



# kendons

CHARTERED ACCOUNTANTS

## YOU & YOUR BUSINESS ACQUISITION

One of a series of business  
advisory publications  
available on request

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# Index

<b>Evaluating the Opportunity</b>	<b>2</b>
A comprehensive checklist of factors you should consider	
<b>Financing the Acquisition</b>	<b>9</b>
<b>What is the best Business Structure for You?</b>	<b>10</b>
<b>So how is the Acquisition Handled?</b>	<b>14</b>

The information presented in this brochure is necessarily of a general nature and should not be relied upon as a substitute for specific advice. For advice on, or assistance with any of the matters raised please contact

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## **Evaluating the Opportunity**

The purpose of this publication is to offer some important guidelines and factors to be taken into account when considering purchasing an existing business. Proper and thorough investigation of a particular opportunity does take a considerable amount of time and research – prospective buyers who are tempted to shortcut them to avoid missing a ‘golden opportunity’ beware! You do so at your peril.

### ***Why is it for Sale?***

People have many valid reasons for wishing to sell their business, and many have strong, established businesses for sale.

However, some investigation needs to be done to ensure the reasons given are not just a cover for adverse events which may include:

- Declining business
- Changes in the character of the neighbourhood
- Lack of competitive strength
- Impending loss of business due to new competition, including competition from imports resulting from changes in Government policy etc
- Obsolete products
- Poor selections of merchandise or materials
- Highway construction or rerouting
- An expiring lease or franchise
- Obsolete facilities
- Inability to collect accounts receivable or problems with creditors
- A need to replace capital assets
- Owner’s bad reputation which may stay with the business
- Labour problems

If these factors apply, the buyer must be able to overcome them to make a success of the business.

## ***Profits, Sales, Expenses***

A detailed analysis of the vendor's financial statements for the past 3 years including profits, sales and operating ratios will assist in projecting sales and profits for the next year or two. Obtain and analyse current reliable records of:

- The owner's income from the business for each of the past three to five years. This can be obtained from the seller's income tax returns or business records, such as bank statements or daybooks.
- Schedule key factors of the sales and operating ratios for the past three to five years. This should be prepared to indicate trends which should also be compared with trade averages, if available, to see if they are in line with other similar businesses.
- Examine sales records to establish if there are any unexplained increases in turnover in the few months prior to the business being listed for sale. Ignore allegations of unbanked takings that have been kept by the owner for personal use.
- Take care in examining the books to look for drawings by the owner as salary and particularly for variable and irregular drawings. Ensure that shareholders' salaries have been properly minuted, and are identified separately from other staff wages to isolate existing staff costs.

## ***The Assets of the Business***

The assets of the business should be closely investigated to determine their value and to make sure that they are transferable to the new owner. Assets may include –

### *Inventory:*

A physical count should be taken (preferably by an independent valuer) and examined for:

- Age
- Quality

- Saleability
- Style
- Condition
- Balance
- Suitability
- Freshness & shelf life
- Costing basis
- Insurance cover
- Is the stock valuation realistic?

*Furniture, Fixtures, Equipment, Buildings:*

- Schedule items to be purchased
- Identify those required to maintain the forecast revenue
- What is their market value?
- How modern, efficient and usable are they?
- Will any be useless or soon have to be replaced?
- Are all in good repair?
- Are they the type the buyer really wants in his business?
- What is the pattern of past repair costs?
- How much has been spent by the seller to keep the facilities in good condition?
- What major changes, additions or alterations will be necessary?
- Are all items paid for or are there monies owing under a hire purchase or lease agreement?
- Are any assets located elsewhere, and if so is clear title held to them?
- Has the depreciation policy been realistic, and how has this affected the profits disclosed?

***Accounts Receivable***

As a general rule, Kendons advise that prospective owners should avoid purchasing Accounts Receivable.

If trading is to continue with these customers, investigate the past history by examining:

- Their age
- The credit standing
- How successful has the seller been in past collections?

- What discounts have been given?
- Is an excess amount of the business coming from credit customers with slow payments records?
- Would this necessitate excessive working capital?
- If a stricter credit policy were established would key customers be lost?
- What is the current economic climate and how does it affect customers' ability to pay?
- Are any credit notes due?

Customers' lists, business and credit records, mailing lists should be included in the sale agreement.

### ***The Lease***

- Is it transferable to the buyer?
- Is it included in the contract agreement so that the legal obligation to purchase depends on availability of the lease?
- Do the covenants of the lease enable the activity envisaged to be carried on?
- What is the annual rent payable?
- What are the rent review provisions?
- What are the tenants' rights to sublet?
- What type of business can be undertaken on the premises? (this will affect subsequent sale price).
- What does the lease provide with regard to the payment of rates and increases thereof?
- How long does it run?
- What are the terms?
- Is there an option for renewal?
- Is there a deadline for the exercise of this option?
- Does the lease grant the lessee the right of assignment?
- Will the buyer be liable, under the terms of the lease, for such expenses as insurance, cleaning, lighting, maintenance etc?
- Does the rental include a proportion of the profits or is it based on turnover?

## ***The Liabilities of the Business***

All liabilities to be assumed by the new owner should be included in the written purchase contract, which should also include a requirement that any claims at the date of acquisition which have not been disclosed, are the liability of the seller.

The Liabilities may be extensive and hidden and may include:

- Unpaid bills
- Chattel mortgages – or security agreements – on equipment
- Back taxes
- Liens against the assets
- Back employee benefit payments including holiday pay, long service pay, sick pay and pending legal suits.
- Other creditors' claims
- Superannuation commitments, redundancy payments

## ***Taxation Matters***

When purchasing shares in a company:

- Check that all income tax returns have been filed and proper claims submitted for any incentives or grants.
- Check the position regarding assessments and payments - are there any current disputes with Inland Revenue?
- Review the reconciliation between accounting and taxable profits and consider whether allowance should be made for deferred tax liabilities.
- Consider the merits of acquiring assets rather than shares.
- Check that PAYE and GST payments are up to date.
- Consider tax advantages available through the deductibility of interest on business borrowings.

## ***Franchises***

- Are exclusive franchises (to sell certain products, for example) transferable to the buyer?
- Are they included in the contract?
- Is it necessary to contact the franchiser to transfer the franchise?
- How long does the franchise run?

- What are the terms?
- What was its original cost, if any, to the seller?
- What is the effect of legislation eg Commerce Act.
- What area does it cover?
- What is the value to you?

### ***Trade Marks, Patents, Copyrights, Other Intangibles***

- Are they included in the agreement?
- Are they transferable?
- Will they be as valuable in the future?

### ***Suppliers' Credit Relations***

- Are business relations with suppliers good?
- What are the trading terms?
- Will they continue and on favourable terms?
- Are the supply sources satisfactory?
- Is there a dependence upon some suppliers?
- If not, is the business committed through contracts to them for a considerable time?
- What future deliveries are scheduled for the period after the new owner takes over?
- Should they be increased – or cancelled?
- Is the estimated average stock turnover greater than the length of credit time granted by suppliers?
- Is the length of credit time granted to customers greater than the credit time granted by suppliers?
- May agencies be transferred to the buyer?

### ***Business Reputation and Clientele***

- Does the business have a good reputation and established, satisfied clientele?
- How can past poor service be overcome?
- Are there many customers who do business with the vendor out of personal attachment, but would leave if he did?
- Does this affect the value of the business?
- Does the new owner need to allow for a probable loss of a percentage of customers?

- Are there firm contracts with key customers and are these transferable to the new owner?
- Does the agreement prevent the seller from re-entering business in competition with the new owner?
- For how long a period of time and within what area?

### ***Trained Personnel***

- Will key employees continue to work for the firm under new management?
- If key personnel are lost, how adversely would this affect the business?
- Will existing employees be an asset or liability to the new owner?
- Will the new owner want to make changes? If so, will there be liabilities for redundancy or loss of office?

### ***Other Factors***

Carefully consider:

- What are past and future trends of the firm, field of business, neighbourhood community?
- How does the business compare with competitors and similar firms?
- What is the history of the location for the past few years?
- How many businesses have been there?
- What types?
- How successful were they?
- How long has this business been for sale?
- Would it be less expensive to establish a new business rather than meeting the seller's price?
- Does the condition of the building and equipment meet local building and health code requirements?

Check zoning ordinances and building codes to determine the existence of non-conforming land uses or violations of building codes. Check for future rezoning, re-development, street or highway changes, highway relocation, limited street access, and elimination of on-street parking.

## Financing the Acquisition

Prepare sales, profit and cash flow budgets for at least the first 12 months to determine the working capital requirements, seasonal demand factors and personal living expenses.

What will be the total ***amount of capital needed?***

There must be enough for:

- Working capital
- Repairs
- Modernisation
- New equipment
- New inventory
- Cash to carry accounts receivable
- Reserves for taxes
- Opening expenses, legal fees, stamp duty.
- Add a further ten percent for unexpected expenses (in our experience, this is the norm)
- Can some items be leased to assist in providing working capital?
- What other assets are available for loan security?
- Does the new owner wish to use them as security?
- What sources are available to provide additional capital?

Is it worth the asking price?

Is the vendor willing to defer or finance a portion of the purchase price?

### ***Goods & Services Tax***

- Is the sale exempt from GST because it is the sale of a going concern between two taxpayers who are both registered for GST purposes?
- If not, how long will the purchaser have to finance the GST content?

## ***Other Factors***

- What is the current trading and economic environment?
- What family members will be involved in operating the business or working elsewhere?

## **What is the Best Business Structure for You?**

The alternatives are:

- To trade with personal liability either as a sole trader or in partnership.
- To trade through a limited liability company.
- To trade as a Trust.

The trite old adage that “the issue must be considered on a case by case basis” still holds true.

The advantages and disadvantages may be considered within the categories of:

- Taxation
- Other commercial issues

and are broadly

### ***Sole Trader/Partnership***

Has the advantages of:

- Lower tax compliance cost
- Ability to eventually sell to a company including the goodwill which has been created since purchase.
- Eventual sale proceeds available when received

### ***Company***

Has the advantages of:

- Name Security
- Limited Liability
- Debenture security

## **But**

Has the possible disadvantages of:

- Must be wound up to extract the eventual sale proceeds without incurring a tax liability
- Higher accounting and compliance costs

## ***Trust***

Has the advantages of:

- Limited Liability
- Lower tax compliance costs
- Sale proceeds available when received

But has the possible disadvantage of more complex structures and greater personal liability of Managers and Trustees.

Kendons do not recommend the use of Trusts for trading but for holding investments including company shares.

## ***Taxation***

- If personal income exceeds \$70,000 there **MAY** be a tax rate advantage through a company structure.
- Commencement on a personal basis does not subsequently restrict the opportunity to convert to a company structure by selling the assets and transferring the liabilities.
- This in fact may be advantageous after a few years during which a goodwill element will probably have been created and this may then form part of the assets acquired by the company and accordingly become accessible to the vendors.
- A personal basis has a lower ongoing maintenance cost due to the lower number of tax and company office forms that are required to be filed annually.
- A sale of assets may attract a recovery of prior years' depreciation claims as a taxable item. If it is possible to sell the shares in a company any gain will not, under present legislation, be taxable to the company.

- If a company sells its assets any capital gain can only be extracted on a tax-free basis during the winding up of the company.
- Any tax losses incurred by a company are locked into the company structure and are NOT available to offset against the shareholders' other personal income – unless the company is specially set up to do so.
- Companies are subject to interest on any income tax which they have not paid prior to their balance date, but individuals do not incur similar charges until their annual tax exceeds \$50,000 (an income of approximately \$159,000).
- Companies are not eligible for “cash basis holder” status under the accruals rules and are therefore obliged to recognise accrued interest which has not been received, as taxable income.
- Companies may become involved in massively complicated “deemed dividend” issues. (A “deemed dividend” is a benefit the Income Tax Act says was received when generally nothing was received at all).
- Fringe Benefit Tax will be payable by companies on:
  - Motor Vehicles available for shareholders' personal use where the expenditure is not reimbursed.
  - Shareholders' current accounts if drawings exceed taxable income and interest is not paid on such debit balances.
- The significance of income taxes has been substantially reduced by the introduction of the imputation system of taxing distributions from companies to individuals.

### ***Other Commercial Issues***

- The advantage of limited liability involved in the use of a company is frequently negated where personal guarantees of company loans or contracts become involved.
- Directors and shareholders may also be liable to creditors if they have received distributions from the company whilst it is NOT solvent.

- The provision of personal guarantees and security over personal assets means that both alternatives have the same exposure to secured debt.
- If there is substantial unsecured debt (trade creditors) then a company structure may provide some additional protection of personal assets.
- Secured lenders are likely to enforce personal guarantees and require personal assets to be sold if the company is unable to meet its obligations.
- The debenture security, which only a company may give, provides a banker with a substantially better security when compared only with a personal guarantee and may involve a lower interest rate.
- Protection against product liability and negligence claims is enhanced by the use of a company.
- The partners of a partnership are jointly and severally liable for the liabilities of a partnership that may give an increased exposure in partnerships other than those of husband and wife.
- The accounting and secretarial compliance costs of a company will generally be significantly higher than for a personal basis.
- The winding up of a company is more complicated and costly than the dissolution of partnership or the cessation of personal trading.
- Because of the availability of debenture security it will generally be easier to raise finance via a company structure.
- The personal Property Security Act and Regulations 2001 is law relating to security interests in property other than land. It will mean an individual can provide a security similar to a debenture.

## **So How is the Acquisition Handled?**

Every business purchase brings with it a complex mix of legal and accounting issues. It is important that both your solicitor and your accountant be involved from the outset and it is as important that various overlapping functions be co-ordinated. Over the years we have developed a close working relationship with a number of solicitors and act jointly with them in completing successful business acquisitions. Over that period an integrated and streamlined procedure has been developed that has expedited the conclusion of agreements and kept professional costs to a minimum.

Although every purchase will have its own unique and unusual aspects we have adopted the following general approach to efficiently handle these joint assignments.

### **STEP 1     *Assessment of Economic Value – Kendons***

An initial assessment of the financial position of the target business will consider the reason for sale, profitability, revenue and expenses and other relevant factors to ascertain the potential profitability and economic viability of the business.

### **STEP 2     *Purchase Investigation – Kendons***

If the initial assessment shows that it is worth proceeding, a more detailed analysis of the accounts will disclose the strengths and weaknesses of the business, the returns and the risks, and the price range.

### **STEP 3     *Financial forecasting – Kendons***

At this stage profit and cash flow forecasts are prepared in consultation with the client and based on the vendor's financial information and Kendons knowledge of the costs of similar businesses.

**STEP 4     *Negotiating the Deal – Client***  
**Your Solicitor**  
**Kendons**

Based on the information from Steps 2 and 3 the client, supported by their solicitor or Kendons, will negotiate the deal. Agreements are rarely settled without negotiation etc. Working closely together, the final form of the agreement is settled with the vendor. Depending on the particular circumstances, negotiations may take place solicitor to solicitor, vendor to purchaser, Kendons to vendor or accountant to accountant.

**STEP 5     *Taxation – Kendons***

Once a decision is made on financial grounds to proceed with the purchase it is important that the deal be structured in such a way as to minimise taxation. This may vary from a complex company structure involving purchase of different assets by different entities to a simple GST registration to ensure the purchase is made by a registered taxpayer and the transaction is zero for GST.

**STEP 6     *Structure – Your Solicitor and Kendons***

There are a number of possible means by which a business can be acquired. Accounting, taxation and legal implications will influence that decision. Depending on the particular circumstances of the purchaser and the business being purchased, it will be purchased either by an individual as a sole trader, by a partnership or by a limited liability company. The decision as to which vehicle is to be used is an important one and should be discussed with both accountant and solicitor. Where it is necessary to form a partnership or to incorporate a company your solicitor will attend to the necessary documentation and, in the case of a company, registration formalities.

## **STEP 7    *Completing the Agreement – Your Solicitor***

Agreement for Sale and Purchase. The Law Society and the Real Estate Institute have prepared a standard form of Agreement for Sale and Purchase of a Business. It is in widespread use and its terms are generally acceptable to most vendors' solicitors. The agreement is completed in consultation with the client and Kendons. Significant issues addressed at this stage include:

- The allocation of the purchase price between goodwill, plant and stock.
- Stock issues including stocktake procedures, permitted stock level fluctuations and stock to be excluded.
- Turnover warranties. In conjunction with Kendons, an appropriate level of turnover warranty is settled on for inclusion in the document.
- Vendor assistance. It is customary for the vendor to provide post-settlement assistance. The extent of this should be discussed with the vendor in association with your advisers.
- Restraint of Trade. Where you are paying goodwill you will not wish your vendor to set up in opposition within a defined area and for a defined time lest he retains existing customers of the business. Written provision should be made in the agreement to cover this.
- Finance. In conjunction with Kendons, your finance requirements are reviewed and any necessary conditions to allow the arranging of necessary finance are incorporated into the document.
- The document is then prepared, executed by you and submitted to the vendor or the vendor's solicitors.
- The treatment of GST.

## **STEP 8    *Terms of Lease – Your Solicitor***

Lease perusal and approval.

Most businesses operate from leased premises.

Leases range from benign to onerous. It is important that you be fully appraised of the obligations that you

will be assuming as lessee. You will also need to be satisfied as to the acceptability of the rent review procedures, the renewal rights and the extent of outgoing commitments that you will be entering into. Following perusal of the lease, your solicitor will discuss the terms with you. The Agreement for Sale and Purchase should contain an express condition that it is conditional on your solicitor's approval of the lease.

#### **STEP 9    *Financing – Kendons***

Funding proposal. A comprehensive funding proposal is completed utilising much of the information obtained in Steps 1, 2 and 3. Kendons have a sophisticated model format that has proved successful with a wide range of financial institutions.

#### **STEP 10    *The Legal Documents – Your Solicitor***

Security documentation. Where finance is required, your bank or lending institution will invariably require security. In the case of a sole trader or partnership, that security is likely to be in the form of a mortgage over real property or a chattels security over the plant and equipment of the business. Where substantial sums are being advanced, banks usually require that the purchaser incorporate as a company and that a debenture be provided. A debenture has a dual role for a lender in that it provides a floating charge over the company's assets including its stock. It also enables the bank to appoint a receiver where the borrower is in default. Your solicitor will attend to the preparation of all security documentation, preparation of any necessary company minutes and to the filing of documentation at the Companies Office.

#### **STEP 11    *Settlement – Your Solicitor***

Final settlement of the purchase will be attended to by your solicitor. Full financial details of the settlement will then be provided to you and to Kendons for inclusion in the business's initial accounts.

## **STEP 12    *Getting Cracking – Kendons***

Post purchase attendances. Kendons will review with you appropriate accounting, stock control, credit and other systems required. Where computer based systems are recommended, Kendons are happy to provide the benefit of their considerable expertise in this field.

### ***PROFESSIONAL FEES***

No two business acquisitions are the same. Your solicitor's and Kendons fees are based upon the extent of attendances provided. For most transactions a reasonably accurate estimate of costs can be made at the outset based on past experience of similar transactions, and estimates of costs can be given before commencing work.

*Please contact us for your copy of one of our other Business Advisory Publications, or download them free of charge from our website at [www.kendons.co.nz](http://www.kendons.co.nz)*

*You and Your Bankers*

*You and Your Business Plan*

*You and Your Business Acquisition*

*You and Your Business Records*

*You and Your Profitability*

*You and Your Qualifying Company*

*You and Your Review of Performance*

*You and Your Trust*

*You are Thinking About Going into Business?*

*You and Your Wealth Creation*

*You and GST on Your Real Estate Transactions*