Part IV

If You’re Buying a Business . . .

The 5th Wave

By Rich Tennant

“All right, ready everyone! We’ve got some down out here who looks interested.”
The flip side of the transaction is the buy side. In this part, we feature a detailed case study on the purchase of a fictional business, showing where the buyer went right and wrong. We also discuss the range of investigation that should go into a purchase, and we even introduce such intensive tactics as forensic accounting.

Buying a business is all about planning and research. It’s not just about the business. How the business fits into your other business operations and, of course, your long-term financial plans is also important.
Chapter 14

How Do You Know Whether You’re Ready to Buy?

In This Chapter
▶ Understanding the elements that drive a business purchase
▶ Identifying the right business
▶ Planning the purchase and stepping through the purchase process
▶ Continuing valuation after you seal the deal

If you’ve ever watched smart business moguls in action, you may have thought they had a sixth sense about business opportunities; they pounce when others seem to be standing around aimlessly. But behind every great intuitive business mind is usually something more powerful that you don’t see: preparation, which is what this chapter is all about. Proper valuation is part of the necessary preparation that goes into any successful purchase of a business.

Knowing What Typically Drives a Business Purchase

Clearly, the dream of owning the hair salon or the boutique down the street motivates people to strike out on their own. Yet like most things that look good from street level, businesses require closer scrutiny.

A business transaction is a courtship. Although friendly (or unfriendly) strangers at the start, both sides get to know each other as the process moves along. Always be on the lookout for changes in the seller’s mood or the involvement of associates or family members in the discussions. (If you haven’t read Chapter 11, you may want to do so just to get a broader picture of how family goals — and disagreements — can affect the value of a business.)
If you put yourself in the place of an entrepreneur, you can find many reasons for wanting to buy a business:

- **Career change:** The urge to get away from working for the Man, the Woman, or the Company from Hell can be very strong. The need for independence has pushed more than a few worker bees over the edge into entrepreneurship. Seeing employed individuals use their savings or their corporate buyouts as seed money for new companies isn’t unusual.

- **Emotion:** This category is a wide one — and a sometimes-dangerous one at that. It contains some element of career change (the desire to strike out on one’s own, the need to get away from a stifling organization, and so on) mixed with some other major human motivations, not all of them of the highest caliber. In some cases, people buy family companies to keep the company in the family — or away from other members of the family.

Some people have a romantic notion about the kind of company in which they’ve always seen themselves. Sometimes, that notion is a very fitting reason for a person to take the leap into a particular business, but sometimes, it’s just a romantic notion; the entrepreneur may not be ready for all the challenges that await him. Buying a business based on emotion can result in something great — or something regrettable.

- **Tax and estate issues:** Tax and estate issues are complicated in their own right, and no particular one-size-fits-all scenario motivates someone to buy a business. But when family businesses pass from one generation to the next, an outsider may get an opportunity usually reserved for the insiders: the purchase of that family business.

- **Continued expansion of an existing enterprise:** The opportunity to buy a business that may be complementary to your own operations may be a better way to grow a business than building it organically. Purchasing a competitor allows a company to diffuse a threat while harvesting customers, product lines, and managerial talent that can make the combined operation considerably more valuable.

## Getting Ready to Buy

You’re looking at a business that you think holds attractive value now and will demonstrate even greater value in the future. But how do you really know?

Sharp outsiders have ways to discover value that the current owners haven’t realized on their own, for any number of reasons. The owners may not be particularly brilliant businesspeople, for example, or they may not have the will to continue in a toughening business environment.
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In any event, successful buyers know the following things:

- That they have the skills to put the tangible and intangible assets of the business to work in new ways that will make the company even more successful
- That the economy is presenting favorable conditions for them to execute those plans
- That they’ve created the financial infrastructure in their personal and business lives to take advantage of any opportunities that surface

Smart buyers develop market intelligence about the best companies out there to buy. These buyers know a lot about the businesses they may be interested in, such as which founders are ready to retire and which well-run companies may not have the ability to expand on their own.

Value often comes from opportunities that no one else sees.

In this section, we talk about some challenges that buyers face, discuss how to determine whether a business is a good fit for you, and tell you how the sale process usually works.

Tackling challenges unique to buyers

Ongoing operations have several advantages. If you’re paying attention, you can see how long a particular company has been in operation; you can investigate its activities through the news media (check the clips to see how good business has really been); and you can go online to see whether you can identify regulatory problems or court actions that the business may have suffered.

Most information about private companies is tightly guarded and must be requested only by serious parties who can guarantee that they won’t spread the information to other outsiders. Finding the answers you need to make a decision is harder when you’re looking at private companies. When you’re considering buying a successful ongoing business or one that’s in trouble, however, you can apply most principles to public and private companies alike.

Unlike people selling houses, business owners don’t always announce their intentions to sell in a public way. How many times have you seen a for-sale sign in the window of a local business? Unlike a house, a business may consist of the business itself, the building it lives in, and every piece of machinery and stick of furniture in it — or it may simply consist of two
guys in a dorm room designing a search engine that takes over the world. (By the way, we just told you two things: how Google was founded and how idea-based companies with no visible assets can turn into something very big indeed!)

But most people who are looking to buy a conventional business with an address and equipment have to deal with the following issues:

- **Lack of listings:** No central repository of business-for-sale information is available, save for independent listings by business brokers or independent businesspeople who advertise in newspapers or online. There are plenty of easy ways to find businesses for sale — companies even put themselves up for sale on Craigslist these days — but no matter where you pick up information on a company, do your due diligence (see “Step 4: Practice due diligence,” later in this chapter). Never trust anything you read until you’ve checked it out or enlisted experienced help to investigate.

- **Competition:** For the best businesses out there, prospective buyers are usually in line before you — people who’ve already thought about swooping in whenever the owners get weary of the operation.

- **Lack of financial data:** Private companies don’t have to make their financials public, so it’s impossible to find much data until you’ve identified yourself as a serious prospect. You may have to put up a few thousand dollars in earnest money before you can do your due diligence.

- **Owner emotions:** Because a private company may represent a sentimental spot in the heart of its present owner (even if she’s absolutely terrible at running the business), the buyer may be dealing not only with numbers and business forecasts but also with some raw emotion.

- **Lack of useful benchmarks:** Benchmarks tend to be very general if they exist at all.

**Looking at whether the business is right for you**

Plenty of successful entrepreneurs started their empires with a simple conversation with the proprietor of a business they frequented who just happened to mention that he was hoping to sell the business in a couple of years and retire. Such conversations are serendipitous, to be sure, but even in those situations, getting from dating to mating takes time.
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Here are the key steps for getting to the finish line the right way:

1. **Before you analyze the business, analyze yourself.**
   
   Maybe the idea just fell into your lap. That “eureka!” idea makes running a business seem like a happy dream — and a doable one. But you need to ask yourself some pointed questions about whether you’re ready for the often-draining responsibilities of running a business. (Feel free to wander back to Chapter 2 for the questionnaire for fledgling business owners.)

2. **Look past the window dressing.**
   
   When a company puts itself up for sale, it does a lot of the same things you do when you’re trying to sell a house or car: clean it up, add a coat of paint to cover flaws, and so on, in the hope that prospective buyers will get a more favorable view of the company. This isn’t wrong. Just don’t let surface improvements keep you from closely examining the numbers and detailed characteristics of the business.

3. **Research the business.**
   
   Under your own steam or with the help of experts, find out what you can about your target company on the Internet, at the public library, or through local business organizations. Then go wider. Consult valuation databases and publications to get an idea of rule-of-thumb valuations for common businesses in that category — keeping in mind that you’re looking at guidelines, not final offering prices (see Chapter 9 for more on rules of thumb). You have plenty to do yet.

   Doing initial valuation research on your own is important because even if you don’t find out a lot, you’ll be in a much better position to speak with experts about how they can help you. Also, if a business you thought you could afford looks as though it could be wildly beyond your means and risk tolerance, you want to know that before you start paying real money for advice.

**Evaluating a failing business**

If you’ve been doing your street-level homework, you may notice when a business you’re interested in has fewer customers or keeps shorter hours. You may also see that some familiar employees aren’t there anymore or that the owner isn’t paying as much attention to matters as she once did.

If tough economic times seem to be affecting the company, here’s some initial research you should do from a macro perspective:
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✔ **Determine whether the business is failing because of the industry or the operation.** Do some research on the fortunes of the industry that the business is in; if its product is going the way of the dodo, that may be the reason the business is failing.

*Example:* As we write this book, many U.S. newspapers are losing circulation and cutting staff. Although some new owners are trying to make their operations work more efficiently — making more staff cuts, realigning delivery routes, and so on — many experts wonder whether print is going out of style.

✔ **Look at the economy.** If the economy is great but the business is failing, the reasons for its failure may be internal — and fixable. If the economy is wiping out an established company, you may want to understand why it’s dying now instead of in earlier tough times it faced.

*Example:* Fuel prices are a significant factor for any business that depends on vehicles to deliver a product or service, whether it’s an airline or a produce company. If energy costs are killing a company, you have a good opening to research ways to make the company operate more efficiently by outsourcing some or all of its transportation functions or to figure out ways to buy fuel more efficiently.

✔ **Evaluate the competition.** Whenever you look at a business, you need to fully view its competition to see whether newcomers are entering the market or whether the existing competition is doing something different. Also, you can’t forget to evaluate how your competition operates on the Internet.

*Example:* If a local bookstore has a monopoly on college textbook sales but is losing money on consumer bestsellers, should it really be selling consumer books?

✔ **Consider labor costs.** If a company is wedded to local employment, that may be noble, but as a prospective owner, you should ask whether — based on current economic conditions and the labor costs of its closest competitors — the company could conceivably make more money by outsourcing or offshoring its labor costs.

*Example:* Many companies (your potential competitors) are outsourcing their customer service operations to domestic or overseas call centers. Could that turn things around if you owned the company?

✔ **See whether marketing and advertising failed the company.** Find out whether customers have gone elsewhere because the business failed to keep them interested.

*Example:* An analysis of current customer lists can reveal whether the company kept good leads in the loop or failed to reevaluate its customer list over the years.
Look at the real estate and the hard assets of this business. Is the business a manufacturing company that hasn’t updated its equipment? You need to determine whether cash needs are preventing the company from upgrading its overall technology. Ask whether a company needs to own the real estate or manufacturing equipment it has; leasing or outsourcing may be a better option.

Example: If a company has clearly not updated its manufacturing equipment in line with current industry standards, determine whether it has held off due to financial constraints or whether some manufacturing alternatives might allow a new owner to dispense with that part of the business altogether.

Understanding how the mating process (typically) works

You’ve found a company. You’ve talked to your family members, your closest friends, your banker, your financial planner, your tax professional, and your attorney; maybe you’ve even placed an early call to a valuation specialist. You’ve shown everyone your own personal research — including some initial, general valuation information — and nobody’s told you that you’re completely nuts.

So what are the next steps? Read on.

Always respect confidentiality when seeking to buy a business. Anyone who’s ever spent time around an office water cooler knows how quickly rumors spread. When management and staff members start hearing that their employer may be putting the business on the block, regular office productivity screeches to a halt in favor of time spent trading gossip and updating résumés. Depending on how big or interesting the prospective buyer and seller are, the news media may want to get a whiff of what’s going on as well. Make sure that all conversations, meetings, and correspondence are conducted with privacy and respect.

Step 1: Find the best way to approach the seller

Depending on the kind of business it is and where it stands in its life cycle, approaching the proprietor isn’t always a matter of knocking on his door and saying, “Have I got a deal for you!” Your research should include details on when to make the overtures and who the best first contact should be.

Stick to a simple concept: Know your audience. Buying a multigenerational family firm involves a different overturing process from buying a franchised doughnut shop or the corner convenience store run by that nice old lady in the neighborhood.
Plan the meeting and the way you’ll formally express your interest. Do you have to write a query letter to a home office somewhere, or can you simply ask the owner out for a cup of coffee and begin to see where she stands on the issue of selling her company? Do you need an intermediary to arrange a formal meeting on neutral turf? First impressions do matter.

Be tactful, particularly about numbers. The early stages of meet-and-greet usually aren’t the time to talk price. Save that discussion for later, when you’re conducting due diligence and negotiating a deal.

**Step 2: Find out how the seller will be represented**

Wouldn’t it be great if you knew each other and the scope of the business well enough to write a deal on a napkin, shake hands, and pass the check? Yes, it would be, but that scenario is largely the stuff of Hollywood movies. Most deals aren’t struck that way, largely because they shouldn’t be.

You need a legally binding deal that’s responsibly negotiated on both sides. Find out whether the seller is going to be aided by an attorney, a business broker, or some other intermediary and whether your representation is equal to the discussion.

When in doubt, check it out — a seller may say that she’s working with a Certified Public Account, a licensed attorney, or a certified valuation professional to help do the deal, but don’t take that statement at face value. Always quietly investigate the qualifications of the people who are working for the other side. Experience and professionalism on both sides don’t always guarantee a smooth business transition, but they definitely increase the chance of one.

**Step 3: Set up a tour**

Confidentiality rules the entire process, but as you proceed, you’ll want to tour the facility, perhaps with a valuation professional or other advisors in tow. This tour can be very informal or formal and may happen several times, depending on the business and on how the parties want to gather information.

If the target company creates a product that could be susceptible to corporate espionage, don’t expect to wander up to the receptionist without an appointment and ask when the plant tour begins. In many situations, before a company owner even decides to let you in the lobby, he’s going to want to know that you’re a serious suitor. You may have to have many conversations with the owner to establish your interest, and at very least, you’ll have to sign a confidentiality agreement (which your attorney should review before you sign). See Chapter 12 for a sample confidentiality agreement.
Step 4: Practice due diligence

This part of the process is where paper starts crossing the table, as each side starts to see the other’s crucial financial information and other data. You’re looking not just at performance numbers but also at the company’s culture, its tax history (which you probably haven’t seen until now), and its compensation structure. The rough outlines of pricing demands on both sides start taking shape at this stage.

Due diligence costs money, so try to estimate these costs in advance the best you can. You may be paying hourly fees to bring accountants, attorneys, or valuation professionals onsite to do the required investigation. Reviewing documents, creating reports, and gathering data mean one thing: The meter’s running.

Because the formal due-diligence process clears you to start talking to landlords, bankers, suppliers, employees, and customers, the seller may require earnest money at this point to show that you’re serious about the process. A separate earnest-money agreement may be necessary if real estate is included in the potential sale. Make sure that you understand not only what you’re going to have to pay but also what this amount covers and what you’ll be allowed to investigate during the due-diligence process. If you’re paying for the right to look at a company’s numbers and additional time to make a proposal, for example, make sure that you’re getting your money’s worth.

For most small to mid-size businesses, earnest money of $5,000 to $10,000 is typical. How long does the earnest money period last? Typically, companies have between 7 and 30 days to complete due diligence and decide whether to go ahead with the deal.

Step 5: Move on to a deal

You’ve popped the question, and you’ve forked over the ring, better known as your initial offer. Based on your due diligence and advice on valuation, you should be prepared for some negotiation, but ideally, both sides have shared enough information that they won’t be far apart if they really want to do the deal (see Chapter 15 for more on negotiating). Assuming that both parties reach a final number at this stage, a bill of sale is prepared and a closing date is scheduled.

Restarting the Value Process

When you get the keys to the business, you start the process of evaluating staff and operations as an owner — a completely different ballgame from due diligence. When your head stops spinning and you get a real handle on
what you have, it’s time to reset the company’s strategic plan to address your own valuation goals and targets. Whether you’ve purchased a high-quality ongoing business or a turnaround company, creating a strategic plan for the next three to five years can help you focus on growth, profitability, and your long-term plans for the value that this business will achieve.

Whether you’re the mission-statement type or simply a person who likes to sit down and talk to your employees (even if you’ve bought a business with only one or two people working the counter), get your employees thinking about what it will mean for them if you reach your targets for increasing the value of the business. Building in affordable incentives for your people over time may not hurt either; if you grow to plan, you’ll be doing more hiring, and better benefits and bonuses tend to attract the best people over time.

When you acquire your first business — or absorb the second or third in a string of transactions — you’ve changed the competitive landscape of a local business community and maybe even the industry in which you operate. That means a whole new round of studying and information-gathering. No matter what point you’re at in your business, the valuation process never really stops. Experienced businesspeople know that business is a process of reeducation every day.

The valuation process of buying a business should give you an in-depth understanding of the business you’re in or entering, and you should keep all those valuation principles in mind while you keep your mind open for the next opportunity. After a transaction is done, staying in business means learning about business practices and procedures that will improve the value of the business over time. Here are some ideas:

✓ **Join an industry networking group.** Making yourself and your business known in an industry organization allows you to learn about competitors who may become potential partners.

✓ **Keep close ties with lenders.** Always be ready to borrow even if you’re not planning to borrow anytime soon. It’s good to keep financials current and the condition of the business in good standing. Stay in touch with the banking community.
Chapter 15
Moving from Valuation to Negotiation

In This Chapter
▶ Seeing how valuation helps the negotiation process
▶ Preparing to meet the potential seller
▶ Understanding negotiation do’s and don’ts
▶ Using experts in the process

Everyone negotiates. People negotiate with family and friends to get things done — or done on their behalf. People negotiate with employees to get better performance from them. And people negotiate with landscapers, car dealers, pet groomers . . . you get the idea. But if you have a valuation based on dishonest or random data and operational practices, what are negotiation skills worth in a business context?

You could fill a warehouse with books on negotiation — how to do it, how not to do it, how negotiations work in various industries, how to negotiate through attorneys and other representatives, and on and on.

In this chapter, not only do we go over key points in business negotiation, but we also discuss a topic that we think is even more important: the quality of information that guides a negotiation strategy (information that you generate or that the target company generates for you). When you’re valuing a company, getting quality information is the first important step that directs all your negotiations involving that business.

No absolute law says that you have to buy a business when you find an attractive company worth owning or sell it when an offer lands unannounced on your doorstep — though you should be prepared for anything. Negotiation is a frustrating, enlightening, and extremely educational part of being in business.
Knowing What Valuation Does for the Dealmaking Process

Legendary business guru Peter Drucker once said, “Erroneous assumptions can be disastrous.” That statement is a fitting description of any situation in which the buyer or seller doesn’t rely on a detailed valuation process before starting negotiations.

You don’t have to have an offer on the table for valuation to make sense — it can educate and can guide you when a deal comes. Valuation is relevant in a pre-deal situation — when a business owner is mulling over a sale of her company, or when she’s making succession or estate plans, or when she’s hoping to seek venture capital financing down the line.

Identifying potential pitfalls and opportunities

Valuation allows a potential seller to discover pockets of hidden value and potholes of trouble that can sink a deal. An early, independent valuation process can unearth the following information:

- **The quality of assets inside the company**: Many owners think what their companies own and do are significantly more valuable than a buyer or a valuation professional would think. The opposite occurs in some situations, too.

- **Lackluster accounting methods**: A savvy buyer or his valuation professional won’t take long to spot holes in financial logic that draw more scrutiny or a move away from the negotiating table. If numbers and processes can be clarified, the seller needs to know the situation and fix the problems before negotiation takes place.

Timing the purchase well

Valuation can help you determine the best time to move on a sale, a management succession, or an application for financing or investors.

Timing is one of the most important factors in the valuation process. If you’re in control of the timing, you may also be in control of the volume of information required to reach your goal.
Minimizing emotional shocks

One of the most beneficial aspects of presale valuation is that it allows owners to get an exact picture of their circumstances — not only so they can improve operations and results before a sale but also so they can adjust to the emotional reality that the business may not be what they thought it was.

Valuation allows sellers to wring emotions out of the process before they face buyers or other family members. It allows negotiations to focus strictly on business and not on conflict, which actually costs money.

Getting Ready to Meet the Seller

You’ve certainly heard the phrase “garbage in, garbage out.” Whether you’re conducting an internal valuation for informational purposes before you sell your company or are valuing a target company for the purpose of buying it or investing in it, quality, depth, and purity of information are everything.

What you find during the valuation process not only identifies the value of the company but also moves the negotiating process toward the conclusion of a deal — or doesn’t. This fact is why we talk about setting standards for the quality of information within your organization as you approach certain milestones: a possible sale, the transfer of a business to family members or associates, a public offering, or preparation to borrow from a lender.

Everything you do in the valuation process — and we mean everything — either speeds or impedes your ability to negotiate for your goal.

Using failure as a great teacher

If, in your heart, you’re the engineering or design guru of your business, you’ll eventually have to master the finance or sales side of the business, too; otherwise, you may miss problems day to day.

You won’t be perfect at negotiation — at least, not at first. Negotiation skills evolve over time.

So when do you find out how to negotiate? Every day, while you’re running your business.

Remember: Everything that happens today may be valuable in a future negotiation.

People may tell you that if a particular deal doesn’t work out, another will be around the corner. The economy and the state of your industry play big roles in determining whether that’s true — but so do you. Use any negotiations with outsiders to build an ongoing discussion about value in your business.
Recognizing window dressing

We mention the concept of window dressing to describe the process that some companies go through when they prepare to sell. *Physical window dressing* is pretty much what you’d think — a fresh coat of paint on the walls and a general sprucing up of the premises to entice buyers. Home sellers do the same thing.

A company does *financial window dressing* to make numbers look better than they are, based on what a company wants to show. A company that wants to sell may engage in the following types of financial window dressing:

- Delay spending on employee training so that expenses in the current year (the year potential buyers may be looking at the books) are lower.
- Extend its terms for uncollectible accounts receivable so that it doesn’t have to be as aggressive about reporting bad debt.
- Complete a sale/leaseback deal on some equipment before the end of the year, allowing the company to feature the proceeds on its balance sheet for the current year and then lease back the equipment the following year.

None of these activities is illegal, but manipulating the timing of certain spending decisions can definitely have an impact on a company’s numbers. For this reason, you need someone who can spot the difference between asset levels driven by the normal course of business and those driven by accounting sleight of hand.

Remembering motives

Understanding motive isn’t just for cops. Motive is critical for any negotiation, and you need to understand not just your own motivations in the process but also the motivations of the person on the other side of the table.

Here are the primary motivations in the business-sale process:

- **Financial**: If the company’s wealth and the owner’s wealth are intertwined, as in most small companies, the seller’s personal financial goals are important motivations.
- **Personal**: How dedicated both sides are to the continuation of the business is another important motivation. The seller may finally be ready to hang it up, but you, the prospective buyer, may be new to the industry or eager to enhance the value of your operation with hers.
- **Emotional**: Emotional issues can drive the need for a valuation. The founder may have died, for example, and the kids are unprepared or unwilling to take over where Dad left off, or they’re quarrelling about what to do with the business.
Timing-related: Timing can be a big motivation. Perhaps an entrepreneur realizes she’ll have to introduce massive research and development (R&D) spending if she hangs onto the business another year, and you realize that you’ll lose a competitive advantage if you don’t pick up her key product line.

Knowing what sellers want

When listing what sellers want, a buyer is a good start. But selling a business isn’t just about having someone show up with a check. Sellers also want buyers who fit their specific needs. For instance

- They may want to make sure that certain key employees — themselves included — stay with the company for a certain period after the purchase.
- They may want certain product formulations and trademarks to continue after a new buyer takes over.
- They may want noncompete clauses and other limitations on their future ventures to be short term rather than long term.

Let’s Make a Deal: Negotiating

Anyone who thinks you can keep emotion and personality issues out of the negotiation process doesn’t have a clue about how business or human communication really works.

We start this chapter by mentioning the quality and transparency of information for two reasons: Getting good, transparent information is good business practice generally, and it gives you enough certainty to keep discussions rational and on point. Reliable information from both sides can speed the negotiating process and diffuse disagreements that come from too many unanswered questions.

Deciding whether to handle negotiations yourself

This book isn’t about negotiation — for that topic, you can check out Negotiating For Dummies, 2nd Edition, by Michael C. Donaldson and David Frohnmayer (Wiley) — but negotiation is a critical aspect. Can you do it yourself?
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All the time, small-business people assert that they don’t have to take on a phalanx of experts to help them negotiate a price for a company. In some cases, this really may be true. Some people are born negotiators, and they have the skills to come out ahead in any deal talks. But we argue that any negotiation is as good as the information behind the negotiator — and in the case of a purchase of a business, that means having solid valuation information.

There’s no one single valuation amount for a business. Although the information that goes into a valuation has to be accurate, so much of the process is analytical and subjective. That’s why you may see five different valuation professionals come up with five different prices for the same asset or the same business.

But in general terms, all buyers should realize that the final price ultimately depends on how quickly the seller wants to sell and how badly the buyer wants to purchase the business. The greater the incentive the owner has to sell, the further below the asking price she’s likely go. By the same logic, however, the more you want to buy the business, the faster you’ll want to get the deal done (and you’ll probably pay a higher price as a result).

Getting ready to negotiate

Even though sellers may have a longer time than buyers to prepare for a deal, it makes sense for buyers to set their parameters well before they find a target. Here are some thoughts on how to be ready for the negotiation process:

1. Think about the best-case scenario of the way you want a negotiation to end.

   Develop a profile of the kind of business you want to buy, the way you’d want a deal structured, and the financial terms that would make the best sense for your business and personal life. Start talking to estate planners, your family, and your business and tax attorneys about scenarios that make sense for you.

2. Start networking.

   Good relationships can lead to efficient deal making, so get to know officials of target companies casually. Based on your particular objective in a deal — finding a business inside your industry or outside — you may want to get involved in local or national business organizations to meet executives from other companies to boost your knowledge of what possibilities may be out there.
3. If there’s interest, meet.

Meetings between potential business partners can be as formal or informal as necessary. Never pass up a chance to make a useful contact. You may be buying that person’s company someday, and good, long-term relationships can make that process easier.

4. Be prepared to sign a confidentiality agreement.

In most business negotiations large and small, the step before kicking the tires is signing the piece of paper that says, “I shall not tell anyone that I kicked your tires.” Confidentiality agreements are a necessary step before a company will open its books to you, or for that matter, its data or facilities to your inspection.

How you write the confidentiality agreement is up to you and your lawyers, but generally, if talks break off or the deal doesn’t go through in the final moments for any reason, that agreement is your insurance. (See Chapter 12 for a sample confidentiality agreement.)

5. Prepare the list of everything you want to see.

You should present the target company with an organized, comprehensive list of all the information you’ll need to make a purchase decision (which is one reason to talk to your team of experts before the due diligence process begins). Asking questions in dribs and drabs makes you look like an amateur — follow-ups to major issues are okay, but make sure you make all major requests together.

You’ll ask for comprehensive (and hopefully audited) financials, of course, but you’ll also want the target company’s recent tax returns, contracts from top revenue-producing clients, and any records from current or past legal proceedings. Be very aware of any hesitation in sharing information.

Tempers may flare during the negotiating process over matters large and small. Your executives may feel that they’re being asked questions that go beyond the bounds of what should be disclosed about the company. An accountant who rubs everyone the wrong way may come onsite. And when so much money is at stake, there’s stress. When things get heated, remember not to take too much personally.

6. Get to know the facility.

Either you or your representatives — and particularly your valuation professionals — need to spend quality time at your target’s facility. How do you really get an idea of valuation without actually looking at the facility, its offices, its machinery, its buildings, and heck, even the way people work together?
7. **Do the valuation.**
   You, your valuation expert, or both of you together should execute the valuation based on all your data and arrive at a price range for the business. Before you present your offer, put in place the elements to pay for it — cash, debt, or a note that you'll offer to the seller.

8. **Start negotiating.**
   Negotiations get more intense as you offer contract language for the seller's review. Unless the buyer has offered you everything you had in mind in Step 1, you come back with your response and request changes based on your conclusions and those of your advisors.

9. **Do a final walk-through.**
   Before you sign the final papers, the buyer and seller usually do a final walk-through of the business with a final inventory count of assets agreed to in the sale. Settle any remaining problems in the deal then, or the deal may go sour at the last minute.

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**Understanding what you should do in negotiation**

You can load your arms with varying titles on negotiation the next time you go to the bookstore, but for now, here are general guidelines for keeping a negotiation calm, informative, and efficient:

- **Don't talk; listen.** You're going to have to talk at some point, of course; we're not suggesting a vow of silence. But the real discovery experience in a business negotiation comes from what you hear, not from what you say. You should take the time to listen to:
  - A target company's key employees, particularly the chief financial officer if the company has one
  - Your family, because your goals for your business affect them directly
  - Your advisors — your business and tax attorneys as well as any financial-planning experts you work with on a regular basis

- **Respect confidentiality.** If you've been successful in business, you ideally know how to guard information as well as use it. As you gather information, make sure that everyone you speak with understands your need for discretion. Don't be a blabbermouth about what's going on, and tell the members of your inner circle to be responsible about any information you discuss with them.
Keep an open mind. Potential sellers come to the table with agendas that may seem at the outset to be very different from your own. If these agendas seem as different on Day 30 as on Day 1, you may have a problem, but you should always try to understand what a potential target is thinking and what her immediate concerns may be (refer to “Remembering motives,” earlier in this chapter).

Even if talks don’t lead to a deal, negotiation puts you in a considerably stronger position to understand your business and the competitive environment it lives in. No matter how firmly you believe that your way of running a business is the best way, an open mind is far more valuable than a take-it-or-leave-it mindset.

Watch behavior as closely as words. The essence of negotiation is in understanding how a customer, employee, supplier, or potential business partner behaves and how that behavior leads to specific actions. Buyers and sellers each want things that the other side has, and manipulation is part of the game. But is this manipulation the kind that goes on in the normal course of everyday business or a dangerous kind that may lead you to give up more than you’d choose to?

You may be dealing with a complete stranger or with someone you’ve known for 30 years, but if you’ve never negotiated with this person before, you need to watch whether he behaves with openness or with stealth. Problems with integrity can kill not only a deal but also a relationship.

Working with someone who’s negotiating for you

The size of the business, the complexity of the potential deal, and your personal preferences affect who you bring in to advocate for you in the purchase of the business. Here are some of the experts who may help you negotiate:

Attorneys: Consult the lawyers you deal with in the regular course of your business and personal life about their thoughts on the best way for you to approach a business purchase. The best sudden-offer scenario is one you get after you’ve already consulted trusted advisors who give you a battle plan.

Even the simplest business acquisitions have complicated contracts. The average business-purchase agreement has dozens of clauses to be negotiated beyond price, down payment, and ongoing terms. Other topics of discussion include noncompete clauses (which may last for several years after a deal is closed), lease assignments (the transfer of payment details on all leases from the seller to the buyer), inspections, adjustments, employee matters, and anything else that crops up as a feature of this individual deal. Tax, estate, and business attorneys you work with form an ad hoc team of advisors you may see based on need.
Your officers: If you run a company large enough to have a dedicated chief financial officer and other executives in legal and operating posts, you hopefully brought trust into the picture when you hired them. Keep them in the loop on your plans for purchasing a new company and use them as conduits to ferret out information on potential targets.

Your valuation professional/professional intermediary: An attorney may be a valuable negotiator for the right company, but attorneys don’t always have significant training and experience in business valuation. The good ones will tell you when they don’t, and often, they’ll have such valuation experts in their Rolodex.

Here are two reasons to use an intermediary:

- Intermediaries can be the good cop or the bad cop in a valuation assignment, which may allow the buyer and seller to maintain a more cordial relationship. For example, if a deal-breaking situation comes up in the valuation, instead of your saying, “No way,” your intermediary can say something more diplomatic: “I know this issue here isn’t in the best interest of my client, and I’d be violating my duty to her if I suggested it.”

- Just having someone who does deals for a living can pay off because based on his financial knowledge, the intermediary can spot different ways to do a deal before attorneys or accountants step in. Intermediaries can do drafts of letters of intent that the company attorney can review prior to closing date. If you’re paying the cost of an intermediary already, having him do these intermediary steps before other hourly professionals come into the process can save significant dollars and time.

See Chapter 7 for more on all the professionals who can help you with the valuation process.

You can’t abdicate all responsibility for negotiating the deal to your experts. Their job is to advise and protect you — nothing more. You should viscerally understand every aspect of the deal before you sign. You have to know whether a change in Clause 15 or Clause 45 would turn out to sour the deal. Nobody knows your goals better than you do, and nobody is in a better position to decide whether the business you’re examining is right for you.
In this chapter, we cover the preparation and study that buyers should do in advance of a deal — the flipside of Chapter 12, which discusses due diligence for sellers. In truth, both sides should do about the same preparation. However, this chapter focuses on the skills and tasks you need to make a complete valuation of a business as a buyer.

Seeing What Due Diligence Means in Practice

Due diligence is the process of thoroughly investigating a business, from the quality of its facilities to the quality of its customers, its brand identity, and most importantly, its numbers. Due diligence happens when you approach a seller and ask for permission to view the company’s operations before you make an offer for the company. The process almost certainly involves signing a confidentiality agreement.

For a prospective buyer, the process determines the following things:

- **The quality of the company’s overall financial reporting:** When you’re actually allowed to see numbers, it pays to have expert help ensure that the data is in order. In some cases, you may want to involve a forensic accountant in the search for errant financial information. (For a look at what forensic accountants do, turn to Chapter 17.)
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✔ The current value of all the company’s assets, both tangible and intangible: Valuation professionals who are familiar with your industry will have a good idea of how to price the target company’s assets.

✔ The existence of any ugly secrets: Lawsuits waiting to happen, employee problems, regulatory hang-ups, and similar issues need to be investigated both inside and outside the company. Sometimes you get wind of legal hassles through news stories. At other times, it’s worth wearing out shoe leather and cellphone batteries to talk with area regulators and licensing agents, just to make sure that the business’s operations are in proper shape.

✔ How the company’s physical operations are maintained: Plenty of companies spruce up before a sale, and that’s great. But you need to look past the new coat of paint to find out whether the expensive equipment and machinery that you’re acquiring in a deal are in good operation or ready for the junkyard.

✔ The quality of the workforce: When you buy a business, you may be buying its human capital. Due diligence should give you an idea of the quality of the top management at a firm; this information should help you decide whether to create incentives to keep these people in place or incentives to get them to go.

✔ The investment required to maintain and grow the business over time: You’ll always find operational surprises after you take over any company, but the due-diligence process should give you a good idea of what investment and cash-flow standards you’ll need going into the business on Day 1 of ownership.

✔ The best time to act: Good timing comes from an intimate knowledge of how a business works, and that involves continuing education. When you’re buying a company, you have to weigh whether now is the time to enter the marketplace with your kind of mousetrap. You need to see what capital you have to invest or may need to borrow. You also may need to start thinking about additional investors to come in with you at the start. Furthermore, you have to look at the quality of competing products in the marketplace, the overall economy, and the economy of the specific industry you’re considering. Then you have to decide whether to jump in at this point in the business cycle or wait a little while.

Looking at the Unofficial First Stages of Due Diligence

Due diligence commonly refers to the process whereby a target company lets you see its financial data and allows you to come inside to kick the tires, so to speak. But if more buyers were to make this process broader by looking at valuation from the start, we believe fewer businesses would fail.
Chapter 16: Due Diligence on the Buy Side

In this section, we talk about the unofficial but necessary first stage of due diligence in a purchase situation: researching a company before you approach the owner to make a deal. We also talk about getting some assistance, because bringing in help confidentially at this stage may be a good idea.

Researching the company

For potential buyers, the due diligence process should start with fully researching the business, its industry, and the economic outlook for the business. As a potential buyer, you owe it to yourself not only to study the target company but also to do the following:

✓ Read everything possible about the company and the industry in which it operates.
✓ Look over rule-of-thumb valuation data (see Chapter 9) as a starting point for pricing data.
✓ Check the success of the company’s product mix.
✓ Assess your capability to finance and manage the company.
✓ Consider the cost of replacing management and staff members, if necessary, after the purchase.
✓ Get a better idea of the company’s competition and customer response through outside intelligence.
✓ Review the quality of the business’s marketing and advertising.
✓ Interview valuation professionals who may be able to assist you in the purchase process (see the next section).
The financing environment for businesses is a critical factor in planning the purchase of a company. Even if you’re able to self-finance the purchase, you may need credit to acquire operating capital later. Establishing financing relationships is an important preparatory step in buying any business.

Consulting your family and the pros

In big and small businesses alike, you need to know your capacity for handling the management and financial responsibilities of business ownership. Finding out how prepared you are for this big lifestyle and career change isn’t something you should do in a vacuum.

Here are some of the people you may want to consult before you start the process of buying a company:

✓ **Your family:** You need to consult your spouse and your kids about how this major decision will affect the family’s lifestyle and finances. Business really is personal when you’re starting or buying a company. Family finances almost always change when one spouse or another (sometimes both!) decides to go into business.

 ✓ **A certified financial planner:** Anyone who considers purchasing an existing business without examining his personal debt, savings, and investment situation is courting trouble. A visit to a certified financial planner who works with independent businesspeople may be a good first step in this process.

 ✓ **Your tax professional:** Few people realize the impact of entrepreneurship on their personal tax situations. Make time to discuss your plans with your Certified Public Accountant (CPA), and consider the advice you’re given as part of the business-planning process. Your personal tax situation may influence the ownership structure you choose for your business.

 ✓ **Business and estate attorneys:** A good business attorney can educate you on the basic legal requirements of operating a business in your community. An estate attorney can work with you, your tax professional, and your financial planner to plan how you’ll grow the business to build your personal fortune — and protect yourself from various risks along the way.

 ✓ **Business valuation professionals:** Whether you plan to use a business broker, a business appraiser, or an accountant or attorney who’s certified as a valuation professional (see Chapter 7), it’s a good idea to contact and review candidates well ahead of any purchase. Interviewing these professionals may give you a broader view of your ideas for owning and operating a company.
Chapter 16: Due Diligence on the Buy Side

**Thinking cash, not debt**

In the rush to own a business, many people focus on the selling price and not on the ongoing costs of staying in business or the risks inherent in being new to a business. Likewise, people who start companies also fail to examine how much cash they’ll need to keep operating before profits start trickling in.

An ongoing business with a solid customer base, staff, and operating system in place is in a much better position to keep generating the cash that’s the lifeblood of any business. (Are you as tired of that cliché as we are? Oh, well, it’s probably still the best description of cash flow.)

So we’ll go out on a limb and say it: Your plan to buy a business should include projections for the worst-case scenario for the company’s cash needs. Based on that scenario, you should go into the purchasing process with a surplus of cash to handle contingencies that can arise when a business changes hands. These contingencies can include the following:

- **Employee turnover:** Some high-producing employees may be lured away to competitors during the ownership transition, and your sales may go down until you bring in suitable replacements for these people. (Alternatively, you may want to install an incentive system to keep the best employees right where they are.)

- **Promotional costs:** You may have to incur promotional costs to assure existing customers that they’ll still be well taken care of and to assure prospective customers that now is a good time to come onboard. You also may offer discounts or other savings to loyal customers to keep them in the fold.

- **Repairs:** Computers, machinery, and anything else with a plug or a fuel tank may break during the first year you’re in business. Yes, you may have inspected all the assets with a fine-toothed comb, but breakdowns happen.

If you’re making a purchase decision during flush times, you may be tempted to go to lenders to finance the purchase. But when times get tough, banks want their money back. It may be a better idea to invest your own money or to get people who are close to you and who understand your skills and your company involved in your business as investors. This arrangement is called *equity financing.* Talk about it with experts you trust. Equity is better than debt because investors have decided to take the ride with you, and you get to set the terms under which they’ll be able to pull their money out of the business. Banks don’t have the same alliance with the owners of the company; when times get tough, banks are seldom as understanding as shareholders will be.

A balance sheet loaded with debt will devalue your business over time. Therefore, if you find that you have to take on debt, treat it as a short-term expense to be extinguished quickly. (That’s not a bad idea for your personal finances, too.)

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**The Informational Game Plan: Cracking the Books (and the Internet)**

Prospective buyers need to be planners, and no matter how many experts are helping you in your quest for a business, building your own independent knowledge of your target company and industry makes good sense.
The nation’s bankruptcy courts are filled with men and women who put everything they had into owning a business but failed because they never took the wide or the detailed view. A valuation professional can help you with the detailed view — the best ones are trained to spot valuation challenges specific to the industry you’ve chosen. But the wide view? That’s where you need to start.

Without a full understanding of the kind of business you want to buy, the industry it’s part of, and the economic and operational challenges affecting it now and expected in the future, you literally have no business being in that business.

Remember that readers are leaders. (Yes, we’re suckers for corny old slogans.) But a big part of due diligence is good old-fashioned book-cracking — or in today’s parlance, Web surfing. Granted, you can’t believe everything you read in newspapers or in magazines, and certainly not on the Internet. But even if you’re bringing in experts to help you value a business, the ultimate decision to buy rests with you, so you have to be smart enough to know whether the people you hire to evaluate a deal are representing you properly.

What should you be reading? Here are a few ideas:

**Trade publications:** Virtually every industry has a trade publication following it. At one time, many trade publications were excessively friendly to the industries they covered, but today, the best of these publications are more objective and journalistically written. They’re great resources for up-to-the-minute industry news, trends, and gossip. If you come across a major business-news story in the paper, on television, or on the radio, chances are that the first rumblings came from the trade journalists who regularly speak with companies, suppliers, and customers every day. In many cases, trade publications are simply closer to business news than general publications are.

Do an Internet search on your industry name and the phrase “trade publication” or “trade journal,” and see what comes up. You may have to try several combinations of words, but soon you start finding titles to work with. Find and bookmark the journals that have the largest circulation; generally, those publications are the leaders in their industries. Many trade publications have their circulation listed with the Audit Bureau of Circulations (www.accessabc.com), and you can check the largest ones in their category there. But the Internet has made it easy to spot major publications by the way they turn up in searches.

When you find your selection of trades, go to their Web sites and search their archives. You also may want to subscribe to print versions of the publications, but first see whether you can score a free subscription offer and consolidate your research during the free-subscription period.
Online databases: Major online databases can help you find news stories, Wall Street analysts’ reports, and company-issued news releases in most industries. Because many of these are paid databases, check with your local public and college libraries to see whether you can access them there for free. For a great list of databases you should bookmark, check Chapter 12.

City business publications: Most major and mid-size cities have some form of business weekly that focuses on the activities of local companies. Search for stories about competitors of the target company and about the local economy.

Trade-association data: Manufacturing, technology, and other industry groups in a particular region may compile annual guides that list all their members — your potential competitors or target companies. Depending on how many years such a guide has been published, checking it is a good way to identify current and past executives, as well as critical reported numbers, products, and other data over a company’s history.

Join a professional organization in your community, the chamber of commerce, or even a civic or nonprofit board that can put you in touch with people who are connected to the industry in which you want to buy.

Gathering the Company’s Data

When you’re touring a facility or speaking with executives at a company that you’re considering buying, always do the following things:

Look at how a company keeps house. Cluttered or messy offices don’t necessarily mean that disorganized or untalented people work there. Facilities that are literally falling down, filthy, or otherwise neglected, however, may indicate that the company is facing financial difficulties or, at the very least, a loss of vision or purpose.

On the other hand, does the place look as though it’s been sanitized to cover up deeper problems? That happens, too. Don’t be afraid to judge the surroundings privately. Keep your questions to the owner polite, but don’t be afraid to ask her why things are the way they are. If you consider such problems to be fixable, housekeeping problems may not be bad, because they may give you a better negotiating position on price.

Check the work environment. Ideally, you know what a healthy work environment looks like. Employees will have disagreements, but in the right environment, they communicate well and even have fun at their jobs. No workplace is perfect, but if you sense that people have a bunker mentality, or if you see fields of empty desks at various times during the day, by all means, ask why.
You may think it’d be fun to clean house and start over with your own team, but hiring and firing people are extremely costly in terms of time and money. If you buy a company and choose to replace someone who’s been there for 20 years, you may lose a crabby, unproductive employee in a layoff, which is good, but you may need to pay his replacement a lot more, which is a sizable expense that you have to figure into the valuation. Every whim in business has a potential cost.

✔ **Observe body language.** Any potential transaction always involves a bit of nervousness, with the parties dancing around each other in the early stages of information sharing. But if you sense fear, evasiveness, or uncertainty about giving you what you need, the situation isn’t too tough to read.

If you’ve been an employee before, just put yourself in the other person’s shoes. Figure out whether she’s just nervous about talking to the potential new boss or whether bigger problems are afoot.

✔ **Decide whether you like the seller.** You may be looking to buy a company whose owner you’ve known for years, and the purchase process is like two friends’ working together to make something great happen. That scenario is the kind of feel-good situation that everyone loves. In most cases, however, you deal with a stranger. The owner may have mixed feelings about the sale; after all, he made this baby. He may be looking to dump a lemon on you. Or in his heart of hearts, he may not think that you’ve got the right stuff to buy the company. Talk about a complex dynamic!

Most people don’t wake up in the morning and say, “Hey, I’m going down to Smitty’s to buy his business!” Smart business deals aren’t born in a day; it may take years to know what you really want and possibly longer to get it. Thanks to the Internet, any storefront or business started in someone’s attic has the potential to become a global company, so you need to do due diligence to figure out the true potential of any company.

In the next few sections, we suggest some questions to ask about the target company.

**Knowing which questions to ask about the target company**

Ask more than one source to answer the following questions. Due diligence begins with basic queries of prospective sellers, such as the following:

✔ What’s your impression of how the company is viewed by outsiders — competitors, the press, the industry, and the community at large? (If you know that the company has problems with its public image, you need to know whether it’s in denial about these problems.)
✓ What kind of gifts and incentives does the company give customers? (See whether these rewards skirt ethical boundaries.)

✓ If the company isn’t doing overseas production now, did it plan to do so in the future?

✓ Does the company pay in dollars or use a system to hedge against currency risk? If so, how does that system work?

✓ What are the company’s most valuable intellectual property assets?

✓ Does the company have any copyrights, licenses, or patents that are ready to expire?

✓ What quality-control systems are in place in various departments of the target company?

✓ What proprietary technology or systems are most valuable to the business?

✓ What are the company’s largest vendors and suppliers? What percentage of the overall purchasing budget do they represent, and how long has the company been working with them?

✓ Who are the company’s biggest customers? What percentage of total revenue do they represent, and how long has the company been working with them?

Checking with the company’s departments

Not only do you want to tour the business you’re thinking about buying, but you also want permission to talk to its employees. Make sure you’re cleared to talk with employees so you can find out what they’re like; if you’re thinking about buying this company, its people may become your people. Would you want them? Here are key departments on which you should focus.

Legal/audit

The company’s legal and auditing counselors depend on the target company for fees or paychecks, so they’re unlikely to say anything controversial. But if they want to keep the company as a client or as an employer, being straight with you is to their advantage.

You need to understand their processes and how they work with the firm; you also need to sound them out for clues about problems and added complexities in the business that you may not have heard from management. Consider asking the following questions:

✓ How open is the company in working with you on legal and audit issues?
✓ What’s your relationship with the chief counsel or chief financial officer?
Part IV: If You’re Buying a Business . . .

✓ Is top management involved in managing legal, tax, and accounting issues?
✓ How would you describe the recordkeeping and support technology for legal and financial matters?

Information technology
Technology is a tremendous driver of business as well as an enormous source of risk. You need to question both top management and the company’s information technology (IT) chieftain (if any) about the state of the company’s technology, how the technology is used in each department, and how secure it is. Here are some questions to ask:

✓ Is the Internet a big part of the company’s operations? If so, how is it used?
✓ What computer hardware does the company own, and how old is it? Does the company have any plans to upgrade its system?
✓ What software is used in the various departments of the company, and how often is it upgraded? Should I be aware of any major software revisions?
✓ May I see a summary of the company’s proprietary data and security procedures?
✓ How do customers interact with the company’s technology? (You want to know whether the technology is doing all it can to support, improve, and speed the customer experience.)
✓ How do suppliers and vendors interact with the company’s technology? (You want to know whether the technology is doing all it can to improve the supply chain.)
✓ Has the company’s IT department ever had a crisis situation, such as a hacker attack or the loss of important data? If so, how did the crisis affect the company’s operation and its relationship with customers?
✓ Does the company use outside consultants to service its information systems?

Sales and marketing
Sales and marketing personnel are important sources because you need to understand who’s pushing the gas pedal on revenue. Here are some questions to ask:

✓ Who does the sales forecasting in the company, and how is that information shared?
✓ Does the company have an internal sales and marketing staff, or does it work with independent reps or contractors?
✓ What are the seasonal sales patterns in the business?
✓ What were the company’s sales trends during the past three years by product or business line?
✓ How did success align with the company’s advertising and marketing spending?
✓ What are the most successful marketing and advertising approaches that the company has taken in recent years?
✓ Does each division have standard payment terms, and if so, are there exceptions to those terms (such as different arrangements for certain types of customers)?
✓ What’s your marketing focus for the next one to three years? Are there specific new territories you plan to enter, and are new products that will lead you there in the pipeline?
✓ How does the Internet figure into the company’s sales and marketing plan?
✓ How does the company measure the performance of its sales and marketing expenditures?
✓ What are the forecasts for goals and spending for the coming year, and how often are forecasts reviewed and tweaked?
✓ Does the company have a relationship with an advertising or marketing agency? If so, how long has the relationship existed, and what do you regard as the agency’s best work?
✓ Have you always had the same advertising or marketing agencies? Why or why not?
✓ What are the three best sales and marketing initiatives that the company is executing right now?

Collecting Outside Data about Your Industry and the Economy

Information about the economy and the particular industry in which the target company operates is critical to the due diligence process for any business. A prospective buyer needs to understand how the general course of the economy will affect the company he’s targeting.

If you took a course in economics, you’ve heard of the business cycle: the periodic, irregular, up-and-down movements in economic activity, measured by fluctuations in gross domestic product (GDP) and macroeconomic variables. Overall growth and contraction of the domestic and international economy tend to lift and lower all boats, yet each industry has its own peaks and valleys based on where the economy as a whole stands. You need to know what those peaks and valleys are.
Breaking confidentiality can get you into trouble

If either party to a deal breaks a confidentiality or nondisclosure agreement, she leaves herself open to legal action and potentially more publicity than either party is going to be comfortable with. Here are some of the laws people may risk breaking in the due diligence process:

✓ **Economic Espionage Act of 1996**: This law makes the theft or misappropriation of a trade secret a federal crime. The law contains two sections criminalizing two sorts of activity. The first section criminalizes the misappropriation of trade secrets (including conspiracy to misappropriate trade secrets and the subsequent acquisition of such misappropriated trade secrets) with the knowledge or intent that the theft will benefit a foreign power. Penalties for violation are fines of up to $500,000 per offense and imprisonment of up to 15 years for individuals and fines of up to $10 million for organizations.

The second section criminalizes the misappropriation of trade secrets related to or included in a product that is produced for or placed in interstate (including international) commerce, with the knowledge or intent that the misappropriation will injure the owner of the trade secret.

✓ **Uniform Trade Secrets Act**: UTSA is a model law that defines the rights and remedies of a common-law trade secret. The law imposes civil rather than criminal liability for misappropriation of trade secrets and creates a private cause of action for the victim. Remedies for misappropriation of trade secrets under the act are injunctions; damages, including exemplary (punitive) damages; and in cases of bad faith or willful and malicious misappropriation, reasonable attorney’s fees.

Nondisclosure agreements may protect you from careless or unscrupulous companies and contractors, but they won’t protect you from the law. These agreements can be overruled legally if a legitimate reason to do so exists (as part of a court case, for example). Also, they can be rendered invalid if they’re worded incorrectly, so make sure you get proper legal documents that clearly define the terms and conditions of the agreement.

Confidentiality is meant to work for you, too. A prospective seller definitely wants his financials and other key data to be kept secret from competitors, but he also wants data on your qualifications to buy the business. Just make sure that the confidentiality agreement doesn’t shield you from getting any information that you’ll need in due diligence production. In this situation, working with a good valuation professional or lawyer makes sense.

Make sure that the target company has three years’ worth of financial data for you to examine, and check carefully to see whether those numbers were audited by a good accounting firm. If not, you’ve spotted another potential trouble sign. Go to Chapter 12 to see what a seller should do in preparation for a sale and for a sample confidentiality agreement.

Many people buy businesses outside their range of expertise, only to find that they’ve bought into a down business cycle in that industry. Have you ever tried to sail a boat in a dry creek bed? It doesn’t work so well.
When you study economic activity, you need to understand how your chosen industry responds to the economy as a whole, and you need to understand what key economic indicators are. Here are some of the most common examples:

- **Gross domestic product**: As the measuring stick for the nation’s total output of goods and services, GDP is the broadest economic measure.

- **Job growth**: Businesses and consumers feel more at ease when the job market is expanding, and they also feel more comfortable opening their wallets. When job growth evens out or starts to shrink over a period of months, it’s a signal that the economy is heading for a slowdown.

- **Consumer confidence**: The Conference Board (www.conference-board.org) and the University of Michigan (www.sca.isr.umich.edu) maintain separate indexes of consumer sentiment based on interviews with heads of households and other resources. Even if you’re not in a purely consumer-oriented business, virtually every economic trend filters up from individual spending.

- **Institute for Supply Management (ISM) index**: The ISM index (www.ism.ws) is viewed as being a solid measurement of whether the manufacturing economy is contracting or expanding. Each month, more than 400 companies provide the ISM with data on changes in production, new orders, new export orders, imports, employment, inventories, prices, lead times, and the timeliness of supplier deliveries. By compiling the responses, the ISM can piece together a national economic picture. An index reading above 50 percent indicates that the manufacturing economy is generally expanding; a reading below 50 percent means that the economy is contracting.

The preceding list represents only a fraction of the national data that’s available. You also need to dig around in your own state and municipality for data that can directly inform your decision making. Your assignment is to study the economic indicators and metrics that affect the company you plan to buy. A good way to find industry metrics and measurement tools is to conduct an online search for the phrase “industry metrics” and the name of the particular industry.
Chapter 17

Forensic Accounting and the Due Diligence Process

In This Chapter

▶ Seeing what forensic accountants do
▶ Recognizing the unique qualities of forensic accounting
▶ Knowing when to use a forensic accountant
▶ Conducting a forensic test
▶ Examining forensic accounting case studies

Thanks to the growing number of police shows on TV that focus on the science of blood and guts, the word forensic has worked its way into the mainstream. It’s worked its way into mainstream accounting, too. But unlike the fictional character Gil Grissom of CSI, though, forensic accountants tend to work in clean surroundings. Only the numbers are dirty.

Wait, though — aren’t forensic accountants hired only for big-company situations? Not anymore. Where numbers are withheld, incomplete, questionable, or possibly fabricated, professionals with backgrounds in forensic accounting can be useful to businesses of all sizes. Even law enforcement officials involved in counterterrorism measures use forensic accounting techniques to detect the tiny amounts of money funneled through cash-based shell businesses, such as convenience stores and tobacco shops.

This chapter focuses on what forensic accounting means, what practitioners do, and what benefits accrue to buyers and sellers who engage forensic accountants in the due diligence process of a business purchase or sale.

Understanding Forensic Accountants

Thanks to prime-time TV, most people know what the forensic part of forensic accounting means — an examination after something undesirable has happened. But forensic accounting definitely involves more. Forensic
accounting mixes accounting, auditing, and investigative skills to determine fraud or other hidden or mistaken activities in an organization's or person's finances. The Forensic Accounting Academy, part of the National Association of Certified Valuation Analysts, offers a definition that's quite clear and succinct: “the art and science of investigating people and money.”

Forensic accountants often work in tandem with attorneys (estate, bankruptcy, divorce, and corporate) and federal, state, and local law enforcement officials to uncover mistaken or illegal activities within organizations. In a business-valuation context, they frequently work to find evidence of value — or lack of value — that others may prefer to conceal.

**Characterizing a qualified forensic accountant**

If you're hiring a forensic accountant, don't automatically assume that he has training in valuation. Check to see which certifications he holds on the valuation side. Certified Valuation Analyst (CVA), for example, is a leading certification that requires specific training and testing in valuation. (For more information on certification and training, turn to Chapter 7.)

What should any forensic accountant you hire know? Some of the items in the following list may be somewhat familiar, because they're the same qualifications you require of a valuation professional:

- Expert knowledge of accounting and control systems
- Solid investigative skills
- Good instincts and training in legal and illegal human behavior
- Knowledge of the industry in which an investigation subject operates, including knowledge of key stakeholders such as customers, suppliers, regulators, shareholders, and lenders
- Knowledge of technology that criminals use to steal money and goods
- Understanding of banking practices and issues related to the flow of money into and out of an organization
- Understanding of commercial, civil, and criminal laws in the pertinent jurisdiction that could affect a particular organization’s valuation
- Awareness of differences in business practices and restrictions in various countries
- Creativity, speed, and accuracy
The forensic accountant who caught Capone

Frank J. Wilson, a U.S. Treasury Department accountant, was the guy who put Al Capone away for evading taxes on income. The true story isn’t quite like the movie *The Untouchables*, but it’s close enough. Capone got away with dozens or perhaps hundreds of murders, but an aggressive bean counter brought him to heel through Capone’s own financial records.

Wilson and his team worked 18-hour days, reviewing more than 2 million documents and other key evidence seized in various raids on Capone’s operations over a 6-year period starting in 1929. They analyzed phone records and investigated banks and credit agencies. They developed a network of snitches, tapped phones, and seized various sets of financial documents related to Capone. Eventually, they found evidence linking Capone to gambling proceeds through a dog-track operation in Florida.

Capone unsuccessfully ordered a hit on Wilson and his wife, who moved from hotel to hotel while the investigation went on. Undeterred, Wilson gathered evidence to prove that Capone had a total of $116,000 in nondeductible expenses after claiming no income. Capone was found guilty and sent to prison in 1931.

Forensic accountants may work in concert with investigators and other covert players in the investigative process, but they need to know the legal restrictions on certain investigative tactics. Therefore, you need to confirm that your forensic accounting professional understands the laws that are likely to apply. If you’re hiring a forensic accountant, ask what her investigative limits would be for your situation, and ask what things she would and wouldn’t do. If she indicates that she operates without limits or is unable to answer your question specifically, go with a candidate who can.

**What training is involved**

Forensic accountants begin as trained Certified Public Accountants (CPAs), but most have something extra: a taste for the discovery and presentation of evidence to fill in the blanks in valuations, divorce proceedings, corporate investigations, and dozens of other kinds of cases and projects. They may spend plenty of time in court testifying on their findings, so they have to think faster than the lawyers who are peppering them with questions. (Forensic accountants may never have to defend their results in court, but their responsibility is to prepare their results as if they will.)

Forensic accountants are often asked to investigate cases that involve fraud, shareholder lawsuits, insurance claims, personal injury, business valuations, and other proceedings involving money transactions. Since 2001, counterterrorism has also been a fast-growing segment of most skilled practices.
Part IV: If You’re Buying a Business . . .

Most forensic accountants may have experience in auditing: reviewing the accuracy of a company’s or person’s figures along accounting guidelines. Beyond basic accounting training that leads to CPA certification, the forensic accounting field (like most industries) is exploding with certifications in a variety of forensic accounting–related skills. Here are a few:

- **Certified Fraud Examiner (CFE):** This designation comes from the Association of Certified Fraud Examiners, a 25,000-member organization in Austin, Texas. Though many CPAs have this designation, you don’t have to be a CPA to earn it; indeed, the CFE was designed for members of the law enforcement and security communities who lacked CPA certificates.

- **Certified Forensic Financial Analyst (CFFA):** This designation is provided by the National Association of Certified Valuation Analysts (nacva.com).

- **American College of Forensic Examiners:** This organization (www.acfei.com) offers a cornucopia of certification courses in a variety of areas, including consulting, accounting, nursing, medical investigation, homeland security, information security, and disaster preparation.

Expect forensic training to grow in the future.

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**Combat CPAs**

Darrell Dorrell is a CPA, CVA, and ASA (American Society of Appraisers business analyst) with financial forensics in Lake Oswego, Oregon. He has trained employees of the Justice Department and the Federal Bureau of Investigation in forensic accounting. Dorrell, who grew up in a military family, only half-jokingly calls accountants like himself “combat CPAs” because they have to work fast, quietly, and thoroughly to get results — sometimes before the object of the investigation knows that forensic accountants are onto him.

Dorrell says the “combat” part applies only partially to the process of investigation. The other part has to do with the tough courtroom grilling many accountants get over valuation assignments and other financial data they uncover. He maintains that typical CPAs trained in valuation alone are not always prepared for tough, detailed questioning on the stand in a particularly nasty divorce proceeding or corporate fraud case.

“Our job is to look behind and beyond the numbers,” Dorrell explains. “Classic ratio analysis used in business valuation is predicated on comparing one set of numbers to another and reaching conclusions based solely on those figures. The observations really don’t tell you about the veracity of the numbers.

“Our job is to drill down into the composition of the numbers and tell you whether something’s wrong or purely structural. Forensic tests such as indices can assess whether financial statements have been manipulated and where the manipulation has likely occurred.”
Where forensic accountants work

Many accounting firms are dedicated to the practice of forensic accounting or have forensic accounting divisions. Some of the biggest employers of forensic accountants are the U.S. government and corporate America.

The Internal Revenue Service, Federal Bureau of Investigation, and many state and local police departments have forensic accountants on staff to address local law enforcement needs, whereas corporations may have forensic accountants on their own payrolls to stem internal fraud.

Some major accounting firms may say that they have forensic departments, but you still need to check an accountant’s experience. Checking a forensic accountant’s qualifications and training is critical.

Recognizing situations that link forensic accounting and valuation

The chief job of many forensic accountants in valuation assignments is to reconstruct income and/or identify the ownership of various assets — most often, its illegal path into the wrong hands inside or outside an organization. In some cases, forensic accountants, such as Darrell Dorrell, CPA, CVA, and ASA, use existing information, such as public-company data or industry benchmarks, but often, they need a subpoena to access needed information.

Following are some typical situations that unite forensic accountants with valuation assignments:

▶ Mergers and acquisitions: Forensic accountants may make appearances on due diligence teams in a host of deals. Forensic accountant Darrell Dorrell says involving a forensic accountant is a good thing to consider in most due diligence situations. Investment banks and other lenders also bring in forensic accountants to safeguard their interests.

Besides scrutinizing numbers, forensic accountants question human beings in the process and do onsite inspections of the facilities being sold to verify the pricing in the deal. Fake or inadequate assets listed as being a major part of a deal may be found by any valuation professional, but forensic accountants specifically look for them.

▶ Purchase of troubled assets: In a tough economy, the last guy standing with cash in his pocket is in a position to make some great deals on business assets or whole businesses. But troubled companies — ones that are barely keeping the lights on, that have idled property and machinery, or that have padlocks on the door — got that way for a reason. Forensic accountants can check to see whether mistakes or malfeasance devalued those assets.
Investigation of company theft: Some of the worst financial crimes happen right under the nose of the boss. Ghost payrollers — fake employees getting real checks — are common in companies and governments alike. Crooked employees can create such scams very easily, based on resources close to them. They can funnel cashable paychecks through currency exchanges that are in on the scam, for example. Forensic accountants are trained to spot irregularities in accounts that can reveal such mischief.

Divorce investigations: Never underestimate the loss potential of love gone wrong. We talk about valuation issues in divorce in Chapter 19, and forensic accountants may play a big part in that process. In family law, a lot of the friction occurs over the lack of information sharing and suspicions that shared numbers are far below — or sometimes far above — where they should be.

Global terrorism: Increasingly, companies have to meet legal standards to make sure that employees in the United States and abroad are not involved in illegal activities that could affect local, state, or national security. Terrorists gather their funding through many disparate sources, delivering small amounts that largely go undetected, says Dorrell.

The USA Patriot Act, signed after the terrorist attacks of September 11, 2001, requires financial institutions to establish and maintain anti-money-laundering programs. In addition, all U.S. companies are required to comply with the Foreign Corrupt Practices Act, which establishes acceptable business practices. Many states have laws governing private investigation practices that apply to CPAs.

From a valuation professional’s perspective

Most of the time, a valuation professional does “amateur” forensic accounting work on her own, but her work doesn’t replace the formal procedures and tests done by a trained and certified forensic accountant. Valuation professionals get close to the forensic process when they begin to normalize the financials of the business. Most of the time, they’re just adding back the owner’s perks or making adjustments for fair market rent, fair market wages, and various other financial activities inside the company. If a valuation professional sees something that doesn’t look quite right, she simply notes it in the valuation report.

Here’s an example that should raise the eyebrows of a valuation professional but could be found more easily by a forensic accountant doing some closer snooping: A medical-device company takes an order, delivers the equipment to the patient’s home, and charges the customer (or his insurance company) for the items. So far, things seem perfectly normal. But suppose that the customer no longer needs that oxygen tank or hospital bed in his home, and he returns it to the company.
Chapter 17: Forensic Accounting and the Due Diligence Process

The transaction was originally structured to declare the patient the owner of that equipment. Here’s the problem: When the material is returned, the company illegally takes the equipment back into its inventory without recording it and then uses the returned equipment to fulfill new orders as they come in. This process works to understate the company’s actual inventory and its overall cost of goods, making the company appear to be more profitable than it actually is. Higher profit means higher valuation — which may be based on fraud.

Because this operation is likely being done off the books (with no formal records being kept), a valuation professional may not catch the fraud. But if she were to smell something funny — such as margins wildly higher than those of competitors in the industry — she’d either try to investigate it herself or recommend an audit. The forensic exercise would take place as part of the audit.

In essence, the forensic accountant would perform an investigation to uncover the truth behind the numbers; then the valuation professional would use the results of the forensic exercise to renormalize the numbers. The two professionals would combine their efforts to establish and reinset the true normal inventory costs, thus realigning gross margins to what they should’ve been.

Many appraisers working on small-company deals don’t catch this sort of operation unless they’re very talented and experienced. They simply don’t have records to tip them off and have to rely on other signals, such as erratic margins or other swings in financial performance that can’t be explained through traditional business evidence. But if a forensic accountant is brought in during due diligence, this situation is exactly what he should be looking for.

An audit can be the very thing that keeps a new owner from overpaying for a business, so if you’re a potential buyer, budget for audits that include the services of a forensic accountant.

From a forensic accountant’s perspective
The relationship between a valuation professional and a forensic accountant should be close. A valuation professional is something like an emergency medical technician, whereas a forensic accountant is like a pathologist. Both parties need to be talking. The same relationship rules go for attorneys and other professionals brought into the process.

Like valuation professionals who are CPAs, however, forensic accountants have only one allegiance: to their certificate, meaning the set of professional standards to which they’re required to adhere. “We have to honor those standards ahead of our client’s preferences because we are often called on
to testify to those findings under oath,” says forensic accountant and CPA Darrell Dorrell. “We are the only credential holders in the United States with the word public in our title. The public expects us to be independent and objective above all else.”

Comparing Basic and Forensic Accounting

Most people think that forensic accounting is part of the basic accounting process. In most cases, the processes are very separate and distinct. According to Darrell Dorrell, the following holds true:

- An audit is a CPA’s commentary on the representation of financial statements produced by management. Typically, virtually no forensic accounting is applied.
- Basic accounting, such as the day-to-day assembly and reporting of a company’s financial transactions, requires virtually no forensic accounting.
- Forensic accounting typically assesses basic accounting reports and compares them with reality, identifying departures, undisclosed items, and related matters.

“Traditional accounting is scorekeeping according to a set of rules such professionals must follow. Forensic accounting is about investigation,” Dorrell explains. Yet he points out that forensic accounting isn’t just about fraud; it’s also an essential component of accurate business valuation based on facts and circumstances.

“It’s not just people outside the accounting profession; people inside the accounting profession often confuse forensic accounting with fraud. The two are related, but fraud is a subset of the forensic accounting discipline,” says Dorrell, whose company provides valuation services in addition to the more common activities associated with forensic accounting. Dorrell continues:

“Business valuation must consist of forensic tests because by exercising forensic tests, you resolve valuation-related questions. For example, with forensic tests, you can determine the actual pattern of cash flows — the ultimate measure of value, what kind of normalization (adjustment of financial statements) needs to occur, the optimal capital structure of the business — measure the similarity of guideline transactions, assess the fit of a discount rate, and so on.”
Can small companies afford forensic accounting?

For many companies, professional bookkeeping and accounting services can be a significant expense. Here are some appropriate questions to ask yourself about affordability:

✓ Do you have a concern about the financials of a target company or a company you already own and think that an investigation is necessary? Assess the reasons you think a forensic investor would be appropriate in this situation.

✓ If the first point is relevant, what are the potential costs of not doing an investigation? The company may face possible civil or criminal charges, or cash may be disappearing at a rate that threatens the viability of the business.

✓ What are the costs in your area for forensic accountants with the correct training and certification, and do they work for companies of your size?

The more complicated the investigation — and whatever chores are tied to the investigation, such as valuation — the more the investigation will cost. Professionals typically don’t charge fixed fees in such complex matters, but fees are worth asking about.

An effective way to manage fees is to instruct the forensic accountant to conduct the work in phases. In other words, consider writing into the work agreement a statement like this: “When you have reached $5,000, let me know your findings and where else it might be beneficial to investigate.” A legitimate specialist will advise you to stop when there appears to be no reason to continue.

Recognizing Business Situations That Trigger Forensic Accounting

Forensic accounting is not all about illegal activity, though questionable financial behavior certainly is a major catalyst for many such investigations. Here are some of the kinds of situations that forensic accountants may be hired to investigate in organizations:

✓ **Ownership**: Evidence of improper or illegal manipulation of ownership within a company or hidden assets relevant to heirs, shareholders, or soon-to-be ex-spouses

✓ **Succession planning**: When there’s doubt that a new management team was formed with proper diligence and planning

✓ **Bankruptcy**: When there’s suspicion of illegal or incompetent financial manipulations that led to companies’ going into bankruptcy or liquidation
Part IV: If You’re Buying a Business . . .

- **A need for added oversight:** When an owner or shareholder needs someone to assess a business valuation done at the request of the controlling shareholder.

- **Skimming and embezzlement:** Anything from petty theft to scams that create massive financial losses within an organization.

- **Top-level corporate fraud:** Companies such as Enron and WorldCom — two major firms that failed in the early 2000s — owed much of their demise to illegal and questionable acts by top management.

- **Mergers and acquisitions:** Errors, either intentional or unintentional, may surface in the valuation of assets when companies are getting together.

- **Tax evasion:** Evidence of hidden tax liability and possible illegal tax avoidance that can become a major liability for future management.

- **Money laundering:** Suspicion that a company may be filtering ill-gotten money through a series of financial transactions so that the money looks as though it came from legitimate sources.

- **Contradictory financial reporting:** When a company has reporting inconsistencies in its financial data, it may not be illegal, but it’s exceptionally important for a prospective buyer or seller to determine what the inconsistencies are and see that they’re fixed before a purchase or a sale.

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**Doing a Forensic Accounting Test**

This book can’t give you in-depth knowledge about forensic accounting processes, but here’s the basic definition of a forensic test: a financial formula or process that puts a company’s numbers through different paces to test or determine the accuracy and completeness of its figures. “By doing forensic tests, you can determine what kind of normalization needs to occur on a balance sheet,” Darrell Dorrell says.

Valuation involves few specific formulas, specific tests that apply within forensic evaluation. A well-known test, TATA (total accruals to total assets), looks something like this:

\[
\text{Total Accruals to Total Assets} = \frac{(\text{Working Capital} - \text{Cash} - \text{Current Taxes Payable} - \text{Depreciation/Amortization})}{\text{Total Assets}}
\]

A TATA test compares the consistency of results period to period. You’d do a TATA computation for, say, two consecutive quarters. Your index should remain about 0.7 throughout all the comparison periods. If you start to see material increases or decreases, digging a little more is appropriate.
Looking at Forensic Accounting

Case Studies

Forensic accountant Darrell Dorrell won’t cite actual situations, to ensure the privacy of clients, but he tells a few stories about small companies that could’ve used outside forensic accounting and valuation help:

**Case 1:** “Two companies were competitors within a geographic region,” he says. “One was large and had been operating more than 70 years; the other, much smaller and had been operating about 5 years. The two companies agreed to merge, and each company had its own very high-profile accountants and attorneys conducting due diligence over an 18-month period. After closing the transaction the following May, the combined operation was out of business within 90 days.”

Dorrell’s firm was called in to diagnose what had happened. They found that the firms’ due diligence had failed to identify the extreme seasonality of the businesses, and both firms went ahead with a leveraged buyout that happened at the precise time when each business historically began losing cash due to the seasonality. “They simply ran out of money. This is an example of how traditional tools and techniques are simply inadequate,” Dorrell says.

**Case 2:** “A company hired a national business valuation firm to determine the value of its shareholdings in anticipation of a sale. One of the shareholders believed that the results made no sense in comparison to his understanding of the company,” Dorrell says.

Dorrell’s firm was called in to assess the results and found that the national firm had used an earnings before interest, taxes, depreciation, and amortization (EBITDA) multiple but failed to account for the post-transaction capital structure. Consequently, the private financing firm backed out of the transaction because it was doomed to fail. (For more on EBITDA, go to Chapter 4.)

**Case 3:** The founder of a company that was more than 40 years old wanted to retire. “The longtime CFO, a supposed friend of the family (he had completed the entire family’s tax returns for many years), structured a deal that was portrayed as beneficial to owners, employees, customers, and lenders,” Dorrell explains.

The trusted chief financial officer had two national valuation firms determine value, and based on that result, he secured additional debt and equity financing to buy most of the owner’s stock. The nature of the accounting treatment enabled the CFO to redeem all the old stock and issue new stock with a private benefit to himself. He gave himself an ownership position of nearly one-third without paying even a penny for his stock.
Within two years, the company was struggling under the new capitalization plan, and it became clear to the remaining family members that the deal had been made for the CFO’s benefit.

Dorrell’s firm was called in to assess the problem, diagnose a remedy, and implement changes. It found that the valuation firms had overvalued the company to trigger the CFO’s accounting treatment. The overvalued company resulted in a debt load that nearly strangled the company. The firm was revalued at its correct value, and the capital was restructured, and the CFO no longer works for the company.

Says Dorrell, “This was to have been a simple sale of a company where the owner had been around for 40 years. He relied on his CFO to arrange the buyout and wasn’t as closely involved in the process as he should have been, but indeed, the CFO structured a deal that ended up giving two-thirds of the company’s stock to the owner’s son and the other third to himself.”

Dorrell has seen many situations in which attorneys, valuation professionals, and corporate accountants and CFOs didn’t make a thorough evaluation of what the deal would cost the company post-closing. He maintains that the preceding examples are only a few of the reasons it’s important to bring in a forensic accountant before any major financial transaction takes place at a company to make sure that its numbers are in order.
Chapter 18

Case Study: Valuation on the Buy Side

In This Chapter
▶ Saving money in the long run
▶ Spotting problems . . . or missing them entirely
▶ Using benchmarks properly
▶ Understanding deal structuring

In this chapter, we give you the step-by-step valuation process for a potential purchase of a company, putting into practice the concepts and steps we outline in the other chapters in Part IV. We start with full disclosure. If you’re planning to use this chapter as a one-size-fits-all template to value a company you’re planning to buy, forget it. No two companies are alike, and no two buyers are alike; therefore, no two valuation assignments are the same, either.

The purpose of this chapter is to tell you a story about one owner’s ups, downs, and in-betweens in the valuation process. The story isn’t a true story; the names and details have been changed to protect real clients. But to say the least, the road to value doesn’t always run smoothly, which is the main point you should take from this chapter.

Use this chapter as a way to prepare for the unpredictability of the valuation process and a way to better prepare yourself before you attempt to buy a company.

Being Frank: Selecting an Industry

The story we’re about to tell you involves an entrepreneur named Frank. Frank was a 50/50 partner in a prosperous consulting firm that placed consultants for information technology projects. When Frank and his partner
were unable to come to terms on the future of their business, Frank’s partner agreed to buy him out, which has left Frank sitting on a considerable pile of cash.

Frank decides that he’s going to play golf; he even gets a job at the local golf course. Six to nine months later, Frank’s wife realizes that when he isn’t at the club, he’s spending a lot of time at home and underfoot. It’s not that Frank’s wife is unhappy with her husband’s success, and she’s glad he’s had a chance to relax a bit, but now he’s disrupting her world, and she’s starting to lobby Frank on his next move.

Frank realizes that he’s getting a bit bored and that it’s time to start looking for the next business to invest in. Whether he realizes it or not, he’s already begun the valuation process. He started to consider what kind of business he wants to start and what business may be recession-proof, or at least relatively so. In other words, he’s echoing the first baby steps of valuation outlined in the Internal Revenue Service’s Revenue Ruling 59-60 (www.irs.gov), which requires potential business owners to consider the following:

- The nature of the business
- The history of the enterprise from its inception
- The earning capacity of the company
- The dividend-paying capacity of the company
- The economic outlook in general
- The condition and outlook of the specific industry in particular

Frank has zeroed in on the medical equipment and supply industry. His logic: Medical equipment is a relatively recession-proof business because no matter what else happens, people have illnesses. At the same time, people are living longer. Frank takes special note of his generation of Baby Boomers, the largest chunk of the nation’s population. As that group ages, he thinks, the demand for medical equipment and supplies is only going to grow as people are discharged from hospitals and require more therapy and care at home. Therefore, the companies that supply hospital beds, walkers, oxygen tanks, and the like are going to be in a very nice position.

**Doing Research in Advance**

Frank, like most experienced entrepreneurs, isn’t afraid to hit the books. He starts with Internet research to determine the best resources on the medical equipment industry and then heads off to the local university library to gather the data he needs. (For information on basic company research and preparing for the valuation process, go to Chapters 12 and 16.)
When he pulls those resources together, he’s off to see his business attorney, his tax attorney, and his personal finance advisor to talk the idea through. They seem to think that the idea makes sense. Frank’s ready to start looking for companies to buy. Tip: If you think that valuation is all about spreading the numbers, consider Frank’s story to this point. He hasn’t begun analyzing the figures in depth, but he’s developing a general knowledge of the business and visualizing his participation in it. The numbers are next.

Frank’s first steps are to contact a broker, do some Internet research, and visit the various Web sites that list businesses for sale.

Tip
To get an overview of which businesses are available, go to the Internet. Three good Web sites are FirstList (www.firstlist.com), BizBuySell (www.bizbuysell.com), and MergerNetwork (www.mergernetwork.com).

Frank finds one business located in Florida that looks very interesting. He contacts the broker who listed this business for sale.

**Contacting the Target**

Through the broker, Frank contacts the target company. He’s required to sign a confidentiality agreement to see the introductory data on the company for sale. Within a few days, Frank receives a small marketing package describing the company.

Frank’s marketing package is fairly standard. It provides details on how and when the business began, how the business has performed over the years, and how it has grown, as well as details on the owners and members of management. The package also includes what ideally are audited financial statements of the target company, signed by the auditor. Most potential buyers go straight to the financials to perform their own version of a quick-and-dirty valuation, which we cover in the following section.

**Negotiating the quick-and-dirty valuation stage**

Frank starts with rule-of-thumb guides (refer to Chapter 9), which are only one part of the initial quick-and-dirty valuation stage. In addition to using rules of thumb, he applies certain market multiples and performs a basic capitalization-of-earnings calculation.
A market multiple is a formula tailored to the specific attributes of an industry to measure its performance. A capitalization-of-earnings calculation allows you to calculate the present value of future cash flow, which is a way to predict future earnings. If you determine that future earnings won’t be greater than the ones the business is making now, why buy the company?

These standard computations can give a prospective owner his first ballpark idea of a company’s current and future value. If the future looks good, the buyer can move forward.

Knowing when to talk . . . and when to hang up

The Florida company’s numbers look good, so Frank organizes a conference call to find out more about the company’s operations. Over the course of a couple of weeks and a few more phone conversations, he finds out even more about what’s going on with the company, its management, and its employees. He even gets a couple of customers to talk on the quiet.

If you’ve read Chapter 16 — the chapter on buyer due diligence — this process is familiar. If not, stick a bookmark in this page, and start reading Chapter 16 now, because Frank dodges a land mine by doing due diligence.

Frank hears from a customer that the company shipped a bunch of recalled oxygen dispensers to a client by mistake. No deaths or injuries were reported as a result of this mistake, but because Frank did his homework, he realizes that such liabilities can surface months or years later. Figuring this risk into his calculations, he decides to terminate the talks, which is good, because this company may have brought him significant headaches.

Frank is one month older and back to square one, and his wife isn’t happy.

This example shows you two important things: Finding the best company to buy takes time, and if a company is up for sale, you need to know exactly why.

Moving on to Company Number Two

Frank sets his sights on a similar company that’s based in Atlanta. He does his initial due diligence and finds that the firm is doing about $1 million a year in gross revenue, with a profit of about $300,000 a year — a very nice set of numbers. Instantly, Frank wants to know more, so he gets out his calculator again.
Frank’s initial figuring puts the company’s value at between $600,000 and $900,000, which sounds good so far and should make his impatient wife happy. He decides to bid at the high end, so he lets the broker know that he’s interested in putting down $600,000 in cash down at closing and the remaining $300,000 in the form of a seller note payable in quarterly payments over four years at 8 percent interest to make it really worthwhile for the sellers.

**Seeing How Failing to Consult an Advisor Can Cost You**

At any point during the scenario we explain in the preceding section, do we mention that Frank talked to any advisor before making that tentative offer? Nope, we don’t — and nope, he didn’t, which is a potentially big mistake. Certainly, Frank is an intelligent guy, and he knows that it’s in his best interest to get a professional advisor involved at some point, but he doesn’t want his costs to escalate out of control.

Doing the quick-and-dirty analysis to educate yourself in the early stages of the valuation process is fine, but it’s not fine to move ahead without the analysis and approval of a professional advisor who has experience in these types of transactions. Failing to consult with a professional advisor can create a very bad situation for you.

**Knowing when to involve advisors**

Should an advisor have been involved from the beginning, even though Frank was just trying to find out about the opportunity? Maybe someone should have asked him these questions:

✔ Do you have enough capital that you can afford to lose a little in case of a mistake?
✔ Do you have such a thorough knowledge of the company’s business and its competitors that you won’t leave any stone unturned?
✔ Are you truly your best advocate, or can you find a better one?

Frank has never worked in this industry before. He’s made a cursory investigation and worked the numbers to his satisfaction. The gods may be with him, and the deal could work out beautifully. But if he hasn’t vetted the decision and his knowledge turns out to be inadequate late in the transaction period — or worse, after the transaction is done — he can’t do much about the mistakes of poor investigation and valuation.
We maintain that you should get a valuation professional involved earlier in the process rather than later, based on the experience you have with the business and industry you’re targeting. Getting backup can help you make better use of your money and time by uncovering fatal flaws in the business.

Failing to work with an advisor early can cost you a lot more time and money than engaging a valuation professional from the start, and it more than likely determines your ability to succeed. This was Frank’s mistake.

Too many times in privately held businesses, you find a story behind the numbers, and this story can be dangerous. Owners can bury extraordinary personal expenses in line items or under-the-table transactions deep within financial statements. In particularly egregious cases, even a professional advisor may not uncover some fatal flaws. But in our experience, it’s generally better to have an expert on the team early, because later, those problems can end up in court.

**Encountering problems**

Frank leaps in with both feet and completes the deal.

Any acquisition involves a transition period in which the new owner gets both feet wet. That transition period can be bumpy if the new owner has never worked in the industry, as in Frank’s case. Frank is busy for the first few months finding out about the customers, the operations, the employees, and dozens of other aspects of the business. A typical business learning curve can last anywhere from three months (for someone who’s operated in the business) to nearly a year (for inexperienced individuals like Frank).

At the six-month point, Frank starts to see things that don’t look quite right. His cost-of-goods reports and inventory numbers, which are supposed to be complementary, are way off.

This situation affects his bottom-line cash flow, because he seems to be spending a lot more money on inventory than the previous owner did, which drives up his cost of goods and slashes his profitability.

**The buyer’s due diligence and the owner’s cover-up**

After Frank valued the company, he made an offer based on the financial statements provided by the previous owner during the sale process. Right after he got the nod, he went to his local banker to finance a portion of that deal. He decided that the company’s profits would more than pay down
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that loan and supply him a nice weekly paycheck. Now, staring down at his uncertain operating figures, he finds himself wondering whether he can pay the bank, much less his own salary. So much for due diligence.

Frank is determined to get to the bottom of the problem. The first mistake he uncovers is incorrect inventory numbers supplied during due diligence. He finds that the company sometimes refurbished used equipment and turned it back into inventory without a record of having done so. The next time a patient needed equipment from the company, a used, refurbished, and possibly broken piece of equipment went out into the marketplace.

Aside from the potential liability of product failure, this situation constituted fraud. Accounting rules prohibit companies from charging a customer for an item and then taking it back into inventory without recording it or paying for it. Technically, the company no longer owned that piece of equipment, because the cost of the equipment had already been charged to someone else. Also, a potential buyer had no real way of knowing about this practice just by taking a cursory look at the company’s financial statements.

The company’s fraudulent practice made the due diligence numbers that Frank evaluated look a lot better. Some orders or fulfillments didn’t have a cost of goods attached or a corresponding purchase of a new inventory item to fulfill each order. This illegal activity overinflated the numbers and made the company look more profitable than it actually was.

Yes, owners sometimes lie

Frank finds more adventures in the accounts receivable department. In the medical equipment and supply industry, equipment is used to fulfill orders. Then someone or something is billed: the patient, a hospital, an insurance company, or state or federal government through the Medicare and Medicaid programs. Each of these entities has a different schedule for paying its bills. Some of these entities pay in 30 days; others, in 60 days; others, in 90 days. Therefore, working-capital requirements are a critical factor in this business.

Frank heard something about this sort of behavior in the industry during his due diligence and asked the previous owner of the company about it point-blank. The problem was that the owner lied, saying that everything was fine.

Frank’s mad now. His inventory and working capital are in shambles. He refuses to make any payments on the seller-note portion of the deal (the $300,000 piece of the $900,000 deal we mention earlier in this chapter). Harsh words ensue, and Frank moves the whole mess into court, where he claims that the previous owner misrepresented the profitability of the company and that as a result, he was duped into paying far more for it than it was worth.
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Seeing what could’ve been done

Over the next two years, Frank shells out thousands of dollars and considerable time to bring the previous owners to heel. In the end, he straightens out and runs the company, and he’s forgiven payment on the $300,000 seller note, but his win comes with considerable personal and financial cost.

Suppose that Frank had hired a trained, experienced valuation professional at the start of the transaction. The problems with the business were essentially a result of the previous owner’s practice of running the business off the books. With no clues in the financial records to go by, what could that valuation professional have done?

In a full valuation scenario, trained professionals should do a ratio comparison of the financials with those of similar companies in the same industry, including current ratio, quick ratio, accounts receivable turns, and inventory turns (see Chapter 8 for some of the ratio formulas). Then they turn to a host of industry-specific metrics that measure comparable industries in a closer way. Checking these computations against those that are common in an industry can bring certain abnormalities to light.

An inventory turn is the inventory turnover, the ratio of a company’s annual sales to its inventory, or how long average items remain in that inventory. Every industry that has inventory has a common healthy inventory turnover period. If a company is ahead of its industry turnover period, typically, this news is good. If the company is behind its industry turnover period, this news usually is bad.

In Frank’s case, the inventory and accounts receivable numbers were seriously out of whack, but he didn’t dig deeply enough to discover this.

Checking Benchmarking Data

The Risk Management Association (RMA) keeps data on more than 700 industries and tracks all aspects of their operations. Granted, Frank could’ve checked that resource and many others in his search, but he chose not to.

Benchmarking data helps you understand performance and operational targets that are typical for the best-performing companies in an industry so that when you do an in-depth evaluation of a particular firm, you can see whether it’s on par with the best performers. The RMA (www.rmahq.org) provides this data to subscribers, but some libraries carry it.

Had Frank made this analysis early in the process, he would never have made an offer or certainly would’ve made a far smaller offer.
Understanding Deal Structure

We give you a thorough overview on rules of thumb in Chapter 9 and tell you where this guidance may be useful. Keep in mind, though, that you can go very wrong with these rules of thumb, as Frank discovered.

If you’re trying to follow up on the hundreds of details involved in buying a business, you probably don’t have adequate time to do a thorough valuation, even if you’re properly trained to do one. If you get an industry rule of thumb or find out that businesses in this industry are trading for a certain multiple, you still won’t know exactly what the structure of that payment will be, which is known as the deal structure. Deal structure affects value.

Every one of the deals listed in the RMA benchmarking tables has a different structure. A certain amount of money comes in at closing in the form of cash; another portion of the overall price takes some other form, such as a seller note or stock. Sometimes, the form is contingent on future performance.

Just looking at a few transactions, the overall purchase price, and the resulting multiples on price to revenue or price to earnings doesn’t always give you an accurate picture. Valuation professionals who understand your industry can do a better job of zeroing in on the elements you need to build a deal.

The moral of the story is that a very deep analysis of any target company is necessary. Buyers must be willing to take the time to do research; they must have patience and the financial strength to place significant amounts of money upfront. Often, hiring an expert to take an unbiased, tough look at a proposed transaction can save you considerable money in the long run.
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