

## Analyzing Your Own Business Or One You Want to Buy or Invest In

- **14 Big Mistakes When Buying a Business**
- **Due Diligence and Investigation**
- **Review of Company — 106 Questions to Ask**
- **Financial Analysis and Legal Matters**
- **Sample Spread Sheets to Analyze Trends**

## 14 Big Mistakes When Buying, Investing In, or Valuing a Business

*The prudent buyer doesn't assume; he or she investigates. The prudent seller knows the questions that could be asked and has the answers ready. The prudent owner knows the key data by which to monitor and measure the health of his or her business.*

If you're buying a business or just investing in one, it pays to ask all the right questions. Even if the company you're looking at is one you've dealt with for years, or one that's located just down the street from you, there still can be plenty of surprises when you look beyond and behind the financial records.

Here are the common mistakes. They also can be very expensive mistakes.

- A potential buyer doesn't request a full audit of the company's financial statements and instead accepts an accountant's Compilation or Review Statement as sufficient.
- The buyer doesn't thoroughly analyze sales by customer for the last three years. *The question:* Which customers no longer do business with the company and why not? *Note:* Past customers and those whose purchases are in downtrend should be contacted.
- The buyer doesn't verify the assignment and transfer of important contracts, e.g., lease agreements and customer/supplier contracts.
- The buyer doesn't prepare pro forma financial statements to determine what the acquisition is costing in both pretax and aftertax dollars.
- The buyer doesn't request the company's tax returns or analyze the differences between the returns and the company's financial statements as reported by its accountant.
- The buyer doesn't check out the company or its principal owner(s) by calling trade references and obtaining independent personal and business credit reports, e.g., TRW and Dun & Bradstreet.
- The buyer doesn't analyze dramatic changes in inventory levels from year to year. *Reason:* Inventory increases can make operating profits look much better than the company's reported results.

- The buyer doesn't require that the seller represent *personally* to the accuracy of the company's financial statements, customer list, backlog, etc. *Result*: The buyer has no recourse against the seller individually for misrepresentations or inadequate disclosures.
- The buyer doesn't analyze affiliated companies and their relationship with the company, owners, and their families. *The questions*: Are the transactions fair and reasonable? If not, can they be questioned by the IRS? Will the benefits of the relationship(s) carry forward to the buyer and for how long?
- The buyer doesn't value the company's assets, e.g., equipment, by determining their reported net book, fair market, and replacement values.
- The buyer doesn't review the *consolidating* financial statements to determine the profitability of each subsidiary, division, or product line.
- The buyer doesn't properly analyze the company's cash flow projections and its future need for more employees, facilities, equipment, and working capital for higher accounts receivable and inventory levels.
- The buyer doesn't concentrate on the people aspect of the deal. People make the deal happen; people make the transition orderly and successful.
- The buyer doesn't use a corporate lawyer who is experienced with asset and business purchases. As a result, buyers end up buying *liabilities* and *problems* they didn't know existed.

\* \* \*

A company that appears healthy on the surface can be drowning in problems and red ink below the surface. *Consider these possibilities*:

- One of the company's largest customers, representing 35% of sales, files for bankruptcy or terminates its relationship with the company.
- A problem with a new product or service exposes the company to liability suits and lengthy, legal proceedings.
- The company's customer, supplier, lease, and employment agreements cannot be assigned or transferred.
- The company's current working capital, facilities, and employee levels are

inadequate to meet its sales and profit projections.

- Research and development efforts have stagnated in recent years. There are no new products or product innovations on the drawing board.
- The company's product line, which has been very profitable in the past, now has some new, foreign competition that is offering the market a real price advantage.
- The company's top salesperson has resigned and is now employed by the company's major competitor.

What you're getting when you own, buy, or invest in a business is a complete package — product line, facilities, employees, marketing, sales, niche, customer list, financial results, reputation. Problems in any one part of that package can substantially deflate or undermine the value of the package as a whole.

This Report will help you conduct a comprehensive review of all those components. You can use it to substantiate the health of a business or diagnose its problems. It's not an easy task. There are more than 100 questions to answer. But the information these questions uncover will be well worth the time and effort spent. Use them *now* to conduct an evaluation of how your business is doing; *keep it* for future use when analyzing another business you are thinking of buying or investing in or when pricing your business for potential sale.

*Now to the many questions by subject area.*

## History of the Business

**FOCUS:** *You want to know whether the company is what it says it is. Request, review, and analyze the following.*

- Date the company was founded, by whom, and the major events in its history and growth, such as an acquisition or move of the company's facilities to a new location.
- Type of legal entity: S or C corporation, limited liability company, partnership, sole proprietorship, franchisee.
- Name of the company, subsidiaries, divisions, and affiliates with the date of formation, function, and ownership breakdown.
- All current owners and any changes in ownership over the company's history.
- States in which the company is incorporated and licensed to do business.
- Corporate charter, bylaws, minutes, and stock certificate book.
- Dun & Bradstreet Report to verify the company's history, officers and board members, ownership, credit, and recorded liens against its assets.

**The buyer doesn't assume; he or she investigates. The prudent seller knows the questions to be asked and has the answers.**

## Management

**FOCUS:** *You want to know who's running the company, for how long, how well, and at what cost to the company.*

- Details on all officers and directors: length of service, age, business background, compensation, and fringe benefits.
- Ownership positions: number of shares, stock options, and warrants.
- Organization chart.
- Does key management devote 100% of their working time to the business? If not, do they have any conflicts of interest, including interests in other businesses?
- What are the salaries and benefits given to key management, including bonuses, retirement plan contributions, stock options, company-paid insurance, deferred compensation?
- Are there any employment contracts: with whom, for what length of time, and what terms? If so, determine the potential liability, i.e., the dollar value of these contracts going forward.
- Have top management and other personnel, e.g., an engineer or inventor, signed noncompete or other restrictive agreements? Have they agreed not to divulge privileged information obtained while employed by the company?

**A company that appears healthy and profitable on the surface can be drowning in problems and red ink below the surface.**

## Market, Products, and Competition

**FOCUS:** *You want to know the company's niche, its products, its profitable areas, its market projections, and its competition.*

- The company's major business, market, and niche.
- Description of the major products with sales literature on all products.
- Growth potential of each market in which the company operates.
- Name, size, and market position of principal competitors. How do the company's products differ from the competition? Include pricing.
- Size and nature of market — fragmented or controlled by large companies?
- Sales trend for each product line. Are sales seasonal or cyclical?
- What is the gross profit margin on each product line? Analyze sales growth and profit margins for at least three years.
- Information on any brand, trade, product names, and research and development expenditures.
- Review statistical information available on the market, e.g., trade association and government reports.

## Sales, Distribution, and Customers

**FOCUS:** *You want to know how the company sells, what those sales cost, to whom it sells, and on what terms.*

- Does the company sell its products through its own sales force or through manufacturers' representatives? How are they paid and what are their responsibilities?
- Are the company's products distributed nationwide or in a select geographic area? How much is spent on advertising?
- Who are the company's principal customers, how much do they buy, and what percent do they represent of the company's total sales for the last three years?
- How long have these customers been buying from the company? What is their credit rating?
- What is the percentage of government and foreign business? How is this business sold, financed, and delivered?
- What are the standard sales terms, discounts offered, return and allowance policies?
- Are any sales made on consignment? Do sales terms involve maintenance agreements or warranties?
- What is the company's bad debt experience over the last three years?
- Have any new products come on the market which would make the company's products obsolete or less competitive?

*Have big customers been lost? If so, call them to find out why. A detailed breakdown of sales by customer for the last three years will help you spot lost customers or those who are not buying as much as the year before. Find out why.*

## Manufacturing and Equipment

**FOCUS:** *You want to know how the products are made, at what cost, in what facilities, by what processes, and how fast (i.e., the production cycle).*

- Obtain a full listing of all manufacturing and office facilities. Are the facilities and equipment owned or leased?
- What is the company's present production capacity based on its current manufacturing equipment and space?
- Is it sufficient to meet the company's sales and profit projections?
- Does the company manufacture from basic raw materials or is it an assembly-type operation? Does it have a proprietary manufacturing process?
- Any problems with the availability of materials required to manufacture the product? How stable are the company's supplier relationships? Are any of them in financial trouble?
- What is the length of the company's production cycle in terms of time — from raw materials to finished product?
- What is the accounting system for work in progress?
- Are any licenses needed to manufacture the product?
- What is the company's safety record? Any current or past problems with federal, state, or local regulations, e.g., OSHA?

## Employees

**FOCUS:** *You want to know who works at the company, for how long, at what pay, for what benefits, with what enthusiasm, and in what kind of environment.*

- Total number of employees by function, class, and job description.
- Details on the local labor market and the company's wage and personnel policies. What are the working conditions and is employee morale good?
- What are the benefits offered to the employees: vacation time, sick leave, pension plan, group health and life insurance, etc.? Review the company's policy manual.
- Is there a union? If not, what is the probability of unionization? What have the historical relations been? Any strikes or work stoppages?
- Is employee level fixed or can the size of the work force be varied easily in response to business volume?
- What is the company's historical labor turnover, especially in key management?
- Does the company comply with *all* discrimination laws, including hiring and fringe benefit programs?
- Has the company ever missed paying withholding taxes to federal, state, or local regulatory bodies?
- Can any of the company's independent contractors be labeled an employee by the IRS? If so, what are the potential tax liabilities and penalties?

## Physical Facilities — Real Property

**FOCUS:** *You want to know what equipment and real property the company owns, where it's located, how old it is, what shape it's in, and what it's worth.*

- Request a list of all company-used facilities by location, square footage, and cost. Which facilities are owned, which leased?
- What is the fair market and replacement value of company-owned buildings and real estate?
- If the facilities are leased, what are the length, cost, and renewal options?
- Is there an option to buy the facilities? If so, for how much and until what date? Is there equity in the purchase option, e.g., the fair market value exceeds the option price.
- What is the present condition of the facilities? Are they modern and equipped for work being done and the number of employees?
- Are facilities adequate for current and projected needs? Will there be major problems if expansion is needed?
- Are facilities adequately protected against casualty loss, such as fire or theft, by sprinkler systems, burglar alarms, and so forth?
- Do the facilities have adequate access to electric, heat, gas, and water?
- Are facilities easily accessible to required transportation?

\* \* \*

*Asset write-ups:* If you're buying a business' assets, you want to write up the assets to fair market value, particularly real estate and equipment. Paying the fair market value will increase your tax deductions. That's why it's imperative to analyze all of the company's assets, including their original cost basis, current net cost after accumulated depreciation, fair market value, and replacement value.

## Ownership of the Business

**FOCUS:** *You want to know who owns the company, how involved the owners are, how old they are, and how free and clear their ownership position is.*

- List all current owners of the company's common and preferred stock, by class if applicable.
- Determine the number of shares exercisable under stock option and warrant/convertible agreements. Find out the option price and expiration dates.
- Break down the ownership by shares and percentage: actual and pro forma (i.e., assume the warrants and stock options are exercised).
- How many shares does the principal stockholder own — personally and through his or her family? Have any shares been gifted or placed in a trust, e.g., a family limited partnership?
- If all stock options, convertible securities, and warrants to buy the company's common stock were exercised, would the principal stockholder still control 51% of the company?
- Does the common stock have preemptive rights? What about liquidation rights and dividend preference? Is there cumulative voting?
- Do any shares of stock carry an investment letter, e.g., are there restrictions on that transferability?
- Is there a buy-sell or other shareholder agreement? Is there an employee stock ownership plan or stock bonus plan?
- Are all the shares fully paid for? Has any stock been sold below the par or stated value?
- If the business is being sold, what percentage of the total outstanding shares is needed to approve the sale?

## Financial Analysis — 17 Areas to Review

**FOCUS:** *You want to analyze cash flow, debt, equity, income, assets, inventory and accounts receivable turnovers, liabilities, and tax position.*

1. Obtain at least three years of financial statements. From these statements compute the following:
  - Current ratio and net quick ratio.
  - Net working capital and net quick assets.
  - Total debt as a percent of stockholders' equity.
  - Source and application of funds schedules.
2. Analyze the company's basic liquidity and turnover ratios, such as:
  - Cash as a percent of current liabilities.
  - Accounts receivable and inventory turnovers.
  - Accounts payable aging.
  - Sales to net working capital.
3. Spread the company's historical income statement accounts for at least three years and analyze any significant percentage variances, e.g., the operating profit as a percent of sales. Do the same for the company's sales and income projections. (See sample *Spread Sheet* on page 18.)
4. If the company has subsidiaries or divisions, review *consolidating* financial statements of profit and loss so you can determine the profitability of each subsidiary, division, or product line.
5. Get a listing of all accounts and notes receivable. Isolate any customer concentration, assess terms of payment, and project potential bad debts.
6. Determine cost basis for inventories and any inventory reserves. Age inventory and relate to cost of sales (turnover).
7. Verify the cash balance, and determine maximum and minimum cash balances needed throughout the year. If the company owns marketable securities, determine degree of liquidity (salability) and obtain current market values.

*(More...)*

## Financial Analysis

8. If the company has investments in or advances to affiliates, compare current fair market value to reported book value. Obtain financial statements on all affiliated companies.
9. If the amounts are significant, analyze prepaid expenses and accruals.
10. Analyze deferred charges by type and by the amortization schedule used by the company's accountant.
11. Obtain details on all fixed assets, including date of purchase, original cost, accumulated depreciation, fair market value, and replacement value.
12. If the company carries goodwill or other intangible assets on its balance sheet, such as patents or trademarks, determine both the reported and fair market value.
13. Analyze all bank debt, lines of credit, and long-term debt, including the interest rate, repayment, and collateral. Review all loan agreements, particularly restrictions (negative covenants) on the company and its owner(s), which could affect the company's future operations.
14. Review pension, profit-sharing, and stock bonus plans for contractual commitments and unfunded past-service liability costs.
15. Determine whether there are any contingent liabilities or other outstanding commitments, such as long-term supplier agreements.
16. Obtain details on franchise, lease, and royalty agreements.
17. Prepare a three-year projection of income and cash flow to determine the company's projected sales, profits, cash flow, and need for future capital.

**Even when you've dealt with a company for years, there can be lots of surprises when you start asking the right questions.**

## Trade and Professional Reputation

**FOCUS:** *You want to know what the outside world thinks of the company.*

Contact these sources for additional information, with emphasis on the company's products, past dealings, and integrity of management.

- Customers
- Suppliers
- Bankers
- Other Lenders
- Trade and business associations
- Accountant, both current and past (if any)
- Legal counsel
- Key personnel

*Also important are personal contacts:* Individuals who know of the owner's reputation and credibility.

## Legal Matters to Review

**FOCUS:** *You and your lawyer want to review all contracts, their importance to the company's survival and growth, their expiration dates, and their potential liability.*

- Corporate charter, bylaws, minutes, and stock certificate book.
- Patents, trademarks, and registration agreements pertinent to the operations of the company. Do any expire soon?
- Licensing, franchise, and royalty agreements. What are terms and when do they expire?
- Lease agreements: Auto, equipment, and facilities.
- Employment contracts and labor agreements.
- Business and personal tax returns.
- Loan agreements with the company's lenders.
- Contracts with suppliers and customers.
- Shareholder agreements, e.g., buy-sell agreement and options to buy the company's common stock.
- Pension and profit sharing documents and other contractual commitments.

## More Big-Dollar Questions to Ask

- When was the last time the IRS or state audited the company's tax returns? Any assessments?
- Does poor access to the local labor market restrict the company's future growth? Are zoning regulations restrictive?
- Is the company in compliance with all environmental laws (e.g., toxic waste, asbestos, lead paint)?
- What about lawsuits? Get a listing of all past and pending lawsuits, assess the allegations, and project the outcome.
- Are there any product liability suits outstanding *or* other contingent liabilities not recorded in the financial statements?
- Is the company a sole proprietorship? If so, request the tax returns and a current balance sheet. Schedule C in IRS Form 1040 doesn't require the owner/taxpayer to prepare a balance sheet.
- What is the company's current backlog by customer? How does it compare to prior years?
- Will the seller or other key executives be employed after the sale? If so, there are some questions to be answered. Do they want to stay? Are they the kind of people with whom you want to work? Are their current salaries and benefits reasonable?

**Spread Sheets** — please see the next page.

# Spread Sheet for Financial Statement Analysis

## Historical Income Statement Data

(Dollars in thousands)	2004		2005		2006	
	\$	%	\$	%	\$	%
Net sales .....	—	—	—	—	—	—
Cost of goods sold .....	—	—	—	—	—	—
General, selling and administrative expense ...	—	—	—	—	—	—
Operating income .....	—	—	—	—	—	—
Other income (expense) ....	—	—	—	—	—	—
Pretax income .....	—	—	—	—	—	—
Taxes payable .....	—	—	—	—	—	—
Net income .....	—	—	—	—	—	—
<b>Return Analysis</b>						
Net income % sales .....	—	—	—	—	—	—
Net income % net worth ....	—	—	—	—	—	—
Net income % assets .....	—	—	—	—	—	—
Gross profit margin .....	—	—	—	—	—	—
Operating profit margin ....	—	—	—	—	—	—
<b>Turnover Ratios (in days)</b>						
Average collection period ...	—	—	—	—	—	—
Inventory turnover .....	—	—	—	—	—	—
Accounts payable turnover ..	—	—	—	—	—	—

## Historical Balance Sheet Data

(Dollars in thousands)	2004	2005	2006
Cash and marketable securities .....	—	—	—
Accounts receivable .....	—	—	—
Inventories .....	—	—	—
Prepaid expenses	—	—	—
Current assets .....	—	—	—
Gross plant and property .....	—	—	—
Less: Depreciation .....	—	—	—
Net plant and property .....	—	—	—
Investments, loans, and advances .....	—	—	—
Other assets .....	—	—	—
Total assets .....	—	—	—
Notes payable .....	—	—	—
Accounts payable/Accruals .....	—	—	—
Current portion of long-term debt .....	—	—	—
Current liabilities .....	—	—	—
Long-term debt .....	—	—	—
Preferred stock .....	—	—	—
Common stock .....	—	—	—
Capital surplus .....	—	—	—
Retained earnings .....	—	—	—
Less: Treasury stock .....	—	—	—
Stockholders' equity .....	—	—	—
Total liabilities and equity .....	—	—	—
<b>Liquidity Ratios</b>			
Net working capital .....	—	—	—
Current ratio .....	—	—	—
Net quick assets .....	—	—	—
Net quick ratio .....	—	—	—
Cash ratio .....	—	—	—
<b>Leverage Ratios</b>			
Long-term debt as a % of stockholders' equity .....	—	—	—
Total debt as a % of stockholders' equity ..	—	—	—

### Important Definitions

**#1.** *Net working capital* is current assets *less* current liabilities. *Current ratio* is current assets *divided* by current liabilities.

**#2.** *Net quick assets* are cash items and accounts receivable *less* current liabilities. *Net quick ratio* is cash items and accounts receivable *divided* by current liabilities.

**#3.** *Average collection period* is accounts receivable *divided* by daily credit sales.

**#4.** *Inventory turnover* is average inventory (beginning and end-of-year position) *divided* into cost of sales (or into sales).

**#5.** *Accounts payable aging* (days) is accounts payable *divided* by daily purchases of goods and supplies.

## About *The Business Library*

This **Report** is part of *The Business Library* (TBL), a collection of 90 Reports and Manuals on subjects of critical importance to business owners, executives, their families, and the professionals who advise them. TBL is produced by an editorial and research staff with an *average experience* of **28** years in helping businesses and individuals manage their finances better.

The company was formed in 1974 by Thomas J. Martin. Martin has written more than 900 articles and advisories and presented *hundreds* of workshops and seminars to *thousands* of business owners and executives on many of the subjects covered in *The Business Library*. He is an Investment Banker and an expert witness in Valuation and Succession Court Cases. He has helped *hundreds* of business owners and executives raise capital, refinance debt, prepare for succession, and value and sell their businesses.

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Tricia Walsh, Publishing Director  
*The Business Library*  
16 Fox Lane, Locust Valley, NY 11560  
516-671-8050 • Fax: 516-671-8077  
E-mail: [triciawalsh@yourbusinesslibrary.com](mailto:triciawalsh@yourbusinesslibrary.com)

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