July/August 2006

Viewpoint on Value

Exit gracefully — and prosperously
Cashing out at top dollar

Reconcilable differences
The ins and outs of collaborative divorce

Everything has its limits (including valuations)
Know the parameters or suffer the consequences

PLUS: What is WACC?

John M. Leask II CPA, LLC.

Business Valuation Services

John M. Leask, II (Mac) CPA, CVA

765 Post Road, Fairfield, Connecticut 06824
Phone: 203-255-3805 • Fax: 203-380-1289
E-mail: mac@LeaskBV.com • Web Page: www.LeaskBV.com

Exit gracefully — and prosperously

Cashing out at top dollar

One way or another, every business will eventually sell or transfer hands. A formal plan covering all likely transfer scenarios — whether voluntary or involuntary — is essential to ensure smooth transfer.

Expect the unexpected

A well-planned exit strategy can help owners extract cash from their businesses, addressing a variety of transfer scenarios. These may include voluntary transfers such as retirement, gifts to family members, donations to charities, stock compensation plans for managers, or mergers or acquisitions. They may also include involuntary transfers such as death or disability, divorce, partner/shareholder disputes, bankruptcy or restructuring, or natural disaster.

Overworked owners tend to overlook the possibility of unexpected events. But operating a business without a contingency plan is like driving blindfolded: Things are fine as long as the road is straight and predictable. But when conditions change, the owner often runs into trouble.

GET PROFESSIONAL HELP

Valuation professionals can estimate preliminary business values. This estimate is the cornerstone of any exit strategy. In addition, appraisers can quantify financial needs upon retirement, disability or untimely death. They can also discuss insurance options to fund estate tax obligations or company buyouts.

Valuators also come in handy when weighing exit strategy alternatives. They can appraise assets for gift and estate tax returns, provide insight into buy-sell provisions, evaluate the tax consequences of various exit strategies, consult on mergers and acquisitions, or prepare fairness opinions for high-profile transactions.

Take the first step

The optimal exit strategy depends not only on the transfer scenario, but also on the owner's personal needs and objectives. Exit planning starts with some number crunching and soul searching.

Beyond the numbers, what else does an owner hope to achieve when he or she leaves the company? When prioritizing goals, it's important to be realistic. Many owners dream of having their children run the show after they leave. But in reality, their children may be incapable of managing the company — or uninterested in taking over the reins.

Weigh alternatives

Once goals are set, it's time to evaluate which alternatives meet the owner's short- and long-term needs. Some of the most common exit strategies for private businesses are:

Buy-sell agreements. When several individuals share ownership, a buy-sell agreement can provide liquidity upon retirement or an unexpected "triggering" event. In some cases, the company repurchases the departing owner's shares. In other cases, the remaining shareholders pitch in. Shareholder life and disability insurance policies can help fund company buybacks.

Comprehensive buy-sell agreements cover a broad array of triggering events — from death to imprisonment — and address valuation issues, such as valuation formulas, payment of appraisal fees, applicable valuation discounts and buyout terms.

Gifts and inheritances. For owners seeking to transfer ownership to relatives or a worthy charity, gifting interests in the business fits the bill. Proactive gifting schedules that span several years can dramatically reduce transfer taxes.

For instance, by transferring business interests to a family limited partnership (FLP), an entrepreneur can gift limited partner units to heirs at significant discounts from net asset value. FLPs also permit the donor — as a general partner — to retain control of the business.

Related-party sales. Rather than give away shares of the business, some business owners need cash and opt to sell the business. Numerous sale options exist. For instance, employee stock ownership plans (ESOPs) generate liquidity for the exiting owner while providing employees with a rare investment opportunity. Other potential buyers include suppliers, customers and competitors. They possess not only the requisite industry acumen to run the business, but also unique synergies that may warrant a premium price.

Mergers and acquisitions with unrelated buyers. Informed owners who can adapt to creative sales terms — including installment sales, seller financing and consulting contracts — often receive more than the asking price.

Public offerings. Public stock exchanges offer a means of raising capital and achieving liquidity. Going public also provides prestige and publicity. The downsides — steep registration fees and stringent reporting requirements — preclude small and midsize businesses from considering this option, however.

Clean up shop

Potential buyers will pay a premium for a business in "move-in" condition. Owners who continually position the company for sale maximize proceeds and expedite closing. Thus, preparing a business for sale is a matter of acknowledging weaknesses and emphasizing strengths. Three areas to target during a cleanup include:

1. Administrative chores. Buyers don't want to inherit an owner's problems, including fraud risks. Owners should implement a strong system of internal controls that includes mandatory vacations, as well as job separation and duplication.

To ease transition to new management, owners should formally document job descriptions and update the organizational chart. It's also important to train and retain second-generation managers.

2. Finances. Transparent financial reporting facilitates efficient business transfers. Buyers are often turned off by the need to recast income statements to eliminate aggressive tax deductions, nonrecurring income or personal expenses run through the business. Prepared sellers bring business plans and financial forecasts to the negotiation table.

Most buyers consider nonoperating assets a hassle — especially for C corporations. Before negotiating a sale, an owner should remove extraneous assets, such as idle equipment, vacation homes or investments, from the balance sheet.

3. Performance. Buyers prefer a business that's running efficiently and effectively. Too often, owners become complacent after years of operating the business. To maximize proceeds, an owner should continually pursue growth opportunities and reinvest in equipment, technology, and research and development.

Start today

For most entrepreneurs, their companies represent the bulk of their personal wealth. Unlike pensions or retirement accounts, private business interests take significant time and effort to sell.

Most owners think about retirement and contingency planning, but few put their thoughts down in writing or distribute them through the appropriate channels. In the high-stakes game of exit planning, there's no time like the present. ▮

Reconcilable differences

The ins and outs of collaborative divorce

Traditional divorce proceedings pit husband against wife. But when each spouse plays to win, both sides lose emotionally and financially. Collaborative arrangements seek win-win solutions that minimize expert witness fees and allow creative, customized asset splits.

What is collaborative divorce?

Collaborative law offers divorcing spouses a novel alternative to formal litigation and mediation. Although the fine details vary from one jurisdiction to another, here is a rundown of the basics: Collaborating spouses sign a contract agreeing to amicably settle their divorce out of court. They promise to openly and honestly exchange all relevant financial information and to negotiate in good faith.

In lieu of traditional litigation, the parties conduct a series of "four-way conferences" between husband, wife and their respective attorneys. Between conferences, the parties gather information, calm emotions and evaluate settlement proposals.

Although both sides retain separate attorneys, neither party may seek (or threaten) court action. If they do, the collaborative process stops.

How can a financial expert help?

Another common participant in collaborative divorce conferences is an impartial shared financial expert who helps keep the parties focused on financial — rather than emotional — issues. Typically financial experts are schooled in accounting, tax and/or business valuation.

Possible financial issues that necessitate the use of a financial expert during a collaborative divorce include:

- Alimony and child support payment options,
- Property values, including private business interests,
- Equitable asset and debt allocations,
- Tax issues associated with marital distributions and support payment options, and
- Postdivorce budgets and tax preparation.

Instead of advocating one-sided victories, financial experts in collaborative divorce encourage value-based discussions and settlements that "expand the pie" before divvying it up.

Collaborating spouses rarely expect financial experts to serve as "hired guns." Instead, financial professionals facilitate settlement with creative financial solutions to complex personal and financial issues that incorporate both parties' needs and priorities.

For instance, many monied and non-monied spouses are emotionally tied to their businesses and homes, respectively. In formal litigation, the parties run the risk of court-mandated liquidation of these prized assets. But the collaborative process allows experts to craft creative solutions that meet both sides' needs.

What are the benefits?

Compared to traditional divorce proceedings, collaborative divorces generally settle faster and at a fraction of the cost. In collaborative divorce all legal fees and financial expert expenses are paid from community funds.

Collaborating spouses also save costs by sharing one neutral financial advisor or valuator, rather than hiring separate experts to battle on the stand. Private business owners prefer to use neutral valuators, because it minimizes the time spent educating experts about business operations and prevents adversarial experts from asking employees inappropriate questions that may precipitate unwanted rumors.

In addition to being more cost efficient, collaborative divorce is often more effective. Four-way negotiations promote ongoing communication after the divorce. Such rapport is especially important when the parties co-parent or retain a financial connection related to support payments, college tuition and/or asset distributions paid on an installment basis.

Furthermore, collaborative divorce minimizes many risks inherent in traditional litigation and mediation. For instance, courts and mediators sometimes mandate one-sided settlements, whereas collaborating spouses mutually decide their final outcomes. In turn, the parties are more likely to comply with self-imposed settlement agreements.

What are the downsides?

Despite its numerous benefits, collaborative divorce isn't perfect. Most notably, if a stalemate occurs or either party seeks legal injunction, the process starts over and both attorneys are disqualified from the case. Not only must the spouses find, educate and pay for new counsel, but also they must hire additional financial experts and fund court costs separately.

If the parties end up in court, information shared during collaborative negotiations can come back to haunt them. Typically, collaborating spouses stipulate that all financial documents, correspondence, draft settlement proposals and expert witness reports generated during four-way conferences are inadmissible in future litigation. However, courts have been known to overrule collaborative divorce agreements.

Moreover, the court is peripheral in collaborative divorce. The only court appearance occurs when the parties present their final settlement agreement to the judge. While often a blessing, the lack of court involvement can also be a curse. It usually precludes formal discovery of financial information, which can lead to incomplete or inaccurate disclosure.

> Collaborating spouses save costs by sharing one neutral financial advisor or valuator.

Unless the parties contractually agree to freeze marital assets, collaborating spouses also have no formal means to restrain spending, incremental indebtedness or indiscriminate asset liquidation.

Finally, court dates establish a timetable for traditional divorce proceedings. In collaborative proceedings — without formal deadlines — one party can drag its feet to punish the other emotionally or financially.

What factors affect the collaborative process?

Since its inception in Minnesota in the early 1990s, collaborative divorce has spread nationwide — from Florida to California, Texas to Wisconsin. Even if collaborative law is not officially recognized in your jurisdiction, many of its provisions can still apply if the parties agree.

Despite its growing popularity, collaborative divorce isn't a realistic option for everyone. For example, unequal bargaining power, narcissistic personalities, fraud suspicions and dishonest participants can hinder the collaborative process. Conversely, collaborative divorce is most effective when the participants are open, honest, committed to settlement and willing to compromise.

When entering into a collaborative arrangement, the parties must assemble a multidisciplinary team of experts. Collaborative divorce represents a radical departure from traditional divorce proceedings, so it's imperative to select legal and financial advisors that are trained and experienced in the collaborative process. ▮

Everything has its limits (including valuations)

Know the parameters or suffer the consequences

Valuations differ in scope and intent. There is no such thing as a catchall valuation that suits every purpose, addresses every possible contingency or remains valid indefinitely.

And some valuations have surprising limitations. For instance, a client may request that the appraiser use the income approach exclusively to keep costs at bay or an adversarial owner may prevent the valuator from performing a site visit.

The bottom line is that, to be able to fully understand an appraisal, one must first know its purpose, parameters and limitations.

3 documents

Each valuation has specific parameters that are laid out in three main documents:

1. The engagement letter. These legal contracts narrowly define the assignment. They address elements such as the appraisal's effective date, the name of the business, the size of the business interest, the standard of value, and the purpose and fees.

Engagement letters also restrict report distribution to internal management, the IRS and/or the court (in a litigious setting). Most strictly prohibit clients from sharing reports with undisclosed third parties — especially potential creditors or investors.

2. A statement of contingent and limiting conditions. This is an appendix included in most valuation reports. Although the possibilities are endless, frequent contingent and limiting conditions include the accuracy of financial statements, the exclusion of subsequent events and full compliance with all applicable federal, state and local regulations.

This statement also indicates whether the valuator (or his or her firm) has any present or contemplated interest in the subject company or any other related party.

3. The management representation letter. A valuation is only as reliable and accurate as its underlying assumptions, particularly the information management provides. Upon completion, the valuator usually requires the client to sign a management representation letter, which recaps the assignment's parameters and confirms that there have been no intentional errors or omissions. Appraisers sometimes attach the representation letter as an appendix to their report or file it away in their workpapers.

The case of the recycled report

To illustrate a misuse of an appraisal, consider Sid McFrugal, the owner of a niche chemical manufacturer. McFrugal hired a valuator while settling a dispute with a minority shareholder. The valuator estimated the fair market value of a 5% interest on a minority, nonmarketable basis as of Dec. 31, 1994.

Last year — during subsequent divorce proceedings — Sid committed a major faux pas. He reused the old valuation report without telling the preparer or requesting an update.

Although prior valuations often have relevance in subsequent assignments, McFrugal's old report was off the mark for several reasons. Most obviously, the valuation was outdated. The chemical industry and the subject company had evolved dramatically over the last decade.

McFrugal's 60% interest also possessed elements of control, unlike the minority shareholder bought out

in the 1990s. Finally, the initial valuation didn't address the chemical company's sizable goodwill. In McFrugal's jurisdiction, family courts bifurcate professional and business goodwill to equitably distribute marital assets.

Because of these shortcomings, the court excluded McFrugal's outdated valuation from evidence and, instead, relied exclusively on the opposing expert's report. Although McFrugal saved some up-front costs, his recycled valuation cost him substantially more in the long run.

A critical understanding

Abusing, misunderstanding or just not knowing the limits of an appraisal can lead to misguided business decisions, as Mr. McFrugal learned, and may even cause courts to dismiss a value estimate out of hand.

A valuator should be sure that his or her client understands and agrees to these parameters, and that they're reflected in the proper documents, before beginning the engagement. ▮

WHAT IS WACC?

Weighted average cost of capital (WACC) is an integral part of a private company's value under the income approach. This valuation methodology converts a future income stream into its net present value using a discount rate.

Many valuation assignments call for appraisers to value "invested capital" (or the sum of equity and interest-bearing debt). For instance, an appraiser might prefer invested capital techniques when a company's capital structure deviates from industry practice, when a company plans to undergo an asset sale, or when valuing a controlling interest. In these situations, WACC may be the appropriate discount rate.

A closer look

The formula for WACC is: $WACC = (K_e \times W_e) + (K_d \times [1 - t] \times W_d)$.

Evaluating whether a company's WACC appears reasonable requires familiarity with underlying components:

Cost of equity (K_e). This is the return investors would demand for investing in the subject company based on comparable investment alternatives. Appraisers typically estimate K_e using a build-up method or the capital asset pricing model (CAPM).

Cost of debt (K_d). The pretax rate creditors charge for a company's borrowings is also important. When selecting K_d, appraisers consider the subject company's credit rating, interest rates charged on the company's existing loans and yields on comparable debt instruments in today's marketplace.

Effective tax rate (t). This factors into WACC, because, unlike shareholder dividends, interest expense is tax deductible.

Capital structure (W_d and W_e). The relative percentages of debt (W_d) and equity (W_e) financing depend on several factors, such as the company's existing capital structure, industry leverage benchmarks and whether the assignment calls for a controlling or minority basis of value.

WACC matters

The WACC formula may at first seem intimidating to those outside the appraisal profession. But understanding its underlying components is key to achieving reasonable value conclusions, making informed business decisions and avoiding legal stalemates.

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and, accordingly, assume no liability whatsoever in connection with its use. In addition, any discounts are used for illustrative purposes and do not purport to be specific recommendations. ©2006 VVja06

John M. Leask II (Mac), CPA, CVA, values 25 to 50 businesses annually. Most often, Mac's valuations, oral or written, are compiled in conjunction with the purchase or sale of a business, to assist shareholders prepare buy/sell agreements, or to set values when shareholders purchase the interest of a retiring shareholder. Here are examples:

- **Due Diligence & Assist with Purchase of a Business.** Mac has assisted purchasers of businesses by determining or reviewing the offer. He helps negotiate the price, perform due diligence prior to closing and/or helps structure and secure financing. Services have included, but are not limited to, verifying liabilities and assets, reviewing sales and expense records, identifying critical issues relating to future success, and helping management plan future operations.
- **Family Limited Liability Partnerships, Companies & Closely Held Businesses.** Mac regularly values various sized business interests for estate and gift tax purposes. He provides assistance to estate and trust experts during audits of reports prepared by other valuators.

Mac also helps business owners and their CPAs and/or lawyers in the following ways:

- Planning — prior to selling the business
- Prepare valuation reports in conjunction with filing estate and gift tax returns
- Plan buy/sell agreements and suggest financing arrangements
- Expert witness in divorce & shareholder disputes
- Plan charitable contributions
- Assist during IRS audits involving other valuators' reports
- Succession planning
- Understanding firm operations & improving firm profitability
- Prepare valuation reports in conjunction with pre-nuptial agreements

More information about the firm's valuation services (including case studies) may be found at www. LeaskBV.com.

To schedule an individual consultation or to discuss any other points of interest, Mac may be reached at ***203 - 255 - 3805.*** *The fax is* ***203 - 380 - 1289****, and e-mail is* ***mac@leaskBV.com****.*

John M. Leask II CPA, LLC.
Business Valuation Services

765 Post Road, Fairfield, Connecticut 06824

PRSRT STANDARD
US POSTAGE
PAID
PERMIT NO. 57
FAIRFIELD, CT