TRANSACTION ACCOUNTING

Pre-Acquisition Accounting Due Diligence Checklist

The accounting questions to answer before you close a deal. Surprises on the opening balance sheet are always more expensive than diligence.

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Why This Matters

Financial due diligence tells you what the business earned. Accounting diligence tells you whether those earnings were recorded correctly — and what liabilities, restatement risk, and integration complexity you are actually acquiring. Most post-close surprises are not business problems. They are accounting problems that were visible in the books before close.

> *Every opening balance sheet adjustment you could not anticipate is one you did not look for. This checklist covers the areas where seller books most commonly misrepresent the economic reality of the business.*

1. Books and Records Quality

- ■ Audited or reviewed financial statements for the past three years obtained and reviewed
- ■ If no audit or review exists: understand why and assess whether the books are reliable
- ■ Trial balance detail obtained and agreed to the financial statements
- ■ Chart of accounts reviewed — is it structured for accrual accounting or effectively cash basis?
- ■ Accounting policies documented and assessed for consistency with GAAP
- ■ Preparer identified: internal staff, bookkeeper, or external CPA firm?
- ■ General ledger access obtained for detail testing on key accounts

2. Revenue Recognition and Quality of Earnings

- ■ Revenue recognition policy identified and assessed against ASC 606
- ■ Deferred revenue schedule obtained — tied to specific contracts, not estimated

- ■ Unbilled receivables identified and underlying contracts reviewed
- ■ Variable consideration elements identified: discounts, rebates, refunds, contingencies
- ■ Contract modifications in the trailing 12 months reviewed
- ■ Revenue concentration: top 10 customers, any customer over 10% of total revenue
- ■ Revenue cut-off tested: no material pull-forward from subsequent periods
- ■ Any side agreements, custom payment terms, or informal arrangements identified

3. Accounts Receivable and Collectibility

- ■ AR aging obtained — full detail, not a one-line summary
- ■ Allowance for doubtful accounts methodology reviewed for adequacy
- ■ Invoices over 90 days reviewed individually — collectibility assessed
- ■ Credit memos issued in the 90 days before and after period end reviewed
- ■ Customer payment terms reviewed for extended terms that inflate the AR balance
- ■ Any AR pledged as collateral identified
- ■ Intercompany AR identified and assessed

4. Liabilities and Accruals

- ■ Accrued liabilities schedule reviewed in detail — not just the total balance
- ■ Payroll taxes confirmed current — back taxes are a common and expensive finding
- ■ Sales tax obligations reviewed — nexus analysis if target has multi-state operations
- ■ Warranty obligations estimated if the business sells products with warranty terms
- ■ Contingent liabilities reviewed with counsel: litigation, regulatory matters, claims
- ■ Lease obligations identified and assessed under ASC 842
- ■ Deferred revenue completeness tested against signed contracts on hand
- ■ Any undisclosed debt, guarantees, or off-balance-sheet obligations identified

5. Fixed Assets

- ■ Fixed asset schedule with asset detail, acquisition dates, and depreciation method
- ■ Useful lives and depreciation methods assessed for reasonableness
- ■ Capital vs. expense treatment reviewed for recent large expenditures
- ■ Fully depreciated assets still in service identified — these need fair value in purchase accounting
- ■ Real property leases reviewed and right-of-use asset calculations verified

- ■ Any assets pledged as collateral identified

6. Opening Balance Sheet Risk Areas

- ■ Working capital definition agreed with seller before LOI if possible
- ■ Intangible assets: identify assets not on the balance sheet (customer lists, IP, trade names)
- ■ Inventory: valuation method, obsolescence reserve, and recency of physical count
- ■ Deferred tax assets and liabilities identified and assessed for recoverability
- ■ Any earn-out provisions reviewed for accounting triggers and fair value measurement
- ■ Pension or retirement obligations identified and current actuary report obtained

Red Flags That Change the Deal

These findings do not necessarily kill a deal — but they change price, structure, escrow requirements, or post-close obligations. Find them before you sign.

- ■ No formal accounting policies — revenue and expense driven by cash, not accrual
- ■ Material reconciling items carried forward more than 90 days without resolution
- ■ Revenue growth in the final quarter driven by unusual terms, discounts, or pull-forward
- ■ Deferred revenue balance lower than the contract backlog would suggest
- ■ Payroll tax or sales tax obligations not current
- ■ Related party transactions not at arm's length or not disclosed
- ■ Books maintained by a bookkeeper with no CPA oversight
- ■ Significant management time required to produce financials for diligence

Acquiring a company? Get the accounting right before close.

VAO CPA provides pre-acquisition accounting diligence, opening balance sheet support, and purchase accounting under ASC 805 for lower middle market transactions.

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