

Eight Essential Elements of an Exit Strategy for Business Owners

By Daniel R. Siburg, CPA, CVA and Stephen E. Koons, CPA/ABV/CFF, ASA

All business owners will need to transition their businesses to new owners at some point in time. The new owners could be business partners or family members, and transactions range from management buy-outs to outright sales of the businesses on the open market. Regardless of the circumstances, every business and business owner should have a transition plan implemented before exiting the business. There are steps owners can take right now that will increase the desirability of their businesses. Without a proper exit plan, a business can suffer loss of significant value during any ultimate transfer of ownership. In fact, it's possible to increase the value of a business by developing and implementing an exit strategy.

What's the Business Worth?

An owner can discover the hypothetical value of a business by having a business valuation done by a business valuation expert. To find the real value, the owner would have to actually sell the business.

The valuation can help the owner to determine how much the business might be worth on the market. A business valuation also can help the owner to come up with strategic plans for evaluating offers to sell, determine the equity interests of family members, determining the division of assets in marital dissolution, settling disagreements among co-owners, or setting values for a buy-sell agreement between co-owners.

In performing a valuation, the analyst typically determines the business's fair-market value, which is the amount of cash that would be required for the business to change hands between a hypothetical buyer and hypothetical seller. The cash that could be received from an actual transaction might be different.

After establishing the business's value, an owner must understand a couple of basic things before selling the business: the selling price of similar-sized businesses in the same market and understanding how businesses are being acquired.

Most business sales are asset purchases where the buyer acquires the assets, both tangible and intangible, versus a stock purchase where the owner sells the stock in the business. These two facts are the starting points. From here, a good transition plan can help an owner keep from losing money and actually making some.

1. Understand the Taxes

Sellers should have a good understanding of typical deal structures and their consequences in terms of income tax. The most common deal structure is when a transaction is structured as a sale of assets. The seller generally pays tax on the difference between the purchase price received and the tax basis of the assets sold. A gain may be taxed at ordinary income tax rates to the seller.

Also the type of business structure affects how a transaction may be treated. If the assets of the business are owned by a C-corporation, the taxes will be assessed at the corporation level. If the business is structured as a pass-through entity (S-corporation, partnership, limited-liability company, etc.), gains may be taxed as ordinary income to the seller.

Other types of transfers may be a sale to an Employee Stock Ownership Plan (ESOP) or gifting to family members. An owner should understand how the form of their organization affects value-and-tax consequences. Pass-through entity structures, such as partnerships, Sub-S corporations, and LLCs, may present simpler tax issues compared to C-corporation structures, where an owner needs to be concerned with double taxation issues.

There may be significant tax advantages for an owner of a C-Corp to convert to an S-Corp, which generally pays no income taxes. Rather, the shareholders pay tax proportionate to their share of S-Corp earnings, whether or not those earnings are distributed. A conversion from a C-Corp to an S-Corp can also help a seller reduce income taxes on the sale of assets. The full benefit of a conversion from a C-Corp to an S-Corp can take years to realize, which could make the business less attractive to sell for tax reasons during the Sub-S conversion period.

A review of the business's ownership structure should take place as part of the exit-planning process.

2. Personal Expenses Should Be Personal

Owners should stop paying personal expenses through the business and cease deducting these expenses from the business's tax returns. Continuing to pay personal expenses through the business can raise questions in the minds of a potential buyer as to the credibility of the business owner. Also, all non-working family members should be removed from the company payroll. It is much easier to attract quality buyers when owners have managed the enterprise strictly as a business.

3. Get Everything in Writing

A significant part of the value of most businesses is represented by the value of intangible assets, such as trade names, patents, customer lists and business relationships, franchise and license agreements, and similar property. To the extent that any agreement is based on a handshake, with major customers or vendors, it is appropriate to obtain a written agreement.

It is important to have loan agreements between the owner and the company documented. And it goes without saying, it is best if the owner can show proof of compliance with the loan agreements. When an owner loans money to the company, he can repay himself, tax free, with proceeds from the sale, as long as the loan agreement has been properly documented and abided.

4. Settle Legal Actions

Nothing will lower the value of a company or make it more unlikely to sell than unresolved litigation matters. A potential buyer of a company wants the assets free and clear, with no legal problems after the sale. Most business sales are structured as asset sales. With a stock sale, the buyer acquires the entity in its entirety (not just the assets), including any legal issues. Be prepared for a potential buyer to walk away from a transaction when there is outstanding litigation.

5. Financial Reporting Pays Dividends

Good financial reporting always adds value to a business. Internal reporting that provides accurate financial and operational information helps the current management team and makes it easier for the new owners to keep things running smoothly after the purchase is complete. In addition, the quality of the financial data is a factor that valuation analysts and potential buyers use to evaluate value and risk, and thorough financial reporting instills them with confidence that they have the information they need to properly evaluate the business.

The gold standard for financial reporting is audited financial statements. Audited financial statements add a level of credibility to internally generated financial and operational information that a buyer will request during due diligence.

6. Develop a Strong Transition Team

The development of a strong management team is usually a necessary consideration in the preparation of an exit strategy. Strong management teams help to ensure a smooth transition with some continuity of leadership and talent for a potential buyer.

7. Avoid Over-Reliance on Normalizing Entries

Sellers should avoid over-reliance on normalizing entries, which are commonly used in business valuation and by sellers to adjust the historical financial statements to economic reality. There are several types of normalizing entries: removal of non-recurring income and expenses, removal of owner discretionary and personal expenses, removal of income and expenses on assets that have no relationship to the business operations, changes in accounting principles from one period to the next, changes to conform to generally accepted accounting principles, and adjustments of transactions between the owner and the company to the amount at which an independent third party would transact business.

Potential buyers can understand the need for some types of normalizing entries, but they also realize that such entries may not reflect economic reality. Buyers determine a purchase price based on actual financial information and performance as presented in the seller's tax returns, internal financial statements, and audited financial statements, when available.

For two reasons, it is difficult for a seller to rationalize certain normalizing entries, especially those that show significant amounts of personal expenses. First, personal expenses can be difficult to adequately document. Second, a federal tax return likely includes an income-tax deduction for the items in question. All of this may lead the potential buyer to question the credibility of the seller.

8. Have Written Strategic Planning Documents

Though a potential buyer is generally buying the assets of the business, they are also buying the future earning potential of the assets. Buyers like to see well-established budgets with goals and objectives as to how the company is planning to achieve their future financial and operational results. Buyers want to know that a seller has a well-established road map for the future of the company.

When the owner has a well-defined process for tracking progress, such as budget versus actual income statements, cash-flow forecasts, and ratio analysis related to the company, buyers can quickly gain an understanding of company historical and future performance.

Proper strategic planning helps the management of the company to talk with a potential buyer about the future activities and the earnings potential of the business.

Conclusion

Be prepared and plan your exit strategy. Transition planning is very important to an owner's ability to maximize value when it is time to sell the business. Every business needs an exit strategy, as it is better to preserve and maximize value than to leave it to chance.

Daniel R. Siburg, CPA, CVA, is the managing director of The Siburg Company, LLC, a boutique consulting firm specializing in financial and operational consulting with an emphasis on mergers and acquisitions—www.TheSiburgCompany.com.

Stephen E. Koons, CPA/ABV/CFF, ASA, is director of the Business Valuation & Litigation Support Services Group of Henry & Horne, LLP. He specializes in business valuation and economic damages—stevek@hhcpa.com.