Chapter 4

We're not going to be going through and discussing a thing called the balance sheet, and there's two key documents that you basically have. Now, this is Section Four in your book, and you're going to find as we go through this, we're going to be talking about the balance sheet, and this in addition to the Profit and Loss Statement are the two key documents that you're really trying to get yourself involved with and check in details, and these are the areas that you're going to have to have the most experience either doing it on your own or having a CPA or accountant help you as you go through this area.

Again, what we're attempting to do here as we go through this section is we're attempting to uncover the different problems you're going to have come up 90-some percent of the time. As a number of other things come up, they don't come up in a significant number. So, what you should do is learn the different areas that you're going to have problems with, and as you go on you're going to pick up an education in the other areas. But, again, I'm not going to cover anything that doesn't happen continually. Again, if you go out tomorrow, and spend a week, by the end of the week you'll be able to teach this section.

What I'd like you to do first to make it easier for yourself as we go through Section Four is why don't you turn to page 4-9, and pull 4-9 out of your book which happens to be the balance sheet for the ABC Company.

Again, what is a balance sheet? A balance sheet is basically a document that tells us in business what the assets are, what the liabilities are, what the net worth is or how much does the owner own, which is basically the net book value. What you really find is if you want figure out what this is mathematically, it's assets, which is the little things you can clutch – the cash, the equipment. We then subtract the thing called liabilities, what do you owe on these items or what do you owe on the business. You subtract that. And, you end up with what? You end up with a thing we call the net worth, or how much the owner has in this business as basically a book value.

Now, the thing you have to realize as you start to go through this, we go to 4-1, we have document like most other documents in business that are not very accurate. These documents are misrepresented. Many of these documents are manufactured on the dining room or the kitchen table. So, you're going to find they're made as instructive, or made as to whatever the people are asking for them. So, be very careful as you're checking these things out.

I also want you to realize those of you buyers will also use the balance sheet as a negotiating tool. We use that after we've arrived at a price maybe of $100,000 to then go back to the seller asset by asset and if they assets don't make too much sense or we don't believe we want to buy them, we negotiate with the seller to have the seller subtract those from the price and have the seller keep those assets, and that way we end up lowering the amount of money we have to pay for the company. We do this all the time. We'll talk about that later.

First of all, on page 4-1, we have understanding financial statements. We're going to talk about four different categories of statements keeping in mind that none of the statements are very accurate. First of all, the audited statement, and I f you haven't been in business before, you're always coming to people like myself and say, "I'd like an audited statement. That's fantastic." But, the problem is in order to get an audited statement it costs tens of thousands of dollars and takes months to provide one. You're going to find that they're usually for a specific period, usually one year. There's a limited scope as CPA opinion because it's incomplete. Also, read the opinion carefully. It may spell out problems. In front, they don't only have the disclaimers and tell you how much auditing they did do, but it also spells out the problems areas that they are aware of.

It's prepared by a CPA, and again, the reliability is based upon how good the CPA is or how much expertise they have or how much the owner tried to pull off on them. Keep in mind, when you start to think about it, there's a number of companies out there over the years that have had the audited statements, and have misled the public. Again, I think of Equity Funding. I think of First National Bank of San Diego. I think of Rolls Royce, Pennsylvania Railroad, Lockheed, Chrysler – all of these companies have audited statements again for a long period of time. They sort of fooled you, and again the audited statements we don't think are that good. Again, they're better than what you're going to run into, but the chance of running into an audited statement unless you happen to be buying a company that has been franchising or maybe a company that is selling a stock on the stock market – they have to have audited statements – or maybe a large company that is getting a lot of bank financing for expansion or to keep going. In a lot of cases, the banks or the lending institutions are required then to have audited statements, but most of the time you're not going to find them.

The next one is the interim statement, usually not audited, used by business to evaluate performance. Again, it's not exactly as good as an audited statement, but again, when you see them, we check everything out. Dot every I and cross every T. Why?

Because over the years we have found as you'll see in a short while, most of them are very Mickey Mouse, and certainly not accurate.

The unaudited year-end statement, again we're getting worse and worse here, it's signed by the company officer, dangerous. It should have an internal book audit, again, the unaudited year-end statement is about as accurate as they want to make it.

The estimated statement, which is really terrible is dangerous to base opinions on estimates. You need the figures that are clearly defined and precisely executed. What you have with an estimated statement, these are the ones that are basically in the category of what's developed on the ironing board, what they made up on their kitchen table or on the cocktail napkin at a bar somewhere.

So, what we're saying is be careful as you go through the statements. Again, I don't want you to become neurotic, but what I want you to do because understand there's a lot of fraud involved – some intentional, some not. What I want you to realize is just verify things. Take your time. Dot the I's cross the T's, and go slowly. You're not going to get ripped off.

As we start to go through this, you can probably follow this on 4-3 and 4-4, we're going to be going through the different aspects, and the first category we're going to have as you look at the balance sheet on 4-9, you see this thing called assets at the top, and the first thing is current assets. What we have here under current assets if you're looking at 4-3, it says the cash plus those items which the company plans to convert to cash over the course of its normal marketing process in the regular context of business. These are available conversion to cash as needed. And, these are basically things that can be converted in the next year to pay items in the next year. As we start to go through this, I'm going to following in different type order, I'm going to be starting with Aging Accounts Receivable, but in order to do that let's take the assets and I'll start with the third one. Again, we're going to come up to the top, and go down, but I will cover all five of them.

Let's take the accounts receivable. The accounts receivable of $120,000 – now, what we're talking about here is somebody has come to the company here and instead of paying cash they're going to pay for it in seven days, 14 days, 30 days which we do. We then carry it on our books or on our balance sheet as a thing called the accounts receivable. This is money owed to the company - $120,000. But, the thing is, are they collectable? And, although we mentioned this in other parts of the tape program, there's two things we're going to be doing. We're going to be doing a thing called aging accounts receivables to find out how many of them are accurate, and the other thing we're going to do and you offer to purchase later in the program, we're going to make sure the seller of the business guarantees the receivables. So, if there's certain ones that we take over as buyers we can not collect on, the seller makes them good. We'll get to that later in the program.

But, right now let's take the receivables, and what I'd like you to do keeping 4-9 out, I'd like you to put your finger in the page at 4-3 and turn to the back of the section, or if you're like, turn to the back and pull out the next to the last page or just look at and that's page 4-13. What we have on 4-13 is a schedule of accounts receivable, and aging of accounts receivable. What we have here is a list of companies, and again we don't have all of them. I just took a cross-section of them. I didn't take all the companies that make up the $120,000 that's owed. So, we took five of them. We have Al's

Manufacturing. They owe us $7,000. Bob's retail, and as we go through this, we find of the $7,000 of Al's Manufacturing, $7,000 is current. They're not past due. So, it looks pretty good on the surface.

But, going down to the third one, we have Cal's Deli, and they happen to owe us $12,000. Of the $12,000, as you can see here, $8,000 is current – hey, that's good – but, we notice going over to the right, $3,000 is 30 days past due, and we have $1,000 that's 60 days past due. What you're going to find as you start to get up towards 60 days past due it becomes very difficult to collect the money. And, incidentally, if they're already up around 60 days past due, a thousand, and $3,000 30 days past due, how collectible will the $8,000 be? And, why are we still giving them credit? But, the thing you have to keep in mind when you're going through a scheduling or aging of accounts receivable, we're also talking about what here? We're talking about our customers, and you don't want to just blatantly when you're going to buy a company or get involved in a company, just go out and say, "Well, look, these people are past due, we're going to put them on COD."

You may end up losing your largest customer, and what you may have to do is you may have to go into that business, buy it, take over those receivables, and then start going to a person like Cal's Deli who may be a large customer and say, "Look, you're 60 days past due. Let's start moving it back and maybe over the next couple of years you'll get it back to 50 days past due." You don't want to break them, 45. The ultimate goal a year or so from now or two years from now is getting it back in line to maybe 30 days past due, or you may have to accept the fact that they're always going to be 60 days past due, and make that your standard payment period and stay on top of it so it doesn't crawl up to 90 days.

One of the temptations that many of you are going to have is to buy these at a discount because you hear about it all the time. Any ones that aren't any good, buy them for ten cents on the dollar. Well, the normal company you get involved in the people that you have now that are collecting this money are going to be the same people collecting it later, and even though you as the owner may be a little stronger in the area, you're going to find it a little difficult to collect and what I try to do in most cases when I'm buying a company or suggesting to you – why not just say to the seller of the business, "This one doesn't appear to be collectible, why don't you keep that and we'll subtract that – in this case here $12,000 – we'll subtract it from the price of the business."

What we find in most cases if the seller's very knowledgeable, the seller knows he or she is going to have trouble collecting this after they end up selling the business. So, what most of them end up doing in closing or at the close of escrow, is they'll turn to the buyer and say, "Look if you can collect this $12,000, we can split it." What happens is you don't have any money invested other than the fact that you're going to have labor invested. If you then collect it, you end up getting half of it. If you don't, it doesn't cost you anything. So, be careful with discounting. Although it may work in some cases buying at a discount, we find in a lot of cases, you end up paying money. Again, even ten cents on the dollar isn't worth it if you're not able to collect that ten cents. So, be careful of these bargains.

Now, you start thinking about the receivables later when you're going out to buy a business. One of the things that we run into when we're first getting involved in a business, we'd like to know what type of customers we have and who they are. Sometimes the seller will hold this back and not give it to you until after you've made the offer. Quite often what you could do if they're turning you down on that, is asking for an aging of the accounts receivable. The thing that's fascinating is it surprises me how many sellers do not even know what they're giving you.

Now, from the seller's standpoint, I suggest you take it from the other side, and again, I agree, do not give you out your customer list or your supplier list until after the offer's been made and the offer's been accepted and you feel good about the other party.

Now as you start to look at the accounts receivable, again you buy standard sheets and you buy these standard sheets from the stationary store. If you have a computer print out again, it's a standard item. What I want you to do after you start to buy a company is work on these to make sure these things are being collected on time because as they extend out you're going to find they become increasingly difficult to collect, and you end up having to write-off all sorts of money that you're business should've collected and should've gone to the bottom line as a thing called what? A thing called profit.

Now, the thing that also I like about you as a buyer going out and asking for this aging is the average person buying a business does not know what an aging is or even what accounts receivable aging is. Once you do this, you're going to find the seller's going to go to the CPA or the accountant and say, "Hey, I have a buyer. The buyer would like the aging." You're not only going to impress the seller, you're also going to do a good job of impressing the CPA because most CPAs that are very knowledgeable in selling know that only knowledgeable buyers ask for things like this. The average buyer doesn't even know what it is.

What I'd like you to do now is let's go back to the page we were working on 4-3 also with the balance sheet off to the side also maybe to the right. We've talked about the accounts receivable and again of the $120,000 receivables, if we find $12,000 are not collectible, how much are we able to subtract from the price we're going to be paying the seller? The $12,000 as long as we get to take those back, he or she.

Going north, the next thing you have up here is a note receivable. Under Notes Receivable of $65,000, I just want to say one thing. In all the years I've been in business, I really don't recall the last time I saw a legitimate Note Receivable because quite often, these are notes made out because this corporation has formed a new corporation and it was a loan made between the old corporation and the new one. The new corporation fails. They still leave the note on the book. How valuable is the note from the corporation that has gone down the tubes? I don't think it's very valuable. So, why not give that back to the seller and lower the price?

The big thing that we run into in this area here on notes receivable and also on notes payable are loans back and forth between the officers, and all I'm going to say is one thing, if there are loans back and forth between the officers of the company and the company, why not just let the officers keep them because we find the owners are doing that either to minimize or avoid paying income tax on profits from the company. So, give them back to them. In fact, I just want to say one thing and that is if you find a legitimate note receivable send me a copy of it. I haven't seen one in probably eight or nine years, maybe ten.

The other thing in notes receivable you have to be careful of is quite often when people are borrowing money from a bank especially on 90 day loans, the bank officers stay on top of their collecting of the receivables because if they're not collecting the receivable, it kills the cash flow of the business and the bank officers worry. Quite often, when an officer in a company is having trouble collecting receivables knowing full well that the bank officer's going to give he or she trouble, what they'll do then is move the receivables that are not collectable into an area called Notes Receivable. If the notes receivables were not collectable as accounts receivables, how collectable are they now? They're not.

I hate to tell you this, you're not going to find many that are legitimate. So, what do you do? Give them back to the seller and lower the price. Why pay that money?

The next thing is cash on hand, and although right now you're going to say, "Well, cash on hand must be legitimate", it normally is, but as you start to get involved in business and find out about things like kiting which are techniques used by embezzlers and also sometimes by business owners to artificially inflate the cash, this could give you trouble in analyzing the business, but if you handle it properly when you're buying it, you end up taking over the amount of money that is really in the bank the day you take over. But, there are different schemes and scams you're going to hear about perpetrated by employees and also perpetrated by owners of businesses, and hopefully you'll take your time and you CPA will cut off the account probably and you will not have trouble with this area – cash on hand.

Next we go to number four in this category and start talking about the inventory. Again, we said here, "How about damage stock? Obsolete stock?" What we try to recommend is use the outside inventory companies. They're listed in the Yellow Pages under "I". You're going to find that they're very good people. They are very professional and they are knowledgeable in the area of the inventory that you are buying or you're selling. You're also going to find the expense is not that high. They're really inexpensive.

You're also going to find generally that they're bonded which means if a mistake is made by these companies in handling the inventory or appraising the inventory or valuing the inventory during a transaction, you're going to find they're good for it. They'll make it good.

Why do we try to get you to do this? We normally find that buyers and sellers end up arguing and fighting and kill a transaction if they're together any more than 40 seconds. You're also going to find the average buyer of a business is not as a knowledgeable in the stock room inventory as the seller, and this then puts them on even footing. It gives the buyer a chance in the transaction.

The next thing we start to look at is a thing called pre-paid expenses and we're talking about $15,000 here. The thing you have to realize is when we're trying to buy a company, we are trying to finance as much as possible. If somebody has put up a pre-paid deposit to pre-paid expenses that we may be able to finance, we as buyers would like to find out about it ahead of time to see if the seller would include this in the financing for 10, 15 or 20 years. Or, if they won't do that, maybe we can set up a side note for five years and finance it.

Now, for those of you listening that are representing the seller or the sellers, what are you looking for? All cash. You want your deposits as all cash. Again, as we go through this, I'm going to be switching hats back and forth to show there's two sides of it, maybe three sides. But, the thing to keep in mind is look for win-win situations keeping in mind as I always state that you can make more money in business honestly than you can dishonestly. So, don't try to rip off the other party. It's not necessary.

We also want to mention that things like change and petty cash are not available for paying bills, and also beware of marketable securities at cost. Why? They may be worth less. My gosh, how could that happen. So, be careful in a number of these different areas.

The next category we start to get involved in as we go down below here are the fixed assets, and what we're saying here is the tangible physical facilities utilized by the company in performing it's function. These assets usually represent a permanent investment in special items such as land, buildings – which we don't have in this one, automobiles, furniture and leasehold improvements. In this case here, it's called leasehold expenses.

Now, as you start to look at this and you think about the leasehold expenses, this thing is normally called a number of things. Sometimes we see it down on the sheet as leasehold expenses. Other times you're going to see it down and it will be described as leasehold improvements, and sometimes it will be called fixtures. What we basically have because we have real estate, we have land, we have a building, and then the business owner then makes additions to this. They attach the fixtures. They make improvements called leaseholder improvements. Whether a fixture is a leaseholder improvements, what it normally means is that they are attached to the property, and once the lease is over five, ten, 15 years from now, the owner of the real estate, gets to keep the fixtures and the other. Again, if you haven't covered the lease section, you might go back and review that because we covered that in detail in the tape that has to do with leasing.

When I start to talk about the next category and the equipment value, is it the original cost or the owner's value or the book value, or is it the real value? What do we mean by that? Well, you're going to have to realize there are two basic categories. There's really not four. There's one and two. What happens is I'll find the owner and I'll say, "Look, I bought the equipment for $100,000 a few years ago or maybe $200,000. I now have depreciated or used the ACRS and the equipment now, from a tax standpoint is worth a lot less." And, they have it down at the value of what they paid for it minus what they've written off, and again, it's not accurate.

On the other hand, you're going to find a person that went down to Charlie's Junkyard about a month ago, bought the equipment for $500 and because there's always some inflation, the equipment has to be worth $30-$40,000 today. Neither one is accurate, and what I'd like you to do is go to the people that supply you with the equipment and you're going to find the people that supply you the equipment are going to provide you with an appraisal on the business. They have things just like a Kelly Blue Book that they use in the auto business that lists what the different pieces of used equipment are, and you're going to find they can come back with a verbal or a written appraisal as to what the equipment's worth, and in most cases, it doesn't cost anything. My gosh, it's a free lunch. There's never a free lunch.

The reason they're trying to give you this free appraisal because they want to do what in the future? They want to sell you more equipment. So, find out – why do we do this? Because recently in the last few years because of inflation running higher than normal, we found a lot of the equipment being purchased is actually worth as much or more than what they paid for it, and you're going to find as a buyer, you're going to pick-up a lot of value in this area. You're going to find owners selling their business for $100,000. The equipment alone is worth $300,000. You're going to come back to me 50 times and ask me what's wrong. In some cases, there is some fraud, but in most cases you're going to find you just happen to get a good deal.

Now, on the other hand for those of you who are sellers or representing the sellers, I would suggest right in the beginning you go out and find out what the equipment's really worth because the seller may end up giving away a couple hundred thousand in excess assets because he or she didn't bother going out and finding out what the assets are really worth. So, go out and find it.

The main thing you normally have to watch out for from a buyers standpoint or somebody protecting a buyer are the seller's don't at cost and what they do is they keep adding to the value. They may have it down at what it's worth today or replacement costs, and most of these approaches like replacement costs end up artificially inflating the value. So, it is possible that you could end up with a value on here that's a little higher. So, check it out to find out how the seller arrived at it or talk to the CPA or accountant, and beware, take your time.

As we start to go to the next category, we start to talk about a thing called intangible assets. Now, these are very difficult to define because in some cases they represent definitive money value while in others they don't have a measurable cash value. Examples are organization expense, patents, franchises, goodwill.

Now, a patent and a copyright have a limited life. Again, a patent has a limited life of about 17 years. A copyright today is basically 50 years or the life of the owner plus 50 years. Trademark is good forever, and again I already said patents are good for 17 years.

Now, looking at this here, we find we have a patent value and the patent value is $25,000. You say, “Hey, $25,000.” This example probably isn’t a very good one because most of the time we find that the owners have not put on the balance sheet the value of the patent based on what they paid for it, but it’s the value that they as the inventory have attached to it. In this case here, $25,000 would not throw off the value or the purchase of the business very much. What happens if you have a business like this and the owner has a total net worth of $220,000 basic and then on top of that there’s another four million dollars of patent value? You’re going to find you’re going to have a hard time putting a transaction together as buyer or seller, and whether the patent value happens to be $25,000 or it happens to $200,000 or a million dollars or two million, what we try to do when you have a case like that as a buyer or an agent for the buyer, we try to have the seller keep the patent and the seller giving us rights under a licensing contract.

Then, instead of having to pay the $25,000 or two million dollars for it, we pay them .02 cents per part produced or sold. Again, I just made up that number. What it is it ties into what you’re doing. Also, if you decide not to distribute or manufacture that product later, you don’t have to pay anymore on that patent. It also is a win-win situation because not only does a buyer win but the seller wins because the average seller that has developed something or has developed a patent – a patentable item – is usually a person that is very attached to that, and this way they keep ownership and they keep all the plans and blueprints. They can keep them under their bed.

The next thing we’re talking about here are miscellaneous assets or on the balance sheet we’re talking about other assets, and they’re identified by the process of elimination. If they don’t fit in other categories, place it here. Items in this category are cash or undervalued life insurance, deferred charges. Again, sometimes different categories are prepaid expense. The prepaid expenses we have in this example happen to be things that are coming up in the next few months. So, they're not long term.

A prepaid asset, can you use it or is it worthless? Example, stationary with an old business name, and in our example here, we have prepaid paper there's a $5,000, and the thing that always fascinates me are paper goods because I can usually walk into the back of a business and tell how many former owners we had by the number of skids with stationary in corrugated boxes because everytime a new owner comes in and the stationary in corrugate boxes are green, the next one's going to want yellow. The next one's going to want purple, black, and so on, and if you go back there and find five different colors it normally means you have five or six different owners, and what I do is I try to get rid of that.

When I'm buying a company or representing somebody, I try to get the seller to buy it and keep it, sentimental value – ten cents on the dollar or whatever. If they don't do that, I deliver it to their garage. Why? There is not one seller man and wife that do not love to reminisce if they've owned that company 15-20 years. That way I deliver all the corrugated boxes and stationary to the garage. That way on the weekend when the grandkids come over to visit grandma and grandpa they can take them out in the garage tell them about their past days owning the company, put together two corrugated boxes, fill it with old stationary, and send it home to their kids. And, actually the kids then after a few weeks don't want to send them to grandma and grandpa's house because of all the junk they bring back.

The next thing we start to get involved in is a thing called the liabilities, and if you'll flip to 4-7 we're talking about current liabilities and those are obligations that mature within one year of the closing date of the financial statement. It include the demand note which have no fixed maturity, accounts payable, notes payable, tax liabilities, accrued items.

Now, the first thing we have here as we look at is a thing called accounts payable and it's $115,000, and what we're saying is let's age the accounts payable. Well, what does that mean? Well, let's turn to the last page in this section, the one right after the aging of the accounts receivable, and either pull it out or just look at page 4-15 which is aging of accounts payable. Now, what we're going to do, again there forms are available from stationary stores in pads of 50 or 100. They're not very expensive. You don't have to make up your own. What we've done here is we've given you a cross-section of the accounts payable. We have a list of them because the accounts payable do amount to $115,000. We've given you five of them.

We have Ace Hardware, and we owe them $4,000 and we're current, but, as we get down to Bill's Deli, we find that there's $5,000 owed, and $4,000 is current and $1,000 past due. You're saying, "Well, why do we want this?" Well, one good reason, when you're buying a company would you not like to know if they're paying their bills or not especially when an owner is telling you that the statement doesn't show what they're making or making a lot more. You then go to the aging of the accounts payable, and what you find lo and behold, they're not paying their bills either. What it usually is a reflection of is there's a problem in the business, and they're past due and you might as well find out about it ahead of time.

Now, also when you're talking about an aging and you're going in as a buyer, if the owner will not give you a list of his suppliers that they have, what we quite often do is ask them for an aging of the accounts payable. Now, what we end up doing is getting that.

Now, for those of you listening that are sellers or agent for the sellers, what I suggest you do, and again you don't have to give this information out before the offer is made and it's accepted, and be careful when they ask for the accounts payable. Incidentally, if you are a small seller and you've been around a while, you do know what they're asking for. They're trying to get the information ahead of time.

Now, as we start to talk about the payables, what I'd like to do is take you back to the first section again, or page 4-9, and also take you back to the section that has to do with the liabilities which is on 4-7. So, you should have 4-7 in front of you and also 4-9.

Now, we talked about the aging of accounts payable, also on the notes payable wouldn't you like to make sure that the notes payable have been paid. In other words, we owe money in this company, wouldn't you like to make sure they're paid and they're paid on time?

How about taxes due? Are there past due taxes? In another section of the program, you're going to find one of the problems we have. Now, with a sole proprietorship you're going to find in buying or selling a business, we end up with the hang-ups or the problems that we have on taxes. In other words whether the taxes have been paid or not, whether there's been fraud. You're going to find out later, we do have a problem we get involved in an area called appropriations because unless you dissolve the corporation during the escrow or closing period, you're going to find that you as a buyer end up buying the stock and maybe the assets, but if you buy the stock and don't have the benefit of a bulk sale, which we're going to cover later, you're going to find out that you end up taking over the taxes unpaid. You also end up taking over all the fraud. We'll show you later in the program how to resolve that problem and how to handle it properly.

Let's continue on here. Are there mechanics' liens on the property? We're going to show you how to check those later. Are there notes past due? We've already talked about that. Again, in the area of the liabilities, check these very carefully and also go through the different protection devices that we show you later. I don't care what state you work in, do not let anybody talk you into waiving your rights under the law because what happens is many of you as buyers end up speeding along in order to speed it up by five days or ten days or three weeks, and you end up getting ripped off in the transaction. So, later as we show you the protection that we have built into the program for buyers and sellers, why not follow them. Take your time, and go through the various steps.