National Tooling & Machining Association

NTMA

PRECISION

Business Management Advisory

For Precision Custom Manufacturers

PL12 **File: PLANNING**

BUYING A BUSINESS

SUMMARY

This BMA is intended to serve as a general outline of the major problems and considerations that typically are involved in the purchase of a business. Of course, every potential buying or selling company and every transfer process have their peculiar aspects, both legal and non-legal. And every state has different laws affecting the mechanics of a transaction as well as the rights and liabilities arising from it. Member companies are cautioned, therefore, to consult their own counsel and financial advisors for assistance in evaluating the particular circumstances applicable to a proposed purchase, analyzing the problems or considerations those circumstances entail, and determining the best means for dealing with them. Let your accountant and your attorney each study this checklist; then review it with them. It is designed with the small metalworking company in mind.

BUYING A BUSINESS CHECKLIST

I. Evaluate Seller's Business

A. Financial analysis - consider the following:

1. Latest audited financial statements. (If none available, consider whether you are willing to accept unaudited figures.)

2. Latest available financial statements. (Evaluate their reliability)

3. Dun & Bradstreet Report.

4. Annual reports to shareholders and reports on file with the SEC (if applicable).

5. Summary financial statements over a period of years with separate profit and loss figures on each product or line of business.

6. Projected operating and financial statements.

7. Description of securities, indebtedness, investment, and other assets and liabilities, other than normal day-to-day accounts.

8. Trial balance and chart of accounts and/or description of accounting practices relative to inventories, fixed assets, reserve accounts, etc.

9. Analysis of inventories: consider the method of inventory evaluation-LIFO, FIFO, etc.- and inclusion of overhead; compare last two physical inventories to reflect slow-moving and obsolete materials compare physical and book at last physical inventory.

10. Evidence of unrecorded or contingent liabilities such as pending law suits or claims against the company.

11. Relationship between cost and price of items manufactured, and the soundness of pricing policies.

12. Breakdown of general and administrative expenses, selling expenses, and factory overhead over a period of years.

13. Analysis of break-even point, product mix, costs and fixed and variable expenses.

14. Analysis of working capital needs throughout the year and relationship of same to volume.

15. List of bank accounts and average balances therein.

16. Reports on credit from banks and lending institutions.

17. Insurance policies, coverage and cost, and worker's compensation rate.

18. Status of renegotiation of price redetermination of defense contracts. If any backlog of government contracts exists, check profit margin.

19. All information regarding patents, trademarks, copyrights, royalty agreements, etc.

20. Federal income taxes:

    a. Availability of loss carry-forwards.

    b. Matters in dispute and/or potential problems.

    c. Period open for adjustments, period that has been audited.

21. Current and past state and local tax payments and/or potential liabilities.

22. Comparison of company's operating results and financial structure with industry data in NTMA's Operating Costs and Executive Compensation (OCEC) Report.

B. Operations of the Seller Consider the following:

1. Production:

    a. Age, condition, present value and replacement cost of buildings and machinery, history of and plans for improvements and modernization, and feasibility of improvements and modernization.

    b. Availability and cost of utilities and alternatives available.

    c. Accessibility and cost of transportation facilities, including alternatives-

    d. Labor costs and prevailing wage patterns.

    e. Efficiency and use of manpower.

    f. Obtain copies of:

        1) Personnel organization chart.

        2) Production schedules, forecasts.

        3) Plant plan and flow charts.

        4) Product list, catalogs or circular.

        5) Daily production reports.

        6) Labor contract.

        7) Daily manpower reports.

        8) List of machinery and equipment, office furniture and fixtures.

2. Purchasing:

    a. Analysis of all major items of purchased materials.

    b. Names and locations of present suppliers - alternate sources.

    c. Present and future availability of raw materials.

    d. Storage capacity for purchased materials.

    e. Information on any long-term supply contracts.

3. Marketing:

    a. Record of company's product sales performance and distribution methods over a period of years.

    b. Forecast of demand for the company's products - company's expectations regarding its future share of the market.

    c. Nature of product distribution: direct sales and/or distributor sales, dependence on particular contracts, and security of contracts if change in ownership of the seller.

    d. Analysis of competitors - price trends and policies in the industry.

    e. Evaluation of advertising and promotion programs.

C. Consider the usefulness of an independent professional appraisal of the seller's business (see BMAs on Appraisals).

D. Check the market price of the stock of publicly-traded companies in the same industry as the seller and determine the value of seller's stock on the basis of price - earnings ratios for comparable companies. (This will not apply to most small companies.)

II. Conditions to be Satisfied

A. Determine whether the seller has power under the corporation's charter and by laws, loan agreements or other contracts, or federal or state securities laws, to carry out the form of acquisition contemplated.

B. Determine the extent to which federal and state securities laws require disclosure of seller, stockholders, or creditors.

C. Determine effect of state corporation laws on proposed transaction.

1. Need for shareholder approval.
2. Rights of dissenting or objecting shareholders.
3. Duty to notify creditors.
4. Procedures for paying out proceeds of sale.

D. Determine what special authorization or consultation will be necessary from:

1. Government agencies:
    a. Department of Justice or FTC antitrust laws.
    b. Internal Revenue Service-tax ruling.
    c. SEC-stock registration requirements.
    d. Any other agency, federal, state or local, which may be concerned with the proposed transaction.
2. Lending institutions.
3. Other parties connected with the seller.

E. Be certain that the prospective transaction will not be upset by significant business changes or long-term commitments made by the seller during the negotiations without clearance from the buyer.

F. Investigate possibilities of undisclosed liabilities of the seller.

1. Investigate the nature of seller's interest in its properties and assure that titles are valid.
2. Ascertain if there is any present or threatened court litigation or administrative proceeding involving the seller.
3. Determine to what extent federal and state tax returns have been filed, examined and/or settled.
4. Determine what warranties of design and/or manufacture seller has given to its customers and what the seller's experience has been regarding such warranties.
5. Investigate all other possible undisclosed liabilities of seller suggested by the nature of the business, the history of seller's operations, the seller's reputation and reliable sources in information about the seller.

III. Determine Form of Transaction

A. Alternative forms of purchase:

1. Purchase of seller's stock (with or without a subsequent liquidation of the seller).
2. Purchase of seller's assets (either directly or through a subsidiary corporation).
3. Statutory merger or consolidation (with buyer or buyer's subsidiary corporation).

B. Factors to consider in choosing form of transaction:

1. Possibility of contingent or unascertained liabilities, such as product liability claims. (The assumption of such liabilities often can be kept to a minimum in an asset purchase.)
2. Objections of minority shareholders. The rights of minority shareholders of either the seller or the buyer to delay or block the transaction and/or to be paid off will vary according to the form of transaction chosen. Each state law differs on this point.
3. Desirability of assuming tax carry-overs of seller. (These sometimes are served in the case of a stock acquisition, merger or consolidation and/or tax-free reorganization. The possibility of using special tax procedures to obtain asset-purchase treatment for a stock purchase where tax carry-overs are not desired should not be overlooked.)
    a. Tax basis of the seller's assets. (The buyer generally will want a high basis for depreciable properties to maximize future depreciation allowances.)
    b. Net operating loss carry-forward.
    c. Accumulated earnings and profits.
    d. Methods of accounting.
    e. Methods of depreciation.
4. Need to expedite transaction. (Depending on the circumstances, one form of transaction may be much faster than another.)

IV Determine Means of Payment

A. Alternative means of payment:

1 . Buyer's stock (common and/or preferred).

2. Buyer's debt obligations (including installment notes, bonds, and/or convertible debentures).

3. Cash (including funds supplied by bank, financial institutions or other third-parties financing the purchase).

4. Any combination of the above, perhaps with a provision for deferred payments contingent in whole or in part upon future earnings of the business.

B. Factors to consider in choosing means of payment:

1. Tax carry-over considerations. (The tax treatment of a transaction will depend upon both the form of the transaction and the means of payment.)

2. Availability of liquid capital for purchase.

3. Desire to avoid dilution of present stockholders' ownership in the buyer corporation.

4. Desire to avoid long-term fixed obligations for installment payments.

5. Availability of unissued stock for use in making purchase.

6. Availability of third-party financing.

V. Negotiate Agreement

A. Determine by whom costs of transactions are to be paid.

1. Brokers' commissions.

2. Legal fees.

3. Accounting fees.

4. Asset Appraisals.

5. Liquidation costs.

6. Stock transfer taxes.

B. Determine whether the following of seller's contracts are assigned, and to the extent they are not assignable whether the necessary parties will agree to such assignments.

1. Licenses and royalty agreements.

2. Employment agreements.

3. Leases.

4. Suppliers' contracts.

5. Customers' contracts, particularly those with the U.S. Government.

6. Collective bargaining agreements.

C. Determine the extent to which the following contracts of the seller are to place an obligation on the buyer:

1. Pension and profit-sharing plans and/or other employee benefit plans.

2. Stock option plans.

3. Deferred compensation contracts with executives and others.

D. Obtain necessary representation from seller

1. It all liabilities of seller are not being assumed, a warranty should be obtained that seller maintains responsibility for unassumed liabilities and will retain funds to pay them when due.

2. If stock of buyer is being issued to seller, a representation that such is being acquired for investment rather than for sale should be obtained if necessary to avoid problems under federal or state securities laws.

E. Obtain necessary indemnification

1. Determine, in the case of a stock purchase, whether the seller is willing to give indemnification and/or enter into an escrow agreement to cover liabilities that exceed the figures given on the balance sheet, as well as liabilities that are not given in the balance sheet.

2. Determine whether the seller will indemnify the buyer against brokers' or finders' fees and other possible liabilities arising out of the transaction and whether there should be an escrow arrangements to cover these.

This BMA was reviewed by Allen Berger, CPA of Blackman Kallick Bartelstein, LLP, Chicago, Illinois