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THE IMPORTANCE OF HAVING GOOD FINANCIAL RECORDS WHEN SELLING A PRIVATE SECURITY COMPANY

***T**here are many attractive, small to medium sized, private security companies in the market today that would be a good acquisition for the generous buyers—and the owners would like to sell. The problem for some of these would-be sellers is that their companies do not have the financial information in place to prove the company's real worth, so the owners can't get the premium they're expecting and deserve.*

Buyers for private contact security companies today are still looking at the types of accounts, geographic operating territory, number of armed guards, average site size, quality of management going with the sale, etc. as a way to establish its initial interest in a selling company. The buyers are also placing a lot of importance on the seller's reported profits at the site level. The seasoned buyer will know how much it takes to run a branch and administrative office, irrespective of what it may be costing the seller, so the profits (or losses) at these levels are not nearly as important to the valuation. But there's not much the buyer can do to improve on the profit at the site level without jeopardizing the relationship with the account.

Therefore, in arriving at its offering price, the buyer will be relying heavily on the profit the seller is reporting at the site level, which usually includes the gross billing and gross guard payroll, as well as other associated costs that apply to the site; such as payroll taxes, workers compensation insurance, uniforms, dedicated site equipment, non billable site supervisors and any other costs that may be associated with running or obtaining the account. The buyer will be performing extensive due diligence to confirm that the figures are correct. The confidence level the buyer will have in the figures will depend on the quality of the financial controls and records the seller has in place. This is why having good financial controls and records play

an important part in the seller receiving a premium when it comes time to sell. If the buyer can't get the confidence level it needs, it will make a conservative offer; one that allows for a margin of error in the buyer having to guess at, or use estimates in computing, the profit at the site level. Unfortunately many owners of small to medium sized companies do not place enough importance on these financial systems, which often results in the seller getting less than what the company is really worth because they can't prove what they're making.

The seller will have to help the buyer build the financial model. The company may have a very attractive site level profit, but it's up to the seller to prove it; and proving it involves a lot more than just handing the buyer billing invoices and payroll registers for a couple of periods. The proof lies in the underlying financials that will confirm that the profit will remain at a certain sustainable level over time.

Not only will a good financial reporting system help add value to the company when it comes time to sell, but it will be a valuable tool in helping the owners stay profitable and competitive during the time the owners are running the company. It will identify the areas where costs may be getting out of hand or otherwise need improving, which is important in today's challenging economy where cost containment is crucial.

Here's what buyers like to see in the sellers' financial reporting system:

- **A customer profit report**—this report will show every customer, by site, with the hours worked, gross billing, gross payroll and any special costs that apply to the customer—such as dedicated site vehicles, special insurance, etc. A more advanced report will further show the billable and non billable hours (vacations, holidays, training, etc.) with the associated billing and pay, as well as the overtime premium for both payroll and billing.

Most companies that have the capability to produce this report can produce it after any billing or payroll

cycle. In examining this report, buyers will be looking for consistency in the accounts from one period to the next, as well as how the information by period compares to the overall site level profit reported on the internal financial statements.

- **Interim Financial Statements with Month End Accruals**—Meaningful interim financial statements will show the results for the current month compared to the same month last year, as well as year-to-date amounts compared to the same period for the previous year. It may also show budgeted figures (although not as important as the actual results). Also, if the selling company has multiple office locations, there should be a financial statement for each branch.

- Sources of revenue and related costs should be identified: In helping a buyer better understand and verify the profit at the site level, the statements will also identify the revenue according to source (i.e.; permanent accounts separate from temporary accounts, regular straight-time billing separate from overtime premium billing, and patrol and any other non guarding service would also be a separate line item).

The labor and the other costs for the various sources of revenue will also be separated so the buyer can readily determine the profit by category of service (i.e.; how much its making on the permanent work vs. the temporary work, and how much its making on the patrol service, etc.).

- Proper cut off of billing and expenses: A common mistake many companies make is not having a proper cut off of billing and expenses. This is especially true where a company has several billing periods available for the clients (i.e.; some on weekly, others on semi-monthly or monthly, etc.) that do not match the payroll period. When this is the case, the company should have a procedure in place to book the revenue that has been performed, but not billed, in order to get the

billing in the same period as the recording of the labor for the respective service.

Another common mistake is not properly recording advanced billings. This is more common for patrol customers than for guard customers, but in either case, if the invoice has been prepared and entered in the financial system before the service is actually rendered, the billing should be booked as advanced billings then recognized as the service is actually performed.

- Certain below the line expenses should be detailed. Not only will the buyer be scrutinizing the financials to determine the reported profit at the site level, but the buyer will also be looking at the costs below the site level profit line. In scrutinizing these costs, the buyer is looking for possible other costs that may be important to running the site, but may have been left out of the site level profit computation; and it's common for companies to leave certain costs out of the site level profit section. Some of the costs commonly left out of this section and put "below the line" are: non-billable site supervisors; dedicated site vehicles; special equipment required at the sites; various insurances (where it's not convenient to break out the total insurance bill between guarding personnel and office personnel), etc. Also, there are some costs that should be detailed, even though they may not be site level expenses.
 - ◇ Insurance—insurance expense should be separated to show the amounts for workers compensation, general liability, employee hospitalization and health, etc.
 - ◇ Classes of Compensation—compensation should be separated to show the amounts for non-billable roving supervisors, executives, clerical personnel, dispatch personnel and any other

classes of labor. The more detail, the better it will help the buyer understand what it takes to run the business.

- ◇ Vehicle Cost—to the extent it can be easily identified, vehicle cost should be separated by roving supervisors and executives.

- **Year End Financials**—The internally generated year end financials, which usually are very detailed, should agree with the outside accountants' financial report. This means the company books will need to be held open until it receives all the adjustments from the outside accountant. This is necessary in order to produce an accurate report (with all required adjustments) that has all the detail the buyer needs.

What does this mean for owners wanting to sell now, but do not have these financial controls in place?

The good news is that sellers needing or just wanting to sell now can still get a good deal in the marketplace even without these elaborate systems in place, because there are buyers that need to make acquisitions. But the selling price may not be quite as good as it would be if the seller has these systems in place; unless the seller can otherwise prove how much profit it's making at the site level. In fact, we find that there are very few of the smaller companies that strictly adhere to GAAP (Generally Accepted Accounting Principles) accounting rules and some do not have systems that show the profit by site on a regular basis. However, the better the financial system, the better the chances are that the seller will command the premium it's expecting and deserves from the sale because it takes away the "margin of error" or "guess factor" the buyers have to consider when they can't get all the information they need to properly evaluate the company.

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- *Using “Market Comparisons” to Value a Security Guard Company*
- *Valuation Methodology: for the Small/Medium Size Security Guard Companies*
- *Why Are Buyers Paying Such High Multiples for Security Guard Companies That Are Only Marginally Profitable, or Losing Money?*

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