INSIDE Entrepreneurship BY SUSAN SCHRETER

"Investing without research is like playing stud poker and never looking at the cards." *Peter Lynch*

What Documents to Look at Before Buying a Business

It is often said that investing in companies is more of an art than a science. Yes, I agree there are a number of qualitative factors that can make a mediocre opportunity a winning opportunity. But more often than not, most mediocre business opportunities remain mediocre opportunities – essentially not worth the small business investor's time and money.

The good news is most potential poor performers can be identified by looking closely at the company's historical operating record, its plans for growth, and the skills of the management team before buying the company. Nasty surprises can be minimized by looking at documents and financial statements for signs of undisclosed liabilities, inconsistencies, side-deals and other factors that may undermine your ability ***to make a profit from your investment.***

Too often business buyers jump to purchase the first company that comes their way. They "fall in love" too fast only to find out that the business they married into just isn't so attractive. And like all marriages, it takes lawyers and money to unwind bad deals. So take it slow and date lots of companies before taking the entrepreneurial plunge.

Here's one final point. During my early days in investment banking and buy out investing, I performed due diligence on acquisition projects for a wide range of manufacturing and technology companies. My work reflected the mindset of all professional investors. The purpose of effective due diligence is to identify reasons NOT to invest, rather than simply confirm reasons to invest.

The following due diligence list is a very general summary of the types of documents that can help buyers assess business acquisition and investment opportunities. While you can ask and receive documents, someone still has to review the information with care and thoughtful consideration. Transaction lawyers, accountants, intellectual property attorneys and industry experts can help you but it is unwise to rely on them to do all the work. Skip over any items that are not directly relevant to your specific investment opportunity.

Buy and Build with Confidence,

With best regards,

Susan Schreter
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General Information Requests

1. Copies of the financial statement and budget or forecasts.

   [Go back as far as you can. The more you know about the target company's prior performance, and the factors that lead to a good year or a bad year, the better you will be able to assess company value. Seek at least 1 year projections from owners who no longer will run the company; 3 year projections from managers who will remain with the company post acquisition.]

2. Copies of all monthly and/or quarterly reports prepared by management including financial statements, budget to actual analyses, etc., if any.

3. Copies of the Company's trial balance and access to the general ledgers.

   [Ugh!! Accounting systems! I know this may sound tedious, but looking at a company's accounting systems will give you a clue to how much you can rely on the accuracy of the company's books and records. If your purchase price depends on the company's records (total assets, etc.), you have an incentive to make sure the numbers are accurate.]

4. Copies of any recent accountant's management letters or outside consultants' reports.

   [If the target company is audited, this will really tell you how reliable the company's books and recordkeeping are. Plus if you intend to keep all employees in place, this information will tell you something about the caliber of staff within the controller's office.]

5. A listing of transactions (including but not limited to rent payments, loans and advances, etc.) with related parties that describe the nature and amount of each transaction. Details of any loans to employees, service or financing arrangements with current or former employees or directors

   [A related party transaction involves key officers, directors or owners. Look closely for the value of any services billed by one related party to your target company. Are you contractually obligated to continue these agreements, especially if they exceed market value? Look closely.]

6. Copies of the monthly or quarterly management information reporting packages which highlight quantitative as well as qualitative operational results, order fulfillment, backlog (open order) status, quality of production, efficiency, etc.

   [Wouldn't it be nice to learn about a company's operating strengths and weaknesses before you buy outright? Operations reports help buyers determine the things that need attention after purchase. Also look at the backlog reports. Are they accurate or overstated? Have customers since rescinded their purchase orders? Check it out. Call several of the accounts to determine real customer expectations.]

7. Copy of the corporate structure and organization chart.

   [Get to know the people who may be working for you.]

8. Copies of any employment, non-compete, special compensation agreements etc with employees or management.

   [Pay attention. You don't want to inherit problems and pay the cost of unwinding expensive agreements after purchase.]

9. Copies of key insurance policies covering the company and officers.

   [Will the company continue to pay these benefits after purchase? Are the benefits reasonable?]

10. Description of (i) significant and/or unusual accounting practices, (ii) accounts that involve a significant amount of management judgment (e.g., allowance for doubtful accounts, reserves for warranty costs and inventory reserves, etc.), (iii) any changes in accounting policies, procedures and practices, (iv) nature and extent of year-end closing adjustments, (v) unusual or non-recurring items of income or expense, (vi) transactions representing "soft" income/losses or income generated from outside normal operations, (vii) transactions with affiliates, (viii) acquisition or divestitures during the historical period, and (ix) changes in business strategies, policies, procedures or practices.

11. A listing of and access to all agreements involving the borrowing of money or extension of credit and a schedule of amounts outstanding.

    [Make sure the company understands you want to know about all debt, all contingent liabilities, and all leases -- basically anything with a short-term or long-term promise to pay.]

12. Description of all agreements or understandings with regard to intercompany indebtedness, intercompany management fees and pricing between affiliates and related parties.

    [This is useful information if you are buying a parent company with subsidiary operations or joint venture operations.]

13. All security agreements, trust indentures, mortgages, deeds of trust, guarantees, installment purchase agreements, finance leases, letters of credit and contingent obligations as to which the company or any of its subsidiaries may be liable in whole or in part.

    [Most of this won't apply to every day business acquisitions, but ask anyway. Let the company tell you if a request does not apply rather than you assuming there isn't an esoteric issue out there for you to uncover post-closing.]

14. Schedule of outstanding bank letters of credit.

15. A listing of and access to all joint venture agreements, if any.

    [Does the company have any technology development agreements, sales agreements, partnerships or other deals that can help you learn something about the company's current and future business prospects?]

16. A listing of and access to all acquisition or disposition agreements entered into in the last three years.

    [Ok, now we are getting into really tedious stuff, but if there was a big buy or sale, or promises to buy or sell something, take the time to read through the docs. It may be straightforward and a "non-event" but every once and awhile you will find odd undisclosed obligations buried in the most unusual places.]

17. A listing of and access to all employee non-compete restrictions, and any buy-sell agreements.

18. A listing of and access to written agreements and summaries of unwritten arrangements or understandings entered into by the company. Examples of the type of agreements include:

    a. any customer agreements or contracts
    b. agreements of indemnification;
    c. consulting, management (20 largest clients) or other service contracts;
    d. agreements with respect to shared facilities and functions; and
    e. purchase and supply contracts
    f. sales rep agreements

    [Are all customer relationships profitable?]

19. A summary of all customer contracts detailing the governmental agency, product line, type of contract and current status (i.e. funded and unfunded backlog and backorder) and current status of these contracts.

20. A listing of and access to any other agreements relating to competition, licensing, royalties, territorial arrangements, distributorships or franchises to which the company or any subsidiary is a party.

21. Information regarding the nature of any significant contracts and agreements not previously identified.

22. Trademarks, patents, copyrights and domain registrations.

Markets and Competition

1. General industry description-Size and trends

2. Forecasts for industry growth (product line forecasts if available)

3. Pricing policy of company vs. major competitors

4. Provide details (signed agreements) of any significant joint ventures/alliances and major relationships with customers

5. List of major competitors by product line

6. Any internally or externally generated reports regarding competitors

7. Externally generated industry reports or market studies

    [Much of this information can be provided by the target company management. Take the time to confirm the accuracy of information given. Look to the Web for help. It is not uncommon for owners to present a short list of competitor names, leaving out more threatening competitors.]

Sales and Marketing

1. Provide historical budgets and marketing plans for the past 2 years

2. Describe your compensation structure for sales and marketing personnel.

3. Copies of standard sales agreements/contracts and rep group agreements

4. Unit and $ volume by sales rep group for the last 2 years

5. Unit and $ volume and margins for top 20 customers for the last 5 years.

6. What percentage of the sales is repeat versus one-time?

7. Provide contacts names for top 10 customers.

8. Provide an accounts receivable ("AR") aging for the past 2 years

9. Document customer credit and collection policy procedures. Review bad debt reports and details of recent write offs.

Manufacturing/Suppliers/Vendors

1. Provide a "product roadmap." List major product introductions over the past five years with revenue for each line. Provide an expected timeline for upcoming new product introductions with revenue projections for each major product.

2. List your top five vendors by dollar and unit volume for last 3 years.

3. Data for each major vendor including description and status of relationship.

7. Provide an accounts payable ("AP") aging for the past 2 years.

8. Discuss capacity of existing internal facilities and major vendors vs. current output

9. Provide copies of significant contracts, if any, with vendors. Include terms of purchase/any impact from currency fluctuations, if applicable.

Other

[The following documents primarily relate to an analysis of risk. Tax information becomes especially important if the buyer is completing an acquisition on a stock, rather than asset basis.]

1. Provide information regarding insurance coverage.

2. Copies of all material correspondence, if any, with the Equal Employment Opportunity Commission; ratings for unemployment and workman's compensation; and all state, local and foreign authorities with which the target company has filed for approval to transact or conduct their respective businesses. Provide copies of all tax returns for prior 7 years, including payroll taxes.

3. Provide your current personnel or company manual.

4. Provide demographic data of the workforce (e.g. average years employed, average salary, employee turnover, benefits as a percentage of total payroll costs, percentage with union membership). Description of the company's bonus plan and/or profit-sharing. Include amounts actually paid in recent years.

5. Provide information regarding stock option, bonus and similar plans, employment agreements, not previously provided and deferred compensation and similar arrangements.

6. Provide information regarding the potential exposure for tax penalties.

7. Provide information regarding the existence of tax records for items such as travel and entertainment and business meals. Provide information regarding property used for personal purposes, if any, such as automobiles.

8. Provide information regarding any other significant transactions during the last two years, such as any restructurings, reorganizations, redemptions, acquisitions, dispositions, property distributions, refinancing, debt discharges, joint ventures, and intercompany transactions.

9. Provide information regarding any policies and significant matters relating to intercompany pricing and the reallocation of income and expenses between related entities.

10. Provide copies of all benefit plans, collective bargaining agreements, pension and 401K plans.

Facilities

1. Provide lease terms for all locations (operating vs. capital lease, length of lease, etc.).

2. Indicate any significant outstanding maintenance agreements or if such is included under lease terms.

3. Provide inventory and site location of all data processing equipment, indicating for each whether owned or leased, with lease terms, if significant.

4. Title insurance and other documentary evidence of title to the real properties of the company or any subsidiary

5. Describe provisions for disaster recovery or contingency planning.

Information systems

1. A listing of system software, operating systems and an understanding of how they support the Company's business processes.

2. A listing of hardware and telecommunications topology and an understanding of how they support the Company's business processes.

3. Information regarding the nature of any contemplated hardware and software applications enhancements, including the potential cost and nature of expected benefits.

4. Identify level of outside resources utilized for the development and/or programming of systems over the last three years. What is planned?

1. Provide a copy of the information system contingency plan.

Operating results

[Your job in looking at current and historical statements is to determine if the financial statements make sense. Do they? For example, have you seen documents regarding equipment leases that don't seem to be "booked" or reflected on the company's financial statements? Look closely at inventory. Is there a ready market for the inventory? Is it dated or worn? When was the last time the company really counted its inventory…..were other independent accountants observing the count? Ask questions to find out answers before you buy.]

Income Statement

1. Information on (i) sales, marketing and distribution strategies, (ii) sales terms, (iii) strategy for setting prices, (iv) critical factors affecting sales prices, including actual or anticipated changes in material costs, order or lot size, and product class, (v) profitability analysis of significant orders (filled).

2. A schedule setting forth the individual components of cost of sales (cost of equipment, freight, labor, etc.), segregated by division and between fixed and variable for the historical period, with explanations for significant or unusual items or trends.

3. A reconciliation of gross revenues to net revenues detailing discounts, claims and allowances (by reason), rebates, and other deductions during the most recent year. Highlight if there are concentrations of claims within key customer accounts.

Operating expenses

1 Provide a schedule setting forth the individual components of operating expenses (salaries, wages and benefits, and general and administrative), segregated by division/department if applicable.

2. Detail analysis of freight revenue and freight in/out costs for each historical period broken out by customer and product line.

3. Provide a schedule of full-time equivalent headcount analysis classified by location by division and by function (i.e. sales personnel, sales managers, corporate staff – administrative, finance, etc.), and the related payroll costs (salaries, overtime, commissions and bonuses) and related benefit costs (employer payroll taxes, workers' compensation, life insurance, healthcare insurance, dental insurance, meals and entertainment, car allowances and training) during the historical period reconciled to the appropriate general ledger expense line items.

4. Provide a schedule of recent advertising costs. Discuss impact of advertising and promotions on revenue generation.

Balance sheet

1. Cash and cash equivalents/cash management. List bank accounts and relevant banking information.

2. Accounts receivable

   a. Provide information regarding the company's credit and collection policies and cut-off procedures.

   b. Access to the aged accounts receivable trial balance as of the historical balance sheet dates with reconciliation to the general ledger. Provide information regarding the company's process of compiling the accounts receivable aging (i.e. invoice or due-date basis).

   c. Provide information regarding the collectibality of significant accounts receivable.

3. Inventory

   a. Information regarding the company's purchasing, delivery, stocking, physical control and counting, valuation procedures and standard cost accounting conventions.

   b. A schedule of inventory by product line and SKU (stock keeping units)

   c. A schedule of excess, slow moving, and recent lower of cost-or-market inventory write-offs. Provide information regarding the company's process for (i) reviewing inventory for obsolete or slow-moving items, (ii) reserving for such items and (iii) the write-off of such items.

   d. A summary of significant inventory purchase commitments, security arrangements with suppliers, and consigned inventories and copies of related agreements.

   e. Information regarding the existence and amounts of inventory at locations other than company owned or leased facilities (i.e., outside warehouses on consignment, in transit, etc.).

4. Property and equipment

   a. Provide information regarding the company's policies and procedures for capitalization and depreciation / amortization with respect to property and equipment, repairs and maintenance expenses, re-tooling costs, start-up costs and research and development expenses.

   b. A roll forward (beginning balance, additions, disposals, transfers, ending balance) of the company's property, plant and equipment, by major classification (e.g. land, buildings and improvements and machinery and equipment), and accumulated depreciation.

   c. A schedule of significant retirements and/or abandonment of property and equipment during the historical period and any planned.

   d. A schedule of property and equipment additions planned for the upcoming year.

   e. A summary of lease agreements and a schedule of future lease commitments. (if not already provided as part of debt review).

5. Accounts payable and accrued expenses

   a. A schedule of principal accounts comprising accrued expenses at the historical balance sheet dates including (i) salaries and wages, (ii) vacation pay, (iii) restructuring, (iv) taxes other than income, (v) customer rebates, (vi) professional fees, etc. Provide information regarding explanations for significant fluctuations.

   b. Provide information regarding the company's accounts payable terms, payment practices and cut-off procedures.

   d. The accounts payable aged trial balance as of the historical balance sheet dates with a reconciliation to the general ledger.

   e. A summary of days purchases outstanding in accounts payable during the historical period and information as to significant fluctuations.

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Thank you.