Mueller Prost
CPAs + Business Advisors

Advising with Vision®

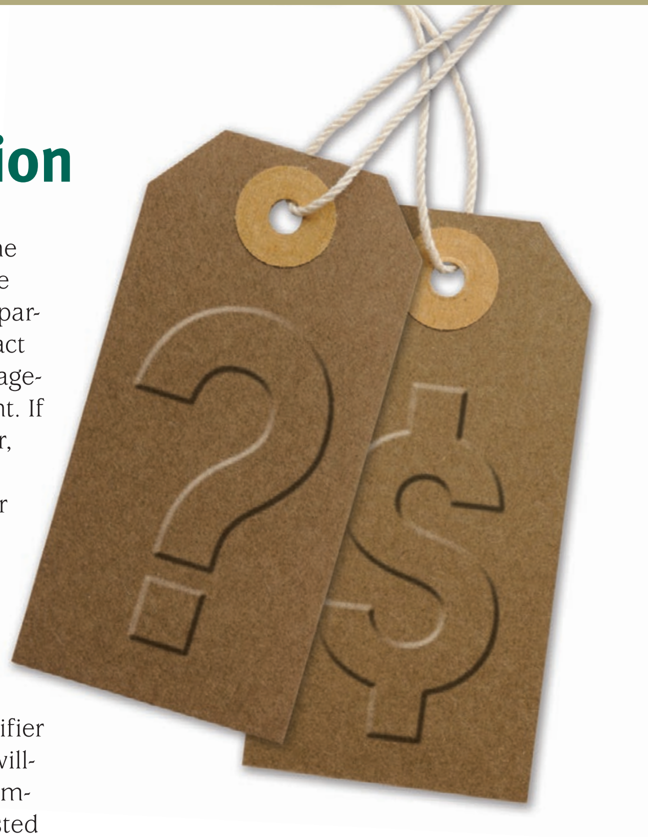
Business Owner's Perspectives

Trends and Strategies for Owners of Closely Held and Family Businesses

Summer 2014

Preparing for Sale

Five Realities of Business Valuation



Often, business owners approach a valuation with a mix of excitement and anxiety. Will the valuation go well? Will the results match expectations?

Before the process starts, though, a reality check may be in order. It's wise to keep in mind these five realities of business valuation:

1. The Value Won't Match the Number in Your Head

It never does. Many entrepreneurs can't help but consider the company their "baby." They have poured their hearts and souls into the business. Because they have such an emotional investment in the outcome, these owners can be disappointed by valuation results that they deem too low.

On the flip side, other owners may be unaware of their company's market position, its unique value drivers or its potential. These owners are pleasantly surprised at their higher-than-expected valuation results.

2. Rules of Thumb Aren't Really Rules

CEOs say the darndest things. "That company sold for 1.5 times sales." "That company sold for five times EBITDA." "Companies in this industry sell for seven or eight times (insert metric here)."

Don't put too much stock into broad statements like these. No two companies are alike, and owners and executives often stretch the truth when it comes to sale price.

Instead, keep an open mind. The valuation process will identify the strengths and weaknesses in your particular business. Many factors impact value, from the depth of your management team to the state of your plant. If your company is an industry leader, you may land ahead of whatever rule of thumb you've heard. If your company is lagging, you will have a lower-than-average valuation.

3. Value Is in the Eyes of the Buyer

You can't ask the question "What's it worth?" without adding the qualifier "to whom?" Different buyers are willing to pay different prices. For example, strategic buyers will be interested in buying a company that has synergies with their existing businesses. Because of this motivation, strategic buyers may be willing to pay more than other types of buyers.

On the other hand, financial buyers (like private equity firms, for example) will be looking for companies they consider to be undervalued but scalable. These buyers are not sentimental — their goal is to make money, so they're looking for a bargain.

4. The Past Is the Past

Valuations are forward looking. As such, they are based on estimated future cash flows, not past performance. So even if your company has had a stellar past few years, that doesn't mean the years ahead will be equally bright.

For example, technology consumers are notoriously fickle. What was popular in terms of computing, personal communication or entertainment two years ago may already be obsolete. Conversely, organic foods and green energy may be even more popular in the future than they are today. A valuation will illuminate such market risks and opportunities.

5. A Valuation Is Worth the Cost

Do you really need a professional business valuation when selling your

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How to Honor Tradition *and* Promote Progress

Family business culture usually involves a certain reverence for the company's founders. The parents, grandparents, aunts and uncles who started the business played a big role in the company's success, and their sacrifices for the business are well known by the next generation.

But sometimes this admiration turns into veneration, which can stymie growth and hinder progress. "That's the way it's always been done," or worse, "That's the way mom and dad did it," can get in the way of innovation.

How can businesses honor their roots while moving forward to meet the evolving needs of today's customers and clients?

Set the Tone

Much of the founders' legacy probably revolves around values — quality, customer service or community involvement, for example. And there's no reason to change these principles.

In fact, as the company moves to the next generation, it's a good idea to reinforce these values in a written values statement. That way, your employees, customers and suppliers know that the company will always honor the standards that launched its success.

Embrace Adaptation

Keeping things fresh is important to job satisfaction and growth. No company survives, let alone thrives, by doing the same thing over and over. New products, new people and new approaches keep a company's products and services current and relevant.

By making adaptation part of the company's operating routine, you create an atmosphere that's open to new ideas. This openness can take many forms, including monthly "lunch and learns" where employees present concepts they're working on, seminar attendance and trade show participation, and periodic job rotation.

As the company moves to the next generation, it's a good idea to reinforce the values of the founders in a written values statement.

Make Tough Decisions

Managing a successful business requires not just working *at* the business, but also working *on* the business. What's not up to par in your company? Does your management team have the skills they need to take your company to the next level? Do you have an unprofitable or difficult customer that's dragging down your operation? Are there locations that aren't thriving, or is there technology that turned out to be a bad investment?

If so, you must address these problems head-on, especially if mom and dad let them go on too long. Making tough decisions can be painful, but it's necessary. Keeping the company profitable should be your top priority.

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Empower People Sooner

Generally, older workers tend to take fewer risks. Once they get to a certain level of comfort in their careers, they can be hesitant to try radically different things. On the other hand, younger people are generally more likely to embrace what's new and different.

As a business owner, it's your job to balance the expertise of your seasoned workers with the curiosity and initiative of younger employees. One way to do this is to empower employees earlier in their careers. Pair younger employees with more experienced mentors and let them make some decisions, and you might be surprised at the progress and innovation that ensues.

Don't let tradition stand in the way of progress. Embrace what brought the company to its current state and honor the essence of the founders' vision. But be deliberate in keeping the company moving forward toward a bright future. ■

Need advice on managing change? We can help you develop a plan for a smooth transition.

Family Employment Policies Set Clear Expectations

Is it possible to be a family *and* a business when it comes to managing people? To some in the human resources world, "family business" is a bit of an oxymoron. Many would say "family" typically trumps "business" in almost every decision — and that's not always good for the enterprise.

One way to ensure that both the family and the business benefit from HR decisions is to create family employment policies. Not only do these policies set expectations for family members, they also take the sting out of difficult decisions because the written policies rule.

Here are some areas to consider as you draft family employment policies for your company:

- **Education** – If your family business is in an industry that requires certain licenses or degrees, your employment policies should specify the type of training or education required. You might also insist that family employees earn degrees and pass licensing or board exams within a certain timeframe.

- **Work experience** – Many businesses require that family members work elsewhere for a period of time before they are allowed to join the family business. This gives young relatives a chance to develop good work habits, see how other companies are run and prove themselves on their merits, not their names.

- **Career path** – How do you want to integrate family members into the business? Some use a training program that rotates family members through different areas so they can get a big-picture look at how the company runs. Others start the kids in entry-level jobs and expect them to work their way up to the management level. Still others assign non-family mentors to help groom young family members for executive positions. There are many options to choose from.

- **Compensation** – This is one of the trickiest aspects of family employment. Most compensation experts advise a simple approach — a market-based salary combined with ownership opportunities when appropriate. Paying family members a market-based salary sends two important messages:

1. It helps family employees realize that their value (or lack thereof) to the company is based on job performance, not on bloodline.

2. It ensures that wages are fair across the board, which goes a long way toward keeping valuable non-family employees content with their compensation.

Other perks — such as club memberships, vacations, the use of company vehicles and family-friendly loan arrangements — should be carefully spelled out. Ownership benefits via dividends and distributions reward relatives for their place in the family, and don't need to be tied to employment.

- **In-laws** – Do they get to work in the business? Do they get ownership shares? What happens in case of divorce? All of these questions should be answered in your family employment policies.

Some companies insist that family employees sign pre-nuptial agreements with their spouses-to-be. Making this a standard requirement tends to alleviate some awkwardness and discomfort, and also lets family members and their intendeds know from a very young age that such an agreement is just part of the deal.

Be sure to update your family employment policies annually and communicate them regularly and consistently to all family members. As you draft them, keep in mind that what you do for one family member will set expectations for all. ■

Considering family employment policies? We can help you think through your choices.

Business Valuation

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business? In almost every case, the answer is "yes." A buyer will want a credible, unbiased, professional valuation before investing in the company. In the case of a divorce or shareholder dispute, you'll need a valuation that can stand up in court. And if it's a tax matter, the IRS will require a professional valuation.

With this in mind, be sure to hire a credentialed, experienced valuation analyst. He or she has studied valuation techniques and principles and has passed national exams to demonstrate a certain level of technical expertise.

If you are concerned about the value of your company, consider the steps you can take to increase value now. Your CPA can help you get your company in the best shape for valuation, as well as talk you through the valuation process. ■

Contact our firm today to learn more about our valuation services.

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How Final ACA Tax Regulations Impact Rental Income

At the end of last year, the IRS issued final regulations under Internal Revenue Code Section 1411 that provide an important change to the treatment of rental income subject to the new Net Investment Income Tax (NIIT) created under the Affordable Care Act.

The NIIT is a 3.8 percent flat tax on unearned income levied on individuals with a modified adjusted gross income (MAGI) in excess of $200,000 ($250,000 for married taxpayers filing jointly, $125,000 for those filing separately). The tax is imposed on the lesser of net investment income or the excess of MAGI over the applicable threshold amount. This tax also applies to estates and trusts in the highest income tax bracket.

Relative to this tax, net investment income includes net rental income, unless it is earned in the ordinary course of a trade or business or considered non-passive. Rental activities are generally considered passive unless the property owner materially participates in the activity to which the property is rented. This non-passive activity is commonly known as "self-charged rent."

For example, rental income earned by business owners who own property outside of their business that they materially participate in and rent back to the business is considered self-charged rent. Prior to the issuance of the final regulations last year, the code and regulations were silent on how self-rental income was to be treated for purposes of the NIIT, causing self-charged rental income to be subject to the tax.

The final regulations, however, provide an important exception for self-charged rental income. As a result, this income is not subject to the NIIT. If you have self-rental arrangements, be sure to discuss them with your CPA to ensure this income meets the requirements for the exception and is not subject to the 3.8 percent tax. ■

Contact our firm to discuss tax-planning opportunities related to the ACA.

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