

Guest Article

■ 10 Mistakes to Avoid When Selling Your Business

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There comes a time for every business when ownership changes hands, whether through transition to the next generation or an outright sale to a strategic or financial buyer. In the latter case, every owner – whether it is a founder hoping to cash out or a private equity firm seeking attractive returns for its investors – wants to obtain the best deal possible.

Unfortunately, many owners – particularly those with little or no experience selling companies – fail to take the steps necessary to obtain top value for their companies.

Following are 10 common mistakes that keep business owners from maximizing their return when selling their companies.

1 Providing financial statements that do not accurately reflect the company's operating results and financial position to the buyer

Since the quality of the seller's financial statements is of significant concern to a buyer, it is important to present accurate statements that conform to United States Generally Accepted Accounting Principles (GAAP). Ideally, these financial statements have been audited or reviewed by independent accountants.

For example, we worked with a pharmaceutical company that operated a virtual business utilizing contract manufacturing and logistics. While the company previously accounted for product returns and sales allowances on a cash basis, our analysis of its revenue recognition policy (among other issues) resulted in a

significant revision. The result: earnings and EBITDA increased as current returns were pushed back and aligned with the initial sale of the product.

Another example involved a manufacturing and distribution company that employed the income tax basis of accounting to report its business activities. The company's emphasis was on minimizing taxes; reporting earnings based on GAAP was of little importance to its owners. Fortunately, the seller's investment bankers were able to persuade the seller to prepare GAAP financial statements, resulting in a more favorable view of the company and an improved valuation.

However, even professionally audited financial statements can understate the company's true profitability, since the business practices of most closely held firms are designed to minimize earnings in order to reduce tax liabilities. While this approach is both understandable and perfectly legitimate, it can present a misleading view of the company's true performance and its value to a potential buyer. Therefore, it usually makes sense to present supplemental information adjusting the company's actual results for these add backs.

2 Failing to identify all appropriate add backs to EBITDA properly

An important element of recasting operating results is the inclusion of add backs. While such add backs vary from company

to company, common examples include valuing inventory at FIFO rather than LIFO, or revising the owner's compensation to more accurately reflect how much a non-owner employee would be paid to handle the same responsibilities. (The owner may also be compensating other employees, such as family members, at above-market rates. These too should be revised to be more aligned with market realities.) Other examples include removing charitable contributions, personal expenses, one-time costs such as legal fees associated with defending a lawsuit, significant repairs and maintenance, and employee severance. Of course, business owners who have been especially aggressive in their accounting strategies should be careful to avoid equivocal add backs, such as those that produce an "audit trail" the IRS might find useful. Examples might include personal expenses, excess travel and entertainment, and inappropriate expensing of capital expenditures.

3 Neglecting to identify all pro forma adjustments properly

The provision of pro forma financials is an essential element in the M&A process. However, business owners frequently overlook items that could have a positive impact on pro forma EBITDA and valuation of their business.

For example, some owners neglect to assess how the addition of new and recurring customers might positively affect future revenues and earnings. Since the credibility of such pro forma financials is crucial, it also is important to understand and present how such customers will likely impact inventories, operations or other added costs that would be incurred to service them. The goal is to show the most attractive numbers possible without raising doubts about the legitimacy of the forecasts.

4 Failing to file income, sales, and use taxes in all relevant states and jurisdictions

This is a very complicated area, and owners of closely held businesses are often surprised when buyer due diligence uncovers delinquencies and liabilities. In such instances, the transaction can be seriously jeopardized or even terminated – especially today, when revenue-hungry state and local governments are intensifying their pursuit of violators. Not surprisingly, buyers are generally unwilling to overlook potential exposure to tax, interest and penalties.

Of course, there often are cases involving legitimate exemptions, such as when the seller's customers are exempted from paying sales taxes. In these instances, the company owner would need to provide proper, credible evidence of such exemptions.

Our firm frequently identifies state and local tax problems during sell-side due diligence, an increasingly popular service in which a third-party thoroughly examines the company to identify potential problems before launch of the M&A process. In most cases, the seller can take steps to rectify these (and other) problems before

going to market, or at the least be prepared to disclose them to the buyer and offer credible explanations and/or potential solutions. A seller might be tempted to ignore concerns and hope they are overlooked by the buyer. This is a very bad idea. Problematic issues are almost invariably uncovered during buyer due diligence, putting the seller in an awkward position, damaging his or her credibility and sometimes leading the buyer to abandon the deal entirely. A better alternative might be to accept a lower purchase price in exchange for letting the buyer address the issue.

5 Using improper tax accounting methods

Another common problem is the use of improper tax accounting methods. Such methods may be acceptable for owners of a private business, but they will create problems for the seller during an M&A transaction. During buyer due diligence, we have discovered situations in which a seller was reporting income on a cash basis in violation of IRS regulations. When the company revised its method of reporting income to an accrual basis, the seller was chagrined to discover additional tax obligations, which resulted in a decrease in the purchase price and a reduction in after-tax proceeds.

6 Inability to provide timely financial information upon request from the buyer

The level of financial detail sought by buyers – such as detailed *monthly* statements that accurately present the company's performance over the most recent 12-month period – is often beyond what the typical business owner requires to manage the company effectively. Buyers will want to analyze profitability by product, individual customer, or project, as well as look at working capital on a month-to-month basis (without potential distortions from the inclusion of non-recurring items). They will also want support for account details, so they can scrutinize the business for excess, slow moving or obsolete inventory; uncollectable account receivables; unrecorded liabilities; or volume rebates for customers. Other typical requests include information on leases, contracts, employment agreements, and minutes from board meetings. Being able to quickly and efficiently provide such information requires both excellent internal processes and solid IT systems.

Ideally, the company owner should be able to show positive trends, such as steady improvements in performance – and, in today's economy, evidence of recovery from the recent downturn.

7 Lacking high quality IT systems

With information technology becoming an increasingly important aspect of most companies' operations, prospective buyers have intensified their scrutiny of sellers' IT systems. For example, the majority of buyers will assess whether the seller's IT system can accommodate the growth sought by the new owner. In many cases, such as in a "roll up" in which two or more companies are merged to form a new and presumably more competitive entity,

the buyer will also evaluate the ease or difficulty of integrating IT systems post-acquisition. Having an inferior information system, such as one based on outdated hardware and software, may lead to a reduction in the purchase price.

At the very least, a company's IT system must be sufficiently robust to enable the seller to quickly and efficiently access volumes of detailed information requested by the buyer.

8 Establishing an improper tax structure for the sale

It is important to remember that when selling a business, what one *gets* for a company is less important than what one ultimately gets to *keep*. That means taking steps to maximize net cash proceeds while minimizing tax liabilities.

For example, owners (and/or their advisers) should perform careful analysis to determine whether an asset sale or a stock sale is preferable. For a variety of reasons, buyers usually prefer acquiring the assets of a business rather than its stock. Sellers, on the other hand, tend to prefer selling stock. If the seller is an S-Corporation, reconciling these opposing positions can be relatively easy via a Section 338 (h)(10) election. In most instances, a Section 338 (h)(10) election provides the buyer with a higher tax basis in the assets being purchased than the underlying tax basis of the assets – and in such a case the buyer will compensate the seller for any additional tax liability that might result from the election.

9 Failing to assemble the best possible team – both to increase the company's attractiveness and to ensure an effective deal process

In many acquisitions, a key buyer consideration is the quality of the seller's management team. Among the issues they may evaluate: Can the buyers run the company themselves (or with their own management team), or will they require the seller to stay onboard for a period of time to help smooth the transition to new ownership? Does the seller's current CFO offer the sophistication and expertise required by the buyer post-acquisition, or will it be necessary to find a replacement? Will the deal involve the acquisition of significant personnel assets, such as a strong and well connected sales force? If so, what must the buyer do to retain those assets after the sale?

Getting the best deal possible also requires assembling an experienced and professional deal team. Owners should select investment bankers with the expertise and resources necessary to identify suitable buyers, manage the process efficiently, and represent them effectively during negotiations. Their attorneys should have in-depth understanding of the particular legal issues associated with M&A transactions. And they will benefit immeasurably from the involvement of top notch CPAs. A well regarded CPA firm can benefit them not only by reviewing and auditing the company's financials; its reputation will often actually enhance the credibility of the financial information being presented to the buyer.

10 Failing to take enough time to prepare for the sale properly

Investment bankers with whom we work agree that, with rare exceptions, sellers who get the best deals are those that have spent adequate time – usually 18-24 months or longer – to take the steps necessary to effectively prepare their companies for the sales process.

This advance preparation enables them to have financial statements audited; identify appropriate add backs; implement processes that allow them to prepare accurate monthly financial statements; replace or upgrade outdated IT systems; strengthen their management teams; analyze and address federal, state, and local tax issues; and take other steps to ensure their business is presented in the best possible light. Ideally, they engage a firm to perform sell-side due diligence and identify problematic financial, legal, and operational issues before their investment bankers take their company to market.

Of course, sometimes circumstances do not permit the luxury of this level of preparation. Perhaps a particular market or industry is booming, and the seller wants to take advantage of current high valuations. Alternatively, maybe an appealing, well-funded suitor has expressed interest in acquiring the company. In other cases, personal issues (health issues, divorce, conflicts among partners, etc.) require the consummation of a sale in a less-than-ideal timeframe.

Even in a condensed time period, there are steps owners can take to enhance their company's appeal, ranging from having GAAP financials audited to assembling a strong and experienced team of advisors to provide expert assistance throughout the transaction process.

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Selling one's company is usually the most significant financial transaction in a businessperson's life. However, the typical company owner – including those who have demonstrated undeniable expertise in operations, management, marketing, sales, and other aspects of the business – is unfamiliar with the process of selling a company, and as a result fails to gain the best possible results from the transaction. Effectively preparing one's company and its financials prior to initiating the M&A process can go a long way toward achieving crucial financial objectives.

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