How to Handle the Balance Sheet When Buying a Business

The buyer of a business, having selected his minimum required rate of return, justifies purchase price of a “going concern” by the cash he expects the business to generate. Implied is:

- The cash to which the buyer is referring is cash generated from operations, as opposed to cash generated from any changes in assets or liabilities; and
- The business was valued based on an estimate of the cash the business will generate from operations on an annual basis; and
- To justify the price, the business should generate 1/365th of such on the first day of ownership; 30/365th during the first 30 days of ownership; 90/365th in the first 90 days; etc.

The only way for the above to actually hold true in an acquisition is if the buyer pays his price in cash and, in exchange, receives the entire business including:

a. All assets necessary to operate the business – cash, accounts receivable, inventory, accruals, furniture, fixtures, equipment, etc. (at “normal” levels with no deficiencies); and

b. All “normal” non-interest bearing liabilities of the business – typically accounts payable and accruals – are assumed by the buyer

Only via this “deal structure” will cash flow be “normal” and in-line with the purchase price. For example, every business needs some cash to operate. If XYZ business requires $5,000 in cash but such was not “left in the business” by the seller, the buyer will have to contribute the $5K on his first day of ownership. Now if the buyer paid full price for the business, he has now paid full price plus $5K. He’s over paid.

For another example, let’s say the working assets of XYZ average $500,000 and the working liabilities average $350,000. XYZ, thereby, needs $150,000 in working capital. Buyer “B” has valued XYZ ... based on its annual “profit” (i.e., cash flow) ... at $1 million. The seller, however, wants to keep for himself all working assets and pay off all working liabilities. As such, the buyer will inherit a business that, on the first day of operation, has no current assets and no current liabilities. The impact of this deal structure will be that the operating cash of XYZ will be hindered, over the first month or two, for a negative $150K. In other words, the buyer will have to contribute $150K into the business for working capital. The buyer, in effect, paid his target price of $1 million plus $150K to cover the impact of the deal structure. And deal structure strikes again.

Businesses should be valued on the operating cash flow they will generate. If the deal structure impacts the cash flow, such as delays when the operating cash will begin to flow, then the purchase price should be modified accordingly.