**Acquisition Due Diligence Checklist | Acquisition Analysis**

The following due diligence checklist is useful as a general list of items to investigate as part of an acquisition analysis, though the full range of questions will probably not be needed. Some questions may need to be added for an industry-specific acquisition, while far fewer will be needed for an asset acquisition.

Target Company Overview

* *Why selling?* There must be a good reason why the owners of a business want to sell it – and they may be excellent ones, such as raising funds for an estate tax payment, a divorce, or retirement. However, there may also be hidden reasons, such as the expectation of a lawsuit, or a downward trend in the company’s prospects, that are really driving the sale. One of these hidden reasons could present such a significant problem that the acquirer must back out of the transaction.
* *Prior sale efforts*. Have the owners of the target company attempted to sell it before? If so, find out what happened. Former prospective buyers are unlikely to talk about the issues they encountered, but an ongoing series of unsuccessful sale discussions probably point toward underlying operational, risk, or valuation issues that must be uncovered.
* *Business plans*. Obtain a copy of not only the most recent business plan, but also the earlier versions of it for the past few years. The team should peruse these documents and compare them to the company’s actual performance and activities, to see if the management team is capable of implementing its own plans.
* *Complexity*. How complex is the business? If it involves a large number of disparate subsidiaries that deal with many products and services, it may be too difficult for the acquirer to manage the operation. These types of businesses are also difficult to grow. Conversely, a company with a simple product line or service is an excellent acquisition target.
* *Market review*. Review the primary players in the marketplaces in which the target competes; determine the competitive niches occupied by each one, and how their actions may impact those of the target company. Also, monitor trends in the industry to see if there have been or are expected to be changes in profit levels or the size of the market. Further, examine the expected impact of new technology on the market, and how the company is positioned in relation to those technologies.
* *Ease of entry*. Is this an industry in which competitors can enter and exist easily, or are there significant barriers to entry? Has there been a history of new competitors arriving and taking significant market share, or does market share appear to be locked in among the current players?
* *Related acquisitions*. Have there been other acquisitions in the industry lately? Have other businesses put themselves up for sale? What is driving these trends? It is possible that the industry is going through a period of consolidation, which may impact the price the acquirer offers to the target company.
* *Reporting relationships chart*. Obtain a chart that states the reporting relationships within the business. This is useful for determining which managers are in charge of which sections of the business, so that the team knows who to contact for more information. It also tells the team who to investigate for roles in the business if the acquisition is completed.
* *Geographical structure*. If the business is based on sales regions, examine how the organization is structured to support regional sales. Is there an adequate infrastructure at the regional level for such activities as sales, marketing, distribution, and storefronts? If there are weaknesses, what could the acquirer do that would improve profits?
* *Organizational legal structure chart*. Obtain a chart that states which subsidiary entities are owned by which parent companies, where each one is incorporated, and the ownership of each one. This is an important document, for the team needs to know if there are any hidden majority or minority investors buried in the organizational structure of the company.

Employees

* *Types of employees*. Obtain information about the number of employees in the various functional areas of the company, such as production, materials management, accounting, treasury, and so forth.
* *Key employees*. Compile a listing of which employees actually operate the business.
* *Customer linkages*. Do any employees have such close contacts with customers that they could take the customers with them if they were to leave the company and go into business elsewhere? This is a particular problem in specialized service industries, such as investment management, consulting, and accounting services.
* *Total compensation*. Compile the total cost of the top employees. This means not only their base pay, commissions, bonuses, stock options, and payroll taxes, but also benefits and any reimbursements for a variety of personal expenses.
* *Pay level philosophy*. What is the company’s philosophy for the level of compensation it pays to employees? Is it near the median pay rate for most positions, or substantially higher or lower?
* *Pay history*. Construct a chart detailing the last date when each person was given a pay increase, and the amount of the increase.
* *Pay freezes*. If the target company has been in financial difficulty recently, it may have imposed a pay freeze on its employees, with the promise of immediate increases as soon as the financial situation improves. This creates an expectation that the acquirer will immediately increase pay.
* *Employment agreements*. There may be agreements with some employees, under which they are entitled to a certain amount of severance pay if the company elects to terminate their employment. The team should locate all of these agreements and document the amount of severance payments, in case the acquirer decides to eliminate their positions or replace them as part of the acquisition.
* *Unions*. Are some groups of employees within the company represented by unions? If so, obtain a copy of the union contract and peruse it for scheduled wage rate changes, work rule limitations, guaranteed benefits, and other issues that may alter the costs of the business. In particular, look for restrictions on the ability of the company to outsource work or relocate facilities.
* *Discrimination claims*. Are there pending discrimination claims against the company? Has there been a history of such claims in the past? If so, are the claims related to a specific person, or are they spread across the management team?
* *Injury records*. If the company is involved in manufacturing or distribution, review its employee injury records. Does the business suffer from an inordinately high proportion of injuries, or do workers’ compensation claims appear to be excessive? If so, consider bringing in a safety expert to review the company’s facilities, and to estimate the cost of adding any needed safety equipment, personnel, procedures, or training.
* *Employee manual*. Always obtain a copy of the employee manual. It should contain a number of policies that impact the costs associated with employees, such as vacation and sick pay, vacation carry-forward, annual reviews, jury duty, military pay, bereavement pay, severance pay, and so forth.

Employee Benefits

* *Benefits*. What medical insurance is offered to employees, and what portion of it must be paid by the employees? Is any insurance also offered to retirees? How do these benefits compare to what is offered to employees elsewhere in the acquirer’s businesses? Is the standard amount of benefits offered in the target company’s industry different from what is offered in other industries in which the acquirer competes?
* *Pension plan funding*. If there is a defined benefit pension plan, ascertain whether the plan is underfunded, and if so, by how much. Also, review the funding assumptions used to derive the level of funding; it may contain optimistic assumptions concerning the future return on investments that are unlikely to be achieved in practice.
* *Vacations*. Determine the amount of vacation time to which each employee is entitled, and how that compares to the industry average and the company’s stated vacation policy.

Financial Results

* *Annual financial statements*. Ideally, there should be financial statements for the past five years, which the team should translate into a trend-line comparison for the full five years.
* *Cash flow analysis*. A key part of the financial statements is the statement of cash flows. This document reveals the sources and uses of cash. Be mindful of the information in this report when you are reviewing the income statement, for the target may report substantial profits even while burning through its cash reserves.
* *Cash restrictions*. Is cash restricted from use in any way? For example, the local bank may have issued a performance bond on behalf of the company, and has restricted a corresponding amount of the company’s cash. Another example would be a cash restriction in order to fund a letter of credit.
* *Expenses categorized as non-operational*. A company may shift expenses into a non-operational expense category, such as extraordinary expenses, in order to make its earnings from operations look more impressive.
* *One-time events*. See if there were any operational events that are unlikely to occur again, and strip them out of the results of operations. This is a common problem for one-time sales to large customers.
* *Disclosures*. Audited financial statements should include a set of disclosures on various topics. The team should review these disclosures in detail, since they can reveal a great deal more information about a company than is shown in its income statement and balance sheet.
* *Public filings*. If a company is publicly-held, it must file the Form 10-K annual report, Form 10-Q quarterly report, and a variety of other issues on the Form 8-K. All of these reports are available on the website of the Securities and Exchange Commission, which is www.sec.gov.
* *Management letters*. After an audit has been completed, the auditors sometimes compile a set of recommendations into a management letter, which they distribute to the CEO and audit committee. Any such letters issued for the past few years are worth reading, since they contain suggestions to rectify deficiencies found in the company’s practices.

Revenue

* *Backlog*. Ascertain the total amount of backlog, by month, for at least the past year. This may reveal an increasing or decreasing backlog trend, which is a strong indicator of near-term revenue levels.
* *Recurring revenue stream*. A key value driver in a business is its recurring revenue stream. Determine the amount of baseline revenue that can be expected to arise on an ongoing basis.
* *Customer changes*. In the past three years, what changes have there been among the company’s top ten customers for each product line? The intent of this analysis is to see if there is a net decline or increase in larger customers, which is an indicator of the general trend of sales.
* *Available regions/channels*. Are there any likely geographic regions or distribution channels that the company has not yet entered? Attempt to quantify the sales and margins likely to result from entry into these areas.
* *Pricing philosophy*. How does the company set prices? Does it add a percentage profit to its costs, or charge based on the value of the underlying product, or set its prices based on those of competing products? Does it position its prices somewhat low, to follow a value strategy, or somewhat high, to follow a premium pricing strategy?
* *Estimating*. Does the company have an estimating department that derives prices for customized services or products? If so, examine the model for soundness, and investigate whether the company has persistently lost money on incorrect estimates in the past.
* *Contract terminations*. If revenues are derived from customer contracts, then obtain copies of the larger contracts and determine the remaining stream of payments related to them, when they expire, and the likelihood of obtaining follow-on contracts.
* *Accounts receivable*. Review the most recent accounts receivable aging report to see if there are any customer invoices that are overdue by unusually long periods of time, and find out the reasons why.

Cost Structure

* *Expense trends*. Load the company’s income statements for the past five years into a spreadsheet and create trend lines from this information as a percentage of sales, to see how expenses are trending.
* *Questionable expenses*. Review certain expense accounts for questionable expenditures. These typically relate to such items as personal expenses charged through the company, reimbursing employees for medical deductions, or excessive travel costs.
* *Loans to employees*. Determine the amount of any loans extended to employees. It is acceptable if these are small payroll advances for a short period of time. However, if they are long-term loans under which little or no repayment has been made, treat them as expenses that reduce the profits of the company.
* *Fixed assets*. A key part of the cost structure of a business is its fixed assets. If there have been few fixed asset replacements in recent years, it indicates a lack of attention to the future competitiveness of the business. If a reduced level of investment is evident, then the acquirer should reduce the valuation of the company by the amount of extra investment it will have to make to bring the fixed asset base back up to a reasonably operable level.

Intellectual Property

* *Patents*. Does the company have any valuable patents? It is extremely difficult for a due diligence team to have sufficient technical knowledge to sort through the various patents owned by a company, and figure out which ones are truly valuable. It will likely require either an outside expert or the services of the acquirer’s own R&D department to make this determination.
* *Trademarks*. Has the company registered its trademarks? If not, see if someone else is using them, and whether they have trademarks or have applied for them.
* *Licensing income*. Determine the size of any licensing income that the company generates by licensing its patents to third parties.
* *Licensing expense*. A company may have licensed critical intellectual property from another party. If so, evaluate the time period left on the licensing agreement, as well as the ability of the licensor to retract permission to use the license in the future.

Fixed Assets and Facilities

* *Valuation*. The net book value of fixed assets as recorded in a company’s accounting records has nothing to do with what they are actually worth if they were to be sold on the open market. If the acquirer intends to sell any of these assets, the team should obtain a rough estimate of their value.
* *Inspection*. Trace the fixed asset register to the fixed asset balance appearing in the company’s general ledger to verify that it is complete, and then trace a selection of the items on the register to the actual fixed assets.
* *Utilization*. Conduct a review of the more expensive fixed assets to see if any are no longer in use. If such assets exist and they are not needed to support peak production periods, then note these items as being potentially available for sale.
* *Replacement rate*. Review the company’s fixed asset replacement history for the past five years. Has it replaced assets at a consistent rate, or is it falling behind?
* *Maintenance*. Have an experienced maintenance person examine the machinery in the production area, as well as their associated maintenance records, to see if maintenance levels have been adequate.

Liabilities

* *Accounts payable*. Review the most recent aged accounts payable report to see if there are any overdue payables, and find out why they have not been paid.
* *Leases*. Determine if any equipment leases have bargain purchase clauses that allow the company to buy assets at the end of the lease period for below-market prices (such as $1).
* *Debt*. Review the debt agreements associated with outstanding debt and see if there are any clauses that accelerate payment in the event of a change in control of the business. Also, there may be personal guarantees on debt that must be removed before the current owners will consent to sell the business. In addition, verify that the company is complying with any covenants included in the debt agreements.
* *Debts to related parties*. Have managers, owners, or shareholders loaned money to the company? What are the terms of these agreements, and do they contain any clauses under which the other party can convert the debt into the company’s common stock?
* *Unrecorded liabilities*. Use interviews with the employees and business partners of the company to uncover unrecorded liabilities. They may include potentially adverse outcomes of lawsuits, guarantees on behalf of third parties, self-insurance, and contingent fees.
* *Collateral*. Verify which assets have been designated as collateral by lenders.

Equity

* *Shareholder list*. Obtain a list of all shareholders of the company, along with the share holdings of each one.
* *Classes of stock*. Verify the stock ownership of all classes of stock, as well as the voting rights associated with each class.
* *Conversion rights*. Examine all debt agreements to see if the debt holders have the right to convert the debt to shares in the company. See if the expected price per share is likely to trigger any conversions to stock, and what this will do to the controlling interest in the business.
* *Options and warrants*. Determine the amount of any stock options and warrants outstanding, and when they expire. Options and warrants give their holders the right to purchase shares of company stock at a certain price point. See if the expected price per share is likely to trigger the purchase of any stock.
* *Unpaid dividends*. If dividends have been declared but not paid, this becomes a liability of the acquirer. Also, if there is preferred stock that has a set annual dividend percentage, verify that there are no unpaid, cumulative dividends due to investors.
* *Stock buyback obligations*. Has the company committed to repurchase the stock of any shareholders? If so, at what price and by what date?

Taxes

* *Is the company continuing to pay taxes?* If a company has been paying taxes in the past, then review its accounts payable records to verify that payments are continuing to be made.
* *Is the company paying the correct amount of taxes?* Just because a company is remitting tax payments does not mean that those payments are correct. Accordingly, the team should audit the calculations used to derive a sampling of tax payments, to see if the payments were calculated correctly.
* *Are there undisclosed tax liabilities that have never been paid?* This is by far the most difficult tax due diligence task, for it addresses the complete absence of tax payments.

Selling Activities

* *Organization*. How is the sales department organized, and how does it make sales? For example, is the organizational structure based on sales territories, distributors, retail stores, the Internet, or some other approach?
* *Productivity*. Match sales records to sales personnel or storefronts to determine which sales people and/or stores are the most and least profitable. Is there an opportunity to prune some staff or stores? Should anything be done to support the top salespeople or bolster the results of over-achieving stores?
* *Compensation plan*. How is the sales staff compensated? What is the mix of salaried versus commission pay, and how does it change over time as a person transitions from sales trainee to salesperson? Does the reward system properly motivate the sales staff?
* *Skills match*. Some products require a relatively non-technical sale that can be assigned to someone with little background training. Other products require a much more detailed sales process that involves a more experienced and well-trained sales technician. The team should review the types of sales occurring, and the skill level of the sales technicians assigned to them.

Marketing Activities

* *Comparative analysis*. How do the marketing efforts of the company compare to those of its competitors? You can conduct this examination in many areas, including product packaging, quality, advertising, distribution, pricing, catalog sales, telemarketing, Internet marketing, after-market servicing, and so forth.
* *Coordination*. Does the marketing department coordinate its efforts with the release of new products and work with the sales staff for coordinated sales campaigns, or does it rely on general advertising?
* *Branding*. Is there a focus on branding every facet of a product’s outer case, packaging, delivery, advertising, and so forth?

Materials Management

* *Supply chain*. Does the company have a lengthy supply chain? If so, does it maintain a sufficient amount of inventory reserves to keep the company operating if there is a supply chain failure?
* *Supply restrictions*. Have sales been impacted during the past five years by restrictions in the amount of certain materials? What conditions caused the restrictions to occur, and what was the impact on sales?
* *Transportation costs*. What proportion of the cost of goods sold is comprised of transportation costs?
* *Spend management*. Does the purchasing staff have a spend management system in place that aggregates purchases by commodity type, and does it use this information to engage in bulk purchasing activities? Does the purchasing department monitor compliance with its spend management system, and follow up with those who do not purchase from approved suppliers?
* *Supplier terminations*. Have any suppliers refused to continue doing business with the company recently. Contact them to ascertain the reason for the termination.
* *Supplier contracts*. Obtain copies of any supplier contracts or master purchase agreements in which the company commits to certain purchasing volumes over a period of more than the next few months. The team should estimate the likely cost of these contracts over their remaining time periods, and whether the costs are above or below the current market rates.
* *Inventory systems*. How well does the company identify, store, and keep track of its inventory?
* *Inventory obsolescence*. In industries where product life spans are short, be sure to examine the inventory for obsolete items, and estimate the price at which they could be disposed of.

Information Technology

* *Systems in place*. The team should create a complete list of all major software packages being used by the company, their version numbers, annual maintenance costs, number of users, and interfaces to other systems.
* *Licenses*. Determine the number of valid software licenses that the company has paid for each software application, and match this against the number of users.
* *Outsourcing agreements*. If the company has retained the services of an outsourcing firm to take over the bulk of its IT operations, review the agreement carefully for such issues as baseline services, pricing for additional services, and change of control clauses.
* *Capacity*. Investigate the usage level of existing systems, as well as the age of the equipment.
* *Customization*. What is the extent to which the company has modified any packaged software that it has purchased elsewhere?
* *Interfaces*. Investigate the interfaces that the company uses to link together its systems. Any interfaces of particular complexity should be noted, since these may need to be reconstructed if the acquirer wants to link into those systems, too.
* *Legacy systems*. Some organizations have custom-made software that requires considerable resources to maintain. The team should locate these systems, determine their annual maintenance cost, decide whether they should be replaced with other systems, and estimate the replacement cost.
* *Disaster recovery plan*. Is there a disaster recovery plan that states how information is to be backed up and recovered in the event of a system failure? Is the plan tested regularly? Is there a backup IT facility that is ready to take over if the main facility is destroyed?

Legal Issues

* *Current lawsuits*. If there are any lawsuits outstanding against the target, ascertain their status.
* *Prior lawsuits*. If there were any lawsuits within the past five years that were settled, obtain copies of the settlement agreements.
* *Legal invoices*. Review all invoices paid to law firms in the past three years, and verify from them that all legal issues have been addressed.
* *Contracts review*. Examine all contracts that the target has entered into within the past five years. Focus in particular on those requiring fixed payments, royalty or commission payments, or the issuance of stock.
* *Charter and bylaws*. Always obtain the most recent version of the company’s charter and bylaws, and review them in detail. They state voting procedures for key events, such as the sale of the business.
* *Board minutes*. The board of directors must approve a number of decisions, such as the authorization of more stock, the repurchase of existing stock, certain compensation packages, acquisitions, and so forth. Consequently, review all board minutes for at least the past five years, and possibly for longer periods of time.
* *Shareholder meeting minutes*. Obtain the meeting minutes for the past few years of shareholder meetings.
* *Audit committee minutes*. If the board of directors has an audit committee, it can be useful to review its minutes for the past few years to see if the committee was made aware of any control-related issues.

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