BUYING OR SELLING YOUR BUSINESS

On a regular basis I and work with buyers and sellers of businesses. In this article, I thought I would walk you through some considerations from an Advisor's point-of-view when helping you in buying/selling a business. As you read this, think about it as if you were in the position to buy or sell your business.

The business purchase or sale situation presents an opportunity to educate the client to the reality of the situation. Among the issues I seek to assess and assist with are:

- Seller motivation and Goals
- Buyer capability and motivation
- Education on the business buy/sell process

SELLER MOTIVATION AND GOALS

For the seller, I want to know "why you are selling?" and we will almost always have to dig beyond the initial rationalization. Many times it is an act of desperation or surrender rather than a valid exit strategy. A rule of thumb in the M&A (mergers and acquisitions) game is that *sellers decide to sell two years after they should have*.

In small business, there is a huge *difference between exit and escape*, the latter being almost always at a loss. Businesses without revenues are generally only worth break-up value.

THE BUY/SELL PROCESS

The private sale of any business, regardless of size, follows a certain procedure. People think they can streamline the process for a very small business sale transaction and cut right to the sale. That is very dangerous.

The steps to successful business buy/sell are:

1. Seller chooses sale as exit strategy
2. Seller packages and markets business
3. Buyer does initial evaluation
4. Buyer submits conditional offer
5. Negotiation and acceptance
6. Due Diligence

7. Final negotiation
8. Execution of Purchase and Sale Agreement
9. Transition of ownership and operations

Skipping any of these essential processes may result in a sale, but it will always cause problems after the sale, likely for both parties.

The first 3 steps involve valuation of the business. First and foremost, a valuation provides a reality check on the feasibility of a purchase or sale so the overly optimistic buyer or seller is stopped before a lot of time and resources are wasted.

PACKAGING A BUSINESS FOR SALE

It may not be easy for an entrepreneur to *reorganize the business so that he or she is not essential to its operation*, but that is crucial if it is to be sold. Improving efficiency is also a good strategy to improve the valuation. Finally, cleaning up for a good presentation helps attract buyers.

The initial sales material includes a description of the business and a summary of assets included by category and sales and profit figures for the last 3 years. It should also include a mention of added value intangibles like leases, patents and contracts, again, without the details. Expense details and customer lists should never be disclosed at this point because they can be very damaging in the hands of a competitor and encourage a potential buyer to become one.

"When can I talk to the employees?" is a question buyers will ask and sellers should consider long before they do. It is part of that packaging for sale. Identifying key personnel and making them part of the transition plan is *must be done before the business can be marketed*.

A seller may be hesitant to put an asking price in the initial sales material for fear of precluding a higher offer but the buyer of anything wants to know the price early on. There is nothing wrong with the strategy of putting the asking price at the high end, leaving room to negotiate, but asking much more will shut out any potential buyer with the business savvy necessary to operate the business.

SBDC Advisors cannot act as agents and most brokers will not handle the smallest of business deals. Often the most likely buyers already have a relationship with the business – stakeholders like employees, competitors, customers and suppliers.

BUYER MOTIVATION AND GOALS

Buyers should also be alerted to seller "tricks" that appear to add to valuation but have a cost after the sale. Deferring maintenance or capitalizing it instead of expensing, buying sales by sacrificing margins, infusing owner cash and cutting necessary staff or owner salary below market are common tricks. Many of these do not show until due diligence - by historical comparison or measure against industry standards.

THE OFFER

NOTE: *The following is not a substitute for competent legal and/or accounting advice. The advice of these professionals should be sought prior to taking any actions in these areas.*

No contract is legally enforceable without an offer and acceptance. The buyer's offer is the first step to the deal to transfer the business. Unfortunately, there are many wrong ways to make the offer.

Firstly, the buyer should never offer to buy "the business" without defining what that is. Otherwise it is perfectly legal for the seller to remove any assets and claim they were not included in the deal.

The buyer may not have had access to the asset records or depreciation schedule before making an offer. The fact that the seller refused to provide them until an offer is made is not a red flag.

The offer must also be conditional to protect the buyer's interest. Common conditions include:

- The purchase price stated above will be allocated as follows:

Land $xxx – cannot be depreciated so buyer would want a lower valuation. The seller may feel opposite as the increase over basis is a capital gain at lower tax rates than ordinary income

Buildings $xxx – depreciated over 29 years from original build date. Generally the buyer will depreciate over the remainder, probably with a different basis. A transfer price over the seller's basis is a recapture of depreciation, taxed as ordinary income to seller.

Equipment $xxx – generally depreciated in 5 to 10 years from in-service date. Generally the buyer will depreciate over the remainder, probably with a different basis. Allocation over seller's basis is a recapture of depreciation, taxed as ordinary income to seller.

Inventory $xxx – expensed as it is sold. Usually priced below cost which was a write-off to seller in prior accounting periods, without affecting buyer.

Goodwill $xxx – depreciated over 15 years from the transfer so buyer usually wants to minimize this allocation. Allocation over basis is a capital gain to seller, so sellers usually want to maximize goodwill value. This component is often negotiated fiercely.

Transition Services (Services provided by seller after the sale to facilitate transition to new owner) $xxx – expensed over the time services are rendered, ordinary income to seller. It is common that the payment for the allocation for transition services be done when services are rendered according to terms, not at the closing.

Non-Compete Agreement $xxx – expensed over the life of the contract. Like transition services, payment may be deferred.

Note: *There is quite a bit of leeway in valuing transition services and a non-compete agreement because they are intangibles. Often these components can make up for slack in negotiations over the value of hard assets*.

Purchase price allocation is often overlooked but has huge long-term implications!

- This offer is valid until noon on <date>. If it has not been accepted in writing by seller by that time, it shall be considered withdrawn and have no binding effect.

- From the date of seller's acceptance of this offer, buyer shall have <number> of days to perform due diligence of the business, during which period buyer shall have full access to all business records and assets. Optional: Buyer shall execute a non-disclosure agreement in favor of seller at the commencement of due diligence.

- A closing will take place no later than <date>and a purchase and sale agreement, which shall include any of these conditions still applicable, shall be executed at that time. Optional: There may be agreed compensation (penalties) if there is a failure to close.

- From the time of acceptance until the closing of the transaction, seller shall not make any but normal and reasonable transactions and may not increase his or her salary and benefits nor sell or remove any assets of the business without buyer's written approval.

- If there is an agent who is due a commission on this transaction, the payment of said commission will be the responsibility of the seller, personally, not through the business.

- The offer is subject to verification of financial data previously provided to buyer and sales at or above $xxx and net income at or above $xxx for the most recent fiscal year.

- All business equipment is in serviceable condition (a demand for a seller warrantee for 30-90 days past the closing is common here).

- All inventory is saleable. Damaged or obsolete inventory has been written off by seller over the course of business as provided by generally accepted accounting principles.

- There are no liens, judgments or pending legal actions against the company. There are no existing violations of code or law. Seller shall be personally responsible for the cost of remedy to any such undisclosed contingencies.

- The seller has the legal right to make the transaction.

- Seller will discharge any tax liabilities of the business existing at the time of closing, or file a short term tax return forthwith, post-closing, and personally pay any taxes due.

- Seller will provide <specific> transition services after the closing (optional: payment terms).

- Seller will execute a <specific> non-compete agreement within the purchase and sale agreement (optional: payment terms).

- This offer is subject to buyer securing approval for a bank loan no later than <date> in the amount of $xxx to finance the proposed transaction. *This condition may state a maximum interest rate or other terms. This type of condition may also be made for investor capital.*

For a business entity sale (versus asset sale):

- The <legal Entity> is in good legal standing and all required filings have been done and fees paid to the date of the closing

- The trade debts of the company do not exceed $xxx

- All other debts of the company do not exceed $xxx

- The trade receivables of the company are at least $xxx and will be assumed by buyer at the closing

- Seller is responsible to file short-year income state and federal tax returns for the company and satisfy all income tax obligations as of the date of closing.

- Seller shall be personally responsible for the accuracy of all tax filings for the company up to the closing date and shall indemnify buyer for any underpayment of taxes up to the closing date.

Once the conditional offer is accepted (in writing), it is binding on both parties, but it provides the buyer with protection. If any situation is subsequently discovered that violates any of the conditions, the buyer can invalidate or amend the offer.

If the seller has been forthright and honest and has run the business properly, he or she should not be concerned with any but the condition on financing (bank loan). Before the seller accepts the offer, he or she should do a credit check on the buyer, perhaps running the deal by his own bank. Otherwise, the seller risks wasting time that could be used to get a qualified buyer.

DUE DILIGENCE

At this point in the business buy/sell process, there should be no holds barred (locked file drawers) by the seller. Restrictions on access to any part that constitutes the entity to be sold is a red flag deceit warning.

One possible exception is customer identity. A seller is justified in keeping that confidential until the closing, but the distribution of sales should be revealed. If, for example, one customer is responsible for a third of sales, that bears looking into to assess the likelihood of continuity.

One aspect of due diligence that must be addressed, and possibly negotiated, is access to employees. For reasons of continuity and stability the seller may not want employees to know their employer is in play. On the other hand, the buyer may want to be sure key employees will stay with the business.

The scope of due diligence follows the size and nature of the transaction. A review of financial records may be sufficient for a deal under $100,000, but transactions over $1,000,000 usually extend to an audit of receivables and payables, environmental surveys, mechanical inspection of production equipment and verification of the value if intangibles like patents and know-how.

Due diligence is where deal becomes real and there is no "I did not know" excuse for the buyer afterwards.

Buyers should be cautioned not to rely too heavily on tax returns. Yes, one is less likely to lie on a tax return than on the internal books, but the purpose of tax returns is only to minimize taxes. Looking at expense detail that does not show on tax returns is the best way to spot deferred maintenance, margin shrink and emerging problem expenses.

The buyer should be willing to execute a non-disclosure agreement at the start of due diligence. Refusal to do so is as telling of deceit as that locked file drawer.

NEGOTIATION

The seller may be concerned with exit, the continuity of the business that was so closely associated with him or her, the financial future of his or her family, the employees and customers – or none of those. It is up to the buyer to try to understand the motivation behind the answer to "why are you selling?"

While seller financing may make the sale possible, it is usually seller's last resort.

It should be noted that the tax advantage to the seller for installment purchase only exists if the seller is a cash basis taxpayer. Individuals all are, but any business with an inventory must be an accrual basis taxpayer. An accrual basis taxpayer recognizes all of the income and pays all of the tax in the year the transaction takes place, regardless of when payment is made. This adverse tax situation arises when there is an asset sale by an accrual based business.

PURCHASE AND SALE AGREEMENT

This is the final step that formalizes the transaction and negotiation should be well over. There is no substitute, no matter how small the deal, of having an attorney experienced in P/S contracts participate. There are "canned" contracts available, but the parties are not likely to understand the long term implications of the clauses without legal counsel.

For help buying or selling a business contact your local SBDC Advisor for confidential assistance.

This article was prepared by Jerry Petrick, MBA, CGBP, SPHR, PMP and Certified Business Advisor with the WSU Small Business Development Center (SBDC) in Longview, WA. Jerry provides no-cost, confidential business advisory services by appointment. He can be reached via email jerry.petrick@wsbdc.org