

Due Diligence for Acquiring a Company: Go Beyond the Balance Sheet

David Deeds (University of St. Thomas)

KEYWORDS: Mergers and Acquisitions, Entrepreneurship, entrepreneurship through acquisition.

Financial statements are the start, not the truth. This guide lays out what to scrutinize on-site—how work actually flows, who really runs the place, what breaks most often, and whether cash flow is durable once the owner's buffer disappears.

Third in a series

A former client once told me, with some relief, that the best deal he ever did was the one he did not close.

The business was a regional specialty distributor serving industrial customers across the upper Midwest. On the surface, it checked nearly every box for Entrepreneurship Through Acquisition (ETA). It had a long operating history, repeat customers, decent margins, and an owner in his late 60s who was clearly thinking about retirement. The financials were professionally prepared. Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA), at least as presented, looked solid. It was the kind of business that shows up again and again in searchers' inboxes and looks close enough to move quickly.

But something felt off.

Nothing was obviously wrong. Revenue was a little choppy, but not alarming. Customer concentration was present, but within what most brokers would call normal. When asked, the owner had reasonable explanations for every concern. Weather. Timing. A few customers who were slow to commit this year but would "be back."

Instead of pushing forward, my client slowed the process down. He asked for more time inside the business. He spent several days on site, sat in on operations meetings, and watched how orders actually

flowed through the system. He talked with the controller, then separately with a couple of long-tenured employees. He asked for customer histories rather than summary lists and tried to understand not just who bought, but why.

What emerged was not fraud or dysfunction. It was fragility.

A small number of customers generated a disproportionate share of profits, and those relationships were personal rather than institutional. Pricing discipline was uneven. Inventory practices smoothed earnings in good months and hid margin erosion in bad ones. Cash flow was real, but thinner and more volatile than the EBITDA suggested once the owner's involvement was stripped away.

He walked away. That decision likely saved him several years of frustration and a great deal of capital.

That story captures what due diligence actually is in ETA. It is not a box-checking exercise designed to confirm that a business exists. It is an attempt to understand how the business really functions, where it is resilient, and where it might break once ownership changes. It also involves asking yourself some tough questions. The answers will affect what you pay for the acquisition and, indeed, whether you walk away from it.

Documents Matter, But They Are Not the Business

Every evaluation begins with documents. At least three to five years of financial statements. Tax returns. A balance sheet that actually reconciles. You want to understand revenue trends, margins, and how cash moves through the business over time.

But documents are only the starting point. Small and mid-sized businesses are rarely designed to be legible

to outsiders. Accounting choices are shaped by tax minimization, habit, and convenience, not by investor transparency. In ETA, the goal at this stage is not valuation. It is coherence. Do the numbers make sense together? Does revenue growth align with headcount and capacity? Do margins behave logically as volume changes? Does EBITDA show up in cash, or does it disappear into working capital and capital expenditures?

If the numbers do not hang together, stop and slow down. Confusion early in diligence almost never resolves itself later.

General Questions to Ask Yourself:

1. *Where does the business actually make money, and where does it just stay busy?*
2. *Which customers drive the majority of profits, not just revenue?*
3. *What breaks most often, and how disruptive is it when it does?*
4. *What would surprise me negatively in the first six months of ownership?*

Normalizing Earnings Requires Discipline

Normalizing earnings is essential in ETA, but it is also where many buyers get themselves into trouble. The purpose of normalization is to understand what the business earns today under normal operating conditions. It is not an exercise in optimism or a way to justify a price you already want to pay.

Owner compensation is almost always the largest adjustment. In founder-owned businesses, pay often bears little resemblance to market reality. Some owners underpay themselves for years, inflating reported earnings. Others extract value through salary, perks, related-party rent, or family members on the payroll. The question is simple but uncomfortable: what would it cost to replace the owner with a competent professional, or to pay yourself fairly to do that job?

Discretionary expenses follow the same logic. Vehicles, travel, meals, and other perks should be adjusted only if you are confident they will not continue. One-time expenses deserve skepticism. If a “one-time” issue appears every few years, it is part of the business.

A useful rule of thumb is that normalization should make

the deal harder to justify, not easier. If your adjusted EBITDA is always moving in the direction you want, you are probably fooling yourself.

Questions to Ask Yourself:

1. *How closely does reported EBITDA translate into cash?*
2. *What expenses disappear with the current owner, and which ones realistically stay?*
3. *What “one-time” issues have shown up repeatedly over the past five years?*
4. *How sensitive is cash flow to small changes in volume, pricing, or cost?*

Cash Flow Quality Matters More Than Growth

Once earnings are normalized, attention should shift away from growth and toward quality. ETA favors predictability over upside. Recurring revenue. Long-tenured customers. Habitual or contractual buying behavior.

Ask where profits actually come from, not just revenue. Which customers matter most? Which products or services drive margin? Which relationships would hurt the most to lose? Cash flow that depends on a small number of fragile relationships is not cash flow you can count on.

Working capital deserves particular attention. Long receivable cycles, bloated inventory, or stretched payables often mask underlying weakness. These issues rarely cause problems on day one. They show up when you need cash the most.

Assets Can Support or Undermine Your Plan

Too many buyers focus entirely on the income statement and give insufficient attention to the assets that support the business. Real estate, plant, equipment, inventory, and any intellectual property should be evaluated not just for value, but for reliability.

Deferred maintenance is not an accounting issue. It is a future cash flow problem. Equipment that “usually works” but fails unpredictably introduces operational risk that does not show up in EBITDA. Inventory quality matters as much as quantity. Obsolete or slow-moving stock quietly drains cash and inflates earnings.

Intellectual property is less common in traditional ETA targets, but when it exists, ownership and transferability matter. Informal know-how residing in the owner's head is not an asset unless it can be systematized.

Assets that allow you to improve cash flow without major new investment are particularly valuable. Assets that require immediate reinvestment should change how you think about price and risk.

Questions to Ask Yourself:

1. *Which assets are critical to daily operations, and what happens when they fail?*
2. *How much deferred maintenance exists, even if it is not on the balance sheet?*
3. *Is inventory an asset or a liability at current levels?*
4. *What knowledge is institutionalized, and what lives only in people's heads?*

Spend Time in the Business

No spreadsheet will tell you how a business actually runs.

Spend time on site. Watch how work flows. Notice where people wait, where they rush, and where they improvise. Pay attention to how decisions get made and who actually makes them. In many businesses, the owner functions as a buffer, absorbing problems personally before they become visible. When that buffer disappears, the real operating system is exposed.

This is where you begin to assess whether improvement is realistic or whether dysfunction is structural.

What You Don't Know Will Hurt You

One of the most common mistakes in ETA is treating missing information as a temporary inconvenience rather than as information itself. Remember every cost you underestimate, every problem that impacts customer retention or cash flow that you miss, and every piece of equipment or plant that needs unexpected repair or replacement comes out of your bottom line.

If you cannot speak with customers, there is a reason. If you are not allowed to talk with key employees, there is a reason. If access to the facility is limited, or if asset inspections are delayed or discouraged, there is a reason. It may not always be malicious, but it is never neutral.

Opacity Increases Risk

In small and mid-sized businesses, transparency is not a default setting. But a seller who wants full value should be willing to support reasonable diligence. When access is constrained, you should assume there is something you are not being shown and price that uncertainty explicitly.

That means increasing your risk assessment and reducing your offer -- not as a negotiating tactic, but as a rational response to incomplete information. If you cannot validate customer loyalty, you must assume it is weaker than reported. If you cannot assess asset condition, you must assume higher capital needs. If you cannot understand how work actually gets done, you must assume execution risk is higher.

The worst mistake is pretending uncertainty does not exist. Unknowns do not disappear because they are inconvenient. They surface later, usually after closing, when your leverage is gone.

Good ETA buyers are disciplined about this. They do not argue about whether access should have been granted. They adjust price and structure to reflect the risk they are being asked to take on, or walk away.

Questions to Ask Yourself:

1. *Where has access been limited, delayed, or discouraged?*
2. *Which questions made the seller uncomfortable?*
3. *If I cannot speak with customers, employees, or inspect assets closely, what risk am I being asked to absorb?*

Listen Carefully to Owners, Employees, and Customers

Owner conversations are among the most valuable and most misleading parts of diligence. Good owners can explain their businesses clearly, including where money is made and where it is lost. Vague answers are not always a sign of dishonesty, but they are often a sign of blind spots.

When possible, talk with key employees. They know how work actually gets done, where systems fail, and what customers complain about. Pay attention to morale and turnover. A business with mediocre systems and

committed employees is often fixable. A business with good margins and deep cynicism is not.

Customers, when accessible, reveal the true state of the brand. Ask why they buy, what frustrates them, and what would make them leave. Loyalty tied to consistent execution is transferable. Loyalty tied to the owner personally is harder to replace.

Questions to Ask Yourself About Employees

1. *Who actually runs the business day to day?*
2. *Who would I least like to lose in the first year, and why?*
3. *Do employees understand how their work affects performance, or do they just execute tasks?*
4. *Is the culture tired but intact, or quietly cynical?*

About Customers and the Brand

1. *Why do customers buy from this business instead of alternatives?*
2. *Are customers loyal to the business or to the owner personally?*
3. *Which customers have left recently, and why?*
4. *Has the brand eroded quietly due to execution issues, or is it fundamentally sound?*

The Improvement Plan Comes Before the Offer

By the time you are considering an offer, you should already have a written improvement plan. Not a pitch deck, but a working document. What will you change in the first 90 days? What will you leave alone? Which risks worry you most?

Most importantly, does the plan reflect your actual capabilities? ETA is not the time to reinvent yourself. It is a time to apply strengths deliberately.

Questions to Ask Yourself:

1. *What will I change immediately, and what will I leave alone?*
2. *Which problems am I well equipped to fix, and which am I not?*
3. *If this business underperforms, will I know why quickly?*

Judgment Is the Final Filter

No amount of diligence eliminates uncertainty. At some point, the question becomes whether you understand the business well enough to live with its risks.

Walking away from a deal is not failure. It is judgment.

In ETA, the work you do before you buy the business often matters more than anything you do after. The quality of that work sets the ceiling on what follows.

LEARN MORE ABOUT ENTREPRENEURSHIP THROUGH ACQUISITION

[How to Choose the Right Company to Acquire](https://eiexchange.com/content/how-to-choose-the-right-company-to-acquire)
(<https://eiexchange.com/content/how-to-choose-the-right-company-to-acquire>)

[Why Buying a Business is Smarter Than Starting One](https://eiexchange.com/content/why-buying-a-business-is-smarter-than-starting-one)
(<https://eiexchange.com/content/why-buying-a-business-is-smarter-than-starting-one>)

[Avoid Legal Minefields When Acquiring Another Company](https://eiexchange.com/content/avoid-legal-minefields-when-acquiring-another-company)
(<https://eiexchange.com/content/avoid-legal-minefields-when-acquiring-another-company>)

[Buying a Business Means Inheriting its Stakeholders](https://eiexchange.com/content/buying-a-business-means-inheriting-its-stakeholders)
(<https://eiexchange.com/content/buying-a-business-means-inheriting-its-stakeholders>)

[If You Don't Price Risk, You'll Pay for it Later](https://eiexchange.com/content/if-you-dont-price-risk-youll-pay-for-it-later)
(<https://eiexchange.com/content/if-you-dont-price-risk-youll-pay-for-it-later>)