EzyAccounts

BUYING A SMALL BUSINESS

HOW TO CONDUCT DUE DILIGENCE WHEN PURCHASING A SMALL BUSINESS

Buying a small business can be very exciting. It's easy to get swept away imagining the impact that owning the business will have on your life. Too often during all of this excitement people don't devote enough time and resources into conducting due diligence on the business they are about to purchase. EzyAccounts has put together this handy eBook to give you some direction and places to start when reviewing whether or not to purchase that small business.

ARE THE BUSINESS SYSTEMS, PROCESSES AND PROCEDURES SOUND AND WELL DOCUMENTED?

Quality systems for business management are a serious asset and one that should be valued. Whether these systems are accounting, point of sales, customer relation management or any other, if they are being utilised correctly they will make a major difference to the successful operation of the business. Keep in mind though that simply having the software systems in place isn't enough, they have to be correctly setup for the business and correctly managed in order to get the real value out of them.

Overtime, small business owners and managers develop better ways of completing business tasks. Often these processes or procedures make a big difference to business performance; this knowledge is referred to, as "trade know how". Make sure that the seller has well documented processes and procedures for every aspect of the business and is prepared to provide you with sufficient handover training. Otherwise you may find that all the knowledge that made the business successful leaves with the seller.

Top tip: Consider including an ongoing support clause in your purchase agreement with the seller. This will help you in case you run into any unforseen operational challenges that you can't remember or haven't been advised how best to address.

ARE ALL THE BOOKS UP TO DATE AND ACCURATE?

Up to date and accurate accounts are one of the most powerful tools when purchasing a business. They give you the ability to see exactly what the financial state of the business is and allow you to start developing an idea of what it is worth to you. Conversely if the books aren't accurate and up to date then you have no idea what you are purchasing and should consider this a massive warning sign.

Top tip: Keeping up to date accounts is crucial for the effective management and success of any business. If the current owner hasn't been doing this, then there are probably other areas of the business that have been run poorly or neglected as well.

ARE THE FINANCIAL REPORTS INFORMATIVE?

Financial reports in business are a lot more than just a Profit and Loss and a Balance Sheet. The seller should be able to provide you with reports that give you the ability to gain a much deeper insight into the business. The information within the reports that are of real value to you include:

1. Identification of any trends within the business, for example continuous decreases in margins, which could mean the business won't be around for much longer.
2. Profitability analysis on the different business sections, allowing you to identify the strengths and weaknesses of the business.
3. A history of key performance indicators that show the development of the business and allow you to determine the impact those certain problems might have on the businesses profits.
4. Historic budgets with actual vs. forecast variance analysis. This will allow you see when things haven't gone to plan and enquire as to why.
5. Seller prepared forecasts that they are willing to be held accountable for. Check that the forecasts correspond logically with historic trends. Even then it is still a very good idea to prepare your own forecasts as well.
6. The ability to confirm that the net cash position and short term profit hasn't been artificially inflated. An example of this is a retailer running their stock levels below the historic levels to make the business look more profitable. Another example is a wholesaler shifting stock to retail customers at discounted prices to increase short term turnover, but resulting in reduced retail orders in the following period.
7. Conduct benchmarking to determine whether this business is indeed successful when compared to others in its market space. The ATO's Small business benchmarks help you assess how the industry is performing overall.

Top tip: Beware the seller who tells you that actual profit is greater than reported— what do you think the likelihood is that an owner is going to be perfectly honest with you, when they are prepared to defraud the tax office, despite all the power the ATO possess and potential ramifications in doing so?

WILL THE SELLER CONSENT TO AN EXTERNAL AUDIT

An external audit, completed by a third party firm is common practice when buying and selling a business. If the seller wont consent to having their accounts audited by a third party then perhaps you should ask yourself what it is they don't want you to know?

If the seller has had a full audit completed, but it was over 6 months ago then you may wish to ask for an updated one.

Top tip: Push for the Seller to pay for the audit rather than you, as they can use it with other interested parties if you choose not to buy.

IS THERE A HIGH-RISK PROFILE?

Consider your level of risk. The risk is higher if the target business: has assets worth less than your offer price; relies on one or two major customers, suppliers or key employees. You are at risk of unexpected further capital investment if the business is operating out of inadequate or old premises or with inadequate or old equipment. Another risk could be difficulties in getting the lease assigned with existing entitlements, with the landlord only prepared to offer a new lease.

Top tip: You don't always have to walk away if the risk is high. Instead you could consider mitigating that risk by utilising clauses in the purchase agreement that takes these risks into consideration. For example, $50,000 to be held in escrow and only paid if the lease is transferred with existing entitlements.

WHAT ARE THE SELLER'S OBJECTIVES?

Does the owner have to sell? If yes, is the owner under time pressure? If the answer is yes to either of these questions then you have an upper hand at the negotiation table already.

Does the owner wish to sell just the trading part of the business, or both the assets (such as a building) and the trading part? The latter of course holds a higher value and reduces the risk profile.

Is money the prime motivation for selling or is there some unrevealed reason, such as a competitor planning to open nearby? If you can uncover the seller's motivations, you'll gain an advantage in the negotiation process.

Top tip: Beware a sellers motivation for wanting to sell you the legal entity (such as the company) that the business trades out of. You may be inheriting liabilities that you aren't yet aware of.

RESEARCH INDUSTRY RISKS

You need to assess the risks and opportunities associated with the business's future. Research the businesses competitors and understand how they are positioning themselves now and for the future. For example are major competitors entering or are there a lot of competitors exiting? Both could be warning signs.

Are there any changes to legislation or political policy that will affect the business? Is the business dependant on imports and the cost of which impacted by currency exchange?

There is a lot of information available to the public by going to the local Planning and Development Office. For example, you'll be able to see if there are any proposed zoning law changes that would change the "permitted use" at the business location.

Top Tip: If there are multiple sellers with similar businesses and in similar locations then you should investigate as much as possible as coincidences are few and far between.

LEGAL DUE DILIGENCE

Check to make sure the seller actually owns everything you are buying from them. This might include property, equipment, vehicles and intellectual property (such as registered patents, designs and trade marks) and client contracts just to name a few. Is the ownership clearly defined in all cases?

Examine all contractual obligations that you will have to others and that they will have to you. This includes employment issues and contracts with third parties such as customers and suppliers. Look for any contingent liabilities. Consider what effect a change of ownership will have. Are you likely to lose any contracts? Complete background checks on the business and the seller/s. Check for any past, current or pending lawsuits, complete searches on ASIC, social media and with the courts. This will help you determine the integrity of the business, the seller and other key people.

Top tip: There is an enormous amount of information about us all available on the Internet. Simply doing a Google search for an individual can yield a lot of telling information.

LOYALTY OF STAKEHOLDERS

Businesses are made up of people and they rely on key stakeholders such as senior employees, major clients and major suppliers, for their success. Therefore it's always important to determine things like, what are the existing customer perceptions and who is their main contact at the business? If their main contact is the current owner, then the owner's continued involvement during the transition will be more valuable.

You need to thoroughly understand all the interpersonal relationships that make up this business and ascertain if these relationships will improve, breakdown or maintain once you take over.

Top tip: Ask these key stakeholders whether you taking over will impact the relationship they have with the business. More often than not, they will give you an honest answer

SOURCE EXPERT ADVISE

No specialist advisor knows it all and if they tell you they do, chances are they aren't specialists. When deciding whether or not to purchase a business there are at least three main types of professionals that you should seriously consider speaking with:

1. Accountant – will be able to assist you in valuing the business, analysing the reports, tax planning and structuring the purchase offer
2. Lawyer – completing legal due diligence on the seller and the business can be hit and miss if you don't know what you're doing. The right Lawyer will be of a lot of value here.
3. Industry advisor – you can either get in touch with relevant industry associations or seek advise from a consultant specialising in that industry. They will be able to assist your evaluation where the business sits in the market as well as future industry changes that may affect you

Top tip: Even within Accounting and Law there are numerous different fields and specialties. Ask the professionals you're thinking of engaging bluntly whether this is the field they specialise in or not.

Here to Help

If you need any more advise or assistance in completing due diligence prior to purchasing a small business:

Call us for advice today: 1300 313 397 (or, send us an email).