Seven Keys to Unlocking the Door to Your Dreams

Exit Strategies for Business Owners

by Robert C. Gellman, CPA

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ROBERT C. GELLMAN, CPA

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ISBN 0-9785617-0-8

I would like to thank those who helped with the content and publication of this book. I want to especially thank Doug Hubert, Managing Director of the CBIZ Mergers & Acquisitions Group, for providing the content for Appendix B.

Foreword

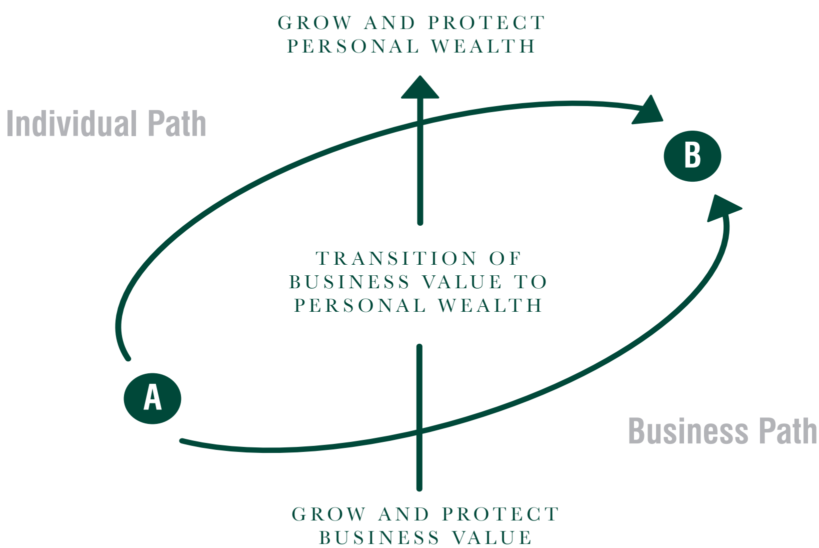
In our daily lives we are confronted with putting out fires, creating opportunities and meeting commitments. It seems everyone is very busy taking care of business. But to what end?

It is healthy to remind ourselves where we are going (our Point B off in the distance), and then be proactive in guiding our businesses and our lives in that direction (getting from Point A to Point B).

This book sets out a process business owners can follow to develop a clear vision of their business and personal goals and to then establish specific objectives that will ensure the attainment of those goals.

This process has been refined over the years, and to be sure, is tailored for each individual situation. An overview of the process is presented in Appendix A.

It is the author's goal to help the reader understand how they can grow and protect the value of their business, transition that value into personal wealth, and to then grow and protect that wealth for this and future generations. This goal is illustrated in the diagram below.



What is Your Point B?

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"When we dream alone, it is only a dream. When we dream together, it is no longer a dream, but the beginning of reality."

A BRAZILIAN PROVERB

Planning Your Exit Strategy:

Seven Keys to Unlocking the Door to Your Dreams

BY ROBERT C. GELLMAN, CPA

Steve, a San Diego business owner, had done fairly well building up his office supply business. But after 15 years of slugging it out to gain market share, he was ready for a change. Even though it was unclear what his next phase of life would be or if he could afford his new lifestyle after he sold the business, he began to plan the transition toward a new life. That was five years ago.

Today, Steve and his wife Joanne are sailing around their new home in the San Juan Islands filled with youthful energy and vitality.

How did he do it? He wasn't the owner of a high-flying IPO. Steve and Joanne merely had a dream of spending endless days sailing lazily around the San Juans. They didn't really know how they were going to accomplish that. More frustratingly, Steve really didn't have the time or the skill set necessary to determine what this dream would cost, or how he would get enough from the sale of his business to realize the dream.

If the challenges Steve overcame challenge you as well, consider these seven keys to unlocking the door to your dreams.

Seven Keys to a Successful Exit Strategy

1. **Begin with the End in Mind.**
   The need to incorporate your exit strategy in your business decisions begins when you acquire your business interest and ends when you transition out of it.

2. **Get Personal**.
   Begin planning your exit strategy with a clear written definition of your personal financial and non-financial goals.

3. **Know How Your Business is Valued**.
   Understand how your business interest will be valued when you sell it. From this process, you will gain an understanding of the variables over which you have control.

4. **Understand Who You Cannot Afford to Sell Your Business To.**
   Your ability to transfer your business to family members and/or employees is constrained by the value range obtainable under each alternative.

5. **Run Your Business with the Goal of Leaving It in Mind.**
   Value management can be used to guide your business towards its value target within your desired timeframe. Leadership, incentive systems and reliable reporting systems help create the framework necessary for your business to run itself.

6. **Protect the Value You Have Created**.
   Protect the value of your business through risk management and tax minimization strategies.

7. **Don't Go It Alone.**
   Exit planning requires the participation of multiple business advisors. Appoint one of these advisors as your personal project manager to ensure your personal plan stays on track.

“A well-devised strategy will provide planning flexibility with the greatest upside potential.”

The First Key: Begin with the End in Mind

The need to incorporate your exit strategy into your business decisions begins when you acquire your business interest and ends when you transition out of it.

Exit strategy planning involves a continuous process that begins with the inception of your business and ends with your transition out of the business.

The need to plan your exit strategy begins very early in the life of your business. In a business' formative stage, exit strategy planning involves choosing the type of entity within which to conduct the business. Your choice of entity (sole proprietorship, limited liability company "LLC", C corporation, etc.) will impact your ability to distribute operating profits, the after-tax value you will receive on the sale of your business interest and the relative ease by which you will ultimately transfer your business to others.

It is unlikely you will know with certainty what your end game will be early on in the planning process. ***A well-devised strategy will provide planning flexibility with the greatest upside potential.*** Flow through entities, such as LLCs, are the entity of choice for the creation of many businesses due to the flexibility they add to the planning process.

The investment you make in your accounting system will impact your exit strategy. Companies with strong accounting systems safeguarding their assets and providing timely, reliable and relevant information are worth more than companies that don't have proper systems in place. A strong accounting system has reliable internal controls, technology, staff, insight-provoking internal reports and a year-end audit to test reliability.

Regarding the myriad of other operational issues required in growing a business, your business will require a business plan designed to achieve growth objectives that are in alignment with your exit strategy.

Of course, cash flow is the life-blood of every business. But, as you grow your business, there will be the constant yearning to draw more and more cash out of the business. The decision to retain earnings in the business or distribute them may have an impact on your exit strategy. It is very important to allow sufficient operating capital in your business for growth. Forecasting your business's operating cash flow needs and capital budget requirements will allow you to better understand your business' ability to make distributions.

If you determine that your business has adequate operating capital and can make cash distributions, consider establishing investments outside your business. Investing outside your business prior to its sale allows you to diversify and protect your assets, develop an alternative source of liquid financial resources, develop your understanding of the stock market, develop relationships with investment advisors, property managers, etc., and to develop your longer-term investment strategy (i.e., your balance of investment in real estate, the stock market, or other investments).

Thinking ahead can pay very big dividends. Most business owners struggle to establish and grow their business, then upon achieving a certain level of success, they turn to their advisors and ask, "What now?" From an estate planning perspective, this approach can be costly. Under current tax law, about 50% of your estate could ultimately be subject to tax. The larger your estate grows, the more tax you will pay. However, for those who look ahead, it is possible to freeze the growing value of their estate and/or minimize the impact of future estate taxes. Early development and implementation of estate tax minimization strategies allows greater planning flexibility at a lower cost.

Selecting and utilizing your team of advisors will be critical to your ultimate success. While the advisors you use in the early years of your business may differ, the advisors you will want to work with as your business matures are those experienced at enhancing and protecting the value of your business as well as those who will work together to develop and execute your transition strategy.

“ Because your estimate of future expenses will drive your definition of financial freedom and ultimately the value you will need to derive from the sale of your business, you will want to give it due consideration.”

The Second Key:
Get Personal

Begin planning your exit strategy with a clear written definition of your personal financial and non-financial goals.

Having a clear exit strategy will allow you to focus on building your business toward specific, personal goals. Knowing how much you will need to fund your preferred lifestyle, when you will need it, and how you prefer to transfer your business will add clarity to your business plan and operating strategy.

While developing your exit strategy, it is important to understand what you will need to have, in terms of economic resources, to be able to live without the business and its potential for eternal cash flow. The value you MUST have to live without the business drives the value you MUST obtain when you transition out of your business. WHEN that value must be obtained depends on your personal desires and is a key variable in the planning process. Being specific about how much your business must be worth and when you plan to transition out of your business adds clarity to your exit strategy and directs your business plan toward targeted growth objectives.

For many business owners, the amount they MUST have to be able to live without their business is an amount that will provide them with ***financial freedom*** for the rest of their lives. A common definition of financial freedom is the economic resources required to allow us to do those things we want to do, when we want to do them (i.e., enough to fund your desired lifestyle and provide for others as you desire).

To determine what you will need to realize your financial freedom, you must anticipate your future lifestyle expenditures (in today's dollars), inflation rates, taxes, and your sources of income. ***Because your estimate of future expenses will drive your definition of financial freedom and ultimately the value you will need to derive from the sale of your business, you will want to give it due consideration.*** Consider your day-to-day living expenses, expenses currently born by the company, the cost of future big ticket items such as boats, cars, weddings, charitable contributions, the cost of health care and perhaps an amount for unforeseen expenditures.

Your financial freedom will also depend on your future sources of income. Once your business has been sold, your sources of income will depend largely on the investments you decide to make and the rate of return you can anticipate from these investments. For planning purposes, it may be best to assume a conservative rate of return. In reality, you will want to begin learning about investing to understand how best to develop the quantity and quality of your future sources of income.

To assess what financial freedom means to you in dollars and cents, consider working with a financial advisor who is trained to help you through the thought process and has the experience necessary to customize your plan. Care should be taken to choose the right financial advisor. Fee-based financial advisors, experienced at working with business owners with your size business, should be sought. Financial advisors experienced at exit strategy planning would be the preferred choice. Expect to invest $5,000 to $10,000 or more for a plan that integrates the income tax ramifications of a sale of your business interest as well as reflects what would happen in worst-case scenarios. Plans that include both a tailored tax analysis of the sale of your business interest and an assessment of other financial planning considerations, such as the structure of your estate plan, can get quite involved. Financial advisors with CPA or legal backgrounds are best suited for this sort of analysis.

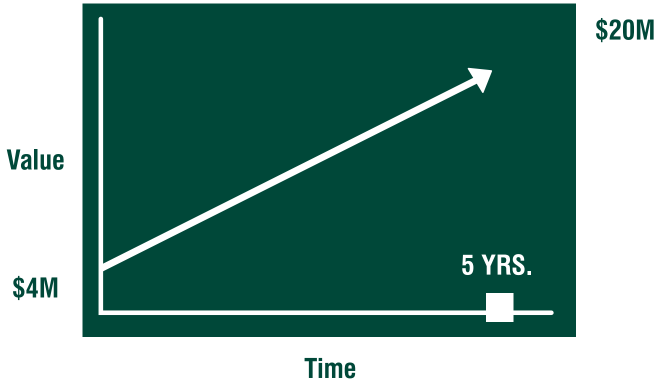
Once you understand the value your business must attain to provide for your financial freedom, the next question to ask is WHEN this value must be attained.

The most common answer we hear in response to this question is "three to five years". No matter if it is three, five or twenty years, the typical answer primarily stems from non-financial considerations versus an assessment of how long it will take the business to attain the value necessary for your financial freedom. If you are fortunate enough to operate a business that has attained its target value, your "when" can more easily be based on non-financial considerations.

To add clarity to your time frame decision, consider the value of your business today and the growth rate required to reach its target value. To help envision this discussion, let's consider what Steve had to go through to plan his exit. Assume that when he began to plan his transition out of the business, Steve had a net worth of $3 million. This $3 million is the approximate after-tax value of his business value of $4 million (assuming a 25% effective capital gains tax rate for simplicity). Assume further, that to achieve his dream of buying an all teak sailing yacht and a home on the water in the San Juan Islands in five years, he would need a net worth of $15 million, or a $20 million pre-tax business value.

This is represented graphically in Exhibit 1.

Business Value



Earnings Forecast

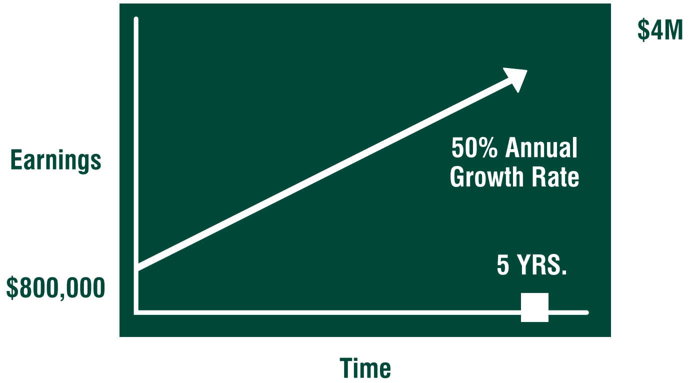


Exhibit 1

To go from a $4 million value to $20 million in five years, the business would have to grow at an annual rate of 50%!

Now reality begins to set in. If Steve felt that a 50% sustainable growth rate was a little steep, he could consider reducing his need to achieve a 50% annual growth. He could look carefully at all the factors under consideration. Within his financial plan, he could consider reducing his future lifestyle expectations, planned expense outlays, and inflation assumptions; or he could consider how to increase his business' after-tax sale proceeds. Steve could also consider how to increase his post-sale investment returns by taking on additional investment risk and/or evaluating alternative investments.

If you are not inclined to lower your targeted financial objectives, you will need to consider how to get the highest and best value for your business (after-tax) while you develop growth strategies to integrate value management into your business plan.

“ Business owners within your industry, industry associations, merger and acquisition specialists and business valuation consultants who specialize in your industry may provide insight into appropriate valuation formulas.”

The Third Key: Know How Your Business is Valued

Understand how your business interest will be valued when you sell it. From this process, you will gain an understanding of the variables over which you have control.

Comprehensive business valuations by qualified valuation professionals will give you an approximation of the current value of your business. Business valuations are generally based on discounted future cash flows. As presented in the Fifth Key, certain buyers use these valuations as the basis for their buying decision. But what if the discounted cash flow buyer will not provide the necessary valuation for your business within your given time frame?

To obtain the most for your business, you may want to consider other potential buyers such as strategic buyers. Strategic buyers will pay a premium for your business if they believe the combination of your business with theirs will allow the combined businesses to achieve more than either business by itself.

A strategic buyer's determination of how much it will pay for your business may be quite complicated. However, for planning purposes, the price to be paid is often summarized as a formula. Identifying whether a formula approach can be used for your business and which approach best fits your business will enable you to integrate the formula into your business plan.

To determine which formula approach to use, it may be useful to ask sources within your industry about the approach they use. ***Business owners within your industry, industry associations, merger and acquisition specialists and business valuation consultants who specialize in your industry may provide insight into appropriate valuation formulas.***

One such formula for service firms is to take a percentage or a multiple of sales (i.e., one or two times sales).

For non-service businesses, another formula approach commonly uses multiples of your business's normalized EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization). For example, you may hear "five times EBITDA "or a "five multiple of EBITDA" as the means of indicating that a business is generally worth five times its EBITDA. Since two identical businesses with completely different debt structures should be valued differently, the net cash one would receive for the sale of his or her business is less the interest bearing debt (bank and finance company-related loans) included on the balance sheet.

The term normalized refers to what your business's income and expense levels would be without items that are unusual either to the period being referenced or to the operation of the business. Unusual period costs, for example, would be expenses related to a fire. Unusual operating costs may be items such as discretionary bonuses to the owner. Costs not incurred such as foregone, but necessary repairs, may require that they be deducted in determining normalized EBITDA.

You may find it worthwhile to test the results of a particular formula approach by obtaining a comprehensive business valuation. Additionally, the value of your business in an actual deal will likely differ from the valuation model. Transactional considerations, such as your willingness to accept stock, an installment note, or a variable payout based on performance, will impact the ultimate selling price of the business. Anticipating these options will help you incorporate their impact into your valuation model.

It is critical to obtain a realistic assessment of value as owners often overvalue their businesses and walk away from opportunities to sell their business for a fair market price.

To see how a formula approach can begin to integrate into your business plan, let's go back to our example. Assume Steve used a five valuation multiple for his valuation formula and that there were no normalizing adjustments required to restate his EBITDA and no bank debt. If the business's value was $4 million when he began planning his exit, then his EBITDA would have been $800,000 ($800,000 x 5 = $4 million). Steve's target value of $20 million would require that he grow his EBITDA from its initial level of $800,000 to $ 4 million ($4 million x 5 = $20 million).

This is represented graphically in Exhibit 2.

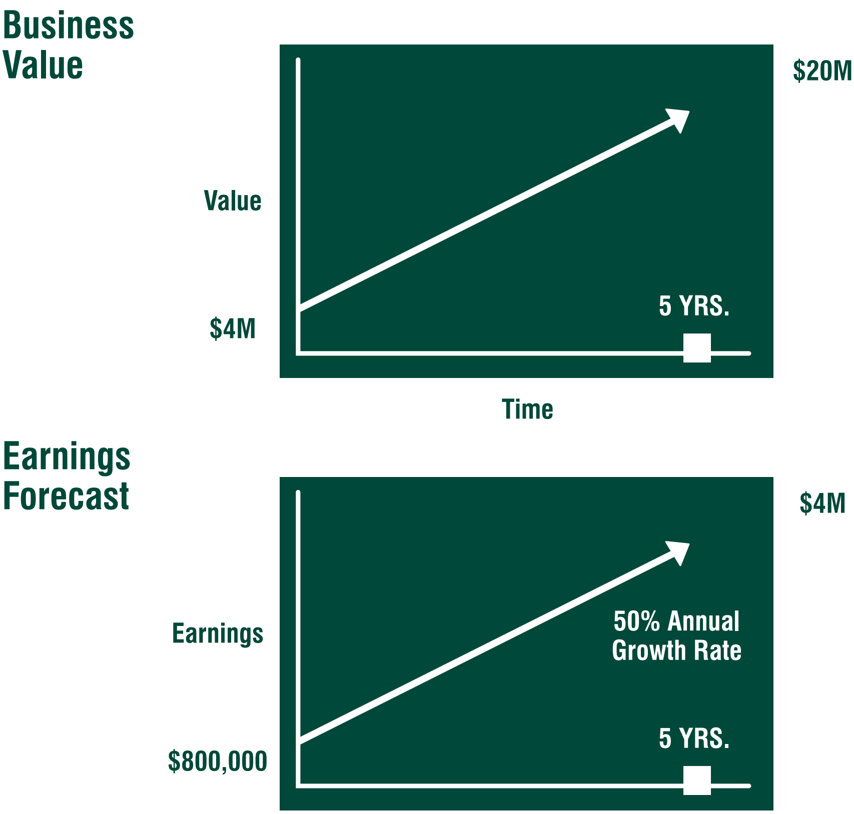


Exhibit 2

Once Steve's personal net worth target has been restated in terms of targeted earnings objectives for his business, he can better align his business plan with his exit strategy.

"Knowing who you cannot afford to sell your business to can have a dramatic impact on your exit strategy/succession plan, and likewise, your business plan."

The Fourth Key: Understand Who You Cannot Afford To Sell Your Business To

Your ability to transfer your business to family members and/or employees is constrained by the value range obtainable under each alternative.

Once you know the value your business must attain within a given time frame, you are better able to plan your exit strategy and avoid conflicting objectives.

Planning your exit strategy should involve the assessment of your transfer options/preferences, their relative merits and pitfalls, and the methods by which you will accomplish the transfer. Typical options/preferences include transfers to family members, employees, management, partners, private equity investors, strategic buyers (related businesses), and going public. An owner's preferences tend to be born out of non-financial concerns.

Considering your transfer options and the manner of transfer is important because each choice will impact the value that can be obtained for your business, the tax ramifications of the transfer and the timing of your receipt of the sale proceeds. Table 1 outlines various transfer options and the manner in which they typically occur.

Table 1

Seller Transfer Options and Methods
Transfer Options & Methods

Family	Employees	Management	Partners	Private Equity Investors	Strategic Buyers	Going Public
Gift	ESOPs	Management Buy Outs/Ins	Buy/Sell	Negotiated	Consolidations	IPO
Self Canceling Installment Notes	Stock Options	Carve Out Acquisitions	Russian Roulette	One-step Private Auctions	Roll Up	Direct Public Offerings
Annuities	Stock Appreciation Rights	Phantom Stock	Dutch Auction	Two-step Private Auctions	Buy and Build	Reverse Merger
Grantor Retained Annuity Trusts			Right of First Refusal		Recapitalizations	
Family Limited Partnerships						
Defective Grantor Trusts						

Table 2 outlines the various methods commonly used to establish the transfer value and where the value ranges typically fall. For example, an inter-family business transfer will typically be valued using a discounted cash flow valuation in line with rules and regulations established by the IRS. On the other hand, the value at which a business transfers to a partner may be established by a pre-set formula (i.e., net book value) within the partners' buy/sell agreement.

Table 2
Transfer Option Value Range

Transfer Option	Value Established by	Value Range
Family	Seller w/in IRS guidelines (Valuation)	Low
Employees	Valuation	Middle-Low
Management	Seller/Valuation	Middle
Partners	Agreement /Valuation	Middle
Private Equity Investors	Valuation/Negotiation	Middle-High
Strategic Buyers	Market Value/Negotiation	High
Going Public	Market Value	High

Depending on your specific circumstances, some methods of sale may not be available to you. On the other hand, some methods may be an obvious choice.

If you have done your homework and understand the value range you require, you can assess the viability of your desired method by understanding the value you would receive from it.

In our example, for Steve to be able to obtain a sufficiently high valuation multiple for his business, he will need to attract a strategic buyer. So, Steve will want to begin planning for a sale to a strategic buyer and de-emphasize other options, such as family or employee business succession.

In sum, knowing who you cannot afford to sell your business to can have a dramatic impact on your exit strategy/succession plan, and likewise, your business plan.

" While it is not easy, it is usually best if entrepreneur-run companies transition into management-run companies."

The Fifth Key: Run Your Business with the Goal of Leaving It in Mind

Value management can be used to guide your business towards its value target within your desired timeframe. Leadership, incentive systems and reliable reporting systems help create the framework necessary for your business to run itself.

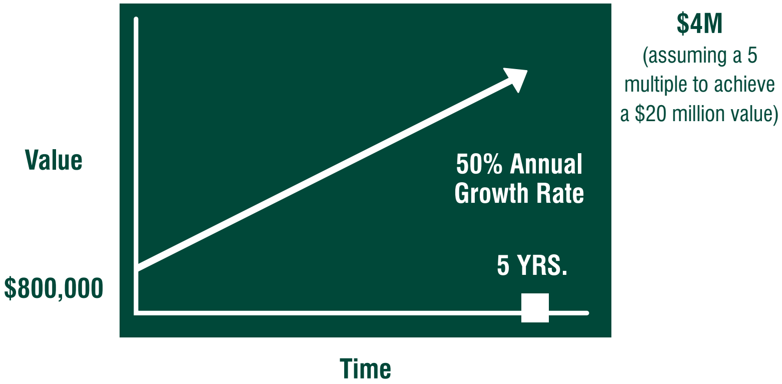
If you were to leave your business for a year, would the business be worth more than when you left? Consider the following tools that can help make that dream a reality.

Value Management. ***The integration of cash flow and capital budget forecasts with your value target will link your business and personal planning efforts. This integration makes clear whether your business operations will result in the achievement of your value target. Used as a compass, it can help keep your business on course toward its target value.***

Planning to close the gap between your required value and the value of your business today will allow you to begin aligning the attainment of your dreams with how you run your business on a day-to-day basis. If the gap can be closed with a reasonable amount of time and the current business strategy, that's great news. If not, you may want to consider developing a strategic plan to address your growth concerns. Strategic and business planning efforts will be enhanced with the knowledge of where the business needs to end up and when.

In addition to operational performance, your business plan should address how you will increase the valuation multiple your business can realize on sale (whether it is used as a multiple times EBITDA or sales). Referring to our example, if Steve could increase his valuation multiple from five to seven, he could sell the business at a higher value (i.e., $4 million x 7 = $28 million vs. $20 million), retire in four years versus five (i.e., he would reach his target value of $20 million faster), or he could lower his required annual growth rate from 50% to 39%. Exhibit 3 illustrates the difference in required growth rate where multiples of five and seven are assumed. Assuming that Steve had some concerns about being able to sustain a 50% annual growth rate, focusing on how he could increase his business's valuation multiple could be the key to Steve's growth strategy.

Earnings Forecast



Earnings Forecast

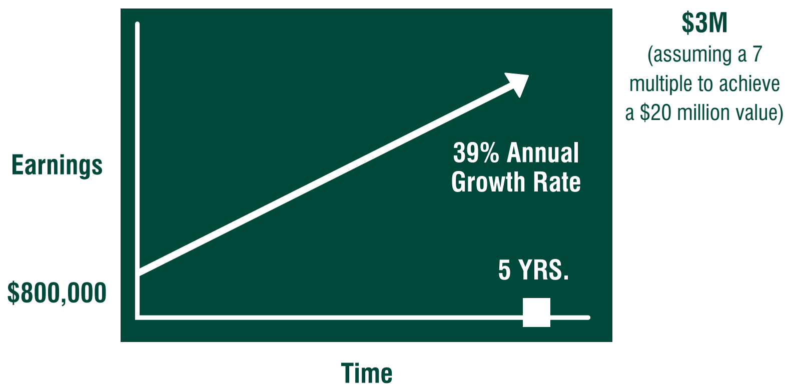


EXHIBIT 3

Achieving Higher Valuation Multiples. ***Probably the single most important factor in a business' ability to achieve a higher valuation multiple is the owners' use of a disciplined approach to the sale.*** There is definitely a right way and a wrong way to sell a business. The highest values are often obtained when a team of professionals work together through a pre-set process to ready the business for sale, market the company, develop a bidding environment for the company, manage the due diligence and negotiation processes and close the deal. For owners considering an exit strategy involving a strategic buyer, it is never too soon to begin this process. **Appendix B**, The Deal Process, provides an overview of the process used to market a business for sale.

Beyond the sale strategy itself, one of the key reasons a business will achieve a favorable valuation multiple is that it will be able to demonstrate a strong earnings history (based on reliable historical information) and a bright outlook for increased earnings (based on achievable earnings forecasts, market opportunities and the buyer's ability to leverage your company's merits with its own). Internal controls, prior year audited financial statements and a well researched and documented strategic marketing plan can pay dividends in support of the business' financial representations.

Timing can play a critical role as well. Selling a company when the market conditions are right can mean an extra push toward a higher valuation multiple. For example, in favorable times, large public companies will pay a premium for businesses that fit their acquisition model. Conversely, down years for the company, its industry or the economy as a whole can mean the loss of valuation multiples. Timing is also a factor with respect to the business' growth cycle. Referring to Exhibit 4, when a company is in a start-up mode, the A range, it is rarely in a position to have an immediate positive economic impact to the acquirer. When a company is near the peak of its growth cycle, the C range, forecasted growth is moderate or flat, then declining. Companies with limited growth opportunities are typically not sought after by strategic buyers. Within the B range, the company has positioned itself for substantial growth, which makes it an attractive target for a strategic buyer. At this point, the company will have its greatest chance to realize a strong valuation multiple.

Business Cycle

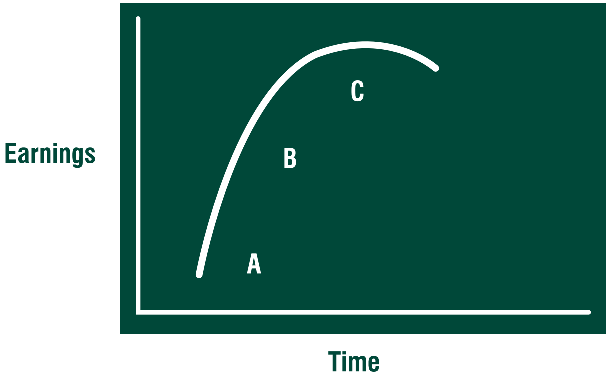


Exhibit 4

To further understand why a buyer would pay a higher multiple for your business, try considering why a buyer would pay a higher price for your business versus your competitor's. Consider reasons such as commanding market share, superior brand recognition, more efficient processes, patents, copyrights, key personnel, geographic location, and so on. During this thought process, it may be helpful to bear in mind that a buyer for your company may be a competitor, supplier, customer, companies in other markets who may want to enter your market, etc.

If you are serious about selling your company in the next two to three years, your advisory team should include an investment banker or other merger and acquisition specialist who can help identify strategies to maximize your business' value.

Goal Alignment. Value management tools can provide the feedback necessary to communicate whether performance merits reward or realignment.

Compensation based on value targets is often used to align the goals of employees with the goals of ownership. However, certain compensation strategies can create complications. The following offer some insight into the issues involved.

Current cash bonuses based on the achievement of value gains provide immediate rewards and are paid out of operating income. There is no lingering liability to pay future bonuses, but there is also no direct financial incentive for employees to stay with the company.

Deferred cash bonuses can be used to provide incentives for employees to remain with the company until sold. Deferred bonuses free up current cash flow in lieu of a future liability to pay the bonuses. However, if the communicated bonus plan defers the payout until the sale of the company, there may be unforeseen consequences. Employees will have a vested interest in the business' sale. They will have expectations and legal entitlements that will be problematic if the sale is delayed or derailed. Of course, there is also the risk that the sale may become public knowledge. A deferred compensation plan measured by value gains, but paid out at an individual's retirement, could be a viable alternative.

The offering of stock either directly or via options can have implications similar to deferred bonuses, but also provides additional complications such as its impact on S corporation elections, income tax payments, buy/sell agreements, voting rights, etc.

The use of an Employee Stock Ownership Plan, or ESOP, is a common value management tool used by a growing number of companies. In that an ESOP credits employees' retirement accounts with stock, employees become vested in the value growth of the company. There are various pros and cons of ESOPs which should be evaluated. Due to their attractive merits, it is worthwhile to consider ESOPs as a goal alignment tool.

In practice, the merits of each compensation strategy are balanced with the circumstances of the company. A combination of these strategies may be utilized to stratify compensation between the rank and file and different levels of management.

A Business that Runs Itself. As a general rule, buyers will pay more for a company that runs itself. Your business is worth more and can provide you with the opportunity for balance in your life if it has properly incentivized employees and reliable information systems.

While it is not easy, it is usually best if entrepreneur-run companies transition into management-run companies. This means that time and attention must be spent on hiring, training and retaining employees with leadership potential, then providing an environment for them to grow.

This also means ownership must be able to rely on streamlined internal reporting that captures relevant, accurate and timely information to monitor the business' progress toward its goals. A goal with some merit would be for you to be able to monitor your business from anywhere in the world with one page of critical statistics. Such a document has been termed a business "scorecard" or "dashboard". This information would be relevant, timely and reliable. You would also feel secure in the knowledge that your management team is actively engaged in day-to-day operations focused on driving the value of the company.

A solid multi-disciplinary CPA firm can play a very important role in the development and testing of systems as well as the production of relevant management reports. It can also aid in the development of compensation systems to ensure the alignment of management's goals with those of ownership.

“ If your corporate controller hires the CPA firm and has all of the interaction with them, including the determination of their level of review of the company’s internal systems, have you accomplished the level of asset protection you require? ”

The Sixth Key: Protect the Value You Have Created

Protect the value of your business through risk management and tax minimization strategies.

Develop a risk management strategy. ***To protect your business, insulate, eliminate or insure against risks while you plan to minimize your exposure to them.***

Insulating risk can be accomplished, for example, via contracts and patents, and by developing asset protection strategies in the nature of entity choice, structure and positioning. Distributing cash or other assets from your business could help insulate those assets from risks inherent in your business. Opportunities to insulate risk and minimize tax may exist and should be reviewed. Discussing options and opportunities with your business attorney and CPA can provide valuable insight.

Eliminating risk might be, for example, choosing not to begin operations in Iraq.

Insuring against risk can best be done by utilizing an insurance specialist who understands business risks and can help you identify and insure against them. Not every commercial insurance provider has the experience required to identify your business risks and develop the best means of insuring against them. Take advantage of offers to have your policy reviewed by those who come well recommended by your other advisors. Consider working with an insurance provider capable of addressing your business and personal risks.

Minimizing risk, for example, would be putting teeth into the consequences your employees would face for the breakdown of critical policies and procedures. In today's environment, a qualified human resource specialist on staff, supported by a good labor law attorney, can be your best insurance against malicious employee lawsuits.

While it is common business practice to review your insurance coverage on your policy's anniversary date, you must be more proactive in taking action to otherwise insulate or eliminate risk. One recommendation would be to perform an overall business and personal risk assessment at the same time your insurance policies are up for renewal. A risk management discussion involving your business attorney, CPA and insurance advisor would incorporate varying views of your risk exposure and how to manage it.

Establish Appropriate Controls and Internal Reviews. As the owner of your business, you need to rely on your internal information reporting systems. You may already hire good people, acquire and implement good systems and even have an outside CPA firm review your financial statements on an annual basis. But have you gone far enough to ensure that your systems are being adequately reviewed to keep management honest?

Consider this. Who did you have hire the CPA firm? Who do you have your CPA report to? Do you have focused discussions with your CPA advisor on his or her assessment of your internal reporting systems? ***If your corporate controller hires the CPA firm and has all of the interaction with them, including the determination of their level of review of the company's internal systems, have you accomplished the level of asset protection you require?***

To best validate your internal information systems, your CPA firm should be hired by and report to the Board of Directors, or similar body, of your organization. The CPA firm should confirm the reliability of your internal information systems directly back to the board.

Think through and document a contingency plan. A seldom-utilized means of protecting the business is a leadership contingency plan. It is recommended that you put down in writing what should happen if you are no longer able to lead your business due to death or disability. Who will lead? What will be their incentive package? Who will sign the checks? Should the business be sold? How will value be sustained until the sale?

An important element of the business contingency plan is also an important element in managing a closely held business. Consider establishing a Board of Advisors consisting of your attorney, your CPA, your commercial insurance advisor, your banker, an investment banker, and whoever else may be a good source of advice. This board is not your formal Board of Directors. In most closely held businesses, the Board of Directors may be only the owner(s) and perhaps their spouse(s). Key members of management may or may not be invited to board (advisor/director) meetings depending on the agenda. A Board of Advisors can be very helpful in assessing operating strategy when you are around, but if something were to happen to you, they can also be very helpful in assuring that your contingency plan will be implemented. For example, if you have Board of Advisors meetings periodically and invite key stakeholders (such as your spouse) to these meetings, everyone will know each other and the roles they will play should something happen to you.

Develop a long-term tax minimization strategy. For almost all business owners, the business is the main source of their financial wellbeing and personal wealth. It is the golden goose that must be fed and cared for. It is this overriding economic concern that must not be compromised by conflicting strategies and tactics. In that cash flow is the life-blood of any business, we must understand the business' need for cash now and in the future and integrate those needs into overall strategy development.

Tax planning should be integrated into the business' need for cash, primarily, and its need to reduce the overall tax burden, secondarily. The following suggests a prioritization of the uses of the business' cash to meet the economic objectives of the business and its owner while minimizing taxes along the way.

Within the business:

- Pay yourself adequate compensation to fund a reasonable lifestyle
- Fund current expenses – consider strategic expenditures that will drive growth
- Fund asset acquisitions
- Fund insurance, accounting, legal and personnel expenditures that will safeguard business assets and protect the business' value
- Fund employee benefits to provide current and long term personal and employee financial needs (401(k), profit sharing, medical, disability, life insurance, etc.), lower your tax liability, and build employee goodwill
- Pay your taxes (personal and business)
- Fund for future reserve requirements
- Distribute cash not anticipated to be required by the business

Most business expenses incurred provide for the economic growth of the business and are either immediately deductible or depreciable. Non-deductible expenses still have economic value. Expenses such as meals and entertainment expenses typically provide a corporate and/or personal economic benefit, are paid for by the company, and build goodwill.

Employee benefits offer the opportunity to invest, acquire insurance and make certain personal expenditures on a pre-tax basis for the benefit of the owner and the employees. Deductible and non-deductible plans should be carefully evaluated for the benefits they can provide in building the value of the company and the wealth of the owner.

Outside the business:

- Payoff non-deductible interest loans and lines of credit
- Fund targeted investments to diversify and grow your wealth
- Fund discretionary expenses

Investments outside the business secure the owner's economic future. These investments are typically made with after-tax dollars, but can be placed in investments that produce tax-free or tax-deferred income. The following is a suggested prioritization of investment choices.

If your company is currently renting its facilities, consider personally acquiring a building and renting it to your business. Buying a home for your business follows the same sort of logic as buying versus renting your own home. However, as an investment, a building allows for the use of debt to increase the value of your investment, it can be depreciated producing deductions to offset business and non-business income, investment gains can be deferred indefinitely, and amounts spent for tenant improvements add to the value of your property and not someone else's. Additionally, an investment in commercial real estate allows you the experience of buying, owning and leasing commercial property, which can provide you with the confidence to invest in other commercial property in the future.

Beyond a building for your business (which can be thought of as an investment you actively manage), you will also be faced with hard choices about how to otherwise invest your money in passive investments (ones you do not actively manage) and who to trust for advice on passive investments. This is a real concern. You have likely spent a lot of time understanding how to best run your business, but very little time understanding how to be an investor. Like most things, understanding how to be an investor and/or who to trust takes time. That is why it is best to begin investing at some level while you still own your business. Practicing how to invest with smaller sums of money will allow you to make mistakes and learn from them at relatively low levels of investment. These learning opportunities will come in handy when you are faced with investing the proceeds from the sale of your business.

A core part of most investment portfolios is the stock and bond securities portfolio. To allow for a certain amount of liquidity and the ability to diversify your investment risk it is advisable to have some portion of your overall portfolio invested in a securities portfolio. Care should be taken to choose how one's investments will be managed. Building a securities portfolio prior to the sale of your business will give you the opportunity to learn about investing in securities and to build a relationship with an investment advisor.

Other investment choices that challenge the investor include direct investment in all types of real estate, indirect investment in a myriad of businesses through limited partnerships or private equity funds, hedge funds, or similar investments. The key to investing in this class of investments is the extent and quality of the due diligence you perform on the investment opportunity and, if applicable, the investment's promoter prior to investing. With these investments, asset protection begins with you. Be prepared, do your homework and have patience.

The prioritized use of a business' most precious resource, cash, is critical to the building of business value and the personal wealth of the business owner. To provide clarity and commitment, a plan for the use of that cash should be thought through, then committed to in writing and shared with those who can help keep the plan on track.

Estate planning. Looking forward with an eye toward minimizing your potential estate tax exposure can be a critical element in the development of your long-term tax minimization strategy.

Because the payment of current year taxes is a recurring problem, current tax reduction typically gets the most attention. But, beware. The current year earnings growth of your company, even with a moderate valuation multiple, could have a dramatic impact on the value of your taxable estate. For example, if your income grows from $1 million to $1.5 million in a year, you may be focused on reducing the $200,000 in income tax due on the extra income. However, assuming a 5 multiple, your taxable estate may have also increased $2.5 million. That translates into an increase in your potential estate tax of $1.2 million, or six times what you will owe in income tax.

Avoid the penny-wise allure of current year tax reduction at the pound-foolish cost of your longer-term estate tax exposure. Or better yet, look to accomplish reductions in both.

" Establish relationships with advisors who will work with you through the steps mentioned in this book."

The Seventh Key: Don't Go It Alone

Exit planning requires the participation of multiple business advisors. Appoint one of these advisors as your personal project manager to ensure your personal plan stays on track.

Consider the cost of postponing your dreams and the reasons why they could get postponed. Perhaps the cost is a few more years of developing your business. But what if during those years, the business environment changes? What if those few years open the door for an economic recession, the entry into your market place of a Wal Mart or Home Depot-type competitor, or your own death or disability? It is conceivable that the attainment of your dreams could be put in severe jeopardy or lost forever.

If postponing your dreams is not an option, you MUST assure that they become reality. Establish relationships with advisors who will work with you through the steps mentioned in this article. Utilize periodic meetings to review the status of action items.

Consider choosing one member of your advisory team who can partner with you to assure that your plan stays on track. This personal CFO or project manager should not be from within your business and should not be conflicted with short-term profit objectives. Fee-for-service CPAs and attorneys, who have the skill set to plan and help manage change, should be considered for this role.

Steve's Path. A recap of the process Steve followed to develop and implement his plan is located in **Appendix A**, Outline of an Exit Strategy. While your situation will represent different facts and circumstances, the process remains relatively constant. Determine where you need to end up, what the gaps are in your plan, and assure that those gaps get closed. Remember, it is not so much the plan, as it is the implementation of the plan, that will ultimately make the difference.

Play to Win.

Understand what winning means to you and those business outcomes necessary to ensure victory. Build a winning team both inside and outside your business. Clearly communicate your intentions and work with your team to build and execute your strategy.

YOUR BUSINESS IS A VESSEL THAT CAN SAIL YOU TO YOUR DREAMS, BUT ONLY IF YOU KNOW YOUR DESTINATION AND CHART A COURSE TO GET THERE.

Appendix A

1. Initiate Personal Goal Assessment

a. Locate and Retain a Planner Experienced in Personal and Business Plan Development and Integration

b. Assess Family Vision and Mission

c. Assess Current Net Worth

d. Assess Future Anticipated Cash Inflows and Outflows

e. Assess:

i. The minimum value required from the sale of your business including an anticipated timeframe for your exit from the business

1. Confirm your valuation methodology and the model you will use for value management

2. Plot your value today vs. your anticipated exit date and value

3. Plot your earnings level today vs. your required exit date earnings level

4. Consider implications of the required growth rate on your personal goals

5. Determine who you can and cannot sell the business to

6. Evaluate the income and estate tax efficiency of your current entity structure and how that can be modified to minimize tax over the long-term

ii. What would happen if you became disabled or died tomorrow

iii. The potential future value of your estate if everything goes as planned

f. Develop:

i. A current valuation estimate for your business

ii.Personal asset protection strategies and Income protection for your family in the case of death or disability

iii. An estate plan to minimize your future estate tax exposure and provide for the management of your estate's assets when you are no longer able to do so

1. Who will be your Trustee(s)/Guardian(s)?

2. What role will your Trustee play in voting the stock/ ownership rights of your company and interacting with the Board/management?

3. What role will your Trustee play in the management of your investment assets?

a. Consider additional contingencies and prepare letters of instruction

iv. A plan to meet or exceed your future investment income objectives *g. Prepare:*

i. An Action Items list (Keep it Simple)

1. Item Description
2. Person Responsible
3. Due Date

h. Meet on a Pre-Scheduled Basis with your Personal Action Items Project Manager to Ensure Steady Progress Toward your Goals

2. Integrate Personal and Business Goals

a. Develop your Business Contingency Plans

i. Ownership succession vs. plan for sale

1. Buy/Sell agreements

    a. Will Buy/Sell Insurance be required?

2. Board action

    a. Who will participate on the Board?

    b. Who will lead the company?

    c. Will Key Man Insurance help the transition?

3. What if you become disabled?

    a. Is this provided for in your Buy/Sell agreement?

    b. Without Key Man or Buy/Sell insurance, how will you fund anticipated cash flow needs?

ii. Management succession

1. Who will lead the company?
2. What will their compensation package look like?
3. Who will sign the checks?
4. If the business will be sold, how will key persons be retained through the sale?
5. Are you indispensable to critical business relationships?

iii. Implement the plan now

1. Board of Directors

   a. Include your spouse, anticipated trustees and children

      i. Assist them in getting to know the Board, Management and your Trusted Advisors

2. Board of Advisors

   a. Work with your advisors to review your agreements, trusts, and business plans
   b. Review and implement corporate asset protection strategies

3. Management and Information systems

   a. The more they can stand on their own now, the better things will run in your absence

b. Confirm the Accuracy of Your Valuation Model *c. Integrate Value Management into Your Budgeting Process*

i. Assess the gap between your current plan and your required plan

ii. Assess the time frame and required growth rate on your business' planning strategies

iii. Assess how you will be able to close the gap

1. Consider earnings objectives/realities

2. Consider opportunities to increase your business' valuation multiple

    a. Establish relationships with outside advisors experienced at identifying, developing and protecting your business' intangible assets

iv. Assess your future cash flow requirements

1. Will your business require additional funding to meet its growth objectives?

    a. Will funding via debt, equity or outside investment capital be most advantageous?

2. Will excess income from operations be available?

    a. How will that income be employed to maximize the business' earnings potential and/or your investments outside the business?

2. Will excess income from operations be available?

    a. How will that income be employed to maximize the business' earnings potential and/or your investments outside the business?

    b. What will be your income tax minimization strategy?

d. Develop Compensation Systems to Align Management's Goals with Yours

i. Assure that management is held accountable to meet value management objectives

e. Develop Relevant and Reliable Information Systems

i. Track information that directly relates to the value drivers within your company

ii. Assure the timeliness of information being produced by the system

iii. Validate your system through internal control/Sarbanes Oaxley-like reviews and audits

1. Confirm that those who are evaluating the reliability of your system are directly accountable to you

f. Prepare:

i. A personal corporate Action Items list (Keep it Simple)

1. Or combine these items with your personal action items list

ii. This list will be in addition to operations-related lists shared with management. This list will not be shared with management.

iii. Format to include:

1. Item Description
2. Person Responsible
3. Due Date

g. Meet on a Pre-Scheduled Basis with your Personal Action Items Project Manager to Ensure Steady Progress Toward Both your Personal and Corporate Goals

Appendix B

To ensure your business sells for what it is truly worth to a strategic buyer, it is recommended that you work through a specialist experienced in the sale of businesses that are of your business' size and complexity. Experience in selling businesses within your industry may also be an important factor. Businesses with values in excess of $5 million are typically handled by "Mergers & Acquisitions" or M&A specialists. Business brokers typically deal in businesses with a value less than $5 million.

The following is a general description of the typical deal process Doug Hubert, Managing Director of the CBIZ Mergers & Acquisitions Group, follows with his clients.

Specific steps during the deal process:

Phase I: Deal Preparation

- ***Obtain Seller Information Upon Our Execution of a Non-Disclosure Agreement.***
- ***Conduct a Detailed Financial Analysis and Business Review*** of your financial and operating condition (including current and projected performance trends) to identify strengths, weaknesses, and key investment considerations for communication to buyer(s).
- ***Provide a Preliminary Valuation*** to ensure your pricing expectations are within a reasonable range of what can be expected from the marketplace. Conduct a detailed review of all potential add-backs (non-recurring operating expenses) and projections.

- ***Evaluate Estate and Tax Matters*** in conjunction with your CPA/Attorney to determine your ability to pursue an asset vs. stock sale transaction and to determine the relevant tax consequences. Additionally, we will jointly determine if there are any unusual tax considerations that need to be addressed as part of a potential transaction.

- ***Identify Specific Buyer(s) and Marketing Strategy for the Transaction.*** Make recommendations to help increase the value or the likelihood of a completed transaction

(i.e., obtain an audit of the financials from a highly reputable accounting firm, conduct an audit of the health and welfare plan, etc.).

- ***Prepare a Comprehensive Selling Memorandum*** that provides a detailed operating and financial summary of the business with specific attention to highlighting the company's strengths and strategic opportunities while putting any weaknesses in their proper perspective. This is typically a 30-60 page document developed to anticipate every pertinent buyer question and to allow the negotiation to quickly move to a pricing discussion.

- ***Selection of Counsel.*** Often a business owner will not be acquainted with an appropriate attorney for this sort of transaction. Unless such an attorney is already available, we will work with you to select an experienced and sophisticated deal attorney for the transaction. In our experience, we have found that the attorney can often make, or break, a deal. So, the selection of the right attorney is paramount.

- ***Prepare a Buyer Confidentiality Agreement*** (in conjunction with your legal counsel) for execution prior to the delivery of any confidential information. In certain cases, the buyer may insist upon using their own format.

- ***Other Preparation.*** Make any other necessary preparations in order to facilitate an orderly and successful transaction.

Phase II: Marketing

- ***Contact Prospective Purchaser(s)*** through a telephone call or other agreed-upon solicitation method and send approved confidentiality agreement.

- ***Execute Confidentiality Agreements and Send Selling Memorandum*** after your review and authorization.

- ***Answer and Organize Responses to all Initial Buyer Inquiries and Questions.***

- ***Arrange Buyer Visits and Meetings with Management.*** Work with senior management to designate a "deal team" and prepare a thorough management presentation for all prospective purchasers. This presentation will be designed to be complementary to the Selling Memorandum, but will be carefully scripted to allow the company to put its "best foot forward." Work to ensure that all relevant transaction and valuation points are discussed in the meeting.

- ***Request Indications of Interest and/or Letters of Intent (LOI)*** from all qualified purchasers. The goal will be to force a select group of buyers to increase their price as much as possible through competitive pressures from other potential buyers.

Phase III: Decision

- ***Evaluate all Letters of Intent (LOI's) for Pricing and Transaction Structure*** to determine suitability to your transaction and financial goals.

- ***Negotiation with Buyers to Improve Offers.*** This may be one of the most important (and emotional) parts of the process as the offer will likely go through several iterations before a final and acceptable price and structure is obtained. Negotiating tactics and experience play a role here. For example, one must always appear prepared to walk away from a potential deal in order for a buyer to put their best offer on the table. Having a deal representative will help keep emotions and personalities out of the way of structuring the best deal.

- ***Negotiation of Letter of Intent & Significant Conditions.*** Work closely with your CPA and legal counsel to negotiate an LOI that outlines the basic terms that have been agreed to as part of the transaction and to deal with any and all significant conditions that may be demanded by the buyer.

Phase IV: Investigation and Closing Documentation

- ***Assist the Seller in Preparing a Professional and Thorough Response to the Buyer's Due Diligence Questions.*** It is critical to organize and prepare professional responses that, in many cases, should be reviewed by legal counsel and your CPA prior to submission to the buyer.

- ***Coordinate all Due Diligence Meetings and Responses.*** Coordinate all due diligence meetings (mostly held off-site) and organize specific responses to questions.

- ***Allow you to Keep Focused on Business Operations.*** Our job is to handle as much of this process as possible allowing you to focus on running the business. It is critical to ensure no deterioration of financial performance during the final critical phases of the transaction, or in the event that the deal does not close.

- ***Assist in Negotiation of the Purchase Agreement.*** We will work intimately with your legal counsel and CPA to assist in the negotiation of the purchase and sale contract and to help you obtain the best possible legal protections and tax structure for the transaction.

- ***Solve any Issues Arising From Due Diligence and/or Legal Negotiations and Act as a Buffer During the Process.*** It is to your benefit to have third party representation in a transaction. We can take a hard position on your behalf, when necessary, which can always be tactically ÅgoverriddenÅh by you without hurting your negotiating posture or future working relationship with the buyer.

- ***Keep all Parties Focused on Hitting Deadlines and Completing the Transaction.*** It is critical to keep a transaction moving toward completion. Time delays are the giant killers of all transactions. Time extensions are never favorable to the seller. It is imperative that everyone be kept to appointed deadlines. We will be working intimately with both sides to keep the deal moving.

- ***Any and All Other Deal "Issues".*** Every transaction has issues that need to be resolved quickly. We work with your team to address these issues immediately as they arise.

About The Author

Robert C. Gellman, CPA

Bob Gellman has been with CBIZ MHM, LLC since 1988 and a director since 1997. He has served as a director in the Tax Services and Wealth Strategies groups.

Currently, as a Tax and Financial Services director, Bob helps clients develop tax strategies consistent with their financial goals. With an eye toward wealth creation and strategic uses of cash, Bob helps clients develop tax minimization and asset protection strategies that make sense over the long run. Bob's experience with these clients gave him the impetus for the writing of this book.

Bob is a CPA and accredited AICPA Personal Financial Specialist (PFS). He has a Master's Degree in Taxation from San Diego State University, Bachelor's Degrees in Accounting and Finance from the University of Southern California and the Certificate in International Business from the University of San Diego.

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Bob Gellman has created a workshop that brings the 7 Keys to life. In his interactive workshop, Bob guides participants through the 7 Keys introducing new concepts, tools and templates providing both an overview and a quick start to the planning process. Bob's workshop expands on:

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The Third Key: Using a Valuation Multiple Calculator and Business Valuation Models to provide insight into the valuation process

The Fourth Key: Succession vs. Exit Strategy Analysis to aid in the assessment of your exit strategy

The Fifth Key: A multi-year business budget with an integrated valuation model to link your personal vision and business operating strategy

The Sixth Key: Business Risk Management and Business Contingency Planning Checklists to help protect your most valuable asset

The Seventh Key: Templates for the documentation of your planning team, action items and time frames

And more.

Bob's workshop presentation was recently included in the speaker's circuit of Vistage International Inc., "The World's Leading Chief Executive Organization"©.

If you would like to learn more about the workshop, contact Bob at 858-795-2110 or bgellman@cbiz.com.

Notes

Notes

Quotes from Business Owners Bob has helped:

We were very focused on our three-year business plan. But, we were stressed and had no time for ourselves. Bob encouraged us to consider our goals and suggested that our business might already be worth what we would need to retire. Now we have a plan in place to sell our business, travel, and be there for our children and grandchildren.

— TRADE CONTRACTOR

Bob and I have been working on my wealth strategy since 1994. We have planned for and sold the family business. But, that was really just the beginning. Since the sale, we have been working through asset protection strategies, wealth succession, real estate investments – everything down to our management company and health insurance strategy. Bob's been there through it all and continues to add value along the way. He's been great counsel.

— FAMILY PATRIARCH

Because I travel extensively for business, I was concerned about what would happen to my family if something were to happen to me. Bob helped establish a business contingency plan, an advisory board, a life insurance strategy, and wealth succession trusts for my children. If all goes as planned, we won't have a problem. But if not, my family has a team and a plan in place.

— AGRIBUSINESS PROCESSOR

ISBN 0-9785617-0-8

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