THE BUYER’S GUIDE TO
DUE DILIGENCE
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Dealmakers have become increasingly sophisticated in how they go about conducting due diligence. While the process has always been a vital component of the deal process, in the wake of the financial crisis, investors and buyers are keenly focused on unearthing non-traditional risks and other liabilities through more thorough examinations.

Now more than ever, though, investors are getting even more specific when gathering information. They spend more time and often partner with more outside experts to avoid missing any potential skeletons in the closet. An emphasis on up-front legal and IT diligence has grown and new areas like cultural and values diligence are becoming commonplace.

We’ve created this guide to due diligence with help from some of the most experienced investors, advisors and legal professionals on Axial. Read on for tips and best practices in some of the most complex and nascent areas of buyer due diligence.
IT Diligence

IT due diligence is one of the most overlooked processes in the pre-close stages of buying lower mid-market companies. Although many deal professionals are thorough with other diligence, IT matters tend to barely enter the conversation.

Jim Hoffman, trusted authority on IT Due Diligence and author of the IT Due Diligence Guide, says that though many investors don’t have the resources to conduct IT diligence easily, it’s getting harder and harder for them to ignore its necessity. “Technology is becoming integral to every business — even if it is just their website or their email,” he says. “These most basic aspects present real potential risks.”

The good news is that unless a company’s technology is not scalable with the business or is falsely represented, almost anything can be resolved. “Almost any technology issue can be remediated with enough capital,” says Hoffman, “which makes doing [diligence] before the deal that much more important.” Do your IT diligence early so that you can incorporate it into how you ultimately price the deal.

Answer these three questions

IT diligence is focused on spotting and anticipating future hurdles and costs. Even if you are unfamiliar with technology yourself, you will likely be able to sense areas causing the company concern or that might present challenges down the road. Explore these vital IT diligence questions thoroughly:

1. **Does the company really own its supposed product?**
   While this question is likely covered during other diligences, it is critical to dig into it in IT diligence as well. If they do not, it could pose the greatest risk to the business model and cash flow.

2. **Is the technology integrated/constructed the right way?**
   This refers to the quality of the product and deals with issues like licensing, IPs, and sustainability. Was the technology built/implemented by employees or contractors? Are those people still available? These questions help to avoid any major legal or operational challenges once the deal has been closed.
3. **Can the technology scale?**
   
   While each integration plan is unique, it’s important to ensure that the technology of the acquired company is scalable. Ensure that the technology can scale and integrate with new marketing and sales organizations. If it requires a complete re-architecting, it’s important to include that in the contract.

   **Check all the boxes:**
   
   - [ ] Confirm the technology is real
   - [ ] Determine the technology’s compatibility with yours
   - [ ] Verify that you have tech support
   - [ ] Uncover licensing risks
   - [ ] Establish scalability
   - [ ] ID key employees and determine how you will keep them
   - [ ] Examine current resources and how soon tech will need to be updated
   - [ ] ID opportunities for cost savings

   **Unless a company’s technology is not scalable with the business or is falsely represented, almost anything can be resolved.**
IT Due Diligence Checklist

- **Confirm the technology is real.** Ideally you should have an expert in the target company’s specific technology and industry review source code, product plans, etc. At a bare minimum, you need to have a technical person sit in on a demo and ask questions. If a technology expert from the acquiring company or investor isn’t available, consultants can be hired for this purpose.

- **Determine the technology’s compatibility.** If the target company uses leading edge or proprietary technology, it may not integrate easily, if at all, with an acquiring company’s legacy systems. This can have serious ramifications for the integration of the companies, the maintainability of the software and the retention of key employees at the target company.

- **Verify that the technology can be supported.** This includes basic things like whether or not the target company has a clean copy of the source code for their technology, or whether they own the rights in the first place. These issues come up more often than you might think. Even if there is a viable copy of software source code and all ownership rights are in order, are the people who wrote the software still employed by the target company?

- **Uncover licensing risks.** It’s not uncommon to find that a smaller tech company has not properly licensed all of its production or development software. Additional licensing costs may eventually come to light.

- **Establish the technology’s scalability.** How will the software or systems behave if the number of customers doubles or increases tenfold? Will the technology expand gracefully with a low marginal cost, or require a large investment in new servers or other hardware? In the worst-case scenario, a complete re-architecture of the technology may be required. These costs should be included in the terms of the transaction.

- **Identify the key employees associated with the technology.** Interview some or all of the target company’s technology staff. Get a good feel for the personalities involved. If the company is being rolled up into a larger company, will they work well in the new organization? If retaining these employees is important, employment agreements or retention bonuses should be put in place to be sure they remain post-transaction.

- **Examine current resources.** Many smaller companies scrape by with minimal resources when it comes to things like networking and other IT infrastructure. Has the target company put off making needed investments in order to artificially inflate profitability? If the systems are noticeably outdated, you could be walking into a large front-end investment that should be included in the sale price.

- **Identify opportunities for cost savings.** Technical knowledge is needed to determine realistic synergies. Don’t assume that you’ll be able to combine data centers just because both the acquiring and selling companies have them. Are the technical platforms compatible? Does the target company’s IT staff have the necessary technical skills? Are there overlaps with the acquiring company’s staff? Confirm synergies to avoid sunk costs and to maximize benefits from the transaction.
Tax Diligence

Since the financial crisis, there has been increased focus on tax diligence. Nick Gruidl, Partner in the Tax and M&A arm of McGladrey, cites investor wariness, increased state and local audit activity, and growing awareness of international tax jurisdictions as some of the biggest reasons for more time spent on pre-sale tax analyses.

Best practices for tax diligence

1. **Research non-income based taxes.**
   If the tax due diligence on a deal only relates to income-related taxes, your results will be incomplete and leave you open to potentially fatal oversights. As an example, the government has scrutinized employee versus independent contractor characterizations made by companies. If the target company has misclassified employees as independent contractors, you may inherit that tax liability. In the past that has been enough to put more than a few companies out of business.

2. **Ensure a wide enough scope for diligence.**
   Look beyond the easy questions to expose all tax risks. For instance, it may be tempting to neglect tax questions around a small international operation, but it is necessary to do the legwork. Particularly if the business operates internationally, examining the differences between tax jurisdictions and separate tax systems is an important step.

3. **Be aware of current trends in federal taxes.**
   Changes in taxes have significant impact on deal activity, either spurring or dampening efforts. At the end of 2012, for example, uncertainty surrounding anticipated tax changes created a spike in deal activity. Stay apprised of changing tax regulations so you can act on these types of developments. Relevant future issues are likely to include individual tax rates, corporate tax rates, and taxation of carried interest. In 2013, the highest tax rates for individuals ticked up to 39.6% plus the additional 3.8% Medicare tax. Corporate tax rates stayed at 35% and there is talk of lowering the corporate rate as part of broader tax reform. This is significant because it’s the first time in over a decade that corporate and individual tax rates have not matched closely. Now that corporate rates are lower than individual rates, appeal of flow through entities might change.
4. **Consider the ideal transaction structure.**

   Proper tax diligence allows you to create the most favorable structure for your transaction. Many buyers make the mistake of making an acquisition without properly considering the post-transaction structure. Consider the merits of corporations versus flow through entities, and the integration into your existing business if the acquisition is an add-on.

5. **Explore potential opportunities and credits.**

   Not all tax due diligence is for the purpose of avoiding risk. You can also uncover opportunities for unrealized growth and savings. The lowest hanging fruit is usually found in various tax credits: R&D, state employment, federal energy efficiency credits and so on. There are so many credits available, it’s likely that the CPA of the target company hasn’t exhausted all opportunities.
Legal Diligence

Even the most planned deal is rife with uncertainty. Whether it is the unexpected departure of a senior employee, the loss of a critical customer or supplier, or some transformative regulatory change, the terms of a deal can quickly change.

Your goal during legal due diligence (or your legal counsel’s goal) is to identify legal risks and liabilities, and negotiate with the seller in order to properly allocate risks and liabilities in the purchase and sale agreement.

**Best practices for legal diligence**

1. **Collaborate with various advisors and consultants.**
   Since legal matters underpin almost every element of a deal, legal due diligence involves frequent interactions with other forms of diligence. You need to understand both the business issues and the industry. Only by having a true and comprehensive understanding of the business and the macro environment in which it operates, can you be certain you are asking the right questions and uncovering the necessary risks.

2. **Come prepared with a checklist.**
   The list should cover different areas of law including general corporate matters, litigation, material contracts, tax, environmental, labor, benefit plans and IP.

3. **Focus on litigations.**
   Identifying historic and settled litigation should be relatively easy. Identifying current and future litigation risks requires in-depth communication with the target company and a strong understanding of the industry. Generally, litigation-related issues are identified early in the diligence process, most often during initial questioning. Though uncovering any litigation can be unpleasant — both for the company and for the deal — you should not dwell unnecessarily on it.
Buyer Beware

REGULATED INDUSTRIES
While checklists and consultants allow you to comfortably review most companies, carefully regulated industries require special attention. Regulations are intricate so you always want to confirm compliance and understand change of control risks. “Hot” industries under public scrutiny need particular attention, too, as unidentified risks can be more problematic and costly. Fracking business, logistics companies with independent contractor risks, and the eCommerce industry with respect to privacy and sales and use taxes are some current examples.

OWNER-OPERATED COMPANIES
Smaller founder-owned companies are generally not as professionalized from a legal due diligence perspective. Because they don’t have the infrastructure and resources of larger companies, they are understandably more focused on building their businesses than legal and regulatory compliance matters. While this is promising for growth, it can create outstanding risk. Determine how to remedy these risks post-closing. Pay attention to added costs from resolutions - like initiatives and/or hires - and its impact on EBITDA going forward.
The Seller’s Perspective: What a CEO Should Expect From the Due Diligence Process

One of the most critical parts of preparing for due diligence as a seller, according to James Darnell, partner at KLH Capital, is to understand the perspective of the buyer. If you know what to expect, have the right attitude, and bring the right people, he says, you will have a successful transaction.

2 KEY TIPS AND DEFINITIONS FOR SELLERS

→ **It’s not personal.** Investors are trusted with other people’s money - generally that of larger LP investors. They are responsible for being wise stewards of that capital, so they must learn about all facets of your business. This is their business, so don’t take their questions and/or concerns personally.

→ **Expect a 3-6 month process.** Led by the investor, a team of lawyers, accountants, consultants and experts will look into 5 major parts of your company: business, accounting, legal, IT and environmental.

A BREAKDOWN OF DUE DILIGENCE CATEGORIES FOR SELLERS:

- **Business Due Diligence.** Investors need to understand the sustainability of your company’s revenue and cash flow, and the prospects of growing your business. Expect questions on: products/services, pricing, supplier relationships, operations, accounting, HR, IT systems, etc. They will likely hire researchers to investigate the broader industry. They may also request calls or meetings with your top customers to gain their perspective on products/services and views on the potential transaction.

- **Accounting Due Diligence.** This is one of the most critical parts of diligence and may seem to take a while. The review is primarily confirmatory - making sure what you told them is the truth. It isn’t as detailed as an audit and is typically referred to as a ‘Quality of Earnings’ report. Accountants will help investors understand your accounting policies, GAAP compliance, and any necessary modifications. Expect investors and your CFO/controller/CPA be very involved.

- **Legal Due Diligence.** A group of lawyers will review all material contracts to understand terms or conditions that could result in liability or change in the business. They’ll also look at leases, any current or prior litigation, corporate books, stock and asset titles and all company paperwork.

- **IT Due Diligence.** Third party consultants will likely help your investor understand the importance of technology to your business, the posture of your IT networks, historical spend, future budget expectations and any infrastructure risks that could be harmful to business.

- **Environmental Due Diligence.** Consultants will review publicly available information, conduct on site inspections, and review any prior claims or issues to understand any environmental liabilities or potential for future liability.
Quality of Earnings Diligence

Performing a Quality of Earnings review of the seller’s financial statements is one of the most important steps in buying a business. Here is where you verify the earnings of the underlying business and any “add backs” that the seller added to the earnings as a representation of what a new owner could expect to receive in cash flow.

*There are 4 important questions to ask when conducting quality of earnings diligence:*

**WHO?**

For businesses larger than $500,000 - $1 million in earnings, buyers generally hire accounting due diligence firms. Their job is to get into the details and prepare spreadsheets and reports of their findings for the buyer. You can expect these firms to be extremely detail oriented and prepared to double-check everything for their client.

**WHAT?**

The diligence firm provides a request list of documents they will use to verify the earnings the seller has represented. Most likely, the firm will spend a few days to a week on site at the company to ask more questions, fine-tune requests, and ask follow-up questions as they get into the details.

**WHEN?**

Quality of Earnings reviews generally happen after a Letter of Intent is signed. It’s generally the first diligence project undertaken by buyers. You will want to verify the earnings power of the business before you spend money with attorneys to draft the legal documents required to close a deal.

**WHY?**

Sellers often don’t represent their earnings power properly - not because of ill intent, but simply because they are not accounting experts. Financial statements need to be in proper accounting format so that all buyers and lenders understand them. For businesses whose accounting is very well done and who don’t make any aggressive add-backs, this will be a “check the box” part of diligence, and should be relatively easy. If accounting is not well done, however, it could be more time consuming and problematic.
WHAT YOU MIGHT FIND IN A QUALITY OF EARNINGS REVIEW:

- **Revenue or expenses in incorrect periods.** It is sometimes easy for revenue or expenses to be accounted in an improper period. Those are easy for diligence firms to spot.

- **Improper accrual accounting.** This is related to the first point, in that accrual revenue or expenses may not be done properly which results in revenue or expenses being in an incorrect period. Also, many businesses that have deferred revenue (customers pay before the service is delivered) do not properly account for it. Accounting for these funds too early causes earnings to be higher than accounting rules would allow.

- **Discontinued operations.** If the seller closed a money-losing business, buyers will look at that as a nice gain for the future. On the other hand, if they had a money-making business that they are no longer operating, you don’t want to include that in the earnings power of the business going forward.

- **Open employee positions or missing expenses.** Are there open positions on the org chart? If so, assume you will need those positions and reduce their earnings estimate to account for it. Is there an obvious expense that they were able to avoid historically, but will be needed in the future?

- **Improper add-backs.** For obvious reasons, sellers want to make their earnings look as strong as possible. Some add-backs are logical and correct. Salaries for owners that are larger than what is needed to pay a professional manager, for example. Other add-backs are not as defensible.

- **Pro forma adjustments (may not be anything you can influence).** While you may not be able to affect this, many buyers add in other expenses that they assume they will need, such as a budget to pay an audit firm to review financial statements. Or, maybe you want to expand the board of directors, in which case you would add budget for that.
Cultural Diligence

Despite being intangible and undefinable, culture can be one of the primary determinants of a deal’s success. Vetting cultural pain points and planning for possible differences can lead to a smooth integration. Neglecting cultural issues can lead to massive turnovers, employee dissatisfaction, and a subtractive deal.

According to Stenning Schueppert, Managing Director at CenterGate Capital, cultural due diligence is one of the basic prerequisites for any deal. “If we cannot provide good evidence of cultural alignment, the rest of the business doesn’t matter” he says. “You would risk buying some assets but losing the people who run the business for you.”

Conducting due diligence is particularly difficult, though, because you can’t simply ask all employees what they think of the company and expect accurate answers. The inability to question employees makes defining the amorphous element of culture even more difficult.

**HOW TO IDENTIFY THE CULTURE OF AN ORGANIZATION**

→ **Understand turnover rates.** Ask the company about its turnover rate, where its employees move to, the last key employee to leave, etc. Any noticeable turnover trend — all employees leaving for the same company or 50% of management team leaving to start a competitor, etc — should offer unique insight into culture and the businesses.

To gain deeper insight into reasons behind departures, ask to review relevant exit interviews (if conducted). If common themes emerge — like unsatisfactory pay, unsatisfactory conditions, or bad managers — make sure they are not critical to your post-acquisition plan.

While major departures may signal a red flag, zero turnover can be just as alarming. If a significant number of employees have held the same position for too long, they may fear change and be resistant to acquisition.
- **Review internal documents.** These can shed light on some of the core values and principles of the organization. Ask to see any employee newsletter, intranet, or social enterprise network. These channels and materials are probably the closest you’ll get to actually speaking with employees about culture. You can see how employees interact with one another, how they participate in company activities, etc.

  Internal documents also offer insight into the thinking of senior management. While you can question them about culture, internal documents can provide actual evidence of previous actions and discussions. Ask senior leadership for the budget and minutes from old staff meetings, management retreats, or board meetings.

- **Validate with external sources.** Unfortunately, licentious business practices have a tendency to escape any formal documentation, and are only revealed when consulting with a third party. Before moving too far along in a deal, ask contacts in the field if they know about the business and for their impressions. If you do not have any immediate sources, customers are a great source of information. While they might not have detailed knowledge, they can offer a worthwhile gauge. If you feel uncomfortable polling customers, ex-employees, market advisors, or industry peers are great resources.

- **Learn from the owner operator.** Ultimately, the best person from which to learn company culture is the existing owner operator. Most small companies have a top-down culture defined by the founder and senior management. It is possible you may learn more about culture from the current CEO by asking why she is selling rather than directly about the culture.

If we cannot provide good evidence of cultural alignment, the rest of the business doesn’t matter.

**CENTERGATE CAPITAL**
Values Diligence

Dealmakers like Kevin Coughlin of **Coughlin Capital** say conducting values due diligence is “one of the most important things to do when speaking with a business owner” because it ensures that you “have an understanding of their business values and the end-result of the desired transaction.” According to Coughlin, “misaligned values can threaten the success of an investment. If the values are clearly conflicting, it’s a non-starter.”

Not only that, but emphasis on values can help you stand out from the competition. Benjamin Gerut of Kuzari Group believes that “most retiring entrepreneurs want more than a simple check; they want a real transition with real mentorship...they want succession.” Having explicit conversations can demonstrate that you are dedicated to maintaining or protecting their priorities.

**WHEN TO HAVE VALUES CONVERSATIONS**

The earlier in the process you have conversations related to values, the better. While the owner’s business values may not be a reason to invest in the business, they can be a reason to walk away. The earlier the conversations, the easier it is to develop trust and create a sincere connection.

That said, you don’t want to have the conversation too early. Prematurely discussing values can undermine its purpose. An owner is unlikely to want to talk business values unless they think feel fairly confident in a transaction.

The ideal time for the conversation, according to Coughlin, is “sometime after a Letter of Intent (LOI), but before the closing of the deal.”

**WHAT TO DISCUSS**

Candor and honesty are vital for ensuring the relationship starts on the right foot. There needs to be a base level of trust between the current owner and the new one (you) - to close the deal AND to ensure future success. Essentially, you need to buy into each other.

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“Mis-aligned values can threaten the success of an investment. If the values are clearly conflicting, it’s a non-starter”

**COUGHLIN CAPITAL**
To build that mutual trust and to ensure optimal post-transaction efficiency, begin by discussing topics like how you will treat each other as owners, how customers, employees, and vendors will be treated, how the day-to-day operations will be run, etc.

Plan and schedule direct, clear conversations around values. Sit down and discuss the owner’s plan. Really understand how they picture the future of the company.

The due diligence process is arguably both the most critical and most complex step for both sides of any acquisition or financing transaction. As with many things in life, expectations are key to having a successful outcome to the diligence phase of selling your business. The more you understand of the due diligence process — and match your expectations accordingly — the more you can prepare, the easier the process will be, and the most likely you will be to achieve the best outcome.