Legacy ADVISORS GROUP

M & A UPDATE®

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Recasting Financial Statements

Bart A. Basi, CPA/Attorney at Law
The Center for Financial, Legal & Tax Planning, Inc.

Introduction

The rule for large, publically held companies is clear. If you are going to list your stock on a stock exchange, your company must present financial statements that are created in compliance with Generally Accepted Accounting Principles (GAAP). These statements are presented to the public and banks to get investors to invest or obtain loans. If your company is a small, privately held company, there is no such rule. All a closely held company is required to do is to prepare tax returns on an annual basis.

The Issue with Tax Returns

The problem with most tax returns is that they are prepared in accordance with the Internal Revenue Code. The goal of these documents is simple, reduce tax liability within the letter of the law. As a consequence, the data presented to the government contains numbers that are formulated to show as low of a profit as possible. Obtaining credit or finding a buyer for your business becomes impossible to achieve when you are using documents prepared with the specific purpose of reducing tax liability.

Recasting the Income Statement

The income figures from the tax return will accurately represent revenue from all sources. However, the expenses taken make the tax return unsuitable for presentation elsewhere. Items such as depreciation, discretionary spending, owner's perks and pensions lower the net profit figures, sometimes past zero on tax returns. Presenting a bank with a financial statement showing a small or no profit is simply unacceptable when applying for credit or a mortgage. Banks will lend a borrower money with adverse information only in limited situations.

The benefit of recasting the income in this scenario is that the recasted income statement will show a better representation of the business, more than likely with more favorable numbers for the borrower. In order to recast financial statements, the following items should be adjusted to reflect reality: owner salaries, nonrecurring expenses and income, investments and nonoperating

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A CASE STUDY

The Tax Court has partially upheld the discounts applied in the valuation of two closely held companies for estate tax purposes. In the case, when the decedent died she held a 43% interest and 23% interest in two closely held corporations. The estate tax return claimed a 68% discount for the decedent's interest in one company and a 65% discount for the other. However, the IRS found that these discounts should have been closer to 30% and 23%. The Court disagreed with the IRS, holding that the materials submitted by the estate supported the previously claimed discounts. Overall, the Court found that the IRS's expert did not take into consideration appreciation in some assets and the fact that the decedent had a smaller ownership interest in one company, providing less control. But the Court did conclude that the estate discount for lack of marketability was too high. Therefore, the Court upheld the majority of the discount applied by the estate, resulting in a savings in estate tax.

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expenses, interest payments, depreciation expense, rent expense, discretionary expenses, and pensions. The result will be a more accurate and reliable presentation of income that a bank or buyers can use to gauge the activity of the business and that an owner can use to make better business decisions.

Recasting the Balance Sheet

The figures presented on the balance sheet attached to the tax return are so inaccurate that only the government finds them useful. Everyone else, business buyers and banks included, need more accurate numbers to work with and make decisions. The balance sheet computed per the tax rules is simply not accurate. Assets such as buildings and equipment are depreciated tax rules. However, in reality, this may not be the case. Another problem with the balance sheet is that inventory expressed on the tax return usually never reflects reality. The reason for this is because most private companies do not make the effort of maintaining accurate inventory numbers.

To accurately adjust the balance sheet, the company recasting would adjust real estate and other assets, obsolete inventory, accounts receivable, loans to the owners, equipment not on the books, and goodwill as well. The recasted statement will give a bank or investor a better idea as to what is actually owned and owed by the company and what its true market value is.

Conclusion

Privately held business owners are in a unique spot in the financial world. As business owners, they are not employees, so their income is not readily determinable by information from a W-2. Unlike those who own publically traded stocks in companies such as General Electric, Coca-Cola, and Wal-Mart, privately held businesses do not have a ready market and their value to the owner cannot be assessed quickly. While privately held business owners may be credit worthy or their businesses may be attractive to them, showing it is simply not possible without professionally prepared documents such as recasted statements or a valuation prepared by experts to make decisions with the statements. If you have any questions about recasting or would like to have your business valued for any purpose, be sure to give the professionals at The Center a call.

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: The value given to a business can have a great impact on the amount of estate tax that is assessed. In this case, the estate value was dependent on the valuation of the decedent's interest in more than one company, making the overall value of the estate more difficult to determine.

It is important when determining values such as these that an expert with adequate experience in valuation be used in order to save the taxpayer as much money as possible. In this case, the Court found the estate's expert to be more accurate than the IRS's expert.

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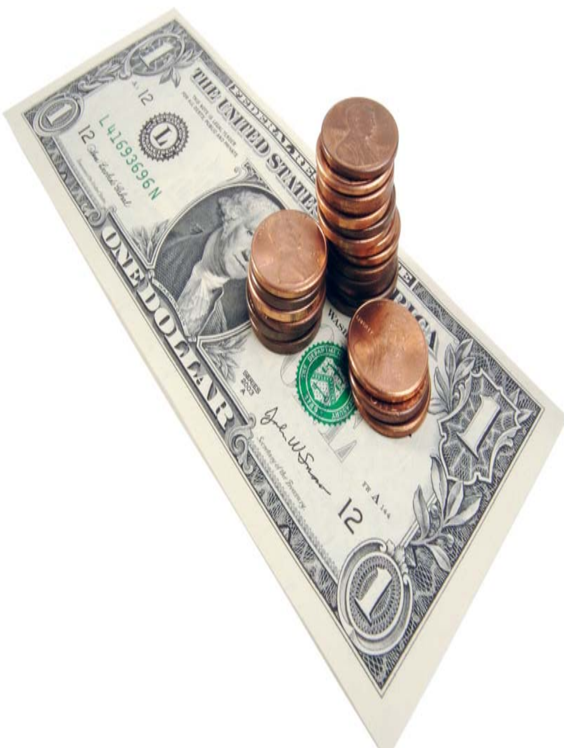
Points of Interest

- **Obtaining credit or finding a buyer for your business becomes impossible to achieve when you are using documents prepared with the specific purpose of reducing tax liability.**
- **Banks will lend a borrower money with adverse information only in limited situations.**
- **The recasted statement will give a bank or investor a better idea as to what is actually owned and owed by the company and what its true market value is.**



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VALUE DRIVERS TO MAXIMIZE THE SELLING PRICE OF YOUR BUSINESS – PART 1

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

This is the first in a series of articles outlining the steps any business owner can take to maximize the value of his/her business when it comes time to sell it.

1. Optimize Cash Flow

It probably comes as no surprise that the primary driver in determining the value of any ongoing business is its provable cash flow. Cash is the lifeblood of any business and the more successful a business has been at generating cash, the more valuable it will be to any buyer. Cash flow can be increased by (a) Increasing Sales, (b) Decreasing Costs, or (c) a combination of both.

Also, a savvy buyer will almost always ask a prospective seller, what his/her ideas are on how to continue growing the cash flow of his/her business. You will want to consider your answer to this question very carefully. A business without any growth prospects is not worth as much as one that has immediate growth opportunities. On the other hand, if the opportunities are that obvious, and that immediate, a savvy buyer will want to know why you haven't pursued these opportunities already.

2. Separate and Optimize Real Estate

If you lease the commercial real estate your business operates from, this might be a good time to re-negotiate a lower lease rate in exchange for a longer lease term. Also, consider negotiating several short options to renew your lease so that the total term equals or exceeds ten years. Most commercial lenders will cap the buyer's loan term at ten years, or the maximum remaining term of the lease. Having ten years to pay it off makes the monthly payment that much more affordable for the buyer.

If you own the real estate inside your business, this would be a good time to separate the real estate into a separate entity still owned by you, and have the business pay fair market rent to the new entity. Since the current selling price multiple for $100,000 of business cash flow is ~3-5x, the multiple for the same amount of net operating income from real estate is ~10-12 times. Thus, while this will lower the business' cash flow, and the business' selling price, it will substantially raise the combined value.

Separating the real estate and offering the business for sale with the option of either renting or acquiring the real estate will also substantially increase the pool of buyers who might be interested in your business.

To be continued…

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 ***mertel@legacyadvisorsgroup.com***

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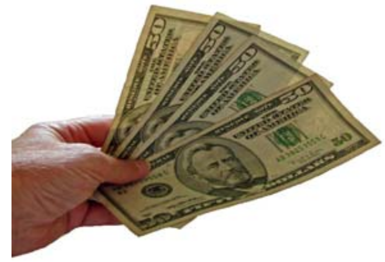

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Frequently Asked Questions…

Q: I am the owner of an S Corporation. If in any given year I do not take any money out of the company, will I have to pay taxes on the income from the business?

A: S Corporations are what is known as "flow through entities". If an S Corporation turns a profit, that profit flows through to the owner(s) of the company. Regardless of what distributions or cash the owner takes from the company, the shareholder will see income from the profit of the company.

Q: What is the latest news with the estate tax?

A: The latest consensus is that the estate tax exemption will remain at $3.5 million. For 2010, the exemption will be unlimited, but in 2011, it appears as though it will be $3.5 million.

Q: Because the country is in an economic downturn, does that affect the value of my business and are there any advantages to this?

A: Generally a down economy will lower a company's value. While a company's value may go down during a recession, annual gift exemption amounts and the estate tax exemption remain the same. Transferring or selling a business to a family member during a rough economic spell actually allows more stock to be transferred without running the risk of tax being assessed.

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