

Financial Readiness: Fixing the Problems Before Going to Market

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When a business owner is considering a sale, financial statements are often the first point of contact with a potential buyer. Before any discussions commence regarding strategy, growth potential, or culture, buyers are going to ask the question, “Can we see your financials?”

Your financials tell the story of your business. When they are clear, credible, and well-prepared, they create momentum and instill confidence in the buyer. But when they are inconsistent, unclear, or require significant explanation, the transaction may stall or halt before it ever really started. Or it could result in an offer that doesn’t meet the seller’s expectations.

Carefully prepared financials are critical to any transaction, and this must be handled before entering the market. It is one of the most important steps a seller can take to protect valuation and keep the deal on track.

The First Test for Buyers

When reviewing a potential acquisition, buyers are going to first evaluate two fundamental issues: the historical earnings of the business and its future earning potential. The historical performance is the foundation for determining valuation. This means the financial statements must clearly demonstrate profitability and reliable cash flow. When there is uncertainty, it can translate into a discounted offer or a decision to walk away.

Sometimes the issue is not that a business is underperforming, it is just that their financial statements are not clearly reflecting the true earning power of the business.

Addressing “Add-Backs”

It is common for many privately held businesses to run a variety of expenses through the company that are not directly tied to operations. When this happens, it can distort the financial picture if these are not identified and adjusted. This can include personal expenses that are run through the business, vehicles or travel not tied to operations, above-market owner salaries, compensation to family members that are not active in the business, and more.

When preparing for a sale, these kinds of expenses will typically be “added back” to EBITDA to reflect the company’s normalized operating performance. When add-backs are properly documented, it can significantly improve the evaluation of the business. But they must be adjustments that are credible and clearly supported, or it can lead to additional concerns and a slower negotiation process.

Quality of Earnings Reports

Within the past few years, Quality of Earnings (QoE) reports have become increasingly common early in the process to review the company's financial performance. Sellers are now commissioning these reports before entering a sale process as opposed to a buyer conducting this analysis during the due diligence process.

Because an independent accounting firm is conducting the analysis, it lends a level of third-party legitimacy and validation to the company's earnings profile. This serves to further reduce uncertainty and can help accelerate the process overall. It can also help to instill confidence for the buyer that can lead to stronger initial offers.

Preparation is Key in Today's Market

We have noted in previous posts looking at the current M&A climate that today's buyers are more disciplined than ever. They are focused on financial clarity and risk management, and they are spending more time evaluating every aspect of a target's financials.

When a seller enters the market with well-prepared financial statements, along with supporting analysis from a third-party, they are often able to move through the diligence process more efficiently and have even greater leverage in negotiations.

It is more important than ever to engage legal and financial advisors very early in the process. This allows ample time to clean up financial statements, resolve inconsistencies, identify areas of adjustment, and prepare supporting documentation. Presenting these kinds of financials that clearly demonstrate historical performance, and future potential allows buyers to justify a higher valuation.

Part of every transaction is storytelling, and your financials must tell a credible story for buyers to have confidence in where the business has been and where it is going. Addressing any issues early in the process, well before going to market, is going to help eliminate surprises and strengthen the position of the seller. This is key to positioning the company for a successful transaction.