Sanli Pastore & Hill, Inc. *The Premier Business Valuation, Financial Analysis & Litigation Consulting Firm*

VALOREM PRINCIPIA

The Principles of Value Volume 9 Issue 2 October 2001

Keeping it in the Family
Keys to Succession Planning

by: Thomas E. Pastore, Chief Executive Officer

After pouring years of blood, sweat and tears into building your business, it would be a shame to lose it, fail to maximize your financial return, or fail to ensure its longevity after you are gone. As we will demonstrate in this article, a little bit of planning can go a long way!

Very successful business owners often overlook the need for succession planning. Whether you decide to retire or you are in the unfortunate situation where you or a business partner become seriously disabled or pass away, a succession plan can help ensure continuity for the business. Succession planning also can save your heirs from paying a hefty estate tax (up to 55%) to the government upon your death.

A solid succession plan addresses legal, managerial, financial and ownership issues. Depending on your goals and objectives, your succession plan may address a gradual transition in management and ownership beginning today, or it simply may define the process to be undertaken in a crisis whereby you no longer could perform your duties.

"Ask yourself if you have the right outside financial advisory team in place that can assist you in protecting your business and estate", recommends Fred Denitz, Regional Vice President of Mellon 1st Business Bank's Century City Office. With seasoned advisors, such as an attorney, commercial banker, CPA, insurance expert and business valuation expert, creating a succession plan is not as daunting a task as many anticipate.

Your succession plan may include a number of components, such as:

- **BUY-SELL AGREEMENT:** If there is more than one shareholder, one of the most important documents you can have is a buy-sell agreement between the shareholders. A buy-sell agreement provides for the continuity of your business if a shareholder is disabled or passes away by structuring for the other shareholder(s) to purchase sufficient shares from you or your estate to operate the business. This can be especially important in a company with two owners, each holding a 50% interest. Without both votes, no decisions can be made. The agreement can include salary and distribution provisions to ensure that even a disabled shareholder is treated fairly. However, as Denitz points out, "It's critical that you have a way to fund this transaction between your partner(s) and your estate".

(Continues on Page 2)

Getting What You Pay For
The Importance of Financial Due Diligence

by: Nevin Sanli and Mary K. Lee-Wlodek

SCENARIO A: Our law firm is considering acquiring another law firm in a market that we have been trying to infiltrate.

SCENARIO B: My client, a sole-practitioner physician, has the opportunity to purchase an interest in a larger medical practice.

Performing financial due diligence for a merger or acquisition involves more than simply reviewing the target's financial statements.

- Do the financial statements reasonably reflect the operations of the business?
- Could there be hidden assets or liabilities that are not represented on the balance sheets?
- Are there discrepancies between the financial statements and tax returns?

SP&H is an expert at financial due diligence. Just as a physician can prescribe the right medication to help you feel better, SP&H can determine whether financial information reasonably reflects the operations of a business in a quick and cost-efficient manner.

For more information on SP&H's Financial Due Diligence services, please contact Nevin Sanli or Mary Lee-Wlodek at (310) 571-3400 in Southern California or Forrest Vickery at (916) 614-0530 in Northern California ◆

INSIDE THIS ISSUE

SANLI PASTORE & HILL

The Measure of Value℠

Los Angeles
San Diego
San Francisco
Sacramento

www.sphvalue.com

- **Life Insurance:** A good way to fund a buy-sell agreement is for the company to purchase life insurance on each shareholder under which the company is the beneficiary. According to Denitz, "The company can use these proceeds to buy back your shares from your estate. This will create treasury stock and thus increase the percentage ownership of the surviving owner(s), ensuring that business-as-usual can continue."

- **Key-Person Insurance:** If you perform valuable services for the company, it may be difficult to continue operating the business in your absence. Key-person insurance, with the company as the beneficiary, can provide funds to retire bank debt, hire a replacement or fund temporary losses.

- **Groom a Successor:** Prepare one or more people in your company to take over your duties in case of your retirement, disability or demise. Grooming your successor(s) is a long-term process, requiring a time commitment on your part. However, this is one of the most important parts of planning for the longevity of your business.

> ***As it is impossible to know when you are going to pass away without the help of a great psychic, you should assume that there will be an estate tax in effect upon your death.***

An important goal of succession planning is to reduce the value of your business ownership interest so that, upon your death, the beneficiary(ies) of your estate will not be burdened by a large estate tax. Although recent legislation gradually phases out the estate tax by the year 2010, the tax will be reinstated in 2011 as it is written, and may be changed prior to 2010 by a new President or Congress.

As it is impossible to know when you are going to pass away without the help of a great psychic, you should assume that there will be an estate tax in effect upon your death. In addition, you should think about diversifying your investments as you approach retirement. Having nearly 100% of your net worth tied up in one company is very risky.

Methods of reducing the value of your estate and/or diversifying your investments while accomplishing the goal of having a solid succession plan for your company include:

- **Establish an Employee Stock Ownership Plan (ESOP):** Selling shares in your company to your employees via an ESOP not only provides diversification of your assets with tax benefits, it can increase employee morale and can provide for management succession. "With an ESOP, you can continue your legacy while liquefying your investment. However, don't forget to establish a funding source to enable the ESOP to purchase your shares", stated Denitz.

- **Gift Shares of the Company:** By gifting minority interest shares of the company to your heirs, you can take advantage of minority and marketability discounts on the valuation of the shares. Hence, you can reduce or eliminate the taxes associated with the gift(s).

- **Attract Fresh Equity:** You may be able to attract equity capital into your business in exchange for a piece of the pie. For growth businesses, equity investors not only can provide a way for you to diversify your net worth, but their deeper pockets and knowledge often can increase your company's growth-rate.

- **Incentive Compensation Programs:** By offering an incentive compensation program that incorporates stock options or Phantom Stock, you will be able to attract key managers as well as retain your management, sales, and product teams. "Many of our customers in very competitive industries have used this method to attract key employees from larger corporations", stated Denitz.

- **Sell the Company:** When you're ready to retire or exit the business, you may want to think about selling to a strategic or financial buyer. However, you must be aware of the long lifecycle required to sell a business and the tax implications associated with the purchase structure.

Taking action today to prepare for retirement, disability or death is an important part of keeping your business healthy and preserving wealth in your estate. In order to maximize your goals for your company and your estate, both financial and otherwise, you need to understand the value of your company and net financial returns under the various options, as outlined above. For example, by instituting an ESOP, you can end up with significantly higher net proceeds than an outright sale of your company, despite a lower valuation, due to the tax benefits.

SP&H can value your company under various assumptions to help you determine which path has the potential to maximize your return on investment and sweat equity.

For more information on how to structure a solid succession plan, please contact Tom Pastore at (310) 571-3400 or tpastore@sphvalue.com. To discuss the many financing options available to liquefy your life long investment in your company, please contact Fred Denitz at (310) 788-9500 or denitz.f@mfbb.com ◆

> ***Man's mind stretched to a new idea never goes back to its original dimension***
>
> ***- George Bernard Shaw***

Friends of SP&H

Greg Friedman

Many of us live our lives assuming that our long term plans will come to fruition. Yet, life has a habit of throwing our plans off-track, forcing us to map out new strategies in order to accomplish our goals. Gregory Friedman was building a successful real estate investment and brokerage business when he suffered injuries as a passenger in an auto accident. We are proud to have Greg as a friend of SP&H, and are pleased we were able to help him by providing an analysis of lost wages and loss of business value as a result of the accident.

SP&H: Greg, please explain your business.

Greg: We are a real estate brokerage firm with three specialities. The first is the representation of buyers and sellers in single-family residences and apartment sales and purchases. The second is our financing division, which provides loans over $1 million and is available for homes, land, apartments, hotels and commerical real estate. We are able to save our clients time by quickly assessing our ability to help or not on a loan. The third specialty is our investment division. Here, we invest on our own and at times have joint ventured with our clients in investment property purchases. By putting up our capital along with theirs, it reinforces that this is more of a partnership than a real estate sale.

SP&H: You have a knack for finding undervalued properties. Are you seeking participants in your ventures?

Greg: Yes. We continually strive for new partners. Now that most California real estate prices are at an all-time high, it has become more and more difficult to find situations that make sense. In fact, most of my current projects are brought to me by other top real estate professionals. We always encourage new projects, investment property or other ideas be presented to our firm.

SP&H: How have you remapped your business model since the accident?

Greg: Since the accident, I have adjusted my schedule and I am much more selective with the clients I choose. The accident has made me realize how precious life is and how much we must enjoy every moment we live. Spending quality time with my family, friends and business associates makes my life better and more fulfilled.

SP&H: What is your key to a successful life?

Greg: Balance. My business associates always thought I was all about business and my friends thought I was all about fun. My clients have become my friends and my friends have become my clients. I work hard and I play hard. I do them both fairly and honestly and the rest has fallen into place. I work hard for my clients, but I make sure I find the time for my family. I have a new son and I want to make sure that I am there for him and my wife as he's growing up. I find that if I keep true to this value, the rest will fall into place.

Greg lives in Santa Monica with his wife, who recently gave birth to their first child. Greg can be reached at (310) 664-8025 or at GregWorld@Yahoo.com ◆

Divorce - *The Ugly Truth*

According to Divorce Magazine, the likelihood of divorce in the United States is as high as 50% for first marriages and 60% for remarriages. For those coping with divorce who are shareholders in privately-held companies, the process of dissolving their marriages is complicated multi-fold.

- How much are the shares worth?
- Is a buyout of one partner economically possible?
- Are the company's financial statements accurate?

Specializing in dispute resolution, SP&H offers:

- Pre-Litigation Valuation Consulting
- Comprehensive Due Diligence
- Superior Reporting
- Litigation Support
- Expert Witness Testimony

For more information on SP&H's business valuation services for marital dissolutions, please contact Mary Lee-Wlodek at (310) 571-3400 or marylee@sphvalue.com in Southern California or Forrest Vickery at (916) 614-0530 or fvickery@sphvalue.com in Northern California ◆

Goodwill Impairment
New Rules of Accounting

Acquisitive companies had it easy in the past. Upon each acquisition, the "goodwill" value of the transaction, typically equal to the difference between the purchase price and the value of the acquired entity's assets, simply would be amortized on an arbitrary, straight-line basis - algebra a smart, high school freshman could handle.

Effective for fiscal years commencing after December 15, 2001, these companies will have to apply a more complex method of accounting for goodwill to comply with FASB* Statement No. 142, ***Goodwill and Other Intangible Assets,*** issued in July 2001.

Pursuant to FASB Statement No. 142, all newly acquired and existing goodwill will be tested annually to compare its fair value with its book value. If the fair value of goodwill **exceeds** the book value, then everything remains status quo, and no expense against goodwill is taken. If the fair value of goodwill is **less** than the book value, then the goodwill will be deemed "impaired" and the company will expense the difference ("impairment loss").

As a result, it is more important than ever for companies carrying goodwill on their balance sheets to retain an independent third-party provider of business valuations, such as SP&H.

(Continues on Page 4)

SP&H Calendar

September 6th & 7th - Monterey
ESOP Association/Western States Conference
SP&H was a Sponsor and Tom Pastore presented
"Executive Compensation & Valuation"

September 13th - Los Angeles
September 27th - Sacramento
Goodwill Loss Seminar
"Advanced Topics in Goodwill Loss Analysis"

September 19th/September 21st - On-Line
CRA Distance Learning Program
Nevin Sanli presented *"Appraisal Techniques & Issues"*

September 20th - Los Angeles
San Fernando Bar Association Tax Section
Tom Pastore presented *"Current Developments in Business Valuation"*

September 21st - Orange County
IRWA - Orange County Mock Trial
Tom Pastore participated as a Goodwill Expert in the Mock Trial

October 12th - Sacramento
IRWA - Sacramento
SP&H will be a sponsor and Forrest Vickery will be presenting
"Goodwill Loss Analysis"

October 24th - Beverly Hills
ACG Middle Market Conference
SP&H is a Silver Sponsor

November 5th & 6th - San Francisco
CLE International - Eminent Domain Conference
Tom Pastore will be presenting *"Loss of Goodwill"*

November 13th - Los Angeles
Tax Night - LACBA & Cal Society of CPAs
SP&H will be an exhibitor

November 15th - Los Angeles
LAVA Workshop
SP&H will be sponsoring & Nevin Sanli and
Mary K. Lee-Wlodek will be presenting
"Valuing Growth Companies"

www.sphvalue.com

Fairness Opinions for Public-Private Partnerships

SP&H pioneered the use of Fairness Opinions by public agencies to ensure that Projects can withstand third-party scrutiny. Let us help you by providing expert analysis to answer such questions as:

- Is the Partnership "fair" from a financial perspective for the Agency?
- Can this Project be considered a gifting of public funds?
- Is the Agency using public funds in a financially sound manner?
- Are there any conflicts of interest inherent in the transaction?
- How can Project completion risks and conflicts of interest be mitigated?

(Continued from Page 3)

SP&H is a specialist in the area of valuing intangible assets, including goodwill, as well as defending its values against stringent, third-party scrutiny.

** FASB is a private sector organization designated to establish standards of financial accounting and reporting. FASB's standards are recognized by the SEC and the AICPA as governing the preparation of financial reports.*

For more information about determining goodwill impairment or valuing intangible assets, please contact Mary K. Lee-Wlodek at (310) 571-3400 or marylee@sphvalue.com

Published by SANLI PASTORE & HILL, INC.
1990 S. Bundy Drive, Suite 800, Los Angeles, CA 90025

Telephone:	**Los Angeles**	**310/571-3400**	**Fax: 310/571-3420**
	San Francisco	**415/955-2699**	
	San Diego	**858/597-7505**	
	Sacramento	**916/614-0530**	
E-mail:	**bizval@sphvalue.com**		

SP&H does not accept responsibility for statements or opinions advanced in articles appearing herein, and their appearance does not necessarily constitute an endorsement by SP&H.

Articles, letters, comments and suggestions are welcome. *Please contact Christine Albino at 310/571-3400 or calbino@sphvalue.com*

Los Angeles
San Diego
San Francisco
Sacramento

SANLI PASTORE & HILL
1990 S. Bundy Drive, Suite 800
Los Angeles, California 90025
www.sphvalue.com

PRSRT STD
U.S. POSTAGE PAID
LOS ANGELES, CA
PERMIT NO. 3491