



The Importance of Financial Statements in the Exit Planning Process

Whether you plan to transfer your business to an insider or sell to a third party, demonstrating financial stability through sound financial statements is a crucial step in establishing a successful business exit. When you first meet with an Exit Planning Advisor, they will want to determine your company's current situation, which will include reviewing business tax returns for the previous two to three years and current financial statements of the business, as well as your personal financial statements.

At first glance, you may be wondering why it's important to bring your company's financial statements to the initial meeting with your Exit Planning Advisor. It is important for your advisor to have a good understanding of what your financial picture looks like for several reasons.

First, the company's financial statements allow your advisor to understand your current financial position and effectively gauge what has already been accomplished and what still needs to be completed in order to create a successful exit plan. If your advisor identifies areas in your business that may need to be built up, they can help guide you through ways of creating a positive cash flow trend, increasing profits or cash, thereby helping you meet your overall exit objectives.

Second, your financial statements provide insight to the advisor about what makes your business tick and what criteria you use to base all of your financial decisions.

Third, and most importantly, the financial statements provide cash flow information, which is used to determine the value your company may be able to be sold for. Financial statements show you and your advisor the historic earnings, cash flow results and the trends that have been established over the past years. These historic results and trends can be used as an indicator of what the future may hold for your company. In short, what you can reasonably expect to receive for your company can usually be determined by properly analyzing and interpreting your company's financial history. You and your advisor then can use this information to create a reasonable projection of future cash flow and corresponding value.

Finally, reviewing your financial statements with your advisor will help to dispel any disparities that may exist in the perception of your company's value. For instance, you may have recently made improvements to your company that you believe will result in increased cash flow and company profits of 300 to 400 percent over the next couple of years. However, your advisor and CPA will want to look at your company's historical trends to determine whether this perception can be supported by past cash flow activity. For example, it is unlikely for a company that's been averaging \$500,000 of cash flow or pre-tax profits over the last three or four years to suddenly increase its cash flow by \$500,000 or \$1,000,000 within 12 months. It is important to realize this reality check early on in the process because any valuation specialist or prospective buyer will more than likely conduct a similar cash flow analysis. They are unlikely to accept your perception of value in the absence of firm historical precedent.



Cash flow in terms of Exit Planning means the free cash flow of your business. Free cash flow is the cash that is available to the company and owners — cash that doesn't have to be used to pay down finance debt, acquire additional assets, or be used by the business for any other reason. In accounting terminology, it is your operating income before tax and after adding back depreciation.

In short, the starting point for sound Exit Planning begins with reviewing well-prepared financial statements.

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