



YOUNG  
VENTURE  
CAPITAL  
SOCIETY

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The following is a list of questions that should be asked during a due diligence review of a proposed sale.

**I. Company Background and Organization:**

In performing these steps, it is important to read the articles of incorporation, bylaws, minutes of meetings of directors and committees of directors, minutes of stockholders' meeting and tax returns.

- A. Ascertain the precise company name, the purpose for which the company was founded, and the date it was founded.
- B. Obtain an outline of company history, including major acquisitions, mergers and divestitures.
- C. Obtain an outline of the company's subsidiaries, divisions and major investments that describes their operations, geographical location and ownership.
- D. Obtain a summary of the principal manufacturing, distribution, and research and development facilities of the company that indicates the size, geographical location and ownership.
- E. Obtain a list of classes of stock and other equity securities that indicates voting rights, dividend preferences and conversion features.
- F. With regard to voting stock, obtain a summary of major shareholders. Do the same for any stock or debt that is convertible into voting stock.
- G. Obtain a summary of directors and officers of the company that provides position, age, business affiliations and committees of the company on which the officers and directors serve.

## **II. Review of Proposed Acquisition:**

Obtain a draft of the proposed acquisition agreement, and summarize its major provisions, including the means of exchange (*e.g.*, stock for stock, cash for stock, etc.), and acquisition price.

## **III. Management:**

### **A. Officers, directors and key employees:**

1. Obtain a summary of officers, directors and key employees that provides name, age, position, description of responsibilities, background, length of service and business affiliations.
2. Obtain a list of compensation paid to directors, officers and key employees during the past several years. This should include salary, bonus, profit sharing, stock options (also note present stock ownership), insurance and any other forms of compensation or fringe-type benefits (including nonmonetary perquisites) both current and deferred.
3. Review employment contracts and outline major provisions.
4. Obtain a list of indebtedness of directors, officers or employees to or from the company.

### **B. Depth, structure and philosophy of management:**

1. Comment upon the abilities and depth of management. Would key members of management be willing to remain after the acquisition? Which members of management are opposed to the acquisition?
2. Compare the organization chart with the actual operating structure.
3. Consider whether the real power is maintained by one or a few officers.
4. Consider whether there are indispensable or key managers.
5. If excessive use of outside advisors is noted, consider whether this indicates any weaknesses within the company's management structure.
6. Is management oriented towards production, marketing, manufacturing, finance, etc.? Considering the industry, competition and the current economic environment, does this emphasis appear proper?
7. Inquire into the company's conflict of interest and ethics policy.

8. Determine the function and importance of the board of directors and its major committees.

#### **IV. Related Party Transactions:**

A. Obtain schedule of significant related party transactions. The schedule should indicate the relationship and business purpose of such transactions.

B. Note family relationships between officers, directors and key employees. Also, note any relationships of officers, directors and employees with business organizations with which the company has significant dealings.

C. If the prospective acquire is a division or subsidiary of another company, inquire as to the existence of intercompany transactions such as sales, receivables, loans and purchases. Also, inquire as to what other services are provided by the parent company (*e.g.*, legal, insurance, banking, research and administration).

D. Obtain D&B and similar reports to ascertain ownership/management of companies where there is indication of close ongoing relationships to acquire.

#### **V. Labor Force-Benefits:**

A. Description of Labor force: Obtain a summary of the company's work force that provides a breakdown by location. Each location should be broken down into union/nonunion, skilled/unskilled, salaried/hourly, etc.

B. Union/management relations:

1. Review the company's history and current status of union/management relations. Are they consistent with that of competitors? Does any one union represent a significant number of employees (making the company more susceptible to a total shutdown in the event of a strike)?

2. Review current union contracts. Note expiration dates. Inquire whether there are any pending or retroactive wage increases.

C. Compliance with federal and state and local employment regulations: Inquire as to compliance with federal, state and local laws and regulations concerning employment practices. Inquire whether the company has been subject to any proceedings with respect to its employment practices.

D. Absenteeism and employee turnover: Inquire as to the company's experience with absenteeism and employee turnover by department, job classification, etc.

E. Wage rates and labor costs:

1. Review the company's wage rate structure and compare structure to that of its competitors. Note the principal features of the pay plan: hourly, weekly, incentive, overtime, etc.
2. Review company's policies and experience with regard to overtime. Review the ratio of overtime pay to straight time pay.
3. Compare total labor costs per dollar of sales to that of the competition.

F. Employee benefit plans:

1. Review and outline employee benefit plans such as a group life insurance, group health insurance, disability plans, holiday and vacation plans, bonus plans, profit-sharing plans, other incentive plans, employee stock purchase plans, employee stock ownership plans and employee stock ownership trusts.
2. Obtain a schedule of the total employee benefits costs as compared to direct labor costs. Has this ratio changed in the past several years?
3. Inquire whether the company has any health or insurance plans for employees that begin or continue after retirement. Are these plans being funded on an actuarial basis and, if not, what is the estimated actuarial liability for these plans?

G. Pension plans:

1. General:
  - a. Note the employees covered and the accounting and funding policies. Also, note whether it is a defined benefit or contribution plan, trustee, insured, contributory or defined noncontributory, etc.
  - b. Inquire whether it complies with ERISA and IRS regulations. Outline the eligibility and vesting requirements.
  - c. Summarize annual pension expense for the past several years. Review for significant fluctuations in current service costs, amortization of prior service costs, interest on unfunded prior service costs and unfunded vested benefits.
  - d. Obtain a summary of the matters affecting comparability of pension expense for the past several years, including changes in accounting methods (actuarial cost method, amortization of prior

service cost, treatment of actuarial gains and losses, etc.), changes in circumstances (actuarial assumptions, etc.), or amendments to the plan.

e. Discuss with the company's actuary whether the composition of the work force and length of service are likely to result in a sharp increase in pension costs that are accrued vested benefits in the near future.

f. Inquire whether the actuary has available, or can prepare, an analysis of the potential cost of discontinuing the pension plan after the acquisition.

2. Single employer pension, deferred profit-sharing or similar plans:

a. Obtain a copy of plan documents or a summary plan description.

b. Ascertain that an IRS determination letter has been obtained with regard to the plan(s), and whether there were any subsequent significant plan amendments that have not been submitted to the IRS for determination. Consider whether the amendments could adversely affect plan qualifications.

c. In the case of a defined benefit pension plan, review the recent actuary's reports.

d. Determine that timely ERISA filings have been made for each plan. Check whether any prohibited transactions are disclosed in the 5500s.

e. Review plan assets and transactions for any indication of possible prohibited transactions or imprudent investment problems.

f. Evaluate whether there are any significant unfunded pension liabilities that may affect the economics of the transaction.

3. Multiemployer plans:

a. Determine whether the acquired company contributes to one or more multiemployer pension plans with respect to union employees. A multiemployer plan is a plan under which various unaffiliated employers contribute to a pension fund that is managed by a joint board of trustees consisting of both union and management representatives, and is pursuant to collective bargaining agreements.

## **VI. Manufacturing:**

### **A. Manufacturing process:**

1. Does the company manufacture to order and/or does the company maintain a stock of standard items in inventory?
2. Determine whether there are any trademarks, patents, licenses or similar agreements that the company uses and must pay royalties for such use.

### **B. Productive capacity and efficiency:**

1. Discuss with operating management the efficiency of major pieces of equipment.
2. Estimate the remaining economic lives of major machinery and equipment, giving consideration to changes in production and technology. In cases of excess capacity, are there alternative uses for the facilities and the machinery and equipment?

### **C. Availability of land, labor, materials and utilities:**

1. If expansion of facilities will be required based upon expected utilization, consider whether there is an availability of land, labor, raw materials and utilities (electricity, natural gas, water, etc.). Inquire about local zoning requirements and environmental regulations, and consider how they will be financed.
2. Describe any controls that the company has over the purchasing function. Note the types of arrangements used for material purchases, including lead time and number of vendors. Evaluate forward commitments in light of actual and budgeted sales.
3. Obtain a summary of the volume of business done with major suppliers. Determine whether the company is dependent on any particular supplier or suppliers. If so, are alternate sources available? Determine the financial viability of major suppliers.

## **VII. Research and Development:**

- A. Describe the company's research and development effort. Include the extent to which facilities are committed to this endeavor and the number of employees.
- B. Inquire the extent to which the company's success is dependent upon the development of new and unique products.

C. Inquire whether the company pays others for a significant portion of its research and development effort.

D. Obtain a list of any significant patents (and their expiration dates) developed as part of the research and development effort. Does the company utilize significant patents owned by competitors?

E. Evaluate the importance of research and development within the industry and its importance to the company.

### **VIII. Marketing:**

A. Products and product lines:

1. Obtain a description of the product lines or major products of the company.

2. Inquire whether any of the products are proprietary in nature. How do the company's products compare with those of its competitors in quality, price, etc.?

3. Consider recent product obsolescence in the industry or in the company.

4. Obtain a list of the company's more significant brand names, trademarks, etc. Note whether the company produces private label goods and the significance of such production.

B. Product markets:

1. Obtain a geographical breakdown of sales of market coverage.

2. Obtain an analysis of any seasonal or cyclical sales patterns.

3. Inquire as to the demographic markets to which major products are sold in each geographical location.

4. Inquire whether the company depends on repeat sales.

5. Inquire as to the percentage of sales made to governmental agencies and units.

C. Distribution:

1. Inquire as to the methods of distribution used by the company. Are they direct to end-users, through wholesalers, retailers, etc?
2. Inquire whether products are shipped directly from the factory or through company warehouses. Determine which means of transportation is used in each channel of distribution.

**IX. Legal and Regulatory Matters:**

- A. Inquire of management and legal counsel as to any pending or threatened litigation, claims or assignments and pending governmental investigations that could give rise to contingencies.
- B. Obtain schedule of any major legal actions including government injunctions, restraining orders, etc., during the past several years.
- C. Obtain a schedule of all internal and external legal costs during the past several years. Inquire as to any significant fluctuations that do not appear reasonable based upon the above investigation.
- D. If the company operates in a regulated industry, describe and review its reporting requirements.
- E. Inquire as to which regulatory agencies (whether federal, state or local) have an impact on the company.
- F. Inquire as to the status of company/regulatory agency relationships.
- G. Review all reports filed with regulatory authorities for the past several years.
- H. Determine if there are any present or prospective regulations that may adversely affect the company's operations.

**X. Contracts:**

- A. Review all major contracts in force not reviewed elsewhere.
- B. Note whether contracts are assignable or transferable.
- C. Note whether there are any escalation, renegotiation or redetermination clauses in any contracts.

## **XI. Insurance:**

- A. Review the company's insurance program.
- B. Review major risks the company may face, product and property liability, and compare with existing coverage.

## **XII. Financial and Accounting:**

### A. General:

1. Obtain the following historical financial data for the last five years:
  - Balance sheets
  - Statements of income and retained earning
  - Statements of changes in financial position
  - Notes to financial statements
2. Review the financial statements and notes, noting the type of audit report and whether there are any unusual or significant footnote disclosures.
3. Describe the accounting principals employed by the company and the methods of applying those principles. Consider whether these principles are consistent with other companies within the industry. Be alert for accounting principles unique to the industry.
4. Determine whether there have been any changes in the application of accounting principles or methods that could make comparisons of historical financial statements more difficult.
5. If the company has engaged a public accounting firm, arrange to review its work papers. Pay particular attention to memoranda on accounting issues and legal matters and evaluations of internal accounting controls.

### B. Cash:

1. Obtain a summary of banking relationships. Also, obtain a schedule of monthly bank balances during the year that separates them into cash, time deposits, certificates of deposit, etc. Note minimum and maximum balances and trends during the year. If surplus balances are evident, describe the company's policy regarding the investment of idle balances.
2. Describe the company's banking arrangements. In particular, review any restrictions on cash balances, compensating balance agreements and

line of credit arrangements. Do the banking arrangements appear adequate based on the company's cash requirements?

C. Marketable securities: Obtain a schedule of marketable securities, separated into current and non-current categories, and list the original cost, the date purchased, the interest rate, the maturity date, current basis of recording and current market value of such securities.

D. Accounts receivable:

1. Describe the company's credit system. Indicate current credit policies, normal trade terms and special trade terms.
2. Obtain an accounts receivable aging as of the most recent date possible and for the same date in the prior year. Also obtain a schedule of significant individual account balances.
3. Review the adequacy of the allowance for doubtful accounts. In reviewing this, give consideration to the current accounts receivable aging and the actual write-off experience during the past several years.

E. Miscellaneous receivables: Obtain a summary of miscellaneous receivables that includes their terms and repayment dates. Special attention should be directed towards receivables from employees, affiliated companies, shareholders, directors, underwriters, and other related parties.

F. Inventories:

1. Obtain an inventory summary by major product line (or major product) for the current and prior year. This summary should separately show raw materials, works-in-progress and finished goods.
2. Describe the company's policy with regard to the provision for obsolete and slow-moving inventory.
3. Inquire as to the reliability of the company's perpetual inventory system and determine the degree of reliance placed on this system.
4. Review the company's cost accounting system.
5. Obtain a schedule of inventory turnover rates and gross profit percentages by product line (or major product) for the past several years. If possible, compare these to industry data.
6. Physically observe the general condition and quality of the inventory.

7. Ascertain whether inventories are stated at the lower of cost of market, and describe the methods used by the company in making these calculations. Particular attention should be paid to products or product lines with low gross profit rates.

G. Property, plant and equipment:

1. Obtain a summary of property, plant and equipment and accumulated depreciation broken down into category totals.

2. Obtain a current listing of each major owned facility showing location, original cost, age and current book value. The listing should also provide the method and rate of depreciation.

3. Inquire as to the replacement values of owned facilities. Review any recent tax assessments and insurance appraisals (indicate dates and methods of appraisals).

4. Obtain a listing of all major owned equipment that provides location, original cost, age, current book value, and replacement value as well as the method and rate of depreciation.

5. Obtain a listing of all major leased facilities showing locations, annual rentals, expiration dates, renewal options, ownership and age. Note the accounting treatment of each lease.

6. Review the terms of the significant leased facilities. Consider the effect of the renewal terms. For leases about to expire, consider what the new rental will be by reviewing current rents for similar facilities. Consider the effects of new rentals terms on future financial results.

7. Obtain a listing of all major leased equipment that provides location, annual rental, expiration date, renewal options, ownership and age. For leases about to expire, consider the effects of new accounting treatment with regard to each significant group of leased equipment.

8. Physically inspect property, plant and equipment for its general condition and age, and note equipment that does not appear to be in use.

H. Current liabilities:

1. Obtain a schedule of major current liabilities by category (trade payables, notes payable, accrued liabilities, etc.) and determine if their status as current is proper.

2. Briefly outline the company's short-term financing methods. Inquire as to any restrictive terms or other significant terms. Obtain agreements for significant borrowings.

I. Income taxes:

1. Review Federal and state tax returns for the last five years. Indicate which years are still open.
2. Schedule any available operating loss carry-forwards and their expiration dates.
3. Obtain a summary of property taxes for the past several years. Inquire as to any significant increases that are noted, and inquire as to whether any significant increases in property taxes are expected.

J. Long-term debt:

1. Obtain a schedule of long-term debt that includes security descriptions, principal amounts, interest rates, advance payment privileges or penalties, late payment penalties, renewal and conversion privileges, sinking fund requirements and principal repayment terms.
2. Review indentures and describe major restrictive covenants such as on working capital, dividends, reorganizations, etc.
3. Inquire of legal counsel whether the impending acquisition would, if executed, constitute an event of default. Inquire whether the debt would become callable or otherwise subject to renegotiation.

K. Contingent liabilities: Inquire whether there are any contingent liabilities outstanding. Inquire specifically about pending or threatened litigation, pending tax matters, regulatory investigations, obligations relating to warranties and product defects, collectibility of receivables, agreements to repurchase receivables sold, guarantees of debt, and price redeterminations and terminations under government contracts. Obtain a description of major contingencies noted.

L. Commitments: Obtain a summary of any major outstanding commitments such as commitments for fixed asset purchases, inventory purchases, advertising campaigns, plant construction, hedging transactions, long-term purchase and sales agreements, employment contracts and profit-sharing and similar plans.

M. Capital stock:

1. Obtain a summary of all stockholder equity accounts that indicates the legal title of the security, the par or stated value, the shares authorized, the shares outstanding, liquidating preferences, dividends in arrears, participating rights, dividend preferences, sinking fund requirements,

conversion privileges, dividend rate and whether dividends are cumulative.

2. Obtain a listing of major shareholders of each type of equity security.
3. Obtain a schedule of any changes to paid-in capital accounts for the past several years.
4. Obtain a schedule of transactions in treasury stock.
5. Inquire whether there are any restrictions on retained earnings.

N. Profit and loss:

1. Obtain explanations for significant fluctuations in the income statements.
2. Specifically inquire as to nonrecurring items included in profit and loss such as extraordinary or unusual items, prior period adjustments, etc.
3. Obtain an analysis of sales, cost of sales and direct selling, and general and administrative expenses by product line (or by major product) that shows both quantities and dollars.
4. Obtain an analysis of gross profit percentages by major product line. Compare sales trends of higher gross profit product lines with lower gross profit product lines.
5. Obtain a schedule that provides information on sales to the company's largest customers, affiliated companies or other related parties.
6. From the summary of cost of sales, selling, general and administrative expenses, etc., obtain explanations for unusual variances in expenses for such items as advertising, research and development, and repairs and maintenance.
7. Obtain a schedule of income and expense accounts that are labeled as "other." Separate these into recurring and nonrecurring items. Investigate the nature of any significant items.

*John W. Masotti, member of Masotti & Masotti, LLC, is a Certified Public Accountant in the state of New York. He has been practicing for over 8 years dealing mostly with tax issues regarding individuals and small to mid size businesses and is an integral part of the new business development for the firm.*