Legacy M&A Advisors LLC

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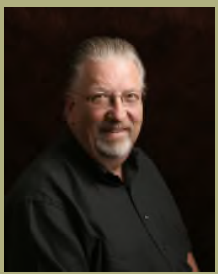

Mike Ertel is a Certified M & A Advisor and a Principal Broker with Legacy M&A Advisors, LLC, a full-service M & A Advisory firm with an office in Tampa, Florida specializing in representing sellers and buyers of small- to mid-sized companies. Prior to joining Legacy M&A Advisors, LLC, Mike's business 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.

Giving the Bank Better Numbers: Recasting Financial Statements

Roman A. Basi, MBA/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 expenses, interest payments, depreciation expense, rent expense, discretionary expenses, and pensions.

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A CASE STUDY

Domestic Production Activities Deduction

The IRS Chief Counsel determined that mobile billboards qualify for Code Section 199 Production Activity Deduction.

In this determination, the taxpayer submitted a fact pattern based on two sets of facts. The first set of facts were billboards that are permanently affixed to the ground as one would view along a roadside or interstate. The other set of billboards were manufactured to be set on trucks and driven around to advertise throughout an area.

The IRS determined that permanent billboards do not qualify for the Domestic Manufacturing Deduction. The mobile boards on the other hand, are movable objects combining two or more materials and concepts together to get one advertising item. Therefore in a determination letter, the Chief Counsel acquiesced and stated that mobile billboards do qualify for the Deduction.

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Cover Story

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

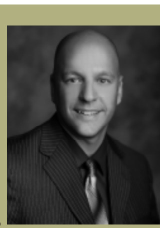
The figures presented on the balance sheet attached to the tax return are so inaccurate that only the government finds them useful. Everyone else, business buyers and banks included, need more accurate numbers to work with and make decisions. The balance sheet computed per the tax rules is simply not accurate. Assets such as buildings and equipment are depreciated per the 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 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.

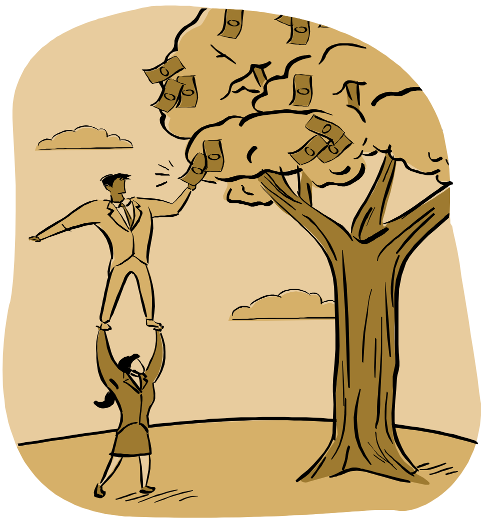


About the author:

Roman A. Basi, President of The Center, is an Attorney, Real Estate Broker, and Title Insurance Agent. Roman speaks and advises The Center's clientele on such matters as Business Law, Succession, Estate & Tax Planning and Real Estate.

Points of Interest

- **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).**
- **The problem with most tax returns is that they are prepared in accordance with the Internal Revenue Code.**
- **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**



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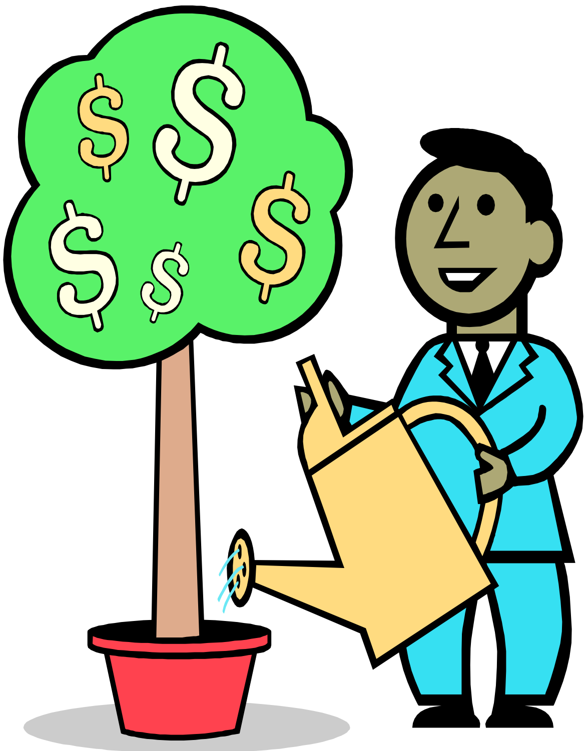
A CASE STUDY CONTINUED:

Editor's Comments:

This is important because it illustrated the broadness of the deduction and what the IRS and Congress intended on allowing the law to apply. A plain reading of the text and regulations imply a wide cast net, but maybe not this wide. Kudos to the IRS for issuing this determination for the manufacturing companies.



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Understanding the Due Diligence Process

It's estimated that only about 80% of all Letters of Intent ultimately result in a closing, usually because the transaction didn't survive the due diligence process. At the same time, it's safe to say that no aspect of the business acquisition /sale process is more mysterious, or more poorly understood by business sellers than due diligence.

So what is involved in due diligence, and how can business sellers be better prepared for it?

It's important to understand due diligence from the buyer's perspective and keep in mind that it's not personal, it's strictly business. Before investing a comparatively large sum of money, any buyer will seek assurances that they are getting exactly what they expect, and there won't be any surprises. In a typical, lower middle market, M&A transaction due diligence will have several phases and may take from 1 – 3 months, and possibly longer. The buyer will engage other professionals to assist with due diligence, including, attorneys, accountants, consultants, and service providers.

Business Due Diligence – The buyer will want to verify the sustainability of your revenue and cash flow, as well as understand the potential for future growth. What products & services does your company offer? Who are your competitors? Why do your customers buy from you? Will they continue to buy under new ownership? Are there customer concentration issues? What is your relationship with your vendors? Are there vendor concentration issues?

Accounting Due Diligence – The buyer will want to verify the accuracy of your revenue and cash flow reporting, and it's consistency with generally accepted accounting principles (GAAP). Sometimes this is referred to as a Quality of Earnings Analysis. Expect the buyer's accountants to require documentation of any and all add backs, and verify recent tax returns.

Legal Due Diligence – The buyer's attorneys will review all material contracts and purchase orders with customers and vendors; all leases and employment agreements; city, county and state business licenses and annual report filing; the corporate record book for being complete and up-to-date; any current or pending lawsuits; and perform background checks on key personnel.

IT Due Diligence – Depending somewhat upon the industry, the size of the company, and the importance of Information Technology in its operations, the buyer may engage consultants and/or service providers to assess the soundness of the company's IT, and identify any vulnerabilities, and any near-term fixes or investments that may be required

Environmental Due Diligence – Depending somewhat on the nature of the business, the buyer and the investors may require an Environmental Phase I Assessment to determine any environmental liabilities.

Insurance Due Diligence – Again depending somewhat on the nature of the business, the buyer may engage a risk management consultant to determine if the company is adequately insured.

Clearly the due diligence process imposes a huge burden on the seller and the management team who are already burdened with running the company, but there is no way around it. The best way to prepare is to: (1) Anticipate all the documents that will be requested, and begin assembling those in advance, (2) Involve all of the right people on your team, and (3) Keep your eye on the prize to achieve the best possible outcome.

If you, or someone you know, may be thinking about buying or selling a business, and who might benefit from a free, confidential, consultation with us, please contact me directly at 813.299.7862, or mertel@lmaallc.com

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Frequently Asked Questions…

Q: I am interested in giving my employees some kind of employee ownership. What do you recommend?

A: While I cannot recommend or give out legal advice via newsletter, one item of interest would be an employee stock ownership plan or an ESOP. In an ESOP, the owner of the company can carefully craft ownership limits and details for their employees. Once the employee resigns, employee is compensated for their shares and the shares can then again be resold to another.

Q: Once again we face the peril of capital gains tax rates and the estate tax burdens rising. What is a good game plan to follow?

A: From a tax perspective, if one is thinking about selling their business, 2015 or 2016 is a good time to do it because of the low capital gains rates. My opinion is that the estate tax will not be much of a factor either as the exemptions will be increased from time to time.

Q: I am thinking about making purchases of large equipment, how much may I deduct immediately under Section 179 in the year 2015?

A: The Section 179 deduction, in 2015 is $25,000. No news has been announced of pushed in Congress to raise the limit for this year.