

Mergers & Acquisitions

Master Class Education Series

Due Diligence and Quality of Earnings

December 1, 2020



BARNES DENNIG
Accounting • Tax • Business Insight



E-TAP
Prepare and acquire
a small business



Due Diligence Overview

1. Team and Expertise required:
 - a) Legal
 - b) Financial and Tax
 - c) Marketing and Benchmark / Forecast Data
 - d) Information Technology Analyst
 - e) Insurance and Risk Management
 - f) Human Resources and Benefits
2. Objective and Deliverables
 - a) Audience
 - b) Timeline
 - c) End Product
3. Potential Outcomes from Due Diligence
 - a) Full speed ahead
 - b) Price Adjustment
 - c) Deal Structure Modification
 - d) Escrow Account for Contingencies
 - e) Earn out
 - f) Breakage
4. Timeline

Due Diligence Checklist

I. Financial Information

A. Annual and quarterly financial information for the past three years

1. Income statements, balance sheets, cash flows, and footnotes
2. Planned versus actual results
3. Management financial reports
4. Breakdown of sales and gross profits by:
 - a. Product Type
 - b. Channel
 - c. Geography
5. Current backlog by customer (if any)
6. Accounts receivable aging schedule

Due Diligence Checklist

B. Financial Projections

1. Quarterly financial projections for the next three fiscal years
 - a. Revenue by product type, customers, and channel
 - b. Full income statements, balance sheets, cash
2. Major growth drivers and prospects
3. Predictability of business
4. Risks attendant to foreign operations (e.g., exchange rate fluctuation, government instability)
5. Industry and company pricing policies
6. Economic assumptions underlying projections (different scenarios based on price and market fluctuations)
7. Explanation of projected capital expenditures, depreciation, and working capital arrangements
8. External financing arrangement assumption

Due Diligence Checklist

C. Capital Structure

1. Current shares outstanding
2. List of all stockholders with shareholdings, options, warrants, or notes
3. Schedule of all options, warrants, rights, and any other potentially dilutive securities with exercise prices and vesting provisions.
4. Summary of all debt instruments/bank lines with key terms and conditions
5. Off balance sheet liabilities

D. Other financial information

1. Federal and State tax returns for past three years
2. Discuss general accounting policies (revenue recognition, etc.)
3. Schedule of financing history for equity, warrants, and debt (date, investors, dollar investment, percentage ownership, implied valuation and current basis for each round)

Due Diligence Checklist

II. Products

A. Description of each product

1. Major customers and applications
2. Historical and projected growth rates
3. Market share
4. Speed and nature of technological change
5. Timing of new products, product enhancements
6. Cost structure and profitability

Due Diligence Checklist

III. Customer Information

A. List of top 15 customers for the past two fiscal years and current year-to-date by application

(name, contact name, address, phone number, product(s) owned, and timing of purchase(s))

B. List of strategic relationships

(name, contact name, phone number, revenue contribution, marketing agreements)

C. Revenue by customer

(name, contact name, phone number for any accounting for 5 percent or more of revenue)

D. Brief description of any significant relationships severed within the last two years.

(name, contact name, phone number)

E. List of top 10 suppliers for the past two fiscal years and current year-to-date with contact information

(name, contact name, phone number, purchase amounts, supplier agreements)

Due Diligence Checklist

IV. Competition

A. Description of the competitive landscape within each market segment including:

1. Market position and related strengths and weaknesses as perceived in the marketplace
2. Basis of competition (e.g., price, service, technology, distribution)

Due Diligence Checklist

V. Marketing, Sales, and Distribution

A. Strategy and implementation

1. Discussion of domestic and international distribution channels
2. Positioning of the Company and its products
3. Marketing opportunities/marketing risks
4. Description of marketing programs and examples of recent marketing/product/public relations/media information on the Company

B. Major Customers

1. Status and trends of relationships
2. Prospects for future growth and development
3. Pipeline analysis

Due Diligence Checklist

C. Principal avenues for generating new business

D. Sales force productivity model

1. Compensation
2. Quota Average
3. Sales Cycle
4. Plan for New Hires

E. Ability to implement marketing plan with current and projected budgets

Due Diligence Checklist

VI. Management and Personnel

A. Organization Chart

B. Historical and projected headcount by function and location

C. Summary biographies of senior management, including employment history, age, service with the Company, years in current position

D. Compensation arrangements

1. Copies (or summaries) of key employment agreements
2. Benefit plans

Due Diligence Checklist

E. Discussion of incentive stock plans

F. Significant employee relations problems, past or present

G. Personnel Turnover

1. Data for the last two years
2. Benefit plans

Due Diligence Checklist

VII. Legal and Related Matters

A. Pending lawsuits against the Company

(detail on claimant, claimed damages, brief history, status, anticipated outcome, and name of the Company's counsel)

B. Pending lawsuits initiated by Company

(detail on defendant, claimed damages, brief history, status, anticipated outcome, and name of Company's counsel)

C. Description of environmental and employee safety issues and liabilities

1. Safety precautions
2. New regulations and their consequences

Due Diligence Checklist

D. List of material patents, copyrights, licenses, and trademarks

(issued and pending)

E. Summary of insurance coverage/any material exposures

F. Summary of material contacts

G. History of SEC or other regulatory agency problem, if any

Due Diligence Checklist

VIII. Information Technology Assessment

- A. Scalability and reliability***
- B. Cyber-security and privacy***
- C. Software interoperability & maintainability***
- D. Software uniqueness & quality***
- E. Barrier to entry & technology moat***
- F. Process, practices & tools analysis***
- G. Team interviews: people & skills***
- H. Technology and software architecture assessment***
- I. Open-source licensing analysis***