

Buying a business invites two storylines to run in parallel. The seller's narrative, usually tidy and optimistic, and the ledger's quieter voice, which sometimes hums and sometimes hisses. Due diligence is your chance to listen to the latter without distractions. Get it right and you protect your purchase price, your financing, and your first year of operating runway. Get it wrong and you inherit problems you did not bargain for, often with interest.

I have sat on both sides of the table, from carve-outs to owner-operator transitions. The patterns repeat. Most irregularities aren't Hollywood fraud. They're shortcuts, poor controls, timing games, or incentives gone sideways. The work is to separate noise from signal and quantify what the signal means for normalized earnings and actual cash.

Why the numbers on the surface can mislead

Financial statements report performance according to rules and judgment. Those rules, whether GAAP, IFRS, or tax-basis, leave room for selection and timing decisions. Judgment gets exercised at revenue cutoffs, estimates for reserves, capitalization vs. expensing, and consolidation boundaries. In owner-managed companies, financials also absorb lifestyle spending, tax planning, and aggressive timing meant to polish a sale. None of this automatically means malfeasance. But every gray area creates a place where reality can drift from representation.

In Business Acquisition Training, we teach that due diligence is not validation, it is recalibration. You are not trying to see if the seller's EBITDA exists in theory. You are trying to rebuild the business's earning power under your ownership, with realistic working capital and capex needs, at a risk level your lender and investors accept. Accounting irregularities matter because they distort that rebuild.

Start at the edges where incentives are strongest

Irregularities cluster where compensation or the sale narrative puts pressure on a metric. If management bonuses ride on revenue or gross margin, inspect the recognition policy and margins by product line. If the sale is pitched on "asset light" operations, examine capitalization policies and leases. If the pitch hinges <https://getcouponsworld.com/site-coupons/thedealmakersacademy.com> on sticky recurring revenue, verify renewal rates, churn cohorts, and deferred revenue. This is more efficient than combing every line with equal intensity.

A real example: a service business boasted 25 percent EBITDA margins with "deferred revenue backing growth." The roll-forward showed a rising deferred revenue balance, but contract reviews revealed half the contracts had termination for convenience with refunds pro-rated by unused hours. That liability was not only real, it was likely to reverse in cash during a downturn. The optimistic margin shrank once refunds and service delivery were timed correctly.

Rebuild revenue from the ground up

Revenue tops nearly every seller's pitch deck. If the top line is off by even a few percentage points, the valuation can wobble dramatically. Do not rely solely on the income statement. Trace revenue to source documents and cash:

- Pull a sample of invoices around key cutoff dates at quarter and year end. Tie them to signed contracts, delivery notes, and shipping logs. Watch for bill-and-hold, channel stuffing, and early recognition.
- Reconcile recorded revenue by customer against bank deposits. If lockbox or merchant processing is used, get processor statements and tie them to the general ledger. Small timing gaps are normal; chronic gaps are not.
- Check credit memos issued in the month after period end. An unusual spike suggests revenue pulled forward and reversed later.
- In subscription or maintenance models, build a cohort analysis from raw customer data. Align invoicing, term length, churn, and upgrades. The general ledger summary rarely exposes churn-driven decay masked by new sales.

Common tells include round-dollar invoices clustered at month-end with vague descriptions, manual journal entries crediting revenue without an invoice trail, and large "other revenue" buckets with inconsistent content.

Dissect receivables with skepticism

Accounts receivable can carry a lot of hope. If DSO is rising while sales are flat, someone is forcing revenue or losing collection discipline. Get the aging detail at multiple dates, then test reality:

- Identify related-party or distributor balances. A struggling channel partner can sit on aging debt to help inflate revenue.
- Inspect the allowance methodology. Many smaller businesses set reserves as a rough percentage, then forget to update. Test historical write-offs to see if the reserve would have covered losses.
- Review disputes and short-pays. They point to service quality issues that do not show up in P&L until churn hits.

I still remember an industrial parts company that “sold” a quarter-end push to a dealer network on 60-day terms, then quietly offered 150-day extensions. The P&L looked great, cash flow did not. When we aged the AR by original due date instead of rolling the terms, half the growth vanished.

Inventory that never ships is a fiction

Product companies hide sins in inventory. Slow-moving stock props up gross margin if standard costs are stale. Overproduction can absorb overhead temporarily. The diagnostics are unforgiving but straightforward.

Get an item-level roll-forward: beginning quantity and value, plus purchases and production, less sales and scrap, to ending balances. Then:

- Tie perpetual records to physical counts and test-count a sample yourself if possible.
- Review standard cost updates and variance analysis. If purchase price variances stay positive while vendors have raised prices, standards lag.
- Age inventory in units, not just dollars, and flag any item with no movement for two inventory cycles.
- Ask for margin by SKU and by customer. Unprofitable SKUs often hide under blended margins.

In one diligence, we found an “obsolete inventory reserve” set at a flat 2 percent for years, regardless of line expansion. Once we re-aged the inventory and recognized actual obsolescence at 12 to 15 percent for two categories, EBITDA dropped by nearly 7 percent. That changed both the price and the covenants we were willing to accept.

Expenses shift easily when controls are loose

Expenses deserve as much attention as revenue. Owner-operators often blend personal and business spending, and some line items swing with classification decisions.

Pay attention to:

- Related-party transactions: above-market rents paid to entities owned by the seller, management fees without substance, and shared services without clear cost allocation. Benchmark rent and services to market rates.
- Payroll composition: off-payroll labor, contractors who are functionally employees, or deferred bonuses. Review payroll tax filings to match headcount and compensation. Inspect accruals for vacation, commissions, and bonuses.
- Repairs vs. capitalization: aggressive capitalization can inflate EBITDA in the short run. Walk through fixed asset additions, descriptions, and useful life assumptions. If carpet cleaning is on the balance sheet, you have a problem.
- Marketing and rebates: cooperative advertising can get netted against revenue or misclassified, changing margins. Trace vendor rebates to see if they are accrued on sales or receipts, and whether they are recurring.

Expense smoothing frequently appears as quarter-end accrual reversals. Run a trend of accrued liabilities and prepaid expenses. If they expand and contract in rhythm with margin targets, dig deeper.

Follow the cash, not just the accruals

The cash flow statement, when properly built, is a lie detector. Compare EBITDA to operating cash flow before working capital. Over multiple periods they should somewhat rhyme. Wide and persistent gaps call for an explanation. Then unpack working capital:

- Days sales outstanding rising at the same time days inventory on hand expands usually means softness that someone is trying to overlook.
- Large swings in accrued expenses near period end often roll back in the next period. Tie them to actual payments or reversals.
- Tax payments that do not align with taxable income can indicate aggressive timing or NOL use that will not repeat.

You should also map non-operating cash flows. Related-party loans, unexplained advances, and distributions can hide within equity and debt movements. In a sale, confirm that any such balances will be settled or excluded at close, and model the tax and cash effects.

The working capital trap in purchase agreements

Even buyers who diligently scrub EBITDA get trapped in the working capital peg. The typical stock purchase agreement sets a target normalized net working capital, with a post-close true-up. If the financial statements carry understates in payables or overstates in receivables and inventory, you will write a check post-close even after negotiating the price down for EBITDA risks.

Solve this by rebuilding working capital from transaction-level data for at least twelve months, preferably twenty-four. Normalize for seasonality, growth, and one-time events. Define what counts as working capital in the agreement, exclude clearly non-operating items, and specify accounting policies in the SPA so the true-up uses the same yardstick.

Tax-basis statements require translation

Many small businesses run tax-basis financials. Those can be perfectly fine, but they reflect choices aimed at minimizing tax rather than portraying operating performance. Cost segregation studies, accelerated depreciation, cash-basis revenue recognition, and expensing of items you would capitalize under GAAP can all distort comparability.

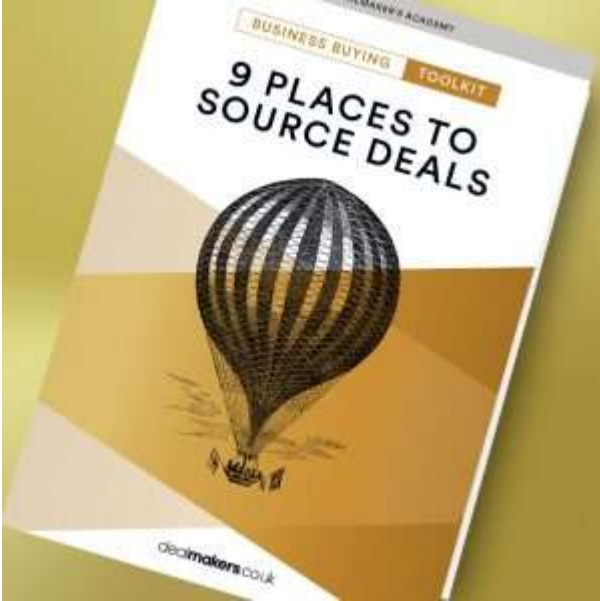
Perform a pro forma conversion of key areas to your reporting basis. Restate revenue recognition if necessary, rebuild depreciation using remaining useful lives, and reclassify owner perks and non-operating items. The point is not to accuse, it is to harmonize.

Related parties and off-balance exposures

Hidden commitments often sit just outside the balance sheet. Think of:

- Personal guarantees supporting bank lines or vendor credit that the seller expects you to assume.
- Leases embedded in service contracts or “take-or-pay” supply agreements that do not appear as liabilities.
- Side letters granting customers special rights, refunds, or discounts that conflict with standardized contracts.
- Litigation threatened but not filed, or warranty claims smoothed over with credits rather than reserves.

Request a comprehensive list of commitments and contingencies, then triangulate it with legal counsel’s letter, board minutes if they exist, email searches for “side letter” and “guarantee,” and a vendor and customer confirmation process that asks about unusual terms explicitly.



Systems and controls telegraph reliability

The cleanliness of the numbers often mirrors the finance function’s maturity. A single-person accounting team that closes in three days without reconciliations is not heroic, it is a risk. Observe how the [Buy a Business](#) books get made:

- Bank reconciliations: Are they monthly and reviewed? Ask for the last twelve months and look for aged reconciling items.
- Journal entries: How many are manual, who approves them, and are they supported? A high count late in the period is a tell.
- Access controls: Who can create vendors and change terms? Vendor self-creation with no approval is an invitation to fraud or error.
- Revenue and inventory modules: Are subledgers reconciled to the general ledger consistently?

If controls are weak, dial up your sample sizes and rely more on external confirmations and raw system extracts than on management-prepared summaries.

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Stress-test margin stories with basic math

Grand narratives dissolve under unit economics. Pick top products or services and build a simple model: price, direct inputs, labor hours, overhead allocation, and expected waste. Compare it to actual gross margin by SKU or service line. When the story requires perfect utilization or zero scrap to work, you have not found a bargain, you have found implausible accounting.

I once reviewed a specialty manufacturer claiming 48 percent gross margin after a process change. The bill of materials, vendor quotes, and machine cycle times could not produce above 34 to 36 percent even under ideal conditions. The bridge from 36 to 48 lived in “production variances” capitalized into inventory during a growth spurt. When demand normalized, those variances had to unwind, and margins fell back to earth.

When the calendar becomes a weapon

Cutoff tricks are timeless. If a business consistently spikes sales the last week of the quarter, that is a red flag, not a badge of hustle. Examine sales and shipping logs by day for the last six weeks of each quarter across two years. If you see volume pulled

forward, look for credits in the following month.

Similarly, expense deferral shows up as “prepaids” and “accrued expenses” that swing in a suspiciously symmetric fashion. Plot these balances as a percentage of sales over eight quarters. Flat or seasonally consistent patterns are comforting. Sharp end-period movements deserve tests of underlying invoices, service periods, and payments.

Data-driven confirmations beat narratives

When stakes are high, reperform key numbers outside the seller’s system where feasible:

- Build your own AR aging from invoice-level data and due dates, not from the seller’s aging report.
- Recalculate inventory costing on a sample using purchase orders and receiving records instead of relying on standard costs.
- Run a duplicate vendor and bank account scan from raw AP vendor master files.
- Use third-party data for reasonableness: payroll tax returns to confirm payroll expense, sales tax returns to test revenue by jurisdiction, shipping records to validate volume.

None of this is adversarial. It is the kind of neutral measurement that preserves relationships by anchoring debate in facts.

Signals from the outside: banks, auditors, and taxes

External stakeholders leave footprints. Ask for bank compliance certificates, borrowing base certificates, and auditor or reviewer management letters. If covenants were tight, what adjustments did lenders allow? If a CPA firm issued a review rather than a compilation, read the inquiries and management responses. Management letters that mention reconciliations, inventory counts, or revenue recognition should guide your test plan.

Tax filings tell their own story. Compare taxable income to book income and reconcile differences. Large and recurring Schedule M adjustments for reserves or depreciation can be fine, but they also indicate where estimates and policies drive gaps you need to normalize.

Negotiation leverage from quantified findings

Spotting irregularities matters less than quantifying their impact. Lenders and investment committees react to numbers and certainty, not general unease. Convert findings into EBITDA, working capital, and capex effects over a reasonable horizon.

For instance, if you identify that 8 percent of AR older than 120 days is uncollectible based on history and customer health, you can propose an adjustment to working capital and potentially an escrow. If revenue recognition pulled forward two weeks of shipments worth 3 percent of annual sales, you can rebase revenue timing, adjust trailing twelve months, and revisit the earnout mechanics.

Structure follows insight. You can push price, tighten reps and warranties, carve out liabilities, or use holdbacks. If issues are material but fixable, an earnout tied to cash revenue or gross profit rather than billed revenue can bridge differences while protecting downside.

How much irregularity is too much?

Every target has flaws. The question is whether the issues are explainable, fixable, and priced. Timing differences that reverse, owner add-backs that are well documented, and controls you can strengthen quickly are manageable. Fabricated revenue, fictitious vendors, or intentional concealment merit a walk-away or, at minimum, a complete reset with full indemnities you can enforce.

A useful rule of thumb from buying a business at the lower middle market: if your normalized EBITDA bridge requires more than three or four major categories of adjustment, or if more than 20 percent of stated EBITDA comes from judgment-sensitive items you cannot verify, you do not understand the earnings well enough to close at the proposed valuation.

Practical cadence for diligence without boiling the ocean

You can spot most irregularities with a thoughtful sequence rather than endless requests. Start with bank statements, AR and AP agings, trial balance, and twelve to twenty-four months of monthly financials. Add the sales and inventory subledgers, tax returns, and key contracts. Then expand based on what the first pass reveals.

Here is a lean workflow that has served well in fast-moving deals:

- Reconcile cash: tie book cash to bank statements and chase reconciling items older than 30 days.
- Validate revenue: perform cutoff tests, cash tie-outs on a sample, and churn analysis where applicable.
- Test working capital: age AR and inventory, confirm reserves, and rebuild a normalized peg.
- Scrub expenses: identify owner-related and one-time items, confirm payroll with tax filings, and scan vendor masters.
- Align with structure: translate findings into price, covenants, and SPA language, especially around accounting policies and true-ups.

Keep management in the loop with calm, specific requests. Surprises at the eleventh hour damage trust and reduce your leverage.

The human factor behind the ledger

Numbers reflect behavior. A seller who handles hard questions directly, produces raw data without stalling, and welcomes cross-checks tends to run a cleaner shop. Evasiveness, shifting explanations, and heavily curated exports suggest you are being shown a set rather than a system. Culture carries forward after closing. If you buy a team that prizes surface optics over substance, you will spend your first year retraining and cleaning rather than growing.

This is why disciplined buyers fold finance diligence into broader Buying a Business judgment. Reference calls with customers about billing accuracy and credit memo behavior, vendor calls about payment timeliness, and employee interviews about month-end practices all seed context. Consistency across these threads is its own assurance.

When to bring in specialists

Some situations call for extra hands. Revenue recognition in software with multiple performance obligations, complex cost accounting in process industries, or carve-outs from larger entities with shared systems can overwhelm a lean buy-side team. Forensic accountants are not only for fraud. They excel at reconstructing histories from incomplete data and spotting patterns normal diligence misses.

Budget for this early. A modest spend on targeted deep dives often pays for itself in price adjustments or in confidence that lets you move decisively when other buyers hesitate.

Staying ready rather than getting ready

The best diligence runs on muscle memory. If you plan to be active in acquisitions, build a standardized request list, a model template for EBITDA and working capital bridges, and a short playbook of tests you can run in the first week. Train your team to spot the usual suspects and to translate findings into deal terms. You will miss less and negotiate better.

Accounting irregularities are not a curiosity tucked in the footnotes. They are the difference between a business that funds its own growth and one that starves the day the music stops. Listen closely to the ledger. Ask the questions the numbers invite. Then price, structure, and plan as if you will own the problems you do not find. Because you will.