



Do You Want to Buy a Business?

Questions You Should Ask

Jim Brooks

FAPC Business Planning and Marketing Specialist

Introduction

Many entrepreneurs who are ready to start their own business often consider buying an existing company that might be for sale. In some instances that concept can be the right option as long as you know the specific questions to ask and where to look for up-to-date information regarding the business and its history. The intent of the following information is to assist you by providing relevant questions that are important to make an informed business decision.

Depending on the size of the company, your “Due Diligence” checklist can be rather extensive or relatively simple to make an informed decision as to the purchase. The more information you can obtain from the existing ownership and the more individual research you can perform as a potential buyer should improve your approach in negotiations.

Please note that this checklist is not intended as legal advice, but only a general guide to assist you in the process of an acquisition. It is strongly recommended that you seek advice of legal counsel before and during your due diligence.

Reasons for Selling

There are many legitimate reasons that individuals, families or partnerships are inclined to sell an existing business, and that “exact” reason may be one of the most important elements to determine in starting your checklist of questions. Some of the most common reasons for selling an existing business are retirement, relocation, health concerns, competition, distribution restrictions, not able to be price competitive, loss of continued interest or new regulatory compliance issues. There also are some reasons for selling a business that are more difficult to evaluate on the surface that will require more investigation and due diligence to make a responsible decision (i.e., pending law suits, loss of major account(s), bad debts, patent and trademark infringements, vendors and suppliers

reduce line of credit or terms, failure to pay state or federal taxes, a large note to the bank due, property liens, etc.).

As you can see the partial list of legitimate reasons for selling a business and those reasons that are not quite as apparent truly emphasize the importance of due diligence and experienced legal counsel. You must take the amount of time necessary for the due diligence process, as there are no short cuts to making solid, sound decisions when acquiring an existing business. It is safe to say that even after you complete your due diligence checklist, there can be some questions that were not completely answered or you forgot to ask, but at least knowing the most important areas of concern in the acquisition phase, you should avoid major mistakes and make a rational informed decision based on the due diligence information gathered by the process.

Real Market Value

One of the most common questions by the existing business owner is how to determine a fair and marketable price for the company. Most owners set a price based on what they would like to sell the business for, not actually based on an appraisal price by an independent source that has years of experience in the industry. The initial price is usually inflated based on length of ownership, family considerations (i.e., “company was founded by Mom & Dad” or perceived equity they have invested over a period of time, not necessarily meaning real dollars). This can potentially be a delicate part of the negotiations, and through the due diligence checklist, you can begin to determine the real value of the company.

Only after you have completed all the information can you actually begin to negotiate with the owner(s), and validate your offer and conditions for the purchase. In some instances it may be appropriate to pay a little more than market value based on years in business, product recognition, assets (i.e. land, new equipment, building, new contract, etc.).

SAMPLE DUE DILIGENCE CHECKLIST

(The due diligence checklist is a tool normally used in the context of buying a business)

1.0 Corporate / Organizational Matters:

- 1.1 Copies / Certificate of "Articles of Incorporation" with Secretary of State.
- 1.2 Latest copy of Health Department inspection.
- 1.3 Is there a Board of Directors, committees or company minutes of meetings?
- 1.4 Owner / Partnership or stockholder agreements for review.
- 1.5 Ownership breakdown.
- 1.6 Internal or external auditor's reports relating to material accounting matters.
- 1.7 Copies of miscellaneous letters of management to or from state or federal tax authorities.

2.0 General Business Information:

- 2.1 Is there a current business or marketing plan?
- 2.2 Owner / partner individual responsibilities for company operations.
- 2.3 List of company's largest suppliers, dollar amounts of product purchased and payment terms for the last two years.
- 2.4 Copies of all contracts or agreements that are material to the company's business.
- 2.5 Copies of all promotional materials (i.e., brochures, advertising, press releases or other materials that describe the company product or services).
- 2.6 Provide all forms, purchase orders, invoices and documents that are used regularly.
- 2.8 Copies of employee manuals, procedures, policies.

3.0 Financial Matters:

- 3.1 Asking price of the company vs. real value based on company growth for last five years.
- 3.2 Annual sales for the last four years based on reported tax returns.
- 3.3 Provide copies of tax returns for the last four years.
- 3.4 Copies of monthly financial statements.
- 3.5 Profit margins for the last four years.
- 3.6 Individual cost of goods for all products offered to the commercial market.
- 3.7 Current aging report of accounts payable and accounts receivable.
- 3.8 Detailed records of fixed assets, appraised values, date of purchase, condition of equipment or service contracts.
- 3.9 Potential bad debts.
- 3.10 Disclose all agreements regarding loans, agreements, contracts, notes payable, lines of credit, equipment loans or leases and any other material debt or financing documents.
- 3.11 Inventory policies, procedures and costing.

4.0 Property Ownership / Leases:

- 4.1 Status of real property whether owned or leased by company.
- 4.2 Describe other property, offices, branches that would be involved in the sale.
- 4.3 List owners or landlords by name, address, city and state, square footage of property and buildings included in sale.
- 4.4 Provide copies of deeds or leases and terms including renewals, options and monthly amounts.
- 4.5 List schedule of all deeds, mortgages, insurance policies, relating to property.
- 4.6 Provide recent appraisals or assessments.
- 4.7 List personal property and equipment.
- 4.8 Provide list of all machinery, equipment, furniture and property owned / leased by the company, and list whether it is owned free of debt or leased by the company.
- 4.9 List of all brand and trade names, trademarks, patents, copyrights, licenses that are owned by the company.

5.0 Regulatory and Environmental Issues:

- 5.1 Provide all state, federal and local governmental and regulatory agency permits, licenses, approvals, consents, special arrangements or agreements that pertain to the business of the company.
- 5.2 Lists and descriptions of all reports relating to mentioned inspections of the business or the facilities by all described agencies including local, state, federal.

6.0 Contracts and Agreements:

- 6.1 List all contacts and deposit agreements greater than \$5,000 per year.
- 6.2 Provide documentation of agreements with suppliers, brokers, sales representatives, or agents, and define method of commission or compensation regarding the sales and marketing of the company and its product lines.
- 6.3 List all current contracts or agreements with current or former officers, directors or employees.
- 6.4 Include any existing contracts or material acquisitions that include the sale of the property, facilities or services of the company.
- 6.5 Inclusion of all contracts or agreements that remain to be completed in whole or in part or which may be an obligation of new ownership for consideration of liability.
- 6.6 Disclosure of any material agreement, contract, understanding or transaction that is not evidenced in writing.

7.0 Management and Employees:

- 7.1 List all officers and directors that are legally associated with the business.
- 7.2 Names of senior management of the company and aggregate compensation at present and for the last five years if applicable.
- 7.3 Provide a complete list of all employees by position in the company, including total number.
- 7.4 Current employee contracts, non-compete agreements, management and consulting contracts.
- 7.5 List all documents pertaining to any receivables from or payables (including loans) to directors, officers, or beneficial owners of more than 5 percent of the common stock of the company if applicable.
- 7.6 Indemnification arrangements with officers and directors of the company, including (but not limited to) liability coverage, risk coverage, employee bonds, etc. Summary of all insurance policies (i.e., casualty, property, liability), including claims history on each.
- 7.7 Copies of employee benefit plans.
- 7.8 All current profit sharing 401 (k) and savings plans; pension or retirement plans, materials describing any of the foregoing; and the latest applicable trust accountings, actuarial reports and any other applicable financial statements.
- 7.9 Disclosure of the company's policy regarding accrued vacations and sick leave and the provisions for the respective payments.
- 7.10 Description of any severance or termination programs or plans in which the employees or officers of the company participate and any statement of the company's policy with respect to termination of employees and officers relating to benefits.
- 7.11 Provide copies of any summary plan descriptions or employee handbooks describing employee benefits, hiring protocol, salaries, wages, benefits, employee loan agreements, vacation policies and employee purchase programs in which employees of the company participate.

8.0 Insurance:

- 8.1 Summary of all material insurance policies and provide copies of all such policies.

9.0 Litigation / Claims:

- 9.1 Description of all current and pending litigation, threatened claims and anticipated outcome of each.

10.0 Environmental Issues:

- 10.1 Description of any outstanding environmental issues.
- 10.2 Provide copies of any environmental liability assessments or environmental compliance audits.
- 10.3 Status of current environmental compliance in areas such as permits and contingency plans.
- 10.4 Provide copies of all recent and current citations for failure by the company to comply with applicable environmental, hazardous waste laws and occupational health and safety laws.
- 10.5 Describe measures being taken to ensure compliance, including any program developed by the company for the lawful disposal of hazardous wastes.

11.0 Management Information Systems:

- 11.1 Complete description of the company's computer hardware and software programs.

Conclusion

It should be very obvious by reviewing the due diligence checklist that there are many areas that need to be addressed in buying an existing business, and any assumptions rather than facts could lead to a potential bad investment. The larger the company/business the more precise your information should

be before making your offer or decision to enter into a contract for purchase.

Again, this due diligence checklist is not intended as legal advice, but a general guide to assist you in the process of an acquisition, and it is further recommended that you seek legal council before and during your due diligence.

Sources: *Bake-Rite Foods, Inc. and David Spencer Law*

The Oklahoma Cooperative Extension Service

Bringing the University to You!

The Cooperative Extension Service is the largest, most successful informal educational organization in the world. It is a nationwide system funded and guided by a partnership of federal, state, and local governments that delivers information to help people help themselves through the land-grant university system.

Extension carries out programs in the broad categories of agriculture, natural resources and environment; home economics; 4-H and other youth; and community resource development. Extension staff members live and work among the people they serve to help stimulate and educate Americans to plan ahead and cope with their problems.

Some characteristics of the Cooperative Extension system are:

- The federal, state, and local governments cooperatively share in its financial support and program direction.
- It is administered by the land-grant university as designated by the state legislature through an Extension director.
- Extension programs are nonpolitical, objective, and based on factual information.

- It provides practical, problem-oriented education for people of all ages. It is designated to take the knowledge of the university to those persons who do not or cannot participate in the formal classroom instruction of the university.
- It utilizes research from university, government, and other sources to help people make their own decisions.
- More than a million volunteers help multiply the impact of the Extension professional staff.
- It dispenses no funds to the public.
- It is not a regulatory agency, but it does inform people of regulations and of their options in meeting them.
- Local programs are developed and carried out in full recognition of national problems and goals.
- The Extension staff educates people through personal contacts, meetings, demonstrations, and the mass media.
- Extension has the built-in flexibility to adjust its programs and subject matter to meet new needs. Activities shift from year to year as citizen groups and Extension workers close to the problems advise changes.

Oklahoma State University, in compliance with Title VI and VII of the Civil Rights Act of 1964, Executive Order 11246 as amended, Title IX of the Education Amendments of 1972, Americans with Disabilities Act of 1990, and other federal laws and regulations, does not discriminate on the basis of race, color, national origin, gender, age, religion, disability, or status as a veteran in any of its policies, practices or procedures. This includes but is not limited to admissions, employment, financial aid, and educational services.

Issued in furtherance of Cooperative Extension work, acts of May 8 and June 30, 1914, in cooperation with the U.S. Department of Agriculture, Robert E. Whitson, Director of Oklahoma Cooperative Extension Service, Oklahoma State University, Stillwater, Oklahoma. This publication is printed and issued by Oklahoma State University as authorized by the Vice President, Dean, and Director of the Division of Agricultural Sciences and Natural Resources and has been prepared and distributed at a cost of 74 cents per copy. 0406 MHG