposited each month from the fleet accounts.

The invoices were reviewed and it appeared that most monthly or quarterly billings sent to the fleet accounts fell between $50 and $100.

Upon examination of the bank statements, it became quickly evident that there were many deposits made to the car wash checking account that were unrelated to the car wash operations. With assistance from the bank, deposit slips were retrieved and it was determined that checks related to oil and gas royalties, construction work performed by another entity owned by the sellers and transfers between accounts were included in the car wash checking account deposits.

Additionally, the total deposits to the car wash checking account did not support the gross revenue reported on the Schedule Cs for years 2009 through 2011. It was not clear how the gross revenues reported on the Schedule Cs were calculated as there was no additional income found on any spreadsheets or other records obtained from the sellers.

Table 1 demonstrates the findings of the FA in a year by year analysis, which resulted in an estimated overstatement of gross revenue for the car wash of $219,649 by the sellers. For comparison purposes, Table 1 shows the gross revenue experienced by the Millers in 2012, which is similar to the previous years, after adjusting out the unrelated income. The level of misreporting by the Sellers went beyond error, as the gross revenue reported on the Schedule Cs was significantly higher than total cash receipts supported by the bank statements.

2.2 Recasting the valuations

The FA was asked to use the estimated gross revenue calculated by examining the deposit detail to recast the gross income multiplier and cash flow based valuations as previously performed by the appraisers. In other words, if the Millers and the appraisers were originally supplied with accurate operating data for Broadview Car Wash, what should they have been willing to pay?

Table 2 demonstrates how the appraisers would have valued the car wash if they had the correct revenues to use in their Gross Income Multiplier methodology. With corrected information, they would have arrived at a value of $141,228 with the 2010 data as they originally used. Application of the same methodology to the 2011 data resulted in a value of $127,104.

Table 3 reports the results the FA found when trying to apply the capitalization of cash flow methodology as done by the original Appraisers. The capitalization of cash flows used by the Appraisers took the net income as shown on the tax return, reduced it by a reserve for replacement of equipment, converting it to cash flow, and capitalized it using 11.68% as the capitalization rate. As a part of the process of finding the correct cash flow, the FA also had to remove some disbursements that were made from the checking account that were not related to car wash operations. Using the appraisers' methodology with the revised gross revenue amounts and revised expense amounts, resulted in small operating incomes. Including the original reserve for replacement used by the appraisers indicated a negative cash flow. When a business operates at breakeven or loss, the value of the business is only the net assets, so to speak. Parsing out fair market values of all the asset categories would have been a completely different engagement for the appraisers. As shown in Table 3 for 2010, the car wash had very low operating income, $8,101, and negative cash flow when considering the replacement reserve. The same adjustments to the 2011 detail data were made, also resulting in a negative cash flow. The capitalization of cash flow methodology would not have worked for the appraisers as planned.

3 Lessons learned

3.1 Due diligence

As discussed earlier, the due diligence process in acquisitions of large companies is expected to be thorough and expensive. In the small business acquisition, buyers and appraisers often start with tax returns. These tax returns should be able to be reconciled with internal financial statements, if available. Logic would dictate that the tax return would present the most conservative view of a company—revenues would be deferred when possible, expenses would be accelerated.

One of the lessons to be learned from this case study is that business owners can be careless with their recordkeeping. That carelessness could come from an attitude of "income and expenses need to be included in the tax return somewhere", resulting in Schedule Cs and partnership and corporate tax returns that may not be reflective of the particular entities' operations. That carelessness becomes fraudulent when business owners supply a Schedule C to prospective buyers and allow them to believe it isolates the target acquisition's performance.

Prescriptively, multiple steps could have been taken to prevent the situation presented in this case study. Thinking like a forensic accountant, the Millers could have asked for detailed sales journals to support the gross revenue. If the record keeping was not thorough and the necessary detail not available, then the Millers could have requested the bank statements. Upon detailed review of the bank statement, the Millers would have found the gross revenue discrepancy.

Some simple estimates could have been done to evaluate the reasonableness of the gross revenue reported. It was determined that car washes ranged from $3 to $8, the simple average would be $5.50. In 2010, gross revenues were reported to be $126,847. Estimated car washes to generate $126,847 would be $126,847 / $5.50 = 23,063 in 2010. Which would be 23,063 / 365 = more than 63 car washes per day. Is that reasonable? Diligent buyers could stake out and observe the number of cars that patronize the car wash each day over multiple days to find out.

3.2 Conclusions

The case study of the acquisition of Broadview Car Wash is a cautionary tale about what happened when assumptions were made that tax returns portrayed an accurate picture of the operations of the car wash. As the case study outlines, extra time and expense in the due diligence phase of the acquisition process could have prevented the Millers from acquiring a business under false pretenses. This case study informs academia and practice—what we teach our students and how we conduct due diligence and small business valuations.

4 Epilogue

The Millers proceeded to sue the Sellers to be made whole by having the entire purchase price returned to them, which included actual damages of about $200,000, given that the calculation of the Gross Income Multiple method of valuation using the appraisers' methodology and the revised gross revenue number resulted in a value of $127,104 and they paid $325,000 for the car wash. Ironically, the Millers sold the car wash in 2014 for $125,000 and continue to try to settle their lawsuit with the Sellers.

References

Bureau of Economic Analysis, Real Gross Domestic Product, Quantity Indexes, May 29, 2014
International Carwash Association, Annual car wash industry report, February 19, 2013

Table 1

Forensic Accounting analysis of cash receipts for Broadview Car Wash

	a	b	c	d	e	f	g
Year and owner	Credit Card Receipts*	Cash and fleet check deposits*	Total of Car Wash income (a+b)	Add unrelated deposits*	Total checking account deposits (c-d)*	Total revenue reported on Schedule C	Income reported on Sched C of unknown source (f-e)
2009 (owned by Sellers)	6,064	34,326	40,390	31,024	71,414	118,092	46,678
2010 (owned by Sellers)	6,073	43,307	49,380	24,161	73,541	126,847	53,306
2011 (owned by Sellers)	7,630	36,812	44,442	32,661	77,103	108,922	31,819
Totals	19,767	114,445	134,212	87,846	222,058	353,861	131,803
Overstatement of gross revenues (g-d)			219,649				
For comparison: 2012 (owned by Millers)	10,078	34,015	44,093				

*amounts pulled from Broadview Car Wash checking account statements from the bank

Table 2

Recalculation of original appraisers' work with revised income numbers

Market based approach

	Credit Card Receipts*	Cash and fleet check deposits*	Total of Car Wash income (a+b)	Mult.	Indicated value
2010 Gross receipts	6,072.86	43,307.45	49,380.31	2.86	141,227.69
2011 Gross receipts	7,630.42	36,811.62	44,442.04	2.86	127,104.23

The original appraisers used a gross income multiplier of 2.86, which they derived by averaging the gross income multipliers that resulted from the sales prices and gross sales of seven other car wash sales transactions and the national average of Gross Income Multipliers for car wash transactions. The appraisers originally used the 2010 gross income to make the calculation. The Forensic Accountant used the estimated corrected gross sales calculated from the bank records for both 2010 and 2011 to recast the valuation using the gross income multiplier approach.

Table 3

Recalculation of original appraisers' work with revised income and expense numbers

Capitalization of Cash Flows approach

	2010	2011
2010 Total disbursements from bank	83,225.23	77,519.84
Less unrelated disbusements:		
Arvest	30,357.93	27,658.94
Double Check, other non business w/d	6,049.90	2,368.39
Wells Fargo	5,538.53	4,423.78
	41,946.36	34,451.11
Revised expenses	41,278.87	43,068.73
Revised gross sales	49,380.31	44,442.04
Revised expenses	41,278.87	43,068.73
Revised operating income	8,101.44	1,373.31
Less reserve for replacement	11,089.27	11,089.27
Revised cash flow	(2,987.83)	(9,715.96)

The capitalization of cash flows used by the appraisers took the net operating income, reduced it by a reserve for replacement of equipment, converting it to cash flow, and capitalized it using 11.68% as the capitalization rate. Using their methodology with the new gross sales amounts extracted from the bank deposits and revised expense amounts shown below, results in a small operating income. Including the original reserve for replacement used by the Appraisers indicates a negative cash flow. When a business operates at breakeven or loss, the value of the business is only the net assets, so to speak. In the case of a business like a car wash, the value of the business is more entangled with the value of the individual assets as the structures are not saleable for another use, like a building and land would be in other industries. As shown below, for 2010, the car wash has very low operating income, $8,101, and negative cash flow when considering the replacement reserve . The same adjustments to the 2011 detail data were made and the same valuation technique applied, resulting in a negative cash flow.