EVALUATING A BUSINESS FOR SALE

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Evaluating the Business

The first step a buyer must take in evaluating a business for sale is that of reviewing its history and the way it operates. It is important to learn how the business was started, how its mission may have changed since its inception and what past events have occurred to shape its current form. A buyer should understand the business's methods of acquiring and serving its customers and how the functions of sales, marketing, finance and operations interrelate. General information about the industry can be obtained from trade associations. The business's financial statements, operating documents and practices should be reviewed. A summary of the items to be reviewed follows.

1. Obtain an accounts receivable aging schedule and determine if there is concentration among a few accounts.
2. Determine the reasons for all overdue accounts.
3. Find out if any amounts are in dispute.
4. Are any of the accounts pledged as collateral?
5. Is the reserve for bad debt sufficient and how was it established?
6. Review the business’s credit policy.

Balance Sheet

Accounts Receivable:

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If your small business needs guidance or assistance, sign-up for no-cost, confidential business advising with the Nevada SBDC at https://nevadasbdc.org/
Inventory:

1. Make sure the inventory is determined by physical count and divided by finished goods, work in progress, and raw materials.
2. Assess the method of valuation and why it was used (LIFO, FIFO, etc.).
3. Determine the age and condition of the inventory.
4. How is damaged or obsolete inventory valued?
5. Is the amount of inventory sufficient to operate efficiently, and for how long?
6. Should an appraisal be obtained?

Marketable Securities:

1. Obtain a list of marketable securities.
2. How are the securities valued?
3. Determine the fair market value of the securities.
4. Are any securities restricted or pledged?
5. Should the portfolio be sold or exchanged?

Real Estate:

1. Obtain a schedule of real estate owned.
2. Determine the condition and age of the real estate.
3. Establish the fair market value of each of the buildings and land.
4. Should appraisals be obtained?
5. Are repairs or improvements required?
6. Are maintenance costs reasonable?
7. Do any of the principals have a financial interest in the company(s) that perform(s) the maintenance?
8. Is the real estate required to operate the business efficiently?
9. How is the real estate financed?
10. Are the mortgages assumable?
11. Will additional real estate be required in the near future?
12. Is the real estate adequately insured?
Machinery and Equipment:
1. Obtain a schedule of machinery and equipment owned and leased.
2. Determine the condition and age of the machinery and equipment and the frequency of maintenance.
3. Identify the equipment and machinery that is state-of-the-art.
4. Identify the machinery and equipment that is obsolete.
5. Identify the machinery and equipment that is used in compliance with EPA or OSHA standards; determine if additional equipment and machinery is needed to comply.
6. Should an appraisal be obtained?
7. Will immediate repairs be required, and at what cost?

Accounts Payable:
1. Obtain a schedule of accounts payable; determine if there is concentration among a few accounts.
2. Determine the age of the amounts due.
3. Identify all amounts in dispute; determine the reason.
4. Review transactions to determine undisclosed and contingent liabilities.

Accrued Liabilities:
1. Obtain a schedule of accrued liabilities.
2. Determine the accounting treatment of: a) unpaid wages at the end of the period, b) accrued vacation pay, c) accrued sick leave, d) payroll taxes due, e) payable accrued Federal income taxes and f) other accruals.
3. Search for unrecorded accrued liabilities.

Notes Payable and Mortgages Payable:
1. Obtain a schedule of notes payable and mortgages payable.
2. Identify the reason for indebtedness.
3. Determine terms and payment schedule.
4. Will the acquisition accelerate the note or mortgage, or is there a prepayment penalty?
5. Determine if there are tiny balloon payments to be made, the amounts and the dates due.
6. Are the notes or mortgages assumable?
Income Statement:
The potential earning power of the business should be analyzed by reviewing profit and loss statements for the past three to five years. It is important to substantiate financial information by reviewing the business's federal and state tax returns. The business's earning power is a function of more than bottom-line profits or losses. The owner's salary and fringe benefits, non-cash expenses, and non-recurring expenses should also be calculated.

Financial Ratios:
While analyzing the balance sheet and the income statement, sales and operating ratios should be calculated in order to point out areas requiring further study. Key ratios are the current ratio, quick ratio, accounts receivable turnover, inventory turnover and sales/accounts receivable. The significance of these ratios, the methods for calculating them and industry averages are available through Dun & Bradstreet and Robert Morris Associates. Look for trends in the ratios over the past three to five years.

Leases:
1. What is the remaining term of the lease?
2. Are there any option periods? If so, is the option exercised only by the choice of the tenant?
3. Is there a percentage of sales clause?
4. What additional fees (such as a common area maintenance or merchants association dues) are paid over and above the base rent?
5. Is the tenant or landlord responsible for maintaining the roof and the heating and air conditioning system?
6. Is there a periodic rent increase to adjust the rent for changes in the consumer price index or for an increase in real estate tax assessments?
7. Is there a demolition clause?
8. Under what terms and conditions will the landlord permit an assumption or extension of the existing lease.
Personnel:

1. What are the job responsibilities, rates of pay and benefits of each employee?
2. What is each employee's tenure?
3. What is the level of each employee's skill in their position, and are they employed under an employment contract?
4. Will key employees stay after the business is purchased?
5. Are any employees part of a union, or is any union organizing effort likely?

Marketing:

1. Are any of the products proprietary?
2. Describe any new, upcoming products and projected sales.
3. What is the business's geographic market area?
4. What is the business's percentage of market share?
5. What are the business's competitive advantages?
6. What are the business's annual marketing expenditures?

Patents:

A list of trade names, trademarks, logos, copyrights and patents should be obtained, noting the period of time remaining before each expires.

Taxes:

1. Are FICA, unemployment and sales tax payments current?
2. What was the date and the outcome of the last IRS audit?
Legal Issues:

1. Are there any suits now or soon to commence?
2. What OSHA and EPA requirements must be met, and are they currently being met?
3. Are all state registration requirements and regulations being met?
4. Are all local zoning requirements being met?
5. Review the articles of incorporation, minute books, bylaws and/or partnership agreements.
6. What are the classes of stock and the restrictions of each, if any?
7. Has any stock been canceled or repurchased?
8. Is the business a franchise? If so, review the franchise agreement.

Competitors:

1. Who are the business's competitors?
2. What is the competitors' market share?
3. What are each competitor's competitive advantages and disadvantages?

All the factors identified in this section on evaluating a business have to be carefully scrutinized and weighed. Some factors will have a positive influence on the decision to buy; others will have a negative influence. Seek out professional assistance if help is needed in interpreting the significance of the information. The important thing is to obtain all the information needed to make a decision. In most instances, all of the business records should be made available to the buyer. In some cases, however, certain information may be withheld until a bona fide offer, contingent upon obtaining that information, has been made. If important information is unreasonably withheld, the likelihood of making the transaction work diminishes.