How to Perform Due Diligence Before Buying a Business

When buying a business, “due diligence” refers to the process of reviewing all of the available information related to that business. The goal of due diligence is to make sure that all legal and financial issues pertaining to the business are in order and that there are no unpleasant surprises should you decide to go through with the purchase.

Due diligence means digging deeper. You’ll need the help of your business banker, accountant, and attorney to do a thorough job of due diligence.

Due diligence should cover the following:

Finances:

Ask for the company’s audited financial statements. Request balance sheets, income statements, and cash flow statements, as well as business tax returns for the past three to five years. You and your accountant should review them with the following in mind:

- Is the business collecting its accounts receivable in a timely manner?
- How much bad debt does the business write off each year?
- Is the business paying its debts in a timely manner?
- What is the business’s profit margin?
- Does the company have any outstanding liens?

Legal issues:

Ask for copies of the business’s professional and consulting agreements; insurance policies; licenses and permits; any documents related to intellectual property, such as patents or trademarks; and any documents related to lawsuits the company is involved in. You and your attorney should review them with the following in mind:

- Are the agreements enforceable?
- Does the company have the rights to its intellectual property?
- Is the business adequately insured?
- Are the company’s licenses and permits current?
- Is the company involved in any litigation, and if so, what are the potential risks, costs, and damages?

Employees:

Request organizational charts, employee handbooks, employment agreements, wage and salary information, benefits plans, noncompete agreements, and confidentiality agreements. Review them with your attorney, keeping in mind:

- Do any employee policies put the business at risk of lawsuits?
- Are there any ongoing grievances with employees?
- Are employees attempting to unionize, or is a third party trying to unionize them?

Business structure:

If the business is a corporation, ask for a copy of its corporate charter and bylaws as well as all minutes of meetings held with the board of directors and/or shareholders. Have your attorney review this with you, considering:

- Is the business in compliance?
- Is the business structured properly for your growth plans, or will you need to change its structure?
- Will you need to buy out shareholders, and if so, what will that cost?

Operations:

Ask for a list of customers, lists of suppliers and vendors, and an operations manual. Review this information while considering:

- Does the business have adequate inventory systems in place?
- Is the company's supply chain diversified so that the business isn't overly reliant on one supplier?
- Is the company's customer base diversified and growing?
- Does the company have necessary equipment and infrastructure in place for continued growth?

At the end of the due diligence process, you should have a clear picture of where the business is today, where you can take it in the future, why the owner is selling, and whether the asking price is fair.

Questions to Ask When Buying a Business

Buying an existing business can be a great way to become your own boss without going through the headaches of startup. However, there are also some risks to be aware of. To improve your chances of success, look for a business in an industry you're familiar with and where you have some past management or operational experience.

To begin, you'll want a business broker on your team. A good broker can help you pinpoint promising companies that are up for sale and that meet your criteria. They can even find companies that aren't advertised for sale but whose owners may be willing to sell.

Once you and your broker have found some companies that look interesting, here are some key questions you'll need to ask and issues you'll need to research.

- What is the state of the industry in which the business operates? Is the industry in growth mode, or is it mature or in decline?
- What is the state of the business's target market? Is its target market growing or shrinking? Are its target customers undergoing demographic changes, such as aging, loss of disposable income, or other transitions that could put the business at risk?
- Is the business's customer base growing? Is the business adequately diversified, or is it overly dependent on one or two big customers?
- How does this business compare to competitors in its industry? How many competitors are there? What are their strengths and weaknesses?
- What is the state of the region where the business is located? Are people moving into the area or are they moving out? What about businesses? Is the local economy growing or shrinking?
- What kind of staff does the business have? Do employees have skills that are difficult to find elsewhere? Are their wages average, above average, or below average for the industry? What benefits does the company offer?
- Is there a lot of turnover at the company? How long have key employees been with the company? Are key personnel likely to stay with the company after a change in ownership?
- What is the company's reputation in the industry and the community? Businesses are often up for sale because of problems the owner may try to hide. Go online and ask around in the community to learn as much as you can about the reputation the company has among customers, vendors, and prospects.

Doing your due diligence (see http://www.accountingtools.com/due-diligence-checklist) will provide answers to these and other questions.

Is the Price of a Business Negotiable?

The selling price of a business is absolutely negotiable. Sellers expect potential buyers to make offers that are sometimes significantly less than their asking price. But be reasonable: If your offer is half the asking price, for example, the seller probably won't take you seriously. Sellers expect to negotiate, but unrealistic offers waste everyone's time.

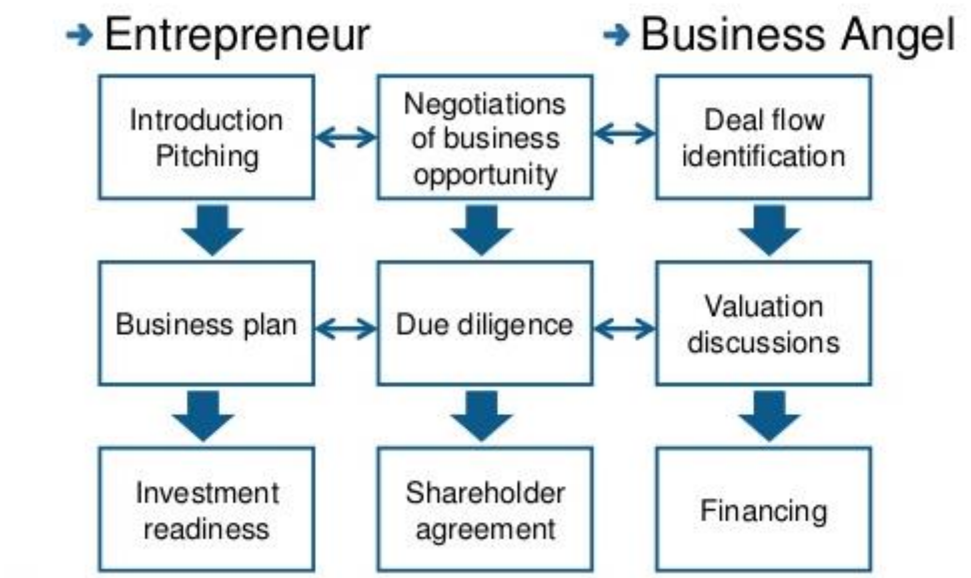
Although there is no precise method for valuing a company, owners who have used an accepted valuation formula to arrive at their asking price will be less likely to stray far from their original figure. Such owners will usually want to remain within 20 percent of their original asking price.

The final price ultimately depends on how quickly the seller wants to sell and how badly you want to purchase the business. The greater the incentive the owner has to sell, the farther below the asking price he or she is likely to go. However, the more you want to buy the business, the more quickly you´ll want to complete the deal. In that case, expect to pay a higher price.

Due Diligence checklist

Track record of the management
Size and growth potential of the market
Demand for product/service among target customers
Ability to deliver product/service on time and at agreed price
Competitive advantage of the product
Competitors
Marketing and distribution plans
Soundness of financial projections
Assessment of the intellectual property rights, if any
Existing or possible legal contingencies
Valuation for the venture

Due diligence process as an ongoing dialogue



www.sautterinvest.ch email: sautterlas65@bluewin.ch twitter: @sautterlas65

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CH-8001 Zürich – Bahnhofstrasse 100