

Suite 1102**ACQUISITIONS & MERGERS**

Acquisitions & Mergers
To purchase a Corporation
Assessing Business Value
Calculating Profitability Ratios
Other Ratios to Consider
How Analysts Present their Findings
The Deal Stage
The Balance Sheet and P&L
Liquidity Ratios
Price Fixing, Cartels, Monopolies & the Law

1102.01 EXPANDING YOUR BUSINESS?

Common ways to expand your business include making a strategic acquisition and merging with another business.

An **acquisition** is when you buy another business and end up controlling it.

A **merger** is when you integrate your business with another and share control of the combined businesses with the other owner(s).

There are many good reasons for growing your business through an acquisition or a merger. These include:

- Obtaining quality staff or additional skills, knowledge of your industry or sector and other business intelligence
- Accessing funds or valuable assets for new development
- Your business underperforming
- Accessing a wider customer base and increasing your market share
- Diversification of the products, services and long term prospects of your business
- Reducing your costs and overheads
- Reducing competition
- Organic growth i.e. the existing business plan for growth is progressing too slowly.

However, a merger or acquisition can also create its own problems.

Deciding if your business is ready

If you are thinking of growing your business through a merger or an acquisition you must consider if your business is ready for expansion. Take steps to make sure that you:

- Understand and know your business
- Carry out a SWOT analysis
- Assess external factors, especially the impact of the economic climate on the price of a deal
- Are clear on what you expect to achieve in your business plan with the deal
- Have or have access to the necessary finances

1102.02 SWOT ANALYSIS

This is a review of your business' strengths and weaknesses and the opportunities and threats your business faces.

- Consider your business strengths such as your strong financial position
- Consider your business weaknesses such as low stock levels.
- List your business opportunities (related to strengths) such as competitors who may poach customers with their ability to provide product on demand.

Analysing your results carefully will show you how to build on strengths, resolve weaknesses, exploit opportunities and avoid threats.

Another strategy technique is a gap analysis. This involves detailed analysis of where your business is now and where you want it to be in the future. By analysing the gap between the two, you can find ways to bridge it.

Remember that apart from paying for the business you acquire, you will have extra expenses to take into account. These will consist of professional adviser fees and internal resources that will be taken up by the acquisition process.

Advice on carrying out a SWOT analysis on the BizHelp 24 website.

http://www.bizhelp24.com/marketing/swot_analysis.shtml

TO PURCHASE A CORPORATION

When you are thinking of buying an existing corporation it is important to determine the best way to structure the purchase. You must determine if you are going to buy the corporation itself (stock purchase) or buy the assets only leaving the original corporation intact. In most situations you will be much better off buying the assets of the corporation rather than the corporate stock. The following are advantages of purchasing the assets vs the stock:

- It help you avoid the liabilities of the existing business
- It gives you significant tax advantage
- It help you avoid acquiring unwanted assets from the corporation
- You are generally able to get a higher tax basis for depreciable assets, which means there's less taxable gain to report if you later sell the assets.

There are some circumstances when purchasing the stock of the corporation has its advantages. Once common example is when the corporation has a uniquely valuable asset that can't be transferred. An example of this would be a lease with an option to renew that is not freely assignable. The availability of keeping the current location may make it more advantages to purchase the stock of the corporation.

1102.03 MAKING THE RIGHT CHOICE

Opportunities to grow by merger or acquisition may exist where the target business:

- In undervalued
- Does not use its assets to maximum effect
- Would benefit from relocation
- Has poor management
- Has complementary products or services which, when combined with yours, will enhance the offering to customers

By contrast, a merger or acquisition may not generate the benefits you hoped for if the other business is already performing well.

Approaching a target business

When you have identified a suitable target business to acquire or merge with, you will need to register your interest in doing so with the owners or management of that business.

You may find it useful to make an appointment with the target or its advisors. Make sure the target understands why you are interested in a deal and how you intend to finance it. Prepare the questions you would like answered. This is also your opportunity to explain your business and your future plans.

Find out what the owners' plans are for selling their business and whether they intend to remain involved in it. Consider their motives for selling.

Many businesses get professional advice from solicitors or accountants to help them decide. If you have not been through this process before, it is strongly recommended that you instruct an adviser at the outset.

Assess the target business

To assess your target business, talk to those who regularly interact with it – the customers and suppliers.

Consider asking about:

- The business' products or services
- The customer base
- The comparison with competitors in terms of payments
- Who the main contacts are
- The extent of involvement of the owner

Ask your target business for:

- Financial information. If you have to rely on un-audited financial accounts get warranties from the seller.
- Trends in sales and profit margins

- Future forecasts. Consider whether forecasts are realistic and tally with your knowledge of the market and its prospects.
- Stock levels and debt collection trends, investments and the business' debts.

Before gathering data about the company you must understand how the Data Protection Act affects business buyers and sellers.

The DPA applies to anyone holding information about living individuals in electronic format and in some cases on paper, from which they can be identified, or information that expresses an opinion about an individual such as appraisal forms. Sensitive personal data includes information about sexuality, race, religion, politics, criminal record etc.

Without the consent of a target business you should confine your information gathering to generic data that cannot be linked to an individual. With the consent of the target business you have more scope, but they need the data subject's consent before they can pass it on to you.

Businesses can amend their data protection notices, contracts and employment contracts to specifically address the possibility of transferring personal data for the purposes of a corporate sale or restructure.

What the industry expert can do.

You can do a lot of this yourself but you will find it invaluable to get some advice from an industry expert.

Ask their view on:

- Market conditions and changes
- Factors affecting market prices and margins
- The business' outlook and health
- Others in the market

ASSESSING BUSINESS VALUE

Buying anything for the best price is a matter of skilful negotiation. But it is advisable to apply one of the following methods of valuing the target business.

1102.04 THE NET ASSET VALUE

The net asset value is the value of the business' assets on the open market, minus outstanding liabilities to creditors, bank borrowings, tax authorities and redundancy payments due.

Entry costs

The cost of starting up a similar business, which might include the assets, product development, employment and marketing costs, and including any savings you can foresee by merging the business with your own.

Cashflow

Forecasted cashflow for a number of years, discounted to net present value. An industry expert will be able to advise on how to apply discount factors.

Price/earnings ratio (P/E)

The most common formula used to value a public business. It is calculated using information that is readily available in the financial press and can be adapted to value any small private business. Divide the company's share price by its earnings per share, so if the company's share price is \$30 and it is earning \$3 per share, its P/E ratio is ten.

To use P/Es to value an unquoted business, look up the P/E ratio for the relevant sector, then apply a discount of at least 30 per cent because the target business is not on the stock market – shares in a public company are much more liquid and seen as more valuable.

A business run by one person is generally valued at around half the value of a comparable private company run by a team of three or more experienced managers. Customers are probably loyal to the owner manager and may not come to any new owner.

The economic cycle also affects private business valuations. At the bottom of the cycle – a downturn – small private companies sell on multiples of between six and eight on average. At the top of the cycle – a boom – the same company may sell for between ten and 12.

Accountants, lawyers and tax advisers often have extensive experience in valuations – using their experience will reduce the danger of you paying too much or owning unforeseen debts.

Some helpful links:

How Mergers are Assessed:

<http://www.offt.gov.uk/NR/rdonlyres/283E1C2D-78A6-4ECC-ICF5-D27F4E4D7B22/0/oft516.pdf>

Merger Publications:

<http://www.offt.gov.uk/Business/Mergers+EA022/publications.htm>

Merger Procedures:

<http://www.offt.gov.uk/nr/rdonlyres/791b6ba9-e321-49dd-8040-01db2e74f5c6/0/oft526.pdf>

Merger Law in Canada:

<http://www.ftc.gov/bc/compguide/index.htm>

CALCULATING PROFITABILITY RATIOS**1102.05 USING FUNDAMENTALS IN DECISION MAKING**

Fundamental analysis is a method used to evaluate the worth of a security by studying the financial data of the issuer. Performing fundamental analysis will teach you a lot about a company. Apply this analysis on two competing companies and it becomes clear which is the better choice.

Companies with greater earnings pay higher dividends and have greater growth potential. You can use profitability ratios to compare earnings for prospective investments. Profitability ratios are measures of performance showing how much the firm is earning compared to its sales, assets or equity.

What is Ratio Analysis?

This technique is called cross-sectional analysis. Cross-sectional analysis compares financial ratios of several companies from the same industry. Ratio analysis can provide valuable information about a company's financial health. A financial ratio measures a company's performance in a specific area. For example, you could use a ratio of a company's debt to its equity to measure a company's leverage. By comparing the leverage ratios of two companies, you can determine which company uses greater debt in the conduct of its business. A company whose leverage ratio is higher than a competitor's has more debt per equity. You can use this information to make a judgment as to which company is a better risk.

However, you must be careful not to place too much importance on one ratio. You obtain a better indication of the direction in which a company is moving when several ratios are taken as a group.

What Can I Learn from Profitability Ratios?

The profitability ratios include: operating profit margin, net profit margin, return on assets and return on equity.

Profit margin measures how much a company earns relative to its sales. A company with a higher profit margin than its competitor is more efficient. There are two profit margin ratios: operating profit margin and net profit margin. Operating profit margin measures the earnings before interest and taxes, and is calculated as follows:

$$\text{Operating Profit Margin} = \frac{\text{Earnings before Interest and Taxes}}{\text{Sales}}$$

Net profit margin measures earnings after taxes and is calculated as follows:

$$\text{Net Profit Margin} = \frac{\text{Earnings After Taxes}}{\text{Sales}}$$

While it seems as if these both measure the same attribute, their results can be dramatically different due to the impact of interest and tax expenses. Similarly, the next two ratios appear to be similar but they tell different stories. As an analyst you are looking to secure a positive return from your decision.

Return on assets (ROA) tells how well management is performing on all firm's resources. However, it does not tell how well they are performing for the stockholders. It is calculated as follows:

$$\text{Return on Assets} = \frac{\text{Earnings After Taxes}}{\text{Total Assets}}$$

Return on equity (ROE) measures how well management is doing for you, the investor, because it tells how much earnings they are getting for each of your invested dollars. It is calculated as follows:

These ratios are easy to calculate and the information is readily available in a company's annual report. All you need do is review the income statement and balance sheet to come up with the data to plug into the formulas.

But, do not neglect other income statement information that can save you from making a costly mistake.

1102.06 WHEN IS AN INCREASE IN EARNINGS A LOSS?

Sometimes an increase in company earnings can disguise an operating loss. If a company's operating expenses exceed its operating income, it has an operating loss. If it also has income from investments and tax benefits, this income can offset the loss and show an increase in earnings per share. However, if these other sources of non-operating income are not recurring, the unsuspecting investor may come to an erroneous conclusion about the company's overall financial health. The lesson to be learned here is to carefully scrutinize the financials especially when operating income is negative.

1102.07 HOW TO USE PROFITABILITY RATIOS TO MAKE DECISIONS

When considering a company as a prospective investment you should review its financial statements. Pay particular attention to the profitability ratios. If you can, calculate the ratios for the same company over several successive years to see if the company earnings are consistent, growing, or declining.

Compare your candidate's ratios to other companies in the same industry. This will help you determine where your candidate stands in the industry.

Do not ignore other financial information on the income statement and balance sheet. Pay particular attention to losses in income items.

OTHER RATIOS TO CONSIDER

1102.08 PRICE TO EARNINGS RATIO (P/E)

The price to earnings ratio, or P/E, is figured by dividing the stock price by the company's earnings per share (EPS). The P/E is a performance benchmark that can be used as a comparison against other companies or within the stock's own historical performance. For instance, if a stock has historically run at a P/E of 35 and the current P/E is 12, you will want to explore the reasons for the drastic change. If you believe that the ratios are too low, you may want to buy the stock.

You will generally find a P/E ratio based on either the prior reporting year's earnings, or the earnings of the prior four quarters added together. This latter number is referred to as LTM or Latest Twelve Months. While this is useful for understanding the history of a company, most analysts prefer to view a forward-looking P/E ratio. This ratio is calculated by dividing the stock price by the analysts' earnings estimate for the next year or two.

One other note on P/E Ratios. Sometimes, when a company is not doing well, it will buy back shares so that the EPS and P/E Ratio will appear better. This can be seen in the example below.

	Example 1	Example 2
Net Income	\$1,000,000	\$1,000,000
Shares Outstanding	10,000,000	8,000,000
Earnings Per Share (EPS)	\$0.10	\$0.125
Stock Price	\$3.00	\$3.00
P/E Ratio	30	24

In the table above, the only change from Example 1 to Example 2 is in the number of shares outstanding. The net income and stock price remain the same. However, by changing the shares outstanding, the EPS has changed quite a bit. This means that the P/E ratio has also changed. At first glance, if a stock's EPS has increased 25% and its P/E ratio has gone from 30 to 24 it might look like a better buy. However, the truth is that nothing has changed but the number of shares. The stock is not a better buy in Example 2 than it was in Example 1.

Where P/E Does Not Apply

When looking at newer companies such as Internet start-ups or bio-techs, there is often no net income, so there are no earnings per share. In these cases the P/E ratio does not apply, forcing analysts to turn to other measures. The most common alternative ratios include: revenues per share, gross income per share or cash flow per share. All these ratios take the relevant number from an income statement, divide them by the number of shares and then divide the stock price by this number.

For example if XYZ Corp. has sales of \$1 billion and 100 million shares outstanding, then the revenue per share is \$10. If the stock is trading at \$90 per share, the price to revenue ratio is 9x.

There are flaws in taking these ratios, but in the absence of a meaningful P/E Ratio, they are a good place to start.

Current Ratio

The current ratio provides an indication of how liquid a company may be in the coming year. To calculate it, take the current assets and divide that number by the current liabilities. You will find all of these figures on the balance sheet.

An answer to 1.0 or better is generally considered good. However this, like other ratios, can depend on a company's current stage of growth. A start-up company should have a lower ratio than an established company. If it does not, then you will want to ask yourself why and do further research.

A current ratio can also be affected by how much long-term debt a company has in relation to its short-term debt. Some companies prefer to use short-term debt and reissue it more often. Other companies minimize their use of short-term debt. Most companies use a mix depending on what is available to them, what is cheaper at the moment and how their economists project interest rates for the future. Hence, this ratio also needs to be used to build a bigger picture rather than in isolation.

Long-Term Debt to Equity

The long term debt to equity ratio can tell you how much debt a company is using to finance its operations. If this number is too high it may signify future liquidity problems. If this number is too low it can signify inefficient use of the financing alternatives available to a company.

This ratio is calculated by taking the long-term debt of a company and dividing it by the shareholders' equity. Be sure to include the company's lease obligations (which can be found in detail in the footnotes of an annual report) when calculating long-term debt.

Start up companies which have access to the debt markets, often have higher ratios than more established companies. In addition, the amount of debt a company can safely issue varies by industry. For example, companies with large manufacturing facilities often have more long-term debt than companies that provide services or software. There, it is useful to look at the ratios of numerous companies in the same industry before drawing any conclusions.

Total Debt to Equity

Since companies can affect either the current ratio or the long-term debt to equity ratio by altering their mix of short-term and long-term debt, this ratio can often be more useful than the other two. This ratio is calculated by dividing all long-term debt, short-term debt and lease obligations by the shareholders' equity.

HOW ANALYSTS PRESENT THEIR FINDINGS

The study of all this data is known on Wall Street as fundamental analysis. Most analysts would view themselves as fundamental analysts, meaning they make investment decisions based on the available information about a company.

After going through the history of the ratios above, other ratios not explained here and the non-financial information available on a company (product, strategy, marketing, management, etc), the analysts build models that project what will happen to a company in the future. Based on these models they issue two pieces of information.

The first piece of information you will likely see is an analyst's projected earnings per share (EPS) for a company. Projections for many companies are available online, where you can see the mean or average projection as well as the extreme projections and the recent movement in the projections.

Since investors rely on analysts to filter the information provided, when analysts change these projections, it will often affect the price of the stock. In other words, the analysts' projections act as an information source in their own right. When an analyst lowers an earnings projection for a company, people assume they have learned something negative about a company's future performance. As a result, they believe a company is less valuable and sell their stock. Conversely, when an analyst raises their earnings projection, people believe they have learned something positive about the future of a company. In this case investors will view the company as more valuable and proceed to buy the stock.

What can go wrong?

The extent and quality of the planning and research you do before a merger or acquisition deal will largely determine the outcome. Sometimes situations will arise outside your control and you may find it useful to consider and prepare for the following situations.

A deal could become expensive if:

- You cannot agree terms such as who will run the combined business – in a merger – or how long the other owner will remain involved in the business.
- You end up in a bidding war where other parties are equally determined to buy the target business
- Your own business' performance suffers because of time spent on the deal and a mood of uncertainty

You may also face pitfalls following a deal such as:

- The target business does not do as well as expected
- The costs you expected to save do not materialise
- Key people leave
- The business cultures are not compatible
- Diverted resources from your business' main aims

Get expert advice from professionals with experience in similar deals to help forecast potential pitfalls and to address any that arise.

Legal aspects to consider

Different legal issues arise at different stages of the acquisition process, and require separate and sequential treatment.

Due diligence stage

Due diligence is the process of uncovering all liabilities associated with the purchase. It is also the process of verifying that claims made by the vendors are correct. Directors of companies are answerable to their shareholders for ensuring that this process is properly carried out.

For legal purposes, make sure you:

- Obtain proof that the target business owns key assets such as property, equipment, intellectual property, copyright and patents.
- Obtain details of past, current or pending legal cases.
- Look at the detail in the business' contractual obligations with its employees (including pension obligations), customers and suppliers – think about any likely or future obligations.
- Consider the impact on existing contracts of a change in the business' ownership.

Always use a lawyer to conduct legal due diligence.

THE DEAL STAGE

When you are considering general terms of a potential deal you will probably seek certain confirmations and commitments from the seller of the target business. These will provide a level of insurance and comfort about the deal and are indications of the seller's own confidence in their business.

A written statement from the seller that confirms a key fact about the business is known as a warranty. You may require warranties on the business' assets, the order book, debtors and creditors, employees, legal claims and the business' audited accounts.

A commitment from the seller to reimburse you in full in certain situations is known as an indemnity. You might seek indemnities for unreported tax liabilities.

Your professional adviser can assist in reviewing the content and adequacy of warranties and indemnities.

1102.09 THE DEAL ITSELF

- Have clear, realistic objectives about what you want to achieve
- Remember that accountants primarily look at the numbers – it's up to you to look at the whole operation
- If you've got doubts, don't ignore them, review them and don't be afraid to walk away if the concerns are serious.

After you have registered interest in doing a deal with the other business you will probably follow a process that embraces the following steps:

- Appointing professional advisers – legal and financial
- Carrying out due diligence
- Valuing the business
- Negotiating financing of the acquisition/merger
- Making an initial offer subject to contract
- Agreeing the main terms of the deal including a payment schedule, warranties and indemnities from the other business
- Updating due diligence based on access to the target business
- Finalising the terms of the deal – including restructuring of the shareholding, if appropriate
- Announcing the deal and communicate it to staff

In the case of a merger, you will need to integrate key aspects of the two businesses specifically:

- Management
- Staff
- Technology
- Communications
- Processes, policies and procedures
- Payroll
- Training
- Personnel policies
- Invoicing and purchasing systems

The role of professionals

It is important for you to seek professional advice when considering a deal. You will use bankers, accountants, lawyers, surveyors and valuers for different matters. Advisers with experience in deals will help you make the right choice, pay a reasonable price and avoid pitfalls during and after a deal.

Advisers can provide valuable guidance in areas such as valuing the business, financing the deal, reviewing legal aspects, terms and contracts and specialist valuation of specific areas of the business.

Make sure you agree clear terms of reference and how the work of different advisers will be coordinated. Advisers may charge fees on an hourly, fixed or contingent – no deal, no fee – basis.

Staffing issues – before and after

One of the main attractions for a merger is that of increased efficiency, which means you will probably need to make some staff cuts or changes.

A merger or acquisition will often go more smoothly if the staff in your business and the target business are protected from uncertainty and involved in the process.

Before the deal begins, consider how you can:

- Keep key staff informed – bear in mind that some information may need to remain confidential
- Retain key staff – eg through bonuses or other incentives
- Involve key staff in the due diligence
- Get senior staff to take on more responsibilities while you negotiate the deal
- Get to know key staff to help you assess abilities and skill levels

In the United Kingdom:

The Information and Consultation of Employees (ICE) Regulations may require you to inform and consult employees on certain aspects of the merger. From 6 April 2005, business with more than 150 employees will have to agree a procedure for informing and consulting employees if more than 10 percent of employees request a system. From April 2008, the regulations will apply to business with 50 or more employees.

Where an employer has a procedure for informing and fails to consult, employees can complain to the Central Arbitration Committee who may impose a fine of up to £75,000.

You can read about the ICE regulations at the DTI website.

Your professional adviser should be able to guide you as to who needs to know what.

After the deal you may find it useful to see staff individually or in small groups to explain future plans and to answer questions.

1102.09 STAFF ISSUES

These may include:

- Skills gaps and how to fill them
- Which posts will be filled by staff either from your business or the target business
- Pay differentials between the two companies
- How to get staff from both businesses to build working relationships
- How to share knowledge between staff
- Appropriate policies and procedures for the combined business
- Relocation issues
- Trade union matters

It is important to get expert advice to help with staff issues such as new employee terms (including pension provision, changes in employment contracts and your responsibilities to employee rights after a merger or acquisition.

The private company price index on the BDO Stoy Hayward website.

<http://www.bdo.co.uk/BDOSH/website/bdoouk/websitecontent.nsf/450808a98b02c3e380OpenDocument>

THE BALANCE SHEET AND P & L

The relationship between the Balance Sheet and the Profit and Loss.

The profit and loss (P&L) account summarises a business' trading transactions – income, sales and expenditure – and the resulting profit or loss for a given period.

The balance sheet, by comparison, provides a financial snapshot at a given moment. It doesn't show day-to-day transactions or the current profitability of the business. However, many of its figures relate to or affect the state of play with P&L transactions on a given date.

The P&L feeds any profits not paid out as dividends into the retained profit column shown on the balance sheet.

The amount shown as cash or at the bank under current assets on the balance sheet will be determined in part by the income and spending recorded in the P&L. For example, if sales income exceeds spending in the quarter preceding publication of the accounts, all other things being equal, current assets in the balance sheet will be higher than if spending (as shown in the P&L) had outstripped income over the same period.

If the business takes out a short-term loan, this will be reflected in the balance sheet under current liabilities, but the loan itself won't appear in the P&L. However, the P&L will include interest payments on that loan in its expenditure column- and these figures will affect its bottom line.

Using balance sheet and P&L figures to assess performance.

Many of the standard measures used to assess the financial health of a business involve comparing figures on the balance sheet with those on the P&L.

Compare balance sheets to assess business performance

There are some simple balance sheet comparisons you can make to assess the strength or performance of your business against earlier periods, or against direct competitors. The figures you study will vary according to the nature of the business. Some comparisons draw on figures from the profit and loss (P&L) account.

Internal comparisons

If inventory (stock) levels are rising from one period to the next, but sales in your P&L are not, some of your stock might be out-of-date. You may also have a cash flow problem developing.

If the amount trade debtors owe you is growing faster than sales, it could indicate poor internal credit controls. You may want to find out whether there is one customer who's having problems and could pose a threat to your business.

Nurturing a positive relationship with your trade creditors is essential. Key to this is managing your cash flow well, so that payments can be made on time. For example, trade creditors are more likely to be flexible about extending terms of credit if you have built up a good payment record.

Making early payments may qualify you for a discount. However, early payment for the sake of it will negatively impact on your cash flow. Good payment controls will help prevent imbalances in what you owe suppliers and levels of stock and inventory.

Borrowing as a percentage of overall financing (gearing) is important – the lower the figure, the stronger your business is financially. It's common for start-up businesses to have high borrowing requirements, but if the figure reaches 50 per cent you're likely to have difficulty getting further loans.

External comparisons

You can also compare the above balance sheet figures with those of direct or successful competitors to see how you measure up. This exercise will highlight weaknesses in your business operation that may need attention. It will also confirm strong business performance.

Use accounting ratios to assess business performance

Ratio analysis is a good way for you to evaluate the financial results of your business in order to gauge its performance.

Ratios can be more helpful than the use of raw statistics. They provide you with the means of comparing your business against different standards by demonstrating the relationship between two figures on your business' balance sheet. This enables you to compare your own business for example, against industry standards.

There are four main methods of ratio analysis – liquidity, solvency, efficiency and profitability.

LIQUIDITY RATIOS

1102.10 THERE ARE THREE TYPES OF LIQUIDITY RATIO

The current ratio is current assets divided by current liabilities. This broadly gauges your business' financial health and assesses whether you have sufficient assets to cover your liabilities. An acceptable ratio for this is 2, indicating that you have twice as many assets as liabilities.

The quick or acid-test ratio is current assets (excluding stock) divided by current liabilities. This ratio excludes stock and measures a business' liquid assets compared to its liabilities. A ratio of 1 in this category would indicate liquidity levels are high – this is an indication of solid financial health.

The defensive interval is quick assets divided by daily operating expenses. This gauges the threat of insolvency by measuring the number of days your business could survive without cash coming in. This should be between 30-90 days.

Solvency ratios

Gearing is the ratio obtained by dividing loans and bank overdraft by equity and long-term loans and bank overdraft. This is expressed as a percentage and is a sign of solvency.

The higher the gearing, the more vulnerable the company is to increasing interest rates. Most lenders will refuse further finance where gearing exceeds 50 per cent. However, some start-up small businesses may find that their gearing surpasses this percentage.

Efficiency ratios

There are three types of efficiency ratio.

- **Debtors' turnover** is sales (including VAT) divided by debtors. The ratio is divided into days of the year, indicating the average collection period and how effective your business' payment terms are. A low ratio would indicate that payment terms may need tightening up or that debt collection is proving difficult. Both these would have a negative knock-on effect to cash flow. The average debt collection should not exceed 30 days.
- **Creditors' turnover** is cost of sales divided by creditors. This ratio is divided into days of the year indicating the average payment period, i.e. how long your business takes to pay suppliers. Suppliers may opt to withdraw credit if payment is not made on time.
- **Stock turnover** is cost of sales divided by stock level. This ratio is divided into the days of the year indicating the average holding period. Speed of stock turnover varies by industry, but a lower stock turnover generally means lower profits.

Profitability ratios

This method involves calculating profit before income tax as a percentage of total capital employed.

This indicates how well you can produce returns on the capital used in your business. This can then be compared to what the same amount of money (loans and shares) would have earned on deposit or in the stock market.

Accounting Periods

A balance sheet normally reflects a business' position on its accounting reference date, which is the last day of its accounting period. An accounting reference period, also called the financial year, is usually 12 months, but can be shorter – or longer in the first year of trading.

Internal accounts

Your business may decide to draw up accounts as frequently as monthly, to help you monitor business performance. In this case the figures – often known as management accounts – are for internal use only.

For additional help – See Suite's 406, 508 and 704

Helpful links:

Financial statement ratio analysis:

<http://www.creditman.co.uk/training/ratios.html>

Summary of different types of ratio analysis:

http://www.exemplas.com/money/292_2124.asp

PRICE FIXING, CARTELS, MONOPOLIES & THE LAW

The law aims to promote healthy competition. It bans anti-competitive agreements to fix high prices. It makes it illegal to agree not to compete with other businesses.

There are heavy penalties for breaking the law. You can be fined, disqualified from being a director – or even sent to prison.

The law also provides extra powers to protect competition. Mergers between businesses can be prevented if they reduce competition. Uncompetitive markets can be investigated.

1102.11 THE BASIS OF THE LAW

In the United Kingdom there are two major laws protecting competition: the Competition Act 1998 and the Enterprise Act 2002.

The Competition Act prohibits anti-competitive agreements between companies.

- You mustn't agree to fix prices or terms of trade. For example agreeing price rises with your competitors.
- You mustn't limit production in order to reduce competition.
- You mustn't share out markets or suppliers. For example agreeing with a competitor that you'll bid for one contract and they'll take another.

Any agreement that restricts or distorts competition is covered. The law mainly applies to agreements between businesses with a significant combined market share. But even the smallest business needs to avoid anti-competitive agreements like price fixing.

The **Competition Act** also prohibits abuse of a dominant market position. This mainly applies to businesses that have a large market share. For example they must not impose unfair prices on either customers or suppliers.

The **Enterprise Act** also covers mergers between businesses that reduce competition. This usually applies if the businesses have a significant market share. The Competition Commission is responsible for investigating mergers in the first instance, referring cases to the Competition Commission for an in-depth inquiry if they believe the merger may be expected to result in a substantial lessening of competition.

The OFT only has jurisdiction over mergers that meet all three of the following criteria to qualify for investigation:

1. Two or more enterprises must cease to be distinct.
2. The merger must not have taken place, or must have taken place not more than four months ago.
3. Either:
 - The business being taken over has a turnover in the UK of at least £70 million.
 - If the combined business have significant market presence. This applies if together they supply (or acquire) at least 25 per cent of a particular product or service in the UK (or a substantial part of the UK), and the merger results in an increment to the share of supply and consumption.

Because of these two tests, many mergers between smaller business do not qualify for investigation.

1102.12 CARTELS AND THE LAW

A cartel is an agreement between businesses not to compete with each other. This is often done by fixing the prices they charge or the prices they offer to suppliers. It can also include:

- Fixing bids for contracts rather than competing honestly
- Agreeing on other contract terms, such as credit periods or discounts
- Agreements to share out customers between the members of the cartel
- Limiting overall production so that prices rise

Cartels are prohibited by law. If you are found to be a member of a cartel, you could be fined up to 10 per cent of your turnover for up to three years. In some cases, you could receive an unlimited fine or a prison sentence of up to five years.

The law is enforced by the Office of Fair Trading (OFT). The OFT is keen to catch cartels. If you help the OFT catch a cartel you are part of, you may be offered a reduced fine or immunity from prosecution.

Additional information is provided in Suite 208.04

Cartels and Monopolies – a tutorial:

<http://www.tutor2v.net/economics/content/copies/mopoly/cartels.htm>

In the United States:

U.S. Department of Commerce

<http://www.doc.gov/>

Federal Acquisition Regulator

<http://www.arnet.vot/far/>

Important Links in the UK:

Cartels and the Office of Fair Trade:

<http://www.offt.gov.uk/BusinessCartels/default.htm>

Competition Act:

<http://www.offt.gov.uk/Business/Legal+Powers/Competition+Act+1998/default.htm>

How to achieve Compliance:

<http://www.offt.gov.uk/nr/rdonlyres/78ad1280-4eb-46d4-a52b-207f9afeaae1/0/oft424.pdf>

In Canada:

<http://www.canada.gc.ca>

In New Zealand:

<http://www.govtnz>

In Ireland:

<http://www.basis.ie/>

Australia:

<http://www.business.gov.au>

South Africa:

<http://www.services.gov/za/service>

