

# Due Diligence Interviews for Transfer Tax Valuation Purposes

Robert F. Reilly, CPA

*Valuation analysts (“analysts”) are often retained by high net worth taxpayers—and their tax counsel—to perform valuations related to transfer tax (or income tax) planning, compliance, audit, or litigation purposes. These valuations often involve private companies, private business ownership interests, or private debt and equity securities. In such valuations, the analyst typically performs various due diligence analyses. This discussion focuses on one due diligence procedure: the valuation-related due diligence interviews related to the owners and managers of the private company.*

## INTRODUCTION

Valuation analysts, property appraisers, forensic accountants, economists, finance consultants, industry consultants, investment bankers, and other professionals (collectively referred to herein as “analysts”) are sometimes asked to conduct valuations for gift tax, estate tax, and generation-skipping transfer tax (collectively referred to herein as “transfer tax”) purposes. Analysts are also sometimes asked to conduct valuations for income tax purposes.

These transfer tax and income tax valuations may be performed for taxation planning, compliance, audit support, or litigation purposes.

This discussion focuses on transfer tax and income tax valuations of private companies, business ownership interests in such companies, private company debt and equity securities, and intangible assets. For both transfer tax and income tax purposes, most valuations are intended to conclude the fair market value standard of value.

However, it is noteworthy that taxation-related intercompany transfer price analyses (of tangible property, intangible property, or services) are intended to conclude the arm’s-length price standard.

There are generally accepted business valuation approaches and methods. These approaches and methods are applicable to the taxation-related valuation of private companies, business ownership interests in such companies, and private company securities.

Likewise, there are generally accepted intangible asset valuation approaches and methods. These approaches and methods are applicable to the taxation-related valuation of intellectual property, other identifiable intangible assets, and intangible value in the nature of goodwill.

A description of these business valuation and intangible asset valuation approaches and methods is beyond the scope of this discussion.

Of course, analysts who perform such valuations should be familiar with all generally accepted

valuation approaches, methods, and procedures. In addition, such analysts should be familiar with the applicable valuation professional standards and the applicable “best practices” valuation professional practices and procedures.

This discussion focuses on the analyst’s due diligence procedures in the development of the taxation-related business, security, and intangible asset valuation. The analyst may perform these due diligence procedures at different levels within the subject entity, depending on whether the subject is the private company, a business ownership interest, a security, or an intangible asset.

This discussion focuses on the analyst’s performance of due diligence procedures (and primarily the conduct of the subject entity company management interviews) within the context of a transfer tax or income tax valuation.

## ANALYST DUE DILIGENCE PROCEDURES

Whether the valuation subject is the total private company, a controlling or noncontrolling ownership interest in that company, a debt or equity security, or an intangible asset, the analyst will attempt to perform as much due diligence as possible during the development of the valuation.

This due diligence is appropriate whether the valuation is performed for transfer tax, income tax, some other type of tax—or for some other type of purpose. And, this statement is true whether the valuation is performed for tax planning, compliance, audit support, litigation, or some other purpose.

With regard to financial and operational data, this means that the analyst may perform the due diligence procedures at the level of the subject entity that has the most information regarding the subject ownership interest.

One typical procedure in the analyst’s due diligence process is the conduct of the subject entity management interviews. The subject entity could be the subject private company, the company that issued the subject debt or equity security, or the company that owns or operates the subject intangible asset.

These management interviews are often referred to generally as due diligence interviews. Typically, the analyst attempts to interview the entity employees who are closest to—and most familiar with—the operations of the subject ownership interest. The following sections recommend practical guidance to the analyst related to the planning for, the conduct of, and the documentation of these due diligence interviews.

The analyst should not necessarily approach these interviews as part of a forensic investigation. That is, the analyst is not trying to “catch” the subject entity management in an untruth or a cover up. Rather, the analyst should approach the due diligence interviews as a fact-finding mission. Therefore, the analyst should apply a healthy degree of skepticism and investigative rigor—to ensure that the analyst receives the complete and unfiltered story regarding the subject entity or the subject ownership interest.

The information obtained by the analyst during the due diligence interview process often affects the development of, the conclusion of, and the reporting of the taxation-related valuation. The analyst’s work product may be a value conclusion that is included in a transfer tax or income tax return, a narrative valuation report, an expert report prepared for tax litigation, or expert testimony before either an Internal Revenue Service appeals division hearing officer or a judicial finder of fact.

The due diligence interview process is a procedure performed in virtually every taxation-related valuation. This discussion provides practical guidance to the analyst who is conducting the due diligence interview process—and to the taxpayer or the taxpayer’s legal counsel who is relying on the value conclusions. And, this discussion provides the analysis with a checklist of topics to consider during the valuation due diligence investigation.

## THE VALUATION DATE DUE DILIGENCE INTERVIEW PROCESS

There are many ways for an analyst to conduct the due diligence interview for the taxation-related valuation. There is no absolutely “right” way—and no absolutely “wrong” way—for an analyst to conduct the interview. However, there are some practical procedures that may help the analyst to conduct—and to document—an effective due diligence interview of the subject entity management.

First, the analyst should be thoroughly prepared to conduct the interview. The motto “be prepared” is good advice for every aspect of a taxation-related valuation. This “be prepared” advice is especially appropriate during the due diligence interview process.

The analyst’s preparation typically includes the performance of these practical procedures:

1. Thoroughly review the subject entity’s website and any other publicly available data about the subject entity (or the subject intangible property).

2. Completely review all of the documents that have been provided by the subject entity management, by the taxpayer, and/or by the taxpayer's counsel.
3. Comprehensively review and analyze the subject entity's historical and prospective financial statements. The analyst may pay particular attention to the year-to-year changes in the entity's financial statement account balances.
4. Thoroughly research the subject entity's industry segment and the local, regional, or national economy (as applicable).
5. Actually write out a list of questions to ask each person who will be interviewed during the due diligence interview process.

Second, it is important for the analyst to interview the appropriate individuals. Determining who is (and who is not) an appropriate individual to interview may be a collaborative process, which may involve the participation of the taxpayer or the taxpayer's counsel.

That is, sometimes the taxpayer may know what subject entity employees are most informed about the subject business ownership interest or intangible property. The selection of exactly who is an appropriate individual to interview will vary with each valuation.

Therefore, the analyst may preview the general topics that will be covered during the due diligence interview process with the taxpayer or with the taxpayer's counsel. And, the analyst should request to interview the individuals (at whatever level within the subject entity organization) who are the most knowledgeable regarding the proposed topics.

In some taxation-related valuations, it may be useful for the analyst to interview individuals from outside of the subject entity. Such individuals may include the following:

1. Independent accountants
2. Commercial bankers
3. Principal customers
4. Principal suppliers
5. Principal competitors
6. Former management employees

Of course, many taxpayers (and taxpayer's counsel) may not allow the analyst to interview individuals other than current members of the subject entity management.

The analyst should balance the need for taxpayer confidentiality with the need for information when

determining which individuals to interview during the valuation.

Third, the analyst should anticipate an interviewee's potential bias. In a typical taxation-related valuation, the role of the analyst is to conclude the fair market value of the subject business, business ownership interest, security, or intangible asset. Depending on the particular transfer tax or income tax issue, the analyst should be mindful that the taxpayer (or the subject entity management) may prefer either a lower value or a higher value conclusion.

In such a situation—where the taxpayer or the subject entity management may have a bias as to the results of the taxation-related valuation—it is important for the analyst to be:

1. diligent in asking all of the relevant due diligence investigation questions and
2. prepared to ask (and document) follow up due diligence questions.

In most valuations, and especially when the management team has worked for the subject entity for a long time, management has much more information about the entity than the analyst has. This access to (and familiarity with) information gives the management team an advantage in presenting a particular point of view to the analyst.

However, the analyst should endeavor to uncover the complete truth about the issues related to the subject entity by:

1. being sufficiently prepared to conduct the due diligence interviews and
2. being sufficiently prepared to anticipate the potential bias of the taxpayer, the subject entity, management, or other interviewee.

Fourth, if the analyst can control the interview process, the due diligence interview should not be restricted to one session. Let's assume that the analyst follows the practical guidance discussed above—that is, the analyst (1) is prepared, (2) interviews the appropriate individuals, and (3) filters out any potential interviewee bias.

Nonetheless, the initial due diligence interview may uncover unexpected issues about the subject entity or the subject intangible property. These issues may require the analyst to conduct additional research and, consequently, to conduct additional follow-up interviews with the subject entity management.

These follow-up interviews may be needed to allow the analyst to pursue unexpected issues raised during an initial interview. These follow-up interviews may be necessary to help the analyst resolve

conflicting “stories” from multiple interviewees. And, these follow-up interviews may be helpful to determine whether the same interviewee changes his or her “story” after a period of time.

New and unexpected issues that are uncovered in the initial interview often turn out to be the important issues in the taxation-related valuation. It is noteworthy that analysts on different sides (i.e., taxpayer and taxing authority) of a valuation often conduct similar analyses and often apply similar methods regarding the subject analysis.

It is often the case that the analyst’s treatment of just a few variables will materially affect the value conclusion regarding the subject private company, ownership interest, security, or intangible asset.

Both the analyst’s identification of those few variables (and of how those variables may affect the value regarding the subject entity or the subject intangible property) and the analyst’s presentation of a persuasive argument for the appropriate treatment of these variables can result in the favorable outcome of a tax audit or tax litigation.

And, the due diligence interview process often helps the analyst to identify which variables are the most important to the taxation-related valuation.

## CAVEATS REGARDING THE DUE DILIGENCE QUESTIONS

It is important for the analyst (and the taxpayer and the tax counsel, if involved) to recognize several caveats regarding the use of any standardized list of due diligence interview questions.

First, the due diligence questions presented in Exhibit 1 are not intended to be comprehensive or all-inclusive. And second, not every question listed is appropriate for every valuation.

The due diligence questions provided in Exhibit 1 are generally applicable to the valuation regarding the subject private company or intangible property. And, the questions presented in Exhibit 1 are primarily directed to the transfer tax or income tax valuation of a business, business ownership interest, security, or intangible asset.

The questions provided in Exhibit 1 should not substitute for the application of the analyst’s independent judgment and professional experience.

## SUMMARY AND CONCLUSION

Analysts are often involved in the taxation-related valuation of a private company, business ownership interest, security, or intangible asset. Such

valuations may be developed for gift tax, estate tax, generation-skipping transfer tax purposes, or for income tax purposes.

Such valuations may be developed for tax planning compliance, audit support, or litigation support purposes.

In appeal or litigation matters, the analyst may serve the taxpayer—and the taxpayer’s legal counsel—as either a consulting expert or a testifying expert.

The due diligence process is one of the generally accepted procedures performed during the taxation-related valuation of a subject entity or subject intangible property.

This discussion presents the foundational elements that the analyst should be aware of with regard to the due diligence component of the taxation-related valuation. In addition, the analyst, the taxpayer, and the taxpayer’s legal counsel should be aware of how the due diligence process affects the taxation-related valuation.

With regard to any valuation for transfer tax or income tax purposes, it is important for the analyst to effectively conduct the due diligence interview process. The due diligence interview process is an important valuation procedure.

During the interview process, the analyst often learns important information that may influence the quantitative analyses related to the business, security, or intangible asset valuation.

The primary purpose of the due diligence interview is to enable the analyst to get questions answered. In addition, the interview may also be helpful to uncover information that the analyst may not otherwise have access to.

Representative due diligence interview questions are presented in Exhibit 1. This list is not intended to be comprehensive. Rather, this list is only intended to provide general guidance to the analyst involved in a taxation-related valuation analysis.

The analyst (and the taxpayer and the taxpayer’s legal counsel) should recognize that every subject entity and every subject intangible property has unique attributes.

Both the list provided in Exhibit 1—and the practical guidance provided above—should not be considered as substitutes for the analyst’s independent judgment and professional experience.

*Robert Reilly is a managing director of the firm and is resident in our Chicago practice office. Robert can be reached at (773) 399-4318 or at [rfreilly@willamette.com](mailto:rfreilly@willamette.com).*



## Exhibit 1

### Transfer Tax and Income Tax Valuations

#### Related to a Private Company, Business Ownership Interest, Security, or Intangible Asset Representative Due Diligence Interview Questions

For purposes of this exhibit, the due diligence interview questions are divided into four categories:

1. Questions related to the business operations of the subject private entity or the subject intangible property
2. Questions related to the subject industry segment and the subject economy
3. Questions related to the financial statements of the subject private entity or the subject intangible property
4. Questions related to specific events that may affect the subject private entity or the subject intangible property

Even the experienced analyst may fail to ask the perfect question to uncover every material issue related to the subject entity or intangible property valuation. Therefore, at the end of the due diligence interview session, the analyst may ask each interviewee a catch-all question. For example, the analyst may ask, “Do you know of any information that has not been covered and that could have a bearing on the issues we talked about?” This type of general question may provide an opportunity for the interviewee to volunteer any material information that was previously undisclosed.

### Questions Related to the Subject Entity or Subject Intangible Property Operations

This category of questions may help the analyst understand how the subject entity or the subject intangible property operates. By asking these questions, the analyst may gain an understanding of the business risks and opportunities that exist for the subject entity or the subject intangible property.

Every taxation-related valuation has unique aspects. These questions may help the analyst to uncover the factors that are unique to the subject entity or subject intangible property valuation.

#### Subject Entity History and Organization

1. When was the subject entity founded?
2. Describe the key events in the entity’s history.
3. Describe any historical business unit mergers, acquisitions, or divestitures.
4. Describe any historical ownership changes.
5. Describe any historical changes in the entity’s lines of business.
6. Describe any historical changes in the geographic area served by the subject entity.
7. For a private company, provide a list of the entity owners and their respective ownership interests.
8. Are any of the entity owners currently active in the business? If yes, explain.
9. Is there any entity stock that is subject to any stockholders’ agreement, stock transferability restriction agreement, buy-sell agreement, etc.?
10. List the names of any subsidiaries of the subject entity or ownership interests in other companies, including the percentage owned by any parent company.
11. List all known related parties (including subsidiaries, affiliates, or relatives) that the subject entity does business with.
12. List the states (or the countries) in which the subject entity currently transacts business.
13. Describe the locations of the entity’s principal facilities and the primary activities that occur at each facility.
14. For a private company, describe all historical transactions in the entity’s stock in the five years prior to the valuation date. Describe the circumstances surrounding each of the transactions, including whether the transaction was at arm’s-length.
15. Describe all current litigation involving the subject entity or the subject intangible property, with these matters categorized as to (a) claims against the subject entity and (b) claims on behalf of the subject entity.

## Exhibit 1 (cont.)

### Transfer Tax and Income Tax Valuations

#### Related to a Private Company, Business Ownership Interest, Security, or Intangible Asset Representative Due Diligence Interview Questions

##### Subject Entity Services (or Products) Offered

1. Describe the subject entity's service/product lines and the approximate percentage of the entity's most recent fiscal year revenue and gross profit produced by each service/product line.
2. Describe the process by which the entity prices its services/products.
3. What other products or services typically compete with the subject entity?
4. What are the advantages and disadvantages of the entity's products or services versus the products or services of the competitor companies?
5. Why do clients/customers select the subject entity to provide products or services—instead of the competitor companies?
6. How long is the typical sale cycle for the entity's products or services?
7. How frequently are the entity's products or services changed/modified?
8. Which of the entity's product or service lines have achieved the fastest revenue growth? Which of the entity's product or service lines have reported the slowest revenue growth?
9. Which product or service lines are the most profitable? And, which product or service lines are the least profitable?
10. Does the subject entity own patents, proprietary technology, or trade secrets that prevents or hinders competitor companies from duplicating its products or services?
11. Describe any products or services that are unique, or not easily duplicated by new or existing competitors.
12. Are the revenue from the entity's products or services cyclical?
13. Are the revenue from the entity's products or services seasonal? If so, what are typically the strongest and weakest months for the entity's revenue?
14. What are the entity's plans for future services/products?
15. Describe the research and development activities of the subject entity.

##### Subject Entity Manufacturing (or Production)

1. What percentage of the entity's products or services is actually produced by the entity? And what percentage of the entity's products or services is subcontracted to a third party?
2. Where are the subject entity facilities?
3. Describe the subject entity production process for its services or products.
4. Is the entity's process more labor intensive or more capital intensive?
5. What are the ages and the conditions of the subject entity facilities?
6. What is the capacity of each facility relative to the current operating levels?
7. Who is the manager of each facility, and how long has he or she been employed by the entity?
8. Does the entity have any planned expansion of its facilities?
9. Does the entity have any planned asset dispositions related to its facilities?
10. How do the entity's facilities compare to similar companies in the same industry segment?
11. Do the facilities enable the entity to earn superior or inferior profit margins compared to similar companies in the same industry segment? Why?
12. How technologically advanced are the subject entity processes?
13. Are the entity's employees unionized?
14. Describe the entity's relationship with its employees.
15. Does the subject entity have any outstanding workers compensation claims?

## Exhibit 1 (cont.)

### Transfer Tax and Income Tax Valuations

### Related to a Private Company, Business Ownership Interest, Security, or Intangible Asset Representative Due Diligence Interview Questions

#### Subject Entity Clients (or Customers)

1. Provide an overview of the entity's client/customer base.
2. How are the subject entity services used by the clients/customers?
3. List the entity's 10 largest clients or customers (as measured by revenue) for the most recent fiscal years, and the percentage of total revenue made from each of those clients or customers.
4. For the entity's largest recurring clients or customers (as measured by revenue), how long has that party been a client or customer of the subject entity?
5. Does the subject entity provide credit to any of its clients or customers? If so, describe the conditions in which the entity offers credit and the credit terms offered by the entity.
6. Do the entity's clients or customers tend to consistently purchase services from the same company, or do they periodically switch services providers?
7. Identify the most important markets for the subject entity products or services.
8. What are the key recent trends in each of these markets?
9. Are the entity's key markets increasing, decreasing, or stable in terms of size?
10. Does the subject entity have existing contracts with its clients or customers? If so, provide copies of representative contracts.
11. Approximately how many current clients or customers does the subject entity have?
12. Is the subject entity typically the sole supplier of products or services to its clients or customers? Or do clients or customers typically buy products or services from multiple suppliers?
13. Are there any large contracts, significant new clients or customers, or new markets that the entity anticipates adding during the next 12 months?
14. Are there any large contracts, existing clients or customers, or present markets that the subject entity expects to lose, terminate, or abandon during the next 12 months?
15. Does the subject entity provide products or services to federal, state, or local governments or governmental agencies? If so, what percent of the entity's total business is from federal, state, or local governments or governmental agencies?

#### Subject Entity Suppliers

1. What raw materials or other supplies does the subject entity rely on?
2. Who are the entity's principal suppliers?
3. How many suppliers does the subject entity have?
4. Are any of those suppliers the sole source of supply for the subject entity?
5. For each key supplier, how long has the entity had a business relationship with that supplier?
6. Are any of the suppliers the only (or the primary) company that supplies the entity's industry segment with a particular product?
7. Describe how the entity's principal supplies were/are priced?
8. What has been the trend in the entity's cost of supplies?
9. List—and provide copies of—any long-term supply contracts or other special purchasing arrangements in place with suppliers.
10. How much notice is required by either the subject entity or the supplier to terminate the business relationship?

## Exhibit 1 (cont.)

### Transfer Tax and Income Tax Valuations

#### Related to a Private Company, Business Ownership Interest, Security, or Intangible Asset Representative Due Diligence Interview Questions

11. Could the subject entity switch suppliers without a detrimental impact on the business? Why or why not?
12. If the subject entity had to find a new supplier for a key supply, (a) could it and (b) how long would it take to find a new supplier?
13. Has the subject entity considered becoming more vertically integrated by acquiring a supplier or by expanding its line of business?
14. To what extent does the subject entity fabricate versus assemble products, and how much flexibility does the entity have in this respect?
15. Does the subject entity use derivatives or other hedging activities to protect against increasing prices?

### Subject Entity Sales and Marketing

1. What is the approximate total size of the market (in dollars) for the products or services offered by the subject entity?
2. What is the entity's estimated market share for each of the products or services offered?
3. How has the entity's market share for each of its product or service lines changed in the last five years? Ten years?
4. What are the most important selling features of the entity's products or services (i.e., price, quality, brand name, service, etc.)?
5. What warranty does the subject entity offer for its products or services? And, how frequently do customers or clients submit warranty claims?
6. How intense is the competition in the entity's industry segment?
7. How are the entity's products or services priced?
8. Describe how new business opportunities are identified, followed-up, prioritized and pursued, and by whom.
9. What distribution channels does the subject entity use for its products or services?
10. How is technology used in the entity's marketing?
11. Describe any changes in the entity's marketing budget from year-to-year.
12. Describe the typical level of experience and typical tenure of the entity's sales staff.
13. Does the subject entity depend on one employee or on a small number of employees to generate sales?
14. Describe the historical turnover rate of the entity's sales staff.
15. On what basis are the subject entity salespeople compensated?

### Subject Entity Management and Other Employees

1. Provide a copy of the entity's most current organization chart, along with resumes for the senior members of the entity's management team.
2. How long have the senior members of the entity's management team been employed by the entity?
3. Do any of the senior members of the entity's management team have known health issues? And, are any of the senior members of the management team close to retirement age?
4. Provide the total compensation for each member of the entity's management team, including perquisites.
5. How many hours per week do each of the senior members of the entity's management team spend working for the entity?
6. How many employees does the subject entity have?
7. What unions (if any) represent the entity's employees, and when do any union contracts expire?
8. How many of the entity's employees are covered by collective bargaining agreements?



## Exhibit 1 (cont.)

### Transfer Tax and Income Tax Valuations

#### Related to a Private Company, Business Ownership Interest, Security, or Intangible Asset Representative Due Diligence Interview Questions

9. Has the subject entity ever experienced any work stoppages due to a strike?
10. What is the total number of employees in each organizational area?
11. What are the critical skills and backgrounds needed in the development, production, and distribution of the entity's products/services?
12. Identify any management or technical positions that have been difficult for the subject entity to fill due to shortages of labor with the appropriate skills.
13. Describe the current labor market for the entity's industry segment. That is, is the supply of employee candidates robust or sparse?
14. How extensively does the subject entity use independent contractors?
15. List the members of the subject entity board of directors and provide a description of the background of each member.

### Subject Entity Outlook

1. Describe the subject entity's strengths, weaknesses, opportunities, and threats.
2. What are the most important things the subject entity must accomplish to be successful over the next five years?
3. What is the entity's expected annual growth rate over next five years in terms of revenue, operating profit, and net profit?
4. What is the biggest risk to the subject entity achieving its projected financial results of operations?
5. What could cause the subject entity actual financial results of operations to exceed—or fall short of—the projected financial results of operations?
6. What is the level of capital spending required to support the entity's projected revenue growth?
7. What are the known large and infrequent capital expenditures that will be made by the subject entity within the next five years (e.g., a plant expansion, an IT upgrade, or the replacement of major equipment)?
8. Do you expect any changes in the product or service lines offered by the subject entity in the next five years (due to either expansion or contraction)?
9. Are there any internal factors that may constrain the entity's business growth, such as lack of access to capital or insufficient cash?
10. Does the subject entity plan to acquire other companies in the next five years?
11. Are the entity's profit margins expected to change over the next five years? Why or why not?
12. Does the subject entity prepare an annual budget? Does the subject entity prepare a long-term financial plan, projection, or forecast? Describe the process that is applied to create the entity's annual budget. Describe the process that is applied to prepare the entity's long-term financial plan, projection, or forecast.
13. Is the entity's annual budget or forecast considered to be conservative, baseline, or aggressive?
14. How do the entity's projected revenue growth and profit margins compare to the entity's historical revenue growth and profit margins?
15. Does the subject entity plan any changes in ownership in the future (for example, through either share buybacks or the issuance of shares)?

### Questions Related to the Subject Entity's Industry Segment and Economic Factors

These questions may help the analyst to put the subject entity in context relative to other similarly situated companies. In addition, these questions may also help the analyst to better understand the long-term outlook for the subject entity or the subject intangible property.

## Exhibit 1 (cont.)

### Transfer Tax and Income Tax Valuations

#### Related to a Private Company, Business Ownership Interest, Security, or Intangible Asset Representative Due Diligence Interview Questions

##### Industry and Economy

1. What national or regional economic factors affect the entity's revenue growth (e.g., interest rates, inflation rate, disposable income, etc.)?
2. How does the subject entity differ from other competitor companies in the relevant industry segment?
3. How has the subject entity performed during recent economic downturns? During recent strong economic periods?
4. Is government regulation a factor for the subject entity? If so, how?
5. What stage of the industry life cycle is the entity's industry segment in (i.e., introduction, growth, maturity, or decline)?
6. What are the most important recent developments or trends in the entity's industry segment?
7. How many companies of the entity's approximate size (e.g., revenue within plus or minus 50 percent) operate in the industry segment?
8. Is the industry segment generally comprised of small local companies or large multinational companies?
9. Describe the barriers to entry in the entity's industry segment.
10. How has the size of the industry segment changed in the last five years?
11. How is the size of the industry segment expected to change in the next five years?
12. What level of innovation and/or change is required to stay competitive in the entity's industry segment?
13. Does the subject entity generally lead or lag the industry segment in terms of new services, pricing, and other similar factors?
14. Is the technology employed at the subject entity considered (a) outdated, (b) current, or (c) leading edge compared to the industry segment standard?
15. What trade associations do the subject entity belong to?

##### Competition

1. Who are the most significant competitors to the subject entity? Describe any publicly traded competitors—as well as any privately owned competitors.
2. Does the subject entity management monitor the financial results and/or public filings of any publicly traded peer group companies? Describe which ones.
3. How large are the entity's principal competitors in terms of revenue?
4. Where are the entity's principal competitors located?
5. What are the principal competitors' estimated market shares for each of the products or services offered by the subject entity?
6. What are the primary strengths and weaknesses of the principal competitors—in comparison to the strengths and weaknesses of the subject entity?
7. On what basis do companies in the entity's industry segment compete (e.g., brand, price, quality, service, technology, or some other basis)?
8. How often do the entity's clients or customers switch between the subject entity and its competitors?
9. How easy is it for the entity's clients or customers to switch between the subject entity and its competitors?
10. Do any principal competitors have proprietary technology, trade secrets, patents, copyrights, trademarks, or other intangible property that give them a competitive advantage over the subject entity?
11. Do the entity's principal competitors have greater or weaker economies of scale compared to the subject entity?

## Exhibit 1 (cont.)

### Transfer Tax and Income Tax Valuations

#### Related to a Private Company, Business Ownership Interest, Security, or Intangible Asset Representative Due Diligence Interview Questions

12. How has competition changed in the last five years (i.e., new competitors, regulatory changes that affected competition, erosion of pricing power, etc.)?
13. How does branding help (or hurt) the subject entity to compete? Or, are the entity's services/products unbranded and considered to be commodity services/products by the entity's clients or customers?
14. For each product or service line, if the subject entity bids on a business opportunity, (a) what competitor companies does it typically compete against and (b) why is/isn't the subject entity typically successful in winning the competitive bid?
15. How intense is the competition among the companies in the entity's industry segment?

### Questions Related to the Subject Entity Financial Statements

Understanding the entity's (or the intangible property's) financial statements is an important procedure in just about any business or intangible asset valuation. This is because of the significant impact that the financial statements may have on the subject entity value or the subject intangible property value.

A discussion of the entity's historical financial statements may also inform the analyst as to any financial statement normalization adjustments—or financial statement errors or irregularities—that need to be considered in the business or intangible asset valuation.

The analyst should develop a general understanding of each account on the subject entity's financial statements. And, the analyst should develop a more thorough understanding of the more material accounts on the subject entity's financial statements.

Consider, for example, the entity's accounts receivable account. The analyst may want to investigate:

1. if the subject entity management considers the stated accounts receivable account balance to be collectable,
2. how long the accounts receivable typically remain outstanding,
3. what client/customer accounts are included in the accounts receivable account balance,
4. if the accounts receivable balance is related to the subject entity revenue or to some other business activities, and/or
5. other similar issues.

Questions that relate to each and every account balance on the subject entity financial statements are not included in the list below. This is because the number of such questions that relate to each individual account on the financial statements would be beyond the scope of this discussion.

### Subject Entity Historical Financial Results

1. If applicable, provide a copy of the independent accountant's letters to the subject entity management (or directors) for the past five years.
2. Describe the accounting principles used by the subject entity (e.g., revenue recognition methods, cash versus accrual basis, and property accounting methods).
3. Have there been any changes in the accounting principles applied in the preparation of the entity's financial statements over the past five years?
4. How do the current accounting principles compare to the accounting principles used by other competitor companies in the entity's industry segment?
5. Explain all significant year-over-year changes in the financial statement accounts (e.g., the interviewee may explain changes such as (a) a 50 percent annual increase in accounts payable, (b) a 15 percent annual decrease in revenue, or (c) the gross margin improved from 30 percent of sales to 40 percent of sales).

## Exhibit 1 (cont.)

### Transfer Tax and Income Tax Valuations

#### Related to a Private Company, Business Ownership Interest, Security, or Intangible Asset Representative Due Diligence Interview Questions

6. Describe any nonrecurring or extraordinary income or expense items recorded during the past five years.
7. What plan does the subject entity have for capital expenditures during the next 12 months?
8. Has the subject entity management or the board of directors received any bona fide offers to buy the entity during the past five years? If so, describe the details of each offer or provide a copy of any written offers received.
9. Have any of the stockholders personally guaranteed the entity's loans? If yes, explain.
10. Describe any short-term and long-term sources of credit and how they were used by the subject entity over the past five years.
11. Is the entity's current capital structure (a) sustainable and (b) expected to change over the next five years?
12. Has the subject entity complied with all of its outstanding loan covenants? If not, explain why.
13. Discuss the entity's dividend history and the outlook for future dividend payments.
14. Summarize any assets owned by the subject entity that may be classified as (a) nonoperating assets or (b) excess assets. That is, are there any assets that do not contribute to the primary operations of the subject entity (e.g., cash and cash equivalent balances that may not be needed for future working capital or capital expenditures)?
15. Describe all of the entity's intangible assets and of the entity's contingent liabilities that are not recorded on the entity's balance sheet.

### Questions Related to Specific Events That May Impact the Subject Entity or Intangible Property

These questions may help the analyst to identify the most significant events that affected the subject entity or the subject intangible property in recent years. These questions may also help identify the significant events that could affect the subject entity or the subject intangible property in the near future.

1. Does the subject entity operate with any license, permit, franchise, or other agreement that permits the entity to operate—either at the total entity level or at the intangible property level? Which of these licenses, etc., are private party agreements? Which of these licenses, etc., are government-issued agreements?
2. How important is location to the entity's results of operations? Could the subject entity move its facilities and still maintain its planned results of operations? What type of impact would a facility relocation have on the entity's planned results of operations?
3. What type of intellectual property does the subject entity own or operate. Specifically, what patents, copyrights, trademarks, and trade secrets does the subject entity own or operate?
4. What procedures does the subject entity employ to protect its intellectual property?
5. What would be the expected impact if the subject entity lost the right to (or ability to) operate its intellectual property?
6. Does the subject entity either inbound license or outbound license any of its intellectual property? If so, please provide copies of all such licenses.
7. What are the most significant long-term contractual agreements that the subject entity has entered into? For example, consider these types of long-term agreements: supplier agreements, customer/client agreements, executive employment agreements, noncompetition agreements, joint development agreements, joint venture agreements, etc. Please provide copies of each of those agreements. Have any such agreements even been unexpectedly terminated or violated? If so, please describe the impacts of that unexpected agreement termination or violation.

## Exhibit 1 (cont.)

### Transfer Tax and Income Tax Valuations

#### Related to a Private Company, Business Ownership Interest, Security, or Intangible Asset Representative Due Diligence Interview Questions

8. How important are the entity's banking relationships? How stable are the entity's banking relationships? How frequently does the subject entity change its banking relationships?
9. What are the entity's principal sources of debt capital? What are the agreements (i.e., notes and debt indenture agreements, bond indenture agreements, long-term leases) that document those financing arrangements? Has the subject entity ever violated the terms of any of these financing arrangements? If so, what were the consequences of such violations?
10. In the last five years, has the subject entity participated in any mergers, service line or entity acquisitions, service line liquidations, or service line divestitures? Please describe each such transaction. Please describe the impact on the subject entity of each such transaction.
11. In the last five years, has the entity implemented a restructuring of its long-term debt or a recapitalization or reorganization of its capital structure? Please describe each such transaction. Please describe the impact on the subject entity of each such transaction.
12. Does the subject entity maintain confidentiality agreements, nondisclosure agreements, nonsolicitation agreements, or any similar agreements with any of its employees? If so, which employees—and how were these employees—selected? Please provide copies of those agreements. Has the entity ever had to enforce these agreements? If so, how?
13. In the last five years, was the subject entity involved in an income taxation, a property taxation, or other taxation audit or dispute at any level? Has the subject entity been involved in a regulatory agency audit or dispute at any level? Has the entity been involved in an environmental audit or dispute at any level? If so, how was each of these audits or disputes resolved? What was the impact of each of these audits or disputes?
14. During the last 10 years, was the subject entity involved in any litigation (as either plaintiff or defendant) involving competitors, merger or acquisition parties, contract counterparties, financial institutions, government agencies, or similar parties? If so, please describe the claims of each litigation matter. Please describe the resolution of each litigation matter.
15. During the last 10 years, was the subject entity involved in any litigation (as either plaintiff or defendant) involving any member of the entity management, any entity director, or any current or former shareholder? If so, please describe the claims of each litigation matter. Please describe the resolution of each litigation matter.

