13 Financial Questions to Ask Before Buying a Business

GUARDIAN Due Diligence

Entrepreneurship Through Acquisition (ETA) is a smart strategy to build wealth. Instead of starting from the ground up with a brand new business, you shepherd an existing organization toward growth and your own success. The only way to make an educated decision about what business will provide that future is to do your research.

Start your research process with financial questions that go beyond examining financial documents. Your research may give you beneficial insights you'll want to know if you do take over. Approach this process like a fact-finding reporter. It's your job to know everything you can. Especially for self-funded searchers, you don't want to miss a key detail and sink your money into a deal that's not right for you.

Consider each of these questions so you can approach your deal with confidence.

1 Are the financial statements from the source?

The financial statements that you receive are the biggest part of your research. You need to make sure they're from the source. They should have the header of whatever accounting software the company is using: QuickBooks, Peachtree, Bench, Zero, etc.

A seller may put monthly financials into a nice spreadsheet for you that is easier to consume. Never accept financials in this state because they might be manipulated. Since the seller has already altered the data to clean up the spreadsheet, you can't trace it back to the system of record or their financial system. If two sets of financials that were provided don't match up, you need to understand what was manipulated or changed. This should stand out as a red flag.

2 What do tax returns say about the company's assets and expenses?

Get three years worth of tax returns from the seller. The IRS asks for specific information that can help you. The asset list is often more specific in tax documents than in financials. You'll see elections that the owners have made which will affect your future cashflow for proforma and forecast modeling.

You also want to see what kind of deductions they've made. If you're buying stock, you're going to incur their tax liability. If the seller underpaid taxes historically, you're going to be on the hook for their underpaid taxes.

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3

Are any salaries deflated?

Salaries and payroll can be deflated in many ways to artificially increase profits/cash flow/SDE and therefore increase what you'll pay for the business. Look out for salaries that are much lower than it would cost to replace the employee, key functions that the business would need to operate that are not shown on the org chart (which may suggest people being paid in cash outside of the records you're reviewing), and cross-trained employees who are great for the seller but you'd find hard to replace at the salary they're making now. Also look for inflated salaries that may need to be brought down to normal.

There are many tricks sellers can play around salaries and many are hard to spot for first time buyers. The most important part is being aware of deflated salaries. How you handle that situation is an issue of discretion.

4

What is the market value of the inventory?

Get to know the company's inventory which includes all products and materials for sale or used in the service of customers. Understand what inventory they have, whether the inventory is usable or dated, and the age of the inventory. Find out if the inventory churns, meaning whether customers are purchasing SKUs represented in that inventory or if some SKUs have gone out of favor. Know when the value of SKUs has decreased.

The main thing you need to understand about inventory is the market value or what you could sell the inventory for. In some cases, if the inventory is significant enough, it would be advisable to at least see or count the inventory. Sellers can be clever when it comes to inventory, so keep an eye on this aspect of the company.

5

Does the pricing structure make sense?

Analyze the company's current pricing structure and determine whether it's relevant. Consider whether the company is pricing products or services too high or too low and whether the pricing structure is based on the right information. Although the prices may be correct, they may be based on inaccurate information which could complicate the process moving forward. For example, you might find that a professional service company is charging for individual projects, but their top 10 customers should be charged on a recurring monthly basis or have a retainer arrangement. You might want to change that after taking over. It may also be advantageous to compare the pricing structure to competitors in the industry.

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6 What is the trajectory of the industry and market segments?

Understand the past and future trajectory of your target company's industry. Get to know the major milestones that lead the industry to its current state and what can be expected moving forward. This includes both the industry that the company operates in and the market segments that it sells to. For example, a metals manufacturer operates in the metals industry but sells to a variety of industries like the automobile and appliance industries. Analyze whether sales have been increasing, decreasing, or stagnant in each market segment. Look for opportunities and risks that might be forthcoming in any of these areas.

7 How does the local market affect how the company does business?

Even if you are already familiar with the industry, you might need to get up to speed on the market economics of your target company's location. For example, if you already own a roofing company but are interested in buying another in a different city, you should consider how that change in location might affect business. Familiarize yourself with the major players related to your business. For roofing, get to know the construction companies and what is driving new house builds. For retailers, get a good idea of the local community including demographics, economic outlook, and competition. For service providers, get a map of the company's service area including major clients. If it's relevant to your business, understand local politics and how the city council operates.

8 What can you expect from the customer base?

Understand the makeup of your target company's client base. They may have blue-chip, Fortune 1000, or Fortune 5000 customers. Or they could have mom-and-pop customers and individual homeowners. Get to know their general demographics and behavior patterns. Find out how much repeat business the company experiences, when the busy seasons are, and how much difficulty the company has with retaining clients. For B2B businesses, have a sense of the industry that your clients participate in. If they are operating in a difficult industry, you might need to worry about a client's ability to continue paying. From a marketing perspective, you need to understand your customers and audience in a very personal way to be able to sell to them.

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9 How much has the company historically spent on advertising?

The most important parts of advertising for you to understand are the costs and the trends for both traditional and online advertising. Sellers tend to say that they overspent on advertising in the previous year and that the new owner won't need to. For example, the seller might say that after analyzing the previous year's spending, 20% of their advertising spend was unsuccessful. Keep in mind that understanding what part of your advertising spend did not result in customers is challenging. If the company has historically experimented with 20% of their advertising budget, part of that may have been what kept their revenue high. That means that you will probably want to continue to experiment with 20% as the new owner. Make your own conclusions based on the company's historical advertising trends.

10 Who owns the sales relationship?

The main metric to analyze when looking at sale records is sales by customer. This will reveal if the business has any customer concentration. A diversified customer base will always carry less risk. You also want to know the arrangements that the typical customer has. Look into the payment terms, when the ownership of the goods transfers, and if there's any recourse.

The person who owns the sales relationship will be most intimately familiar with these arrangements with the customers. To find out who this person is, start asking questions about sales records. Keep asking down the org chart until you find the employee that fully and deeply knows the client. That's the person that makes the business revenue. That's who you want to know because they're integral to the revenue that you're going to generate on an ongoing basis if you take over.

11 What does current Accounts Payable tell you about liabilities?

Accounts Payable reflects all of the money that the company owes. This information should be listed on the balance sheet, but ask the seller for clarification about what is all owed. Analyzing what is owned (and when) will give you an idea of how well cash flows through the business. This information might also come out when you ask the seller about agreements, contracts, and the full list of liabilities. If you see any payables older than 90 days, check if there are any liens on the business.

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12 What does current Accounts Receivable tell you about customers?

Accounts Receivable (AR) includes everything owed to the company. This information will be on the balance sheet, but you should understand the aging of those accounts. Consider a seller who claims that their customers pay within 20 or 30 days. The AR aging report could reveal that the average payment time is actually almost 90 days. The seller will have their reasons for this discrepancy, but it allows you to understand the true payment terms. Banks don't like aged receivables and you shouldn't like aged receivables that linger close to and over 90 days

Receivables should also reflect the sales and customer list. If the top 10 customers pay on terms, they should all show up in the AR list. Consider it a red flag if the AR list does not look like the customer list. You also want to know the credit condition of the major parties who owe the business money. If the company's biggest customer is experiencing financial hardship and they owe half of the receivables on the balance sheet, those accounts may never get paid. AR is a great place to find information that will help you forecast, understand cash availability, and decide what you'll pay for the business.

13 What marketing strategies have worked in the past?

Find out how the company attempts to reach customers and whether those strategies are successful. Most importantly, determine whether those strategies can be repeated after you take over. In some situations, a company's marketing strategy might exist in the mind of a single employee. If that marketing strategy is successful, that person will need to be a mission-critical member of your team. If you find that the current marketing strategy is not working, know that you will have to invest resources into this area after taking over.

In this list, we focused on financial questions to ask about your target business. We looked at how your target company makes money, what it owns, and how it's structured. Coming up next, we turn our attention to other important matters such as the liabilities, insurance, and reputation. Make sure to read **"12 Other Critical Questions to Ask Before Buying a Business"** to get our complete thoughts on necessary research before buying a business.

Read "12 Other Critical Questions to Ask Before Buying a Business" here.

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About Guardian Due Diligence

GUARDIAN
Due Diligence

We are your deal champion. Each deal needs a lawyer, a CPA, and an expert deal professional. Guardian is the expert. We provide the advice that allows buyers to more effectively manage the highly layered process of buying a business and feel comfortable that they are not getting fleeced or buying a lemon. This allows our clients to focus on the deal and not the details. Our services provide an expert layer of protection for your investment.

Deal Sourcing & Evaluation

Sourcing high quality deal flow & evaluating best deal opportunities to pursue.

Preliminary Negotiations

Creating Indication of Interest (IOI) and Letter of Intent (LOI). Guiding discussions with sellers.

Due Diligence

Deep financial & operational analysis. Manage 3rd party vendors in specialty areas (Lawyer, CPA, etc.).

Transaction Completion

Finalize negotiations. Deal structuring and capital raising.

Post-Close Growth Planning

What operational levers will grow the business? How can we maximize ROI/IRR?

Other Helpful Resources

Due Diligence War Stories

Sample Quality of Earnings Report

Due Diligence Case Studies

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