



# TRANSACTIONAL INSIGHTS

Quality of Earnings and Beyond





# PREFACE

A well-prepared quality of earnings report supports the critical investment decisions made by lenders and acquirers. But additional considerations outside of quality of earnings can impact the value of an asset and influence the choice to close a deal. Expanding your decision-making tools beyond quality of earnings can further increase the transparency of the deal, expose potential risks, and uncover added value in a company that transcends its balance sheet.

*Transactional Insights—Quality of Earnings and Beyond* is a collection of articles from a multidisciplinary team of CohnReznick professionals. Our goal is to offer a variety of insights, ideas, and actions to consider as you make your way through the transaction process.

If you have questions, comments, or wish to discuss the subject matter presented, contact the CohnReznick professional referenced at the end of each article.

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# HOW ACQUIRERS AND LENDERS CAN USE EBITDA TO EVALUATE A COMPANY'S PERFORMANCE

In evaluating a company's performance, EBITDA is capital neutral. It is not affected by decisions related to how a company finances its balance sheet (i.e., debt, equity, or a mix of both) and it excludes certain non-cash expenses like depreciation and amortization.

While some view EBITDA as a proxy for operating cash flow, earnings and cash flow are calculated using two completely different accounting methods—i.e., the accrual vs. cash basis of accounting. Since EBITDA is based on accrual figures, it does not accurately represent the cash the company has collected. So, to value a business, acquirers and lenders should consider looking beyond EBITDA, and analyze free cash flow.

## Adjusted EBITDA or Quality of Earnings

Adjustments to EBITDA are made to “strip out” non-recurring and/or non-operating transactions to reflect the annual “run-rate” or normalized earnings of the company. These adjustments fall into two broad categories: (i) fact-based adjustments and (ii) pro forma adjustments.

Fact-based adjustments relate to items that are non-recurring and unusual in nature and typically include:

**GAAP adjustments:** Adjustments to reflect the company's records consistent with Generally Accepted Accounting Principles. Examples include cash to accrual, interim period vs. year end, and capitalization vs. expensing of cost. Cash to accrual adjustments include recording pre-paid expenses, deposits, payroll accruals, etc.

- Interim period vs. year-end adjustments include:
  - (i) inventory true-up for physical count and obsolescence; (ii) bonus accruals; (iii) analysis of sales returns, warranty and self-insured liabilities; and (iv) allowance for doubtful accounts.
- Typical examples relating to the capitalization vs. expensing of costs include: (i) expensing direct labor and overhead costs to operations rather than capitalizing them as part of inventory; and (ii) expensing repairs and maintenance that meet the criteria for capitalization.

**Owner's compensation and benefits, including discretionary expenses:** Owner salaries are often not market relative to a salary that would be paid to a third-party manager. Extraordinary owner salaries need to be added back to calculate normalized EBITDA. Further, it is not uncommon wherein the company compensates

family members who do not play a role in the business, expensive family vacations, and other discretionary purchases.

**Rent of facilities:** Most companies do not own the facilities they occupy, and may rent them from a holding company owned by a shareholder. The rent is often arbitrarily set. EBITDA would be adjusted to ensure market-related rent.

**Management fee:** Portfolio companies are usually charged a management fee by private equity owners. This is typically added back to EBITDA assuming the private equity owner does not perform functions that are necessary to operate the day-to-day business.

**Unrealized gains or losses:** This represents gains or losses that do not have actual cash flow impact and have been recognized in the P&L through journal entries. Examples include unrealized foreign exchange gains or losses from the translation of foreign currency-denominated assets and liabilities and unrealized gain or losses from investments.

**One-time expenses, such as settlements and claim recoveries, transaction fees, and severance, including:**

- Lawsuits, arbitrations, insurance claims, and one-time disputes are considered extraordinary items; hence, an EBITDA addback.
- Legal fees associated with the transaction and legal disputes.
- Restructuring charges, including severance, are considered non-recurring items.



## Pro Forma Adjustments

Pro forma adjustments relate to events that are normalized to reflect the annual “run-rate” EBITDA impact. Typical adjustments include:

**Start-up costs:** If a new business line has been launched during the period being analyzed, the associated start-up costs should be added back to EBITDA. This is because the costs are non-recurring, and will not continue going forward. However, if the company is in the growth stage and expects to open new stores or locations year-on-year, the opening costs can be considered as recurring expenses.

**Lost customers or new customers:** Significant lost customers or new customers can be presented as pro forma adjustments as if such loss or gain took place at the beginning of the period being analyzed. However, if the company operates in an industry where its customer base is highly volatile, and gaining or losing customers are recurring events, these can be considered as ordinary course.

**Discontinued products and discontinued operations:** EBITDA attributed to the discontinued product, discontinued operations, and store closures can be removed from EBITDA to reflect the normalized earnings going forward.

**Run-rate adjustments** for acquisitions or divestitures of businesses.

**Run-rate adjustments for natural disaster**, for example, recently hurricanes have impacted operations across the country.

**Run rate adjustments for employee turnover**, such as a gap between someone leaving and a replacement hire.

**Stand-alone costs:** In a “carve-out” transaction where the company is a division of a larger entity, post transaction, the business will require an accounting department and other back-office functions.

**Synergies:** As a product of a merger or combination of two entities, synergies may result due to increased purchasing power, cross-selling, payroll cost savings, etc. ■



EBITDA adjustments, depending on the specific situation, will be assessed in the context of the business. There are no hard and steadfast rules. Interpreting the impact is an art that comes with experience and exposure to different industries and circumstances.



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# ELIMINATING ORGANIZATIONAL CHAOS:

## The First Step Is Admitting You Have a Problem

When you think about chaos, you typically think worst-case scenario—a company’s death spiral. But chaos is more common than you might realize. It’s what happens when a company—any company—operates in a way that’s siloed and disorganized. People, process, and technology are disconnected. Individuals “do their own thing.” Chaos occurs when there is no time to follow the rules and when no rules are established.

Chaos within an organization is not a death sentence. In fact, it is often a sign that a company is growing quickly or that the company is evolving. But that doesn’t mean it’s a good thing. In all cases, organizational chaos results in inefficiencies and less than optimal performance. Moreover, organizational chaos often results in significant lost productivity, frustration, and poor morale.

Many companies suffering from organizational chaos think they’re operating in a highly structured and controlled environment. How can that be? Here’s how.

In any organization, there is a line that delineates structured work from unstructured work. Above the line, there is a foundation of systems, such as ERP applications, that companies believe are managing, tracking, and controlling transactions across the organization in an efficient manner. This is the structured work.

Below the line is the unstructured work. Multiple, disparate processes exist where information is shuffled from department to department. Employees use email as a proxy workflow tool. There is a heavy reliance on Excel to augment or perform data gathering, reporting, and data analytics. Key files are stored on a local desktop rather than in a collaborative centralized repository. Information is collected on paper or hidden in one-off word docs instead of being captured in a central location.

This lack of structure often leads to errors and inaccurate financial information that can impact the achievement of strategic objectives, financial performance and entity value.

These are the symptoms of organizational chaos. And the reality is that many companies spend most of their time there, ignoring the symptoms or feeling too locked into the chaos to find a way out.

How pervasive is organizational chaos? A recent CohnReznick survey of more than 200 senior-level executives in various industries found that 91.9% of respondents identified chaos within their organization. Nearly half reported that chaos is pervasive across their organization. Unfortunately, only 27% have plans in place to fix it.

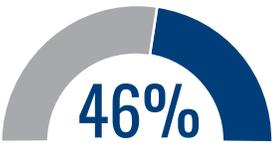
For organizations looking to become more efficient, increase value, or sell to an acquirer, chaos is counterproductive, to say the least. It adds cost, complexity, and inefficiency to the organization’s operating model, ultimately leading to operational, financial, and security risks.

The elimination of chaos must start at the top, and it cannot be viewed through a narrow lens. Senior managers must be fully engaged and willing to enforce difficult decisions to effect real change. People, process, and technology must all be on the table since, in today’s world, these are all intertwined.

And organizations must be patient. They can’t clean up chaos all at once. They must start with small steps. The key is to establish quick wins that demonstrate real value to the organization and to individual employees. Those first few wins should not simply be measured in dollar signs. Rather, they should have far-reaching impact and touch everyone within the organization. Then, they have a better chance of being embraced and repeated. That is how change takes root and grows.



Say employees spend most of their time fighting fires



Report pervasive chaos across their organization



Have no plans to eliminate chaos



Attribute time constraints for continued state of chaos



Chaos is from the Greek *khaos*, which means chasm or void. The key to minimizing it is to connect people, data, systems and information—all the time and everywhere. Here are some areas where chaos is common and how to address it.

**Communication:** Many process-related issues result from a lack of communication. If one part of an organization is not getting the information it needs from another part, inefficiency results and, with time, the issue grows larger. Start by creating a standard for sharing information and developing a process that ensures all vital information is accounted for.

**Data:** It's often disparate. Bring data from multiple business applications and sources together in one place to create a common language gateway throughout the organization. Provide access to those that need to make decisions on that data in a timely manner and with easy access to it. Let them spend most of their time analyzing data as opposed to collecting it.

**Workflow or Automation:** Too frequently, this is ill-defined. Well-defined workflow drives action, ensures consistency, increases visibility, and improves control by connecting people to vital information. People are empowered to work better, smarter, and faster—ultimately delivering better business outcomes. The development of process-enabling business applications can provide organizations with the tools to reduce complexity, increase accountability, and enable growth. Many individuals are afraid of the word automation. The fact is if a process is repeatable enough that it can be automated, it should be automated. If your organization does not automate your repeatable processes, others will. Maybe even your competitors.

**Measurement:** For any process or activity to be successful, it must be measured. To eliminate chaos, we need to understand how successful we are in reducing the number of steps in the process, the time it takes to complete the process on a consistent basis, and the causes of process bottlenecks.

In today's always-on business environment, companies must continuously find ways to be more profitable, stay competitive, and drive market share. Chaos gets in the way. By creating faster, more consistent processes, companies can lower costs, reduce mistakes, increase value, and ultimately eliminate chaos—once and for all. ■



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Organizational chaos is far more prevalent than people will admit. To eliminate chaos, start small. Establish quick wins that demonstrate real value to the organization—and to individual employees. From a transaction perspective, it's important to distinguish organizational chaos stemming from a poorly managed company as opposed to organizational chaos resulting from a rapidly growing company. Your diligence team will be in the best position to help distinguish one from the other.



## SUDDEN IMPACT: New Revenue Recognition Rules Will Immediately Affect Acquirers

Businesses are dealing with the most significant accounting changes in over a decade. With U.S. and international accounting standard setters issuing largely convergent new rules on how to account for revenues and associated direct costs, *Revenue from Contracts with Customers* (ASC 606 and IFRS 15) requires sweeping changes for many companies globally.

Starting this year for public companies and in 2019 for private companies, the new standard requires an allocation of revenue to each promise of performance made to a customer in a contract. It then requires the deferment of expense recognition to align with the contract's performance delivery.

These are not entirely new concepts in accounting principles. But as companies move through the compliance process, many are surprised to learn how much they may have underestimated the complexity of this transition. The changes will require many companies to completely rethink the way they do business—and that rethinking needs to happen right away, even for acquirers or lenders.

Say, for example, a public company is interested in buying a private company. For private companies, the revenue recognition deadline isn't until 2019. But once the business is purchased, all of that changes, since conversion work needs to start the day the deal closes.

This means publicly traded acquirers must make the new revenue recognition standard a central part of their due diligence efforts. They need to plan appropriately and allocate sufficient resources to ensure that conversion to the new standard happens immediately.

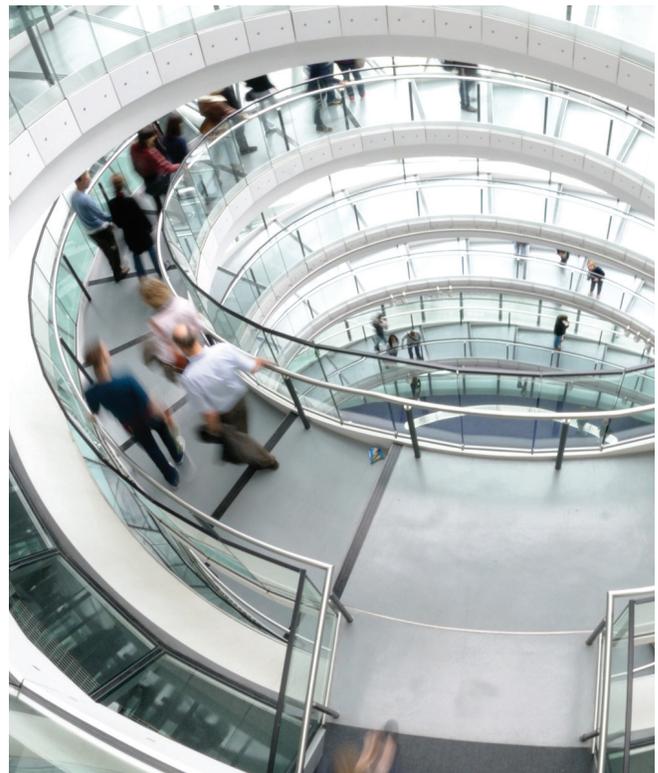
What's more, acquirers and lenders will need to change the way they value a private company, at least for this year. It's not uncommon for acquirers to use public market valuations when trying to figure out the price for private companies.

In 2018, public companies will be presenting their financial statements based on the new standard, while private companies will report using the old U.S. GAAP standard. This means it will be very difficult, if not impossible, to make an apples-to-apples comparison between the two.

Revenue recognition will impact some industries more than others. Software companies that operate under a license plus long-term customer maintenance fee model

will feel the effects strongly as the allocation and timing of revenue between the two components of these arrangements may change drastically. Retail companies offering accumulating loyalty programs may also experience significant change. In the past, loyalty programs were often considered a marketing expense. Going forward, though, they may need to be reported as a deduction against top-line revenue.

Additionally, any company that pays its salespeople a commission will be impacted, since the new guidelines contain strict rules on amortizing expenses. Prior to the new rules, sales commissions were typically expensed in



full when paid to the salesperson. But under the new standard, commissions must be spread over the estimated life of the revenue arrangement with the customer, including a consideration for expected customer renewal periods.

As an example, if a SaaS company pays a one-time commission to a salesperson for bringing in a new customer, but the average customer stays with the company five years on average, the sales commission would have to be deferred on the balance sheet and expensed over a five-year expected customer relationship period. The commission payment needs to align with the revenue being generated from that customer over the expected period.

**The transition to ASC 606 and IFRS 15, *Revenue from Contracts with Customers*, is not a simple switch. Companies must reexamine every one of their contracts and begin recognizing revenue differently than they did before.**

In a more extreme example, let's say an insurance broker signs up a new client who purchases a life insurance policy for \$100 a month for the first year, and automatically renews thereafter without any additional work to be done by the broker. The broker-dealer's track record is that life insurance policies have a very high renewal rate with average policies renewing for 15 years. The company would typically record the initial policy year's revenue and pay the sales rep a one-time commission for securing that initial contract. Moving forward, it would record renewal revenue and pay a smaller residual commission in each year the policy is renewed by the customer. The company would record the expense of that commission at the time of each payment to the salesperson.

But under the new revenue recognition guidelines, companies are prevented from doing this. Instead, they are required to accrue revenue for the initial policy commission plus an estimate of all future renewal commissions they expect to receive based on past renewal experience. They must then accrue the expense of that commission payable to the broker over the estimated lifetime of the contract. Thus, the new guidelines will have an impact not just on revenue recognition, but on book profits vs. cash flow. Companies may consider changing their definition of EBITDA.

The transition to ASC 606 and IFRS 15, *Revenue from Contracts with Customers*, is not a simple switch. Companies must reexamine every one of their contracts and begin recognizing revenue differently than they did before. Some companies will be more affected than others. Those that get it right will thrive in the coming years. Those that don't will be forced to restate their revenues, which could be chaotic for their business. ■



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**Every organization must be prepared to reevaluate each of its contracts as part of the transition to the new revenue recognition standard. Additionally, transaction teams are advised to adjust how they value targets and to make the new standard a central part of the diligence process.**



## LENDERS TAKE NOTE: Independent Sponsors Are an Emerging Force in the Market

Competition for private equity transactions from independent sponsors is on the rise. As this emerging asset class of investors grows in size and power, it is gaining momentum in the market and searching for larger deals.

Who are independent sponsors? They are typically M&A professionals who have left a private equity or investment banking firm to pursue deals on their own, without a formal fund behind them. Instead, they raise capital on a deal-by-deal basis. Independent sponsors may include family offices and executives with deep industry expertise looking for equity ownership in a business. They typically like to be more involved in a business than do traditional private equity investors.

Many independent sponsors believe that their approach to investing gives them greater flexibility to pursue deals and allows them to have a greater alignment of interest with their limited partner investors. What's more, an abundance of capital in the market has made it easier for independent sponsors to attract financing partners and raise money one deal at a time.

Lenders, in particular, should be attuned to the growing influence and deal acumen of independent sponsors. In the past, lenders shied away from independent sponsors because they did not have a long track record of closing deals. But independent sponsors are proving to be quite resourceful, carving out a significant slice of deal flow for themselves and establishing a model of success that involves a keen understanding of the industries in which they operate.

Independent sponsors are adept at gaining the trust of target companies, spending months and months with the management team to learn about the business and forging deep relationships. It's no surprise, then, that independent sponsor-backed deals are becoming more prevalent in middle-market transactions with values of \$10 million to \$75 million. And many of these sponsors are starting to move further upstream. For lenders, this means more deals that will require the use of debt.

A significant advantage for independent sponsors competing for deals is their natural appeal to business owners. Rightly or wrongly, many business owners still

hold an outdated opinion of private equity as corporate raiders intent on maximizing returns through financial engineering. By contrast, they see independent sponsors as real people they can personally connect with—not always the case with a PE firm, they believe.

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PE firms, for their part, are beholden to investors who demand to see a return on their investments within a set timeframe. Private equity firms have about three to five years to put investments to work, a handful of years to grow their portfolio businesses, and a fixed period to exit those deals so they can raise their next fund.

Independent sponsors, however, operate under a different model. They can provide longer-term capital and without limitations on how long they can hold onto their investment. They are not bound by certain structures to exit an investment quickly. That is a very attractive selling point for, say, a family-run middle-market business looking for capital.

Another advantage independent sponsors have is that family-run enterprises are eager to partner with family offices because they share commonalities in their approach to business. For instance, having an investor that truly understands how a family-run business operates can go a long way to contributing to the future success of the business.

The bottom line is that independent sponsors represent an increasingly important source of capital for private companies in the market. From a lender's perspective, independent sponsors represent an emerging opportunity that they should seriously evaluate. ■



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Independent sponsors are an exciting new asset class in the M&A market. Lenders are advised to take these groups seriously, as many are setting their sights on larger deals that will require more debt.





## MOVE OR LOSE:

### Leave Your Comfort Zone to Innovate and Grow

Few companies will be the next Google, Amazon, or Apple—companies that successfully change the rules of the game. But any company can embrace a culture of innovation to move ahead of the competition in its own industry. Done well, a culture of innovation enables a company to turn new ideas into sizable returns.

So where does that innovation come from and how can you foster it at your company? It comes when you consciously encourage open-mindedness and experimentation, when you actively embrace new ideas and explore their limits. It comes when you support a corporate ethos that says it's OK to fail quickly, fail often, and fail uniquely. Because organizations that never fail are, by definition, organizations that never truly attempt to innovate.

The innovation mindset is one that's always open to new and different ways to do business—new ways to sell, manufacture, market, or build a supply chain. You can't do any of that by conducting business as usual. For the most part, business as usual involves processes that do not add uniqueness or value to your organization.

For example, the ability to reconcile bank statements. Yes, this is good thing to know how to do properly. But it's largely a commodity. It won't win you any new business. It's the sort of process that dwells at the bottom layer of the value creation chain—the layer that is all about saving money by spending less on commoditized processes. Again, these processes are important. But organizations don't prosper if they primarily focus on spending less. You can't save your way to success. Instead, you need to figure out how to automate those bottom layer processes as much as possible so you can focus your energy higher up the chain.

The middle layer of the value creation chain consists of those processes that help you do business well. Maybe it's the way you engage with customers or how you work with suppliers. You want to develop a robust set of systems and controls around these processes so you can deliver them consistently and effectively.

This middle layer enables you to make money, but it won't help you make new money. That requires innovation. This is the top layer of the value creation chain: processes that create new revenue. The winners going forward will be the companies that consistently find those processes—and innovation is how they'll do it.

Every company now must ask itself what it is and what it can do to create new business. Take Sears. By no means is this company an equal of Apple or Google in terms of innovation. In fact, many think Sears should be dead by now. But it does innovate. Not long ago, Sears created a real estate investment trust, Seritage Growth Properties, to extract money from its massive real estate holdings. And today, Seritage is actually in a position to profit as Sears itself declines.

So where do you start? One of the most effective ways to innovate is to use data. Organizations that are better able to aggregate and analyze data are in a better position to make good business decisions and produce value faster than others. That's because they have the vision to spot



## Savvy organizations are not sitting still. They're embracing innovation as the central strategy to drive change and growth.

opportunities that others simply can't see. By getting deep into their data, organizations can uncover important business trends, drive new efficiencies, improve processes, and ultimately innovate.

This is not easy, of course. The challenge is to turn raw data into actionable information that can drive accurate decision-making. The disruptor will be the capability to analyze data through more powerful analytics, machine learning, and artificial intelligence applications. This will give corporate decision makers the power to shift from planned and preventive maintenance to prediction and competitive advantage.

Savvy organizations are not sitting still. They're embracing innovation as the central strategy to drive change and growth. They understand that gaining or losing market share in the years ahead will depend on how well they can innovate to meet and beat the ever-changing market. ■



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A culture of innovation is the key to growth in today's fast-moving business environment. Innovation can help organizations not just save money or make more money. It can help them make *new* money—critical to any growth strategy.

# SECURITY CHECK:

## Make Cyber Part of the Diligence Process

In today's digital economy, every company is a technology company—which means every company is susceptible to a cyber attack. That's why organizations seeking an M&A transaction must pay close attention to the cyber risks of companies they plan to acquire.

The due diligence process typically focused on uncovering the financial condition, assets, liabilities, and overall health of the target company. It still does. But the business world's heightened reliance on IT assets and emerging technologies adds a new and necessary layer to the due diligence process: cyber diligence. A breach can have a significant impact on financial performance and, consequently, quality of earnings.

A cyber diligence assessment examines vulnerabilities of the target's IT assets and the scope of damage that could occur in the event of a breach. While cyber diligence might not always provide complete assurance of the target company's ability to protect and defend against cyber threats, it can provide a reasonable understanding of the target company's current capabilities.

For example, how is the target company currently monitoring threats? What kind of response plan does it have in the event of a hack? How quickly can the company recover if an attack disrupts its supply chain or its ability to bring products to market?

Performing a cyber diligence assessment can shed light on these questions and, depending on the answers, impact the way an acquirer values and structures a deal. After all,

Verizon ultimately paid \$350 million less than planned for Yahoo following the disclosure of two massive breaches.

By contrast, sellers that demonstrate a strong cyber security posture can see their valuations increase. In many cases, good "cyber hygiene" at a target company is symbolic of other good habits, such as proper operational controls and excellent governance.

When it comes to cybersecurity, companies don't need to boil the ocean. But they must do the basics and do them right. This includes making sure their systems are updated and patched on a regular basis, and putting the proper security configurations and password controls in place. It also includes providing cyber training to employees. People are often the weakest link.

Per a new survey conducted by CohnReznick and Nexia International, a leading, global network of independent accounting and consulting firms, on the current state of cyber preparedness, 20% of organizations have never conducted a cybersecurity assessment and only 25% provide cybersecurity training to employees at least annually. What's more, 20% of companies that are required to have a cybersecurity program based on government, industry, or customer regulations don't have one.



The reality is that cyber attacks are very likely to increase in volume, velocity, and variety. Understanding the risks, including the potential financial impact from a quality of earnings perspective, is critical.



**Alignment with industry standards and cybersecurity best practices is essential. Acquirers and lenders should seek answers to questions like:**



Do the target company’s cyber security strategies and procedures meet the relevant industry standards?



How mature is the security program?



If the company experienced past cyber security incidents, how were they handled? Did the company communicate effectively with internal and external parties, including customers, regulators, and law enforcement regarding the security incidents and/or breaches?

An acquiring company or lender needs to understand and evaluate whether a target company has established an adequate cybersecurity strategy and has proper governance to ensure that its processes and controls are working adequately. Strong cyber processes and controls will defend against threats from both external malicious attackers and from internal users who may fall prey to phishing emails and clicking links that provide sensitive information to intruders seeking access to the network. For the lender in the transaction, understanding the risks and financial impact of a breach can impact the underwriting of the business.

Acquirers should also know whether a target business has recently engaged a third party to undergo a vulnerability assessment and penetration testing of its network. These tests will gather intelligence on any past breaches at the target company and ascertain whether any customer information—or the target company’s intellectual property—has been compromised and is available for sale on the dark web.

Equally important is whether proper security awareness training is provided to employees. Does the culture promote identifying, detecting, and notifying IT management or responsible parties if employees see something malicious? If not, that company could be at heightened risk. ■



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## STEPS TO SUCCESSFUL M&A INTEGRATION

Post-merger integration remains one of the most difficult challenges for acquiring companies. In fact, many stumble over their integration efforts.

Integration is especially hard work. And like most hard work in the boardroom, it's absolutely vital. Acquirers don't want to end up running two separate businesses because that means they would not realize the full benefits of their newly combined entity. Revenue synergies, cost savings, and enhanced profitability simply don't happen without proper integration. And, often, it is the value of the combined entity that the lender has used to place debt on the business.

Another concern is exit routes. Imagine a business buying a handful of companies over the course of several years but not successfully integrating any of them. When it comes time to exit, it will be extremely hard for buyers to value that business. How can they? The data is not consolidated, their technology systems are all over the map, and employees are still doing their own thing.

This sort of disjointed operation won't command the same value as a well-oiled M&A that has achieved cost savings and economies of scale thanks to common systems and a coherent market strategy. Indeed, those companies that handle integration well deliver as much as six to 12 percentage points higher total returns to shareholders than those that don't, per McKinsey & Company.

Most enterprises have an acquisition strategy. They know which kinds of companies they want to buy and why they want to buy them—but they have no integration strategy thereafter. They have little to no idea how to successfully blend their newly acquired entities.

This is particularly common in the middle market, where companies tend to operate with limited resources. They will have an acquisition team scouting deals and conducting due diligence, but they won't have a dedicated integration team to game plan post-deal strategies and map out all variables. Such a team is critical because effective integration efforts start long before a deal is completed. In fact, integration should start the moment a company decides to make an acquisition.

The process should begin with a few basic questions. Is the target company a cultural fit for our business? Does it have synergistic technologies we can leverage

post-close? What are the key issues related to integrating the finance organizations? Can we limit the risk of losing essential talent? What will the new leadership look like? How will this acquisition impact EBITDA?

These are all integration questions. But they also have a bearing on an overall acquisition strategy—another reason it is crucial to have a defined integration team in place that works with the deal team in any due diligence process. If the integration team is involved early, it can identify various integration challenges that may impact a deal as well as factors that may drive revenue synergies and cost savings.

The integration team should be composed of core stakeholders charged with running the combined entity going forward. The team should be multidisciplinary, including representatives from IT, Finance, and HR, and handle every aspect of the overall integration process.

The last thing any acquiring company wants to do is close a deal, then wake up that night in a cold sweat wondering what in the world they will do next. By that time, it is too late. Integration cannot be done on the fly.

Before any deal is ever closed, acquirers should have adjusted and readjusted their integration strategies. They should know how to consolidate various technology systems. They should know exactly what to say to customers and suppliers about the nature of the acquisition. They should be prepared to communicate with concerned employees.

Another reason preparation is vital is that integration should be fast and thorough. Speed is essential because the quicker a business can move through the integration process, the lower their risk of losing customers to competitors during this process. Competitors will take advantage of any perceived turmoil to steal customers away.

Acquisitions often fail to deliver significant value creation when there is no coherent integration strategy. Acquirers need to start early and put the right leadership team in place to drive their M&A initiatives forward. Having an integration strategy for each deal will set the course for success long before the ink on the contract is dry. ■



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The hardest part of any acquisition is the post-merger integration. Integration efforts should start well before a deal is completed. Put in place an integration team early in the process that can identify challenges that may impact a deal, as well as factors that may drive revenue synergies and cost savings going forward. Lenders are well advised to inquire about post-close integration activities as the details may provide comfort or expose risks.





## HOW LENDERS AND ACQUIRERS CAN NAVIGATE AND SURVIVE A NATURAL DISASTER

Natural disasters and extreme weather conditions are very real threats to businesses everywhere. This was made painfully clear last year when Hurricane Harvey slammed into Texas, followed shortly by Hurricane Irma in Florida, and Hurricane Maria in Puerto Rico. These storms were among the most expensive in history, causing hundreds of billions in damages.

Extreme weather events seem to be on the rise and will continue to take a toll on communities and businesses. The risk to acquirers and lenders is compounded. While their own functions may be directly affected, they must simultaneously navigate the implications the disaster is having on their portfolio companies. In diligence, determining if the natural disaster is truly impacting earnings must be validated and that negative performance is not due to inherent, ongoing business factors.

That's why it's essential for acquirers and lenders, as well as their portfolio companies, to take the necessary precautions to protect themselves and minimize the damage to their

operations. Unfortunately, too many businesses do not. In fact, one in four small to mid-sized businesses hit by a major storm never reopens again, and 84 percent do not have disaster insurance, according to the Eastern Kentucky University Department of Safety, Security, and Emergency Management.

What's more, whether it is an earthquake in Japan or a massive hurricane in Texas, the damage is not limited to companies in those geographical regions. With businesses today operating within a global supply chain, even a natural disaster that occurs halfway around the world can have serious consequences for firms and their portfolio companies.



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A natural disaster can dramatically impact the lives and businesses of those in its path. Acquirers and lenders will be affected based on the natural disaster and the makeup of their portfolios.

It is essential to create the framework for re-establishing business continuity and recovery to ensure both earnings and cash flows are not impacted to the degree where they would affect covenants and the ability to service debt.





## STEP 1

### Assess the Situation

Gather as much information as possible about the ways that your firm's portfolio may be affected. As soon as possible, try to contact the companies in your portfolio to understand the damage they sustained and the impact the event may have had on their business. Keep an eye on the general status of the affected area as well. Take note of recovery efforts, disaster declarations, and current conditions. The more information that you can obtain, the more knowledgeable your decisions will be in moving forward.

## STEP 2

### Lend a Helping Hand

Provide any helpful information that you can to the companies in your portfolio. The success of their recovery is not only vital to your success, but also to the larger recovery of the area hit by the disaster. Advise companies to keep meticulous records of any recovery expenses they incur, as well as economic impacts of the storm. These records will help companies apply to recovery programs as they become available. Remind companies to review their flood insurance policies and to begin filing their claim. Accessing quick financial aid can help your companies overcome the disaster and succeed.

## STEP 3

### Have a Supply Chain Strategy

Even if a company was not directly hit by a disaster, the nature of today's global economy means that its supply chain probably was. This can result in a chaotic scramble to find new suppliers and lead to production delays and product shortages. For instance, if a key supplier's factory is flooded due to a natural disaster, how long can your portfolio company survive without them? If the portfolio company is forced to ramp down production, how will this impact its business and the future of its brand? It is vital to consider how long a particular supply may be unavailable and make contingency plans to lessen any interruption using alternative sources. Companies with a detailed response plan for potential supply chain disruptions will have a distinct advantage over competition.

## STEP 4

### Develop a Long-Term Recovery Plan

Try to predict the impact that the disaster will have on companies in your portfolio and the possible impact that future governmental recovery funding might play in long-term success of those companies. Specifics will vary from firm to firm, but using your judgment to create a specific plan for moving forward is integral to successfully navigating the disaster. Reassess and update your plan as new information becomes available.

## STEP 5

### Scout for New Opportunities

Along with the many challenges that come with a disaster, there will also be new opportunities. Firms that can remain calm and take advantage of new opportunities that arise are positioned to help recovery efforts by providing portfolio companies with the capital they need, and to prosper as these companies succeed. Firms should try to assess the impact that disaster funding, recovery initiatives, and community re-growth may have on the economic landscape and look for promising opportunities to reinvigorate their portfolios. ■

# COMMON TAX EXPOSURES CAN COMPLICATE A TRANSACTION

Although lenders are generally superior in priority of investment recovery to equity holders, they are not immune from consequence of large tax exposures. As such, they should not overlook the potential for tax to delay, alter, or even completely derail an otherwise profitable deal. A tax due diligence review can identify and assess the potential tax exposures leading to complications, impact on the quality of earnings, and overall value.

Here are some of the more common tax exposure issues that may be discovered during tax due diligence.

## Federal Income Tax

A corporation that has been a Subchapter S corporation since inception can, for the most part, focus its tax diligence on the initial and continuing validity of the Subchapter S election. Some relevant questions to ask include:

- Was the election properly and timely made by all shareholders at the date of election?
- Has the company had only eligible S corporation shareholders at all times?
- Have all income and loss allocations and distributions been made pro-rata to all shareholders?

If the election has been terminated for violating any of the eligibility requirements, the entity may be liable for corporation taxes for all open tax years (typically three).

For taxable (“C”) corporations, potential exposures exist not only in the timing or actual amount of any Net Operating Loss (“NOL”) carryforwards accumulated in prior years, but also in their ability to utilize them. Ownership changes (including partial changes) can trigger limitations on the use of NOLs to offset taxable income. NOLs utilized, notwithstanding a triggered limitation, create a potential exposure likely to be discovered on audit.

## State and Local Income Tax

Some state and local jurisdictions do not recognize the Subchapter S election, imposing net income tax at the entity level as if the entity is a C corporation. Other jurisdictions impose various franchise or gross receipts taxes on Subchapter S corporations and partnerships. Many companies, mistakenly or otherwise, do not file income tax returns in states where their activities have established income tax nexus. Once nexus is established, if the

company is a taxable C corporation it may have significant potential exposure for income tax liability. This will depend on the amount of net income apportioned to the state.

Many states have recently enacted economic nexus statutes that impose income or gross receipts taxes on companies that have no physical presence in the state, but whose revenue derived from the state, exceeds a specified threshold. Companies selling across the country are often blissfully unaware that their top line growth to a geographically diverse customer base has rendered them liable for state income taxes to which they were previously not subjected.





## Sales and Use Tax

All too common is the failure to comply with sales tax requirements in states where independent contractors provide services to, or on behalf of, the taxpayer.

The growth of the internet has created traps for the unwary. Many states have enacted “Amazon laws” that attribute the physical presence of one otherwise unrelated business to another where certain online relationships, known as “click-through nexus,” exist between the two.

The other side of sales tax is use tax. Purchases of supplies and equipment to be used by the company in conducting its business are subject to sales tax because, for such purchases, the company is the end user. If (properly or improperly) sales tax is not collected on the transaction, the business is required to file a use tax return and remit the appropriate amount of tax.

## Payroll and Employment Tax

One area of potential liability is the classification of service providers as independent contractors rather than as employees. Notwithstanding that the parties agree on independent contractor status, the IRS and state tax authorities analyze all of the attendant facts and circumstances in the relationship in accepting or rejecting the parties’ classification. Where a taxing jurisdiction is successful in asserting a reclassification of contractors as employees, a business may find itself liable for unpaid withholding, payroll, and employment taxes, as well as benefits attributable to prior years.

## Unclaimed and Abandoned Property

The most common types of unclaimed property are uncashed payroll checks, old accounts payable, or customer credits, and gift cards. In recent years, the increased use of direct deposit has lessened the risk of having uncashed payroll checks, while conversely, the explosive growth of gift card usage has increased the occurrence and risk of gift cards as unclaimed property.

## U.S. International Tax Information Reporting

Regardless of the U.S. taxability of foreign operations, the existence thereof may trigger information reporting and/or tax withholding requirements. The presence of foreign ownership, foreign subsidiaries, and foreign bank accounts all trigger information reporting requirements that carry penalties of \$10,000 per required form, per year.

When transactions between U.S. companies and foreign related entities are not done based on arm’s -length pricing, potential exposures may exist in the U.S. or foreign country (or both). Companies that have not had proper transfer pricing studies prepared are at greater risk of exposure. ■



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**Tax due diligence will expose tax concerns during the transaction process, achieving the best possible post-transaction tax treatment. Many buyers and sellers rely on a long-time accountant to counsel them through these events. However, if that professional does not have specific and significant transaction- related experience, they may be doing themselves a disservice, which may adversely impact the transaction.**



# WINNING COMPANIES EMBRACE DIGITAL TRANSFORMATION NOW

Digital changes everything. Every industry, every channel, every market. It's revolutionary and promising—but it's also challenging. You need to be on your toes in the ever-shifting digital landscape to stay a step ahead of your competitors and anticipate incursions by pesky disruptors.

In today's environment start-ups are upending incumbents. Identifying opportunities for digital transformation must be a high priority. Savvy organizations understand that innovation, when properly applied, can help even an average company create significant added value.

Consider, for example, a business-to-business supplier of auto parts that has always relied on a traditional sales force dealing with customers via phone, fax, and email. Now let's apply innovation. It could be as simple as an enhanced digital presence, such as the introduction of a web-based interface, that now allows customers to check inventory and place their own orders online. An obvious yet effective innovation like this could lead to such value-adds as lower customer acquisition costs, improved customer relationship management, reduced selling and marketing expenses.

The same might be accomplished by applying digital innovation to a company's supply chain management process. Or, by utilizing data from its ERP and CRM systems by leveraging the cloud may bring new ways to create value and enhance growth. These are all ways that digital innovation can create a more profitable, more efficient, more successful business—and the way that a firm valued at 8X EBITDA could ultimately be worth 10X.

By the same token, companies without a digital strategy may see their value plummet. Take, for example, a company that lacks vital data about its customers. Perhaps the company is running its operations from Excel spreadsheets. It doesn't have the digital platforms to surface critical information and insights. It doesn't know how much revenue is generated per customer and it has no way to forecast future revenue based on customer segments. Thus, a potential acquirer may think twice about investing in the business, or a lender may question the company's ability to sustain and grow revenue over the term of a loan.

In today's digital environment, the most successful companies are capturing information at a pace and volume never seen—and can make sense of it all in real time.

This can provide significant competitive advantage. For example, unstructured datasets, including data from social media platforms, can help a company unlock previously unseen opportunities and identify previously unknown issues.

**In today's digital environment, the most successful companies are capturing information at a pace and volume never seen—and can make sense of it all in real time.**

Some companies are differentiating themselves by aggregating masses of information from blog posts, Twitter feeds, and Facebook comments. They are then leveraging that data to build a better feature set for their next product release. This approach to analytics enables companies to quickly and accurately build the products and functionality that will have the greatest impact in the market.

A company can begin reaping the benefits of digital quickly and cost-effectively. The key is to start small, be flexible, and move quickly. By applying the tenets of agile development—rapid prototyping, continuous feedback, and constant iteration—companies can immediately put a digital strategy into action and reap benefits right away.

Successful digital transformations occur through continuous innovation—by radically changing business models and capabilities in measured steps, over time, and as resources allow. This agile approach empowers organizations to launch, learn and relaunch digital initiatives by swiftly reacting to changing market conditions and customer needs.

The digital world will continue to up the expectation ante. Companies that embrace agile digital transformation can radically change their business models, meet those demands head-on, and gain competitive advantage. ■



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A digital strategy is no longer a nice to have—it's a must have. Increasingly, there are only two types of companies: the disruptors and the disrupted. The right approach to digital can help an organization create a more profitable, efficient, and successful business—and ultimately increase its financial performance and value.



# CONCLUSION

Lenders, investors, and companies should expand their scope outside of the traditional quality of earnings report to fully assess the financial, operational, and risk management profile of a transaction.

As a Firm committed to providing credible and insightful quality of earnings reports, CohnReznick hopes the articles contained in this publication offer some complementary tools as you evaluate transactions. Our team of advisors is dedicated to providing forward thinking ideas to help your business grow.

# ABOUT COHNREZNICK



**Leading**  
audit, tax, and advisory firm  
in the United States



Approximately  
**270**  
partners/principals



**2,400+**  
employees

More than  
**\$600 million**  
in annual revenue



**25** offices



**International reach**  
via Nexia member firms in  
more than **100 countries**

CohnReznick is a national audit, tax, and business advisory firm founded in 1919. As one of the top accounting firms in the United States, CohnReznick provides forward-thinking service across nearly two dozen industries and serves businesses ranging from multigenerational family-run enterprises to public companies in the Fortune 1000. We have the deep resources and technical acumen of a large national accounting firm without sacrificing the hands-on, entrepreneurial approach that today's dynamic business environment demands. This combination allows us to offer the proactive insight and guidance our clients need as they grow and evolve. CohnReznick has developed specialized practices in key industries, allowing us to specifically target relevant service offerings and knowledgeable personnel to each client. Because of our depth of resources across service lines, we serve in a variety of client service roles, including primary auditor, advisor, tax consultant, and other specialized roles. In addition to solid capabilities in core practice areas, CohnReznick has expanded the breadth of our service offerings in response to our clients' needs. We foster collaborative connections across every level and branch of our organization so that the professionals who will serve you will have access to our firm-wide depth of resources.



# ABOUT COHNREZNICK'S TRANSACTIONAL ADVISORY SERVICES PRACTICE

CohnReznick's Transactional Advisory Services team delivers comprehensive services across the investment lifecycle. In today's highly competitive transaction environment, we mobilize quickly and deliver forward-thinking services that exceed client expectations.

We provide a full range of due diligence, acquisition integration, and other transaction advisory services to companies on and lenders.

## Financial Due Diligence

- Historical financial performance review
- Identification of key business drivers, profitability trends, and significant concentrations of risk
- Identification of potential hidden liabilities and costs
- Quality of earnings analysis (normalization of earnings) including the identification of aggressive accounting policies
- Sustainable earnings and future cash flow validation
- Working capital analysis

## Financial Due Diligence—Special Situations

Special situation transactions are unique and complex. With extensive experience in working with financially distressed companies, CohnReznick has the requisite knowledge of the bankruptcy process and understands the necessity to work with all stakeholders—in a compressed timeframe—to preserve the going-concern value of the target. If beneficial to the process, we can collaborate with our Bankruptcy and Restructuring practice professionals to confirm the results and findings we obtain.

## Human Capital Due Diligence

- Cultural fit assessment
- Health and welfare program and cost evaluation
- Management retention risk assessment
- Retirement plan benefits evaluation
- Review of compensation structure and expenditures
- Review of union labor contracts and collective bargaining agreements, if applicable

## Information Technology Due Diligence

- Current systems and processes assessment
- IT organization assessment
- Review of data and network security
- Review of software development life cycle
- Synergies and redundancies assessment
- Third-party service and software provider assessment

## Sell-Side Due Diligence

- Assistance in preparing management presentations
- Evaluation of potential buyers and bids received
- Financial and transactional modeling performance
- Sale alternatives analysis
- Strategic alliances analysis
- Tax strategy planning

## Tax Due Diligence and Tax Structuring

- Identification of alternative deal structures
- Review of tax returns to identify potential tax risks and tax planning opportunities
- Review and evaluation of tax attributes, credits, and incentives

## Acquisition Integration

- Change plans
- Communication plans
- Consolidated transition plans; Day 1, First 100, and Beyond 100 days
- Integration status and reporting schedules
- Revised team structure
- Synergy and cost tracking models
- Systems integration plans and reported status

## Purchase Price Disputes

- Adjusted closing balance sheet preparation
- Allocation of purchase price for optimized tax environment
- Assessment of whether GAAP has been consistently applied
- Breach of warranty claim advice
- Earn-out disagreements resolution
- Financial sale and purchase agreements review
- Negotiation of adjustments after closing

To learn how your company can benefit from CohnReznick's transactional advisory services, contact Claudine Cohen at [claudine.cohen@cohnreznick.com](mailto:claudine.cohen@cohnreznick.com) or 646-625-5717, or visit [cohnreznick.com/transactions](http://cohnreznick.com/transactions).



# ABOUT COHNREZNICK ADVISORY

High-performing organizations and digital disrupters are continuously innovating and redefining everything, from the way industries operate to how they do business. As a result of today's business environment, organizations require speed and agility. Innovative companies are focused on expectations around development, operations, technology, risk, growth opportunities, and changing customer experience. These companies seek new ways to apply lean, strategic, profitable, and competitive business practices to optimize their business model.

CohnReznick Advisory offers a national team of professionals who are dedicated to helping organizations CohnReznick Advisory can address the many different challenges resulting from growth, economic issues, opportunities, or crises. We work side-by-side with client teams to identify and implement effective solutions to help organizations optimize profitability and growth, improve workflow and performance, and manage risk and compliance. We offer the following services:

## Digital and Technology

- CIO advisory / technology strategy
- Cloud solutions
- Cybersecurity
- Digital and innovation consulting
- Enterprise resource planning
- Information management and analytics

## Dispute Resolution

- Computer forensics
- eDiscovery
- Forensic accounting
- Litigation support

## Government and Public Sector

- Audit, accounting and financial management
- Compliance support for Federal, state and local government regulations
- Contract compliance and integrity monitoring
- Disaster response and recovery
- Fraud, waste, and abuse prevention
- Program and project management

## Management Consulting

- Business transformation
- CFO and financial advisory
- Compensation and benefits strategy
- Operations advisory
- Supply chain optimization

## Private Clients

- Business and investment management
- Financial planning and wealth preservation
- Insurance consulting
- Succession planning
- Tax planning, preparation and compliance
- Trusts and estates

## Real Estate Advisory

- Business transformation and enterprise architecture
- Business process optimization, operating models, and organizational design
- CIO advisory, technology triage, technology roadmaps/architecture, and system selection
- Cybersecurity
- Forecasting, planning, and analysis
- Information management
- Portfolio strategy and optimization
- Risk management and internal audit
- System implementation and integration

## Restructuring and Insolvency

- Corporate restructuring
- Financial recovery for debtors/creditors
- Pre-bankruptcy and reorganization

## Risk Management

- Cybersecurity
- Governance support
- Internal audit
- IT audit and controls
- Sarbanes-Oxley compliance

## Transactions

- Buy- and sell-side due diligence
- Corporate development
- Deal sourcing and pre-transaction services
- Post-transaction improvement/integration
- Purchase price disputes

## Valuation

- Purchase price allocations (PPA)
- Restructuring and dispute resolution
- Right-of-way valuations
- Tax and financial reporting
- Transactions and strategic advisory

To learn more about CohnReznick Advisory, visit [www.cohnreznick.com/advisory](http://www.cohnreznick.com/advisory).



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