Key Ingredients to Success for Entrepreneurs

PRESENTED BY

John W. Haag, Sr., CPA/ABV, CVA,CFF
Principal

Thomas R. Gawne, CPA
Senior Manager

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CPAs & BUSINESS CONSULTANTS

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Discussion Topics

- Introductions
- Selection of proper organization formation
- Tips for building a successful operation
- Strategies to deploy maximum valuation results
- Making the most of the new accountant/client relationship
- Next Steps

General Tips

- Use separate business accounts & credit cards for all business activities
- Keep thorough and businesslike books (or enlist a Professional)
- Record business and personal use of assets
- Select form of entity carefully

Types of Entities

- Sole Proprietor
- Limited Liability Company (LLC)
- Partnership
- S Corporation
- C Corporation
- Non-profit

Sole Proprietor

- Basic/simple
- No limits on liability
- *How taxed?* – through individual return, Schedule C
- ***<u>Advantages</u>*** - easy to form and operate, least costly
- ***<u>Disadvantages</u>*** – Unlimited liability, fringe benefit limits, profits subject to self-employment tax

Limited Liability Company

- Limited liability for "members"
- Unlimited number / type of members
- All members may participate in management
- Different classes of ownership available
- Operating agreement needed
- ***Advantages*** – creates liability protections for minimal cost
- ***Disadvantages*** – too simplified for rapid growth strategies

Partnership

- Consists of two or more co-owners
- No limits on liability
- Share in risks/rewards
- Profits/losses flow to individual from a Form 1065, K-1 form
- ***Advantages*** – relatively easy to form, flow through profits/losses
- ***Disadvantages*** – unlimited liability, fringe benefit limits, profits subject to self-employment tax

S Corporation

- Taxed like a partnership – limited liability like a C Corporation
- Gains/losses passed through to shareholders
- ***Advantages*** – double taxation avoided, no self employment tax (if adequate shareholder compensation)
- ***Disadvantages*** – limited flexibility (number/type of shareholders/stock), fringe benefit limitations

C Corporation

- Incorporate under state law, separate tax entity
- Liability for shareholders limited to their investment
- ***Advantages*** – limited liability, unlimited life, ease of transferring interest, no self employment taxes – but . . .
- ***Disadvantages*** – more complex, double taxation, personal service corporation equals a high tax rate

Non-profit

- Must file and gain approval at federal & state level
- Determine and focus on a mission – charitable purpose
- Record keeping change depending on type
- Audit requirement above certain limits
- Does not pay income tax except for non-related business income
- ***<u>Advantages</u>*** – capitalization can be funded by charitable contributions
- ***<u>Disadvantages</u>*** – complex rules and requirements

Key Considerations?

- Business objectives
- Potential tax issues
- Liability issues
- Management setup
- Capitalization
- Exit Strategy

Accounting Method & Revenue Recognition

- Must clearly reflect income consistently from year to year
- Cash method –
  - Record income when constructive receipt occurs
  - Deduct expenses when payment occurs
- Accrual method –
  - Record income when earned not necessarily received
  - Deduct expenses when incurred
- Hybrid method – combination

Deducting Expenses

- ***Ordinary & Necessary*** in carrying on your trade or business
- Substantiation and documentation key - especially in key areas
  - Mileage and travel – logs
  - Meals & entertainment
- Be careful of independent contractor vs employee status
- Capitalizing "start-up" costs

Building the Successful Operation

- Develop a short, mid and long term strategy
- Selection of form organization
- Build your foundation for growth
    - Staffing
    - Systems
    - Marketing

Business Valuations

- Overview of The Valuation Process:
    - Information request
    - Preliminary analysis
    - Market/Industry/Economic research
    - Management on-site interview
    - Prepare draft report
    - Review with client
    - Produce final report

Valuation Approaches

- Approaches to Value
  - Asset-based (cost-based) approach
    - Adjusted Net Asset Method
  - Income-based approach
    - Capitalization of Earnings Method
    - Discounted Cash Flows Method
  - Market-based approach
    - Comparable Transaction Method (Private)
    - Guideline Public Company Method

Valuation Approaches

- Sanity Checks
  - Justification of Purchase
  - Rules of Thumb
  - Prior Sales in Company (if at arm's length)

Key Valuation Considerations

- Standards of Value
    - Fair Market Value
    - Fair Value
    - Strategic/Investment Value

Key Valuation Considerations

- Buy-Sell Agreements
  - Beware of the standard valuation formula
  - Best to stipulate fair market value and let appraiser determine value
  - Consider annual valuations and formal agreement by shareholders
  - Ensure that buy-sell is funded

Strategies to Build Value

- Solid income stream, minimizing normalization adjustments
- Annual compiled, reviewed, or audited financial statements
- Proactively address typical valuation discounts:
  - Key man
  - Concentrated customers, vendors, product lines
  - Unstable earnings
  - Marketability and control discounts
  - Leverage

Strategies to Build Value

- Focus on economies of scale, build a business that can be scaled
  - Hard to sell a job as opposed to an investment
- Identify and maximize the intangibles in your business
  - Customer lists, website, name, proprietary processes, etc…
- Must have good IT and accounting systems with adequate controls

Strategies to Build Value

- Planning for a Potential Sale
  - Should begin five years or more prior to desired sale date
  - Always be ready, keep financials current
  - Maintain a list of potential buyers (and potential sellers) and update this list at least once a year
  - Stay tuned to your industry, listen for rule of thumb data, try to find out what the competition is selling for

Final Thought on Business Value

- Most business owners, when asked, will say that their retirement plan IS the business they own. In other words, all of their retirement eggs are in one basket. When asked the follow up question, 'so how much is your business worth?', they cannot answer the question.
  - If your business is your number one retirement asset, you MUST know what it is worth on at least an annual basis.
  - You also must work with your CPA and financial advisors to diversify this risk. Having all your retirement assets in one basket is very risky. Business owners have a tendency to invest everything back into their business. While this is noble, it does nothing to diversify risk and shows a potential buyer that there is no return on investment.

Making the Most of your Accountant Relationship

- Importance of the trusted business advisor role
- Setting proper clear expectations for service – on both sides
- Clarity of communications – using minimal jargon
- Values a long-term relationship
- Relationship should take a pro-active future vision approach
- Should have a mix of needed tactical as well as strategic insight
- Ability to serve you along your trajectory growth path

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- Full-service CPA firm with **offices throughout Michigan:** Alma, Ann Arbor, Flint, Greater Detroit, Kalamazoo, Lansing, Midland, Saginaw, and Southgate
- Team of more than **200 professionals**
- Ranked among the **Top** Certified Public Accounting and Consulting firms in the region
- **Best Places to Work** – Metro Detroit & West Michigan

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Pure Michigan Business Connect Program Participant

- Developed by the Michigan Economic Development Corporation (MEDC), Pure Michigan Business Connect program connects early-stage and expanding Michigan companies with professionals who will provide legal, accounting and other services at little to no cost.
- In January 2013, Yeo & Yeo committed to provide a grand total of $250,000 in services for start-up or expanding businesses over a five-year period, from 2013-2017.

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Next Steps

- Make wise decisions to lay a solid business enterprise foundation
- Consult with a Professional
- Reach out to Yeo & Yeo for Outstanding Business Solutions!
- Questions?

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CONNECT with Us:

yeoandyeo.com

John W. Haag, CPA/ABV, CVA, CFF, Principal
johhag@yeoandyeo.com
989.631.6060

Thomas R. Gawne, CPA, Senior Manager
thogaw@yeoandyeo.com
734.769.1331

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