

DUE DILIGENCE



Purpose

- Don't buy a dog in the bag
- Verify that what is in the sales memorandum is true
- Check to identify what's not in the sales memorandum
- Identify potential latent wins, synergies

Use

- Usually the binding sales contract is pending upon successful due diligence

Timing

- No definite rule

Contents

- General/Legal/Regulatory
- Sales/Marketing
- Finance/Accounting
- Personnel/Employment
- Manufacturing/Materials
- Data Processing
- Engineering/R&D
- Miscellaneous
- Industry specifics

Who should conduct it?

- Given the stakes the answer is obvious: your best people in charge of the evaluation of the data room

General/Legal/Regulatory

- History of company: e.g., how and why organized; founders; funding; important milestones; original shareholders/debt holders.
- Name, date, and state of incorporation of the company.
- Copies of company's charter documents, Certificate of Incorporation, and By-Laws, as amended.
- All government licenses and permits, and importance to company. If important, description of regulatory/legal environment: past, present, and trends.
- List and description of all subsidiaries.
- Minutes of all meetings of the Board of Directors, any committees thereof, and shareholders of the company covering the last five years.
- All press releases issued by the company in the last five years. Also, new articles, product evaluations, letters from customers, etc., regarding company's products, services, and personnel.
- Details on date, amount, and form of each issue of securities, including copies of documentation used in the private placement and/or public offering of any securities during company's history.

General/Legal/Regulatory

- All filings with Securities and Exchange Commission, stock exchanges, etc. for last five years, including 10-Ks, 10-Qs, 8-Ks, proxy statements, registration statements etc.
- Stock book of the company and form of the company's stock certificates.
- All correspondence with, reports of or to, filings with, or other information with respect to any regulatory bodies that regulate the company's business.
- Description and documentation of all joint ventures and partnerships of the company.
- All royalty or licensing agreements, franchises, and conditional sales contracts to which company is a party.
- All securities contracts of company, including stock option plans, forms of stock option agreements, registration agreements, and shareholders' and voting trust agreements, including explanation of any agreements among shareholders to vote jointly, formal or informal.
- All documents relating to any mergers, consolidations, reorganizations, or acquisitions or dispositions of assets of company, with discussion.

General/Legal/Regulatory

- All contracts or agreements of company and all documents relating to transactions with the company to which directors, officers, or 5%-or-greater owners of company are parties, including receivables from or payables to the company, during last five years.
- Schedule of all confidentiality agreements, patents and applications, trademarks, copyrights, etc., that relate to the company's business or name, whether or not held by company. Include comments on cost, term, and importance of each to operation of the business.
- Schedule of all litigation, administrative proceedings, or governmental investigations or inquiries, pending or threatened, including attorneys representing company. Description of any judgments against co.
- All consent decrees, judgments, orders settlement agreements, etc., to which company is subject.
- List of all jurisdictions in which company is qualified to do business

General/Legal/Regulatory

- Explanation of any effects on company of current or anticipated environmental legislation, regulation, etc.
- Discussion if any officer, director, or major shareholder has ever had any difficulties with (been the subject of any inquiry from, under indictment by, or investigated under or threatened with prosecution for violation of a state or federal statute) the Securities and Exchange Commission, the National Association of Securities Dealers, or any public or state securities commission or agency; or been convicted of a felony; or declared bankruptcy; or been denied a security clearance by a U.S. government agency.

Sales/Marketing

- Information on all company's products, services, pricing, and margins broken out by product category and by type of customer, account, or market.
- Description of markets and geographical areas served, currently and in future.
- Breakdown of revenues and operating profits by line of business, market, product line, etc.
- Description of international activities of company: export, import, joint venture, operations, subsidiaries, etc
- Description of sales and marketing organizations, activities, and expenditures, including spending on advertising, promotion, market research, and other support activities.
- Copies of price sheets, sample quotation forms, and discussion of pricing policy.
- Brand names sold by company, proprietary and for customers (private brands), with explanation of brand recognition and importance to business.
- Forms of all rental, warranty, and service agreements of company.
- Listing, with comments, of independent sales persons and/or distributors of company together with standard form of marketing, sales, and/or distribution agreements, including details of any rebate agreements.

Sales/Marketing

- Number and location of distribution outlets, company-owned and independent.
- List and description of principal competitors with comparison of products, pricing and capabilities to those of company, estimated revenues and market shares, and projected trends and changes.
- List of principal customers in last three years, including products purchased, billings, level of satisfaction, current standing, and competitive activity. Explanation of any changes in major customer list.

Finance/Accounting

- Complete financial statements for past five years and current year to date. Supplemental information on:
 - banking relationships
 - investments: market value vs. book value
 - accounts receivable: list and aging; reserves; bad debt history
 - inventories: raw material, work in process, finished goods; provision and history for shrinkage, slow moving and obsolescence; accounting treatment; physical inventory adjustment history
 - prepaid items
 - fixed assets: breakdown by type; depreciation methods; other depreciable assets including fleet vehicles and data processing equipment; explanation of changes in depreciation methods in last five years
 - explanation of capitalized expenses
 - other current and non-current assets, particularly intangible assets: list and value; amortization methods

Finance/Accounting

- tax provisions; methods, experience with I.R.S. audits, open items
- current liabilities; by category including status of accounts payable by major vendor; accrual methods
- details of stock ownership including any treasury stock; major shareholders and relationship to company and among themselves; number of shares authorized, issued, outstanding; preferred and common stock; dividend status, policy, and history
- explanation of extraordinary or non-recurring items, deferred write-offs
- discussion of contingent liabilities including litigation, renegotiation, open orders, warranties, cost-plus contracts, unfunded pension past service costs, fines/penalties
- explanation of cash flow if materially different from earnings
- All documents relating to existing or available debt of the company, including loan and credit agreements, promissory notes, guarantees, etc.
- Description of any secured or company-guaranteed debt, whether company's or that of others.

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Finance/Accounting

- All documents relating to existing or available debt of the company, including loan and credit agreements, promissory notes, guarantees, etc.
- Description of any secured or company-guaranteed debt, whether company's or that of others.
- All documents relating to other financing arrangements; e.g., capital leases, sale and lease-back arrangements, installment purchase, etc.
- Correspondence with lenders for the last five years including compliance reports submitted by the company or its accountants. Discuss any violation of loan covenants.
- Listing and description of potentially dilutive items; e.g., stock options and plans, debt or preferred stock conversion; warrants; rights; etc.
- Description of budgeting and forecasting processes. Earnings and cash flow forecasts for balance of current year and next year with assumptions.
- Copies of budgets, business plans, and strategic plans with description of budgeting/planning process.
- Copies of any appraisals of the value of the company, particularly those rendered in connection with the purchase or sale of any securities of the company, in the last five years.

Finance/Accounting

- Description of accounting and finance organization, systems, procedures, and controls.
- Copies of income tax returns for last five years, federal, state, and local.
- Description of experience with auditors/public accounting firm, including any disagreements and resolution thereof, and explanation for any change in auditors in past. Copies of accountants' letters.
- For all real property of company, all deeds, mortgages, security agreements, deeds of trust, leases, and related agreements together with listing of each property including location, whether owned or leased, when acquired, and size and use of any facilities.
- All title insurance policies for company's property.
- List and description of all offices and facilities, with tax bills, maintenance of adjustment bills, current value (if owned), and renewal or purchase options (if leased). Description of anticipated future expansion needed if any.
- All leases for equipment or other personal property, whether company is lessor or lessee.
- Details of capital expenditures for last three years and budget for projected year. Explanation of investment needed to maintain company's position. Comparison with competitors' (current and potential) and available technology. Cost trends and comparison with competitors.

Personnel / Employment

- Description of structure of company and organization charts covering principal functions with key personnel identified. Brief summaries for each key person including resumes, history with company, compensation, responsibilities, job description, etc.
- Summaries of personnel by function, department, skill class, etc., for last year, current, next year. List unfilled positions and requirements. Include agreements and amounts spent in past year with employment agencies.
- All collective bargaining agreements, employment agreements, and consulting agreements, including numbers of employees covered by each union contract, if any.
- General description of labor relations including information on union organizing efforts, contract negotiations, strikes, settlement of grievances, and labor-related legal activity during last five years. Identify any difficulties in personnel turnover or in obtaining qualified personnel.
- List of outstanding workers' compensation claims with related correspondence. List of past E.E.O.C. activity.
- All documents relating to bonus, retirement, profit sharing, incentive compensation, pension, and other employee benefit plans or agreements.

Manufacturing / Materials

- Description of production organization, process, equipment systems, and facilities, service networks, etc.
- Description of materials/logistics organization, systems and capabilities.
- Description of inventory management policies and systems; scheduling, requirements planning, manufacturing control, finished stock policies; cyclical and seasonal requirements; inventory controls (transaction processing, weigh counts, cycle counts, physicals), etc.
- Summary of transportation/freight policies and capabilities
- Summary of procurement policies: major contracts, blanket purchase orders, spot buys, relationships with vendors, etc.
- Description of all barter and trade agreements.
- List of principal vendors/suppliers with amounts paid and availability of alternate sources for key components and materials. All agreements with suppliers.
- Description of customer service function: systems and procedures, order entry and tracking, credit and collection policies, warranty and repair policies.
- All supply or requirements contracts to which company is a party, with description, including any subcontracting relationship, long-term contracts or commitments, unique requirements (e.g., bonding).

IT/Engineering/Miscellaneous

- **Data Processing**
- List and description of all data processing equipment, when acquired, cost, current value, usage, software (including origin), integration, in-house and service bureau activities including software development and processing, current status and future plans and needs: by function.
- **Engineering/R&D**
- Description of engineering organization, facilities, and equipment, with discussion of importance of function to business. If company is in a technology-based business, details of engineering staff, turnover, difficulty in finding and retaining qualified personnel, confidentiality agreements, budgets, importance of patents and trade secrets, rate of exchange in technology, etc.
- **Miscellaneous**
- All other material contracts and agreements, including any customer, agency, or commission agreements.
- Copies of all insurance coverage (products, property, liability, business interruption, key employees, etc.).

Issues

- Due Diligence
 - Purpose
 - Timing
 - Topics
 - Latent values