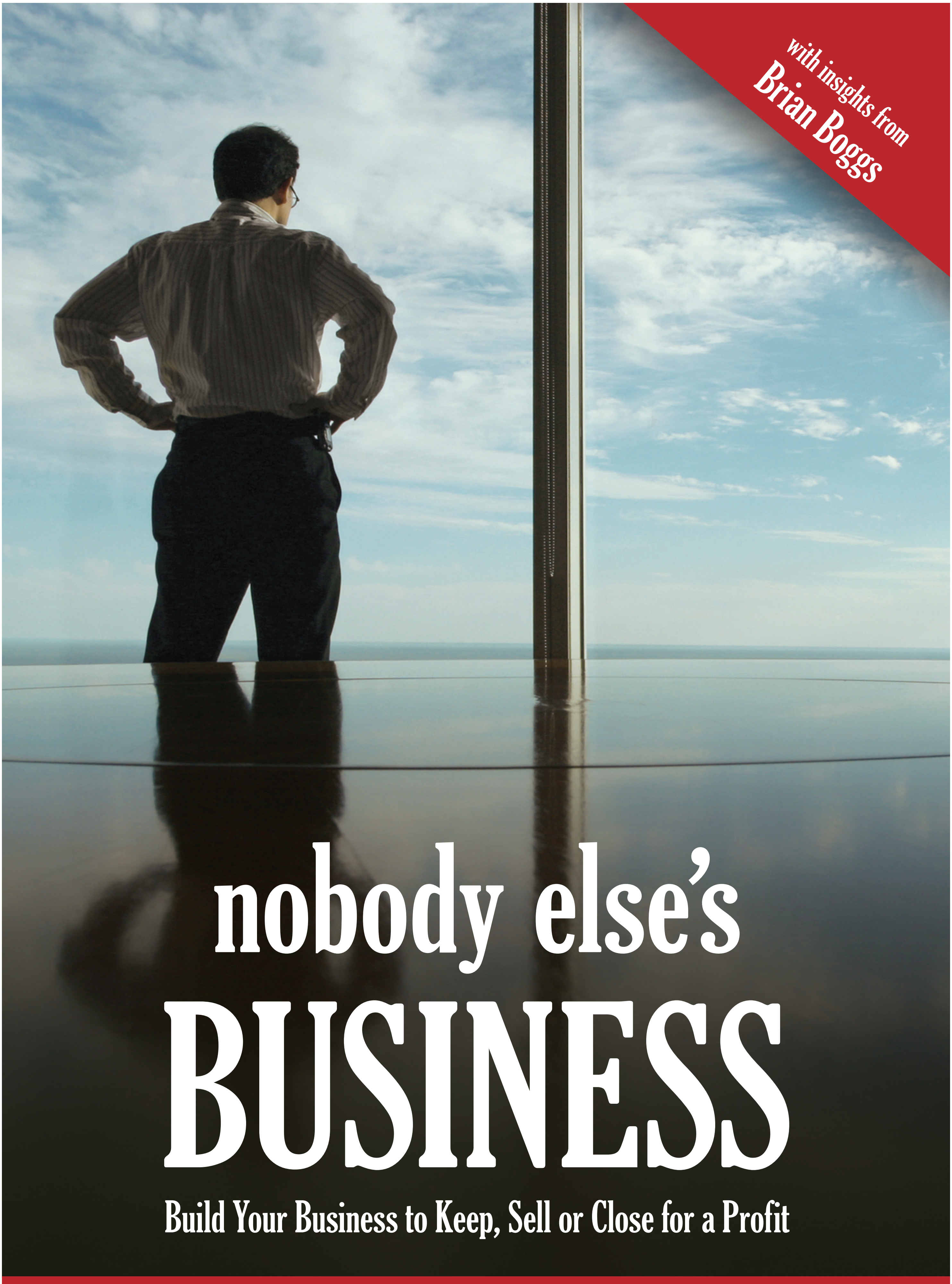

with insights from Brian Boggs

# nobody else's BUSINESS

## Build Your Business to Keep, Sell or Close for a Profit

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# Contents

# Chapter 1

# There's No Business Like Your Business

THERE ARE AT LEAST two million businesses in Australia[1]. They come in all shapes and sizes, from self owned home office (SOHO) businesses, family businesses to professional partnerships and big businesses. They sit across a wide range of industries and their owners go by a host of monickers: advisers, entrepreneurs, retailers, consultants, investors, inventors, franchisees, partners, promoters, operators, professionals and service providers – to name but a few!

Some are high school dropouts, some have found their feet in a trade, others have been inspired by a university education. They come from the most privileged backgrounds in Australia and from the humblest. They are young and old; male and female. And they all have one thing in common: They work hard and for better or worse, they are in control of their own destinies.

You name it, almost any enterprise can be a business producing goods or services for a profit be it gym instructing, accounting, hair dressing, financial advising, mortgage broking, real estate selling, plumbing and building contracting and whatever it is that you do.

Business is where the money is. It is also where the Big Ideas that create Big Businesses originate. Just think for a moment about Apple Inc. and where it came from.

Business is also where the action is. As a business owner you can do a variety of things every day. Unlike employees, you can sell, buy, borrow, invoice, collect, pay, invent, innovate, change, guess, decide and take risks every single day.

Of course, you also worry, usually about things like meeting your employee salaries, paying suppliers, repaying loans, solving problems, bringing in more revenue, doing the right things and doing the right things right. But every morning you get up and find a way to do what your business needs to do.

1 Australian Bureau of Statistics (ABS) 8165.0 – Counts of Australian Businesses, including Entries and Exits, Jun 2007 to Jun 2011

A good business should also generate profit. Enough profit for you to extract some for yourself while you are working in it and enough to walk away with money in your pocket when you leave … whether you leave and:

- pass the business to others who will keep it going *(keep)*
- sell the business to others who will keep it going *(sell)*
- close the business down (*close*)

The unfortunate reality, however, is that for many business owners these two ambitions will never be more than pipe dreams.

# The First Deadly Sin

## ARE YOU FAILING TO TAKE PROFIT?

The first deadly sin many business owners commit is failing to take maximum profit from their business. The reason they fail is because they don't understand how to maximise the value of their business and they don't know how to continuously take money out of it.

Try this quiz, simply answer yes, no or unsure to the following questions:

| Item | Issue | Yes | No | Unsure |
|---|---|---|---|---|
| 1. | My business meets my annual income needs | ☐ | ☐ | ☐ |
| 2. | My business will meet my future capital needs when I retire or if I have to exit the business early | ☐ | ☐ | ☐ |
| 3. | My business will meet my family's security and income needs if I unexpectedly die or suffer a critical illness | ☐ | ☐ | ☐ |
| 4. | My business is simply structured and understood. It is tax efficient and I understand the personal liabilities it may incur | ☐ | ☐ | ☐ |
| 5. | My business and personal financial strategies are documented correctly, regularly monitored and reviewed, up-to-date and can be easily located | ☐ | ☐ | ☐ |

If you answer no or unsure to one or more of the items above you may be committing the deadly sin of failing to profit from your business correctly or efficiently.

# It's Your Business

The success of any business or any enterprise revolves around great leadership. The success of your business revolves around you building a business for your successors to keep, or to sell to a third party or to close. Your drive and initiative to take your business forward – through business planning, marketing, generating business revenue, taking care of necessary business expenses such as payroll, utilities and rent is what ultimately makes a great business. Nevertheless your business should not be all about you.

## Building a business to keep

Building a business for your family to keep when you move on involves you mentoring a successor manager from within your family. It also means either continuously building sufficient wealth outside your business or structuring an arrangement with family members who are active in the business, so that when you leave, you and your spouse are not reliant solely on the business for your lifestyle and retirement income.

If you don't have an obvious successor, your business may not be able to provide you with the after tax income you want for your retirement and it may not be able to be transferred to family members to operate.

## Building a business to sell

Building a business to sell for a profit means you are going to have to be able to demonstrate to a prospective purchaser that the value of the future earnings generated by your business can be maintained without you. If you are building your business to be sold you need to calculate whether the value you will receive on sale will be sufficient for you and your family's lifestyle needs. If not, you may need to consider how to supplement sale proceeds by continuously extracting profits and investing outside your business.

## Building a business to close

If your business is reliant on your expertise or persona then it may not be able to be sold for a profit. It should therefore be built to provide you with an income; so that you can invest outside your business.

A planned closure could mean you are able to sell your business assets at a better price than if you simply closed the business and liquidated the assets – depending of course, on the type of assets your business holds. Any business, from micro to large, not for profit or profit is based on using assets to provide goods and services. Profits can be continuously realized from income earned or realized in the form of capital on the sale of the business, or a combination of both.


Businesses consist of different types of assets. One point of differentiation is whether and to what extent the human value of the business is used to deliver goods and services. Moving from a micro-business to a big business will result in you relinquishing a greater degree of control over the day-to-day operations. Nevertheless unless your business is still dependent on you, its value as an enterprise to be kept within the family or sold to third parties may be significantly diminished. In effect without you, your business may have to be closed.

| Ranking | Market segment | Definition |
|---|---|---|
| 1 | Micro Business | Less than 5 employees |
| 2 | Small Business | Less than 20 employees |
| 3 | Medium Business | 20 to 199 employees |
| 4 | Big Business | More than 200 employees |

## ASSETS

The Statement of Accounting Concepts SAC 4 *Definition and Recognition of the Elements of Financial Statements* defines an asset as, "the future economic benefits controlled" by an entity "as a result of past transactions or other past events"[2]. This definition embodies three important characteristics of an asset:

- The notion of providing future economic benefits to the business
- The control of those future economic benefits by the business
- The origin of those future economic benefits from a transaction or past event

## TANGIBLE ASSETS

In broad terms, the tangible assets of a business consist of its land, building, plant machinery and motor vehicles, as well as assets such as cash, inventory, debtors and prepayments which constantly fluctuate. Tangible assets are easily identifiable and the benefits flowing from them are more easily measured than intangible assets.

2 Statement of Accounting Concepts: Definition of the Elements of Financial Statements (1995), p14

## INTANGIBLE ASSETS

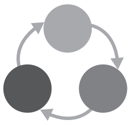
An intangible asset is an asset which exists on paper – for example, goodwill, trademarks and patents – may constitute significant assets of the business. Such assets are a product of the efforts, skills and expertise of the 'human capital' of the business.

**TANGIBLE**
Building, Plant and Equipment, Cash

© ® TM

**INTANGIBLE**
Intellectual Property – Patents, Trademarks

**GOODWILL**
Customers, suppliers, staff, market



**PROCESS**
Business System

If your business has either or both tangible and intangible assets, which produce maintainable benefits, it may be kept or sold.

## DELIVERY OF GOODS AND SERVICES

Businesses can also be distinguished on the basis of how they provide goods and services. Goods and services may be delivered through human capital or via the tangible assets of a business. For some businesses the primary method of delivering goods and services is through the business owner or principal. Where no intangible assets exist which allow the development of systems or the training of other people to provide the good or service, the business is more likely to be closed on the owner's exit. How assets are managed and controlled will ultimate dictate whether the business can be kept, sold or closed when the owner moves on and whether or not it will transfer profits to the owner.

# The Business You're In

## Understand Your Business

Before you can maximise the value of your business you need to understand the following:

### BUSINESS MODEL

There are basically two business models:

- Businesses that are established to provide you with an income to live a certain lifestyle
- Businesses that are established to be kept within the family or sold for a profit

Once you understand your business model you will able to plan and build your business to keep, sell or close.

### SIZE

Size matters. The size of your business plays a role in determining whether it can exist without you and therefore whether or not and to whom it can be sold. When we say 'sold' we mean transferred for market value. Generally speaking, the bigger the business the more easily it can be sold – although this is not always the case.

### THE LEGAL FRAMEWORK OF YOUR BUSINESS

Surprisingly very few business owners can simply outline how their business is legally structured. The legal framework of any business should be understood within three parameters, known as the CAB Rule.

- Control
- Assets and liabilities
- Benefit entitlements

Every legal structure, be it sole proprietorship, partnership, trust, public company or private company, is based around these three parameters. Your business may have more than one legal entity or be part of a franchise or a network.

### TEST YOURSELF

Can you outline simply how your business is structured? Who controls your business? What are the assets and liabilities of the business? Who is entitled to income and/or capital benefits?

If your business is part of a franchise or network, the sale of your business and your exit from it may require the approval of the franchisor or the network lead.

## INDUSTRY TYPE

The industry your business operates in will influence decisions connected, for example, with risk management – things like ensuring adequate cash flow and how you take money out of your particular business.

## BUSINESS LIFE CYCLE

This refers to how mature your business is – this will also influence how much money you can take out of your business and when. A new or growth business, for example, needs capital, while a mature or declining business may have excess capital on the balance sheet to distribute.

## BUSINESS RISK CYCLE

The risk profile of your business is determined by two factors:

- **external risk factors** – factors such as market fluctuations, external regulatory regimes and competition
- **internal risk factors** – factors such as the loss of key personnel or obsolete or inadequate information technology

Generally the less risk the business faces, the easier it is to sell for a profit and capital gain.

## GROSS REVENUES AND PROFITS

If your business has profits and revenues available, you may be able to embark on a growth strategy that can add real value to your business. Alternatively, you may be able to extract some wealth from your business.

## CASH FLOWS, THE COST OF DOING BUSINESS AND SOLVENCY

Cash flow is the oxygen of any enterprise. It is critical to manage business cash flow to meet existing, anticipated and unanticipated cash flow needs. The ability to manage cash flow will impact on both the continuity of your business and your ability to take profits to meet your own personal financial needs.

## VALUE OF THE BUSINESS

The value of your business relates to the value of its assets and, in general terms, the amounts owed to external persons by your business. It is therefore important to understand the composition of financial statements and how you can take profits from your business.

## DEBT AND EQUITY

The optimal allocation between debt and equity for your business will depend upon a wide range of circumstances but it will be a crucial factor in determining the net value of your business and in identifying financial strategies which can help you take profits from your business.

### PERSONAL LIFE CYCLE

Your age, the nature of the interest you hold in your business and who will take it over when you leave all impact upon your business succession planning and how you can take money out of it.

### PERSONAL FINANCIAL PLANNING REQUIREMENTS

You need to decide whether or to what extent the business will contribute to your family and personal financial planning needs or whether you will need to reinvest in the business and live modestly until you can sell it for a profit and realize a capital gain.

### INCOME AND CAPITAL NEEDS

This is about your financial objectives as the business owner, including your personal income needs. You will usually need your accountant's help to work these out.

# The 3Rs of Business

Once you understand your business you will be able to understand what drives its value. The three Rs that drive business value are:

## Return

The first step is to examine ways you can improve. If you are building your business to keep or sell, improving profits should mean you can extract the income you need now and invest in your business so that you can build its capital value so that you can sell it later.

For an income only business, improvements in profits will mean you can take more money from the business to fund your current lifestyle and to invest for your future.

You should also look at ways in which to reduce waste. Few business owners focus on the efficiency of their systems and processes and yet improving them may eliminate up to 30% of waste in operating costs. Waste could be a result of:

- Inappropriate use of staff – are senior people doing unskilled work?
- Inefficient flow of product and process
- Product waste – is too much product being scrapped as off-cuts?

Costs have a direct impact on profit. A waste review may identify savings that will be immediately reflected in increased profit.

It is also important to consider how profits are presented.

A business valuation will make profitability adjustments for expenditure which is abnormal or which can be particularly attributed to you as the current owner. However, there may be less obvious impacts on profits that a potential purchaser might not identify. By planning ahead for the sale, you can make sure that your final years' profits are not affected by such items.

## Risk

The second business value driver is to understand and manage the external and internal risks of your business. Factors that affect internal business risk could include the following:

| Factors Decreasing Risk | Factors Increasing Risk |
|---|---|
| 1. Strong customer relationships at all levels | 1. Weak customer relationships and frequent turnover |
| 2. Proprietary products or services | 2. Lack of proprietary products or services |
| 3. No single customer accounts for more than 5% of revenues or profits | 3. A single customer accounts for over I5% of revenues or profits |
| 4. Strong management team (important mainly to financial buyers) | 4. A weak management team. Principal dependent business |
| 5. Low employee turnover and good employee relations | 5. High employee turnover and poor employee relations |
| 6. Consistent revenue and earnings trends | 6. Inconsistent revenue and earnings trends |
| 7. Plant and equipment in good repair | 7. Plant or equipment has been neglected and requires significant repairs |
| 8. Legally protected intellectual property assets | 8. Lack of legally protected intellectual property assets |

The less risk your business has, the more likely you can take profits from it along the way or when you sell.

## Readiness

Your business has to be ready for you to walk away from before you can expect to take profits from it. Things that will hamper your business readiness include:

- Being too dependent or significantly dependent on you
- Having liabilities – for example, claims for poorly manufactured products
- Litigation or pending litigation
- Taxation penalties or compliance problems
- Product warranty obligations or litigation
- Long-term debt obligations

Some of these issues may take years to resolve. If your business does have any of these issues you may still be able to extract value from it, but chances are you:

- May not be able to transfer or sell your business easily
- Won't be able to continuously extract value
- Won't get the maximum price from the sale of your business
- Will run up high accounting and/or legal fees trying to urgently rectify problems
- You won't be able to demand full payment upfront – this may mean an earn out where total payments are not paid for some time, if at all, or at a reduced amount

To avoid these problems:

- Ensure audited accounts and tax returns are available before the sale process commences
- Ensure the entity is tax and litigation problem free
- Make the assets transferable by removing long-term debts
- Make the business transferable by making it less dependent on you
- Simplify entity structures
- Remove vendor tax impediments

# Who Are You Going to Call?

Good advice can mean the difference between making it big when you're in business and when you want to sell, and going nowhere. When you need professional advice, who are you going to call? How do you pick a good adviser from the pack?

## The 3 E's

There are numerous advisers you will need to call upon to help you build wealth and take profits out of your business, including accountants, marketing consultants, financial advisers and solicitors. All of these advisers will need to have the 3E's – expertise, experience and efficiency – in order to handle your initial, ongoing and exit requirements. A good adviser needs to understand not only their own craft, but also yours. They also need to understand your personal needs and objectives.

There are three 'types' of advisers that can help: the specialist, the experienced adviser and the efficient adviser. A specialist has a high level of expertise; an experienced adviser knows their craft and yours and an efficient adviser delivers well on requests but is generally not proactive. It is the experienced adviser who is likely to become your trusted adviser because they have the right blend of the 3E's. They "get" your business and what you're trying to achieve. As such they will be able to access and coordinate any other experts and services you may need. These advisers can explain, review and confirm strategies with you and your other service providers – for example, solicitors and accountants, as well as liaising and negotiating terms with your bank.

So who is your adviser? If you don't have one, then start looking.

# Competing Needs – You or the Business?

As a business owner you are always balancing your own personal financial needs with the needs of your business, especially if your business is very small. These competing needs can generate great internal conflict. We will discuss how to deal with this conflict in more detail in Chapter 2.

## Your Personal Financial Objectives

Your personal financial objectives are likely to include one or more of the following, although of course your objectives may change over time.

### MAXIMISE INCOME

One of your most obvious needs may be to put bread and butter on the table. However, the more money you take out of your business as income to feed yourself and your family, the less opportunity you have to grow and enhance the value of the business. It's a trade-off that perhaps you have not even been fully aware of.

Sometimes the nature of your business gives you little or no option but to focus almost exclusively on maximising income. You may, for example, be an expert in your field operating a consulting business where your skills sets are not easily replicated. You can probably command high levels of income while you work in the business, but there is little prospect of selling it after you leave as it is unlikely that your business will hold what we call 'valuable transferable assets' – that is, assets which can be easily be sold – for example, a hairdresser who owns her own hair salon with a huge personal following and no staff.

### MAXIMISE CAPITAL GROWTH

You may want to build and grow a business which you can later sell at a profit – that is, realise a capital gain. If this is your main aim, then you will be focused on maximising the value of the business rather than on drawing an income from it. Again, there's a trade-off. You will have to rely on income from elsewhere or accept short-term sacrifices in lifestyle in order to build the business to a point where it can be sold at a profit.

### A BALANCING ACT

Chances are you will have to balance the competing and often conflicting need for income with the need for growth. You will need to decide what is the right mix for you, your business and your family and this is likely to change over time.

Even when you have what you believe is the right balance, the value of your business may remain static. This is particularly the case where there is no mechanism to transfer the value of your business without your continued involvement. For example, your business may have a limited value if it relies almost exclusively on your skills and expertise and there is no protection of the intangible assets generated by the business.

# Objectives of the Business

Unless your business is a not-for-profit enterprise, the primary objective should be to maximise its financial value. In some cases, this means producing income knowing that the business will be closed or liquidated on your exit while in other cases it means developing the assets of the business or sale/transfer upon your exit.

## INCOME BUSINESS

Income focused businesses predominantly rely on human capital to provide services. A classic example of such a business is a professional accounting firm.

Such firms will maximise the number of fee earners and attempt to charge a premium for the services they provide to produce high levels of income. They will use marketing and develop internal skills and expertise in an attempt to establish a unique point of difference and justify the premiums they charge.

If you business is also a knowledge intensive business it may develop intangible assets – for example, a trademark. This will increase its value. When these sorts of assets represent a significant part of the value of the business and generate significant revenue, you may need to change your focus and strategy – from an income to a capital growth strategy. That said, these sorts of businesses are built to provide income and have few assets that can realized for a profit (capital gain).

## CAPITAL BUSINESS

Capital focused businesses predominantly rely on fixed assets such as machines, buildings and equipment and working capital assets such as raw materials to provide goods. A classic example of such a business is a manufacturing business. These businesses are built to be sold for a profit to realize a capital gain for the owners.

## ANOTHER BALANCING ACT

In some businesses there is an 'optimal' trade-off between income and growth objectives reflecting the fact that the business has the opportunity to enhance its value by maximising both income and by continuously taking profits from the business and accumulating capital assets.

You will need to strike a balance which is in line with your business model and strategy. And, once again, your business strategy may change over time.

## Your Needs Versus Your Business Needs

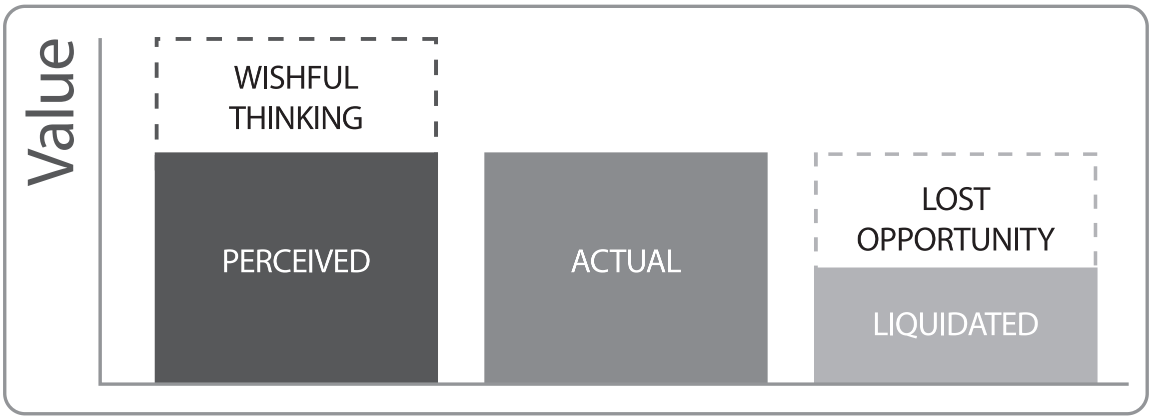
Of course, the need to grow and develop your business and maximise its value will not always sit well with your personal need for income and if you are a small business owner, your personal needs are likely to trump those of your business.

How well the two sets of needs align depends on how important your business is to you as an asset which can:

- Be sold to a third party
- Produce an income for and be transferred to your family
- Closed

## Business Value

Valuing a business is part art and part science and there is no universally accepted correct method. But there is one mistake you should avoid – mistaking perceived value for actual value.




### VALUATION METHODS

There are four commonly accepted methods of measuring business value.

#### Market Value

The market value of a business is the price someone will pay for your business as a going concern, if it was sold at arm's length. This definition is in line with the decision in *Spencer v Commonwealth [1907] 5 CLR 418* which determined that market value is, in broad terms, worked out on the basis of what a willing but not anxious buyer would agree to pay and a willing but not anxious seller would agree to accept as payment for the business.

**Deemed Market Value**

When the sale is not at arm's length, it will have a 'deemed' market value. There are a number of different ways to calculate (deem) the market value based on, for example, discounted cash flows, multiples of earnings and net assets.

- Where the business being valued was acquired relatively recently, the deemed market value will be the recent acquisition price. The use of this method is limited due to factors such as changes in market conditions, the passage of time, regulatory changes and other relevant factors.
- Where the business has an established trading history, the deemed market value can be a multiple of earnings.
- Where the business derives a significant percentage of its value from its assets, the deemed market value can be the value of its assets.
- Where the business is undergoing significant changes, has entered a dynamic period of growth or is operating within a highly fluid environment, the deemed market value can be the value of present cash flow or the discounted expected future cash flows of the business.
- Industry benchmarks – the sale price of similar businesses can be a guide for determining the market value of a business but this method has limited usefulness.
- Where the shares in the business are linked on a recognised exchange the market value of the business is obviously the relevant quoted share price.

**Book Value**

This value is simply the difference between the assets and liabilities of a business. The accounting equation is: Assets minus Liabilities equals Owners Equity (Assets – Liabilities = Owner Equity). This calculation measures the level of owner's equity, which often reflects the level of re-investment of retained earnings or additional investment into the business.

**Liquidation Value**

Businesses in financial distress may be valued solely on their assets. In some circumstances, the value may be based on only a few selected business assets, resulting in an even lower overall value.

If your business is not capable of being sold for a profit when you leave (but profits can be annually and continuously extracted from it) you may need to plan to close your business and avoid selling assets at a lower than actual value – that is, at liquidation value. Try to avoid selling your business and/or business assets at liquidation values.

**Perceived Value Versus Actual Value**

A considerable time can elapse before your vision for the business is converted into an asset from which you can either continually take profits or sell at a profit. In the interim you may come to believe your business is worth more than it actually is and fail to take profits from it along the way. This means you could be left short when you ultimately exit the business.

# Strategic Actions

When you really understand both your business and your personal financial needs, you will be able to decide on and implement strategies to build your business to keep, sell or close. You can then take profits from it along the way and invest them outside the business. Or you could sell it and realize a capital gain when you exit the business. A third option is a combination of both.

- Determine your personal needs and objectives ☐
- Understand your business model ☐
- Understand your business value drivers ☐
- Select appropriate advisers ☐
- Decide how you want to extract wealth from your business ☐