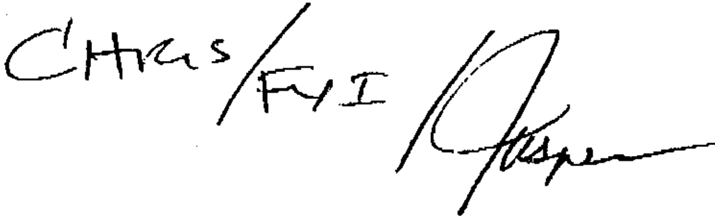

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THE UPSTART GUIDE TO

Buying, Valuing, and Selling Your Business

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DEARBORN™
A Kaplan Professional Company

Glossary

ability to pay valuation method This is an interesting method that serves as a reality check on the other valuation results. The practical "ceiling" on the price of the typical small business is dependent on the company's ability to pay the owner a salary, provide a return on the owner's down payment and working capital investments, and finally service the debt associated with the purchase on credit.

absentee or semiabsentee ownership If a business can be run near capacity and optimal profitability without the owner present (absentee-run), its value is significantly increased. From a standard valuation point of view, multiples are higher or capitalization/discount rates are lower for such a business. Most small businesses are valued based on the cash flow accruing to a single, active owner.

acceleration clause An important provision in a promissory note that gives the seller (lender) the right to declare the entire amount immediately due and payable upon violation of a loan provision, such as late payments. In each case, default should be clearly defined to prevent misunderstandings.

accounts payable (A/P) Balances owed to creditors on open account for the purchases of goods and services. As concerns the purchase of a business via an asset sale, the buyer should expect all A/P to be paid in full at or before closing. Under a stock purchase, unless otherwise agreed, all liabilities pass to the new owner. This requires careful review on the part of the purchaser for what these amounts are and the maximum amounts to be assumed by purchaser should be mutually agreed on before closing with any debts beyond these discussed and agreed to being paid from cash balances set aside from the purchaser's down payment. All such assumed liabilities should be listed and attached to the purchase contract per addendum or attachment. Buyers may request a formal "set-aside" account be established with the escrow company to satisfy any unknown or undisclosed payables that surface subsequent to the closing.

accounts receivable (A/R) Amounts owed to a business for product or services sold on account. Under an asset sale of a business, A/R will typically belong to the seller. Under stock purchases, ownership of the receivables passes to the new owner and should be carefully considered in terms of the actual final purchase price. The purchaser should ask to see an "aging schedule" of A/R, indicating amounts owing and the age of the accounts (e.g., 0–30 days, 30–60 days). Also investigate historical write-offs of bad debt, specifically noting if there are any significant current problems. It is possible to overstate net income by failing to formally recognize bad debt expenses.

accrual basis A method of accounting (as opposed to cash basis) whereby revenues and expenses are recognized as they are earned, regardless of when cash is received or spent. There may also be different procedures used for book as opposed to tax purposes. When evaluating the cash flow of a target business, adjustments must be made to account for accrual based entries (e.g., sales made on credit).

adjusted cash flow (ACF) This important concept underlies much of the business valuation process. It represents the actual cash benefits (before income taxes) accruing to a single owner-operator and is calculated by adding non-cash expenses, such as depreciation and amortization; personal or discretionary expenses, such as travel, entertainment, and personal automobile expenses; interest expense and one-time or nonrecurring expenses such as start-up advertising campaigns to the net income for the period. Depreciation is added back because it represents a non-cash expense and interest is added back to arrive at a cash flow figure available to a new owner to do with as he or she pleases (e.g., salary, debt service, and a return on investment).

agency The legal relationship between a principal and an agent arising from a contract (e.g., listing contract) in which the principal hires the agent to perform certain duties on his or her behalf. Brokers and their agents may represent the seller, the buyer (buyer broker), or both (dual agency). Agency must be disclosed to all parties in a timely fashion.

amortization The periodic write-off of costs associated with the acquisition of intangible assets, such as patents, goodwill, and organization expenses. For tax purposes, all intangible assets must currently be amortized over 15 years. Amortization expense is a type of non-cash expense that is added to net income in determining the annual cash flow (ACF) of a business.

asset sale One of two general choices faced by buyers and sellers in the sale of a business (see stock sale for the other alternative). There are advantages and disadvantages to buyer and seller with each option. Consult your broker, CPA, or tax attorney for a thorough analysis. Most sales of small businesses are asset sales. The advantages to the buyer are significant. First, by purchasing the assets, all equipment and fixtures may be fully "redepreciated," allowing a significant tax benefit. Secondly, an asset purchase does not carry the same "baggage" as a purchase of stock. A stock purchase brings all liabilities (known and unknown!) to the new owner. There are possible benefits to a stock sale as well, such as a speedier closing process, that should be considered.

assignment of lease A critical buyer contingency for businesses with a property lease. Most offers to purchase such a business are subject to the satisfactory assignment/transfer of the existing lease.

assumption of liability A common occurrence in the purchase of a business. Typical assumptions relate to equipment leases, credit card processing arrangements, and several types of bank loans, all of which can be considered part of the purchase price.

backup contract A contract to buy a business that becomes effective if a prior contract falls through. A seller's best interest is served by allowing backup offers, but the buyer with the first contract will often request that the seller accept no further offers until the first deal is completed or aborted (the buyer does not want the seller to continue searching for a more favorable deal).

better business bureau (BBB) A useful due diligence tool, the BBB is a system of more than 200 independent offices serving their respective communities in resolving disputes and building trust for more than 100 years.

bill of sale A written instrument given at closing to pass title of personal property from a seller to a buyer. Related closing documents include a promissory note, UCC-1 financing statement, and chattel security agreement. The escrow company will hold on to the original bill of sale until the promissory note is paid in full.

binder As concerns insurance, this is a contract for temporary insurance coverage. When purchasing a business, you should attempt to ensure constant coverage for both property and liability, and obtain a binder receipt as evidence of an application to extend the existing coverage of the seller.

books and records clause An important contingency placed into purchase offers, it allows the buyer ample opportunity to review the books, records, and operations of a company before placing money at risk.

book value This has two primary applications. Concerning a business, the book value is the difference between total assets (net of depreciation, amortization) and total liabilities as they appear on the balance sheet. This is the same thing as net worth and owner's equity. Concerning specific assets, book value is the original cost (capitalized value) less accumulated depreciation and amortization as it appears on the balance sheet.

capitalization Refers to the process whereby income or cash flow is converted to a value. An income stream can be capitalized into a numerical dollar value. For example, an expected "stream" of $100,000 for five years, discounted with a 12 percent capitalization rate (cap rate) yields a value of $404,410.

cash business When a business is described to a buyer as a cash business, the primary implication is that this business completes a great deal of its transactions for payment in cash, as opposed to checks or credit cards.

certified funds Bank certified monies, required by escrow company for closing process and transfer of business ownership interest. Out-of-state funds require extra time for processing and can unnecessarily delay the closing.

closing Technically, the act of transferring ownership of a business from seller to buyer in accordance with a purchase agreement. After all contingencies relating to the contract (e.g., books and records review, lease assignment) are removed, escrow is opened and an earnest deposit is made. Unless the closing occurs at an attorney's office, it will normally occur at the offices of a qualified escrow company (specializing in business closings as opposed to real property closings). The escrow company will typically prepare all closing-related paperwork (closing documents), including the bill of sale, promissory note, chattel security agreement, bulk sales waiver, broker disclaimer, closing statement, etc., at the same time it is conducting a thorough review of the public records for any existing liens, attachments, judgments, or other encumbrances affecting the ownership of the business and its assets.

compiled statements These are commonly used by smaller "mom and pop" businesses. Essentially, they are compilations of account balances calculated based on information supplied to the CPA by the firm. They are not audited or reviewed and

lack any assurances from the CPA as to their fairness, or conformity with GAAP. Remember, garbage-in, garbage-out. Caveat emptor!

contingencies These are events that must or must not occur before a certain time. Offers written to purchase a business almost always are contingent on the occurrence/nonoccurrence of certain events. If an offer is accepted by the seller, so are the contingencies contained therein. Once there is this agreement on price and terms, contingencies must be removed. There can be both buyer and seller contingencies, with buyers typically including several in their offer.

contingent liability Pending litigation, disputed customer claims, court decisions under appeal, or any other negative event representing possible future financial liability. Purchasers should ask the seller to comment on any such contingent liabilities (seller's disclosure form) and warrant that they either do not exist or have been properly disclosed and/or addressed.

cross-default clause This clause is a condition of sale that ties default on the property lease with default on the seller's carry-back note. In other words, if the new owner defaults on property lease payments, the note to the seller is considered in default and subject to payment in full (acceleration clause). Importantly, this clause may also state that default on the note to the seller will be considered as a default on the property lease, allowing quicker reentry into the business by the seller. This clause protects the seller's interest in the business, which would be severely damaged if the new owner defaulted on the lease and was evicted. The seller should also try to work out a separate arrangement with the landlord to facilitate reentry if the need arises (reassignment of lease clause).

distress sales Businesses that are experiencing financial difficulties (illiquidity and insolvency) and are in or near bankruptcy. Favorable terms can be secured for these turnaround opportunities. Local auctioneers, bankruptcy attorneys, credits rating agencies, and the local public records are all excellent sources of prospective acquisition. Extra care during due diligence is required.

due diligence This term represents all the steps taken by the prospective purchaser of a business to verify that the information presented by the seller is accurate and that the purchaser is fully convinced of his or her choice. Due diligence is completed when contingencies are removed and the purchaser is ready to open escrow and schedule closing. In addition to hiring an accountant, consider calling the better business bureau for an inexpensive look at the company's public record and Dun & Bradstreet for a minimal cost look at its financial history.

earnest money deposit This is a deposit of funds by a purchaser that serves as evidence of the buyer's serious intentions. In many cases, this earnest check will be held by the business broker, uncashed, until all contingencies are removed, and then placed into an escrow account (escrow is opened). The escrow check will normally be at risk only after escrow is opened.

earn-out clause This creative financing option can resuscitate a deal and lead to closing. The premise is to tie the final payments made to the seller to the actual future performance of the business subsequent to closing. They can give the buyer courage to take on a dying or damaged business while allowing the seller to potentially receive top dollar upon sale. Exact details and possibilities

are limited only by the imagination. The payments can be based on sales (dollars or units), net income, or ACF.

employer identification number Every new business and most businesses changing hands need to obtain this number, which is used by the IRS to identify taxpayers. Call 800-829-1040 or your local IRS office for the proper forms and instructions. Many IRS forms are also available by fax at 703-487-4160 or through the World Wide Web at http://www.irs.ustreas.gov or at its previous online service at 703-321-8020.

evergreen clause This is another clause that protects the seller's remaining interest in the business after sale on terms. This clause requires the new owner to maintain inventory (can also address equipment) at or above a certain threshold or default on the note will occur. This condition of sale is intended to prevent the new owner from liquidating inventory to the point of damaging the long run stability of the business. If a business is sold on terms with a low down payment, the seller should seek to prevent the possibility of the new owner liquidating the inventory, equipment, and fixtures for amounts more than the original down payment and destroying the business.

fair market value The amount at which a business would change hands between a willing buyer and seller when both sides are acting with reasonable knowledge and a lack of excessive compulsion. What a willing buyer will pay a willing seller under normal conditions.

full disclosure This concept applies equally for the sale of a publicly traded security and a privately held company. All licensed business brokers, for example, are legally mandated to disclose all material facts and treat all parties fairly, regardless of their particular agency allegiance. This full disclosure applies to physical, financial, and economic conditions relating to the subject business. See the sample seller's disclosure form (in Chapter 4) for precise inquiries to make.

generally accepted accounting principles (GAAP) Generally accepted accounting principles are the backbone of financial statements. The value of these principles lies in the resulting ability of users to accurately and consistently compare one firm's financial performance with another firm's performance over time. Financial statements prepared for most small businesses are compiled (as opposed to audited) and are not prepared in full accordance with GAAP.

gold card visa Officially known as employment creation visas, foreign residents may obtain permanent residency by maintaining certain investment and employment levels in U.S. firms. Generally, an amount of $1 million must be invested and ten jobs created or maintained. Numerous specific requirements and exemptions exist, so attorney assistance is mandatory.

goodwill Technically, goodwill represents the dollar amount paid for a business that exceeds the market value of the assets. A business purchased for $200,000 with only $120,000 of "hard," tangible assets (machinery, fixtures, inventory) contains $80,000 of goodwill. This basically means that the business, complete with customers, suppliers, and procedures, is worth more than simply the value of the assets.

indemnification A type of representation or warranty made by buyer or seller in a purchase agreement signed by both parties. Basically, an indemnification serves

to protect the buyer or seller from clearly specified liabilities, known or unknown. In the purchase/sale of a business, both the buyer and seller will indemnify the other party to one extent or another (cross-indemnification). For example, sellers will typically indemnify buyers against any unknown or contingent liabilities and the buyers will indemnify the sellers against future claims, made by lenders, other creditors, or shareholders.

intellectual property Intangible assets that must be protected through proper application and filing with state and federal agencies. Intellectual property includes trademarks, service marks, patents, and copyrights, and are considered intangible assets. Continued protection of a newly acquired trade name is critical.

inventory The most important asset for retail businesses (percent of total assets) and a significant asset for manufacturing businesses. When evaluating a business for purchase, important investigations include:

- How much of the inventory is unsalable, obsolete, or damaged? Pay only for salable goods.
- Has the owner paid suppliers on a timely basis? Ask directly and check Dun & Bradstreet.
- Is the bulk sales law applicable (requires certified letters to all creditors from prior two years)? Do parties agree to waive bulk sales law? Consult your attorney.

letter of intent An instrument for purchasing a business whereby the prospect states an interest in furthering discussions and negotiations without being legally bound to do so. It is an expression of desire to enter into an agreement without actually doing so, and is a weaker expression of interest than a standard offer to purchase.

lien search The escrow company or attorney will conduct an independent search of municipal, state, and federal recorded judgments, liens, attachments, or other encumbrances affecting the business being sold. If any are found, they should be satisfactorily addressed before the closing can occur. The seller is generally warranting that the business is being sold free and clear of any liens, attachments, or encumbrances.

liquidation value Cash value received as a result of a forced sale of assets, typically as a business is closing down. Liquidation values of assets can be as low as 5 to 10 percent of original cost. A seller of a business is almost always better off selling the whole of his or her operation at what seems like an unfavorable price as opposed to waiting too long and receiving only a liquidated value for the assets.

listing agreement or contract This is the formal agreement between the seller and a business broker regarding the marketing and sale of a business. It must contain an asking price, terms (if any), commission amount, and beginning and ending dates. There are four general types of listing contracts: sole and exclusive, exclusive agency, agency, and one-party. Brokers will prefer a sole and exclusive listing, which gives them the right to collect a commission regardless of who locates the buyer, whereas the seller may prefer an agency listing, which

allows them the right to locate a buyer either on their own or with the assistance of another broker without obligation of commission.

market basket approach to valuation If you seek to obtain an accurate estimate of a company's current fair market value, consider valuing the business using a collection of valuation methods (three or four different methods) and averaging their results. This approach is surprisingly accurate in most circumstances.

misrepresentation A buyer's worst nightmare. This is the making of untrue statements, either deliberate or unintentional. If there is misrepresentation of a material fact, the injured party can sue for damages or seek recision of the contract. Generally, buyers should take all necessary and precautionary steps to independently verify any claims.

net present value (NPV) The core of modern financial theory, this concept holds that the attractiveness of any investment (including into a business) is measured by the net present value associated with the relevant cash outflows and inflows. The DCF technique for valuing businesses is growing in popularity.

noncompete agreement Also referred to as covenant not to compete, this clause is a legal promise by the seller not to compete with the purchaser for a certain number of years in a certain geographical area in a certain service or product line. It must be reasonable in order to be enforceable.

no-shop clause An agreement between buyer and seller in either a letter of intent or formal purchase offer that restricts the seller's marketing efforts after signatures are obtained from both sides. This clause prohibits the seller, to varying degrees, from soliciting or engaging in negotiations or other communications with other potential buyers for a stipulated period of time, typically ranging from one to four months.

promissory note A written instrument signed by a creditor (purchaser of a business) acknowledging a debt and a promise to pay. Promissory notes may be signed individually or by a corporation, but most sellers will require the note to be personally guaranteed. Regarding the sale of a business (personal property), promissory notes will be secured by the assets of the subject business through an executed chattel security agreement, with a corresponding UCC-1 financing statement recorded at the appropriate local and state agencies.

right of first refusal The right, but not obligation, of a party to match the price and terms of a proposed sale of a business before the contract is executed. Oftentimes a contract will be signed between purchaser and seller allowing the business to continue to be shown to other interested parties during the due diligence period. Until all contingencies are removed, escrow is opened, and the deal closed, an outside party could come forth and offer to close the sale at a better price. Under these conditions, the original purchaser could ask for a right of first refusal against forthcoming offers.

right of offset (aka holdback or set-aside) This contractual clause leads to an agreed on amount of the buyer's down payment being placed into an escrow account (preferably interest-bearing) at closing, to be disbursed on certain events occurring, such as the discovery of overlooked or intentionally ignored liabilities of the seller. The undefinable risk to the seller is that the buyer can concoct reasons for tapping these funds that may or may not be legitimate.

rules of thumb A collection of formulas utilized to value both small, privately held and larger, publicly traded businesses. They are based on annual or monthly sales, adjusted cash flow, net income, earnings before interest and taxes, asset values, number of accounts, or any combination thereof. Purists reject the usefulness of rules of thumb, but they must be properly understood. Their usefulness revolves around decades-long development based on historical sales of similar businesses.

Schilt's risk premiums Sound procedure (empirically proven) for establishing discount and capitalization rates used to value small businesses. These risk premiums range from 6 to 30 percent and are added to a risk-free discount rate of approximately 7 to 8 percent (includes inflation premium).

Section 179 expense This IRS provision allows business owners to expense up to $25,000 of business personal property, rather than capitalizing and depreciating the assets over their useful lives. From a due diligence perspective, this means that a company might have thousands of dollars worth of equipment that has been expensed and therefore excluded from the balance sheet.

seller's disclosure form or statement Important document utilized by the buyer to obtain pertinent, material information about the business (personal property) and/or the building (real property). There should be separate disclosure forms for both the business and for the real property.

SIC (Standard Industrial Classification) Codes General SIC Codes are provided for each sector of our economy in an attempt to categorize the many sections of our economic system. Numerous invaluable sources of data are categorized, presented, and analyzed by SIC Code, including financial statement ratio analysis (e.g., Robert Morris Associates).

skimming This controversial behavior involves underreporting of income by small business owners. There is great incentive to underreport sales for the purpose of minimizing income tax payments. Most buyers find it difficult to give credit to the seller for unreported sales. In some types of businesses, skimming is the rule rather than the exception. Buyers may conduct a visual audit, with the seller's permission, to help verify the claimed amount of sales, or actually watch the seller account for the sales of the day.

start-up business One of two general choices facing an individual seeking to be a self-employed business owner. As opposed to purchasing an ongoing business, a start-up operation might require less up-front financial outlays. However, buying an existing business offers a proven product and a proven location with customers and cash flow.

stock sale As opposed to an asset sale, a stock sale involves the purchase and transfer of ownership through shares of common stock. A stock sale generally provides more benefits to the seller than the buyer. The actual outcome depends on the type of corporation utilized by the owner, "C" or "S." There are significant differences between the two. Again, you need to consult a CPA or tax professional for current interpretations. For a C corporation, gains on asset sales will be taxed twice, once at the corporate rate and again at the shareholder (individual) rate. Also, there are currently (as of 1993) significant tax benefits to stock sales of small C corporations (up to 50 percent of the gain excluded from taxation, if stock was held for at least five years). A buyer might want to purchase the stock of a company because

it can be procedurally quicker, given that the buyer is agreeing to assume all liabilities, whatever they are.

Subchapter S Corporation A popular type of incorporation chosen by small business owners. Besides the general benefits of incorporating, such as limited liability for shareholders, there are favorable tax implications. Specifically, income is taxed only once as direct income to the shareholders, avoiding the double taxation that occurs for C corporations (corporate profits are taxed and then dividend distributions from after-tax profits are taxed again as ordinary income to shareholders). A limited liability company (LLC) enjoys the same pass-through benefits, but is less restrictive on the number and type of shareholders.

training agreement Most business sales include a provision regarding training to be received by the buyer from the seller, typically included as part of the purchase price. This provision can be brief and general or substantial and detailed. The basic components of a training agreement include areas and length of training and additional compensation to seller (if any).

Uniform Commercial Code (UCC) A group of laws adopted by most states in an effort to standardize state laws dealing with commercial transactions. UCC laws are relevant for chattel security agreements, promissory notes, and bulk transfers. Particularly relevant to the sale of businesses is the bulk sales law, which serves to protect the unsecured creditors of the business being sold.

valuation methods Wide-ranging tools utilized by professionals to establish the value of going concerns. The type of method utilized depends on the size and type of the business and the sophistication of the preparer and the audience. They are generally asset-based, cash flow–based, or some combination of the two.

venture capital A form of investment that entails sacrificing ownership and control in exchange for cash that may or may not be returned to the investors. It basically provides capital and expertise in exchange for an equity stake. The common forms of financing include preferred stock, convertible bonds, or warrants. Consult *Pratt's Guide to Venture Capital Sources*.

warranties and representations Multifaceted statements, claims, and inferences that are binding components of legal contracts, particularly for purchase contracts. Both sides (buyers and sellers) make a number of such claims. Examples include statements regarding the buyer's ability to consummate the deal and the seller's ability to substantiate claims related to earnings and asset values. Warranties tend to be based on current or future facts while representations tend to be apply only to existing facts.

working capital This area of investment is often overlooked and even subconsciously ignored. After the close of escrow, working capital is needed to support the daily operation of the business, including payroll obligations, inventory purchases, utilities, and other necessary expenditures. Some businesses will immediately generate sufficient cash flow to sustain these commitments, but most will not (particularly if the business is providing credit and growing).