

The Due Diligence Phase

More than Meets the Eye

The Due Diligence Phase – More than Meets the Eye

The process of performing due diligence on a target company entails an exhaustive review of, among other things, all significant business documents and records in an effort to assess the health and viability of the business under consideration...the due diligence phase is without question far more than a Quality of Earnings report.

Getting the Process Underway

Due diligence commences the moment the Letter of Intent is signed, or at least it theoretically should begin immediately thereafter. Unfortunately, many sellers are wholly unprepared to address the breadth and depth of your questions and documentation requests at this moment. They often don't realize the vast amount of data they have to provide during due diligence and what it takes to get to the closing table. This is particularly true in deals sourced on a proprietary basis and, perhaps, less so in brokered deals. However, it is very common for brokers to control the flow of information in an equally challenging way.

Allowing Enough Time for the Due Diligence Phase

It is quite common for sellers to expect that due diligence should take no longer than 60 days when they are fully committed to the sale of their business. Seller urgency could be motivated by any number of reasons such as previous busted transactions or tax planning considerations when year-end is fast approaching. This type of pressure on the buyer may manifest as early as the IOI stage so you may have to work very hard to manage seller expectations.

In reality, however, the due diligence phase will most likely take longer than 60 days. In the vast majority of cases, any delay tends to be the fault of the seller, who is often slow in responding to supplemental data requests or detailed questions. In brokered transactions, the broker may serve as the conduit between buyer and seller and prove to be an impediment.

Regardless of the circumstances, stay proactive with communications throughout the process. Push and prod for information and don't be reluctant to pick up the phone and be a pain in someone's side. Appreciate that other people don't always work as fast as you'd like, so mentally prepare yourself for 90 days. As mentioned elsewhere in this document, never lose sight of how many different components of the transaction Searchers are required to manage concurrently.

The length of time for due diligence should coincide with the length of exclusivity laid out in the LOI because buyers want to avoid a seller being able to negotiate with other buyers while due diligence is still under way. Good faith on the part of both parties usually enables an extension of time when needed; however, a Searcher may want to consider negotiating an automatic extension of 30 days under certain circumstances. The complexity of the target business will certainly influence how long due diligence may take.

Based on the above, what are some due diligence best practices to consider?

-) **Speed is a critical driver of success.** Identify the key deal dynamics and don't let loose ends languish in your evaluation process. Get to "Go" or "No Go" quickly in order to conserve time and financial resources.
-) **Consider whether there is a basis for "Trust" among the parties.** First and foremost, determine quickly if you "Trust" the seller(s). Then, quickly gain a seller's, their adviser's, and

influencer's "Trust". Trust changes everything. It's the foundation to a successful due diligence process and affects every aspect of the deal. Trust speeds up the process and is a deal catalyst. Your personal credibility is the foundation of all trust.

) **Maintain your objectivity.** Search Fund investors aren't likely to have felt remorse when a Searcher told us he or she walked away from a deal for the right reasons. Search Fund investors will only experience regret when a Searcher loses objectivity and closes on a less than great business and risks years of fighting headwinds.

- Reaffirm your comprehension of what makes a great Search fund business
- Avoid confirmation bias; don't rationalize a perceived outcome
- Create an environment and structure that forces you through an objective process
- Seek out experienced river guides with unbiased opinions
- Even neutral investor feedback should be understood and respected
- Know that a bad deal can quickly redefine success as "paying back the banks and returning investor capital"

) **Identify the business value drivers.** Learn what potential growth levers there are early in the process and translate them into a vision and scorecard. What is the targeted value proposition; in other words, why would you fall in love with the business? Refrain from falling into the "invest in sales" trap when undertaking this exercise unless that truly is an avenue for growth.

Transformational synergies can come from unlocking one or more long-standing constraints on a business, whether it involves delving into new products, services or territories previously not explored by the seller. However, be mindful of disruptive actions because transformation usually involves introducing more complexity into the organization. Change can have a significant impact on an organization's resources. Searchers should focus on a handful of targeted opportunities, processes, or organizational capabilities, sometimes referred to as "bets" that can make breakthrough performance possible and financially accretive.

) **Start Detailed integration and planning during due diligence.** The primary deliverable of due diligence should be the 100-day plan, which should not be focused as much on figuring out "what to do," but more on "how" to realize the targeted transformational synergies and deal drivers identified during due diligence.

) **Engaging in communication with Search Fund investors.** Whether it be frequency, depth or manner of communication, less is never more as you work through this stage of the process. Purposeful communication will increase the likelihood your Search fund investors stay highly engaged. Demonstrating that you are juggling the balls successfully: lenders, due diligence providers, attorneys and seller dynamics, is essential.

- Know who on your team to engage during different aspects of the due diligence process
- Avoid generic canvassing emails
- Anticipate questions and be prepared with knowledgeable responses

- Resist the temptation to “sell” the deal (did we mention – stay objective?)

Search Fund Capital Management

The Search fund capital is a Searcher’s lifeline throughout the search period. Managing capital during the search is relatively straight forward. The biggest threat to prematurely exhausting your capital base is unnecessarily spending money during due diligence. For obvious reasons, it is imperative that Searchers manage the due diligence process and consultants appropriately in order to conserve their capital base. This means rolling up your sleeves, dusting off or acquiring knowledge of QuickBooks in many cases and doing as much diligence yourself prior to bringing consultants in. When possible, negotiating fee deferral agreements such as those with Search Fund lawyers and QoE accountants can preserve funds. Partners to the Search Fund community who we have solid relationships understand and are accepting of this custom.

Quality of Earnings Review Engagement

Searchers should expect to complete a quality of earnings analysis during due diligence. Ideally, as mentioned above, Searchers should attempt to arrange a fee deferral agreement with their contracted CPA firm in order to preserve search capital in the event that a deal falls apart. Searchers should solicit a document request list from the CPA firm before beginning due diligence in order to supplement their own document request list. Searchers should also complete as much due diligence as possible prior to authorizing a CPA firm to complete their analysis. On occasion, a risk based QoE Light or phased approach has been used effectively to control scope and costs.

Search Process Management

One of the biggest challenges is maintaining a search effort while in due diligence. This task is particularly difficult for single Searchers, but is critical to a successful search. This is where a strong intern program will be of great value to you. It is important to continue searching and to keep the pipeline full so that if and when a deal falls through – and they frequently do, you will have other prospects to focus on immediately. Even if you are fortunate enough to have multiple LOIs in the works at the same time, don’t overlook the need to continue to fill your prospect funnel. Momentum is very important.

Investor Communications

Search Fund investors should be made aware of an executed LOI as soon as possible. Searchers will have likely worked closely with a handful of investors to prepare the LOI terms. Some Search Fund investors prefer pre-execution notification simply to enable them to best support the Searcher. Searchers should put together a summary (2-5 pages) of the opportunity and distribute the document to the entire group. The objective of the initial communication should be to gauge preliminary interest and to identify a list of key risks to focus on during your diligence effort. Publication of an iterative Q&A can provide the Searcher and Search Fund investors with the benefit of crowd sourcing knowledge and problem solving. Searchers should maintain close contact with Search Fund investors throughout due diligence in order to provide updates on the diligence effort. As you move through the diligence process, investor communication objectives should shift towards desired equity investment and Board construction. A detailed investment memorandum should be provided to Search Fund investors when all or most of due diligence has been completed. Examples of deal summaries and investment memos are available to Searchers from any member of the Search Fund investor team.

Seller Relations

Managing seller relations is a delicate and critical component to navigating due diligence, especially for a deal sourced by proprietary means. A small business often has several family members and long term employees / friends with management positions and even more members with ownership positions. Regardless of titles or ownership, however, there will be many opinions and motives when it comes to an important decision, especially one as important as selling. The business is often the largest source of economic net worth and future earnings for many or all of those involved.

A Searcher must try to stay neutral in any family dynamics while at the same time understanding the goals of the different decision-makers. For example, one family member may not want or need liquidity, while another does; one seller might want to pass employment onto their children, while another seller's children have no interest in working for the company.

If a family has built a successful business, it will have an enormous sense of pride in the company. Often a seller's identity is tied up in its business, and the thought that the business may not persevere is frightening and sometimes paralyzing. A Searcher must be sympathetic to this emotion.

Below are a few best practices to keep in mind:

-) **Cultivate the relationship:** Developing a strong relationship with the seller can be a helpful asset when in the midst of a tense negotiation. We advise Searchers to spend as much time as possible with the seller in order to strengthen the relationship. For many sellers, identifying the right successor is important to them. As the relationship strengthens, sellers will become more comfortable with the idea of leaving their company to you. It can also prove to be useful in further researching the business and preparing for transition. Some Searchers have stayed at the homes of the sellers while visiting the company. Dinners are also a helpful activity for relationship building.
-) **Emphasize the importance of competent advisors:** Inexperienced and/or unsophisticated lawyers and/or advisors are one of the most common ways that a transaction can derail. Searchers should emphasize the importance of competent advisors ideally prior to the execution of a Letter of Intent.
-) **Pay attention to red flags:** As you move into the purchase and sale agreement negotiation, be aware of which areas the seller focuses on and take note of any extreme asks. For example, if the seller seeks to eliminate their liability in the event of a representation and warranty breach, it may signal that there are undisclosed financial or operational flaws.
-) **Be very conscious of the dynamics between people during the due diligence process** (dust off your Psych 101 textbook): Anticipate points of friction and have a plan on how to handle them, and when to ask for help from your Search Fund investors. Among the areas where friction may arise are 1) seller(s)/partnership interpersonal dynamics, 2) family matters (spouse and children in the business), 3) sellers with different needs and objectives - "Who wants to kill the deal and why" and 4) seller(s)/partnership roles and economic partnership have diverged over time. Avoid getting blindsided where possible. Scenario analysis may help insulate you from a seller walking away a few days before closing because three of the partners bought out the majority partner; this is a real life example!

-)] **Be cautious in handling a “No” answer for information from the seller:** Listen for signals, is the information a must have, are there suitable alternatives that don't compromise your goals in the process, watch for a pattern of behavior (is the seller chronically “hiding the ball”).

Board Construction Activities

Identify very interested investors during the due diligence process. These individuals may have been the Searcher's industry river guides or most active investor(s) in some cases. Determine if these Search Fund investors are willing to meet with the sellers and key talent on site. This level of interest and engagement may lead to a natural progression of the investor becoming a Board member and comforting for the sellers to see a few “Gray Hairs” on your team. The construction of the Board is arguably one of the most important tasks to consider during the later stages of due diligence.

Using Checklists during Due Diligence

Checklists are helpful for guidance, but should not be used to just “check the box.” The key to due diligence lies in applying the 3Rs technique asking the Right follow-up questions at the Right time to the Right person. A well-defined due diligence process and tools such as checklists are important, but the right level of experienced resources is necessary to ask the right follow-up questions, which will provide the right answers. The checklists will help you uncover specific red flags but your curiosity will detect intangible risk factors.

As a reminder, a Searcher's journey will most likely NOT begin in a traditional due diligence “data room” but will frequently commence with volumes of loosely organized documents provided at different intervals. If a Searcher is fortunate, he or she may be provided with a list of all the documents that would normally be included in a due diligence data room (an example of a middle market due diligence checklist is provided later in this document). This is more likely to happen in professionally intermediated (brokered) auction style deals.

Take a “Risk Based” Approach to Due Diligence

Focus on staging the spectrum of due diligence activities. This includes a “discovery phase” wherein the Searcher identifies the top 3 to 5 risks to your growth and profitability thesis and how to effectively mitigate them. Also, identify the top 3 to 5 greatest risks of falling short of your first twelve months of operation's financial performance and how, if possible, you can mitigate them. There is a Learning Loop to follow: Investigate, Discover, Confirm, Mitigate and Learn.

What could possibly go wrong in the due diligence process?

There are numerous pitfalls throughout the due diligence process to avoid if possible. The following are a few examples of situations and behaviors the Searcher should be mindful of:

-)] Treating the due diligence like an academic process rather than an investigative process
-)] Requesting sensitive information, such as customer lists and employee compensation, too soon
-)] Asking for information or information that doesn't get you closer to qualifying or closing
-)] Not accepting information piecemeal but insisting on complete package of data

-) Hiding behind email communication and foregoing open dialogue and face-to-face communications
-) Over delegating to due diligence providers and failing to immerse yourself in the fine details of the business where possible
-) Inability to identify over-dependence on one market sub-segment. The expertise gained may have fueled past success, but without diversification, a smaller target can be particularly vulnerable to a downturn
-) Susceptibility to opportunity exaggeration as sellers tend to overestimate potential success in markets and industries they're not familiar with based on historical results in their own sandbox
-) Failure to identify exogenous risks such as disruptive technologies, non-traditional competitors, regulatory changes and macroeconomic developments which can have an outsized impact on smaller, non-diversified companies
-) Thinking the entire deal can be reduced to a large Excel model, but it can't be

Financial Due Diligence

The finance area is the most common point of focus in the due diligence process and no one should be surprised to hear that financial information is the cornerstone of Search Fund deals. In all likelihood, the financial review will be the most intensive and important of the due diligence process. During this time Searchers will also need to determine net working capital (NWC) needs, which will later serve as the basis for the NWC peg.

Searchers will want to analyze a seller's accounting policies for various procedures, including, but not limited to revenue recognition, accounts receivable, capitalizing assets, depreciation and amortization methods, and adjustments to EBITDA, as well as reviewing any changes in accounting methods. Don't be surprised if the seller has simply been operating out of the checkbook and all records are on a cash basis of accounting, and not Generally Accepted Accounting Principles (GAAP).

The due diligence process should identify any material change to the normal business or financial practices made by the sellers in the last twelve month. For example, a recent price increase or reduction of staff to thin out expenses are signs of dressing up the business for sale. The primary objective is to learn why the sellers made the moves and what the short and mid-term impacts are on goodwill (i.e. client retention, competitive position, employee engagement or internal capabilities). Searchers must determine if they are buying a \$2 million EBITDA business that has been run on a shoestring budget with minimal staff and can only be successfully operated post-closing with a significant increase in operating expenses.

The due diligence checklist is a good starting point for compiling the financial records that will be required for review by the prospective buyer. Financial due diligence data is critical in the determination of the value of the ongoing business.

A focus on identifying and analyzing key financial and operational trends that are important to gauge the likely future earnings power of the target is essential. The materials a Searcher receives ideally contain

not only the last two to three years historical financial records but also financial forecasts for the current year.

Quality of Earnings Considerations

Because financial statements include the use of estimates and may contain nonrecurring or unusual income and expense items, it is important to determine whether the current financials are an accurate representation of the target's true earnings power. Generally, items to consider should include:

-) Do the target's earnings closely approximate cash flows, and if not, why?
-) What accounting treatments does the target utilize in relation to its relation to its peers, and what is the reasonableness of estimates?
-) What is the fundamental driver of earnings, and which historical items should be excluded from assessing earnings quality?
-) How realistic are the target's projections in light of historical results and its operating environment?
-) What is the required capitalization of the entity, and what are the future capitalization requirements?
-) Is the target subject to any off-balance sheet or contingent liabilities that were not disclosed by management?

Legal Due Diligence

The legal due diligence phase of the process is generally the second area to be explored. What is provided should contain all the business legal documents. The legal due diligence should also contain a detailed explanation on ownership and owners of the company. Additionally, copies of all contracts and agreements should be made available to the Searcher and his or her counsel. If the target company has intellectual property or patents, copies of all employee and company documents related to ownership of corporate intellectual property should be included in the legal due diligence review.

Operational Due Diligence

The operational due diligence phase will hopefully result in well documented overviews of the major processes associated to the operation of the business. Business relationships, suppliers and distribution channels should also be clearly documented. You will be looking for areas of risk such as customer concentration, customer churn and if applicable, a single supplier that could affect ongoing success. The sales cycle is another area that requires an in depth review.

Sales and Marketing Information:

Who are the Seller's customers, and how do they market to them? Who are their competitors? The following are some of the sales and marketing basics any Buyer wants to determine during due diligence:

-) Complete customer list, including name, address, telephone number and contact name
-) Listing of any major customers lost in the last 3 years and the reasons why

-) Listing of open orders and copies of all supply or service agreements
-) Surveys and market research reports
-) Schedule of the company's current advertising programs, marketing plans, budgets, and physical marketing materials
-) Listing of the company's major competitors

Searchers should request customer data by major product line and by percentage of sales. A customer with sales that represent more than 5 percent of the gross sales should be considered major.

Review current and historical sales pipelines. Consider whether the current pipeline will convert to the next six months of expected revenue or not. Sellers may give you access to "Lost clients" earlier in the process. Lost clients are a great source of intelligence. Also, consider making "blind" research contact with the seller's direct competitors to learn more about the competitive landscape and trends.

Initially, sellers are likely to provide the buyer with an anonymous list (using a code such as "customer 1", "customer 2", and so on). In some cases, only if and when a seller believes the Searcher will close the deal will the seller release specific customer names. For convenience, that list should match the anonymous list (that is, customer 1 should be the first customer on the list, and so on). Release of the specific names of customers could occur late in the due diligence process but is essential to performing customer satisfaction surveys.

If Searcher is asking to speak with some customers prior to close, seller may only grant that request as a last and final step before closing. In other words, all other due diligence should be finished and the purchase agreement should be completed.

IT and Intellectual Property Due Diligence

IT due diligence information should include a detailed listing of all information systems and applications used in the normal business processes. If the company is a software development company or has developed any software for internal use, all of these programs should be documented in detail. Any use of third party software and related software contracts should also be documented, as well as any use of "open source" software.

Evaluating any patents or trademarks should be included in this section of the due diligence review. The company's internet presence should be documented including information on ecommerce, web hosting and online customer records.

Procedure and overview documents should cover such topics as security, backup procedures, controls, and auditing.

Personnel Due Diligence

Documents contained in the personnel due diligence data request should include an organizational chart of all management, a resume on each critical employee (for tech companies, key developers, designers, programmers, etc.), wages and salary contracts for all executives and key employees. This section should also contain any and all HR, benefits, and compensation contracts and policies.

Although reviewing these documents may be a practical approach to personnel due diligence, of possibly greater importance is finding the “key people” in the company who make it go day in and day out, learning more about them and their motivators, and how you will retain and engage them post acquisition. This is especially true when the composition of employees is made up of highly educated and technical resources in industries where the Searcher has no prior experience.

The due diligence process should help Searchers determine if the company has severely underinvested in people, namely mid-level managers and what the cost to plug gaps will be in the first and second years. Search fund investors generally expect some under investment in staff by sellers. One of the most common gaps in the typical target is the Finance function where, on occasion, the seller’s spouse is the “Controller” but simply manages the checkbook. However, if the staffing deficiencies run deeper the Searcher and his/her investors need to know how deep the hole is. If the seller has invested in management but the positions need to be upgraded at least some amount of expense is already on the P&L and merely needs to be optimized.

Managing the Financing Process During Due Diligence

Bank financing: Leverage in a Search Fund transaction is a crucial component in order to generate the returns expected by Search Fund investors. Searchers should strive for striking the balance between conservative leverage and an optimal amount of debt to achieve return targets but not jeopardize the business. However, because of the relatively small size of a typical transaction and the asset light nature of the businesses that are being targeted, it can be difficult to source attractive bank financing. Fortunately, at the time of writing, more commercial banks are developing awareness of the Search Fund model and have sufficient interest and capacity to deploy funds in the Search Fund niche. Below are a few recommendations for managing the debt component of your capital structure.

-) **Begin the process early:** Many lenders, particularly senior lenders, have a tendency to be quite bureaucratic when moving through an evaluation process and therefore it is helpful to begin a dialogue as early as possible. If possible, have discussions with prospective lenders just prior to or shortly after signing an LOI. Solicit term sheets within the first two weeks of signing an LOI as the approval process and subsequent diligence and document efforts can take as much as eight weeks.
-) **Ideal lender profile:** Over the years Search Fund investors have developed some lending relationships and have had mutual experiences which could prove beneficial in arranging financing for your transaction. Please reach out to your Search Fund investors when formulating a list of lenders to solicit. Targeting senior lenders that are in reasonable proximity to the business can be helpful in managing the relationship post transaction. Searchers are encouraged to develop a 2-5 page summary of the investment opportunity and send an email to numerous lenders, not just those we are familiar with, in order to begin the process and gauge interest.
-) **Manage the lenders:** As previously mentioned, the process within a bank can be very slow, so set very clear deadlines for terms sheets and a commitment letter and manage lenders proactively.

-) **Leveraging your Search Fund investors:** The investor network is happy to provide a summary of model debt financing terms. When soliciting term sheets, be up front about exactly what you're looking for with regard to amount of financing and terms. By doing this, Searchers will avoid a wide spectrum of bids and several iterations of negotiations.

Attachments

[Appendix I - Sample Topics to Cover in Due Diligence](#)

[Sample Due Diligence Timeline](#)

[Sample Due Diligence Questionnaire and Timeline](#)

[Grant Thornton M&A Due Diligence Checklist for Middle Market Buyers](#)

Sample Topics to Cover in Due Diligence (not intended to be all inclusive)**I. GENERAL COMPANY DATA (note: some of the following presumes a stock purchase)**

1. A list of each direct or indirect subsidiary of the Company.
2. Capitalization of the Company showing the record owners of such shares.
3. Certificate or articles of incorporation and bylaws of the Company, or articles of Organization and operating agreement in effect.
4. All agreements among stockholders or members of the Company relating to management, ownership, or control of the Company.
5. All documents entered into with respect to or related to any prior financings or equity issuances of the Company.
6. An address list of the locations of all land, buildings, and other improvements either leased or owned by the Company.
7. All material governmental permits, licenses or authorizations, and related correspondence, of the Company.
8. Other than customer contracts, any agreements with any federal, state, or local regulatory authorities to which the Company is a party.

II. FINANCIAL INFORMATION

1. Audited financial statements for each of the Company for the last three fiscal years (presuming an audit has been performed), with the auditor's opinion and all footnotes.
2. Un-audited financial statements for each of the Company for the most recent month, quarter end or YTD.
3. Comparison of last two (2) years forecasted budgets compared to actual performance.
4. Detail of capital expenditures for the last three (3) calendar years.
5. Receivables aging schedule and history of write-offs.
6. All correspondence between the Company and the Company's auditors for the last three (3) years.
7. The Company's forecast projections for performance for the next three years.

III. CORPORATE AGREEMENTS

1. All documents and agreements evidencing other financing arrangements to which the Company or any Subsidiary is a party or under which the Company or any Subsidiary is otherwise obligated, including sale and leaseback arrangements, capitalized leases, real estate and other installment purchases, make-whole agreements (or covenants) and guarantees.
2. All material agreements encumbering real or personal property owned by the Company or any Subsidiary, including all mortgages, deeds of trust, and security agreements.
3. All real estate contracts of the Company.
4. Deeds and title policies relating to any real property owned by the Company or any Subsidiary.
5. All leases of real or material personal property.
6. All joint venture, partnership, or other management, operating, or consulting agreements relating to the Company.
7. All agreements between the Company and its 20 largest customers, and a form (or forms) of any agreement typically used by the Company to provide services to its customers.
8. All material vendor contracts.
9. A list of the Company's 20 largest customers and vendors, determined by annual revenues and expenditures, respectively.
10. Other than customer contracts, any agreements with any federal, state, or local regulatory authorities to which the Company is a party.

IV. INTELLECTUAL PROPERTY RIGHTS & PRODUCT INFORMATION

1. Schedule of all trademarks, service marks, trade names, copyrights and patents that relate to the products, services, operations or names of the Company.
2. All agreements concerning confidentiality, nondisclosure and assignment of inventions with employees, contractors, or other parties.
3. All documents concerning registration of trademarks and service marks, including registration certificates, applications, correspondence and searches, and the results of any trademark or service mark searches conducted by the Company.
4. All agreements and documents concerning assignment, purchase, sale or license of proprietary rights, royalties or maintenance, including patents, copyrights, trade secrets, and trademarks.

V. INSURANCE COVERAGE

1. Description of each property, general liability, automobile, worker's compensation, and umbrella liability insurance policy issued to the Company, specifying:
 -) Name of insurance carrier(s)
 -) Annual Premium
 -) Coverage
 -) Claims within the last 3 years
 -) Self-insured retention, co-payment, or deductible
 -) Whether the policies are "occurrence" or "claims made" policies.

VI. LITIGATION HISTORY & AGREEMENTS

1. A list of any litigation or judgments settled within the last 5 years in which the company was involved either directly or indirectly.
2. A list of all pending or threatened litigation or administrative proceedings, inquiries, or investigations, including copies of petitions or complaints.
3. A list of names and addresses of all legal counsel who are currently acting on behalf of the Company.
4. A list of all consent decrees, judgments, injunctions, other decrees, orders, settlement agreements, arbitrations, and arbitration findings to which the Company is subject or bound

VII. EMPLOYEES AND HUMAN RESOURCES

1. All management employment contracts, "golden parachute agreements," severance agreements, consulting agreements, "stay" agreements and agreements not to compete to which the Company is a party.
2. An organizational chart which lists the name and title of each employee.
3. With respect to each employee benefit plan, copies of plan documents and any related trust, insurance policy, annuity contract, or other funding vehicle;
4. Copies of all bonus, severance, employee option and employee equity participation plans or agreements.
5. Details of all other employee plans and arrangements that do not constitute Employee Benefit Plans.
6. Discuss number of employees and average tenure.

VIII. TAX FILINGS & RECORDS

1. All federal, state, local, and other tax returns and reports filed by or on behalf of the Company for the last three fiscal years and for all open years.

2. All information related to any audit of any return or report filed by or on behalf of the Company for the last five fiscal years or related to any pending audits or administrative or judicial disputes relating to taxes for any open periods.
3. Agreements which waive or extend the period for assessment or collection of any federal, state, local or other taxes.
4. Any tax elections which may have a material effect on the Company.

IX. CUSTOMER AND MARKETING INFORMATION

1. Total customer counts by major product/service for each of the last 3 years.
2. Listing of any customer that constituted more than 5% of total sales during the last three years.
3. Discuss primary sales channels.
4. For each of the Company's products, discuss target customer and marketing strategy. How are sales efforts organized?
5. Describe how new business is generated and the process of entering into arrangements with the customer.
6. Absent any significant sales expenditures, how does the Company drive growth?
7. Discuss the importance of individual customer relationships in the business.
8. List the company's top competitors, their market share and how the company differentiates itself from each of these competitors including competitor products, market focus and pricing.
9. How does the Company's customer base differ from its competitors?
10. Does the Company have any strategic alliances or business relationships with other industry participants? How are they structured?

X. INTERNAL CONTROLS and INFORMATION SYSTEMS

1. Generally describe the information systems used by the Company and how they compare with industry standards and the Company's direct competition.
2. Complete List of all hardware and software used to manage the business. Quantify the dollar investment made by the Company over the past three years with regard to its technology.
3. Describe the Company's accounting and financial controls and MIS functions. What MIS and technology expenditures will be needed in the future?
4. Generally describe the IT physical security as well as Internet IT security.

5. Identify which employees have “administrative” or “super-user” access to critical company files and databases. How many of those employees were terminated within the last 24 months.
6. What is the backup procedure to secure critical business electronic records and databases?
7. Are any records secured in an offsite or third party location?
8. Does the company have a disaster recovery plan?

XIII. SALES OPERATIONAL INFORMATION

1. Breakdown of sales by channel (distributors, direct, e-commerce) by month for the last 3 years.
2. Listing of top 20 resellers or distributors and revenue by reseller for the last 3 years.
3. Revenue derived from new customers verses existing customers as well as revenue from new product sales verses recurring maintenance contracts for the last 3 years.
4. Provide information related to the Company’s planned new product releases (i.e., expected timing of release, related product and service margins and markets targeted).
5. Discuss any new business the Company might have been awarded and comment on any business which may have been recently lost.
6. Are there particular areas of the Industry that the Company would identify as significant growth opportunities?
7. Discuss the Company’s major partnerships, if any, and how these help drive revenue growth.

XIV. SUPPORT SERVICES AND PRODUCT PRICING

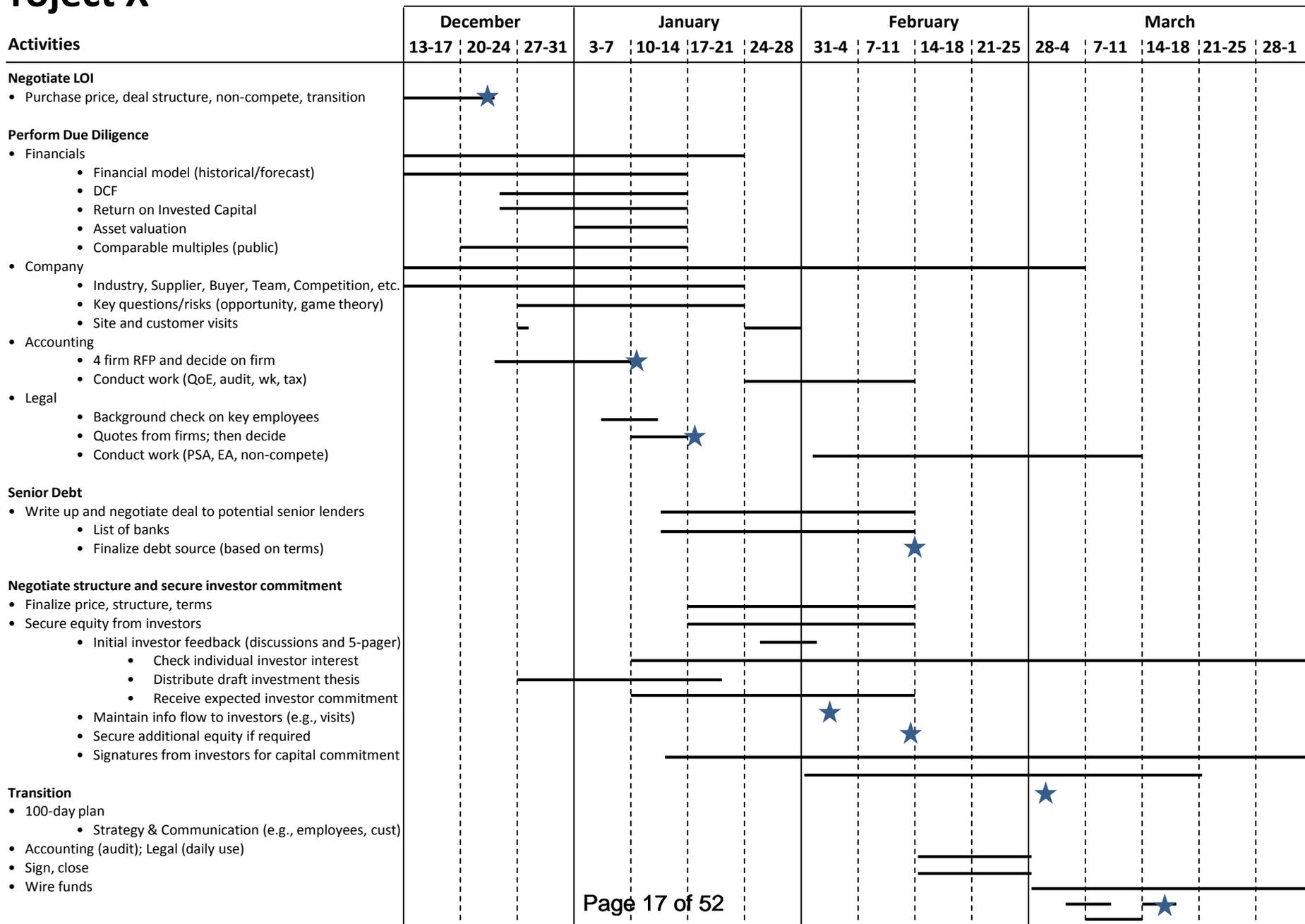
1. Discuss the economics behind (1) product fees, (2) license fees and (3) maintenance fees, (4) other revenue producing fees.
2. Discuss current margins and growth in margins for (a) Products and (b) maintenance services.
3. What pricing advantages does the Company have versus its competitors?
4. Discuss the Company’s pricing strategy and contract terms.
5. Describe the Company’s proprietary products, systems and technologies with specific reference to economics underlying the offering.
6. Does the Company perform any product customization? If so, discuss the economics behind this offering.
7. Describe the Company’s support function. Is this 24/7?

Sample Timeline

★ Milestone

MM/DD/YYYY
DRAFT

Project X



Primary Activities	Beg. Week	Duration (Weeks)	End Week	Person Resp.	Internal Reminde	Info Recvd	Compl.	Follow-Up Req'd	Week 1	Week 2	Week 3	Week 4	Week 5	Week 20	
A. General Items																
1) Deliver due diligence request list to Company or Company's representative																
2) Receive all available due diligence material from Company and create an inventory if necessary																
3) Visit Company facility(ies). Obtain a list of states in which the Company does business and copies of licenses to operate in those states.																
4) Review the history of the business - ownership; when/why started; key milestones, etc.																
5) Review any consultant reports, operational reviews, monthly management reports, etc.																
6) Understand fundamental changes in the business due to technology, competition, etc.																
7) Understand Company's primary strengths and competitive advantages																
8) Understand Company's primary weaknesses and how to improve upon them																
9) Understand economic factors affecting the business - what happens in a recession?																
10) Perform Company background check through public sources. Conduct Seller background check.																
11) Obtain date of formation of Company with copies of Certificate of Formation (or similar Organizational Documents) and Operating Agreement																
12) Obtain a list of stock ownership of the Company if applicable.																
13) Obtain all stock record books and a list of all outstanding stock certificates.																
14) Obtain copies of any plan or other documentation relating to the Company's actual and proposed compensation of key employees and sales staff.																
B. Strategy and Product																
1) Obtain a copy of any strategic planning documents and budgets.																
2) Provide release documentation for each product release for the last 3 years.																
3) Describe upcoming product releases and planned functionality. Provide any available documentation on future releases.																
4) Provide copies of press releases, articles, case studies or other documents concerning the Company or any subsidiary or their products for the last three years.																
5) Obtain a status and costs incurred to-date for any in-process R&D projects.																
6) Obtain documentation regarding the software development process including all third party software used in the development and testing processes. Include the maintenance costs for all tools used, along with renewal dates.																
7) Obtain a copy of the SOC Certification (service center internal controls).																
8) Provide the current outstanding list of defects or "bugs" not yet corrected and the list of defects or "bugs" corrected over the last 2 years.																
C. Service Offerings																
1) Review/analyze all services that are provided for each market segment																
2) Understand unique features of Company's service offering																
3) Understand the target market for the Company's services - who are the end users?																
4) Review portfolio of intellectual property and life of patents/copyrighted material.																
5) Understand the basic needs of the end users/customers that need to be met - what capabilities are required to meet these needs?																
6) Obtain market share by location / service line / segment																
7) Understand current opportunities and threats for each service offering within each market segment																
8) Understand the differentiation and market position vs. competitors																
D. Customers/Customer Support																
1) Interview significant customers, present/past - why do they do business with the Company; positives/negatives; alternative sources																
2) Review a list of customers; identify length of and evolution of relationships.																
3) Review all contracts with significant customers and distributors.																
4) Review the top 50 customers based on revenue for the last 3 fiscal years - historical/projected revenue and gross profit; contact information; tenure with the Company; services/products provided; market segment; key terms; concentration issues																
5) Understand the customer service program & correspondence procedures with customers.																
6) Review Customer Support functions																
7) Support process / philosophy																
8) Satisfaction / Dispute overview																
9) Statistics on calls																
10) Handled per day																
11) Resolution rate																
12) Level 1 - 2 - 3 support process																
13) Software system to support customer service																
14) Attrition/gain rate of customer base per year (Last 3 fiscal years) and projections																
15) Descriptions of major deployments, including cost, service, integration, and maintenance requirements																
16) List of any customer disputes, if any																
E. Sales & Marketing																
1) Understand structure of sales and marketing organization - appropriate for the industry? Cost effective?																
2) Understand selling process and how new business is procured																
3) Identify all people important to making the purchase decision / basis for making decisions																

Comprehensive M&A due diligence checklist for buyers

1. General
 - a. Overview
 - i. Read the Letter of Intent and Definitive Agreement
 - ii. Read the latest available interim financial statements related to the Target.
 - iii. Obtain copies of internal financial statements for the historical period. Determine that such financial statements reconcile to trial balances/general ledgers for each period in the historical period
 - iv. Interview Target management and key accounting personnel to obtain an understanding of the operations and the accounting, reporting and control systems
 - v. Understand key terms of all significant customer and supplier contracts
 - vi. Understand key terms of all significant lease agreements
 - b. Accounting policies
 - i. Summarize significant accounting policies adopted by Target, including judgmental reserves and estimates
 - ii. Obtain detail of any changes in accounting policies/restructuring/impairments recorded by the Target.
 - iii. Understand any change in accounting methods or principles during the last five years and the reasons such change was undertaken.
 - iv. Review any letters from the Company's outside tax advisors and accountants during the last five years regarding the Company's accounting controls, method of accounting and other procedures.
 - v. Review any non-GAAP financial measures used in public documents, accompanied by the most directly comparable GAAP financial measure and reconciliation to GAAP, along with reasons for use of non-GAAP measures.
 - c. Audit / Review Workpaper Review
 - i. Identification of scope, audit procedures, control issues, passed adjustments, contingencies, accounting policies, etc., as it relates to Target
 - ii. Read the management representation letter, if applicable
 - d. Contracts
 - i. Review contracts which have a remaining term in excess of one (1) year.
 - ii. Review a schedule of any transactions (including purchase, sale, financing or loan agreements) between the Company and any shareholder, member, officer, director, employee or affiliate of the Company (including spouses, children and

other relatives of any affiliates thereof), and copies of all documents relating to such transactions.

- iii. Analyze contracts or letters of intent for the sale or acquisition of capital assets or securities.
- iv. Review powers of attorney, agency or representation agreements.
- v. Review logistics contracts or warehouse management agreements.
- vi. Understand key terms of license agreements.
- vii. Review any franchise agreements.
- viii. Review any joint venture agreement, partnership agreement or agreement involving a sharing of profits or technology of the Company, or joint marketing, development or distribution efforts by the Company.
- ix. Review any guarantee of the obligations of the Company's customers, suppliers, officers, directors, employees or others.
- x. Review any distribution, dealer, sales agency, advertising or consignment agreement to which the Company is a party or by which it is bound.
- xi. Review any material supply or requirement contracts to which the Company is a party or by which it is bound.
- xii. Review any non-competition, stand-still or confidentiality agreement to which the Company is a party or by which it is bound or any other agreement limiting the Company's ability to engage in any business anywhere in the world.
- xiii. Review a schedule and description of any agreement or contract to which the Company is party or by which it is bound under which the Company or another party is in default or which is in the process of being terminated or modified.
- xiv. Review any note, instrument, agreement, mortgage, lease, license, franchise, governmental permit or judgment, order or decree which involves covenants or other restrictions which could be violated or triggered by an acquisition of the Company or any of its assets.
- xv. Review and understand the key terms of purchase orders and other similar contracts and commitments.
- xvi. Review any professional service agreements.
- xvii. Review contracts relating to capital expenditures in excess of \$_____.
- xviii. Review contracts relating to any sale of any significant asset or property, other than inventory in the ordinary course of business.

- xix. Examine agreements or instruments which place restrictions or encumbrances on assets of the Company (including security agreements and judicial or administrative orders or decrees).
- xx. Examine all material contracts with customers.
- xxi. Review building or construction agreements.
- xxii. Understand the company's standard language/form (and any material third-party form used) including, but not limited to warranty agreements or terms, purchase orders, invoices, vendor and customer agreements.
- xxiii. Review purchase or lease agreements for machinery, equipment or other personal property.
- xxiv. Review computer contracts (hardware, service bureau, etc.).
- xxv. Examine all contracts with any governmental entity (including federal, regional, state, local and foreign) which may include, but are not limited to, any contracts with national defense, homeland security, or other national security responsibilities, including law enforcement responsibilities as it relates to defense, homeland security or national security.
- xxvi. Review agreements that may restrict the Company's activities in any significant manner.
- xxvii. Examine written summaries of oral agreements.
- xxviii. Identify material correspondence relating to material contracts.
- xxix. Review all other contracts and agreements involving the Company not otherwise covered by the above list and involving annual payment or receipt by the Company of \$_____ or more.
- xxx. Examine any other material contract or contract not entered into in the ordinary course of business.

2. Corporate

a. General

- i. Review the Articles of Incorporation of the Company, as amended to date.
- ii. Review the bylaws of the Company, as amended to date.
- iii. Examine the minutes of the last five (5) years of meetings of the Board of Directors of the Company and any committees thereof and of the stockholders of the Company and copies of written consents in lieu of such meetings.

- iv. Review materials prepared for distribution to shareholders or directors in the past five years.
- v. Examine the list of jurisdictions in which the Company is qualified to do business as a foreign corporation.
- vi. Review a schedule of all states and countries in which the Company has offices, plants, employees, or representatives or in which the Company has annual sales of at least \$_____.
- vii. Examine the list of names under which the Company does or has done business.
- viii. Review a summary of the corporate history of the Company and any predecessors, including any mergers, acquisitions, changes in control, divestitures and corporate reorganizations.
- ix. Review documents relating to any past or present ownership interest of the Company in any other enterprise.
- x. Review the stock transfer ledger of the Company and copies of stock certificates of the Company.
- xi. Review the management and investment studies or reports of the Company, including any valuations and appraisals of the Company or divisions during the last five years.
- xii. Examine the brochures and reports describing the Company and its products.
- xiii. Review all organizational charts and policy manuals, including corporate codes of conduct.
- xiv. Review any press clippings and releases relating to the Company for the past three years.
- xv. Review a list of the business associations of which either Company is a member and copies of any documents related to such membership.

- xvi. Review a list of bank accounts (with authorized signers)
 - xvii. Review any documents relating to the Company's status as an approved vendor to any party (including the federal government), and evidencing quality awards or designations.
 - xviii. Review a list of all transactions or business relationships of the Company with any subsidiary, parent or affiliate including, but not limited to (a) borrowing arrangements or other credit arrangements, (b) joint or shared activities including purchasing, marketing, sales, common offices, common management and (c) staff or other services provided. For each such relationship, provide copies of agreements or other written descriptions of such arrangements, together with fee schedules and amounts involved for each of the last five (5) years.
- b. Capitalization
- i. Review a summary of the classes and series of securities authorized and the number of shares or membership interests of each class or series issued and outstanding.
 - ii. Review a schedule of all issuances of Company securities and grants of any stock options, warrants, convertible securities, restricted stock awards, stock appreciation rights, phantom stock rights, plans, or other commitments to issue securities. listing the holders thereof, the date of grant, the number of shares entitled to be purchased, vesting schedules, exercise price and fair market value on the date of grant) as well as any associated stock option, performance, or incentive plans.
 - iii. Review a schedule of repurchases of capital stock or other securities.
 - iv. Review a list of all current security holders (record holder as well as beneficial holder, if they are not the same person or entity), including number and type of securities issued or issuable upon exercise or conversion.
 - v. Obtain all governmental permits, notices of exemption and consents for issuance or transfer of the Company's securities and evidence of qualification or exemption under applicable blue sky laws.

- vi. Identify and review all agreements among security holders, or between any security holder and the Company, with respect to voting, grants of proxies, dividend declaration or payment, rights of first offer or first refusal, co-sale or participation rights, observation or information rights.
- vii. Review all agreements among security holders, or between any security holder and the Company, with respect to the management, ownership or control of the Company.
- viii. Examine stockholders agreements, put or call agreements, voting agreements, stock transfer agreements or other arrangements among the shareholders of the Company.
- ix. Review agreements relating to registration rights, preemptive rights, rights of first refusal or co-sale rights.
- x. Examine any contract or agreement to which the Company is a party which contains a change of control provisions.
- xi. Understand the key terms of trust agreements or other documents (if shares are held in fiduciary or entity capacity).
- xii. Examine agreements, offering circulars, private placement memoranda, disclosure letters, and similar documents relating to sales (within past five years) or proposed sales of securities.
- xiii. Review agreements with any broker, finder, or other person or entity relating to the past, present, or proposed offering of securities.
- xiv. Understand any claims made since inception by any person asserting a right to an equity interest in the Company.
- xv. Identify any restrictions on the Company's ability to make dividend payments to its shareholders.

3. Financial Results (and Accounting, Tax and Financial Information and Operating Information)

a. Historical Trends

- v. Understand the trends in the major categories of controllable expenses over the last two years and TTM period (i.e. direct operating expenses, advertising and promotions, utilities, general and administrative, repairs and maintenance, supplies, etc.)
 - vi. Understand the trends in the major categories of non-controllable expenses over the last two years and TTM period (i.e. rent, property taxes, property insurance, G&A costs, etc.)
 - vii. Obtain an understanding of significant third party vendors/suppliers
- f. SG&A
- i. Understand the trends in the major categories of food, beverage and paper costs over the last two fiscal years and TTM period
 - ii. Understand major drivers for significant components of costs (salaries, insurance, rent, utilities, etc.)
- g. Corp Infrastructure / Allocations
- i. Understand procedures performed at corporate vs. at the locations
 - ii. Analyze the significant components of corporate expenses, identifying unusual trends, current fluctuations and any significant non-recurring income and expense items
 - iii. Analyze/understand costs that are allocated/not allocated to individual locations for services performed by corporate (i.e. is management fee only allocation?)
- h. Outside Services
- i. Obtain a listing of outsourced services and discuss with management the relationship and capacity available at these key vendors
- i. Obtain copies of all written investment policies of the Company.
- j. Tax Information
- i. Examine copies of all federal, state, local and foreign tax returns for the last five (5) years, including sales, property, franchise, payroll, excise, withholding and capital tax returns and consolidated returns (if any) of the Company.
 - ii. Review a list of any pending tax matters, including, but not limited to, audits, extensions of time, waivers of statutes of limitations, and deficiency/assessments, and the status of any outstanding tax audits, including a list of all audit adjustments proposed by any taxing authority.
 - iii. Examine copies of all communications and agreements between the Company and any taxing authority for the preceding five years. Describe any undertakings

given by the Company to tax authorities or any special tax rulings or agreements arranged with taxing authorities.

- iv. Describe any preferred tax status or tax benefit which may be adversely affected by the proposed acquisition and any related transactions, including a summary of any available tax attribute carry-forwards.
 - v. Obtain a list of tax years open and indicate whether the IRS or any other taxing authority has indicated that a claim may be asserted with respect thereto.
 - vi. Review audit and revenue agents' reports (federal, state, and local) for last five years
 - vii. Review correspondence regarding any audit or investigation inquiries
 - viii. Examine settlement documents and correspondence for last five years
 - ix. Review agreements waiving statute of limitations or extending time for filing tax returns.
 - x. Review material tax opinions.
 - xi. Identify evidence that all payroll, withholding, sales, use, franchise and real and personal property taxes are paid.
 - xii. Identify evidence that the Company has paid all transfer taxes related to the sale of personal or real property (if applicable) for last five years
 - xiii. Examine tax sharing, tax allocation or related inter-company agreements.
 - xiv. Analyze unemployment tax rate and payment status.
 - xv. Describe any tax abatement or incentive agreements.
- k. Operating Information
- i. Understand the markets served by the Company and the Company's target market segments.
 - ii. Obtain total market size for major products and market forecasts.
 - iii. Prepare a list of major competitors and describe generally their competing products. Provide an assessment of the relative market share of the Company and its major competitors in each of the product lines in which the Company competes.
 - iv. With respect to each product line, understand the Company's existing marketing strategy and any contemplated changes.

- v. Obtain current and historical market research and customer surveys and market research into geographic expansion opportunities or new product development.
 - vi. Determine whether the Company produces or trades in articles or services (including those under development) that may be designated or determined in the future to be defense articles or defense services?
 - vii. Obtain a list or description of each specific product or service the Company has sold or supplied for the past five years. For products, obtain SKU, UPC or other identifying information. Obtain gross margin earned for each product line.
 - viii. Obtain historical sales data by product/service category for the past five years.
 - ix. Review a list of production capacities by facility and discuss current utilization of capacity (e.g., percent of capacity used, number of shifts and plants, etc.).
 - x. Obtain a current price list for all products sold, together with methodology, assumptions, analysis and build up related to the determination of product pricing.
 - xi. Understand any backlog in existing or planned product lines.
 - xii. Review the Company's collection process and the terms extended.
 - xiii. Obtain all information pertaining to quality assurance, including but not limited to compliance manuals, internal memoranda, correspondence, testing reports, agendas and minutes of meetings with heads of operation, safety directors and quality control directors.
 - xiv. Understand the channels of distribution used for each of the Company's products.
 - xv. Review a listing of all international sales/service agreements and relationships.
 - xvi. Review copies of all labels, packaging, advertising, and promotional materials for all products (or services) for the past five years.
 - xvii. Review copies of all warranties applicable to products or services sold or supplied for the past five years.
 - xviii. Obtain a listing of all international sales/service agreements and relationship.
 - xix. Examine copies of the last two external ISO audit results.
4. Customers, Capacity and Vendors
- a. Obtain a schedule of the Company's twenty (20) largest customers, including the amount sold annually, a description of discounts, promotional allowances, payment terms, rebates, or referral fees for each.

- b. Review a complete customer list.
 - c. Provide a detailed breakdown of customer attrition data for the past five (5) years.
 - d. Economic capacity:
 - i. Understand the current operations (e.g., number of shifts, number of hours per shift, number of days operation per week, etc.).
 - ii. Understand the current practical capacity (sales volume) given current organizational, human resource and facility constraints.
5. Suppliers and vendors
- a. Understand the status of the relationships with major suppliers and vendors, including a description of any supplier quality issues.
 - b. Obtain a listing of relationships with major service/installation organizations.
 - c. Obtain a schedule of the Company's twenty (20) largest suppliers and vendors, setting forth annual amounts purchased. Obtain a summary description of the supply arrangement, e.g., pursuant to a written contract or through another arrangement.
 - d. Understand the major production materials required by the Company in the operation of its business.
6. Personnel And Labor Relations
- a. Obtain a schedule of the names of:
 - i. Current officers and directors and other key employees (together with resumes for each); and
 - ii. Any officers and directors and other key employees who have recently resigned or been terminated and all compensation paid during the last five fiscal years to the same, including base salary, bonus program (if any), benefits, prerequisites and length of service.
 - b. Obtain a staff organization chart, listing all employees with titles and grade levels. List any open positions to be filled in the next six months. Include copies of executive resumes, to the extent available. Please indicate if employees are part time.
 - c. Obtain a list of all temporary employees of either Company and copies of contracts or agreements relating to such employees.
 - d. For each employee listed on the organizational chart prepared under 6(b) above, obtain list base salary, bonus potential, and all benefits.
 - e. Review copies of any management and service agreements, employee collective bargaining agreements, employment agreements, deferred compensation agreements or arrangements, severance agreements or arrangements, consulting agreements, change of control agreement, including a description of any oral agreements.
 - f. Obtain a list of any involvement of officers, directors and employees in criminal proceedings and significant civil litigation.

- g. Examine Indemnification agreements with officers or directors.
- h. Obtain a schedule of all loans to any officer, director, employee, or shareholder and copies of all related documents.
- i. Review any employee manuals, employee handbooks, relations policies, programs, practices, agreements, procedures and arrangements or other documents containing employment policies, job descriptions and organizational charts or relating to terms and conditions of employment.
- j. Examine any Patent, trade secret, non-disclosure, confidentiality, non-compete, and non-solicitation agreements with employees, consultants, agents, sales representatives, officers, managers or directors.
- k. Understand the description of any other employment policies, including any unwritten policies.
- l. Obtain a schedule of any prior, pending or threatened (a) unfair labor practice charge or complaint against the Company before the National Labor Relations Board (NLRB), Equal Employment Opportunity Commission (EEOC), Occupational Health and Safety Association (OSHA), State Worker's Compensation Agencies or any other federal, state or foreign labor relations board, (b) employee grievance against the Company, (c) arbitration proceeding against the Company, and (d) human rights complaint against the Company.
- m. Obtain a schedule of all worker's compensation claims experienced by the Company in the last two years showing (a) the amounts paid to date in respect thereof, (b) the current status of such claims, and (c) the amounts, if any, reserved for such claims.
- n. Obtain a schedule of any bonus or special compensation granted or increase in compensation or benefits payable to any directors, officers or employees of the Company for the past five years, other than increases required by the terms of any applicable collective bargaining agreement.
- o. Examine all confidentiality and non-compete agreements.
- p. Review a description of any labor union organizing activity in the last five years.
- q. Review a listing of management employees through department head with experience, responsibilities, years with the Company and compensation (including salary, bonus and fringe benefits).
- r. Review a listing of the number of employees by category, location and department.
- s. Analyze Employee turnover statistics.
- t. Review a schedule of all loans to employees and copies of all related documents.

- u. Review a list of all independent sales persons, consultants or other independent contractors and copies of all agreements relating to such person.
 - v. Obtain a schedule of any employee claims other than worker's compensation claims (including worker's compensation, employment discrimination, unfair labor practices, etc.).
 - w. Review all material labor disputes, strikes or work stoppages which have occurred in the last five years.
 - x. Obtain absenteeism, disciplinary actions, accident records and turnover rates of employees the Company.
 - y. Obtain copies of any special compensation or retention arrangements in connection with the proposed transaction.
7. Payroll & Benefits
- a. Labor Costs
 - i. Understand total employee costs and reconcile to 3rd party payroll provider or in-house payroll reports
 - ii. Understand compensation paid to key management and sales personnel over the historical periods
 - iii. Understand the trends in the major categories of Labor and Benefits over the last two years and TTM period (i.e. direct operating labor, payroll taxes and employer benefits)
 - b. Benefits
 - i. Understand the basis for recording benefit costs and liabilities
 - ii. Analyze benefit packages available to employees (i.e., length of time before receiving benefits, management and administrative benefits, fringe benefits, commissions, and bonuses)
 - iii. Review copies of any bonus, pension, profit sharing, stock option, stock purchase or annuity plans affecting the compensation of officers, directors and employees in effect during any portion of the last three years.
 - iv. Understand any thrift, stock purchase, stock option, performance, bonus, incentive, retirement, welfare, hospitalization, disability, life or other insurance plans or programs available to employees and any other employee benefit plan, program, agreement or arrangement.
 - v. Review any administrative service agreements (or other agreements with benefit plan administrators) with respect to any benefit plans.
 - vi. With respect to each pension plan:
 - (a) Review plan and pension trust instruments;

- (b) Understand plan summaries (handouts for employee participants);
 - (c) Examine financial statements and plan evaluations for the last plan year;
 - (d) Review the most recent actuarial evaluation reports;
 - (e) Examine IRS Forms 5500 for each plan for the last three years;
 - (f) Examine financial statements and plan evaluations for the last plan year;
 - (g) Review copies of any and all IRS determination letters; and
 - (h) Understand cost benefit information for the most recent plan year, including administrative costs, employer contributions, employee contributions and benefit distributions.
- vii. Obtain a description of all severance policies (including any written materials describing such policies).
- viii. Obtain a description and itemized schedule of all non-salary “perks” offered to officers and employees.
- ix. Obtain copies of all agreements relating to “rabbi trusts” or other arrangements securing in any way the payment of deferred compensation, severance or other payments to employees or directors.
- x. Obtain any notices or other communications issued with the past five years relating to blackout periods under any defined contribution plan or regarding any further reductions in medical, pension or other employee benefit or regarding the termination of any employee benefit arrangements.
- xi. Obtain a list of any multiemployer or multiple employer plans to which either Company has or had in the past an obligation to contribute, including pension or welfare funds, together with copies of all contracts and agreements related to the same.
- xii. Obtain copies of the most recent report regarding post-retirement liabilities prepared in accordance with FASB and a schedule of life and/or health benefits for retired employees or dependents indicating whether liability for those benefits has been determined, whether and how these benefits have been funded and the number of retirees receiving benefits.
8. Balance Sheet
- a. Assets
 - i. Cash
 - (a) Obtain an understanding of the Target’s treasury function
 - (b) Analyze the corporate bank reconciliation as of the latest balance sheet date
 - (c) Understand and assess the cash management controls and practices related to cash/credit cards received at the store register through to their deposit in the local deposit accounts and subsequently from the local accounts to the corporate accounts
 - ii. A/R
 - (a) Scan accounts receivable to identify unusual items

- (b) Obtain an understanding of the receivable system and controls, walking through a standard transaction through the sales, billing, accounts receivable and collections cycle
 - (c) Analyze recent claims collection rates and compare to Company's allowance for doubtful accounts
 - (d) Comment on any aged receivables in relation to the allowance for doubtful accounts and the bad debt history
 - (e) Analyze accounts receivable ratios at the end of the last two fiscal years and TTM period
 - (f) Obtain aged AR trial balances for Target and agree to financial statements, scanning for unusual items
 - (g) Understand the factoring relationship and fees incurred
- iii. Inventory
- (a) Obtain an understanding of the Company's inventory costing system and reasonableness of reported costs on the Company's financial statements
 - (b) Determine how often the Company takes physical inventories and the methodology used to determine obsolete inventory.
 - (c) Obtain information regarding inventory valuation, turnover, and obsolescence.
 - (d) Obtain listings of historical book-to-physical adjustments for the last two fiscal year-end counts.
 - (e) Review a schedule of any write-down of the value of any inventory or write-off as uncollectible of any notes or accounts receivable made by the Company during the last five years other than immaterial write-downs or write-offs in the ordinary course of business.
 - (f) Understand the Company's accounting for inventory reserves, if any, and the effect on current periods' earnings
 - (g) Obtain inventory aging by category
 - (h) Analyze inventory reserves for reasonableness
- iv. Fixed Assets (Fix Assets)
- (a) Obtain a schedule of fixed assets (quarterly rollforwards since January 1, 20xx) and agree to financial statements
 - (b) Obtain dated copy of latest physical inventory of all equipment and other assets
 - (c) Understand the Company's capitalization policy
 - (d) Determine capital expenditures made in the last two fiscal years and TTM period as well as projected capital expenditure assumptions
 - (e) Consider the depreciation policies adopted
 - (f) Review copy of the most recent fixed asset register.
 - (g) Analyze depreciation methods by asset class.
 - (h) Prepare a legal description of all properties owned or utilized by the Company.
- b. Supplemental balance sheet data
- i. Obtain a copy of most recent aged accounts receivable report.
 - ii. Obtain a copy of most recent aged accounts payable report.

- c. Review a detailed description of any off-balance sheet arrangements, liabilities or obligations of any nature (fixed or contingent, matured or unmatured) that are not shown or otherwise provided for in the Company's current financial statements. Review (i) the nature and purpose of any such off-balance sheet arrangements; (ii) the importance to the Company of such arrangements; (iii) the amounts of revenue, expenses and cash flows arising from such arrangements; (iv) any known event, demand, commitment, trend or uncertainty that is reasonably likely to result in the termination (or reduction in availability to the Company) and the course of action the Company has taken or proposes to take in response to such circumstances.

- d. Liabilities
 - i. Leases/Indebtedness
 - (a) Obtain a schedule of equipment and office leases, segmented by capital vs. operating
 - (b) Obtain copies of all significant lease agreements
 - (c) Obtain a schedule of all available credit agreements, credit lines, letters of credit or other financing arrangements involving the Company and a description of any security therefor.
 - (d) Review any agreements or documents evidencing or providing for borrowings by the Company in excess of \$_____, whether on a secured or unsecured basis.
 - (e) Examine material correspondence with lenders of the Company during the last three years including all compliance reports submitted by the Company or its independent public accountants during the last three years.
 - (f) Review mortgages, leases of personal property, security agreements, UCC-1 financing statement filings, indentures, guarantees, installment purchase agreements, letters of credit and financing leases.
 - (g) Identify all encumbrances and restrictions affecting property.
 - (h) Obtain a detailed description of any bad debts and agreements or arrangements that are expected to result in a loss.
 - (i) Obtain a list and description of any contingent liabilities not disclosed or described in financial statements.

 - ii. A/P
 - (a) Scan the latest accounts payable aging
 - (b) Identify debit, large or old outstanding balances

 - iii. Accrued Liabilities
 - (a) Obtain a list of general accrued liabilities (i.e. identifiable operating liabilities) and scan for completeness and agree to Financial Statements
 - (b) Obtain an understanding of the Company's month-end accrual procedures for each significant accrual
 - (c) Inquire about any "off-the-books" activities
 - (d) Understand and document policies related to accounting for worker's compensation, product warranties, and group insurance.

- iv. Identify all (i) the monetary reserves established for specific risk situations and (iii) disagreements with the Company's outside auditors concerning the Company's financial reporting, including those arising from contracts and agreements, price redetermination or renegotiation, unfunded pension plan liability, antitrust matters, or environmental matters.
- v. Obtain a schedule of any capital expenditures in excess of \$_____ made by the Company during the last five years, together with a description of any planned capital expenditures.
- vi. Determine amount of capitalized software and related amortization schedule.

e. Financing

- i. Obtain a schedule of currently outstanding short-term debt, long-term debt, inter-company debt, contingent obligations and capital lease obligations of the Company, including amounts, maturities, balances due, interest rates and prepayment terms, together with copies of correspondence to/from lenders during prior 12 months and compliance reports prepared by the Company or its auditors.
- ii. Review copies of all agreements evidencing borrowings by the Company, whether secured or unsecured, documented or undocumented, including loan and credit agreements, mortgages, deeds of trust, letters of credit, indentures, promissory notes and other evidences of indebtedness, and any amendments, renewals, notices or waivers.
- iii. Understand any financing agreements with or for suppliers/customers.
- iv. Review copies of all documents and agreements evidencing other material financing arrangements, including capital leases, synthetic leases, sale and leaseback arrangements, installment purchases or similar agreements.
- v. Examine all agreements pursuant to which the Company is or will be subject to any obligation to provide funds to or to make investments in any other person (in the form of a loan, capital contribution or otherwise).
- vi. Obtain a summary of currently outstanding interest rate or foreign currency swaps, caps, options, forwards or other derivative instruments or arrangements to which the Company is a party.
- vii. Obtain a current listing of standby letters of credit, performance bonds, performance guarantees and similar credit support obligations (including, without limitation, copies of all letters of credit outstanding under the senior revolving credit facility and the underlying agreement(s) requiring the Company to provide such credit support).
- viii. Review copies of any currently outstanding commitment letters or other correspondence relating to proposed financing or borrowings which may involve amounts in excess of \$_____ of indebtedness of the Company.

- ix. Understand all encumbrances and restrictions affecting the Company's assets.
- x. Understand any liabilities retained in connection with the divestiture of assets or operations during the past five (5) years.

9. Real Property

- a. Obtain a list of the address and description of each office, manufacturing, warehouse or other facility that the Company now maintains or has maintained; stating, for each presently maintained facility, its age, type of construction, amount of floor space, estimated remaining life and whether owned or leased.
- b. Review copies of deeds with respect to all owned real estate, including copies of all related title papers, title insurance policies, appraisals and surveys.
- c. Review copies of any leases or similar agreements under which the Company is lessee of, or holds or operates, any real property owned by any third party lessor, including a description of each such lessor and a list of leasehold improvements including cost, depreciated value and ownership.
- d. Examine all contracts for the purchase, sale or lease of real property or any option to purchase or sell real property or any management contract relating to real property to which the Company is a party or by which it is bound.
- e. Review a description of mortgages, liens, pledges and encumbrances.
- f. Review copies of all agreements affecting real property.
- g. Examine certificates of occupancy
- h. Review any engineering reports or studies regarding any facility.
- i. Examine all agreements affecting real property.
- j. Obtain a list of security deposits held.
- k. Review all easements and rights-of-way required for operation of business
- l. Obtain a list of continuing obligations under expired leases or agreements relating to the sale of real property by the Company or any predecessor entities.
- m. Review the options and rights of first refusal to and from the Company.
- n. Examine zoning status and variances.
- o. Review estoppel certificate from landlord with respect to any significant leased real property.

10. Product Liability and Warranty

- a. Obtain a list and summary description of all product liability claims for the last five years.

- b. Obtain a list and summary description of all warranty claims for the last five years.

11. Litigation and Regulatory Matters

- a. Review a documentation relating to and description of all pending, threatened or completed litigation, claims, suits and proceedings in which the Company is, was or could be a defendant for the past five years, including the nature of the litigation, the amount involved and any opinion of counsel as to the probable outcome.
- b. Review copies of all pleadings or substantive filings in the possession of the Company with respect to the matters described in response to Section 12(a)
- c. Review all reports to the Company's Board of Directors, or equivalent managing body, from attorneys, appraisers or others during the last five years regarding unsafe, questionable or illegal matters or practices of the Company.
- d. Examine all letters from the Company's auditors to management, auditors' inquiry letters and all replies to the foregoing for the past 5 years.
- e. Obtain a description by project of all work performed by outside law firms.
- f. Review a schedule of all laws, regulations, rules, ordinances, injunctions, franchises or court orders in respect of which the Company is not in compliance or has received notice of a possible violation.
- g. Review any consent decrees, judgments, other decrees or orders, settlement agreements and other agreements to which the Company is a party or by which it is bound requiring or prohibiting any future activities.
- h. Obtain a list of all audits, inquiries or incidents with respect to regulations relating to the transportation of dangerous goods, including the Transportation of Dangerous Goods Act.
- i. Review all reports, notices or correspondence relating to any violation or infringement by the Company of government regulations, including any regulations relating to occupational safety and health and the transportation of dangerous goods.
- j. Review copies of letters from lawyers to accountants concerning litigation and other legal proceedings, including all attorney audit letters for the last five years.
- k. Review all reports filed with state or federal governmental agencies, including all securities law filings not otherwise available at www.sec.gov.
- l. Examine reports of any regulatory body that has audited or reviewed the Company.
- m. Review copies of all lobbying registration or disclosure filings with any governmental entity.

- n. Examine information regarding any bankruptcy, receivership or similar proceedings with respect to the Company or its officers or directors.
- o. Obtain a schedule of all material licenses, permits, registrations, governmental approvals and clearances obtained, pending or otherwise required for the conduct of the business of the Company.
- p. Prepare a schedule of all laws, regulations, rules, ordinances, injunctions, franchises or court orders to which the Company or its operations is subject, the status of compliance with respect to each and a description of all programs, presentations, guidelines, policies or similar documents relating to the Company's compliance with the laws and regulations of any governmental entity.
- q. Obtain a summary of all material governmental agency inquiries, citations, notices of violation, fines or penalties (if any), whether written or oral and including any threatened formal or informal actions or inquiries.
- r. Review reports of any regulatory body that has audited or reviewed the Company.
- s. If applicable, obtain a description of the Company's compliance with Gramm Leach Bliley, Basel Convention and HIPAA, together with any other similar governmental regulations it is subject to in any jurisdiction (e.g., European Union related restrictions on data privacy) with respect to the use, collection, storage, disclosure and transfer of any data or personally identifiable information collected by the Company or by third parties having authorized access to the records of the Company.

12. R&D and IP

- a. Obtain a schedule including a list and copies of all technology, inventions, patents, patent applications, utility models, designs, trademarks, service marks, trade names and copyrights , whether registered, unregistered or the subject of a pending application owned by the Company or in which the Company holds any right, license or interest, (hereinafter, "Company Intellectual Property") showing with respect to each: (a) the product, device, process, service or business covered thereby; (b) the registered or other owner; and (c) in the case of any of the foregoing not owned by the Company, a brief description of the nature of the right, license or interest of the Company.
- b. Review copies of all documents, information or other materials pertaining to the application or registration of the Company Intellectual Property.
- c. Obtain a schedule including a list copies of any intellectual property searches or any clearance, availability, validity or other opinions concerning either Company Intellectual Property.
- d. Obtain a schedule including a list and copies of all agreements involving the licensing, assigning or granting of any security interest or other right or ownership interest in any of either Company Intellectual Property rights to a third party.

- e. Obtain a schedule including a list and copies of all agreements involving the licensing, assigning or granting of any security interest or other right or ownership interest to either Company in a third party's intellectual property rights.
- f. Obtain a schedule including a list and copies of all documents and other information or materials related to any charges of intellectual property infringement or any other intellectual property dispute made against the Company.
- g. Review copies of any license agreements, including, but not limited to, computer software; other agreements, including research and development agreements.
- h. Review copies of any royalty agreements (whether the Company pays or receives the royalty).
- i. Obtain a summary of annual royalties paid or received by the Company and projections for such payments in the future.
- j. Obtain a summary of research and development expenditures over the last five (5) years.
- k. Obtain a summary of significant new products, technologies or processes currently under development.
- l. Obtain a summary of significant computer software used or acquired by the Company and copies of related licensing agreements.
- m. Review agreements (or standard form of agreement) with employees regarding assignment of intellectual property and confidentiality
- n. Review documentation or information relating to any dispute regarding intellectual property rights.
- o. Obtain a summary of research and development expenditures over the last five (5) years.
- p. Obtain a summary of significant computer software acquired by the Company and copies of related purchasing, licensing and other agreements or documents.
- q. Obtain a summary of all third party computer software, databases and other intellectual property which are used by the Company in the conduct of its business and copies of related license or other agreements or documents.
- r. Examine forms of the Company's assignment of IP rights and confidentiality agreements, along with a description of the Company's policy as to which employees and consultants are required to execute such agreements, and confirmation that the Company has, as a general matter, complied with such policy. Please indicate whether or not the Company has been involved in any disputes with any current or former employees or consultants over the past five years in which any employees or consultants have claimed to have rights in any Company IP.

- s. Review copies of nondisclosure or any other agreements restricting disclosure, sharing or other dissemination of intellectual property.
- t. Prepare a listing and copies of all consent or other agreements involving any of the Company's intellectual property rights not otherwise encompassed by the above provisions in this Article 13.
- u. If the Company is engaged in research and development, production or sale of technology, goods, software or services subject to U.S. export controls, obtain the applicable U.S. Munitions list categories, ECCN numbers or other information identifying the subject matter of the export and all applicable export control policies and related procedures employed by the Company.
- v. Review opinions for patents including right to use, patentability, blocking patents, infringement and validity. Review opinions for trademarks including registrability and infringement.
- w. Review documents relating to third-party development and/or testing of the Company's products, services and/or proprietary products/information, including third-party certifications or testing.
- x. Obtain a list of the Company's internet sites and newsgroups
- y. Obtain copies of all legal opinions, "cease and desist" letters or other communications relating to alleged or actual infringement
- z. Review assignments involving Company Intellectual Property.
- aa. Examine the use of copyright notice.
- bb. Describe all patent proceedings and other administrative proceedings in the U.S. Patent and Trademark Office (including, for example, opposition proceedings, cancellation proceedings), as well as any consents, judgments, settlements, or decrees relating to same.
- cc. Obtain a schedule of all trade secrets and descriptions thereof, together with a list of third party claims with respect the same and a description of procedures used to protect trade secrets.
- dd. Obtain a list and copies of all agreements pursuant to which source code of the Company is held in escrow.
- ee. Review all material pending, threatened and resolved claims, disputes, suits, actions, litigations or proceedings concerning the value, validity, enforceability, ownership, registration, infringement or use of any Company IP or alleged infringement of any third party intellectual property.

13. Personal Property

- a. Obtain a list of all personal property, such as office equipment, automobiles, etc., and copies of leases or conditional sales agreements relating to such property.
- b. Confirm that all assets are at the facility.
- c. Review most recent personal property appraisal.
- d. Review maintenance contracts related to Company personal property.
- e. Examine service records related to Company personal property.
- f. Examine documents of title related to Company personal property.

14. Insurance

- a. Obtain a list of insurance coverages in force (e.g., business interruption, directors and officers, fire or casualty, extended coverage, general liability, key man, motor vehicle, professional liability, product liability, unemployment compensation, etc.), including names of carriers, brokers, description of coverage, amounts of coverage, amounts of premiums, expiration dates and significant conditions and benefits.
- b. Examine copies of any insurance analyses or reports prepared for the Company.
- c. Obtain a list of bonding arrangements.
- d. Obtain a schedule of loss and claims experience for the past five years.
- e. Description of areas in which the Company is self-insured, and methods of self-insurance.
- f. Describe any potential uninsured or underinsured liabilities.
- g. Review copies of cover sheets of policies and binders.
- h. Provide an analysis of worker's compensation coverage and claims experience for the last five years.
- i. Describe any changes in coverages during the last five years.
- j. Review of actuarial evaluations.

15. Environmental

- a. Review all information and correspondence regarding compliance with federal, state, local or foreign environmental laws and regulations (including, without limitation, permits, permit applications, notices of violation, compliance orders and agreements, pollution control capital expenditure reports, and information relating to the presence of UST's, PCB's or asbestos).
- b. Review all information and correspondence regarding generation, treatment, storage and disposition of hazardous substances (including, without limitation, permits, spill reports

and notifications, manifests, financial estimates and reserves for environmental liabilities, and a list of on-site and off-site waste disposal sites).

- c. Examine all internal Company reports concerning environmental matters relating to current or former Company properties or properties formerly owned or operated.
 - d. Review all material documents relating to regulatory proceedings (including, without limitation, information requests under CERCLA '104(e) and similar federal, state, local or foreign laws or regulations).
 - e. Examine copies of all other environmental studies and surveys, including any Phase I or Phase II reports.
 - f. Examine copies of all notices, complaints (whether formal or informal), suits or similar documents sent to, received by or served upon the Company by any environmental regulatory or protective agency, whether federal, state or local.
 - g. Review a description of any past or ongoing remediation efforts.
 - h. Obtain a list of all environmental permits and permit applications of the Company, together with copies of related correspondence and consideration of transferability.
 - i. Obtain a description of the condition of neighboring areas (landfills, Superfund or Part 201 sites, spills, relations with neighbors, common drainage of waste treatment areas)
 - j. Review regulatory lists and files (state records and Part 201 List; National Priority List, state policy, fire marshal underground storage tank records).
 - k. Obtain copies of all waste manifests related to real estate for which Company has environmental responsibility.
 - l. Obtain a list of former Company properties and properties formerly owned or operated by the Company. With respect to current or former Company properties or properties formerly owned or operated, provide evidence of chain of title for at least the last 50 years, together with a history of the property's use during that period.
16. Risk Management
- a. Obtain copy of the Company's disaster recovery plans for (i) any hosted products sold to customers, and (ii) for internal office systems, development systems, etc.
 - b. Obtain copy of the Company's information security policy (if any).
 - c. Obtain copies of the Company's documentation retention or destruction policy.
 - d. Obtain copy of all information security programs, procedures and metrics.
 - e. Identify the person primarily responsible for the Company's information security programs and indicate the percentage of that person's time which is dedicated to security programs.

- f. Identify the person primarily responsible for the Company's physical security programs and indicate the percentage of that person's time which is dedicated to physical security.
- g. Obtain copies of any security assessments performed by or with respect to the Company.

17. Information Technology

- a. Obtain schedule of all IT assets owned or leased by the Company, including PCs, servers, telephones, and other general telecommunications equipments (e.g., PBXs, routers, switches), together with copies of the relevant agreements.
- b. Understand the applications used to run the Company's business and support important internal departments and functions including, but not limited to: (i) human resources; (ii) finance; (iii) customer service; (iv) product provisioning; (v) email / fax / mobile devices; and (vi) intranet.
- c. Understand technological infrastructure, including servers, network and data centers, which are used to run the Company's and support important internal departments and functions including.
- d. Understand how the technologies in Section 18(a) and 18(c) are supported including, but not limited to, helpdesk, application support and infrastructure support.
- e. Identify who is responsible for software and hardware asset management. Describe how this management is performed.
- f. Review a reconciliation of all deployed desktop software. Are invoices available for all software deployed?
- g. Understand the internal authentication security mechanism (Active Directory, etc) for regular office use, development and remote access.
- h. Determine what metrics are tracked for internal systems and infrastructure. Obtain a recent copy of such reports.
- i. Review copies of all IT policies and procedures (development process, security (both physical and electronic), back up and recovery, data privacy, trade secret policies, Acceptable Use Policies, regulatory compliance, export control, internal controls, etc.).
- j. Obtain copy of the Company's data (including consumer data) privacy policy.

18. Other Information

- a. Review documentation relating to acquisitions or divestitures in the past five years.
- b. Understand current plans or negotiations relating to potential acquisitions or divestitures.
- c. Review other documents viewed by the Company as material to its business, prospects, assets, results of operations or condition (financial or otherwise).

- d. Review any other material information or document.

19. Special Industry Considerations

a. Software

i. Revenue

- (a) Understand revenue recognition policies and issues related to multiple revenue elements (i.e., hardware, software reselling, software development, training, maintenance, etc.)
- (b) Obtain an understanding of the Company's contract accounting policies and procedures
- (c) Obtain an analysis of sales and margins by major product group and contract components (i.e., hardware, software reselling, software development, training, maintenance, etc.)

ii. Software Development Costs

- (a) Understand the Company's policies surrounding the capitalization of software development costs

iii. Deferred Revenue

- (a) Understand the calculation of deferred revenue balances, if applicable, at the end of the last two years and TTM period

b. IT Target

- i. Obtain high level architectural descriptions of each of the Company's products and major product components including size (lines of code).
- ii. Understand development environment in which products (including applications, user interfaces and intermediate tier programs) are written.
- iii. Identify databases (including versions) deployed.
- iv. Understand, for each product, typical hardware requirements for (a) client; (b) middle tier(s); and (c) database.
- v. Understand major engines and components of the products.
- vi. Understand how security is implemented in the products, including but not limited to (a) use of separate architectural layer; (b) access control; (c) role based and field level controls; and (d) encryption techniques.
- vii. Understand methodologies and technologies utilized in product development and delivery.
- viii. Understand release schedules for each product and current status of each upcoming product.
- ix. Attach bug/defect lists for each product at the end of each of the last five calendar years.
- x. Identify third party controls, tools or public domain utilities utilized used in development or deployment of products.
- xi. Understand third party product use at a component level.
- xii. Indicate whether the Company has source code for all of its developed technology and describe the quality of the source code and related documentation.
- xiii. Understand data and network security measures taken by the Company and whether the Company's products are recognized security standard compliant.

- xiv. Indicate whether the Company has been subject to SAS 70 audits; and copies of any reports resulting from such audits.
 - xv. Do they assess application development capability using the Software Engineering Institute's Capability Maturity Model (CMM)? If so, what CMM level (1-5) have they reached?
 - xvi. If offshore outsourcing is utilized, understand processes and controls.
 - xvii. Understand release management and version control processes and procedures, including products used for control.
 - xviii. Understand your build process including level of automation and frequency of builds.
 - xix. Understand source code control procedures including products used for control.
 - xx. Understand QA metrics established.
 - xxi. Understand QA automated tools and test procedures employed.
 - xxii. Understand new product launch cycle and methods.
 - xxiii. Understand how this product is used in a multi-tenant online (ASP) environment.
 - (a) What limitations are envisioned in this type of environment;
 - (b) Understand current owned or leased online ASP data center environment;
 - (c) Obtain list of current customers (if any) running in online ASP mode; and
 - (d) Understand plans to convert existing customers from local to online ASP mode.
 - xxiv. Understand the software development life cycle used from beginning to end.
 - xxv. Understand the process for hiring and training new development employees. If this differs by role please describe the process for each role.
 - xxvi. Understand the implementation process for customers.
 - xxvii. Obtain a sample project plan for a new customer implementation.
 - xxviii. Understand the Company's account management process.
 - xxix. Understand the customer support process that is in place for servicing customers. Understand how escalation is handled.
 - xxx. Obtain a summary of the volume and type of customer issues over a reasonable period of time, as well as the resolution of those issues.
 - xxxi. Understand the process for hiring and training new implementation, account management and support employees
 - xxxii. Understand which products are hosted and provided in a SaaS environment.
 - xxxiii. Understand the hosting environment:
 - (a) Technology infrastructure
 - (b) Outsourcing vendors
 - (c) Architectural limitations or challenges of the products in this environment.
 - (d) Technical support (application and infrastructure) in this environment.
 - xxxiv. Obtain Service Level Agreements, either internal goals or contractual commitments.
 - xxxv. Determine if the Company hosts SPII (sensitive personal identifiable information) on behalf of its customers. This would be data that would require a consumer disclosure if a data breach occurred. If so, determine which persons has responsibility to provide the consumer disclosure. Determine if there have been any data breaches and response to the same.
- c. Retail
- i. Revenue

- ii. Analyze returns (as a percentage of sales) during the last fiscal year by prepaid, credit card and open account orders, and reasonableness of reserves, if any
- d. Construction
- i. Obtain an understanding of the Target's policies and procedures surrounding contract accounting
 - ii. Obtain an understanding of external auditor's procedures surrounding contract accounting, if applicable
 - iii. Obtain detailed support for a sample selection of open contracts at December 31, 2004, and analyze the sufficiency and accuracy of the Company's estimation process related to contract margins
 - iv. Obtain detail concerning any loss contracts open at the end of the TTM period
 - v. Understand the Company's backlog of contracts at the end of the TTM period
- e. Restaurants
- i. Overview
 - (a) Understand key points for all significant franchisor / franchisee agreements
 - (b) Understand Company's policy for accounting for franchise fees and [Franchisor]'s franchise rights.
 - (c) Obtain schedule of capitalized franchise fees and capitalized [Franchisor]'s franchise rights (roll-forwards for last three fiscal years through TTM period) and agree to financial statements.
 - ii. Revenue
 - (a) Understand the trends in major categories of food, beverage and paper costs over last two years and TTM period
 - (b) Understand revenue recognition policies/issues, etc. including tracking of discounts to employees/customers and deferred revenue related to food or beverage vendors
 - (c) Understand Company's policies for tracking cash and credit card sales and procedures followed at individual stores as well as at corporate that result in cash deposits (try to develop some procedures to verify deposits on a scope basis)
 - (d) Perform a proof-of-revenue assessment, comparing cash deposits to revenue recorded for a certain period of time
 - (e) Understand the trends in major categories of food, beverage and paper costs over the last two years and TTM period.
- f. Customs
- i. Obtain copies of representative Entry Summary for each different type of article imported by the Company within the past year, including documents showing country of origin, exporter, importer of record, Harmonized Tariff Classification and duty paid.

- ii. For any imported article subject to preferential duty treatment based on the country of origin or export, obtain all documents verifying or confirming the country of origin for the article, its component parts and materials.
- g. Export Control Compliance
- i. Review copies of correspondence to or from the Bureau of Industry and Security (BIS), Office of Defense Controls (ODC), or Office of Foreign Assets Control (OFAC).
 - ii. Review copies of all export compliance policies and procedures.
 - iii. Review copies of all export recordkeeping procedures.
 - iv. Obtain representative sample of export documents, including shipper export declarations.
 - v. Review copies of any licenses provided by BIS or ODC and any license applications for past five years.
 - vi. Review copies of any registration records with ODC.
 - vii. Review copies of any commodity jurisdiction rulings.
 - viii. Review copies of any reports of internal investigation reports of potential violations of International Traffic In Arms Regulations (ITAR), Export Administration Regulations (EAR), or OFAC regulations.
 - ix. Review copies of any voluntary disclosures of violations of export regulations.
 - x. Determine whether the Company sells (directly or indirectly through sales representatives) or exports any goods directly to customers in any of the following countries: Cuba, Iran, Burma, Sudan, countries of the Balkans region, Belarus, Cote d'Ivoire, Democratic Republic of the Congo, Iraq, Liberia, North Korea, Sierra Leone, Syria, or Zimbabwe.
 - xi. Determine whether the Company has screened all suppliers, customers, and agents against (i) OFAC's list of denied persons and Specially Designated Nationals, (ii) persons denied export privileges by BIS or ODC, and (iii) list of BIS entities involved in weapons proliferation.
 - xii. Determine if any of the Company's products defense articles included in the U.S. Munitions List. If so, indicate whether the Company registered with the ODC as a defense article manufacturer or exporter.
 - xiii. For each product that is not a defense article controlled under the U.S. Munitions List, obtain the product's commerce control list classification.
 - xiv. Determine if the Company been the subject of any civil or criminal enforcement action or investigation by BIS, ODC, or OFAC.

- xv. Determine whether any employees are foreign persons (i.e., neither U.S. citizens nor permanent residents).

h. Sarbanes-Oxley (SOX) Matters

- i. Review corporate governance policies and procedures, including but not limited to copies of all codes of ethics/conduct, whistleblower policies, document retention policies and other material corporate governance policies and procedures.
- ii. Review corporate governance committees, and copies of all charters and meeting minutes thereof.
- iii. Obtain a schedule of all whistleblower complaints and actions taken.
- iv. Review director independence / nonindependence.
- v. Review internal controls and procedures.
- vi. Understand any deficiencies in the Company's internal control structure reported to the audit committee or the Board of Directors by the Company's independent auditors, and descriptions of resolutions of same.