

**The things you need to know before you buy any business!**

Buying an existing business can be a much less risky and more quickly profitable venture than starting your own business from scratch. But it's not entirely risk free and your success will depend heavily on how wisely you choose and evaluate the business you buy.

Here are the "tyres to kick" as you begin investigating a prospective business purchase. These items are not meant to substitute for an in-depth evaluation -- which you will want to conduct once you've gone through this first step.

We receive a lot of phone enquiries about buying lawn rounds. In many instances the chap buying the round mentions that the old contractor admits to not having raised his prices for a few years, and that "you will need to raise the prices after you buy my round."

The only thing of value in a lawn round is the goodwill. When it is sold, the new chap has not had time to establish customer loyalty, something that develops from goodwill. So when he attempts to increase mowing prices to somewhere near a realistic return, he finds that he loses more than half of his new customers.

If the old contractor is too lazy, or incompetent, too scared, or any other excuse for not maintaining realistic prices, then he can not expect to get a good price. And new buyers beware, you will probably lose half of the clients that you just paid good money for.

I believe that it is the responsibility of the selling contractor not to undercharge. The consequence of cut-price work is that the real value of the 80 customers grossing \$400 per week (*this averages 40 customers per week for only \$10/cut*) is that the business has no value when it is offered for sale.

If the selling contractor has not regularly maintained his goodwill (which is an asset, just like property or a vehicle) by regular small price increases then the value of his asset diminishes, just the same as a neglected item of machinery.

We asked several accountants and business agents for the best way to establish the value of a lawn round. They all agreed that profitability was the most important issue. In a labour intensive business, profit was the best indicator that operating expenses and overheads were matched by the rate charged for services performed. If you were to buy a business, the one thing that would influence you more than anything else would be how much profit does it make. How soon could you recover your investment? Their suggestion was that a small service industry business such as a lawnmowing round would have an approximate value of the average of the last three years net profit. If the annual net profit was regularly increasing, then the value would be a little higher. If the net profit showed a decreasing trend, then the business was running down and the value would be less than the lowest annual net profit.

Accountants warned against the danger of setting a valuation based on sales turnover (the magic formula method) because it does not take into account operating expenses or profit.

The benefits of recording all transactions should be promoted on the basis of its importance in running a successful business. Undisclosed cash earnings seriously reduce the value of a business when the proprietor proposes to sell. For example, reinvesting cash in the business will increase its value when you go to sell, and good record keeping enables better financial control. As numerous contractors have discovered when they try to sell their lawn round, the result of keeping a couple of hundred dollars each week in their pocket as undisclosed cash earnings has dramatically lowered the valuation of their business from \$25000 down to \$15000, a 40% reduction in value.

The vendor should provide this information if he is a genuine seller

**Gross Takings (Sales)** [from Profit & Loss a/c and Taxation records]  
**Total Expenses**  
**Net Profit per Year**

Preferably over at least three years trading. This will indicate whether the business is growing; is run down; or stagnating. Other critical information to evaluate the financial viability of the business can be derived.

Normal Daily Trading Hours

Hours worked/week:

Average Weekly Sales

Average Weekly Net Profit

Number of clients

Hourly rate charged to clients

Effective hourly rate

[Weekly Sales / Hours worked]

Net hourly rate

[Net Profit per week / Hours worked]

**Does this compare favourably with the Horticultural & Nursery Industry Award? (see fact sheet 24)**

One of the options you may choose when getting into business is to purchase an existing business. Having taken the decision to buy a business, you should then investigate thoroughly all the information available before making any financial commitment.

If the information presented is either inconclusive or insufficient to make an informed decision, it may be necessary to undertake further investigations or reject the proposition entirely.

Buying a business includes the purchase of plant and equipment, stock in trade and usually a goodwill component. In part, existing customers and your reputation represent the goodwill. Other factors will most certainly include the profitability of the business or its income producing capability. The correct assessment and identification of the value of the business is one of the critical issues to be addressed in the process.

Obtaining professional assistance in this process becomes almost mandatory, and certainly places the novice purchaser at great risk if the decision is to go it alone.

It is important to understand that whilst buying business is an opportunity for both employment and to increase your capital wealth over time, the reverse situation, failure, is also a reality to be guarded against.

Your chance of success will be greater if you understand and prepare yourself to overcome the many problems you will encounter in business, especially in the early stages.

Endeavour to match your personal strengths and interests with a suitable business.

Before you start looking, think about which kind of business is right for you. The type and size of business should be compatible with your experience, personality and capital.

It is critical for the purchaser to understand precisely every aspect of the purchase decision.

The quotation "buy in haste repent at leisure" is never more evident than when buying a business.

### **Financial Statements**

Look at both financial statements and tax returns from the past 3-5 years to judge both the current fiscal health and financial trends. Make sure you see figures that are accompanied by an audit letter from a reputable CPA firm. Don't accept a simple financial review or a compilation, because those are based on figures supplied by the seller. Is the business in sound financial condition? Do financial statements match tax returns? Are sales and operating ratios in line with the industry average? Your accountant can help you analyse these figures to determine the net worth of your company.

### **Payables and Receivables**

Check the dates on invoices to see the business is keeping up with its bills. Normal payment times vary from industry to industry, but generally 30 to 60 days is standard. If bills are being paid 90 or more days past the invoice date, the owner may be struggling with cash flow.

Inspect the accounts receivable with a sceptical eye; often their stated value is somewhat inflated. Take a close look at the dates on them to determine how many are delinquent and by how long. This is important because the older the receivable, the lower its value and the greater the chance that it will never be paid.

### **Customers**

These are the most important assets you may be buying with the business. Make sure they're as solid as the other tangible assets you'll be acquiring. Does the clientele have a special relationship with the current owner (long-time friends or relatives)? How long have these accounts been with the business and what percentage of the income do they represent? Will they leave or stay when the business passes to new hands? Does the current owner or manager seem to have good relationships with the customers? Is there a written policy for handling customer complaints, returns, disputes, etc.? Has the owner supported the local community or the industry?

### **Competitors**

When you're buying a business, you need to understand the competitive environment in which it operates. Pay attention to industry trends, and how they might affect the company you're considering. How competitive is this industry? Who are your competitors and what are their tactics? Are price wars common in this business? How has the competitive environment changed recently? Have any competitors gone out of business? Why? You can track this information by contacting an industry association or reading trade publications.

### **Image**

How a company is perceived can be a serious asset or a liability that can't be judged from a balance sheet. There are a wide range of intangibles that you need to consider when you're evaluating a company -- everything from the way it services its customers to how it answers the phones to whether or not it supports the community or the industry. This category is often referred to as "goodwill." Talk to customers, suppliers, competitors, banks, and owners of other businesses in the area to learn more about this firm's reputation. Remember that it is very difficult to change a negative perception.

Professional assistance in the process is almost mandatory. Some of the professionals that may be used include:

An experienced reputable **business broker** is totally involved in analysing and appraising businesses and has first hand knowledge of the market. They are however, almost exclusively representing the vendor.

**Accountants** will investigate and comment on the historical financial records, interpret performance, prepare future projections and assess the value of business.

**Solicitors/lawyers** will construct, interpret and comment on all legal documents to protect your interest.

The process of finalising the transaction, including arranging exchange and stamping of contracts, payment of all monies (vendor etc), all adjustments, rates/taxes etc.

*All these specialists can contribute significantly to a successful trouble free acquisition. Obviously most of them charge for their services, however the benefits more than compensate for the costs.*

There is no "approved" document that needs to be used when a business is being sold, However ALMA recommends the use of "Form 2" of the Land and Business (Sales) Act. This document gives both the buyer and the seller protection at law if either party defaults

However, if you choose not to engage an agent, a solicitor can draw up a legally binding offer and acceptance. Business Brokers and the Real Estate Institute have contract forms that are available through the Real Estate profession.

Ensure that all promises or undertakings given by the vendor are evidenced in writing for your own protection.

## **YOU AND THE BUSINESS**

- Is this the type of business you were actually looking for?
- Is the type and size of business compatible with your interests, experience, personality and capital?
- Will the cash flow from operations be sufficient to meet your debts and expenses?
- Is an adequate salary allowed for work done by the owner and family in addition to an attractive profit margin?
- Can you increase sales with current resources - human and financial?

***At this point you have completed the evaluation over a period of time during which some details may be glossed over or only partially satisfactory. Review the questions and if comfortable proceed to the negotiating table. Remember time is on your side in most instances.***

## **PLANT AND EQUIPMENT**

- Is the plant/equipment in good order? Is it efficient and safe?
- Is the plant/equipment in danger of becoming obsolete or difficult to service?
- Could it be sold easily at the asking price?
- Are the assets you're buying free of debt and liens? Have you checked this out carefully?
- What is the book value, the market value and replacement value of the fixed assets?
- Has the owner avoided some expenses that could be delayed such as equipment maintenance?
- Has the equipment been depreciated in the books and if so, how does the depreciated value relate to the asking price? Is the equipment being sold at realistic values?
- Is any equipment leased? What arrangements are being made between the vendor and the finance company regarding the lease agreements?

## **PROFITABILITY**

- Does the proprietor receive interest on loans made to the business and is the interest charged to the profit and loss account?
- Are profits adequate to warrant taking the risk?
- Have all sales been reliably recorded? Have you checked the daily sales book to compare and verify with the bank deposit book, and the annual sales in the profit and loss account?
- Are all sales in reliable records? Are the total sales broken down by product line, if applicable?
- Do you know what costs are allocated to which product, and how a change in product 'mix' would affect costs?
- Has the previous owner received any payments in advance - deposits, etc. that are due to the purchaser?
- Have you considered what effect inflation will have over the years to come? on sales? on costs?
- Will you have to build up and fund your own accounts receivable? Have you figured out how this will affect your cash flow and working capital requirements?
- Are bad debts deducted from sales, or are they still shown as receivables?
- Have the financial records including balance sheets, profit and loss statements, tax returns, purchases and sales records and bank statements been made available? Have the records been well kept? Have they been professionally analysed? Three years records for an established business are desirable.
- Are all expenses shown? Will you as new owner, have the same level of expenses? Check the cash payments book to establish accuracy and disclosure of specific expenses appearing in the profit and loss statement.
- Are there annual expenses coming due soon? eg. Council rates, water rates, insurance premiums.
- Are there new or increased expenses you should anticipate? eg. working capital and taxation implications on borrowed capital for the purchases.
- Have you consulted an accountant on how to value the various assets for the best tax advantage?

- Are you aware of the "additional" costs associated with the purchase (eg. stamp duty, legal fees, deposits, rates and taxes adjustment etc.)?

## RESEARCH

- How long has the business been owned by the current proprietor?
- How long has it been on the market?
- Do you know the precise reason why the business is for sale? Falling sales? Health problems? Financial problems?
- Do you require any special licences to operate the business? If you need new licences, do you know what is required to obtain them? See \alma\licences.doc
- Is the business in a good area? Will anything affect the location in the foreseeable future?
- Is the product or service likely to maintain or improve its marketability or is it in danger of becoming over-sold, out of style or obsolete?
- Do you know the minimum likely sales? The maximum likely?
- Have you examined the effect of increased or decreased sales on profit and costs?
- What is the sales pattern year by year and month by month? Is the pattern seasonal or related to some business cycle (such as weather or other uncontrollable variables)?
- Are you certain that the sales disclosed have all been generated from the business under review? It is possible for sales to be included from another similar business also owned by the same vendor.
- What expenses do similar businesses have?
- Based on past financial results, have you projected the future cash flow and profitability of the business? What is the break-even point?
- Are there any adverse industry trends? For example, small retailers may be losing market share. If at this point there are unanswered or negative aspects evident then the business may not be for you. Proceed with caution through the next phase of business analysis.

## TRANSFERABILITY

- Is the vendor's personal role critical to the success of the business?
  - Is a particular key employee critical to success?
- If Yes is the answer to either point will you be able to retain that person in your employment?***
- Is the seller being cooperative in supplying you with all relevant information? A trial period before settlement is recommended.
  - Will the vendor train and assist you after the purchase?
  - Will the vendor agree not to compete with you for an agreed time and/or distance after the purchase? (Trade Restraint).
  - Although not a preferred option, are you buying the accounts receivable? Do you have a listing of these accounts by age? If you are taking over some debts do you know the exact terms of repayment? Is this in writing? If not realised these amounts are not tax deductible as bad debts.
  - Have you decided what intangibles you want - mailing lists, business name, exclusive rights, leases, etc.? Can they be transferred?
  - Is the staff adequately paid, or do they expect wage increases soon? Bonuses? Holiday pay? Has accrued holiday pay, loadings and long service leave commitments due to existing employees been determined and adjustments made?
  - If buying a share of a company or entering a partnership do you know what limits there are and do you know what authority you will have in the management of the business?
  - Does the contract of sale describe the assets to be purchased, what liabilities are to be assumed and when the business is to be taken over?
  - Don't part with all funds until possession is obtained.
  - Vendors rarely finance the sale, this may be the sign of an anxious seller.

## REFERENCES

Australian Government Business Entry Point	<a href="http://www.business.gov.au">http://www.business.gov.au</a>
Business Development Corporation WA	<a href="http://www.sbdc.com.au/">http://www.sbdc.com.au/</a>
Business Support & Employment, ACT	<a href="http://www.business.act.gov.au/">http://www.business.act.gov.au/</a>
Business Tasmania	<a href="http://www.tdr.tas.gov.au/">http://www.tdr.tas.gov.au/</a>
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Small Business Advisory Services, NSW	<a href="http://www.business.nsw.gov.au/">http://www.business.nsw.gov.au/</a>
Small Business Victoria	<a href="http://www.sbv.vic.gov.au/">http://www.sbv.vic.gov.au/</a>
The Business Centre SA	<a href="http://www.tbc.sa.gov.au/">http://www.tbc.sa.gov.au/</a>
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