WHAT DO I DO NOW?

After you and the seller agree on the price and terms of the sale, you must begin your "Due Diligence". The first step of this process is checking books and records so that you can verify or calculate the Cash Flows of the business. In most cases you will be given tax returns, financials or a proforma...

Step 1 Verify revenues. This can be done by checking deposit slips, sales receipts or even the seller's calendar on the wall. 99% of all businesses you look at will have unreported income – so you may as well accept it and learn how to deal with it. This is not the time to philosophize about it – instead take time to check total sales by observation, looking at the Seller's private records or doing your own demand study. If you will be using a professional he/she will not do this step for you. You must sit outside and count the customers at different times of the day, check pizza boxes, tomato and cheese purchases or how much water is being used etc. to verify sales.

If you've studied the industry you should have an idea of what this business can do based on what and how it's selling, where it's located and how current management is handling business. If you think you can do it better – use that number in your proforma – but remain realistic!

Step 2 Check the expenses. Compare the pro-forma you were given to the tax returns and/or financials. Better yet, take a blank piece of paper and list all the expenses you find on the tax return, financials and pro-forma and determine the value of each item. Most of these expenses can be verified by looking at the check book & credit card statements of the Seller. The other expenses like rent will be verified from the lease and other contracts.

Insurance can be verified by calling the Sellers insurance broker & your broker. Get a quote on what it will cost to insure this business and use that number.

Labor expense is also easy to verify. Through observation, checking work schedules & time sheets list all the people you need to operate the business. Multiply the hours these people have to work by the rate they get paid to determine payroll. Add taxes at 10% (some payroll might be cash) to get total payroll. Often you'll wind up with more payroll expense than what's shown because of cash labor. Don't forget to add this difference to your sales revenues. Why? Where do you think the Seller is getting the cash to pay these people?

Continue until you've listed a value for all the expenses you noted and than sit back and think if you missed anything – if nothing comes to mind you're probably finished. Your professional will look at your work to make sure you haven't forgotten anything.

Step 3 Determine the Gross Profit %. One way to do this is to check the retail prices on a representative sample of the items you sell. Then go to the vendor invoices and look up the cost of that merchandise. Calculate the Gross Profit % on each item until you can assume what the overall Gross Profit % is. Now multiply the estimated Gross Profit % by total sales to determine the businesses Gross Profit $'s.

Step 4 Determine your Cash Flow. Subtract your total expenses from the Gross Profit $'s. Do you have enough left over to pay yourself a fair salary? Can you payback the cost of the business over a reasonable period of time and even have a return on your cash investment? Do you see light at the end of the tunnel? Remember it might take you a few months to get into the swing of things, so allow for that in your pro-forma (e.g. calculate the figures as if running at normal not start-up).

If you can't or don't want to do this much work – then don't even bother making an Offer on this or possibly any other business – this is not something you leave to chance.

Also note, your professional can help you adjust the tax returns and financials you get to show how they would look if you were running the business. How he might handle unreported cash, personal expenses, cash labor etc. is something you should ask in your first interview. But most of the above will be left to you to research and quantify.

This procedure can be used for businesses that sell something tangible. For service and manufacturing businesses the above will help but the Gross Profit and Cost Of Goods as described above will be different. For restaurants you'll find rules of thumb that will help define this section.

The above was designed so anybody can read between the lines of a business he/she is thinking about buying – so for lack of anything else and the time required to learn all kinds of accounting stuff – the above will suffice and get you thinking about the business in question.

Even if you do the above and are knowledgeable about the many other items we haven't discussed that need to be checked, I still recommend that you use a professional who can help you – and preferable help you look past what is written on the tax return and financials. If the professional you hire only looks at the tax returns and/or financials and doesn't question personal expense items and the possibility of unreported income – then either do it yourself or hire someone else. You professional knows all the ways to check a business with poor, incomplete or shoddy records just like the IRS does – so use him to help you analyze the business your thinking of buying – especially if the records leave something to be desired.

One last thought – should you consider buying a business that isn't making money and should you pay something more than the value of the assets?

The answer isn't simple – it's a yes and a no and how much – it depends. Did this help? Well, if you can tell why a business is loosing money and can correct it – then do your own pro-forma and if the results look good – buy the business. Sometimes someone will buy a perfectly good business in a good location and screw it up. Sometimes because of their own incompetence, being undercapitalized, poor health, can't stand being an entrepreneur making decisions etc. or just plain bad luck like the weather, an aberration in the economy etc. the business under performs . If you can see what caused the poor performance and can correct than this business may be a great opportunity. As far as pricing, even though the Owner hasn't done well, he might be smart enough to realize he is sitting on a gold mine and won't let it go for a song and a dance – so he will price accordingly. If you want to know how something like this might get priced – than assume it was running well and price it out - than discount because it actually hasn't happened and there is a certain amount of risk that it won't perform as planned. In any event I tell people it's not what you pay – it's how much you make that counts. In Real Estate it may be true that it's what you pay that makes a project successful – but in a business – it's what you deposit in your account every week that counts. Remember you'll probably forget how much you paid for the business until its time to sell it. In the meantime you will be enjoying the rewards of the business everyday.

I hope this brief outline will help you get started in checking the Books & Records of the business you are planning to buy – in any event it won't hurt – anything you can do to get to know the fundamentals of the business your thinking about buying will help you. I think everyone should hire a professional to help them with such a big decision – even if you think you know what you're doing.