HOW TO SELL YOUR BUSINESS

through

www.ownersellers.com

0333-123456-2

BEFORE YOU START….

If you have decided that you want to sell your business there are certain key initial questions that you must answer:

1. **Who is the seller**? Is your business run by a company? Are you a sole trader? Do you have a partner?
2. **What are you selling?** Is this a Goodwill & Asset sale or a sale of shares?
3. **Is the business ready for sale**?
4. **Have you identified the key selling aspects of your business**

1. WHO IS THE SELLER?

A. Sole Trader/Partnership
If you are not trading as a limited company then you are probably trading as a sole trader or partnership. In which case what you are selling is the Goodwill and assets of your business.

B. Company
If you trade as a company then are you selling your shares in the company or is the company going to be the seller and it will be selling its assets & goodwill?

This is a critical question to answer as the tax and financial implications of getting it wrong are substantial.

If you need help then call us on 0333-123456-2.

2. WHAT ARE YOU SELLING

A. Sole Trader/Partnership
The assets you are selling need to be identified and are usually made up of things such as Plant & Equipment and Property (usually known as Fixed Assets) and the Stock, vehicles and other moveable assets used in the business.

Stock is usually sold “subject to valuation” which means that at or prior to completion of the sale, the stock is valued by either an independent person or by the buyer and seller and a price agreed.

Debtors and Creditors are usually retained by the seller in an asset and goodwill sale, although occasionally debtors are also sold to a buyer or are collected by a buyer and paid over to the seller after completion.

Goodwill is basically “air” and is made up of such things as the brand name, reputation, location, recurring income streams and customer relationships of your business. A Goodwill Premium is the difference between the “hard assets” of a business and the total asking or sale price.

Valuing Goodwill is a contentious issue and for every opinion there is a contrary opinion. Ultimately a business value comes down to how much someone is prepared to pay for it having regard to the risks.

If you need help in valuing your business call us on 0333-123456-2

If you occupy premises from which the business operates then you will also need to transfer the lease to the buyer. This will usually require your landlord's consent. It may be that your buyer or the landlord will prefer to grant your buyer a new lease.

You need to start talking to your landlord or his agent at some stage during the sale process although you may prefer to wait until you have a buyer.

When you start advertising your business for sale and if it includes the sale or transfer of a leasehold or freehold property then you will need to get an Energy Performance Certificate (EPC) for the building. This is essential and if you don't you could be subject to a considerable fine. **Do Not Ignore This!**

B. Companies

If you are selling your shares in your company then you are effectively selling everything inside that company

A company is a separate legal entity and it (not the shareholders) owns its assets; the shareholders own shares in the company which in turn owns the assets.

Often a buyer will prefer to buy the assets out of the company rather than to buy the company itself, because they are easily identifiable and the buyer does not have to worry about what else may be inside the company.

A vendor on the other hand will generally want to sell his shares in the company because it is considerably more tax effective for him to do so.

When a purchaser buys the shares in a company he buys the company and everything inside it. Unless specifically excluded, this includes stock, creditors, liabilities, plant & machinery, employment obligations, lawsuits, claims, real estate, cars, goodwill, IPR (intellectual property rights) and cash.

This means that a company must be groomed for sale before the sales memorandum is issued. If there are any problems or issues within the company such as loans to directors or claims by employees, then generally these should be solved before issuing the sales memorandum or should be fully disclosed within it. A purchaser will inherit all of those problems and liabilities if he buys the company so he needs to know about them before doing the deal and he may discount the value he places on the company in order to take account of those problems.

Similarly there may be surplus cash balances or loans from directors or banks which may need to be distributed or repaid before completion or specifically identified in the Sales Memorandum either to increase or to justify the asking price.

There are likely to be considerable tax advantages to you selling your shares and you need to get solid tax advice before going down this road. If you need tax advice then contact our tax advisers in our Advice Centre on taxadvice@ownersellers.com

3. IS YOUR BUSINESS READY FOR SALE?

A. Sole Trader/Partnership

Things that you need to consider before selling your business are:

- **Website -** If you have a website, do you own it and are there agreements in place. Do you own the domain name and the email addresses, can you transfer them to your buyer without any problems? Have you got the licences for all the software you use on your computer(s)?
- **IPR** – Do you own the intellectual property rights in any designs, photographs or drawings or other technology/trademarks/copyright/designs used in your business?
- **Assets** – Do you own all the assets you use in the business? You cannot sell what you don't own! Are any assets subject to lease or HP? If so, you will probably need to pay these off at completion unless your buyer has agreed to take over the finance agreements.
- **Lease** – Can you transfer/assign the lease? How many years are left on the lease? Is there a right of renewal? (The shorter the lease term the more this will affect the goodwill value). Are there dilapidations on the premises which you will have to deal with before being able to transfer the lease? (This can be deal-breaker and must not be ignored!).
- **Freehold**- If you are selling the freehold as part of your business sale then do you know where the title deeds are? Very often sellers only remember at the last minute that the title deeds are with their bank and this can delay or frustrate a sale.
- **Employees** – Do your employees have employment contracts in place? If not you will need to do these. Are there any employment disputes? A buyer is obliged by law to take on your employees on the same terms and conditions as currently, including any ongoing disputes. Neither you nor the buyer can fire or make redundant any employee in anticipation of the sale or for a period after the sale and even then you and the buyer need to tread very carefully in case you are subject to an unfair dismissal claim. You should definitely be speaking to your lawyer about your employees in the run up to a sale.
- **Accounts –** This is probably one of the most crucial things of all. Your Accounts need to be clear and clean. You need to ensure that they are easily understandable and not mixed in with your other business or personal interests. If there are items in your accounts which require explanation (such as one-off expenses, personal expenses or unusual fluctuations in trading) then you need to explain these clearly. All buyers will be very concerned if the accounts don't make sense or look suspicious and you will probably never sell your business. You also need to ensure that you can produce regular management accounts during the financial year. If your accounts are a mess or are not up to date then we strongly recommend you appoint a bookkeeper to bring them up to date and keep them in shape. A buyer is likely to want to see at least the two or three preceding years' accounts. Are these available? Do you need to make any explanations on the numbers?
- **VAT** – A buyer will almost certainly want to see your VAT returns. Are these up to date and available?

B. Companies

All of the preceding comments regarding a sole trader apply equally to a company. However in addition there are a number of important additional considerations:

- **Balance Sheet** – Because a buyer is buying everything inside the company when he buys your shares, you need to ensure that you only leave behind what you want to leave behind and that your buyer knows exactly what he is buying.
- Usually this requires some work on the Balance Sheet.
- **Directors Loans** – Do these need to be repaid prior to completion? Or are they being paid off as part of the sale with the purchaser allocating part of his purchase price to repay the loans and paying you the balance for your shares?

- **Trade Creditors & Trade Debtors** - these are usually left behind for the buyer to take over.
- **VAT and Corporation Tax** - these need to be paid off and up to date as at completion.
- **Cash @ bank –** Will you be taking out any surplus cash prior to completion or is your asking price exclusive of the cash? Are you expecting to be paid cash for cash on top of your asking price?
- **Debt and HP** – Are you going to pay off all the bank debt and HP before completion? Are you expecting the purchaser to buy the company with all the debt still inside it? Or is your asking price a gross price from which the debt is to be deducted?
- **Zero Cash Zero Debt -** When going through the Balance Sheet we would strongly recommend you write the Assets and Liabilities onto a separate piece of paper/spreadsheet leaving out the Cash @ Bank figure and the Debt and other liabilities which should be paid off on or before completion, such as bank loans, HP, director's loans and the Corporation Tax bill.

This exercise will give you a clear idea of what are to be the Net Assets on completion and from there you can start to build up your Net Asset valuation.

Generally your revised balance sheet would look something like this:

ASSETS
Plant
Stock
Debtors

LIABILITIES
Trade Creditors
VAT
PAYE
Accruals

This will then give you the opportunity in your Advert or Information Memorandum to explain to the purchaser that your asking price is on a Zero Cash Zero Debt Net Assets basis (ZCZDNet Assets) and that you are expecting the cash to be removed and the debts to repaid on or at completion.

In reality what usually happens on completion is that the cash and debt are left in the company for the purchaser to deal with and the sale price is adjusted up or down £1 for £ for any movement in the ZCZDNet Asset figure (this is known as a ratchet).

Likewise the ratchet on the ZCZDNet Asset figure allows for fluctuations in cash, debtors and creditors between the time of your valuation and the completion date.

Sometimes this exercise on the completion Balance Sheet that you have done will reveal a Balance Sheet that is too thin or even has negative assets, in which case you may need to leave cash in the business in order to plump up the completion balance sheet and justify the asking price.

Our suggestion is that in the Sales/Information Memorandum the following words (or similar) are used:

"The company is being sold with anticipated Net Assets on completion of £XX as per the attached projected Completion Balance Sheet and/or on a Zero Cash Zero Debt basis. The final purchase price will rise or fall £ for £ depending on any rise or fall in the Net Assets."

As you can see, the writing of your Sales Memorandum and the cleaning up and finalisation of your Balance Sheet is a critical part of the sale process. If you don't get it right from the start then you are likely to see lots of misunderstandings arise and your deal will fall part.

If you need help in sorting this out please contact us on **0333-123456-2**

4. REASONS FOR A SHARE SALE

The reason why a vendor will be so keen to sell his shares rather than for the company to sell its assets is principally tax. In essence if a vendor sells his shares then, provided he has held them for more than 1 year, he will pay Capital Gains Tax at the rate of 10% on the gain between what he paid for the shares and what he sells them for less transaction costs. (There are a couple of exceptions to this rule but generally in the case of a typical owner/manager, this is the case).

On the other hand, if a company sells its assets then it will pay corporation tax on the profit it has made on the asset sale (there is no capital gains tax for companies)…..being the premium paid over their book value, which means it pays tax on the profit at between 20-30%. The cash then sits inside the company and can generally only be distributed to the shareholders by way of dividend, which means that the shareholders will pay tax on the dividends they receive at their full personal tax rate.

In order to persuade a purchaser to accept a share sale deal it may be necessary to emphasise the importance of some or all of the following factors:

- Appearance of continuity of business. A change of name or trading style may give the impression that the business has changed hands or worse, gone bust and done a phoenix.
- There may also be customer and supply contracts which will be difficult to re-write in the name of a new company.
- Similarly it may be easier to get a landlord to agree to the change of shareholding rather than having to enter into an assignment of the property lease; and it will almost certainly be considerably less expensive in terms of legal fees.
- Intellectual Property Rights ("IPR") traditionally are messy and complicated, particularly copyright in software. It may be almost impossible to create a chain of title and even more difficult to get all parties to agree to an assignment from the company to the purchaser. It may be considerably easier to "let sleeping dogs lie".
- A purchaser may prefer to leave the company's banking arrangements in place; this is particularly the case in respect of leased plant and machinery and term loans. A bank will normally want to be satisfied as to the probity and credit-worthiness of the purchaser, but will usually be more relaxed about leaving pre-existing secured loans in place.
- The company may have historical tax losses inside it, which a purchaser may find useful. A vendor may try to increase the price because of these tax losses although usually that is difficult to do and most purchasers will not pay a premium for them.
- There may be other contractual arrangements also in place with the company which could be difficult to assign to a new company, such as options arrangements with staff, other employment contracts, future royalty contracts, licences etc.

5. TAX & STAMP DUTY

As stated previously the sale of shares in a company for which the vendor gets Entrepreneur's Relief, attracts a 10% flat capital gains tax rate provided the shares have been held for more than 1 year.

If a company sells its assets then it pays corporation tax on the profit and the shareholders pay income tax on any dividend distribution of the asset sale proceeds.

Stamp duty is 0.5% on a sale of shares and on other property (such as debtors and real estate) it is a sliding scale up to 7%.

6. VALUATIONS

There are a number of different ways to value a company and a number of factors to take into account:

- **Net Asset Valuation**

What are the assets? Tangible/intangible: Tangibles are generally the hard assets like plant & equipment, stock, debtors and cash. Intangibles are things like goodwill and IPR.

One would generally ignore Intangibles on a Balance Sheet as one is effectively valuing goodwill when pricing in a Goodwill Premium, so it would be double counting.

Very often a company will have its assets valued within its books at a price which can only be justified if the company is still in business, whereas if the company went into receivership those same assets may only be worth a fraction of their book value because of age, specialisation or difficulties in removing them from the premises.

If the company is sold for Net Asset Value then there may also be redundancy and lease dilapidation and termination costs to be taken into account by a purchaser, which could depress the valuation.

- **Accounting Rate of Return (ARR) or Return on Capital Employed (ROCE)**

This is essentially looking at the total amount of money required to buy and run the business (including all bank debt and HP leases), then looking at the EBIT (= earnings before interest and tax) and deciding whether that is a satisfactory return on the investment given the risks involved.

- **Discounted cashflows**

This is an actuarial calculation involving calculating the overall cashflow demands and returns of the company over a period of say 7 years and then discounting them back to their net present value. It is safe to say that this method is usually only used for larger corporations or new and substantial businesses. If someone asks you about it then they are probably just jerking your chain!

- **Internal rate of Return (IRR)**

This method is generally used when the transaction is highly geared and is normally used by venture capital investors. An example is, if you buy a £300,000 investment property with a £250,000 mortgage and then sell it three years later for £500,000 then your IRR (assuming that the mortgage has not reduced and the rent has equalled the mortgage interest costs) is going to be your capital gain of £200k as a percentage of your original investment of £50k divided by the number of years you held the investment. i.e. (250/50)/3 = 166%IRR

- **P/E and Multiples**

This means looking at the pre and post tax profit of the company and then multiplying it by a number which is usually somewhere between 1-10. The lower the multiple means the higher the risk and the less sustainable the profit stream.

The term “multiple” is usually used for pre-tax numbers and “p/e” for post-tax numbers. It is sensible however when using these terms to make it clear that you are talking about either pre or post tax numbers. There is a big difference between the two, a pre-tax multiple of 4 is about the same as a post p/e of 5.

- **Net Assets + Adjusted EBITDA**

This is our preferred method of valuation and is relatively easily understood by buyers and sellers.

We go through the Balance Sheet and adjust for Zero Cash Zero Debt as outlined above. This gives us a Net Asset figure. We then agree the Net Asset figure with the vendor.

We then look at the P&L and remove all Amortisation, Depreciation, Extraordinary/One-Off costs, Interest costs and costs relating to the Vendor. We agree this figure with the vendor.

(NB. If the company is being sold with No Debt then obviously there is no interest cost.)

Having done that, we then put in a sensible salary for replacing the single vendor. If there is a second vendor also working in the business then we would also deduct a sensible replacement salary, bearing in mind that it is often a wife/partner who either does the books or doesn't actually do any significant work. Sometimes an owner will have hidden costs within the business, these should be extracted and identified in the Sales Memorandum.

The result of these calculations is that we arrive at an Adjusted EBITDA figure. This figure and how we arrived at it should be put into the Sales Memorandum.

This method of calculating the Adjusted EBITDA usually only works for businesses making more than £100k of profits. For smaller businesses the Adjusted EBITDA figure is usually calculated before deducting a single owner's drawings. This gives a figure of what a single owner/purchaser can expect to earn from the business.

To arrive at the Goodwill Premium we would then multiply the Adjusted EBITDA figure by somewhere between 1-5 depending on the size of the business, whether the Adjusted EBITDA is pre or post a salary for the owner/manager, the sustainability of the profit, the company history, and the size of the Net Assets.

We would add the Net Assets figure to the Goodwill Premium to arrive at the preliminary valuation figure.

However as a cross check on the valuation we would then see what sort of return on investment (ROI) the purchaser will be making having regard to the risks and size of the deal.

If the ROI is less than say 20% then we would probably reduce the multiple used to calculate the Goodwill Premium which will then reduce the valuation.

Most purchasers we deal with are looking for between 20-50% ROI with a general average of about 30%.

Some valuations on this ROI basis will show that the company is worth less than its net assets; (e.g. a company that makes an after tax profit of £50k but has net assets of £500k). We call this "*the big tail on a small dog*" syndrome.

In that case, it is likely that some pre-sale grooming may need to take place so that the net assets are reduced, such as the directors putting the freehold property into their pension fund and leasing it back to the company. If that is not possible then either the company may be sold for a value equivalent to its net assets or often a discount to them. There may be situations such as where the company has one very expensive machine costing £500k which allows the company to make a profit of £50k; in which case a purchaser may question the wisdom of risking so much money for such a small return and the business may be unsellable.

Engineering businesses often have significant Net Assets and yet may also make decent profits. Even so, as a rule of thumb we would use a low multiple of say 1-2 to arrive at the Goodwill Premium plus the Net Assets. For example a company with net assets of £1.3m and a profit of £400k we would value at c£1.9m-2.1m which would be an ROI of only 21-19%.

7. PRE-SALE DRESSING UP

The following are some ideas that should be explored in order to maximise the amount of money that the vendors receive and to show the company in the best light:

- **Take out all or part of the cash**

There may be no need to keep all the cash within the company. This could be distributed by way of dividend, payment into the owner's pension fund or repayment of any directors' loans. Alternatively if it's more tax effective to do so, then as suggested above, the sale price can be inflated by the cash at bank figure so that in addition to the agreed purchase price, the purchaser pays "cash for cash".

- **Make sure Net Asset Value (NAV) matches up with p/e, ROCE valuation**

As indicated above, sometimes the NAV is out of kilter with any normal valuation of the business, this can for example be because the company owns its premises. In that case it may be sensible to move the property into the director's pension fund and lease the property back to the company; this will reduce the profitability but will transfer an asset with a good yield into the director's pension. You should do the calculation to see if the benefit of extracting the property asset from the company exceeds the resulting reduction in the goodwill value because of the lower profit figure.

- **Repay directors' loans**

These should be repaid prior to a sale, if the cash is available. If it is not then they will normally be repaid out of/deducted from the sale proceeds at completion.

- **Sell car to owner**

Very often the owner will have a car that they will want to keep after completion but which is owned by the company. Legally the company is entitled to keep the car, however if the owner wants to keep it, it needs to be either transferred out before completion or specifically identified and excluded in the Sales Memorandum.

- **Do a stock-take**

If you are selling your business you should definitely do this asap, this is the classic area in which purchasers chip away at the price. The vendor needs to clear out or write off any old or redundant stock so that the balance sheet is a true reflection of the company's net worth.

- **Clean up the balance sheet**

The projected completion balance sheet should look clean and tidy and not contain any items which need explanation or which cause the purchaser to worry about what he/she is about to buy!

8. WHAT IS PROFIT?

A good initial question to ask yourself is what you would consider to be the profit of the company if you were the purchaser.

Depending on the size of the business the profit should be the arm's length profit of the company if the management team/owners were salaried employees being paid market rate salaries. This means that things like management costs should be scrutinised to make sure they stack up. It may be necessary to impute certain costs back into the P&L to take account of the fact that a purchaser will look at it on an arm's length basis.

Similarly if there are any unusual or extra-curricular costs paid to family members for example, then these should be extracted from the P&L and written back into the profit.

This method of calculating the profit usually only works for businesses making more than £100k of profits. For smaller businesses the profit figure is usually calculated before deducting a single owner's drawings. This gives a figure of what a single owner/purchaser can expect to earn from the business.

Make sure that the profit figure being sold matches up with any adjustments you are making to the balance sheet being sold. For example, if a property is being taken out of the company then a rental will presumably need to be written into the expenses.

Lastly, extraordinary costs should be carefully scrutinised. Sometimes what a vendor thinks is extraordinary would be regarded as a normal cost of business by a purchaser.

9. SALES MEMORANDUM

The Sales Memorandum must be a complete picture of the company and what is being sold. You must make sure that it ties in exactly with the information you have provided and reflects what the purchaser will be buying on completion. This means that if anything is not to be included in the sale then the memorandum must show this and if there are any issues which will come out in Due Diligence, then these should be fully disclosed and explained in the document.

The sales memorandum should detail the company, its business, products, key personnel, modus operandi, history, sector, customer profile and detailed financial history.

As a result of reading the memorandum the recipient should have a good understanding of the company and what it does.

If the accounts are to be re-drawn in order to show a different set of numbers from those in the historical accounts then this should be done and explained in the memorandum. If there are to be no changes then the historical accounts prepared by the company's accountants should be used. Ideally the last 3 years of accounts should be attached.

I strongly recommend that if the proposed Completion Balance Sheet is different from the last company Balance Sheet then you should create a spreadsheet which shows the current Balance Sheet and the proposed Completion Balance Sheet side by side, so that it's absolutely clear what is being sold.

If you need help preparing your Sales memorandum then please contact us on **0333-123456-2**

10. THE PROCESS OF SELLING A BUSINESS

The traditional steps involved in selling a business are:

1) Finalise Completion Balance Sheet and agree Adj EBITDA
2) Issue Sales Memorandum
3) Deal with purchasers
4) Ensure purchasers have funding capability
5) Appoint lawyers for each side
6) Negotiate and agree Heads of Terms (HoT) between Purchaser and Vendor
7) Agree a timetable for completion
8) Purchasers begin commercial and legal due diligence
9) Purchasers begin accounting due diligence
10) Purchaser's solicitors issue draft Sale & Purchase Agreement (SPA)
11) The terms of the SPA are negotiated and agreed; it includes Vendor Warranties; TUPE obligations; Tax Deed – warranties and Indemnities; Payment terms including any escrow payments or deferred payments, earn-outs etc
12) Remove vendor's personal guarantees with the Bank; obtain Bank's approval to the sale if required.
13) Exchange & Completion of the Agreement is usually simultaneous primarily because the trading of the company is a moving target and the warranties and completion accounts are only valid and applicable at the time of completion

11. DIFFERENT DEAL STRUCTURES

Every deal is different and purchasers and vendors may have different ways of achieving what they want. Some examples:

"Earn-Out" means that a part of the purchase price may be paid to the vendor over a period of time after completion ("on the drip") provided maybe that they stay working for the company and/or the company achieves certain pre-agreed profit or other targets.

"Vendor Financed" means that part of the purchase price may be loaned to the purchaser by the vendor to enable completion to take place. Normally the vendor will get, as security for the loan, either loan notes or a hybrid form of shares, or they will get a mortgage over the company, although this is usually a second mortgage behind the bank. Vendors are traditionally reluctant to provide this sort of finance; however it may be required in order to achieve the sale price they are seeking.

"Lock-Step" means that the purchasers buy an initial shareholding which is then increased as certain milestones are achieved.

If you need help with doing your deal then call us on **0333-123456-2**.

12. THINGS THAT GO WRONG

- Change of heart by purchaser or vendor
- Economic climate
- Trading downturn/upturn
- Personality problems between vendor & purchaser or their advisers
- Due Diligence reveals problems
- Contractual difficulties- the parties unable to agree terms
- Types of warranties required by purchaser are unacceptable to vendor
- Product liability issues cause the purchaser to back out
- Threatened or actual litigation cause the purchaser to back out

- Employees’ redundancy costs make the deal uneconomic
- Financing problems means the purchasers cannot complete
- Employees’ terms of employment make the deal uneconomic
- Customers unhappy with change of ownership
- Sale/Offer Price change
- Disagreement over Deal structure (asset vs share sale)
- Disagreement over Completion Balance Sheet

13. GLOSSARY OF TERMS

- **Profit & Loss Statement, or P&L**

  This is the statement of the revenue and expenses of a company over a period of time; one is subtracted from the other to produce a profit or loss. Things to look out for are the treatment of opening and closing stock figures (which can inflate/deflate profits), extraordinary items of income or expense, payments to the directors and their family, property costs, interest payments, capitalisation of R&D costs.

- **Balance Sheet**

  Basically a statement as to the net worth of a company at a single point in time. It lists the company’s assets and liabilities. Areas to focus on: type of assets and their valuation; amount and type of creditors; amount and type of debts; cash at bank.

- **NAV**

  This is the net asset value of the company i.e. the bottom line of the balance sheet, showing what is the difference between assets and liabilities.

- **EBIT**

  Earnings before interest and tax; ie the pre-tax, pre-interest profits of the company.

- **EBITDA**

  Earnings before interest, tax, depreciation and amortisation. (Depreciation being the depreciation of the assets inside the company and amortisation being the depreciation of the intangible assets of the business).

- **PBT & PAT**

  Profit before tax and profit after tax.

- **MBO**

  Where the existing management team buy the company from the vendors.

- **MBI**

  Where an incoming management team buy the company from the vendors.

- **BIMBO**

  A combination of MBO and MBI.

- **R&D**

  Research and Development costs. These might be the cost of building prototypes or developing new products or software. It is often used as a method of taking an expense off the P&L (which improves the profit) and inflating the assets in the Balance Sheet (which increases the net asset value). To a certain extent it is an accounting trick and if the R&D

expense is large, then you need to understand what is involved, as almost certainly a purchaser will look very sceptically at it.

- **DD**
  Due diligence conducted by the purchaser's accountant (Accounting Due Diligence) and purchaser's lawyer (Legal Due Diligence). It may also be conducted by the purchaser's bank too. Commercial due diligence is an assessment by the purchaser and/or his advisers of the commercial risks associated with the business, this may include meeting with the business' key customers and key employees (both of which the vendor will be keen to prevent and the purchaser will view as an essential part of the deal). DD is essentially like a detailed audit, the purpose of which is to discover any problems within the company and/or give it a clean bill of health. The DD is highly intrusive and involves the purchaser's advisers spending a number of days at the business going through the books, interrogating the owner and possibly some senior staff members and the vendor's bookkeeper/accountant.

14. NOTES ON COMPANY ACCOUNTS

A company's Profit and Loss (P&L) is a statement of the income, expenses and profit/loss of the company for the relevant period (usually the Company's financial year).

A company's Balance Sheet is a statement of the Company's Assets and Liabilities and Net Worth at a particular date (usually the last day of the Company's financial year).

Below are some notes on each of these:

PROFIT & LOSS

SALES/FEES/INCOME/TURNOVER	£	
COST OF SALES		
Purchases	£	
Direct Labour	£	
GROSS PROFIT	£	(%)

OVERHEADS
Rent & Rates
Power and Gas
Stationery
Wages/Salaries/Indirect Labour
Postage
Bank charges
Telephone
R&M (is this a true number? Has it been inflated by additional costs?)
Motor vehicle (exclude owner's car costs if not required for business)
Directors expenses/salaries (exclude, highlight or state at market rate)

TOTAL EXPENSES	£
OPERATING PROFIT	£
Depreciation (is this relevant to the business?)	
Interest (exclude if the purchaser is not taking on any existing debt)	
NET PROFIT	£

BALANCE SHEET

FIXED ASSETS
Tangible/Fixed Assets (= Plant& Equipment, buildings etc)
Intangible Assets (= Goodwill/Patents etc –you can usually ignore goodwill for valuation purposes)

CURRENT ASSETS
Stock
Debtors (= money owed by customers)
Cash (usually extracted on a Zero Cash Zero Debt deal)

CURRENT LIABILITIES
Overdraft
Trade Creditors (= money owed to suppliers)
HP/Lease (= any finance owed on cars and/or equipment)
VAT
Corporation Tax (usually this is the tax bill on <u>last</u> year's profit and needs to be paid off before completion)
Other short term loans (includes any principal instalment of any mortgage debt which is repayable this year, usually paid off in a Zero Cash Zero Debt deal)

NET CURRENT ASSETS (= Current assets less Current Liabilities)

LIABILITIES (of more than 1 year)
Bank Debt (usually mortgage debt or a term loan)
Other Loans (such as Director's Loans)

NET ASSETS (= All Assets less all Liabilities)

15. FAQ

A. **What's Depreciation?** It's a method of allowing a business to claim as tax deductible a percentage of the capital costs incurred in doing business, such as the cost of the plant and equipment, the computer equipment, the cost of the building, the motor cars etc.
B. **What's a capital cost?** It's a non-recurring expense that is incurred to purchase an asset such as the cost incurred in buying a machine, a car or a building. It is an expense that is usually not written off in one year and so it is not included as an expense in the P&L although it is partly written off under the Depreciation heading.
C. **What's Adjusted Profit?** It is the stated profit of the business as shown in the accounts plus or minus any expenses that were written off within the business but which would be costs not normally incurred by the buyer once he has bought the business; such as adding back the non-working wife's salary, the unusually expensive car expenses; the unusually high R&M costs.
D. **What's the difference between Gross and Net profit?** GP is the income less the variable costs of doing the business, ie. after deducting the costs that will rise or fall depending on the level of sales (such as the cost of the goods purchased to make the finished product and the direct labour costs incurred). These are also known as Above the Line Costs. The Below the Line costs are the semi-fixed costs, such as rent, telephone, administrative salaries (often lumped under the heading Administration costs) which need to be deducted from the Gross Profit before arriving at the Net profit.
E. **What's the difference between a P&L and a Balance Sheet?** A P&L is the statement of the income less regular expenses of the business; it shows the "Earnings" not the Assets of the business. The Assets and Liabilities/Debts of a company are shown in the Balance Sheet. The Net Assets of a company are the Assets less the Liabilities.
F. **What's happening to the Balance Sheet on Completion?** There are a variety of ways that it can be agreed to sell a company and to clean up the Balance Sheet before a sale….some examples are:

- The parties may agree that the Balance Sheet will be left largely unchanged with an agreement that there will be no substantial improvement or deterioration in the Net Assets and that any improvement will be in addition to the Sale Price and any reduction will be taken off the Sale Price; or
- The Balance Sheet will be unchanged at completion and in addition the vendor will be paid £ for £ for any cash in the company at completion which is over and above an agreed level (usually an amount equivalent to say one month's working capital requirements…..a bit like having enough petrol in a hire car to do the first 50 miles); or
- The Balance Sheet that will be handed over on completion will be on a zero cash-zero debt basis…meaning that the vendor will take out all the cash in the company and use it to pay off all the bank debts and similar (but not trade creditors) and then keep any balance for himself……in practice what usually happens for tax reasons is that after paying off the debts, the vendor leaves the cash balance inside the company and then the purchaser pays him £ for £ for that cash in addition to the Sale Price.; or

As we know, just about any kind of deal structure is possible and it’s all subject to negotiation.

If you need help with your deal call us on **0333-123456-2**