Legacy Advisors Group

M & A UPDATE®

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Getting Financing in Tough Times

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Introduction

If you've paid any attention at all to the news recently, you are well aware of the country's current credit crises. The gross liquidity that was available just a few short years ago, to nearly any borrower is now only being offered to those with elite financial positions and stellar credit ratings. The government has made repeated attempts to loosen the credit liquidity, however, with mixed and limited results. Most experts predict the credit crises will loom at least into the immediate future, which leaves most in the business world wondering, "What can I do to improve my credit worthiness and get the credit I need?"

Most accounting issues for privately held businesses have centered on tax liability reduction in the past. That emphasis has shifted for now. To achieve the ratios desired by finance professionals and bank personnel, businesses must have higher incomes and carry more assets to gain access to credit. In order to get credit, companies must be able to do three things: 1) have recasted financial statements and be able to show solid profits, 2) carry more assets, and 3) create and convey a specific purpose for the funds.

The Recasted Income Statement

Generally speaking, most accounting for closely-held businesses focuses on the tax return with the ultimate objective of reducing taxes. The reason closely-held businesses file tax returns is simple, it's required by law. From a financial perspective, or perspective that accurately reflects reality, the tax return does not show a good financial picture of the business.

On the other hand, few closely-held businesses create what are known as true value financial statements. Financial statement principal and disclosure rules are not required under law for closely-held businesses, as are tax returns. Accordingly, only a few closely-held companies carry them. Publically traded companies are required to have financial statements, if they intend on marketing their stock to the public. The goals of financial statements are to reflect the true reality of the finances of the company and therefore, are used to present a better and accurate picture of a company's finances in order to obtain loans and promote investment by banks and investors respectively.

A recasted income statement is a presentation of the company's finances to represent a more optimistic picture than traditional tax accounting statements present. The accountant preparing the income statement will remove non recurring expenses, family salaries, investment or other nonoperating expenses or income to family members to the extent possible. In effect, a restructured income statement presents a more realistic income picture of the business which a banker can use to justify a loan.

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A CASE STUDY

The Ninth Circuit Court of Appeals upheld a taxpayer's criminal liability for payroll taxes, holding that the government did not have to prove that the taxpayer had the ability to pay such taxes. The taxpayer in this case managed nursing homes. While it filed all of its income tax returns, it failed to pay the payroll taxes due in full. After many attempts to collect, the IRS finally charged the taxpayer with willful failure to pay taxes. The taxpayer argued that it could not be held criminally liable because it simply lacked the ability to pay. However, the Court ruled that in order for the failure to pay the tax to be considered "willful" the taxpayer only had to voluntarily and intentionally neglect to pay the tax. As a result, the taxpayer was held criminally liable.

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Mike Ertel is a Certified M & A Advisor and a Principal Broker with Legacy Advisors Group, a full-service M & A Advisory firm with an office in Tampa, Florida specializing in representing sellers and buyers of small- to mid-sized companies. Prior to joining Legacy Advisors Group, Mike's business career spanned 30+ years with Fortune 500 and Fortune 1000 Companies, with senior management roles in Marketing, Operations and Logistics. Mike also served as President, COO of a mid-sized Manufacturing company headquartered in Tampa. Mike also holds a BS in Electrical Engineering and an MS in Industrial Administration, both from Purdue.

CoverStory

After the income statement is recast, the business person can determine if the recasted income statement is enough. If not, the owner can find ways to increase income further such as trimming expenses. The added efforts generally will beget more income shown on the recasted statement. It should be remembered that the recasted financial statement is not to be used for tax purposes, but can be used for financing purposes.

Recasted Balance Sheet

As with a recasted income statement, a recasted balance sheet should also be presented. The goal of a recasted balance sheet is to show a banker that you have real assets that can be used as collateral by a bank and gives the banker a comfort level. When recasting the balance sheet, assets are revalued at their fair market value, inventory is presented at replacement cost, and loans made to the company by the owner can be written off or subordinated if doing so would not constitute bad faith. In many instances, due to taxes, expenses are written off that affect the balance of assets that are shown on the books of the company.

Accordingly, if expenses are adjusted (as stated above for income statement purposes) these adjustments will also affect the assets on a balance sheet. An example of this is I.R.C. section 179. In a situation that was just reviewed, a company wrote off $100,000 in expenses and lowered the assets on the balance sheet. A recasted balance sheet should put the $100,000 worth of assets back on the books as the tax deduction distorts both the income statement and the balance sheet.

Specific Purpose

Banks also like to know what you intend on doing with the money they loan to you. A specific purpose assures the bank that the money will not be frivolously spent while the business gains no advantage to repay the bank. In order to present a specific purpose to the bank, it is likely the bank will require a specific statement of what the funds will be used for. In addition, the bank may even require a full blown business plan for use of the funds. Either way, you should be able to present the bank with an accurate intention of how the funds will be used. Finally, the company should also have a definite plan as to how the funds will be paid back. This entails a projection as to the months that funds will be available to pay back principal on the loan. Another statement that assists in presenting this information is referred to as a cash flow projection.

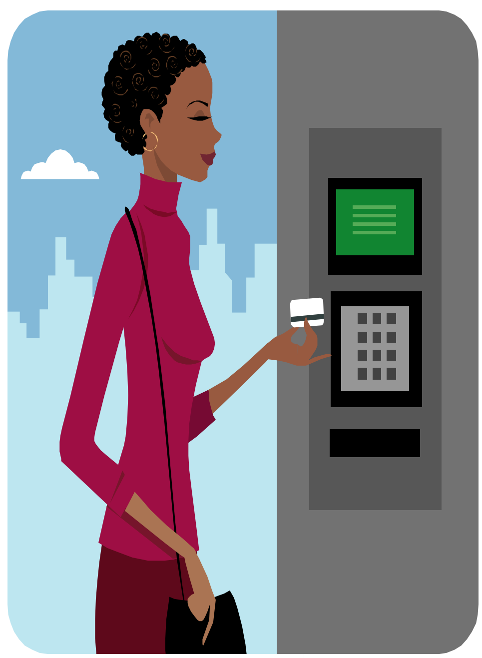
Conclusion

The current economic downturn is one of the worst since the 1930's. Even though the country suffers from the credit crises, credit is still obtainable. With the right help and professional assistance, credit can be found and at the right price. The professionals at The Center routinely aid those trying to get financing, value their business, sell their business, or plan for business succession and/or exit strategy. Contact the experts at The Center if you need assistance in the restructure of your financial statements for bank purposes.

Dr. Bart A. Basi is an attorney, CPA, and the Senior Advisor of The Center for Financial, Legal & Tax Planning, Inc, a full service company specializing in financial, legal & tax matters. Basi is a nationally recognized author, lecturer, and advisor on how to structure deals to minimize taxes. Tax structure makes the difference between getting the deal done and watching the deal fall apart. Many of you may be familiar with Basi and the topics he covers in the Financial, Legal & Tax Advisory which may be read in various industry-specific trade publications.

A CASE STUDY CONTINUED:

Editor's Comment: In support of its holding, the Court reasoned that a taxpayer could not deliberately use up all of the financial resources of his business in order to claim that the company has nothing left to pay the payroll tax liability. This thinking would go against public policy. It is important to remember to give your tax liabilities priority in order to avoid an outcome like the one in this case. Also, remember that the penalty is equal to 100% of the tax due.



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Points of Interest

- Most experts predict the credit crises will loom at least into the immediate future.
- To achieve the ratios desired by finance professionals and bank personal, businesses must have higher incomes and carry more assets to gain access to credit.
- With the right help and professional assistance, credit can be found and at the right price.

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The Major Pitfalls in Selling A Business – No. 3 – Allowing Emotion to Overrule Reason

Mike Ertel, CBI/ M&AMI/ CM&AA

Selling a business is something that most business owners will only attempt once in their career. With an estimated 70% - 90% of their total net worth tied up in their business, they can't afford to make a costly mistake, but their success in running their own business generally doesn't prepare them to handle one of the largest and most crucial financial transaction in their life.

This is the third in a series of articles exploring some of the common pitfalls in selling a business:

Major Pitfall No. 3 -- Allowing Emotion to Overrule Reason

By the time most owners come to sell, they've invested most of their working life in building the business to its present size and profitability. In addition to their considerable investment of time and money, they understandably have a tremendous psychic and emotion investment as well. Many owners, and especially founding owners, tend not to respond well to questions about why things are done a certain way, or suggestions on ways the business might be further improved, or observations that the business may have certain systemic weaknesses even while acknowledging that it has many strengths.

It is for similar reasons, I suppose, that residential real estate agents prefer/insist on showing a home to a prospective buyer WITHOUT the owner present. This is obviously not feasible – or even desirable, in most cases -- when showing a business.

Because selling a business can be emotionally gut-wrenching and that emotion can spill over into irrational reactions to prospective buyers in the sales process and potentially damage or even derail an otherwise successful sale, a principal role of the M&A intermediary, is to keep the process and the discussion as objective and rational as possible.

Determining the fair market value is one issue sellers commonly have difficulty with. They are inclined to associate value with the years they put into the business, the investment they made in plant and equipment, and how much it would cost to replace it all, rather than from the perspective of what level of investment/acquisition price will the business support today with its current and projected profit and cash flow and still give the investor/buyer a fair return on his investment.

The successful sale of a business requires a carefully planned approach in which each step is done right. While owners are experts at successfully running their own organization, few are equipped to navigate this complex process and, therefore, they are at a distinct disadvantage. The use of professional advisors who can provide the expertise, support and representation required to sell a business for the best price and terms will typically more than pay for itself.

If you know of a business owner who's thinking of selling or buying a business and who might benefit from a free, confidential, consultation with us, have them contact me at mikeertel@legacyadvisorsgroup.com

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Frequently Asked Questions…

Q: My wife and I run a business together, how must we file our taxes?

A: If only one spouse owns the business and the other works as an employee, then you may file as a sole proprietorship under Schedule C on your Form 1040. If the both of you materially participate in the company and you divide income according to ownership status, then a Form 1065, Partnership Return would be appropriate.

Q: How do you determine whether a worker is an employee or independent contractor?

A: Primarily, you look to the control that you have over the employee. If you generally control the worker and methods the worker uses to perform their task, they tend to be classified as an employee. If the worker has a fair degree of autonomy on the job, autonomy with finances, and less relationship with the principal, generally these workers can be classified as general contractors.

Q: Recently, because of the recession and real estate market, I decided to sell a rental property at a loss. What form must I file to show a loss on the sale of a rental property?

A: The loss on the sale of a rental property is reported on Form 4797.