Value Driver 5: Effective Financial Controls

Effective and reliable financial controls are critical to managing your business, can safeguard your company's assets, and help achieve consistent profitability. And when it comes time to sell, effective financial controls can testify to the financial condition of your company.

One of the best ways to prove that the company has financial controls and that its historical financial statements are correct is through a certified audit or review by an established CPA firm. A certified audit or review is important because lack of financial integrity is one of the most common hurdles encountered during the business sale process. An audit demonstrates to potential buyers that the historical information can be relied upon when making judgments about buying the company based on historical cash flows. It can be very important to have your CPA review your current financial statements and practices so that any financial irregularities or inadequacies are immediately exposed and corrected.

One common "irregularity" that we often see is the shifting of income. Everyone understands that for the years prior to the sale, owners will naturally handle the company's finances from a perspective of minimizing tax consequences. This is good tax planning and is anticipated by the sophisticated buyer - the kind with whom you are likely to deal.

Unfortunately, some owners go one step too far in an effort to minimize tax consequences. They shift income from one year to the next and shift expenses from one year to the next. Neither the expense nor income shifts relate to one another or to the actual services or manufacturing activities that give rise to the income or expense item. Other owners may improperly report inventory or lack sufficient inventory controls.

What This Might Look Like in Practice

Jared Price owned a successful (fictional) plumbing parts company in Minneapolis, Minnesota. For years, Jared had understated his inventory in an effort to reduce his profits, thus reducing his tax liability. Jared provided the doctored numbers to his accountant who, year

after year, used those numbers to prepare the company's tax returns.

At Jared's 60th birthday party, his youngest son (who Jared had always hoped would take over the business) announced his plans to attend medical school. Jared's employees had neither the money nor the talent to take over the company, so Jared decided to investigate the option of selling his company.

During Jared's first meeting with an exit planning advisor, he was asked about his stated inventory of $250,000. "How can you possibly support annual sales of $10 million with an inventory this small?" Jared then admitted how, unknown to his accountant, he had cleverly "saved" hundreds of thousands in taxes over the years by understating his inventory. Jared faced a difficult choice. He could choose to correct his inventory numbers so EBITDA* would support the desired sale price, but would likely be charged with tax fraud.

Jared then asked, "What happens if we let the numbers stand?" The advisor replied, "In that case, I have good news and bad news. The good news is: you may not go to jail." Taken aback, Jared asked, "Then what is the bad news?" The advisor replied, "The bad news is that without correcting the numbers, your company's EBITDA is too low to support the sales price you require. In fact, no buyer will want to risk acquiring a company with unsupportable numbers."

Dejected, Jared left the advisor's office. He ran the company for eight more years until he had enough money in the bank to support himself in his retirement. At the end of those eight years, he liquidated the assets and closed the doors.

Taking Corrective Action

If you recognize yourself as an owner who has been overly aggressive in shifting income and expenses, (or, more likely, have given the financial controls insufficient attention over the years), it is of fundamental importance to the entire sale process that your past aggressiveness be diligently reviewed and corrected where appropriate. Making sure that you have effective and documented financial controls within your business can be the value driver that makes or breaks the sale of your company.

**EBITDA: earnings before interest, taxes, depreciation, and amortization*

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