



## **HANDY GUIDE TO PURCHASING A BUSINESS**



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There are many reasons you may want to buy a business: to create financial independence; to be your own boss and control your own destiny; to have pride of ownership; to invest in the United States; to get a visa, or just to be a business owner and you don't want to start it yourself. And while there are many reasons for buying a business, there are an even greater variety of purchase prices.

When a buyer determines what price they would be willing to pay, there is logic and emotion involved. This article will discuss the logical due diligence that needs to be addressed when exploring a purchase.

The purpose of a buyer's due diligence is to gather the information needed to determine the price (or value) of the business being considered. The potential purchase price depends primarily on the following:

- the condition of the business, especially the financial and physical condition of the organization
- the buyer's business plan to generate cash flow
- the risk factors that affect the business's ability to continue historic operations and/or achieve anticipated operations

Taking the information gained from due diligence into account, there are three approaches to valuing a business: asset, income and market approach.

For the asset approach, price can be based on the sum of all assets and liabilities. When you are looking at buying a business, you would not pay less (and sellers would not sell for less) than the value of each of the assets, less each of the liabilities. This is not the historic balance sheet that is shown on a financial statement or a tax return. What you would pay is the true fair-market value of the net assets.

In the market approach, price can be based on the price of similar companies. Of course, no two businesses are exactly alike, but comparison is a good basis for evaluation.

With the income approach, price can be based on the future benefits (net income or cash) of the business. Although you may look at the historic income or cash flow of a business, your decision is based on what you expect it to do for you in the future.

Regardless of your reasons for wanting to buy a business or the approach used to determine price, most owners are ultimately seeking a positive cash flow and a reasonable profit that would allow them to reinvest and perhaps grow the business. As a starting point, you should be able to purchase an organization and still support your current lifestyle through the wages that you pay yourself. There should also be additional year-end cash flow to provide you with a return on your investment into the business. Ideally, this would be commensurate with the return that you would receive if you were to make conservative investments in the public securities market.

So what considerations should you address that could affect that additional positive cash flow?

- **Conditions in the national and local economy.** Is the current economy strong or in a recession? What is the economic forecast for the national and local economy? If it is a business that operates only in a local market, the national economy can still have an affect. For example, a restaurant may be dependent on tourism and national and international economic conditions can impact the business.
- **Conditions in the industry in which the business operates.** Is this business in an industry that is at the end of its life cycle, such as video rental stores, or is it in something new like Redbox franchises?
- **Conditions of the competition.** Does this business have a lot of competition? Is the industry easy to enter so that new competition has an opportunity? Intense competition makes the business more risky and therefore the potential purchase price should be lower than that of a firm in a less competitive environment.
- **Conditions of the business and its financial strength.** This area has quite a number of points to be addressed:
  - Does the business have the assets it needs to operate? Are they in good condition, or will they need to be updated soon?
  - Has it been operating at a profit in its recent history?
  - Has there been cash available for distribution to the owner from this business?
  - How many customers does the business have? If revenues are concentrated in just a few customers you risk “putting your eggs in one basket.”
  - Do key employees have employment contracts? If not, can they take business away or disrupt operations if they leave?
  - How many suppliers does the business have? Too few suppliers can be a risky.

A purchase price can be different for every buyer depending on their view and the answers to the questions above. But every buyer should consider how well the future business operation can repay their investment. The more risk a buyer sees in the business, the less the purchase price should be. The opposite is true also: the less risky a business, the higher the price and the more years it will take to repay the investment initial investment.

The bottom line is without conducting the appropriate due diligence you will not know the risk and will be unable to make a sound purchase decision.

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