Title: Buying Basics – Due Diligence
By: Matt Manske

Unlike buying a house or a car, buying a business is a process of determining the true value of the business while uncovering any issues that may enhance or detract from the future operation of the business. The process of analyzing the business prior to the purchase is referred to as "due diligence" and the time period for performing these actions is referred to as the "due diligence period."

The purchase of a business takes the cooperation of several parties including a lender, an appraiser, an attorney, an accountant, and a consultant. The lender is needed to underwrite and finance the transaction. The appraiser is hired by the lender to determine the real estate value. The attorney is needed to prepare and review the purchase agreement, bill of sale for the business and deeds for the property. An accountant is needed for reviewing the tax implications of the transaction. And the consultant, facilitates due diligence, negotiates transaction and financing terms, maintains open communication lines with all parties and helps ensure all required documents are communicated to facilitate a timely closing.

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In business transactions, the due diligence process varies depending on the type of business being evaluated. Common areas of concern include financial operations, business operations, personnel, marketing, property and equipment. Other areas of concern include legal and tax matters, insurance coverage, review of outstanding debt, employee benefits, labor costs and availability.

In reviewing the financial operations, the buyer will examine the financial records and accounting methods to determine the company's historical cash flows, receivables will be analyzed to determine collectability, payables and debt will be reviewed to determine the quality of vendor and lender relationships and product pricing and service mix will be reviewed to determine consistency with industry norms. Note that the quality of recordkeeping practiced by the target business usually goes a long way in giving the buyer a feel for the quality of the target business.

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The personnel of the target business will be reviewed to determine the necessity and pay level of each employee. In small business acquisitions, most employees are rehired at the same pay rate as long as their services are necessary to business operations. Any employees that are not essential to operations are normally not rehired and their pay and benefits are added back to the expected cash flow of the business.

Property and equipment owned by the target business will be reviewed to determine the useful life and appropriate fair value of each. Appraisals are conducted and the values will be used in the allocation of the purchase price to establish the depreciable values of the assets and equipment. Leases, rental agreements and property deeds are also reviewed.

Business operations are reviewed to assess the location, inventory, vendors, management, customer relations, insurance policies and any other items specific to the industry of the target business. The main point is to question each item to see where improvements can be made. Is the business located in the right market area, is inventory adequate, are vendors providing quality goods at reasonable prices, has management run operations effectively, are customers satisfied with the services provided and are insurance policies adequately protecting the company from liabilities.

Marketing practices, advertising campaigns and public relations programs are reviewed to determine the effectiveness of each. Is the company using an appropriate marketing and sales strategy? How does the competition market their business and products? Could any of these practices be enhanced or changed to produce a better return on investment.

When commercial real estate is involved in a purchase, environmental due diligence refers to site assessments performed to uncover any potential liabilities associated with the property. These assessments are called Phase One and Phase Two Environmental Reports. A Phase One is almost always ordered by the lender for commercial real estate transactions. A Phase Two is not normally required unless a potential liability issue is uncovered by the Phase One.

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