



Due Diligence – What to Expect? Strategic Company Sales

This checklist and guide is intended only to provide a service of alerting sellers to matters which should be considered when selling a business. It does not purport to be comprehensive but rather it is to be used as a guide only.

DUE DILIGENCE

Due Diligence is a process undertaken by a buyer of a business in order to determine the attractiveness, risk and issues of that potential acquisition. The due diligence can be either external (assessing the future potential of that company in a competitive marketplace) or internal (assessing the key legal, financial and managerial issues within the company).

When considering selling your business in the future it helps to address the key issues that buyers will look for when the sale time comes. Conversely, you may be looking at acquiring a business, in which case the Mind Maps below can act as your checklist for what you should be looking out for.

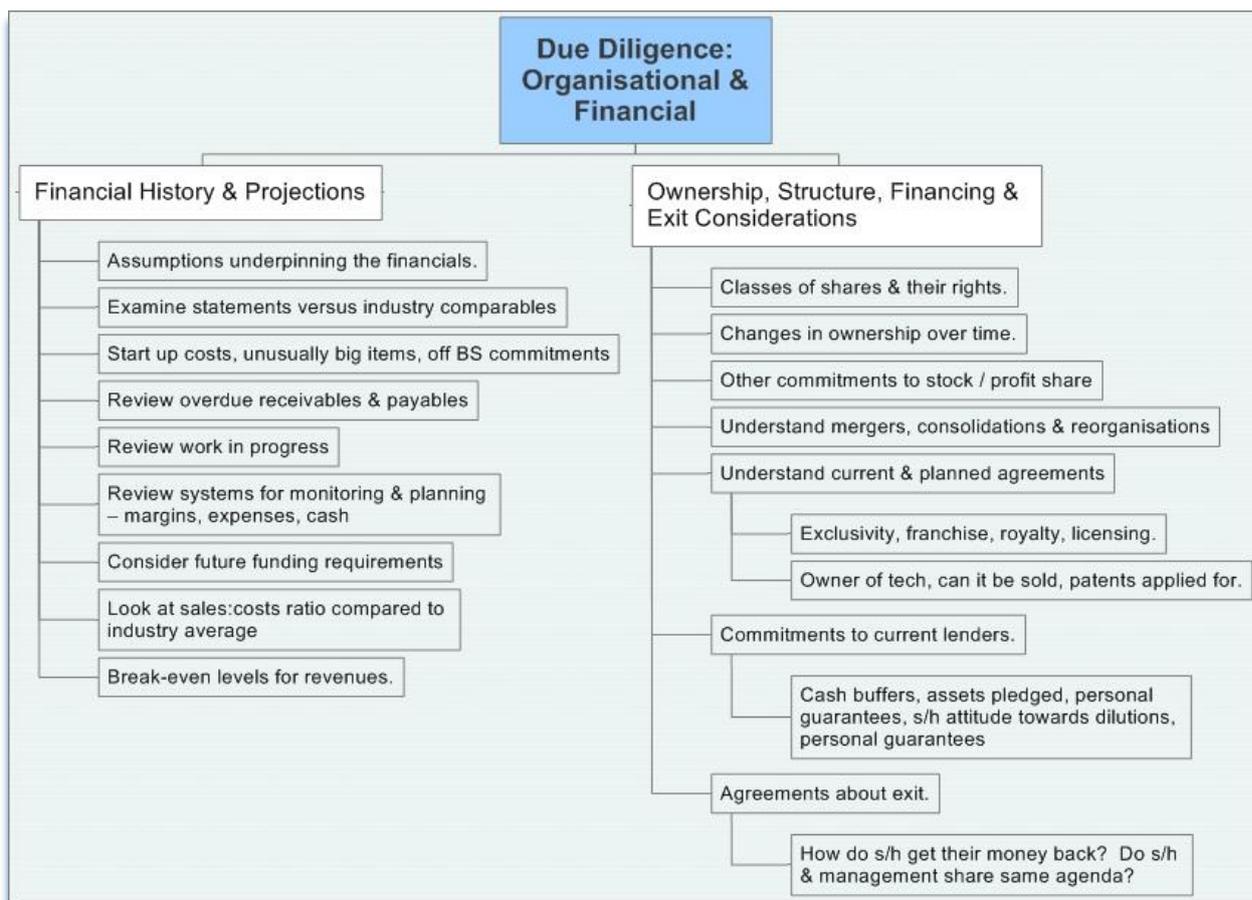
As part of the negotiation process it is also important to ascertain what the motives are of all of the other parties involved. In particular, why is the owner selling? What does the owners' management want to get out of this? Why does the owner want cash rather than shares? What are the motivations of the other parties?

Due Diligence is a large & complex subject in itself, but this series of Mind Maps will graphically list the key areas that you need to be aware of:

Due Diligence – Organisational & Financial

You, the seller may provide financial projections in order to maximise the value of the business. A buyer will compare these projections with actual trading history. If there is a major discrepancy, the buyer will think that if the seller is so confident of this, why would he or she wait a couple of years until those projections had been realised and sell the business at that point?

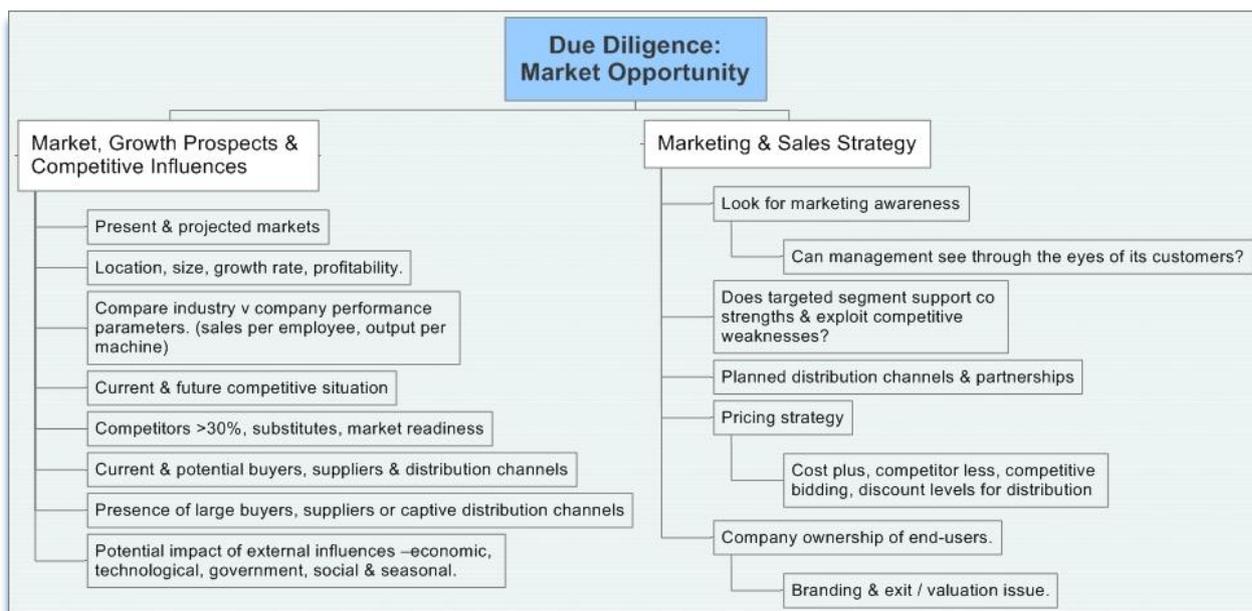
Ownership may not simply be a case of transfer 100% of a company over from one party to another. There may be other issues clouding the transactions including minority shareholders, commitments to management staff and suppliers, ownership of technologies and lender covenants.



Organisational & Financial - Due Diligence

Due Diligence – Market Opportunity

Assessing the market opportunity for a venture involves strategic due diligence, and in order to undertake this successfully, a buyer will need to source more opinions than those of the owners. This analysis involves the size and growth potential of the market, the customers and potential customers accessible and the major current and potential customers.



Due Diligence - Market Opportunity

Due Diligence – Legal, Technical & Manufacturing

The incumbent management team of an existing company is frequently cited as being a major reason for the success of that company. Will those individuals stay with the company, and if so, will the buyer need to offer them incentives or “golden handcuffs”? Alternatively, the buyer may not want them to stay, particularly if they are purchasing a company believing it to be undervalued *because* if the ineptitude of their current management?

Technology also may or may not be important. For technology companies, technology will be the cornerstone of its competitive advantage, but buyers will need to look at most companies with a manufacturing facility to determine the state of their processes. How efficient are they? What capital expenditure may be required to ensure that obsolescence is not an issue?

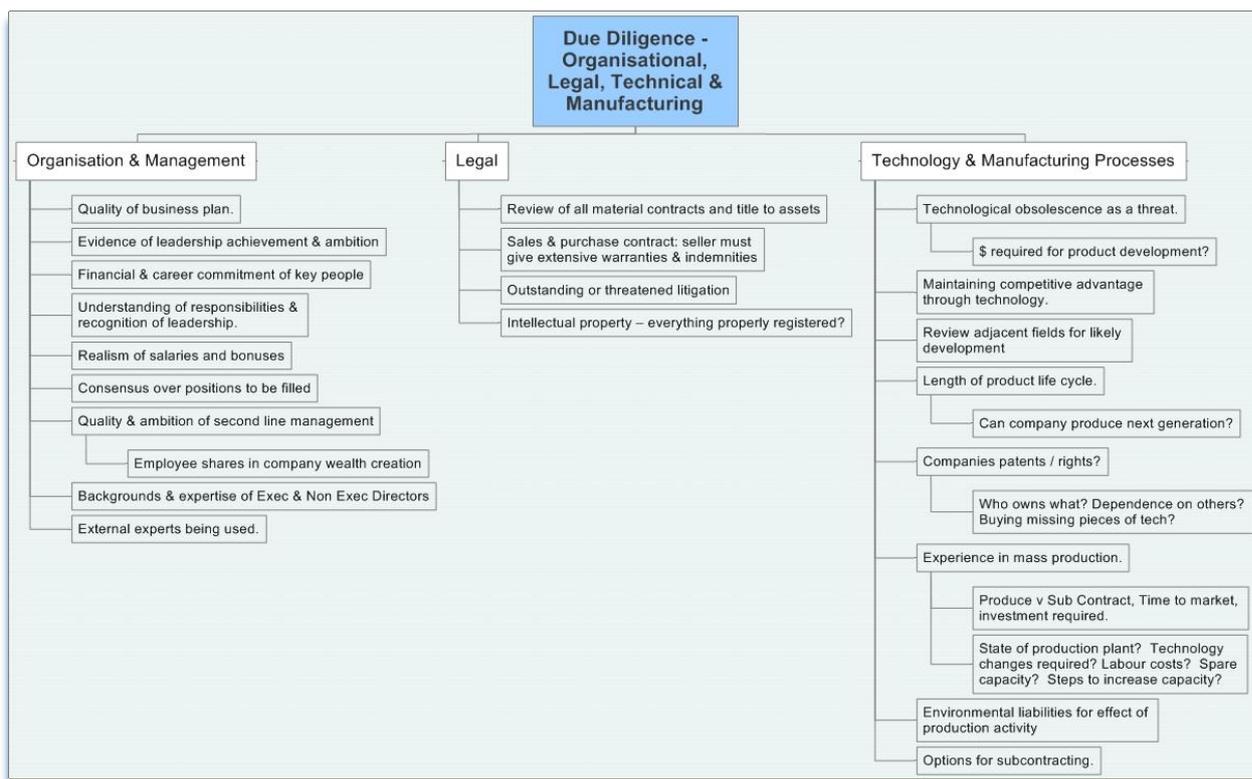


Figure 1: Organisational, Legal, Technical & Manufacturing Due Diligence

General Information

- Name, location and general nature of business.
- Who owns the business assets? A business structure chart may be helpful.
- Have you consulted your accountant/taxation adviser regarding the intended sale of business?
- Do you have a business plan for handover to the purchaser?
- What taxation and financial records can be made available for inspection by prospective purchasers? Are they up to date?
- What confidentiality agreements are applicable for potential purchasers?
- The various documents may be required (if applicable) including:
 - copies of taxation returns for the past three years, including copy of the depreciation
 - schedule for plant and equipment;
 - copies of any Business Activity Statement (BAS) statements;
 - copies of evidence of tax payments and tax invoices?
 - service or other agreements relating to employees;
 - current leases or credit purchase agreements relating to plant or equipment included in
 - the sale; and licences, permits or approvals relating to the conduct of the business.

- Are there any problems with or limits to your capacity or title, such as any registered or unregistered mortgages or charges over any assets included in sale (obtain details).
- Have you given any personal guarantees for the business which will continue after the sale?

Business Name and Intellectual Property

- Details of business name, trade name, product name or trade mark to be included in sale.
- Obtain certificates of registration for business name, trade name, product name or trade mark included in the sale.
- Intellectual property rights in systems and procedures should be addressed.

Finances

- Are accurate financial results available?
- Are financial statements regularly generated and are they complete, accurate and timely amongst key executives?
- Are individual profit centres identified with COGS categories associated with each profit centre?
- Are cash flow statements and forecasts regularly generated and reviewed?
- Are year to year profit changes analysed?
- How has working capital fluctuated over the previous reporting periods? Are the accounts payable figures acceptable?
- Are there processes in place to identify and determine lengthy debtors, and ascertain whether to continue servicing them?
- Is sufficient capital or access to capital for the needs of the business available?
- Are breakeven analysis regularly conducted and current?
- Are performance benchmarks established, monitored and compared with other industry participants?
- Is the unit (product and/or service) margin calculated and understood?
- Have the financial reports be confirmed by a financial authority?
- Have the financial reports been restructured to the intended audience of prospective buyers?
- Does forecasting and budgeting of the profit, cash flow, and financial conditions occur for the coming year?
- Are the impacts on the business of different opportunity or threat scenarios regularly performed and understood?
- Are budget variance reports regularly generated and reviewed?

Goodwill

- In respect of the business is there “personal” goodwill? Is goodwill ‘location’ based? Will its transition be hard or easy?
- Do you have significant referral sources?
- Is the goodwill tied up in systems, manuals or other intellectual property?
- Is the goodwill tied up in e-commerce?

- You will need to agree to be restrained from affecting the goodwill of the business after completion of the sale.

Compliance

- Are all compliance processes being followed? Ensure compliance records are ready for inspection by purchaser
- Are all licensing requirements being met?
- Is a complaints register properly maintained?

Employees

- Prepare an organisation chart with job descriptions (and CV's for key personnel).
- Is it proposed that all employees be transferred with the business? If yes, prepare details of all employees, length of service, rate of pay, employment status (casual, permanent, etc) and accrued leave entitlements.
- Obtain copies of service contracts, awards or agreements relating to employees.
- Do the service contracts contain confidentiality and restraint provisions?
- Do you require advice regarding termination and redundancy liability?
- Are there any key employees who are essential to enable sale of the business? If so, does the business have binding contracts with such employees to ensure he/she stays with the business
- Are there regularly scheduled audits of compliance to HR, superannuation and OH&S legislation?
- Are there regularly scheduled reviews of existing policies and procedures?
- Do all key employees have formalised and regular reviews, training needs analysis, an incentive structure and a grievance mechanism?

Clients/Customers

- Do you have client lists which should be handed over to the purchaser on completion?
- Does the purchaser have the benefit on completion of work in progress ("WIP") and client/customer enquiries? If so, do you have capacity to prepare reports of outstanding WIP and enquires?
- Are you, subject to privacy requirements, prepared to allow the purchaser to inspect the current financial plans and the risk analysis undertaken for select clients on a no name basis?
- Are the client files in order and, subject to appropriate controls and privacy requirements, in a format which facilitates an easy inspection on a no name basis?
- Should the purchaser retain client records, files, including completed and current matters, subject to client's consent?
- Do you have a report showing the analysis of funds, recurring revenue and fee for services?

- Which of the following exist with regards to customer support? Customer support plans, call centre procedures, customer feedback / satisfaction surveys, complaint handling procedures, a database of answers to FAQ's?
- Are customer relationship management (CRM) tools used?
- Does a customer loyalty and repeat business programme or procedures exist?

Marketing & Sales

- Are marketing performance statistics e.g. number of leads, leads to sales, average sales amount, average number of transactions per customer, kept and maintained?
- Is there a marketing budget for new leads and a separate marketing budget for existing clients?
- Does a formalised Competitive Intelligence system exist to regularly monitor competitor's behaviour, and market trends in the competitive environment?
- How useful and updated is the website? How well does the site rank in organic search and are commercial services employed to achieve "hits"?
- How are leads traditionally generated? Where do records exist of previous leads generated?
- What traditional above and below the line forms of advertising are used? Press, media, PR, events, seminars and workshop, exhibitions etc?
- Is eMarketing utilised including newsletters, email campaigns and online social networking?
- Does effective sales management exist to properly direct and control the sales force?
- Are account management processes defined and tracked?
- Do systems exist to ensure sales related activities such as customer services are not neglected by the sales team?
- Are lead to sale conversion rates, sales variance from forecasts and after sales customer satisfaction statistics measured and tracked?

Plant, Chattels, Fixtures

- Obtain detailed list of plant and chattels included in the sale.
- Consider whether depreciated value for taxation purposes is appropriate for sale purposes.
- Attribute value to each item being sold.
- Are any items subject to chattel lease or credit purchase (or similar arrangements)? Should you pay out liabilities or is the sale subject to the purchaser taking over liability?
- Are the chattel leases or credit purchase arrangements capable of being transferred?
- Does the purchaser require the computer network and systems? Is the software licensed?
- What are its terms?
- Are there any items which will not be sold with the business?

Licences Issues and Beneficial Contracts

- Have you considered the dealer representative agreement to ascertain whether you need consent from the licensee to sell the business and the revenue rights?
- Do you have contractual arrangements relating to the supply of goods or services to you, "back office" services, advertising, communications and the like, which are being sold as part

of the business?

- Consider the terms of contracts and the possibility of assignment to the purchaser or termination.
- Consider the need and ability to assign licences, and the procedures and consents required.

Processes, Services & Systems

- Are telephone and facsimile transmission services, post office box, e-commerce presence including web site and email to be retained by the purchaser?
- Are your business systems documented, effective and well implemented?
- Are KPI's used to measure both the financial and the non financial performance of the business?
- Do the following operational processes exist? A quality assurance plan, standard process diagrams or procedures for all operations, performance or process improvement, purchasing system?
- Do the following manufacturing processes exist? A manufacturing control system, a manufacturing cost system, a production control system?
- Does an inventory control system exist? Are inventory statistics and stock data maintained? Are inventory reorder levels formalised and does economic order levels and lot size analysis regularly occur?
- Does any formalised risk management occur? This includes a risk management plan, disaster and recovery procedures and an insurance plan?
- Are there formalised IT (information technology) procedures including a data backup policy, security management, records management and financial and customer record security?

Leases

- Consider the basis for your occupation of the business premises.
- Peruse lease (etc) documents, consider adequacy of registration, mortgagee's consent, provisions relating to assignment, option, rent review, rights of access, use of additional amenities, parking, common portions of the building and the like.
- Also consider the following: Entitlement to affix and remove fixtures, Entitlement to assign or sublet, and the conditions of that entitlement, obligations involving the doing of work or the expenditure of money, including paying rates, insurance, to repair and maintain the premises, restrictions on user and ability to change user, provision (if any) entitling the lessor to terminate the lease for any reason or to relocate the lessee in another part of the building.
- Are you aware of any defaults under the lease?
- Are your obligations under the lease guaranteed? Can the guarantors (or the bank guarantee) be released on assignment?
- Is there any currently pending rent review?
- What asset leases have been utilised by the vendor - the ownership or use of assets such as motor vehicles, tractors, printing equipment, plant, machinery, IT, shop-fits, etc?

- To what extent are the assets assignable to a buyer? Will the purchaser agree to assume the liability under the agreement(s) and to indemnify the vendor for the period after completion? Will permission be granted by the financier?
- Have the following lease / HP issues been considered in the transition: relocation & demolition clauses, refit and remodelling clauses, retail leases legislation, security bonds and “right of entry”

Liabilities

- Are there any current or likely future negligence claims against you?
- Are there any current or threatened legal proceedings against you by regulators, suppliers, creditors, clients or others? Any judgements, writs of execution or applications to appoint a receiver?
- Any notices, orders or proposals by the local council or other statutory authority?
- Should any arrangements be made with the purchaser regarding the conduct of such claims and the sharing of responsibility between the vendor and the purchaser?

Other Matters

- What representations (written or oral) have been made by you or on your behalf to the intending purchaser such as relating to recurring revenue or the like? Are there any Trade Practices or similar issues?
- Should any warranties be included in the agreement relating to these matters?
- Ensure dealer/dealers licence/proper authority issues are addressed.
- Advice should be taken on income tax, capital gains tax and GST.
- Computers, software licences, backup tapes and access codes must be addressed where business records are maintained on computer.
- Post sale, should restraints of trade be imposed? Has the appropriate type been considered?
- Will the buyer be trained by the vendor? What continuing forms of employment or consulting would be considered, and over what period?