Selling a Pharmacy

A "HOW TO" GUIDE

NCPA® MANAGEMENT INSTITUTE EDUCATION SERIES

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Selling a Pharmacy: A "How to" Guide
was funded in part by an unrestricted grant from:

COMMUNITY PHARMACY FOUNDATION

Printed in the United States of America

Selling a Pharmacy: A "How to" Guide can be purchased for educational and business use.
For purchasing information, contact the publisher below:

NCPA®
NATIONAL COMMUNITY PHARMACISTS ASSOCIATION

National Community Pharmacists Association
100 Daingerfield Road
Alexandria, VA 22314
www.ncpanet.org/store

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Acknowledgements

NCPA thanks the following pharmacists for their participation in this publication:

- Norm Bowles — Lexington, Virginia
- Diane D'Amato — New Milford, Connecticut
- Linda Garrelts MacLean — Spokane, Washington
- Chuck Wilson — Danville, Arkansas
- Kristopher Zepeda — Lubbock, Texas

NCPA also thanks its 2005–2006 Committee on Management which contributed to this publication. It particularly thanks Bob Coulter for his work in making this publication possible.

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Chapter 1

Making the Decision to Sell

INTRODUCTION

As a pharmacy owner, you make important decisions every day regarding the health of both your patients and your business. Eventually, there will come a time when you make another important decision—how and when to sell the business you have nurtured and grown. For a family-owned business, it may be a (relatively) simple matter of handing over the reins to a son, daughter, or other family member.

Yet for others, the exit strategy involves selling the pharmacy completely. Obviously, this can be a stressful decision, involving complexities, terminology and legal jargon that seemingly have no rhyme or reason to you. And why would they? You've devoted your career to building your business and providing customer care. Learning the intricacies of selling a business was not your primary focus.

As you go through the selling process you may be presented with offers from chain pharmacies that may make this process seem all too simple. These corporations have full-time, trained staff devoted to purchasing independent pharmacies and converting them into chain pharmacies. The chain's offer will probably give you a dollar amount based strictly on

Linda Garrelts Maclean: *"Our business had increased in value. It seemed to be a good market at the time. My partner and I decided to sell even though we were 'at the top of our game.'"*

Diane D'Amato: *"We decided to sell because of multiple reasons—age, 3rd party insurance hassles, upcoming Medicare questions, 70 hour work weeks, and limited vacations."*

Chuck Wilson: *"I was worn out and burned out. I needed to unload the responsibility of running a business and just concentrate on working for someone else so I could focus on taking care of the patients."*

Norm Bowles: *"I decided to sell because of my desire to retire and the increasing difficulty of finding suitable employees. I contemplated selling the pharmacy for about two years."*

Kris Zepeda: *"I wanted to explore options allowing me more free time to try new and expanding things. Also, I wanted to expand my areas of expertise."*

prescription volume and inventory along with job offers for you and your employees. Before you jump on these offers, please take a moment to think about the future of your pharmacy and your patients if you make this deal. Remember that you have devoted your career to building this business. A majority, if not all, of your customers come to your pharmacy because of the difference in service and customer care from that of a chain pharmacy. You may wish to pass along the pharmacy to another owner to maintain it as an independent and carry on the same level of customer care to your patients.

With that in mind, the NCPA Management Institute has created "Selling a Pharmacy: A How to Guide" designed to assist you in selling your pharmacy. We hope to provide a comprehensive road map to the selling process, from the moment you decide to sell, all the way through the process, until the sale becomes final. We'll discuss the many options that are available to help the sale go as smoothly as possible, and point out potential stumbling blocks to avoid. Preparing for a sale is time consuming; however this process can greatly increase the value of your business and make the entire selling experience proceed in a much smoother and less stressful fashion.

DEMOGRAPHICS OF THE INDEPENDENT PHARMACY OWNER

In 2004, NCPA conducted a membership profile survey of 225 members and 133 nonmembers who would be potential candidates for membership.[1] Of those surveyed, 68 percent of the respondents were owners. More than half (53.1 percent) of the respondents were 55 or older. Within five years, 23.5 percent of all respondents planned to sell a pharmacy, and approximately 30 percent of respondents planned to retire. The survey also shows that pharmacy owners, on average, own 1.5 pharmacies.

The survey results and the demographics of the industry indicate that a many pharmacists will be making the decision to sell in the near future. One very important detail in the selling process is to be prepared and educated about the events leading up to and during the sale of a pharmacy. According to the Small Business Administration (SBA), selling a business is a multi-step process that can take months or possibly several years.[2] This is why it is important to begin the process far enough in advance so that you will be able to sell the business in an appropriate time period. Once again, it should be reiterated that being prepared for the process can maximize the value of your business and minimize the amount of time spent on the process.

WHY DO YOU WANT TO SELL?

The specific reasons why a pharmacy owner chooses to sell will vary from one individual to another. Many have reached the time in their lives when they plan to retire from the workforce completely. Others may choose to take on an alternative career path. If you are contemplating the sale of your business, then one of the most important questions you'll have to answer is: Why do you want to sell? Potential buyers are likely to initiate any inquiry into the purchase of your business with this question. Owners sell for many different reasons and there is no one magical answer that will be appropriate for every situation.

In an informal survey of NCPA members who decided to sell, there were a variety of responses. One said that he was simply fatigued after 25 years, and wanted to focus more on patient care as opposed to the business side. He is now a pharmacist on call at the pharmacy that he sold.

Another decided to sell because of age and increasingly complex issues surrounding third party insurance and Medicare. Another decided to sell at a relatively young age to move in a different direction, and the pharmacy had appreciated in value to a point where she could sell and make a nice return.

It will be important to think about the answer to the question of "Why do you want to sell?" before a potential buyer asks. Think about your answer from the buyer's perspective. How does it sound to you—is there a sense of desperation, does it sound like you are hiding something, or does it sound like a valid, honest reason to sell?

James Laabs, author of the book "The Business Sale System: Insider Secrets To Selling Any Small Business," recommends that the seller not sound desperate. He also does not suggest hiding situations such as serious illness or burnout (cited by one NCPA interviewer who sold his pharmacy), because these reasons will almost certainly come out later in the selling process. Laabs recommends that a seller not be afraid to admit that burnout is a reason for selling. This is a valid reason that many buyers will certainly be able to understand. The most appropriate action to take when explaining the reason to sell is to be honest, but also present to the potential buyer that you do have an alternate plan if the business does not sell right away.[3]

WHEN TO START THE SELLING PROCESS

Ideally, the time to start thinking about the selling process should occur at the beginning and throughout the business' life cycle. Throughout the life of your business, you have been building its value and every major decision along the way has an impact on the final value when you decide to sell.[4] For many, the ultimate goal is to maximize the value of your company so that you receive the highest selling price.

For the purposes of this publication, we will consider the starting point to be the period in time when the owner first has serious thoughts about selling the pharmacy. As the selling process can take years, beginning the planning process early will pay off in the long run.

PREPARING FOR THE SALE

According to Laabs, getting your company ready to sell means sprucing up operations, along with making sure your financial statements, budgets, and business plans are ready to be scrutinized by potential buyers. Although this preparation is time consuming, many business owners find that preparing the business for sale improves management practices and greatly increases the value of the company. And should a great offer come through soon after the business is put on the market, the preparation will put you in better position to close a deal quickly.

FINDING THE RIGHT BUYER

Selling a business that you have spent years building can be an emotional process. Your pharmacy is likely a pillar of the community, a place where patients can count on honest and compassionate service. In the sales process, finding the right buyer, somebody who will carry on the good reputation that you have developed, is in many ways just as important as getting a fair price.

NCPA has made a concerted effort to promote independent pharmacy ownership in recent years, through programs such as its annual Pharmacy Ownership Workshops, along with outreach to future pharmacists with initiatives such as the Pruitt-Schutte Student Business Plan Competition.

The Pruitt-Schutte competition has already reaped benefits, as one pharmacy student in Kansas used elements of his business plan to successfully purchase an independent pharmacy shortly after graduation. Many pharmacy owners, through options such as junior partnerships, will hire young pharmacists with the intention of grooming them for ownership. The potential buyer can "learn the ropes" and help calm any concerns the owner might have before he or she turns over the reigns completely.

There have been a number of innovative programs designed to groom pharmacists for independent ownership. In 2004, the South Carolina Pharmacy Association created the Community Pharmacy Institute, where future owners can obtain hands-on management skills to successfully run their own independent community pharmacy. The first two pharmacists to complete the program have gone on to purchase pharmacies. Other pharmacists use the services of brokers to identify promising potential buyers.

Finding the right buyer will be discussed in detail in this publication.

WHAT'S NEXT?

In the coming chapters, this publication will lead you through all the steps of the process. This includes:

- Finding suitable candidates for the purchase
- Advice and counsel from other professions
- The role of financial analysis in the transfer of ownership
- How to determine a selling price
- Financing the sale
- Legal considerations
- What to do with the money after the sale

CONCLUSION

As you reach the decision to sell, you must remember that getting out of business is a process, just as purchasing a business is a process. During the selling process, you will have multiple steps to take to reach the ultimate goal of maximizing the return on your invested time and effort that went into building your business. Remember, preparation for the selling process is a very important factor leading to a positive outcome and a smooth transaction for both the buyer and the seller.

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Chapter 2

Finding Suitable Candidates for the Purchase

INTRODUCTION

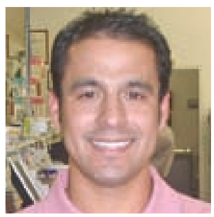
Once you have made the decision to sell your pharmacy, it is important to aggressively obtain several suitable candidates for the purchase. Having several potential buyers increases your chances of receiving market value. Furthermore, you will not feel pressured to take the first offer you get or to accept unfavorable terms. In order to obtain suitable candidates, use a deliberate process. Start by increasing the financial and physical appeal of the pharmacy. Even if you have an offer or candidate in mind, consider using a broker or matching service to increase the pool of candidates and take advantage of other services they provide. Qualify your list of potential buyers by using confidentiality agreements and statements of interest, which can be drawn up by your attorney. For qualified buyers, prepare a selling memorandum to provide quantitative information about the pharmacy's past, present, and future potential. Finally, while qualified buyers are investigating your pharmacy, scrutinize them to select the most suitable candidates.

INCREASING APPEAL

One way to attract potential buyers is to improve the appeal of the pharmacy from both financial and physical standpoints. If possible, start three years before putting it on the market.[1] Three years of preparation is an important time period because it is standard for buyers to request the last three years of financial statements for review. It is also standard to include this same time period of financial data in the selling memorandum. Thus, you would prefer to have three solid years of

Norm Bowles: *"Our computer system was upgraded in all areas of the pharmacy and new carpet was installed prior to putting the business on the market."*

Kris Zepeda: *"In the last year, the pharmacy spent over half a million dollars implementing innovative new practices, such as our telepharmacy."*



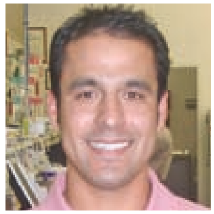
financial data on the books to show potential buyers. You should strive to improve assets, eliminate liabilities, improve income, keep financials current, set a realistic price for the pharmacy, and make it a turnkey operation. On average, once your pharmacy is on the market, it will take about a year to find the final buyer and complete the deal.[2]

- ***Improve assets.*** Dispose of front-end inventory that is not moving and unproductive assets. Buyers will not be interested in them. Your accountant can write off any resultant losses. Sometimes the pharmacy owns assets that are exclusively for the owner's personal use, such as a company car. If you would like to retain the asset after the sale, buy it from the pharmacy at the current book value before putting it on the market. If the pharmacy owns real estate, you might consider the possibility of retaining it and leasing it to the new owner as a source of income for yourself.[1]
- ***Eliminate liabilities.*** Pay off debts. Settle any legal problems. Large debts and lawsuits will cause potential buyers to look elsewhere[1].
- ***Improve income.*** Increase your earnings before taxes. For example, evaluate if keeping the pharmacy open extra hours will generate more revenue, cut unnecessary expenses, have your accountant reevaluate reporting methods for depreciation to cast financial statements in the best light. Such activities should begin at least three years prior to selling so that historical statements provided to potential buyers will reflect these efforts.[1]
- ***Update financials.*** Tax reporting extensions and delayed financial statements will scare off potential buyers. If staying current has been a problem, switch accountants or upgrade your accounting software.[3]
- ***Make it turnkey.*** Most potential buyers interested in maintaining an independent community pharmacy want to purchase a turnkey pharmacy. They want to turn the key, enter the pharmacy and begin practice without investing in changes, so make sure the pharmacy is fully functional and looks appealing.[1] Have a fresh set of eyes view it and comment on areas requiring attention such as orderliness of work flow, visual appeal of stock and its arrangement, and designated areas for counseling, expanded services, and educational materials. Buyers do not want to have to renegotiate key contracts immediately. So if the sale is likely to occur before a contract is scheduled to expire, renegotiate early for a favorable rate locked in for the purchaser. Have your lawyer make sure the contract will be assumable by the new owner.[2]

- ***Realistic pricing.*** Rarely will a business sell at a price that equals or exceeds the annual sales of the business. If you are seeking a greater selling price, anticipate every detail of your financial statements being fully scrutinized and seek expert advice for valuation and pricing of your pharmacy.[3]

POSSIBLE CANDIDATES

Many owners have a potential buyer for their pharmacy in mind. It may be a relative or an employee, a local competitor, or the owner may have received an unsolicited offer. If you do not have a buyer in mind, your national, state, and local pharmacy associations are a good place to start. Within these organizations, special interest groups for independent owner pharmacists and employee pharmacists may be a source of potential buyers. Schools of pharmacy and wholesalers can often provide leads. You may decide to place ads in pharmacy journals or selected newspapers to find a buyer. Because most pharmacy owners have no prior experience selling a company, the services of an intermediary should be considered. Local, state, and national pharmacy associations may be able to provide recommendations and contact information for intermediaries.



Kris Zepeda: *"My existing partner was the individual that bought me out of my store. It was very smooth and informal."*

INTERMEDIARIES

An intermediary can bring more prospective buyers to your pharmacy than you could ever do on your own. Intermediaries can maintain your confidentiality by revealing information about the business but not your name. Such services can save you time by separating serious buyers from casual browsers.[4] Some prospects may also be more comfortable, initially, communicating through an intermediary rather than directly with an owner.[5] The right intermediary can help you price your pharmacy properly and usually help you sell it for more than you could on your own. Intermediaries can also serve as a resource in the selling process.[6] Two general types of intermediaries are available: brokers and matching services.

Diane D'Amato: *"We saved ourselves a lot of work and hassle. We got a lot more for the business than we would have if we went it alone. The broker put a value on the pharmacy much higher than we had thought it was worth. All the discussions about price, inventory, deposits, and other issues were handled by the broker. We said yes or no to him, and he handled all the negotiations for us. In the end, the commission was more than worth it."*

Linda Garretts Maclean: *"The broker researched the market, understood business valuation, and had many good contacts to show our business to. The broker took a percentage of the sale for payment, so we compensated by ensuring that the sales price was sufficiently inflated to allow us to clear the amount we wanted."*

Brokers

A business broker acts as an agent for an owner looking to sell a business. Some real estate agents broker businesses but most business brokers are themselves, small businesses.[7] Brokers may specialize in representing businesses in a specific geographic area or they may represent businesses in a particular industry, such as pharmacy. To select the right broker, interview more than one,[8] and start asking questions:

- ***Ask about background and experience.*** Look for a seasoned broker who is well grounded in business valuation and the legal aspects of selling a business.[9]
- ***Ask about accreditations and trade associations.*** Look for accreditation by the International Business Brokers Association (www.ibba.org) via the designation, certified business intermediary (CBI). Membership and participation in broker associations can also be a sign the broker is staying current within the profession.[9]
- ***Ask about a license to sell real estate.*** Ninety-two percent of business brokers have a real estate license.[10] Make sure your broker carries the license. Unlicensed brokers may either be inexperienced or could have questionable records.[10]
- ***Ask about services provided.*** Proposals from brokers should all include help with placing a value on the pharmacy, establishing a sales price, and of course locating qualified buyers.[11] But brokers can also provide assistance with a variety of other steps in the process including preparing the selling memorandum,[12] and structuring and completing the deal.[13]

- ***Ask about the web site.*** A web site is a powerful way for brokers to market their services and an indication of how well your pharmacy will be marketed to others. Brokers without web sites are not up-to-date.[10]
- ***Ask about research tools.*** Look for a broker who uses the Internet to identify buyers, rather than just posting advertisements. The brokers should also utilize the Internet to access high-end business information about retail pharmacy.[9]
- ***Ask about marketing tools.*** Competent brokers should use a variety of ways to reach potential buyers including ads in local papers and trade publications, listings on general "business for sale" websites, and pharmacy-specific sites.[9]
- ***Ask about printed marketing materials.*** All brokers write an offering summary for each business they represent. Request the broker to show you such printed marketing materials developed for previous clients, and assess whether they are well written and complete.[10]
- ***Ask about price and fee structure.*** Brokers generally charge three percent of the sale price,[14] but the fee can go as high as 10 to 12 percent for a small business.[4] Many brokers collect an upfront fee and commission paid upon sale of the business. Negotiate so that the fee will be paid at the time you receive the purchase price, not at the time the deal is closed. This is important if you finance the price over a number of years. You will pay the broker only as you actually receive the money.[4] Be wary of brokers who seem too optimistic about the selling price and then ask for money up-front.[15]
- ***Ask about references.*** Brokers are unregulated or, at most, loosely regulated.[15] Check with the Better Business Bureau regarding complaints against the broker.[16]
- ***Ask for references to satisfied clients.*** Do not accept a response alluding to customer confidentiality. Truly satisfied clients are willing to share their good experiences.[15] Talk with any pharmacy owners that may have previously used the broker to sell a pharmacy. Ask for statistics. What percentage of the broker's clients actually sell their business?[15] How many pharmacies have used the broker to sell their business?

Matching Services

A matching service provides sellers and buyers with the ability to connect in a confidential environment where they can trade information regarding the possible transaction. Often matching services are focused on a particular industry. For example, the Independent Pharmacy Matching Service (IPMS) was developed by the National Community Pharmacists Association (NCPA).[17] The service connects sellers and buyers of community pharmacies. For a fee, matching services will place a listing on their website for a designated period of time. In some cases, basic services are included in the fee. For example, NCPA includes a professional evaluation of the pharmacy and preparation and posting of the listing. Matching services function as a go-between transferring messages of potential buyers interested in a listing to the owner. Matching services do not serve as brokers; however, many provide access to the services of a broker upon the request of the owner.

Qualifying Buyers

If you do not use the services of a broker, then you will need to qualify potential buyers yourself. Ask all potential buyers to sign a confidentiality agreement and provide a statement of interest before proceeding further. A confidentiality agreement is a contract in which the potential buyer agrees to be very careful with any information shared about your pharmacy and agrees to return all information received if no longer a potential buyer.[18] Any potential buyer who does not send back a signed confidentiality agreement should be eliminated right away. Potential buyers who you do not recognize immediately as qualified (such as a competitor looking to expand) should be asked to provide a statement of interest outlining their background and reason for interest in buying the pharmacy. The statement of interest can also be used to qualify buyers financially by including a request such as the following: "Confirm that you have sufficient resources to finance a pharmacy purchase of $ (sales price)." Alternatively, you could make the following request: "Describe the pharmacy you seek to acquire in terms of price and size."[18] Based on the responses received, the list of qualified buyers can be narrowed to candidates who will receive more information about the pharmacy in the form of a selling memorandum.

PREPARING A SELLING MEMORANDUM

A selling memorandum is one of the best ways to promote your pharmacy to qualified buyers. The selling memorandum should provide an excellent first impression of the pharmacy by laying out the pharmacy's past, present, and future potential. It should be believable and compelling.[19] The main sections of a selling memorandum include the business summary, asking price, financials, asset list, and an appendix.[12, 19, 20, 21]

- ***Business Summary.*** The business summary should begin with an explanation of why you want to sell. The reason should reflect favorably upon the pharmacy.[12] Next, other company information should be provided including a brief history, organizational structure (sole proprietorship, limited partnership, etc.), description of departments and staff (if applicable), operation details/achievements (prescription volume, expanded services, etc.), and customer base (including major facilities and employers served).[21]
- ***Asking Price.*** Present the price you are asking with a working calculation of the valuation method. Terms of the sale that are not negotiable should be identified.[21] Your accountant (and broker if applicable) should assist in preparing this section.
- ***Financials.*** Financial statements will eventually be fully disclosed to the buyer. Sufficient financial information should be provided in the selling memorandum to give an accurate portrayal of the financial position of the business. Your accountant should help prepare this section which contains a three year history of quarterly statements and a three year forecast of cash flow and profit.[21]
- ***Asset List.*** Provide the age, condition, and value (with the help of your accountant) of the major assets of the pharmacy to be included in the sale, such as the building, the land, vehicles, fixtures, etc. Provide photographs of these assets.[21]
- ***Appendix.*** The appendix should contain any photographs or diagrams referred to in the text.[20]

You should have a signed confidentiality agreement from anyone viewing the selling memorandum. In addition to qualified buyers, this includes your accountant, broker, or any other party. Lawyers do not need to sign a confidentiality agreement because they are already bound by professional responsibility requirements.[12]

SCRUTINIZING QUALIFIED BUYERS

While qualified buyers are investigating your pharmacy, you should also investigate them. Such investigative activities can be time consuming, so you will need to rely heavily on your pharmacy staff to keep operations running smoothly. Investigate both financial and intangible factors.[22]

- ***Financial.*** Often the sale of a pharmacy is not an all-cash deal. The owner may finance part of the sales price or it may include stock options. So investigate the prospective buyer's capital base, cash flow, bank accounts, liquidity, stock value, or potential to go public to determine the full value of the deal.[22] Your accountant, banker, and/or attorney may be helpful resources during the investigation of the prospective buyer's finances.

- ***Intangibles.*** The new owner will likely be serving your patient base, acquiring your employees, and possibly acquiring you as an employee in the event you negotiate to continue working there. Visit the potential buyer's current operations. Observe how patients and employees are treated. Request interviews with owners and key employees, particularly those who have been involved with other acquisitions.[22]

Based on your investigations, you should then be able to narrow the list of qualified buyers to the one or two candidates who are most suitable for the purchase of your pharmacy.

CONCLUSION

If you are like most owners, selling a pharmacy is something you will do only once. You will have one opportunity to put a price on the assets and goodwill you have amassed over the years. You have aggressively built and maintained a successful practice, so be equally aggressive in finding suitable candidates for purchase. Start early, allowing at least three years to make the financials and the pharmacy itself as appealing as possible. Consider capitalizing on the expertise of an experienced pharmacy broker or matching service. Qualify potential buyers by requesting that they sign confidentiality agreements and provide statements of interest. Prepare a selling memorandum for qualified buyers, and while they are scrutinizing your pharmacy, do the same.

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Chapter 3

Advice and Counsel

INTRODUCTION

"Knowledge," according to Francis Bacon, "is power." Nowhere is this so true as in the highly competitive business community. Since the community pharmacy exists within this marketplace, it is essential that the pharmacy owner be as knowledgeable as possible about all aspects of business enterprise. The acquisition of advisors should be accomplished many years before the owner contemplates the sale of the pharmacy. This assures that all records are in order and that the proper steps have been taken to assure a smooth transition of ownership.

Being knowledgeable in all the areas of pharmacy management is often difficult for one person to accomplish. The retail pharmacy market is extremely complex in nature and involves a great many different activities. It would be unreasonable to expect one individual to be able to totally master the intricacies of all the specialized fields that touch upon a business enterprise. Large businesses normally solve this problem by employing specialists to provide owners with advice and counsel in certain matters, such as finances, business, accounting, and law. Small business owners, however, do not generally enjoy the convenience of having such expertise on immediate staff. Instead, business owners must either attempt to handle such matters internally—a difficult and often risky task—or must make arrangements with independent, outside specialists to advise in such matters.

Fortunately, there are many and varied resources available to the pharmacy owner that can provide invaluable assistance. Among the human resources discussed in this chapter are: the accountant, the attorney, the banker, the business consultant, the insurance agent, professional and trade associations, the Small Business Administration (SBA), the wholesaler, the pharmaceutical manufacturer, and pharmacy schools.

The purpose of this chapter is to describe these human resources and to illustrate how they can be helpful to the pharmacy owner in today's complex and competitive business arena. Given the importance of the services these specialists are to perform, it should be obvious that they should be selected judiciously and with extreme care. It is also essential that the pharmacy owner realize the extent and the limitations of the services to be provided.

HOW TO SELECT AN ACCOUNTANT

Kris Zepeda: *"I was introduced to an*

accountant that was recommended by a pharmacist colleague and friend. The accountant was one of the most important aspects of keeping the sale tax friendly."

Accounting has been defined as the process of collecting, recording, summarizing, and analyzing business transactions and interpreting their effects on the business. In this sense, an accountant is a business advisor who can be of vital importance to the pharmacy owner.

Whether an independent accountant or a certified public accountant is chosen for this role, the pharmacy owner will find that the accountant can provide valuable assistance regarding the financial condition of the firm. There are several areas in which the pharmacy seller may best utilize an accountant. Among them are the areas of specialization described below:

- ***Accounting system design.*** In order to make the most effective use of the financial data generated within the business, it is essential that an individualized accounting system be developed. The pharmacy owner can benefit greatly from the advice of an accountant in terms of the types of financial records he should maintain to assure a procedure that will best serve the pharmacy's needs.
- ***Financial statement preparation.*** These statements are of pivotal importance in helping the pharmacy owner keep abreast of the financial conditions of the firm. Periodic financial statements enable the owner to pinpoint problem areas and implement solutions before the problems become unmanageable. The accountant will on a monthly, quarterly, and annual basis construct financial statements such as the balance sheet or the income statement. These are usually prepared using data provided by the pharmacy's bookkeeper.
- ***Financial analysis.*** By comparing the operating data on the financial statements to national averages and by studying appropriate ratio analysis, the accountant may periodically advise the pharmacy owner of certain problems

that call for immediate ownerial attention and actions. There will be further discussion on this topic in Chapter 4, "The Role of Financial Analysis in the Transfer of Ownership," as well.

- ***Securing loans.*** The accountant may assist business owners in securing loans and credit by gathering and organizing the financial information required by the lending agency for short or long-term loans.
- ***Tax return preparation.*** Since the accountant is intimately familiar with the financial data of the business, he or she is in an excellent position to prepare the periodic tax returns required by city, state, and federal governments. More importantly, perhaps, the accountant should be able to recommend procedures that will result in maximum savings for the firm procedures involving such variable items as deductions, credits, and optimum depreciation for fixed assets.
- ***Federal forms preparation.*** The accountant may handle the preparation and filing of federal forms such as those required for withholding taxes and social security.
- ***Financial statement audit.*** If the firm is a publicly owned company, laws require that annual financial statements be issued. For the protection of the investors, those statements are audited by certified public accountants. Auditing, incidentally, deals with the verification of accounts and is, therefore, by no means confined to publicly owned corporations; even very small firms are audited regularly. Quite often, for example, an audit may be necessary when applying for a bank loan.

Selecting an accounting firm is not always an easy task. In most large communities, there will be literally hundreds of independent accountants and certified public accountants (CPAs). Consequently, there are three steps that should be taken:

- ***Step #1***: Ask business associates and established businesses in your community for referrals. For reasons that should be obvious, you will want an accounting firm that has a reputation for integrity and competence.
- ***Step #2***: Invite a number of candidates to individual interviews so that you can determine if the experience, professional knowledge, and staff skills they possess are of a nature compatible with your business.
- ***Step #3.*** Ask for a list of the firm's current clients and follow up by checking them to determine how well the firm provides the services you require. Attempt also to determine if the firm will have the time and the staff to handle your business financial needs.

The fees for an accountant, like most business advisors, are usually based on time charges. Some accountants, however, may provide routine services such as the preparation of financial statements for a fixed fee. It is, therefore, essential that the pharmacy owner make the most efficient use of the accountant's time.

The American Institute of Certified Public Accountants lists several ways you can get the most value from your accountant.

- You should discuss your company's plans and objectives with your accountant. Your accountant can best serve your interests if he or she knows where you want to go.
- Tell the accountant in precise terms your service expectations.
- Keep your accountant informed of changes in your business philosophy, new directions, and developments that may affect his or her judgments.
- Always seriously take into consideration their suggestions and recommendations. After all, that is what you are paying them for.
- And, finally, make a concerted effort to avoid using your accountant's time for non-professional work. Remember that, as a businessperson themselves, they must charge fees for time spent on any project.

THE ROLE OF AN ATTORNEY IN A PHARMACY OPERATION

Many pharmacy owners fail to realize that an attorney may be of great importance in areas far removed from pressing or defending a lawsuit. Contrary to popular belief, a businessperson needs an attorney for more than merely avoiding trouble with the law; he or she also need an attorney in order to take advantage of opportunities permitted by law. Legal services may appear on the surface to be almost prohibitively expensive, but a pharmacy owner would do well to remember the old advice that "an ounce of prevention is worth a pound of cure."

Specifically, there are a multitude of areas in which an attorney can be especially valuable to the sale of a pharmacy. The pertinent areas have been identified by the Small Business Administration (SBA) and are capsulized here:

- ***Organization.*** It was pointed out earlier that the form of business organization can have marked implications for the financial future of the firm. The pharmacy owner should discuss the various possibilities fully with a competent attorney, paying particular attention to the rules regarding taxation, liabilities of the owner, forms of management, and so forth. Depending on the form of organization chosen, legal services are a necessity in the filing of appropriate contracts and forms, such as articles of partnership or articles of incorporation with the state.

- ***Acquiring property.*** Legal services may be invaluable with regard to real estate that is leased or purchased. The attorney can explain in lay language, for example, certain provisions in the lease covering cost of improvements, renewal provisions, provisions in case of fire or other damage, or subletting. If the building is purchased, the services of an attorney are most important in certifying the title to the real estate.
- ***Financing.*** Inventory, of course, is the largest investment in the community pharmacy. Since the initial inventory is seldom purchased with cash, financing will probably be necessary. At this point, an attorney can be extremely helpful by making sure that the owner fully understands the commitments being made. The attorney can also be valuable in securing short or long-term bank loans where certain restrictions may be imposed on the business. Finally, if the owner seeks to increase funds by selling part of the business to another person or by offering stock to the general public, an attorney is almost always required.
- ***Taxes.*** The complexity of tax laws virtually necessitates the use of an attorney with tax experience. Some areas in which advice may be rendered include: which fiscal year to use; the legal aspects of pension plans; how to capitalize the business to minimize taxation; and the availability of stock options.
- ***Litigation.*** In the event that your firm is sued or if you should find it necessary to sue some other person or firm, it would be necessary that an attorney represent you in court. If this should occur, it would be better if you had an attorney who was familiar with you and your business. This is just another reason for securing and maintaining the services of an attorney.
- ***Credit problems.*** If the pharmacy develops financial problems and is unable to pay debts, an attorney may be able to work out a plan for paying off the debts over a period of time. In terms of pharmacy customers who are unable to pay their debts to the pharmacy, the attorney may be able to suggest procedures whereby those funds may be obtained at a minimum cost to the pharmacy.
- ***Disposing of the business.*** Legal advice is essential if the pharmacy owner wishes to sell part or all of the business. An attorney may be able to provide

valuable advice and assistance concerning the many tax implications that such a transaction may produce for the owner.

- ***Preparation and Review of Legal Documents.*** The documents and contracts used in the sale of a business should be reviewed by an attorney prior to signing.

Selecting an attorney is accomplished in much the same manner as selecting an accountant: ask for referrals from business associates; invite candidates for interviews; and follow-up on references. During the interview, you should discuss the requirements of your business in detail to determine if the attorney has the training and experience to represent you in this area.

Some of the other factors that should be discussed include the attorney's fee structure and whether or not he represents competitive pharmacies. In addition, you should give serious consideration to whether you feel you could work with the attorney on a personal basis. Many companies find it advantageous to arrange for an attorney to represent them on a retainer basis. This form of remuneration plan sometimes proves to be less costly to the pharmacy, particularly if legal questions arise with any regularity. It also assures that the attorney will be more familiar with the firm's operation. The small pharmacy owner, however, will probably decide to secure the attorney on a fee-for-service basis. Whatever the case, the financial arrangements should be thoroughly discussed and considered in making a decision on which attorney to select.

Please refer to Chapter 7, "Legal Considerations in the Sale of a Pharmacy," for more information on the role of the attorney.

THE IMPORTANCE OF SELECTING A COOPERATIVE BANKER

Bankers probably know more about prevailing business conditions in any given community than any other person the pharmacy owner may contact for advice and consultation. Because they are involved in so many business activities on a day-to-day basis, bankers are generally in excellent positions to suggest or recommend other professionals or organizations to small businesses that have operating problems or are looking for opportunities to grow.

Most people feel that the primary purpose of a bank is to provide credit. While this is true to a large degree, your local bank may provide many other services for your pharmacy, which you may find to be very beneficial under certain circumstances. According to Dun and Bradstreet, these include:

- ***Source of credit.*** Intermediate and short-term loans may be divided into two general categories: line of credit and term loans.
    - If a pharmacy's money needs are recurrent, a line of credit may be arranged with the local bank. Funds may then be borrowed as necessary and paid back as convenient. There is a maximum amount agreed upon and a fixed time period usually one year. The amount of the line of credit is dependent on such factors as the financial condition of the firm, general business conditions, and the loan position of the bank. The bank may, however, expect to be kept informed of the progress of the business and, in some cases, the business may be required to maintain a minimum balance in a deposit account. The line of credit may be useful in paying one's bills on time or taking advantage of cash discounts and special buying opportunities.
    - Term loans are also available through the local bank. These may provide for repayment within one to five years or more in periodic payments that are geared toward the pharmacy's cash flow. The bank may require certain stipulations for term loans, among them the maintenance of a specified working capital position, limits on other borrowing, or the submission of periodic financial statements.

Like many other advisors, recommendations concerning the choice of a banker may be obtained from accountants, attorneys, other pharmacy owners, or business associates. The recommendation you may get from other pharmacy owners should bear some greater degree of weight, because another pharmacy owner is more knowledgeable about those banking services considered important to the operation of a pharmacy.

From a personal point of view, your choice of bankers should involve consideration of individuals with whom you feel you can work closely and well. It is important, for example, to determine whether or not the banker has a genuine interest in you and your business. This is the kind of subjective consideration that can be significant to the success of your business in the long run.

HOW A BUSINESS CONSULTANT CAN INCREASE A PHARMACY'S APPEAL

As business management has become more complex, there has been an increased need on the part of pharmacy owners to utilize the services of specialized consultants who offer assistance in the management area. The function of these specialists is to assist a company in moving toward a predetermined objective, and that objective is almost always the maximization of profit.

Basically, the functions of the consultant include diagnosing problems, recommending solutions, and helping to implement them when necessary. Many pharmacy owners and owners appear to be reluctant to use the services of business consultants to any great degree. There are, however, reasons in favor of using outside specialists as opposed to trying to solve the problems internally, as William Arrnstein pointed out several decades ago in his book, *Management Services by Accounting Firms*, The Ronald Press Company, New York, 1967:

- They are likely to know all the various techniques capable for solving a given problem.
- They have seen the application of each technique in various companies and are, therefore, in a better position to choose the correct technique for the problem at hand.
- They are not limited in experience or viewpoint to a single area of operations. This permits them to better deal with problems involving several areas.
- Recommendations which are recognizably correct but innately distasteful to management tend to be more acceptable when made by an objective outsider.

The business consultant is generally in a position to offer a wide variety of specific services to help solve certain problems. Some of those having particular relevance to pharmacy operations are as follows:

- ***General management problems.*** This includes such critical areas as overall business strategy and long-range planning.
- ***Marketing problems.*** An area including marketing strategy and market research.
- ***Financial problems.*** This includes the various functions of accounting, budgeting, forecasting, and profit planning, as well as budgetary and cost controls.
- ***Personnel problems.*** Consultants in this area provide assistance with

selection procedures, employee motivation, equitable compensation, and employee training.

- ***Administrative problems.*** This includes records management and information retrieval.
- ***Data processing problems.*** As electronic data processing becomes more and more important in pharmacy operations, assistance in this area will involve integration of data flow, computer feasibility studies, equipment specification and selection, cost and quality control, staffing requirements, and personnel training.
- ***Management information problems.*** This area involves the design, development, and implementation of management assistance systems which provide information that assists in the identification and solution of management problems.

On the surface, it would appear that these problems are primarily limited to large business enterprises and are, therefore, not reflective of a relatively small business such as the community pharmacy. However, that is not the case. These same problems do exist for the community pharmacy owner, who must draw upon his/her own expertise or the expertise of trusted advisors such as friends, family, professional associations, or a business consultant.

In conclusion, it may be stated that the business or management consultant can be of significant value to the small-business owner, primarily because the consultant may possess considerable experience with business problems the pharmacy owner may see infrequently.

PROFESSIONAL AND TRADE ORGANIZATIONS IN PHARMACY

It has been stated on several occasions that pharmacy is "the most unorganized, organized health profession." What is meant by that, of course, is that as a whole the profession is not represented by any one unified group. Instead, there are many different, well-organized groups that represent various segments of the profession.

All of these associations provide advice, information, and counsel to their members in specialized areas within pharmacy. Some of the more significant associations serving retail pharmacy are the National Community Pharmacists Association (NCPA), American

Pharmacists Association (APhA), the American College of Apothecaries (ACA), and the National Association of Chain Drug Stores (NACDS). In addition, each state has at least one association that is divided into smaller district associations providing some of the same general services as the national organizations, but on a more localized basis.

The purpose of these associations is to advance the best interests of their members and, in doing this, they offer some valuable services to the pharmacy owner. While it is beyond the scope of this text to provide a comprehensive listing of all organizations, along with the many services they provide, it is possible to discuss the services generally so that the pharmacy owner will be aware of some of the advantages accrued through membership in professional or trade associations. The Small Business Administration has described these functions as they are paraphrased here.

- ***Accounting services.*** Many associations provide assistance of one sort or another in the area of accounting. Most of this assistance comes in the form of information contained in journals, booklets, and continuing education. Specific examples of materials provided include accounting manuals, comparative statements and ratios, and uniform and account classifications. In some cases, these associations also conduct cost studies and provide accounting consultations.
- ***Marketing services.*** Some associations provide assistance in this area by furnishing members with advertising materials or by conducting studies and providing information regarding improved methods of merchandising and promotion. This may be done primarily through professional journals, continuing education, or niche programs offered by the professional trade associations.
- ***Consumerism.*** All professional and trade associations feel that an important function is assisting members in protecting the consumer. In addition to publishing a code of ethics, most associations also work with state agencies on licensing programs and conduct educational programs informing the public about what the profession is doing to protect consumers.
- ***Education.*** It is in this area that the pharmacy owner stands to gain the most from membership in professional associations. Most of them sponsor short courses, clinics, seminars, and workshops on various areas of pharmacy management. In addition, most of them also provide valuable information through official journals and some provide a list of publications and films

that can prove beneficial to a pharmacy owner. Some state associations also provide similar services.

- ***Government relations.*** At a time when government has become community pharmacy's single largest customer through the Medicare Part D, Medicaid, TRICARE, and federal employee programs, the professional association can have a marked impact for the members of the profession on the decision makers in government. The association also serves as a mechanism that allows the individual members to keep informed as to what is happening in government regarding their profession. Some of the specific areas of assistance by the professional association on both a national and local basis include cooperation with governmental bodies in the solution of problems affecting the profession, drafting legislation or model laws, and encouraging members to be politically active. The link between business and politics is one that should not be underestimated as a key to success.
- ***Publishing.*** Assistance is provided by associations in keeping their membership well informed about changes in the profession. This is exemplified by the publishing of bulletins and newsletters, membership directories, handbooks and manuals, and the journals mentioned earlier.
- ***Research and standardization.*** Most of the associations serving pharmacy provide valuable assistance by performing some research themselves, by establishing standards for the profession, and by disseminating information and statistics to the membership.
- ***Store modernization.*** Some associations provide specialized assistance in helping the pharmacy owner to redesign his or her pharmacy layout.
- ***Legal services.*** Others will provide limited, free legal services in certain areas, as in problems pertaining to suppliers or third-party administrators, for example.

THE SMALL BUSINESS ADMINISTRATION AND HOW IT CAN HELP A PHARMACY

In 1953, Congress created the SBA. The primary purpose of the SBA is to provide aid, counsel, and assistance to small business concerns in order to preserve our free enterprise system. Many of the services offered by the SBA can be of special benefit to the pharmacy owner.

It is estimated that nine out of 10 business failures are caused by management difficulties. For this reason, one of the SBA's major objectives is to remedy this situation. To this end, the SBA provides at little or no cost to the businessperson, the following services:

- ***Management information.*** The SBA has many web sites featuring discussions of various aspects of business management. All of them are written in non-technical language.
- ***Management training.*** The SBA regularly co-sponsors training programs with universities, colleges, chambers of commerce, and other organizations in an effort to reach as many interested small business owners as possible.
- ***Management counseling.*** The SBA has established the Service Corps of Retired Executives (SCORE) to help small business owners who cannot afford independent management consulting firms.
- ***Loan assistance.*** The SBA has helped literally thousands of firms get started or expand with funds borrowed through the auspices of the SBA. This is accomplished by either direct loans from the SBA (if the applicant cannot qualify through normal banking channels) or from banks with the SBA guaranteeing a major portion of the loan. Since SBA loans or SBA-guaranteed loans will be covered in another chapter, it should suffice here to merely indicate that this service is available.

HOW THE WHOLESALER CAN HELP BY PROVIDING VALUABLE SERVICES

The wholesaler is more than just a supplier of merchandise. In reality, the wholesaler quite often plays a major role in the eventual success of a pharmacy operation. In the context of a pharmacy seller, the wholesaler can help improve the business appeal through offerings listed below and can be instrumental in identifying potential buyers.

In recent years, drug wholesalers have experienced certain economic pressures that have caused them to increase their participation at the retail level by dramatically expanding their services to the pharmacy owner. As a result, the wholesaler is now in a position to provide advice, counsel, and specify services that can be especially beneficial and useful to the retail pharmacy. As described by the SBA, the services frequently offered include the following:

- ***Promotion.*** The wholesaler may provide promotional assistance through various processes, such as supplying advertisements of pre-selected items that may be featured on a cooperative basis with other retailers. Point-of-purchase promotional material is also available from most wholesalers and the wholesaler may participate in cooperative advertising with the retailer.

- ***Inventory control.*** Since inventory control is so important to a wholesaler, their staff possesses much expertise in this area—expertise that can be extremely useful to the pharmacy owner. The wholesaler's experience, for example, can provide an accurate determination of the beginning inventory for a new pharmacy, thus allowing the owner to minimize initial investments. Most wholesalers also offer computerized inventory control to their customers, thus providing them with a way to scientifically maximize turnover and return on inventory investment.
- ***Market information.*** The wholesaler is in a good position to feel the pulse of the pharmaceutical market, sensing changes in consumer demand, prices, and supply conditions. By making the retailer aware that these changes are occurring, the wholesaler provides a valuable service.
- ***Financial advice.*** Quite a few wholesalers help their customers maintain adequate accounting systems and some even provide retailers with specific accounting functions such as credit management.
- ***Management advice.*** Some wholesalers offer advice that retailers can use in establishing policies and improving operational methods such as public relations, housekeeping, administrative assistance, and personnel management.
- ***Location analysis.*** Most drug wholesalers have a staff that possesses expertise in location analysis. This analysis could provide eventual justification for an increased selling value for the business. Traffic counts and potential market studies may also be conducted by some wholesalers.
- ***Store layout.*** Specialized staff members may provide assistance to the pharmacy owner in the areas of store layout and selection of fixtures.

It should be obvious that the wholesaler today has a great deal more to offer than just merchandise. In choosing a wholesaler, therefore, it may be wise to consider the advice, counsel, and services each wholesaler has to offer in addition to the types of merchandise and the discounts.

SCHOOLS OF PHARMACY: VALUABLE SOURCES OF ASSISTANCE

One of the principal resources a pharmacy owner can turn to for management information and assistance is his or her nearby pharmacy school. Most schools of pharmacy offer periodic continuing education programs in the management area. This continuing education is usually provided in the form of seminars, lectures, videotapes programs, correspondence courses, audiotape programs, or continuing education bulletins.

In addition to regularly scheduled programs, the pharmacy administration faculty of those schools of pharmacy are often quite willing to discuss particular problems that a pharmacy owner may encounter in his or her business. Furthermore, the libraries of these schools represent a most important resource for up-to-date texts in the areas of management, as well as a permanent repository for all major journals and periodicals in the pharmaceutical arena.

Many schools use community pharmacies as sites for intermediate advanced practice experiences. In doing so, these schools often offer assistance to planning owners in the implementation of various value added clinical services which can benefit the pharmacy as well as serve as an excellent educational mechanism for the students and the school.

In short, the school of pharmacy may represent one of the most beneficial resources available to the pharmacy owner for assistance in management. All you need to do is ask them for help.

CONCLUSION

Inasmuch as the business component of community pharmacy is complex and diverse coupled with the lack of management education for the pharmacy owner, it is often necessary to seek the aid and counsel of competent advisors. Since the economies of the typical community pharmacy do not provide for the permanent employment of these specialists, it is often necessary to seek their aid on a limited basis. Knowing the benefits of these individuals and how to select them can be an important part of the community pharmacy owner's business armamentarium.

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How to Choose a Bank. "Choosing a Bank for your Small Business." Copyright ©2001–2006. Gaebler Ventures. Accessed 4 Nov 2006 from www.gaebler.com/Choosing-Banks.htm.

Resources

National Community Pharmacists Association
100 Daingerfield Road
Alexandria, VA 22314
(703) 683-3619
www.ncpanet.org

Small Business Administration (Answer Desk)
6302 Fairview Road, Suite 300
Charlotte, NC 28210
(800) U-ASK-SBA
www.SBA.gov

American Association of Colleges of Pharmacy
1426 Prince Street
Alexandria, VA 22314
(703) 739-2330
www.AACP.org

Chapter 4

The Role of Financial Analysis In the Transfer of Ownership

INTRODUCTION

The fiscal condition of the business is an important consideration in the determination of an equitable selling price and an important factor in deciding to buy or sell a business. There are formulas (See *America's Pharmacist*, October 2002 and 2004) that can provide one with a good indication of the fair market price for a community pharmacy. Based on several subjective factors such as the competition, business trends, how badly the seller wants to sell and the buyer wants to buy, the value determined by the formulas may be adjusted up or downward. A very important objective factor affecting the value of the pharmacy is the financial condition of the business as determined by financial analysis.

In addition to providing additional information related to the valuation of the pharmacy, a favorable financial analysis will assist the seller in the negotiation process. By pointing out those aspects of the business, such as profitability, solvency, efficiency, etc., the seller may be able to negotiate a better selling price. To be certain, an astute purchaser would be quick to point out negative financial statistics in an attempt to negotiate a lower purchase price.

The performance of a financial analysis is important for a buyer inasmuch as it may identify certain problem areas that may be remedied to produce a more favorable financial picture for the pharmacy thereby increasing its true value.

A financial analysis is a fiscal exam of a business that is not unlike the annual physical examination that we are encouraged to obtain from our physicians. As a part of that physical exam, we normally have laboratory tests on a blood and urine samples. Some 10 to 20 different tests are performed and the results of the analysis of our blood are compared with "normal" or "usual" values to determine if our values are "too high" or "too low."

In a very similar fashion, we can examine the components of the income statement and balance sheet of a community pharmacy and compare them to normal or usual values. In addition, we can mathematically manipulate some of the components of the financial statements and calculate ratios and percentages to compare with normal values as well. We compare our values with acceptable or normal values which enable us to pinpoint problems ahead of time and offer solutions for those problems before they become very serious.

In reality, that is the same reason that we have an annual physical exam. There may be things wrong with us that are not readily discernable. A physician performs laboratory tests so that those problems can be detected early and then the appropriate solutions or remedies applied before those problems get very serious. The same thing is true in the business enterprise. The financial analysis enables an owner or owner to detect problems before they become serious.

The financial analysis procedure that we will discuss is of two types. The first is a comparative analysis and the second is a ratio analysis. Let's begin by taking a look at what is meant by a comparative analysis. A comparative analysis is conducted by expressing each component on the financial statements to those of a "normal" or average pharmacy described in the *NCPA-Pfizer Digest* (available annually from NCPA). Rather than compare actual dollars, each component of the income statement is expressed as a percentage of annual sales and each component of the balance sheet is converted to a percentage of total assets. Since these percentages would vary according to the annual sales volume of the pharmacy, average benchmark data segmented by sales volume is provided in the *NCPA-Pfizer Digest* for comparative purposes.

The second type of financial analysis is financial ratio analysis. This consists of taking individual components of the income statement and balance sheet and relating them one to the other and calculating various ratios and percentages. These then are compared to benchmark values in the *NCPA-Pfizer Digest.* Like the comparative analysis, these benchmarks vary with the sales volume of the pharmacy and are segmented in the Digest. Approximately 20 of these ratios are used in the analysis which have been segmented into four major categories indicating: profitability, productivity, financial position, and cash flow.

These ratios, as well as the percentages calculated from the comparative analysis, should also be compared with those calculated on the business from previous years to determine any trends (especially negative) that may be occurring in the business. Just examining a ratio for a given period of time is important, but if we compare it with recent years, it can tell us if a trend may be occurring.

COMPARATIVE ANALYSIS

Income Statement

Figure 1 provides the annual common-sized, normal or usual income statement data for an average or typical independent community pharmacy. These latter data were obtained from the *2006 NCPA-Pfizer Digest*. These data represent the average for all pharmacies combined, however, as pointed out above one should use the income statement data that are stratified by sales volume for comparative purposes.

Note that each component of the income statement has been expressed as a percentage of annual sales for comparative purposes. Converting your pharmacy's income statement data in a similar fashion will allow you to make comparisons of these benchmark values.

Figure 1 • **Common-Sized (Average) Income Statement Data from the *2006 NCPA-Pfizer Digest* (Percentage of Sales)**

Sales	$3,485,602	100%
Cost of Goods Sold	$2,663,000	76.4%
Gross Margin	$822,602	23.6%
Expenses		
Payroll Expenses	$467,071	13.4%
Rent	$41,827	1.2%
Other Expenses	$184,736	5.3%
Total Expenses	**$693,634**	**19.9%**
NET OPERATING INCOME	**$128,968**	**3.7%**

Cost of Goods Sold/Gross Margin

A traditional community pharmacy has a cost of goods sold percentage approaching 76.4 percent up from 73.7 percent just ten years ago. This has been brought about primarily by the proliferation of managed care and third-party prescription programs. Obviously, the lower the cost of goods sold the better. A cost of goods sold percentage that is too high may be indicative of several potential problems, including the need to revise your prescription pricing system, or secondly, it could be an indication of shoplifting, theft by customers, or pilfering, which is theft by employees. It may also be a symptom of the pharmacy's not taking advantage of any available earned cash discounts often generated by paying bills by a certain time. Since third-party prescriptions have lower margins, a high cost of goods sold percentage may be indicative of honoring too many third-party contracts with low fees which may need to be reevaluated. Since sales minus cost of goods sold equals gross margin, a high cost of goods sold would produce a low gross margin, which averaged 23.6 percent according to the *2006 NCPA-Pfizer Digest*.

Expenses

Total expenses in an independent pharmacy represent 19.9 percent of sales. The largest expense in a community pharmacy is payroll which averages 13.4 percent of sales, therefore, careful consideration should be given to this expense if it is above the normal value. If it is too high, one can decrease employee wages by decreasing the number of employees or the number of hours that the employees work. Another significant way to decrease employee wages is to simply decrease the number of hours that the pharmacy is open. Quite often the first hours and the last hours are not as productive, in terms of sales, so changing the hours can sometimes improve this percentage.

Net Operating Income

The normal net operating income is approximately 3.7 percent of sales. Obviously, a low percentage can be the result of a high cost of goods sold or expenses.

Balance Sheet

Balance sheet data for average community pharmacies obtained from the *2006 NCPA-Pfizer Digest*. Unlike the comparative analysis of the income statement where each component is expressed as a percentage of sales, each component of the balance sheet for comparative purposes is expressed as a percentage of total assets. As is the case

Figure 2 • **Common-Sized (Average) Balance Sheet Data from the *2006 NCPA-Pfizer Digest* (Percentage of Total Assets)**

ASSETS	
Current Assets	
Cash	17.8%
Accounts Receivable	21%
Inventory	43.3%
Other Current Assets	4.6%
Total Current Assets	86.7%
Fixed Assets	9.3%
Other Assets	4%
Total Assets	**100%**
LIABILITIES	
Current Liabilities	
Notes Payable ‹ 1 Year	4.2%
Accounts Payable	17.3%
Other Current Liabilities	5.8%
Total Current Liabilities	27.2%
Long Term Liabilities	
Notes Payable to Owners	7.4%
Other Long Term Liabilities	7.7%
Total Long Term Liabilities	15.2%
Total Liabilities	**42.4%**
TOTAL OWNER'S EQUITY	**57.6%**

with the income statement data, balance sheet data are stratified by sales volume and your pharmacy would be compared against those with a similar sales volume.

Assets

The assets section of the balance sheet lists those items owned by the business and is divided into current assets, fixed assets and other assets. Current assets are those assets including cash and those that can be converted into cash in a relatively short period of time as opposed to fixed assets such as fixtures and equipment whose use is fixed against other uses. The current assets section of the balance sheet provides data primarily on cash, inventory and accounts receivable. As may be determined from Figure 2, cash amounts to 17.8 percent of assets, with accounts receivable and inventory 21 percent and 43.3 percent respectively. Poor accounts receivable or inventory management would be reflected in high percentages of these two components and most likely a low cash percentage.

Liabilities

Liabilities, or what the business owes, are composed primarily of two types, current liabilities, those owed within one year, and long term liabilities, those owed more than one year. Current liabilities are made up of primarily accounts payable (funds owed for goods purchased but not yet paid) and notes payable within one year. A too high percentage indicates the pharmacy may be experiencing cash flow problems and is not able to pay suppliers in a timely fashion. The average percentage for current liabilities is 27.2 percent. Long term liabilities are represented primarily by long term debt and may be higher in newer pharmacies and lower in older pharmacies.

Net Worth (Total Owner's Equity)

Subtracting what the business owns (its assets) from what it owes (its liabilities) indicates the net worth of the business. The average percentage is 57.6 percent.

FINANCIAL BENCHMARKS (RATIO ANALYSIS)

Financial ratio analysis involves relating various components of the income statement or balance sheet to another or to other data. Approximately 20 ratios are grouped into four categories that indicate the profitability, productivity, financial position and cash flow position of the pharmacy.

Common-sized (average) financial benchmarks (ratios) from the *2006 NCPA-Pfizer Digest* are provided in Figure 3. These percentages, like those for the income statement and balance sheet, would vary according to the annual sales volume of the pharmacy. Average benchmark data segmented by sales volume is provided in the *NCPA-Pfizer Digest* for your comparative purposes comparing your pharmacy to those of a similar sales volume.

By comparing your pharmacy’s ratios to the common-sized averages, much valuable information can be obtained about these four vital areas. Like the comparative analysis, these ratios should be calculated periodically and compared year to year to discern any negative trends that may be occurring.

Profitability Ratios

Profitability is a very important indicator of the financial success of a business, but not the only indicator as evidenced by the many ratios that will be described in this section of the chapter. Net operating income percentage is calculated by dividing net profit before tax by total sales. The average pharmacy has a net operating income percentage of 3.0 percent. In dollars, the average net operating income is $102,566.

Productivity Ratios

Productivity is primarily measured by examining how well the owner manages the pharmacy’s largest expense (personnel) and sales. There are seven benchmarks that may be used to measure productivity. These may be examined in Figure 3.

The first of these is sales per employee which averages $393,560. The staff cost per employee is $40,998 reflecting the cost of pharmacy personnel. How efficiently floor space is being used is indicated by the next three ratios. Prescription sales, non-prescription sales and total sales per square foot are $3,993, $98 and $1,207 respectively.

Financial Position Ratios

These ratios provide an indication of how well the owner is managing assets, debt and return on investment. The first of these measures of management efficiency is the ratio of sales to assets and measures how many dollars in sales each dollar invested in assets generates. The ratio of sales to assets averages $5.45. Return on investment provides an indication of the percent return measured by the net operating income as a percent of the total investment in the business, its net worth. This averages 26.6 percent.

Debt to net worth indicates how well the owner manages debt (total liabilities) and is calculated by dividing total liabilities by net worth. It indicates the creditors’ interest in the business. The amount owed (total liabilities) should be less than what the business is worth, so this ratio, or proportion should be less than 1. The average is 0.56.

Cash Flow Ratios

The cash flow ratios provide a measure of the liquidity of the business or how well the business can meet obligations. Maintaining an adequate cash flow is essential for the efficient operation of any business.

Figure 3 • **Median Financial Benchmarks from the *2006 NCPA-Pfizer Digest***

PROFITABILITY RATIOS	
Net Operating Income Percentage	3.0%
Net Operating Income Dollars Before Tax	$102,566
PRODUCTIVITY RATIOS	
Sales per Employee	$393,560
Staff Costs per Employee	$40,998
Rx Sales per Square Foot	$3,993
Non-Rx Sales per Square Foot	$98
Total Sales per Square Foot	$1,207
FINANCIAL POSITION RATIOS	
Sales to Assets	$5.45
Return on Investment	26.6%
Debt to Worth	0.56
CASH FLOW RATIOS	
Current Ratio	3.51
Quick Ratio	1.49
Inventory Turnover	10.4
Inventory Turnover (days)	35 days
Rx Inventory Turnover	11.8
Rx Inventory Turnover (days)	31 days
Accounts Receivable Turnover	19.9
Accounts Receivable Collection (days)	18 days
Accounts Payable Turnover	23.3
Accounts Payable Turnover (days)	16 days

The first ratio is the **current ratio**, which is probably the most widely used financial ratio in business circles today. It's obtained by dividing current assets by current liabilities. The usual range should be greater than 2. For the average community pharmacy the ratio is a very healthy 3.51.

The second ratio, the **acid test ratio**, is similar to the current ratio. It involves dividing cash and accounts receivable—or current assets minus inventory—by current liabilities. This ratio should always be at least 1:1. This ratio measures the ability of the business to meet current obligations of the business without using inventory, the least liquid of the current assets. Whenever the current ratio is favorable, and the acid test ratio is not, it indicates a problem with too much inventory. The average is an acceptable 1.49.

The greatest investment in a community pharmacy is inventory and the traditional measure of inventory management efficiency is the **inventory turnover rate**. The inventory turnover rate indicates conceptually how many times the inventory of the business is bought and sold each year. Generally, the higher the value the better, unless the small inventory produces outages. It is calculated by dividing the average inventory by the cost of goods sold for the year. This ratio has been increasing in recent years and now averages 10.4. Prescription inventory turnover is better averaging 11.8. Dividing the overall turnover rate of 10.4 into 365 provides an indication of the average number of days of stock on hand. The average pharmacy experiences a turnover in inventory every 35 days.

The **accounts receivable collection period** provides an indication in days, how long it takes a business to collect an individual or third-party account. It is calculated by taking the ending accounts receivable outstanding and dividing that by annual credit/third-party sales to get the accounts receivable turnover rate. The average accounts receivable turnover rate is 19.9. The accounts receivable turnover is then divided into 365 to determine how long it takes to collect an account on average. The value of this ratio should be between 30 and 40 days. If it is more than 40 days, it indicates that it is taking too long for that business to collect accounts receivable. If those accounts receivable are primarily private charge, it may indicate that the business is not being as aggressive as it should in collecting accounts or it might be that the business is not being restrictive enough in granting credit. It could be that the bulk of those accounts receivable are third-party. This may be a little more difficult to control than private charge. If a pharmacy has a poor accounts receivable collection period due to third-party programs, the only solution may be to drop those third-party programs that are delaying payment to the business. The average rate is 18 days.

The last cash flow ratios are the **accounts payable turnover rate** and **collection period**. They are similar in calculation to the accounts receivable turnover and collection period. The latter provides an indication, in days, of how long it takes the business to pay an accounts payable or invoice for merchandises purchased.

The accounts payable turnover rate is calculated by dividing annual purchases by the ending accounts payable. As may be seen in Figure 3, the average accounts payable turnover rate is 23.3. The accounts payable turnover rate in days is calculated by dividing the accounts payable turnover rate into 365 which indicates how long it takes the business to pay the average accounts payable. This value should be between 15 and 25 days. If it is over 25 days, it indicates a potential problem of the business in making payments for accounts payable and it may indicate a shortage of cash within the business. Paying invoices late may cause the business to lose cash discounts, which can negatively affect the bottom line. The average is 16 days.

CASE STUDY

An example financial analysis is provided to illustrate the application of a comparative analysis and ratio analysis to the financial statements of a community pharmacy practice. Figures 4 and 5 provide the financial data for an example pharmacy practice along with benchmark data from the *NCPA-Pfizer Digest* which have been stratified by sales volume.

Comparative Analysis

Income Statement

Examination of the income statement in Figure 4 reveals that this pharmacy has annual sales of $3.1 million and its cost of goods sold is approximately $2.5 million, yielding a gross margin or a gross profit of $600,000. Total expenses are $562,800 yielding a net operating income of $37,200.

Figure 4 • **Professional Pharmacy, Inc. Income and Expense Statement For Year Ending 20XX**

		PERCENT OF SALES	*2006 DIGEST* BENCHMARK
Prescription	$ 2,790,000	90%	93.3%
Other	310,000	10%	6.7%
Total	**$3,100,000**	**100%**	
COST OF GOODS SOLD			
Beginning Inventory	370,000		
Purchases	2,520,000		
Ending Inventory	390,000		
Total Cost of Goods Sold	**$ 2,500,000**	**80.7%**	**77.4%**
Gross Margin	**$600,000**	**19.3%**	**22.6%**

		PERCENT OF SALES	*2006 DIGEST* BENCHMARK
EXPENSES:			
Salaries, wages	$378,200	12.2%	11%
Rent	36,000		
Utilities	12,000		
Accounting & Legal Fees	5,000		
Taxes & Licenses	15,000		
Insurance	15,000		
Interest Paid	6,000		
Computer	3,000		
Depreciation	7,000		
Miscellaneous	85,600		
Total Expenses	**$562,800**	**18.2%**	**19%**
NET OPERATING INCOME	**$37,200**	**1.2%**	**3.7%**

Figure 5: **Professional Pharmacy, Inc. Balance Sheet December 31, 20XX**

Assets		**Percent of Total Assets**	***2006 DIGEST* Benchmark**
Current Assets			
Cash	$ 43,500	6.1%	20.3%
Accounts Receivable	230,500	32.4%	19%
Inventory	390,000	54.9%	44.7%
Total Current Assets	**669,000**		
Fixed Assets			
Original Fixtures & Equipment Cost	$ 90,000		
Less: Accumulated Depreciation	60,000		
Net Fixed Assets	30,000		
Other Assets			
Prepaid Expenses	15,000		
Total Assets	**$711,000**		

Liabilities and Net Worth		**Percent of Total Assets**	***2006 DIGEST* Benchmark**
Current Liabilities			
Accounts Payable	$ 186,000	26.2%	13.4%
Notes Payable (1 year)	40,000	5.6%	
Other Current Liabilities	15,000	2.1%	
Total Current Liabilities	$241,000		
Long-Term Liabilities			
Notes Payable	80,000	2.6%	15.4%
Total Liabilities	**$321,000**		
Net Worth	**$390,000**		
TOTAL LIABILITIES AND NET WORTH	**$711,000**		

Cost of Goods Sold

The first step in the comparative analysis involves expressing each major component of the income statement and balance sheet as a percentage of sales, and then comparing those with common-sized averages. The first component that we'll examine is cost of goods sold, which, as we can see in our example, is 80.7 percent of sales, compared to a normative value of 77.4 percent. Even small differences are significantly important. A difference of only 1 percent in this pharmacy amounts to $31,000 which is almost as much as the net operating income it now earns. This difference of over 2 percent in cost of goods sold is large and may be indicative of several potential problems the most important of which may be the need to revise the prescription pricing system. Secondly, it could be an indication of shoplifting—that's theft by customers—or pilfering, which is theft by employees. It could be a symptom of the pharmacy not taking advantage of earned cash discounts. Another potential reason for the difference could be the pharmacy's cost to acquire products. A call to the pharmacy's wholesaler to make sure the pharmacy is taking advantage of all pricing programs available should be considered. A last potential cause may be a large proportion of third party prescriptions with low margins. Perhaps some of the contracts need to be re-evaluated and certain ones eliminated. All of these are possible causal factors of a cost of goods sold percentage that is too high. Addressing these potential causes can decrease cost of goods sold, and increase profit margins.

Expenses

An examination of various expenses as a percentage of sales reveals that the payroll expenses are higher than average of 12.2 percent of sales. One can decrease employee wages by decreasing the number of employees or the number of hours that the employees work. Another significant way to decrease employee wages is to simply decrease the number of hours that the pharmacy is open. Quite often the first hours and the last hours are not as productive, in terms of sales, so changing the hours can sometimes improve this percentage.

Net Operating Income

As might be expected because of the higher than average cost of goods sold and personnel cost, the net operating income of this business is significantly below average at 1.2 percent, compared to an average of 3.7 percent.

Increasing the net operating income can be accomplished in several ways, not the least of which is decreasing cost of goods sold, which can be accomplished by modifying the prescription (both compounded and non-compounded) pricing systems, paying close attention to shoplifting and pilferage, and taking advantage of cash discounts. Net operating income may also be increased by decreasing expenses, and the most significant one under our control is employee wages.

Balance Sheet

Figure 5 provides the balance sheet for the pharmacy. Similar to the income statement, we have expressed each component on the balance sheet as a percentage of total assets for comparative purposes. In addition, the benchmark data from the *2006 NCPA-Pfizer Digest* are provided. The benchmark data are based upon data that are stratified by sales volume.

Current Assets

The current assets section of the balance sheet lists the cash, accounts receivable and inventory. As may be determined, the cash (6.1 percent) is significantly below the average of 20.3 percent. This would suggest potential problems with cash flow.

Inventory, the largest investment in the pharmacy, at 54.9 percent likewise is considerably above the average of 44.7 percent, indicating the need to possibly reduce the inventory level. Accounts receivable (32.4 percent) is considerably above the average (19 percent) suggesting a problem in collecting accounts, the extension of credit or slow paying third party programs.

It is obvious that this pharmacy needs to decrease its accounts receivable and could do so by being more aggressive in collecting accounts, by being more selective in granting credit to individuals, or perhaps by decreasing third-party programs that are not paying quite as quickly as they should. Funds that are tied up in accounts receivable and inventory takes cash out of the cash flow cycle. Note again that the pharmacy has very little cash.

Figure 6 • **Professional Pharmacy, Inc. Financial Benchmark Analysis**

	Professional Pharmacy	***2006 DIGEST* Benchmark**
PROFITABILITY RATIOS		
Net Operating Income Percentage	1.2%	3.4%
Net Operating Income Dollars	$37,200	$94,292
Productivity Ratios		
Sales/Employee	$281,818	$394,895
Staff Cost/Employee	$34,381	$39,331
Rx Sales/Sq. Ft.	$3,487	$3,603
Non-Rx Sales/Sq. Ft.	$141	$82
Total Sales/Sq. Ft.	$1,033	$1,100
Financial Position Ratios		
Sales to Assets	$4.36	$5.65
Return on Investment	9.5%	21%
Debt to Worth	0.82	0.37
Cash Flow Ratios		
Current Ratio	2.78	4.26
Quick Ratio	1.14	1.97
Inventory Turnover	6.6	10.4
Inventory Turnover (days)	55 days	35 days
Rx Inventory Turnover	8.5	11.8
Accounts Receivable Turnover	10.1	19.2
Accounts Receivable Collection (Days)	36.1 days	19 days
Accounts Payable Turnover	13.6	27.6
Accounts Payable Turnover (Days)	26.8 days	13 days
Other Data		
Square Footage	3,000	3,122
Square Footage Rx Dept.	800	
# Employees	11	12.8

Current Liabilities

As we might have expected because of the little cash available, the accounts payable (26.2 percent) is significantly higher than the common-sized average (13.4 percent). A large accounts payable may mean that cash discounts may be lost because invoices are not paid on time. This will have a negative impact on net profit as well.

The accounts payable is too high because the cash is too low, and the cash is too low because too much money is tied up in accounts receivable and inventory. In addition, too much cash is being paid out in the form of employee wages. So already we know, just by the comparative analysis, that this pharmacy has problems with cost of goods sold, payroll, accounts receivable, accounts payable and inventory being too high, and cash being too low.

Long Term Liabilities

The last section of the balance sheet indicates that long term liabilities (2.6 percent) are much lower than average (15.4 percent), which suggests that it would probably not be problematic if the pharmacy may need to borrow funds on a long term basis.

Financial Ratio Analysis

The next component of the financial analysis is the financial ratio analysis of the income statement and balance sheet data from Figures 4 and 5. As indicated earlier, the financial ratios involve simply relating one component of the income statement or balance sheet to another component, expressing certain percentages or other mathematical manipulations. These benchmarks are divided into four major areas: profitability, productivity, financial position, and cash flow. The financial ratios for Professional Pharmacy along with benchmark data stratified by sales volume from the *NCPA-Pfizer Digest* may be examined in Figure 6.

Profitability Ratios

As may be determined from Figure 6, the net operating income percent (1.2 percent) as well as dollars ($37,200) are far below average. A high cost of goods sold and payroll expenses are contributing factors and should be decreased.

Productivity Ratios

The sales per employee is considerably less than the typical pharmacy reflecting the high payroll as determined in the comparative analysis, which reinforces our finding in the comparative analysis that personnel costs need to be decreased. The staff cost per employee is somewhat below average.

Prescription sales per square foot are lower than normal while the non-prescription sales are above average. Total sales are lower than average.

Financial Position Ratios

The sales to assets ratio is lower than average reflecting an over investment in assets compared to the sales volume. The return on investment is low due to low net profit and owner's salary. The debt to net worth is very high indicating the need to decrease liabilities, namely accounts payable, an endeavor that is difficult unless cash is increased.

Cash Flow Ratios

Both the current ratio and quick ratios, indicators of solvency, are within acceptable limits, indicating solvency but below benchmark values. The inventory turnover rate and the turnover in days are less than acceptable and below average, reinforcing the need to decrease inventory as stated previously. The prescription inventory turnover is also lower than average indicating a potential problem with a too high inventory.

The accounts receivable turnover and turnover in days do not compare favorably to the normative values suggesting that the accounts receivable needs to be decreased by actions described earlier.

Accounts payable does not seem to be managed well either as reflected in a low accounts payable turnover and a high turnover rate in days. Increasing cash may allow for this to happen.

Summary of Case Study

To summarize, the financial analysis of Professional Pharmacy is:

- Cost of goods sold high
- Payroll high
- Net profit low
- Net operating income low
- Cash low
- Accounts receivable high
- Inventory high
- Accounts payable high

Based on these factors the following specific recommendations may be appropriate for the next year:

- Reduce cost of goods sold to 78 percent of sales
- Reduce total payroll to 11 percent of sales
- Decrease inventory by $48,000
- Decrease accounts receivable by $35,000
- Decrease accounts payable to $140,000
- Increase net operating income to 4.0 percent of sales

This financial analysis provides insight into current and potential problems associated with the financial condition of Professional Pharmacy. Unlike the situation where a pharmacy is judged to be in excellent financial condition, these problems may result in the valuation as determined by formulas to be decreased. In addition, it provides insight as to how these problems may be corrected, which is of value to the new owner.

CONCLUSION

In summary, there are two basic procedures which may be utilized to perform a analysis of a pharmacy's financial statements. They include a comparative analysis wherein each component of the pharmacy's income statement and balance sheet is compared to those of a common-sized or average pharmacy and a ratio analysis wherein various components of the two financial statements are mathematically manipulated to produce ratios and other data that are compared to normative data. These analyses will identify real and potential financial problems. Following the identification of these problems, recommendations may be established for their amelioration or elimination. The financial condition of the pharmacy is an important factor in assessing the fair market value of the business and can play a valuable role in the successful transfer of ownership.

References

2006 NCPA-Pfizer Digest

Chapter 5

How to Determine an Equitable Selling/Purchase Price for a Community Pharmacy

INTRODUCTION

Norm Bowles: "Our broker did a pharmacy evaluation and appraisal that included a review of the physical premises and the competition in the marketplace. I personally investigated the selling prices of similar businesses for sale in the state."

Making the decision to sell your pharmacy is indeed difficult. For many, the pharmacy is like a member of the family. Like a child, it was created, nurtured, and brought to maturity through many years or decades of constant attention and care. Once the decision to sell has been made, a necessary first step is the determination of an equitable selling price that is acceptable to both the buyer and the seller. It must be a win-win situation for the transfer of ownership to be successful.

The determination of an equitable selling price for a community pharmacy is difficult for most pharmacy owners. For many, it is a once in a lifetime experience for which they have received little or no formal education or training. Further exacerbating the situation is that many pharmacy owners tend to set an unrealistically high selling price for their pharmacy. This comes about because most owners let emotion play too much of a role in selling price determination. As stated above, the pharmacy is like a member of the family and one tends to set a price more with the heart than the brain.

VALUATION FORMULAS

The value of a business is usually determined through a process of negotiation between the buyer and the seller. The eventual selling price will lie somewhere between the initial price asked by the seller (usually too high) and the price the purchaser is willing to initially pay (usually too low). The valuation of a business is not an exact science. It is based on the assessment of facts about the business, informed judgment, and some aspects of common sense. In the final analysis, the valuation is subjective, however, several formulas have been developed to estimate the equitable selling price of a business.

There is no single formula that is best for all pharmacies. Many formulas should be used, providing for a range of valuations. Each formula provides for an assessment of the valuation of the business from several perspectives, e.g., profitability, net worth, sales and more. To illustrate the use of these formulas, a pharmacy with approximately $2 million in annual sales will be used. The income statement and balance sheet for this example pharmacy appear in Figures 1 and 2.

It should be pointed out that some adjustments may need to be made in the data provided on the financial statements before being used in the valuation formulas. For example, some of the formulas use net profit in their calculation. In some situations, an owner may be taking an unusually large or small salary, thereby resulting in an inordinately small or large net profit. In this case the owner's salary would need to be adjusted to a more "realistic" figure and the net profit adjusted upward or downward for use in the valuation formulas. Other adjustments from "book values" to more realistic figures may be necessary such as paying a higher rent than market price if the pharmacy owner owns the building or is paying a relative a salary that is higher than justifiable.

In addition, since depreciation is not an "out of pocket" expense, it is usually added to the net profit in those formulas wherein net profit is used in calculation of the selling price. Those formulas for the outright sale of the business yield a valuation that does not include cash, accounts receivable, accounts payable, or notes payable. These would be the responsibility of the seller and would not be transferred to the buyer.

The valuation procedure is provided via an example pharmacy. We shall assume the data have been normalized. As may be determined, our example pharmacy has annual sales of $2 million and a net profit of $90,000.

FORMULAS FOR OUTRIGHT PURCHASE

Formula #1: Sales Volume Method

One valuation method that relates to a simple percentage of sales should be mentioned since it has been used for many years to estimate the value of a pharmacy. The traditional formula of one-third of annual sales is no longer applicable due to shrinking profit margins and would result in an overstating of the value of the pharmacy. A more appropriate "rule of thumb" in today's competitive community pharmacy marketplace would be closer to 25 percent of sales. Using 25 percent, this gives us a value of (0.25) ($2,000,000) or $500,000.

Formula #2: Return (Net Profit) on Investment (Purchase Price)

Another method uses the return on investment as an indicator of the value of the pharmacy. The "return" is the net profit per year and the "investment" is the selling price of the pharmacy. If a reasonable return on investment of 20 percent was desired, the selling price would be $450,000.

(0.20) (Selling Price) = Net Profit

(0.20) (Selling Price) = $90,000

Selling Price = $90,000/0.20 = $450,000

Figure 1 • **Income Statement, Professional Pharmacy, Inc. For Year Ending, 20XX**

SALES	
Prescriptions*	$ 1,800,000
Other	200,000
Total	2,000,000
Cost of Goods Sold	1,560,000
Gross Margin	440,000
Expenses	
Owner's Salary	100,000
Employee Wages	160,000
Other Expenses	50,000
Total Expenses	**$ 350,000**
NET PROFIT	**$ 90,000**

***50,000 prescriptions filled annually**

Formula #3: Direct Assessment

A third method involves a direct assessment and is outlined in Figure 3. In the example, the inventory investment is $180,000 and fixtures and equipment are $60,000, which totals $240,000. (The book value of the fixtures and equipment is used in this example, however, the true value would probably be different.) This is the value of the tangible assets of the business. The next item, earning power, represents the amount that might be earned by investing the $240,000 in something other than the purchase of a pharmacy. Assuming a 10 percent return, this means that the earning power of $240,000, if not invested in a pharmacy, would be $24,000.

The next section lists the salary that the prospective owner might make if he or she were a owner elsewhere. This is estimated to be about $90,000. Therefore, if instead of purchasing the pharmacy, the prospective owner invested the $24,000 and went to work as a owner somewhere else, he or she could expect to have a total income of $114,000 ($90,000 + $24,000).

The total income that could be expected if the prospective purchaser actually purchased the pharmacy would be $90,000 in net profit from the pharmacy plus the owner's salary of $100,000, which totals $190,000.

Figure 2 • **Balance Sheet, Professional Pharmacy, Inc. December 31, 20XX**

ASSETS	
Current Assets	
Cash	$60,000
Inventory	180,000
Accounts Receivable	80,000
Total Current Assets	**$320,000**
Fixed Assets	
Fixtures and Equipment	$80,000
Less Depreciation	20,000
Total Fixed Assets	**60,000**
Total Assets	**$380,000**
LIABILITIES	
Current Liabilities	
Accounts Payable	60,000
Long Term Liabilities	
Notes Payable › 1 year	10,000
Total Liabilities	**$70,000**
NET WORTH	**$310,000**

The next item, the extra earning power, is calculated by subtracting the earning power and salary if employed elsewhere ($114,000 from the income of the pharmacist if he or she were to purchase the pharmacy ($190,000). This would be $76,000 in the example.

The next section in Figure 3, intangible assets, is calculated by multiplying the extra earning power times an item that is known as the years-of-profit factor. The years-of-profit factor is a number varying from one to five that indicates the approximate number of years it would take a newly opened pharmacy to get to the financial position of the pharmacy under consideration. A value of 1 would be used for a pharmacy that was not very profitable and a value of 5 would be used for a pharmacy that was extremely profitable and stable. If we assume that our pharmacy is average, we would use a years-of-profit factor of three. Multiplying this factor times the extra earning power yields a value of $228,000. The final calculation of the purchase price involves adding the intangible assets to the tangible assets from the first step. The valuation total for this example is, therefore, $468,000.

Formula #4: Percentage of Sales Plus Inventory

The fourth method involves taking 15 percent of sales and adding that to inventory giving a value of $480,000.

(0.15)(Sales) + Inventory

(0.15)($2,000,000) + $180,000 = $480,000

Formula #5: Net Income Approach

The net income approach involves multiplying the sum of the net profit and owner's salary by 1.5 and adding the value of the inventory. This yields a value of $465,000.

1.5 (Net Profit + Owner's Salary) + Inventory

1.5 ($90,000 + $100,000) + $180,000 = $465,000

Formula #6: Net Profit Approach

The net profit approach involves multiplying the net profit by a factor of 5. This is based on the reasonable assumption that one would want to be able to pay for a purchased business in five years using the net profit of the business. This yields a value of $450,000. Mathematically, this produces the same result as a return on investment of 20 percent.

5(Net profit)

5($90,000) = $450,000

__Linda Garretts Maclean:__ "The pharmacy valuation was based on seven formulas. We threw out the highest and lowest values, then we took an average of the remaining values."

__Kris Zepeda:__ "We used a number of calculations and took the average of them all. In the end, it was a number that both my partner and I could agree on."

Formula #7: Itemization

If one considers what is actually being purchased when the ownership is transferred, (inventory, fixtures and equipment and goodwill (estimated as 1–2 years net profit), an equitable selling/purchase price may be estimated by adding the value of the three components. This yields a value of $375,000. This method usually results in a lower valuation than the other methods. Some may argue that the goodwill should be valued higher, say two years net profit, which would make the valuation higher and more in line with the other valuation methods.

Inventory + Fixtures and Equipment + Goodwill

$180,000 + $60,000 + 1.5 ($90,000) = $375,000

• Formula #1: Sales Volume:	$500,000
• Formula #2: Return on Investment:	$450,000
• Formula #3: Direct Assessment:	$468,000
• Formula #4: Percentage of Sales plus Inventory:	$480,000
• Formula #5: Net Income Approach:	$465,000
• Formula #6: Net Profit Approach:	$450,000
• Formula #7: Itemization:	$375,000
• Formula #8: $ Per Prescription plus Inventory:	$430,000
• Formula #9: $ Per Prescription:	$500,000

Range: $375,000–$500,000

Average: $458,000

Formula #8: $3–7 per prescription filled annually + inventory

This is a formula that is used by many chains in their estimation of a selling/purchase price. For example, using $5 (the midpoint between $3 and $7) per prescription for an average pharmacy produces a value of $430,000.

($5) (# prescriptions filled annually) + inventory

($5) (50,000) + $180,000 = $430,000

Formula #9: $10 times annual prescriptions

Multiplying $10 times the number of prescriptions filled annually is also used by some chains, in a value of $500,000.

($10) (# prescriptions filled annually)

($10) (50,000) = $500,000

SUMMARY OF VALUATION FORMULAS FOR OUTRIGHT PURCHASE

Range: $375,000–$500,000

Average: $458,000

The estimated range of the value of the pharmacy varies between approximately $375,000 to $500,000 with an average of approximately $458,000. Among other objective factors, the financial analysis will indicate whether the price should be at the upper, middle, or lower range of the valuations provided by the formulas. Further, certain intangible, subjective factors described below would result in the calculated valuation being adjusted upward or downward.

Figure 3 • **Tangible Assets**

Inventory	$ 180,000
Fix/Equip	60,000
Total	**$ 240,000**
Opportunity Costs	$ 24,000
Salary if Mgr. Elsewhere	90,000
Total	**$ 114,000**
Net Profit	$ 90,000
Owner's Salary	100,000
Total	**$ 190,000**
Difference	$ 76,000
Years of Profit Factor	X3
Intangible Assets	$ 228,000
Tangible Assets	+240,000
VALUATION	**$ 468,000**

OTHER FACTORS AFFECTING VALUE

A complete and thorough financial analysis is an objective factor that would affect the value of the pharmacy. In addition, there are several subjective factors that would affect the value of a business. An assessment of each of the following would be important in adjusting the valuation of a pharmacy as determined by various formulas described above. Important factors include:

- Physical appearance and condition of the pharmacy (Are certain fixed assets in need of repair or replacement?)
- Cash flow (Examine past cash flow and make future projections.)
- Competition (How aggressive are pharmacy and other non-drug outlets and is expansion planned?)

- Inventory composition and condition (Does inventory reflect needs and demands of physicians and customers and is it saleable or shopworn?)
- Economic trends in the community (Is the community stable with high employment?)
- Future projections for retail pharmacy (Are other pharmacies stable?)
- Managed care (What percentage of prescriptions are third-party and what is the outlook for the future?)
- Lease terms
- Location
- Image of the pharmacy in the community
- Terms of sale
- How badly the seller wants to sell
- How badly the buyer wants to buy

Norm Bowles: "Other factors that affected the value of my pharmacy included the potential for growth, close proximity of many physicians and the hospital, ease of parking, and a drive thru window."

After the financial data have been "normalized", several formulas have proven to be useful in establishing an equitable selling/purchase price for a pharmacy. Following this determination, several subjective factors must be taken into consideration resulting in an adjustment to the valuation.

CONCLUSION

The first step in the transfer of ownership is the determination of an equitable selling/purchase price. Often the pharmacy owner is tempted to determine that price with his or her heart rather than the brain because of the emotion involved. Formulas provide an effective way to begin the process of valuation. With these assessments in mind, the more subjective factors can then be considered. Following successful negotiation the transfer of ownership can be facilitated.

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Chapter 6

Financing the Sale

INTRODUCTION

One of the most significant challenges to a pharmacy owner transferring ownership to an individual rather than a chain (other than finding an interested individual with the entrepreneurial spirit) is the lack of capital on the part of the aspiring owner. There are several ways that the purchase of a business may be financed: a bank loan, owner financing, and the establishment of a junior partnership.

BANK LOAN

This section will serve as a starting guide for individuals that have little or no experience pursuing a bank loan for the purchase of a business. As a seller, you may wish to share this information with the potential buyer. This information may save you and the potential buyer time by providing valuable information concerning the search for a bank loan, the loan application process, and steps to take once approved or rejected for a loan.

Before Approaching the Banker

According to the Small Business Administration (SBA), there are four key points to consider before approaching your banker for a loan.

1. Ability to repay the loan
2. Collateral
3. Credit History
4. Equity

The bank will review the cash flow from the business and the collateral when addressing your ability to repay the loan. Banks tend to be more comfortable lending to an existing business because they have a financial track record to review and thus will be a less risky investment for the bank. Collateral is considered a secondary source of repaying the loan in the event the business fails. Collateral can come from a number sources, including a home, personal financial investments and savings, or a life insurance policy.[1] See below for a general approximation of how collateral may be valued by a typical bank and the SBA.

Collateral Type	Bank	SBA
House	(Market Value x .75) - Mortgage balance	(Market Value x .80) - Mortgage balance
Car	Nothing	Nothing
Stocks & Bonds	50–90%	50–90%
Insurance Policy	Cash Value	Cash Value

Credit history will also be an important consideration before applying for a business loan. This includes both your personal and the business credit history. The credit history of the business will be out of your control, but it will have influence over your potential loan request.

If you do not know your personal credit history, it is advisable to run a credit report. You can now get one free credit report annually from each of three main credit reporting agencies: Experian, Transunion, and Equifax. The free credit report can be obtained from www.annualcreditreport.com. When reviewing your credit report, you want to verify that all the information is correct, in particular your name, social security number, address, and all the past credit information. If you find any errors, you will need to report them to the credit agency. The correction process could take 3–4 weeks, so try to address any errors as early as possible. The bank will be looking at this information, and you want to make sure every detail is correct.

Equity will be another factor that will come from the business financials. The bank will want to verify that the total liabilities, or debt, of a business is not greater than four times the amount of equity.[2] The debt-to-equity ratio allows the bank to measure the financial risk of the business. The higher the number in the ratio calculation, the higher the risk. If you want more details on the debt-to-equity and other financial ratios specific to independent pharmacy, refer to the *2006 NCPA-Pfizer Digest.*

Finding a Bank

The pharmacy seller will be a good individual to start with when looking for a bank. Most sellers will be helpful to the potential buyer when it comes down to finding financing. Remember, they want to sell their business!

The pharmacy seller will have a history with one or more banks in the area. These banks will be a good starting point because they will already be familiar with the financial situation and nature of the business. This will make the application process easier. However, it is usually a good idea to check with other banks in the area to evaluate all the available offerings and small business loan programs.[3] Remember, banks do compete with each other for loans, and thus one bank may offer better terms or rates in order to attract your business.

Loan Application Process

Banks will require a loan application and potentially a business plan before they will lend you money. You will want to ask the bank if they require a business plan. If they do not specifically ask for one, they will certainly require many of the documents that are found in a business plan. We will discuss the business plan in further detail below.

The loan application will probe into details of your financial past, along with that of the business you wish to purchase. The bank will want to understand everything about the business-past, present, and future, the products, the customers, the suppliers, the competition, and the owners. The bank will look at your personal credit report and current financial standing to gauge your character and ability to manage debt. Banks will usually request personal financial statements and 2–3 years of personal tax returns from the loan applicant to make this assessment.[4] When reviewing your loan application, banks tend to place more emphasis on the company's ability to repay the loan than your personal credit and financial information.

The SBA has identified key questions that bankers will ask:[5]

- Can the business repay the loan?
- Can you repay the loan if the business fails? (Is collateral sufficient to repay the loan?)
- Does the business pay its bills?

- Does the business have a profitable operating history?
- What is the future of the industry?
- Who is your competition and what are their strengths and weaknesses?
- Have you run a business before?
- Is your credit history clean?

Overall, the loan application process may take more time than you think. The amount of time required for the entire process varies among each application. One variable will be the amount of time required to fill out the application and gather all the necessary financial and tax documents. If you turn in your application without all of the required information, then this will only prolong the process. Once the application is received by the bank, then it may be as long as 30 days before you receive the results. Loans directly from the bank (such as a non-SBA loan) tend to have much quicker turnaround time compared to loans backed by the SBA. With an SBA loan, the bank you apply to will actually provide the loan, but the SBA will guarantee a portion of the loan to the bank. Thus, the SBA will require further paperwork and review of your application before they will be willing to back part of your loan.

Figure 1:

Elements of a Business Plan:

1. Cover Sheet
2. Statement of Purpose
3. Table of Contents
4. The Business
   a. Description of the business
   b. Marketing
   c. Competition
   d. Operating procedures
   e. Personnel
   f. Business insurance
5. Financial Data
   a. Loan applications
   b. Capital equipment and supply list
   c. Balance sheet
   d. Breakeven analysis
   e. Pro-forma income projections
   f. Three-year summary
      i. Detailed by month, first year
      ii. Detailed by quarters, second & third years
   g. Assumptions upon which projections were based
   h. Pro-forma cash flow
6. Supporting Documents
   a. Tax returns of principals for last three years
   b. Copy of resumes of all principals
   c. Personal financial statement (bank has these forms)
   d. Copy of licenses and other legal documents

Source: www.sba.gov/smallbusinessplanner/plan/writeabusinessplan/SERV_WRRITINGBUSPLAN.html

Business Plans

A business plan is a document that has multiple purposes within the business. It can be used when applying for a loan; as a management tool that allows you to track, monitor, and evaluate your progress; and as a planning tool to help you and your employees understand where the business is going.[6] It is highly recommended that you write out a business plan, not only because many banks require it, but it is a valuable tool that can help the business become more successful.

The parts of a business plan can be found in Figure 1, previous page. The business plan provides a description of the nature of the business, marketing plan, finances, and the management team.[6] For more information on how to write a business plan, it is recommended that you read "Small Business Administration: How to Write a Business Plan." This document is available on the SBA Web site (www.sba.gov).

What to Do Once You Are Approved for the Loan

Congratulations, you made it through the stressful process of applying. However, there are still details of the loan that need to be reviewed. You will want to review the terms of the agreement, especially the interest rate and fees. You can also ask that your attorney or accountant review the conditions of the agreement if you believe that is necessary. You need to be sure that you are comfortable with the terms of the agreement, because once you sign, it becomes a legally binding document.

What to Do if You Are Declined

If you are declined for a bank loan, the most important step you can take is to ask why. If you leave the bank without asking, then you are missing out on very important information! There are two reasons why a bank will decline your application:

- The bank may currently have a limit on the amount of funds it can lend out. Your application may be a solid loan application, but the bank does not want to overextend on the total amount of outstanding loans it can take on. The banker will explain the circumstances if this situation were to occur. The banker will also provide feedback regarding your loan application. You may be able to take your current application straight to another bank to receive the funds needed for the purchase. The banker may also provide some suggestions for improving your current application before applying elsewhere.
- Your application carries too much risk or raises some concerns. If your application falls into this category, then have the banker explain why. The banker will be more than willing to explain why your application was rejected. With

this information, you will be able to make corrections or additions to the application. Then you can present your revised application to this bank or another bank and hopefully have better outcomes the next time around.

OWNER FINANCING

Another mechanism for financing the sale is through owner financing. The upsides, downsides, and mechanisms are described below.

- The downsides of owner financing include the owner taking on the same risks that a lending institution takes. The ability of the purchaser to repay the loan depends on the continued success of the business. Since the prior owner may not be present and the new owner unfamiliar and inexperienced with the business, this may be problematic.
- The upside is that owner financing may be the only option available if the prospective owner is unable to obtain a bank loan. Other benefits may include a tax advantage of spreading the purchase price over several years rather than receiving the purchase price all at once. Please refer to Chapter 8 "After the Sale—What Do I Do With the Money?" for more information regarding the financial aspects of the sale.

Several other advantages to the buyer and seller of the business using owner financing are summarized here:

- Reasonable interest rate
- Less demanding credit review
- The business serves as collateral
- Personal guarantee less likely
- Can be combined with a conventional loan

The best case scenario for some owners may be receiving the entire amount for the purchase at one time as in the case of the purchase by a chain. Since an aspiring individual owner is unlikely to have access to that kind of capital, a down payment would be in order. Some may not have the capital to make any down payment.

The down payment for the owner financed loan should be as large as possible to minimize the strain on cash flow associated with the business loan repayment. The business itself serves as collateral for the loan. Should the new owner not be able to make payments, the previous owner would regain ownership. A lien on the business should be filed with the Secretary of State to assure proper procedures are followed in the event of a default on the loan. Please refer to Chapter 7, "Legal Considerations in the Sale of a Pharmacy," for further discussion and examples.

It is suggested that the down payment be enough to cover taxes, expenses associated with the sale, loans, and other payables that are the responsibility of the owner. Most commercial loans require 25–30 percent to assure the new owner does not walk away if the going gets rough. This may be a wise and prudent standard for owner financing as well.

The interest rate may be negotiated and would reflect, among other things, the prevailing commercial interest rate as well as the desire of the seller to assist the new owner in the acquisition of the pharmacy. With regard to the latter, the owner may choose to charge no interest if it would facilitate the ability of the new owner to purchase the pharmacy.

The term of the loan would be dependent on the purchase price as well as the profitability of the business. Five to seven years would be normal, although it would not be unreasonable to consider a longer term especially if the purchase price was high relative to the profitability of the pharmacy.

Like the junior partnership described later in this chapter, owner financing may be implemented for a portion of the business (e.g., first 50 percent) at which time the new owner, now owning 50 percent of a thriving business, may be able to obtain a bank loan to pay off the remaining 50 percent of the loan to the previous owner.

Other security measures that the owner may take include additional collateral for the loan including the purchaser's home or obtaining a personal guarantee on the part of the purchaser. Using only the business as collateral may be problematic if the new owner destroys the business markedly decreasing its value. A life insurance policy should be required of the new owner with the previous owner named as the beneficiary so the loan will be repaid in the unlikely event of the death of the new owner.

For additional information on how all of these terms are incorporated in the appropriate legal documents, please refer to Chapter 7, "Legal Considerations in the Sale of a Pharmacy."

ESTABLISHMENT OF A JUNIOR PARTNERSHIP

For the purpose of the junior partnership example, we shall assume that the selling/purchase price for this example pharmacy has been negotiated and is $500,000.

The establishment of a partnership or a "junior partnership" is an alternative to a direct and immediate sale. In this example, the sale of the pharmacy occurs over several years, with the new owner acquiring a gradually increasing percentage of ownership in the pharmacy while increasing his or her share of the management.

For many owners the transfer of ownership to an individual rather than a chain is difficult because the prospective buyer may lack the necessary capital to make the purchase. It is this problem that causes many independent owners to sell to a chain rather than an individual. The junior partnership example described in this chapter provides the owner and potential buyer with a practical "how to" guide the transfer of ownership of a community pharmacy may be accomplished in a situation wherein the buyer has little or no capital. Adjustments in the factors in the example such as the time frame, percentage of purchases per year, and amount paid may be adjusted to meet special needs of the owner or purchaser.

To explain the establishment of a junior partnership, a case study has been developed in which the first 50 percent of the pharmacy is purchased over a six-year period at approximately 10 percent per year. After the sixth year, the junior partner could purchase the other 50 percent using a bank loan, owner financing, or the same procedure as for the first 50 percent. In our example, the junior partner pays for and receives the first 10 percent of the pharmacy after the second year of the agreement, which gives him two years to save for the purchase of the initial 10 percent. During years three through six of the agreement 10 percent is purchased per year based on the valuation of the pharmacy at that time.

All provisions of the junior partnership should be agreed upon in writing by both the owner and junior partner. This agreement should be drawn up by an attorney. The description of the current example may serve as a guide. Particular attention should be given to provisions that would allow the owner or the junior partner to terminate the agreement should particular situations develop. In the event a portion of the pharmacy had been purchased by the junior partner at the time of termination, provisions should be delineated to describe the disposition of the junior partner's share, i.e., would it be sold back to the owner and, if so, how would the purchase price be determined?

As mentioned earlier, for the purpose of this example, it shall be assumed that the purchase price has been determined to be $500,000. Adjustments will be made each year in the value of the pharmacy. The annual rate of increase in value is assumed to be six percent in this example. In terms of salary for the junior partner, the agreement calls for him to receive an annual salary of $90,000 plus a $12,000 bonus each year. This bonus is used as an incentive for the junior partner to remain with the pharmacy and continue to participate in the junior partnership. Salary increases would be provided each year as allowed for in the junior partnership agreement.

Ten percent of the ownership in the pharmacy will be transferred to the junior partner beginning at the end of the second year and continuing through the end of year six. Therefore, the junior partner will obtain 50 percent of the ownership of the pharmacy in six years. In this agreement, the junior partner will actually pay for only five percent of the pharmacy at the end of each year in which a payment is due. An additional five percent will be provided by the owner at no charge as an extra incentive for the junior partner.

Income to the Owner

During the first six years of the junior partnership agreement wherein the junior partner purchases 50 percent of the pharmacy, the owner receives compensation in the form of his share of the net profit (line 6, Table 1) of the pharmacy and the payment from the junior partner (line 3, Table 3) for the incremental 10 percent of the business beginning at the end of year two. The total income of the owner from net profit and purchase payments is provided in line 7, Table 1.

The net profit (line 4) and value (line 1) of the business are projected to increase at six percent per year. Line 3, which is the payment from the junior partner, is determined as follows: the initial value of the pharmacy was established to be $500,000. By the end of the first year the value of the pharmacy has increased to $530,000 based on a 6 percent increase each year. The actual value may be recalculated each year. It should be remembered that the junior partner pays for 5 percent of the business, but actually receives 10 percent. At the end of the second year when the junior partner purchases the first 10 percent of the business, 10 percent of the value ($561,800) is $56,180, but the junior partner only pays for 5 percent of the business or approximately $28,090

By summing line 3, it can be determined that the owner will receive $158,346 in payments from the junior partner over six years for the purchase of 50 percent of the business at 10 percent per year after years two through six of the agreement.

The net profit of the pharmacy is estimated to increase 6 percent per year (See line 4). The owner's share of the net profit decreases 10 percent each year after the second year (see line 6). In years one and two of the agreement, he/she still owns 100 percent of the business so all of the net profit accrues to him. In year three the junior partner owns 10 percent of the business so the junior partner receives 10 percent of the profits and the owner 90 percent or $96,472 (see line 6). The total received by the owner from his/her share of the net profit over the six years of the junior partnership agreement is $544,082 (the sum of line 6).

Assuming that the value of the pharmacy increases six percent per year, the remaining 50 percent of the pharmacy will be valued at approximately $354,649 at the end of the six-year period (50 percent of $709,259). The junior partner may then agree to pay the remainder to the owner over a period of years through owner financing. He or she may choose to go to a lending institution and obtain a loan to purchase the remaining 50 percent. He would have 50 percent of the pharmacy to then use as collateral. Of course, the remaining 50 percent may be purchased by simply continuing the purchase agreement used for the first 50 percent of the business in years seven through 11.

As may be determined from Table 1, the total income for the owner at the end of six years, in terms of annual payments from the junior partner and his/her share of the net profit, would be approximately $703,148 (the sum of line 7). The purchase price of the remaining 50 percent is $354,629 (one-half of the value of $709,259). Assuming the junior partner obtained a loan from a lending institution at the end of 6 years and paid the $354,629, the total amount received by the owner over the six years would be

$1,057,793, which is the sum of $703,148 from payments by the junior partner and the owner's share of the net profit, and $354,629 from the purchase of the remaining 50 percent of the business.

By comparison, let's consider the income to the owner if the pharmacy were sold outright for $500,000 instead of entering into the junior partnership described above. If invested at six percent interest, this would yield about $209,259 interest or a total of about $709,259 for the six years of the junior partnership agreement example. The junior partnership example provided the owner with $1,057,793 or a $348,534 difference. Considering that the owner's share of profits and payments from the junior partner could also be invested, the $703,148 figure from the junior partnership could be even larger. Therefore, it may be seen that the partnership yields a significantly greater financial dividend for the owner.

Projected Payments of Junior Partner

Table 1

	End of Year 1	End of Year 2	End of Year 3
Pharmacy Value ($)	530,000.00	561,800.00	595,508.00
Junior Partner's Ownership	0	10%	20%
Contribution to Seller ($)	0	28,090.00	29,775.40
Net Profit ($)	95,400.00	101,124.00	107,191.40
Seller's Ownership	100%	100%	90%
Seller Net Profit ($)	95,400.00	101,124.00	96,472.30
Total to Seller ($)	95,400.00	129,214.00	126,247.70

End of Year 4	End of Year 5	End of Year 6	Total
631,238.50	669,112.80	709,259.60	
30%	40%	50%	
31,561.92	33,455.64	35,462.98	158,346
113,622.90	120,440.30	127,666.70	
80%	70%	60%	
90,898.34	84,308.21	76,600.03	544,802.90
122,460.30	117,763.90	112,063.00	703,148.80

Table 2 provides information concerning the junior partnership from the perspective of the junior partner. The income from net profit (column 2) is based on the junior partner's share of the net profits which increases each year beginning at the end of the second year. The last column represents the payments that the junior partner makes to the owner each year based on the purchase of 10 percent of the business for which he pays only 5 percent. These numbers correspond to the data in line 3 of Table 1. From Table 2, it is obvious that the junior partner would have to use little of his or her personal funds to make payments to the owner because payments are made primarily from the junior partner's share of the net profit and the bonus. By the time the junior partner makes the first payment, he or she would have received two bonus payments. Using these bonus payments plus saving $170 per month from salary in the first two years the junior partner could make the payment. In year three, $588 per month would need to be saved from the junior partner's salary plus the bonuses to make the payments. None of these amounts are unreasonable for a practicing pharmacist. Beyond year three, the payments could be made totally from the junior partner's bonus and share of the net profit.

Table 2 • **Income from Bonus and Profits and Projected Payments of Junior Partner**

Year of Transfer Agreement	Income from Net Profit	Income from Annual Bonus	Net Profit and Annual Bonus of Junior Partner	End of Year Payment to Current Owner
1	$0	$12,000	$12,000	0*
2	$0	$12,000	$12,000	$28,090*
3	$10,719	$12,000	$22,719	$29,775**
4	$22,724	$12,000	$34,724	$31,561
5	$36,132	$12,000	$48,132	$33,455
6	$51,066	$12,000	$63,066	$35,462

*Junior partner needs to save $170 per month to avoid borrowing

**Junior partner needs to save $588 per month to avoid borrowing

From this example it may be determined that it is possible through the establishment of a junior partnership for an independent owner to transfer ownership to a prospective purchaser who may not have the necessary capital to purchase the pharmacy outright. The procedure is financially beneficial for both the owner and the junior partner. Most importantly for many independent owners, it provides a mechanism to transfer the ownership of the pharmacy and keep their independent pharmacy independent.

CONCLUSION

Financing will be the biggest obstacle for any individual purchasing a pharmacy. In this chapter, we have presented several options available to finance the deal, but there is not one option that is better than the others. The decision to choose one option over another will be dependent on the preferences and negotiation between the seller and the buyer. Overall, the important variables to consider in choosing the type of financing will include the financial situation of the buyer, when you wish to officially leave the business, the manner in which you and the purchaser choose to transfer ownership, and when you wish to receive the monies from the sale of your pharmacy.

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Chapter 7:

Legal Considerations in the Sale of a Pharmacy

INTRODUCTION

Once you attract a serious buyer for your pharmacy, you will need to work out the terms of the sale and put the deal in writing. The letter of intent and nondisclosure agreement are important interim documents that signify a commitment to the proposed sale without reaching an agreement on all the terms of the transaction. Completion of these documents allows negotiations to move forward to the closing where contracts are executed including the asset purchase agreement, bill of sale and assignments, non-compete agreement, and, if applicable, an employment agreement.

LETTER OF INTENT

A letter of intent (LOI) is a non-binding letter in which the buyer outlines his or her intentions to pursue negotiations to purchase your pharmacy.[1, 2] The LOI is typically drafted and signed by the buyer once you both have reached a general agreement as to the price and terms of sale. If the seller, in turn, signs the LOI, it indicates both parties intend to move forward with the transaction.[3] Typically, at the time the buyer submits the LOI, he or she provides earnest money toward the purchase price, similar to procedures followed in a real estate deal.

The LOI signals to third parties that you and the buyer are in serious negotiations. The LOI provides the buyer with sufficient documentation to approach lenders to secure financing. Lenders want to be sure there is a serious deal under consideration rather than pursuing every possible lead with a seller.[2]

The LOI should expressly state that the letter as a whole, and indicated paragraphs, do not constitute a legal and binding obligation. In other words, the LOI is an "agreement to agree." Courts have consistently held that an agreement to agree is not binding on the buyer or seller.[1] The LOI should state that either party can terminate negotiations at any time for any reason without liability or obligation.[4]

The LOI may contain an acceptance paragraph indicating that other buyers will not be considered while negotiations continue with the present buyer.[2] As a rule of thumb, a buyer's first offer is usually his or her best offer. So, after identifing the best offer, do not pit buyers against each other or expect them to make additional offers and counteroffers.[3]

Due Diligence

A signed LOI allows the process of due diligence to commence. The buyer is granted a specified period of time in which to conduct a due diligence investigation of the seller and the pharmacy being purchased. During this time the buyer should have access to the seller's financial records, bankers, accountants, facilities, and employees. Due diligence by the buyer should only last 4–14 days. As long as the seller is organized and ready with all important documents, this is all the time a competent business buyer should need to investigate the business for sale.[5]

The seller needs to conduct his own investigation of the buyer's credit records, management experience, reputation, and plans for the pharmacy's future operation. This is especially important if the seller plans to continue employment or a consulting arrangement with the buyer after the sale or if some part of the purchase price will be paid in the future through a financing arrangement.[6] Though sellers often insist that the culture and operations of the pharmacy remain unchanged, in reality, the buyer's own culture and style will prevail. As long as the remaining pharmacy employees will be comfortable in the environment, culture should not take on paramount importance in the decision.[7]

One section of the LOI that should be binding on the purchaser is the confidentiality agreement. In this section, the buyer agrees to keep confidential the fact that negotiations are proceeding as well as any information including financials learned during the negotiations. The confidentiality agreement affords the seller with some protection if the negotiations fall through.[3]

The LOI should designate a time frame for completion of the transaction. If negotiations are on track but running behind schedule, deadlines can always be extended. A reminder of the deadline can be a useful tool in moving along a stalled buyer.[2]

NONDISCLOSURE AGREEMENT

A nondisclosure agreement (NDA) is a contract in which the buyer and seller promise to protect the confidentiality of secret information that is disclosed during the transaction. NDAs can be classified as one-way or mutual. A one-way NDA is used when only one party is making a disclosure. For example, the seller is providing financial information about the pharmacy. A mutual NDA is one in which both parties are exchanging confidential information. For example, in addition to the seller's disclosures, the buyer is providing information to support his/her credibility as a potential purchaser.[8] The NDA contains the five basic elements described below:

- ***Definition of confidential information.*** The NDA should list the categories of confidential information to be protected in the agreement. Examples of categories of confidential information listed in generic NDA forms include financial information, present or future suppliers, clients, customers, employees, personnel matters, etc. Categories are used to define the subject matter without revealing the actual protected information.[9]
- ***Exclusions from confidential information.*** Every NDA excludes some information from protection. For example, information cannot be treated as confidential if the recipient had prior knowledge of the information or the information was revealed to the recipient by a third party. Additional exclusions include information in the public domain, requested by a government agency, or independently developed.[10]
- ***Obligations of receiving party.*** The NDA will state that the receiving party (or parties in the case of a mutual NDA) must hold and maintain the protected information in strict confidence and limit its use.[9] An NDA typically states that confidential information is the property of the disclosing party and must be returned upon completion or termination of the NDA.

Under most state laws the receiving party cannot breach the confidential relationship or induce others to breach it. Keep in mind, a contract is only as good as the person signing it. If a potential buyer breaches the NDA, you can take the party to court for damages and request the court to stop the violator from making future disclosures. However, this can be expensive, time-consuming, and difficult to quantify the damages.[11]

- ***Time periods.*** NDAs will often require the receiving party to maintain the confidentiality of information for a limited period of years. The time period can be negotiated. Two, three, or five years are commonly used in NDAs.[8]
- ***Miscellaneous provisions.*** The end of an NDA includes miscellaneous terms such as which state's law will apply in the event the agreement is breached, and should a dispute arise, whether arbitration will be used and whether attorney fees will be awarded to the prevailing party.[9]

A word of caution is in order. While the intent of an NDA is to preserve confidentiality of private information, some NDAs have the opposite effect. They contain clauses or disclaimers that waive any claim of confidentiality. Be wary of the following language: "This agreement does not create a confidential relationship." "No obligation of any kind is created/assumed/implied/imputed by the receipt/exchange/disclosure of information.[8]"

Please refer to the accompanying CD for a sample Non-Disclosure Agreement.

ASSET PURCHASE AGREEMENT

If due diligence results in favorable information, lawyers representing the buyer and seller negotiate the details of the purchase agreement.[12] Unlike the letter of intent, the purchase agreement is binding. This is one of the most important legal documents both parties will ever sign. The buyer's lawyer typically provides the initial draft of the purchase agreement with the seller's lawyer drafting sections pertinent to his or her client. As the seller, your years of hard work will be represented in this single transaction. A carefully constructed purchase agreement will ensure your ability to collect the money you are due and avoid future legal problems.[13] A purchase agreement contains the basic elements and sections described below:[14]

- ***Total price to be offered.*** The agreed upon selling price is specified, and the components of the price are outlined including the amount of the security deposit and down payment, amount of bank debt, and amount of seller financed debt.
- ***Sale of assets.*** The asset and liabilities being purchased are delineated. Examples typically include inventory, furniture and office equipment, machinery and equipment, vehicles, cash on hand, accounts receivable (minimum amount to be collected), intangible assets (including goodwill, Internet web pages, telephone listings, prepaid expenses, etc.), and accounts payable (maxi-

mum amount to be assumed). A description of the operating condition of equipment at settlement is typically included.

- ***Limited assumption of liabilities (indemnification clause).*** This section confirms the right to offset the purchase price in the amount of any undisclosed liabilities that come due after settlement and in the amount of any variance in inventory from that stated in the agreement.
  - For example, if the buyer becomes subject to a lawsuit by a customer or employee due to events that transpired when the seller owned the business, the seller agrees to pay for the buyer's defense costs and to pay damages. It is not always easy to enforce an indemnification clause. Therefore, buyers often negotiate for an escrow agreement whereby some part of the purchase price is placed in the hands of a neutral third party, typically a bank, to be released to either party upon the happening of certain events. If problems surface in a designated time period, the buyer will get all or part of the escrow funds. If nothing goes wrong, the escrow funds are released to the seller at the end of the escrow period.[15]
- ***Representation and warranties.*** This section includes warranties of clear and marketable title, validity and assumability of existing contracts, tax liability limitations, legal liability limitations and other appropriate warranties.
- ***Compliance with bulk sales act.*** Many states require that when a business sells the bulk of its inventory outside the regular course of business, it must formally notify all creditors at least ten days before the sale. Otherwise, the creditors can repossess those goods from the new owner, in repayment for debt. In some states the creditors will have a lien on the proceeds of the sale. The purpose of the law is to allow creditors to recover what they are owed. State laws usually allow the notification requirements to be waived if both buyer and seller agree. In such cases the buyer will then want an indemnification clause to provide protection against the claims of creditors.[16]
- ***Various conditional clauses.*** The following conditions are stated in an asset purchase agreement: a provision that the business will be able to pass all necessary inspections, a provision (where appropriate) to make the sale conditional on lease assignment, verification of financial statements, transfer of licenses, obtaining financing or other provisions, and a provision for any appropriate prorations such as rent, utilities, wages, and prepaid expenses.

- ***A non-compete covenant.*** This is an agreement whereby the former owner promises not to compete with the new owner by engaging in the practice of pharmacy as an employee or owner of another pharmacy with limitations on time and geography. It is sometimes part of the purchase agreement and sometimes a separate exhibit to the agreement.[17]
- ***Allocation of the purchase price.*** The sale of a business is really the sale of a collection of assets, some tangible and some intangible. The purchase price must be allocated among these assets. According to IRS rules, the buyer and seller must use the same allocation, so allocation must be negotiated and put in writing as part of the sales contract. The buyer typically wants as much money as possible to be allocated to items that are currently deductible or assets that can be depreciated quickly. This will improve the pharmacy's cash flow by reducing its tax bill in the critical first years. Conversely, the seller wants as much money as possible allocated to assets on which the gain is treated as capital gains, rather than ordinary income. The current tax rate on long term capital gains is much less than on ordinary income.[18]
- ***Conduct of business by seller prior to closing.*** This section delineates restrictions on how the business is to be operated until settlement. Typically the seller is expected to conduct business as usual preserving acquired assets and preserving relationships with customers, employees, suppliers, and other business relations.
- ***Settlement date.*** At the settlement or closing all necessary documents are signed by all the parties, apportionment of expenses up to the date of closing is done, money and keys are exchanged, and the buyer becomes the new owner. Expect the buyer to conduct a "walk through" immediately prior to closing to ensure the presence and condition of the inventory, fixtures, equipment, and other assets listed in the purchase agreement. If the assets listed or their condition has changed, be prepared to adjust the purchase price.[19] The date, time, and place of the closing are documented in the purchase agreement. Furthermore documents to be delivered to the buyer by the seller at the time of closing are listed. Examples include bills of sale, titles, and other instruments or covenants.

Please refer to the accompanying CD for a sample Asset Purchase Agreement.

NON-COMPETE AGREEMENT

Underscoring its importance, a non-compete agreement is often a separate document from the purchase agreement. It is a contract not to compete. To be enforceable, the courts require that the agreement be limited geographically and by time duration.[20] The limitations should give reasonable protection to the new owner. For example, the new owner does not want the former owner opening another pharmacy across the street. Similarly, the new owner doesn't want to lose the customer base when the former owner begins working for the independent pharmacy across town. In a standard non-compete arrangement, the previous owner might agree not to provide similar services, i.e., engage in the practice of pharmacy as an owner, part owner, or employee of another pharmacy, within a 100 mile radius of the sale pharmacy for a period of five years. Furthermore, the former owner would agree not to solicit customers or employees for the same period of time. Sellers should be cautious when presented with a non-compete agreement. Review it closely to decide how reasonable it is for you. Assuming it was written by a competent attorney, follows applicable state law, and is reasonable, you'll be bound to its provisions.[20]

Please refer to the accompanying CD for a sample Non-Compete Agreement.

BILL OF SALE AND ASSIGNMENTS

The bill of sale is proof of the sale of the business. The bill of sale transfers the ownership of properties and assets from the seller to the purchaser and identifies the amount of consideration paid.[21] Typical assets listed include inventory, furniture and office equipment, machinery and equipment, vehicles, purchased accounts receivable, books and records, intangible assets (software licenses, web pages, domain names, e-mail addresses, telephone numbers and listings, etc.), and assigned and assumed contracts. The bill of sale also delineates excluded assets. These are assets to be retained by the seller and not transferred to the purchaser. Examples of retained assets include inventory sold and supplies consumed prior to the closing, accounts receivable accrued prior to the cut off date, i.e., excluded accounts receivable, cash on hand and bank accounts as of the closing date.

Please refer to the accompanying CD for a sample Bill of Sale and Assignment.

EMPLOYMENT AGREEMENT

Sellers will sometimes desire to continue working in the pharmacy as an employee of the new owner. By signing an employment contract the seller can continue to receive insurance and other perks in addition to salary. Payments of salary and benefits are deductible as business expenses by the new owner and taxed as ordinary income for the former owner/employee.[22]

The employment agreement defines the obligations between the employee and owner. The employment is clearly stated to be "at will," i.e., it can be terminated at any time by either party without notice. The employment agreement also places restrictions on the employee regarding solicitation of customers or other employees on behalf of a competitor and treatment of confidential information belonging to and related to the operation of the pharmacy.

Employment contracts are most successful when used in family run businesses as part of a succession plan as the younger generation learns from the older mentor. In such arrangements it is important that the mentor really operate as an employee. If not, the salary and benefits will not qualify as deductible business expenses. Conversely, if the mentor continues to work as before performing all functions of an owner, other tax problems can ensue.

When the former and new owner are unrelated, employment contracts have a poor track record. The employer/employee relationship usually dissolves in less than two years. Therefore, if using an employment contract, make sure it is a separate document from the purchase agreement. If the employment relationship falls apart early on, the entire deal will not be jeopardized.[22]

Consulting contracts are a good alternative for sellers who want to continue working for an unrelated buyer. Typically the seller consults for a preset amount of time and the buyer makes payments at periodic intervals. These payments are deductible by the buyer and taxed as ordinary income for the seller. Oftentimes, payments under consulting arrangements are made as a way of reducing the purchase price. Because there is potential for abuse in this situation, it is important to draft a written consulting agreement and ensure payments would be considered reasonable for the industry, i.e., consulting in the community pharmacy setting.[23]

CONCLUSION

When negotiating the sale of your pharmacy, a letter of intent will signify a commitment to the transaction. Because confidential information will be exchanged by both parties, a nondisclosure agreement should be executed. If due diligence clears both parties, their respective lawyers will negotiate further and draw up a purchase agreement. They will also draw up supplementary contracts including a non-compete agreement (prevents the former owner from competing with the new owner), the bill of sale and assignments (transfers ownership to the buyer), and an optional employment agreement (in the event the owner desires to continue working in the pharmacy). At closing, the purchase agreement and all supplementary contracts are signed, money is exchanged, and ownership transfers.

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Chapter 8

After the Sale—What Do I Do with the Money?

INTRODUCTION

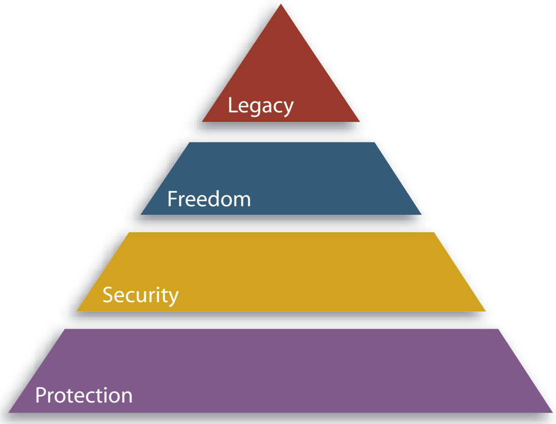
In 1985, a 45-year old pharmacist made a dangerous decision. Midway through his career, he purchased a small, independent—and somewhat unprofitable—pharmacy in a Georgia city, and leaped from the security of a job to the uncharted waters of self-employment. Twenty-one years later, after transforming that business into one of the state's most profitable pharmacies with an 8.5 percent profit margin, Tom successfully sold it to his junior partner and received $1 million for his efforts. More importantly, through deliberate, disciplined, and strategic financial planning, he and Karen, his wife of over 30 years, made the most of this significant asset by providing a comfortable and dignified retirement for themselves. Hopefully your story will be similar.

Now that you have sold your practice, what will you do with the money? How will you ensure that the financial results of your life's work are not decimated by inflation, estate taxes, or the ever-increasing costs of health care and long term care? Worse, will you outlive your money? In this chapter, I will walk you through Tom and Karen's story to illustrate three essential financial planning strategies that every pharmacist must consider. Obviously their implementation will differ in your situation; however, with a firm grasp of the concepts, you will be well on your way as you begin the journey.

GETTING OUR BEARINGS

Before we set out, let's get our bearings by figuring out where we are going. The words "financial planning" have almost limitless meaning. To some, it simply means "assets under management". To others it might mean annuities or insurance. Unbelievably, even people in the profession confuse the matter by providing different levels of service while calling themselves planners. Studies show that the American consumer does not clearly understand what financial planning is, because financial "professionals"

Wealth and Security Model: Four Finacial Needs



Financial Planning: The integrated, coordinated, and ongoing management of your personal financial concerns.

have not clearly disclosed what they do and do not do, much less how they get paid.

So, let's agree to a standard definition of financial planning: the integrated, coordinated, and ongoing management of one's personal financial concerns. If you are not receiving this level of ongoing professional advice and service in a long-term relationship with your advisor, then I would suggest that you have not employed a financial planner. Further, every financial plan must—by definition—address the four financial needs of the wealth and security model: protection, security, financial freedom, and your legacy. Every house has to be built on a solid foundation to stand the storms of life. Likewise, a financial plan's foundation is **protection**. Adequately addressing this need helps protect your loved ones from the risks of premature death or disability, protracted illness, or the liability exposure of the primary owners and/or earners. The second need for **security** involves an ample emergency cash reserve (and a good yield thereon) coupled with prudent debt and cash flow management. Next, **financial freedom** means different things for different people; however, it usually focuses on having enough assets and income to do the things you want to do, while minimizing the risk of outliving your money. Last, but definitely not least, planning your **legacy** means making meaningful contributions to the financial livelihoods of loved ones and/or favorite charities and institutions—both while alive and thereafte without the decimating erosion of income and estate taxes.

Diane D'Amato: *"The sale of the business alone would not have provided enough for retirement. The selling price sounded wonderful, but taxes took a large chunk."*

CHART YOUR COURSE

In the movie Jerry McGuire ("Show me the money!!"), Tom Cruise's character Jerry distributes a "mission statement" to his fellow co-workers, one in which he attempts to pull the firm back to its roots of caring for its clients above its profits. Of course, he is fired; however, the rest of his life is spent fulfilling that statement and realizing dreams—both for himself and his clients. Similarly, every financial plan centers on your personal financial mission statement, which in many ways really is a life mission statement. More than the dollars and cents, what we do with money reflects the core of who we are and our feelings for those we care about.

Before any financial planning begins, ask yourself one simple question: "What do I want this money to do for me and my family?" Take some time to think about it, and write down your answer. It will have a profound impact on your life and decisions. It provides a benchmark against which all financial decisions are made, and it will help you create strategies that build and protect both wealth and security for you, your family, and your heirs. In the end, you will have the confidence of knowing that all of your financial decisions have been made and implemented with that goal in mind. In Tom and Karen's case, their financial mission statement was simply to have a comfortable and dignified retirement without burdening their children.

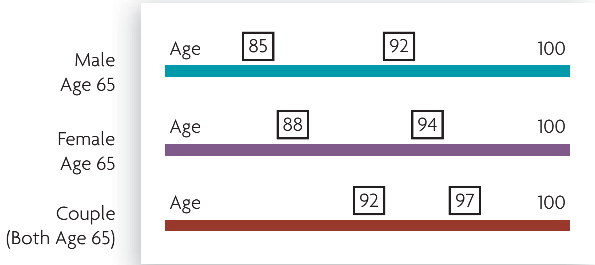
Strategy #1: Retirement Income Planning

Do you have a hard time imagining what retirement might be like? Nick Murray, a nationally recognized planner and author, tells this story: Have you ever known a 90-year-old couple? How about two? Imagine a door opening at a seniors' condominium complex, and a 90-year-old woman walking out the door (because she can still walk) and bending over to pick up her morning paper (because she can still bend over). Now, picture at that same moment, fully half the other condo unit doors opening, and another 90-year-

Age	65
Locations	1
Gross Revenue	$4,200,000
Owner Income	$300,000
Investments	$1,200,000
Pharmacy	$1,000,000
Real Estate ($2,000/ mo rental income)	$500,000
Net Worth	**$2,700,000**
ANNUAL LIFESTYLE	**$120,000**

old coming out of each one, to get his/her paper. There is some statistical hyperbole here—half of any large sample is never likely to be 90. However, the ordinariness of the 30-year two-person retirement is imminent.[1]

You May Need Income for 30+ Years: Life Expectancies for 65 Year olds

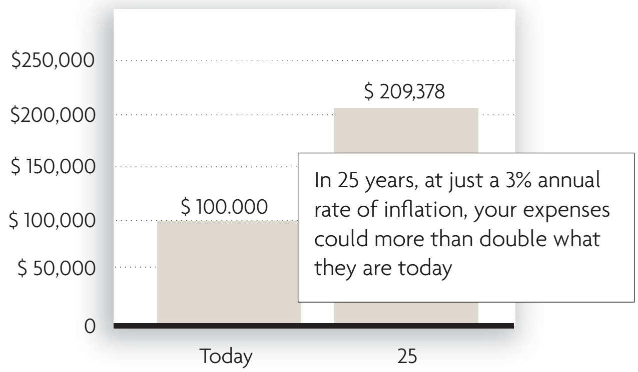


Life expectancies for 65–year olds in good health from the Annuity 2000 Mortality Table, American Society of Actuaries, as cited in Fidelity Investment's Lifetime Income Planning, 2004, page 9.

In preparing for this, Tom and Karen's first priority was to identify their true standard of living. This is difficult for a pharmacy owner to do. Having owned a pharmacy for more than 20 years, Tom and Karen had become quite comfortable with salaries, annual profit distributions, and running various expenses through the pharmacy. Now they had to live on more limited sources of income. To make sure they would have enough, we identified and wrote out a spending plan that showed their anticipated sources of income, expenses, and the surplus or deficit (i.e., "net profit"). The graphic on the right summarizes their financial position. This was the most difficult task for them to accomplish; however, it was the most useful one. Now they know exactly what their lifestyle requires. Use the skills that you acquired in your years of ownership to help you do the same. This step is crucial in successfully addressing all of the others. If you spend too much, you run the risk of running out of money.

Tom and Karen now needed to know how long their money would last. In other words, if we need $120,000 per year to live on, will our money sustain us for the remainder of our days, or will we outlive our money? To answer this question, you need to be aware of inflation and your expected longevity. Life expectancies in the U.S. have been increasing for over 100 years. A newborn male in 1900 could expect to make it to 47. Today's 65 year-olds, however, should plan on living well into their 90's. In fact, the American Society of Actuaries projects that for a 65-year old couple, the likelihood of one of them living to age 92 is 50 percent, while the probability that one of them will live to age 97 is 25 percent (see illustration). Are you willing to bet your financial plan on living less than that?

Inflation Damages Purchasing Power



Based on $100,000 today calculated with a hypothetical 3% rate of inflation to show the effects of inflation over time; historical average from 1981 through 2005 was 3.1%; actual inflation rates may be more or less.

Over their expected two-person 30-year retirement, Tom and Karen must assume that their cost of living will more than double. My father's first auto purchase was a 1961 Pontiac Ventura (389 tri-power V8, dawn-fire mist hard top) for $1,600. Today we commonly pay well over $28,000 for a basic 4-door sedan. Over the last 25 years ending with 2005, inflation as measured by the Consumer Price Index has averaged 3.1 percent according to the Bureau of Labor Statistics. In other words, in 25 years, you will need $209,378 annually to buy the same things that $100,000 buys today if inflation averages 3 percent (see illustration). Consequently, your investments and income must be able to outpace inflation.

In spite of the new Medicare Part D prescription drug benefit, health care expenses will be a significant portion of your retirement budget, whether now or some time in the future. The Centers for Medicare & Medicaid Services (CMS) projects that health care costs will increase by 7.2 percent per year for the next decade and that by 2015 we will spend one out of every five dollars on our health care. Further, several studies indicate that one of every two 65-year olds will spend time in a nursing home, with half of those staying six months or more. About one in ten will stay three years or more. Long term care costs are not covered by Medicare after the first 100 days, meaning that your assets and income will have to pick up the tab. With costs ranging from $33,000 per year in Louisiana to $91,000 per year in Connecticut, the drain on your assets can be severe. Tom and Karen helped insure against this threat by purchasing a long-term care insurance policy. Depending on the cost of the care that they might need, such a policy can provide significant asset protection. This was important for them because they wanted the flexibility to decide who provides their care and its location, and they did not want to burden their children with the cost and duties associated with their care. In preparing your financial plan, long-term care insurance should be considered as one of your plan's key risk management components.

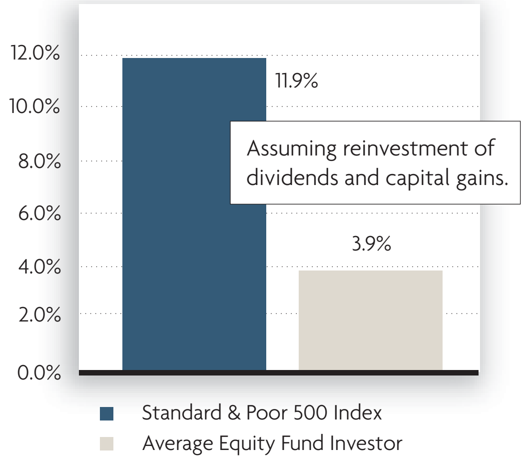
To tie all of this retirement income planning together, projections that include inflation, taxation, and a reasonable rate of asset growth are essential. They should show how your assets grow (or not) as your income is withdrawn. Hopefully the projections will not show that you run out of money. If they do, it is better to know it now rather than later so that adjustments can be made. The issues and the math can get complicated, and the assistance of a competent financial planner is highly recommended.

Strategy #2: Asset Allocation

Fortunately for Tom and Karen, their projections indicate that the buyout proceeds, existing assets and investments, Social Security, and rental income should sustain them. With long-term care insurance in place to help protect their assets, the focus now turns to investment strategies. Often folks accumulate investments and properties over the years, resulting in portfolios with significant diversification and allocation problems. Tom and Karen owned ten mutual funds before they sold their pharmacy, thinking they were adequately diversified. However, a closer look revealed that eight of the funds were invested in one asset class, large capitalization U.S. stocks. Even worse, many of those eight funds actually owned the same stocks, eliminating the benefits of diversification. In short, even though Tom and Karen owned ten different mutual funds, their portfolio acted as if they owned one. Each fund grew or lost value at the same time. This meant that they could face serious problems when the next stock market correction (or bear market) occurred. Think back to the bull market of the late 1990's and the bear market of the new millennium for a friendly reminder.

With the sale of the pharmacy, Tom and Karen now have $2.7 million ($1 million from the pharmacy and $1.7 million from existing investments and real estate) that must provide a lifetime income that is not decimated by inflation. Many times people purchase investments that performed well in prior years because of what they see or read in the financial media. The problem is that those investments performed well in

Average Annual Return, 1986–2005



Dalbar's "Quantitative Analysis of Investor Behavior" study, cited in InvestmentNews, June 12, 2006, page 14.

prior years. They may not do so going forward. History is littered with examples of fads that crashed. In 1982, it was gold; in 1986, real estate; 1989, Japan; 1991, high yield bonds; and in 1999, technology. What's next? Who knows. As investors try to pick the best performing funds, they tend to "buy high and sell low" rather than "buying low and selling high". According to Dalbar's "Quantitative Analysis of Investor Behavior" study, cited in the June 12, 2006, issue of *InvestmentNews*, the average stock investor has earned only 3.9 percent over the last 20 years, while the S & P 500 index has returned 11.9 percent—almost three times the average investor's return (see chart). And, according to a 2003 Hewitt Associates study, an individual investor owns an average of 3.6 mutual funds across only one or two asset classes. Clearly, attempting to time the market, poor asset allocation, and under-diversification often lead to serious investment problems.

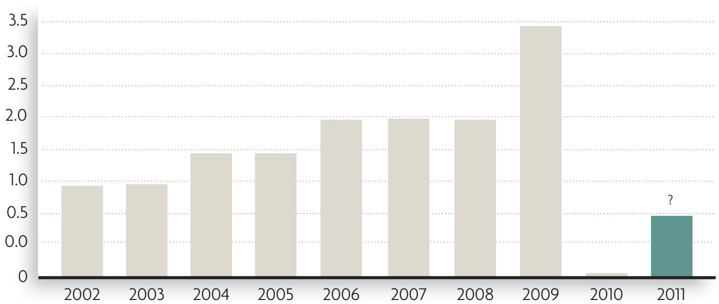
So, what will you do to help prevent you from outliving your money? The proper asset allocation is crucial. This is the mix of stocks, bonds, real estate, and cash that is in your portfolio. A landmark study by Gary P. Brinson, L. Randolph Hood, and Gilbert L. Beebower found that 93.6 percent of a portfolio's performance was determined by its asset allocation while only 6.4 percent of its performance was driven by the actual security selection and timing of the investment.[2] The allocation decision is one of your most important investment decisions, other than your commitment to stick with your plan regardless of market conditions.

In determining their asset allocation, Tom and Karen were asked several questions about their "time horizon" (how long they will need their income) and "risk tolerance" (how much risk they were willing to take to achieve their goals). Obviously they needed their income for life and wanted as little risk as possible. What was not addressed in the questionnaire was the potential impact of rising living costs over a two-person 30-year retirement. We reviewed the history of investments in the U.S. over the last 80 years. Interestingly, Tom and Karen learned that bonds have provided a modest total return above inflation while affording principal protection. They also found that stocks have historically generated higher total returns over inflation than bonds, but with more volatility. While recognizing that past history does not guarantee future results, Tom and Karen agreed that their investments should be allocated more toward equities and less toward bonds as they faced the realities of their two-person 30-year retirement. This differed greatly from much of the advice that they received from friends and the financial press.

Strategy #3: Legacy Planning

With their retirement income plan and investments in place, Tom and Karen could turn their attention to what will happen with their money at the end of their lives. Their main desire was to intervene meaningfully in the lives of their sons and grandchildren. Proper wills were needed to ensure that their directives were carried out. However, they discovered that approximately 15 percent of their assets—$405,000—would be taxed away at the second person's death because of estate taxation, based on the current tax rates. Implementing the correct wills alleviated most of the problem. Changing the ownership of certain assets took care of the rest.

Estate Tax Thresholds



Source: Internal Revenue Service

Unfortunately for Tom and Karen, the current estate tax law will expire at the end of 2010, meaning that higher rates and lower thresholds will return unless Congress acts beforehand. In 2006, the assets of an estate that are over $2 million are subject to the estate tax (including individually-owned life insurance). Rates range from 18–45 percent.

In 2011, this threshold reverts to $1, million, and the rates increase (see chart for current taxable thresholds). This means that unless the law changes, Tom and Karen's estate tax could be much higher after 2010. The impact on their plan to meaningfully intervene in the lives of others would be substantially altered if this issue were not addressed. In their situation, investments would have to be liquidated to pay the tax. Would you have to sell a business, land, or some other significant asset to pay your tax?

We decided to keep Tom's existing life insurance policy in force as an inexpensive way to pay whatever tax would be due, if any. This shifted the burden to the insurance company in exchange for the premium. Alternatively, if there is no estate tax for Tom and Karen, the insurance adds to the legacy left behind, free of income taxes. Insurance policies should be reviewed periodically to make sure you are making the best use of the premium and cash value. In their situation, it provided an efficient tool for multiplying the estate at minimal cost.

CONCLUSION

The sale of your business is now complete. After investing your life's work in this wonderful profession, you have now traded the fruit of your labor for an installment note or a lump sum payment. Will you have enough money to live on, or will you outlive your money? Should you invest this newfound source of wealth? If so, how, and to whom do you turn? What would happen to the money—and your family—if you died prematurely, had a protracted illness, or needed nursing home care? Will you be able to do the things you want to do, and protect your assets and family at the same time? Do you have a trusted advisor who can put all of these issues together? These issues are at the tip of the iceberg when one considers the financial planning consequences of selling a pharmacy. Putting it all together may seem overwhelming. However, it does not have to be, especially if you take a step back and look at the bigger picture: "What do I want this money to do for me and my family?"

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Author Information

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Dr. Jackson is a native of Atlanta, Georgia. He received his B.S. in Pharmacy from Mercer University Southern School of Pharmacy in 1969. He attended graduate school at the University of Mississippi where he received his M.S. in Health Care Administration in 1971 and a Ph.D. in Pharmacy Administration in 1972. In 1972 he joined the faculty of Mercer University College of Pharmacy and Health Sciences where he currently serves as Professor and Director of Mercer's Center for Community Pharmacy Practice and Research.

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Dr. Jackson established and operated three community pharmacies in the metropolitan Atlanta area for over 10 years and is a registered pharmacist in the state of Georgia.

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Candace Wilt Barnett earned her B.S. in Pharmacy from Purdue University and Ph.D. in Pharmacy Health Care Administration from The University of Florida. She is a member of the faculty of Mercer University College of Pharmacy and Health Sciences where she holds the rank of Professor. Dr. Barnett also serves the College as Senior Associate Dean and Director of the combined PharmD/MBA program. Dr. Barnett teaches courses in communication skills, marketing, management and medical ethics. She has over 60 publications in scholarly and professional journals and is the author of chapters in two books titled *Marketing Pharmaceutical Services and Personnel Relations*. Dr. Barnett has been a speaker at the national, state and local levels on topics primarily related to communication skills for pharmacists and human resource management issues. She has served on the USP Advisory Committee on Patient Counseling and the Dupont Pharma MBA Advisory Committee. Dr. Barnett is a recipient of a Searle Fellowship in Pharmacy faculty mentor award. Her most prized award is the Mercer University College of Pharmacy and Health Sciences Distinguished Educator Award, bestowed for advancing the scholarship of teaching and fostering critical thinking, problem solving and life-long learning among students.

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Mike Tarrant oversees and coordinates the financial affairs of a select group of families, pharmacists, and business owners. As the Vice President of Financial Network Associates, an independent wealth advisory and financial planning firm based in Atlanta, Mike holds various securities registrations and insurance licenses and is also a registered representative of Financial Network Investment Corporation, a national independent broker-dealer and member of

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He provides holistic wealth advisory services in an ongoing relationship with each client, with strategies designed to help protect and grow wealth for their families and businesses. Serving as a client's primary financial advisor, Mike helps ensure the implementation of a wealth management plan through independent investment advisory and insurance services. He also maintains a network of professionals, such as accountants, attorneys, mortgage brokers, bankers, and pharmacy consultants to assist with specialized issues. Previously he served as Treasurer of the Financial Planning Association of Georgia.

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Bryan Ziegler received a PharmD degree from the University of South Carolina College of Pharmacy in 2001 and a Master's degree in Business Administration from the University of South Carolina Moore School of Business in 2006. Bryan is a licensed pharmacist in South Carolina and Virginia.

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