

How to Prepare Your Business for Sale

Part 1: Get Your Books in Order

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How soon should you begin to prepare your business for sale? Typically, all things being perfect, a business owner should begin one year in advance of actually placing the business on the market. However, most business owners make the decision to sell based on emotional considerations and therefore do not place much emphasis on the preparation necessary to command the highest price for this important investment pronouncement. There are several key areas which need attention prior to the placement of the business on the open market.

The first area to tackle is the financial records pertaining to the business. This is where many small businesses fail the “buyer’s exam”. Any prudent buyer will dig into the financial records during the “due diligence” period and expect to see documentation to back-up the sales and expenses of the business. Sloppy record keeping can quickly extinguish any buyer’s enthusiasm for purchasing your business. Your goal here is to establish a good impression on the buyer by making this step as seamless as possible.

You will need to put together at least three years of financial documents to include profit and loss statements along with a current balance sheet and year end tax returns. To be honest, the more formal the statements (accountants attestations vs. owner prepared) the more reliable they appear to a buyer and consequently the greater the impact. If you are not currently using an accountant you may want to consider spending the extra money and hire one now in order to upgrade your record keeping system. Bear in mind—not all accountants are CPA’s (Certified Public Accountants) and therefore may not conform to a rigid set of standards such as Generally Accepted Accounting Principles. (GAAP) Please do not accept lower standards in this department in order to save money—it may hurt you later.

Once you get your financial data together you can begin to construct a “Seller’s Discretionary Cash Flow Statement”. This statement is very important to a buyer because it shows the cash currently generated from the business after all ordinary expenses are deducted. It is the cash a buyer can expect the business to produce. In preparing the cash flow statement, many times there are items to add back from expenses which may be considered non-operational because they represent deductions of a personal nature such as: automobile payments for a spouse’s vehicle who does not work in the business. It is generally understood such expenses may exist but they need to be verified and added back to accurately show the cash generated. It should be noted—too many of these types of add-backs will leave considerable doubt from the buyer as to the validity of the statement. Therefore, carefully scrutinize all non-operational expenses and decide if they truly need to be counted as a business deduction.

Nobody likes to pay any more taxes than necessary, however we can sometimes get caught up in saving a few dollars here and lose value for our business on the sale. For instance, it is sometimes common to use multiples of discretionary earnings as one method to value a business. If a multiple of three times Seller’s Discretionary Earnings (SDE) is used for a particular business and SDE is 100K then we can assume a value of 300K for the business. However, if the seller is not reporting all of the sales in order to reduce his tax liability then the SDE will be skewed. If this so called “hold back” is 50K

then we can safely assume the business value should be closer to 450K. As you can quickly surmise, the value of the business is reduced by 150K because we wanted to save 50K from tax liability. It is all a matter of preferences—do you want to cash out now or when you sell. Remember, the tax liability on capital gains is currently 15% not the higher personal income tax rate you may fall in—so how much money are you really saving?

Another area of concern in regards to “holding back” sales is financing. If our business should be worth 450K but the SDE indicates only 300K—guess what figure the bank will use when analyzing cash flow? I know you are a very reputable business owner and the banker should accept your word about the hold-back amount but I assure you the lower figure will be used even if you offer-up your bank statements to prove the additional income.

Now that your books are in order, get a formal “third party” evaluation. Never attempt to enlist an appraiser before the books are in good shape—you may regret it later. Formal evaluations are not cheap, get your money’s worth—show the business realistically without all of the clutter and doubt surrounding poor bookkeeping. An objective outside source can give you a tremendous amount of insight into your business and how it compares to similar businesses. This evaluation may even uncover some market condition you should be aware of and sometimes certain deficiencies which can be corrected prior to placing your business on the market.