The ABC's of Buying a Business

Buying an existing business is an excellent option that is often overlooked by entrepreneurs, but it does have advantages. You will have an established name, existing customers and an immediate revenue stream. However, searching for a business to buy can be difficult, and finding the right one to buy is tougher yet.

The process can be time consuming, costly and frustrating. Even the most skilled businessperson may find this experience challenging. To provide some "structure" to this very complex decision, the following process-oriented steps may serve as a checklist to help you go through the process.

Personal Assessment and Criteria

Based on what you know about yourself and why you are interested in this business, you must constantly assess if the concept and the business is right for you. Does it fit with your interests and your resources? Cash, credibility, skills and contacts: do yours match what this business will demand?

Ask for the Business Plan

Does the seller have a current business plan? Do they have any business plan? The business plan—or its absence—may tell you a lot about the business, its history, the owner's view for its future, and their interest in selling.

The Seller

If you should purchase the business, you are going to be dependent on the seller for information, contacts and resources. Based on what you know now, what do you think your relationship with the seller is going to be like? Can you expect that to be a positive experience? If you see signs of a "difficult" person in the initial purchase investigation stages, it may become more stressful for both parties as things progress.

Figuring Out the Numbers

Regardless of the response to the business plan question, access to the "real numbers" behind the business is crucial. This may be more challenging that one might expect. Business owners are often reluctant to share operating and financial data, often for tax and competitive reasons, even when they are in a "selling mode." Ask if the financials that you will review are "recast financial statements" and, if so, what adjustments have been made to these statements? Be as specific as you can when you gain information about the source of these statements. You may not receive any meaningful financials until after signing a confidentiality agreement and proving you have the financial ability to make the purchase.

The Help of Professionals

You may decide to approach a business broker to help you find the right business for you, but remember that the broker's loyalty may lie with the seller. You will want to retain a Certified Public Accountant and an attorney who is knowledgeable in business acquisitions. A CPA will to help guide you through the financial analysis process, and you may benefit from legal counsel as agreements are drafted and signed. Their expertise and the emotional separation from the process can make the costs for their services your wisest investments in the entire process.

Business Valuation

Ultimately, negotiations will lead to a business valuation to determine what the business is actually worth. There are several ways to estimate the value of a company, such as the value of the company's assets, how much debt does it hold, and from what sources are the company's current revenues and profits? All of these are going to have a different impact on the value of the business. Other factors to consider in the valuation process include:

- Level of risk: How volatile is the business?
- Competition: What is the competitive environment like—sleepy or cutthroat?
- Growth: Is this a growing or declining industry, how does that compare to the trend of the business, and what are profitability trends?
- Organizational stability: How established is the business itself in terms of infrastructure and personnel?
- Management team: Is there a competent management team in place and will they stay? Will that be an issue or opportunity for you?
- Overall desirability: Will the business be desirable for the "next" buyer?

The Structure of the Deal

The phrase "it's all in the terms and conditions" applies here. Based on a valuation that you find acceptable, the specific arrangements of the financial transaction may determine if this is a "go" or something to walk away from and feel good about. For example, a one-time cash offer is going to result in a radically different figure than an arrangement where a down payment is followed by a seven-year buy-out. Ideally, the structure of financing will meet the needs, resources and interests of all parties involved.

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Adding Value

Determine if you are going to be able to add value to the business or if your goal is simply to keep "the machine" running. Once you have purchased the business, what are your objectives? Are you planning on owning the business for the next twenty years, or growing it over the next five years and then looking for the opportunity to sell? This will impact the intangible assessment of what the business may be worth to you and help assess the potential challenges ahead. Beginning your business plan will help to clarify your objectives and the business potential ahead.

The Bottom Line

- Take your time.
- Be methodical about gathering all the information you can.
- Pay attention to the details.
- Get help when needed and leverage available resources.
- Continue to "test" to see if the business and its demands fit who you are and what you want your business to be.
- If the deal doesn't feel right, keep looking.

Planning for Purchasing a Business

A business plan is normally essential to the process of purchasing a business. A good business plan always defines the business' specific mission and objectives, new ownership, sales focus, market, strategy, management team, and financials. This is particularly important when you are purchasing an existing business, because there is so much uncertainty involved.

Start with Existing Information

Start with the information you get from previous owners. Ideally, during the purchasing process, you received a business plan from the previous owners. One of the important functions of a plan is to define business prospects, therefore, sophisticated business sellers normally use a business plan as a selling document. It should contain information about business history, financial history, previous management, and possible prospects. You may want to read through a related article on this site, Steven Windhaus' recommendations for questions to ask when buying an existing business.

Proceed with Caution

If you do have such a plan, provided by the sellers, proceed with caution. Assume the seller's plan was developed to sell the business, not to manage the business, and may be too optimistic. Question the assumptions. At every point that you possibly can, compare the seller's plan for the business with its past financial information, market data from objective sources, and whatever other reality checks you can find.

You should have always have financial information. Normally you'll have past financial statements, and copies of tax forms, at the very least; few transactions take place without some basic financial information. Use this financial information as a basis of comparison. Question the information sources: copies of tax forms, if they are real, show what the sellers have told the government. Do they match the financial statements coming from the accounting? How reliable are the financial statements? Have they been audited by outside accountants? Is the seller willing to allow an audit?

Growth forecasts are immediately suspect. Compare projected growth to past results. If the seller shows a future much more rosy than the past, ask why? What assumptions justify the change? Why was this business for sale? If projections are optimistic, then why is the business for sale? However, sometimes sellers have good reasons -- needing capital, aging, divorce, for example -- so don't automatically assume that all growth projections are false. Try to understand why owners are selling a business, and how this affects their willingness to produce real numbers, and how it affects your own possibilities to make this purchased business work for you.

Don't underestimate the importance of reality checks. Don't rely on second-hand information. Where possible, spend time at the business in question, talk to customers, eat at the counter, use the service. For retail locations, for example, you can spend some time outside the store, count the customers, see how many go in empty-handed and how many come out with bags.

Make estimates. Count the business for some sample hours, and then calculate what total sales might be by multiplying your estimated average purchase value per hour. For example, say a shoe store has three customers per average hour, and guess that the average sale is $50.

That's $150 per hour total, which would be $1,200 per day and $7,200 per six-day week at eight hours per day. If that's what you estimate and the seller reports $30,000 in sales per month, you're reassured, because the two numbers -- your estimate and the sellers reports -- are in the same range. $7,200 per week for 4 weeks is $28,800, so $30,000 is close. However, if the seller is reporting $100,000 per month you will need to investigate carefully to explain this discrepency.

Plan a New Business or an Existing One?

As you plan for the business you purchase, you start by making an important choice: business plans can be either for start-up new businesses or for already-existing and ongoing business. When you buy a business from somebody else, either option is acceptable. This is a choice you make.

The main difference between the two options is the existence in the plan of either a start-up table, or a past performance table. In a new business, a start-up table establishes opening balances for starting expenses, and financial balances including initial capital, debt, and assets. For an existing business, a past performance table shows past history of profit or loss, and balances of capital, debt, and assets. How to decide? Either way can be acceptable. Here are some suggestions:

- Does the previous history build your business reputation? Would a loan or a new investment be more likely based on the previous history, or less?
    - When you are purchasing a strong business with a good past, use that strength as an asset by developing a plan for an existing business. Develop a plan for an ongoing business, use the past performance table to set your balances, and include a section on company history.
    - If you're purchasing a failed business (presumably for a good price), then start over, with a new plan, built for a new company. Set your start-up table for a new business, and treat the business as a new business when you describe its history (or lack of history), ownership, and strategy.
- The better the information available from the sellers, the more advisable that you develop the plan as a plan for an existing business. In the worst cases, when you have little information available, then you don't really have the option of starting with past performance, because you don't know about past performance.
- Consider the name. If you plan to keep the business name, lean towards a plan for an existing business. If you are planning to change the business name, then you're

more likely to be better off with a new plan, not an existing plan. The naming decision is often a tip-off to the same variables that affect the plan. The factors that make you want to keep the name will make you want to use past performance and develop a plan for an ongoing business.

Ultimately, It's Your Choice

Remember a business plan is always your plan; not the consultant's plan, not the expert's plan, but your own plan, for your business. As you look at the business you're purchasing, decide what makes you feel best about it, and make that the choice for start-up or ongoing.

Buying A Business:

Questions to ask When Buying a Business

There are so many questions to ask when considering the purchase of an existing business. In fact, there is not enough room on this page to list them. But let me give you a few examples that relate to financial, marketing, ownership and operations:

- Most importantly, why is the seller selling? The answer will either raise red flags or be consistent with, and met with, no resistance when asking the information in the questions below.
- Have you asked to review the certified financial statements of income, cash flow and balance sheets for the last three years? If you borrow from a bank to purchase the venture, the bank will want to see them.
- Have you asked to see the company's (not the owner's personal) Tax returns for the last three years? The bank will.
- Have you asked for a copy of all documents of all outstanding indebtedness like notes payable, accounts payable, real estate and equipment leases? The bank will.
- Has the seller offered to stay around for awhile after the sale to help with transition, and have you discussed some compensation for his services during that transition period?
- Have you been allowed to talk with the employees, or is this sale of a confidential nature at this time? If so, why are the employees not being told of the impending sale?
- Has there been any significant turnover of employees? If so, why is that?

- Have you learned anything about the quality of customer relations at the company? Is there a close relationship between company and customers?
- Have you learned anything about the relationship between the company and its vendors? Do vendors display preferred, regular or irregular relations with the company?
- Are there any members to a management team for this company? If so, are they aware of the impending sale, and how do they feel about it?
- What are the actual conditions of the working environment? Are there any hazardous situations or is this a well-kept workplace?
- What are the actual conditions of existing fixed assets like office equipment, machinery, vehicles and the like? Do employee, managers and supervisors demonstrate good maintenance and cleanliness of company property?
- There is so much more to ask, but this is a brief list designed to give you a starting point from which to begin the investigation of the venture in which you are about to invest.

We have not even discussed the issue of fair market value or selling price of the venture. I would suggest you will want to examine some of the expert panel responses on this subject. It is a detailed matter requiring a significant explanation.

Another relevant source of information on buying and selling businesses is the *Entrepreneur Magazine Small Business Advisor*. It is an excellent book with a most extensive array of subjects for any small business entrepreneur, addressing all aspects of the operation in easily understood language and graphic examples of the topics. It is an excellent investment for the purchasing process and can be used repeatedly when operating the venture. It is readily available online or at a reputable bookstore.

Buying a Business

For some people, buying an existing business is a better option than starting from scratch. Why? Because someone else has done much of the legwork for you, such as establishing a customer base, hiring employees and negotiating a lease. But if you want to buy a business, you'll need to do some thorough research to make sure that what you see is what you're going to get.

What Type of Business Should You Buy?

The kind of business you should buy depends on the types of work you've done in your life, classes you've taken or perhaps special skills you've developed through a hobby. It's almost always a mistake to buy a business you know little about, no matter how good it looks. Not only will you have to struggle up a big learning curve after you buy it, but you might not know enough about the industry to determine whether a particular company is a good value.

In addition to buying a business in an industry that you know, try to choose one that you love. It's less difficult -- and a lot more fun -- to succeed in business when you enjoy the work you're doing..

Finding the Right Business

After you've decided what type of business you want to buy, you're ready to begin your hunt for the perfect company. Consider starting your search close to home. For instance, if you're currently employed by a small business you like, find out about the present owner's circumstances and whether she would consider selling the company. Or, ask business associates and friends for leads on similar businesses that may be on the market; many of the best business opportunities surface by word of mouth -- and are snapped up before their owners ever list them for sale.

Other avenues to explore include newspaper ads, trade associations, real estate brokers and business suppliers. Finally, there are business brokers -- people who earn a commission from business owners who need help finding buyers. It's fine to use a broker to help locate a business opportunity, but it's foolish to rely on a broker -- who doesn't make a commission unless he makes a sale -- for advice about the quality of a business or the fairness of its selling price.

Research the Business' History and Finances

Before you seriously consider buying a particular business, find out as much as you can about it: thoroughly review copies of the business' certified financial records, including cash flow statements, balance sheets and accounts payable and receivable, employee files, including benefits and any employee contracts, and major contracts and leases, as well as any past lawsuits and other relevant information.

This review (lawyers call it doing "due diligence") will tell you a lot about the company you're buying and will alert you to any potential problems.

For instance, if a major contract doesn't allow the current owner to assign it to you without the other party's permission, you should enlist the owner to help you obtain the other party's consent.

Don't be shy about asking for information about the business. Here are some other details you should determine before you commit yourself to buying a particular business:

- who holds title to company assets
- whether there is any potential or ongoing litigation
- whether there have been any workers' compensation claims or unemployment claims made by company employees
- whether the company has consistently paid its taxes, and any potential tax liabilities
- whether any commercial leases and major contracts can be assigned to the new owner
- whether the company has given any warranties and guarantees to its customers
- whether the company owns trade secrets, and how it protects them
- whether the company owns patents and copyrights
- whether the company holds registered trademarks
- whether business licenses or tax registration certificates are transferable
- whether the business is in compliance with local zoning laws
- whether there are any toxic waste or environmental problems, and
- if the business is a franchise, what it will take to get the necessary franchisor approval.

This isn't an exhaustive list; you should review any business records that will provide you with information to help you decide whether the business is a smart purchase. If the seller refuses to supply any of this information, or if you find any misinformation, this may be a sign that you should look elsewhere for the right business to buy.

Closing the Deal

If you've thoroughly investigated a company and wish to go ahead with a purchase, there are a few more steps you'll have to take. First, you and the owner will have to agree on a fair purchase price. A good way to do this is to hire an experienced appraiser who can estimate the company's fair market value.

If all goes well, you and the business owner will agree on a fair price as well as other aspects of the purchase, such as which assets you will buy and the terms of payment -- most often, businesses are purchased on an installment plan with a sizable down payment.

After you have outlined the terms on which you and the seller agree, you'll need to create a written sales agreement and possibly have a lawyer review it before you sign on the dotted line. There are a number of legal sources that one should use before signing on a contract. Ensure that you do consult with a lawyer.

Example: A husband and wife have been working in his father's small business for almost four years now. They would like to buy his small business from him. It is a independent copier/fax dealership located in a small town.

They know the market potential and that his accountant has taken advantage of all of the possible loop-holes to shelter him from taxes. This will be the first year that the financials will depict a (pretty close) picture of the company. How do they evaluate the company and gain a fair evaluation of what they should offer him for his company?

Two major financial statements should be reviewed with their accountant, the balance sheet and the statement of income and expense.

The Balance Sheet should show how the assets, liabilities and net worth of the business are valued. Items shown on the Balance Sheet may not tell the entire story. For example, is the equipment valued realistically? The equipment may be obsolete despite what is shown on the statement. Are the accounts receivable fully collectable? Also, the liabilities may not reflect contingent liabilities, such as a pending lawsuit or potential tax liabilities. These are just a few of the many questions you must ask to determine true value of a business.

Looking at the next important financial statement is the Statement of Income and Expense (also called the Profit and Loss Statement). Are the sales correctly reflected? Unfortunately, many businesses dealing with cash do not deposit all the sales receipts. If so, how can the seller prove the correct sales. Or, when anticipating selling the business, the sales may be overstated. The expenses may contain personal items that are not business related. The point I am trying to make is that you need an experienced CPA or business appraiser who represents your interests to represent you when buying a business.

In this example we may be dealing with a father who is trying to help his kids as fairly as he can. He may be willing to agree to terms that will not be a strain on their finances. We may also assume, that in retirement, he would like to have an ongoing income stream from the business. Since the business shows good prospects for the future I can envision structuring a deal that is beneficial to both of them. The idea is for the buyers to give as small a down payment as possible to afford them maximum working capital.

A percentage of the gross sales or net profits can be paid out to the father for a certain numbers of years. Using such a formula will enable him to benefit by any future growth in the business. To arrive at a total payout amount would, of course, require knowing a lot more information than is provided in this quick example.