

# Understanding the Small Business

Presented by

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# Disclaimer

This material is presented for educational and discussion purposes. It does not represent the opinion of Gosule, Butkus & Jesson, LLP.

Methodologies have been simplified for educational purposes.

# Introduction

- Understanding the small business
  - Legal framework – taxation
  - Financial aspects – understanding financial information
  - Issues in divorce
  - Valuation concepts

# Topics of Discussion

- What are the basic legal forms of a business?
- How are businesses taxed?
- What information should be available?
- How do I understand it?
- What should I be looking for?
- Does it have value?

# Basic Legal Forms

- Sole proprietorship
- Corporations
- Partnership
  - General Partnership
  - Limited Liability Partnership
- Limited Liability Company

# Sole Proprietorship

- Single owner, unincorporated business
- Tradesman
- Professionals
- Can be any business

# Corporation

- Can be single or multiple owners
- Can limit personal liability
- Has stockholders
- May have restrictive agreements
- Receive wages and/or dividends
- Income/dividends must be distributed in proportion to ownership

# Partnership

- Two or more partners
- May or may not be a partnership agreement
- Partners hold percentage ownership in total partnership
- Income may be distributed differently from ownership



# Limited Liability Corporation (LLC)

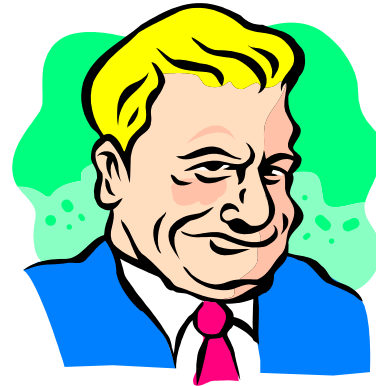
- Is a corporation
- Typically acts similar to partnership
- Has members
- Tax invention; taxed like a partnership or corporation
- Income may be distributed differently from ownership, if taxed as partnership

# Questions



# All Businesses File Tax Returns

.... Or should ....



# Taxation of Business

Sole Proprietorship	Files Schedule C on their 1040
Corporation	
• C-Corp	1120
• S-Corp	1120S
Partnership	1065
LLC	1040, 1065, 1120, 1120S

# Taxation of Business

- Sole proprietorship and LLC taxed as partnership – ALL self-employment income
- Corporation – Income as compensation subject to payroll taxes; dividends from C-Corp taxed as qualified dividends (capital gains rates)
- S Corporation – passthrough income taxed as ordinary income

# C Corp v. S Corp

<b>C Corporation</b>	<b>S Corporation</b>
No legal difference	Difference in how taxed
Taxed on corporate profits	Profits are taxed at shareholder level
Profits are distributed as taxable dividends	Distributions (dividends) are not taxed
May take out profits as compensation	Tend to try to minimize compensation
Reasonable compensation can be an issue	

# Questions



# Financial Aspects

- Explanation of common terms
- The well-run business
- The not-so well-run business
- What to expect



# Sample Financial Statements

- Balance Sheet
- Income Statement
- Tax Return – Form 1120S

# Personal Financial Statement

**Assets**

less

**Liabilities**

equal

**Net Worth**

# Business Financial Statement

**Assets**

equal

**Liabilities**

plus

**Owners' Capital**

# Owners' Capital

Corporation	Shareholder or Stockholder Equity
Partnership	Partner Capital
LLC	On Financial Statement – equity On Tax Return – Depends on Type of Return Filed

# Cash versus Accrual Financial Statements

- Most small businesses keep books on cash basis.
- Cash basis – think checkbook
- Accrual basis includes accounts receivable, prepaid expenses, accounts payable, accrued expenses and so forth
- Accrual basis statements are generally a better indicator than cash basis.

## BALANCE SHEET

<b>Jason and Sandra Enterprises</b>		
<b>Balance Sheet</b>		
As of December 31, 2020		
		Accrual
<b>Assets</b>		
Cash		\$ 20,000
Accounts receivable		10,000
Due from shareholder		4,000
Total current assets		<u>34,000</u>
<b>Fixed assets</b>		
Land		20,000
Buildings & improvements		20,000
Equipment		5,000
Vehicles		25,000
		<u>70,000</u>
Less accumulated depreciation		(31,600)
Total Fixed Assets		<u>38,400</u>
Other assets		20,000
Total Assets		<u>\$ 92,400</u>

## BALANCE SHEET

<b>Jason and Sandra Enterprises</b>		
<b>Balance Sheet</b>		
As of December 31, 2020		
<b>Liabilities and Stockholders' Equity</b>		Accrual
Note payable		\$ 15,000
Accounts payable		3,500
Accrued compensation		15,000
Current portion of long-term debt		5,000
Total current liabilities		38,500
Long-term debt		10,000
Stockholders' equity		
Common stock		100
Paid-in-capital		-
Retained earnings		43,800
Total stockholders' equity		43,900
Total liabilities and stockholders' equity		\$ 92,400

## INCOME STATEMENT

<b>Jason and Sandra Enterprises</b>			
<b>Statement of Income and Retained Earnings</b>			
For the 12 Months Ending December 31, 2020			
<b>Revenues</b>			
Gross revenues		\$ 350,000	
Less returns and allowances		(2,000)	
Net revenues		<u>348,000</u>	
Cost of goods sold		225,000	
<b>Gross Profit</b>		<u>123,000</u>	
Operating expenses		99,800	
Operating income		23,200	
Other income and expenses		(1,000)	
Income before taxes		<u>22,200</u>	
<b>Income taxes</b>			
Federal income taxes		(21,600)	
State income taxes		(2,100)	
Total income taxes		<u>(23,700)</u>	
<b>Net income</b>		<u>(1,500)</u>	
Retained earnings - beginning		40,900	
Distribution			
Retained earnings - ending		<u>\$ 39,400</u>	



## INCOME STATEMENT DETAILS

<b>Jason and Sandra Enterprises</b>		
<b>Income Statement</b>		
For the 12 Months Ending December 31, 2020		
Revenues		
Gross revenues		\$ 350,000
Less returns and allowances		(2,000)
Net revenues		<u>348,000</u>
Cost of goods sold		
Direct labor		150,000
Materials		75,000
Total Cost of Goods Sold		<u>225,000</u>
Gross Profit		123,000

## INCOME STATEMENT DETAILS

<b>Jason and Sandra Enterprises</b>		
<b>Income Statement - continued ...</b>		
For the 12 Months Ending December 31, 2020		
Operating expenses		
Owners' salary		50,000
Other wages		10,000
Auto expenses		7,500
Depreciation		7,300
Employee benefits		10,000
Equipment rental/expense		4,300
Office expense		9,000
Rent		1,200
Taxes		500
Total operating expenses		99,800
Operating income		23,200

## INCOME STATEMENT DETAILS

<b>Jason and Sandra Enterprises</b>		
<b>Income Statement - continued ...</b>		
For the 12 Months Ending December 31, 2020		
Other income and expenses		
Interest income		2,000
Interest expense		(4,000)
Gain on sale of asset		1,000
Total other income and expenses		(1,000)
Income before taxes		22,200

## INCOME STATEMENT DETAILS

<b>Jason and Sandra Enterprises</b>		
<b>Income Statement - continued ...</b>		
For the 12 Months Ending December 31, 2020		
Net income		(1,500)
Retained earnings - beginning		42,400
Distribution		
Retained earnings - ending		<u>\$ 40,900</u>

# Jason's Income

Salary		\$ 50,000
Employee benefits		10,000
Auto		7,500
Yard service buried in cost of sales		<u>1,200</u>
	Total	<u>\$ 68,700</u>

Form **1120S**

**U.S. Income Tax Return for an S Corporation**

OMB No. 1545-0130

Department of the Treasury  
Internal Revenue Service

▶ Do not file this form unless the corporation has filed or is attaching Form 2553 to elect to be an S corporation.

▶ Information about Form 1120S and its separate instructions is at [www.irs.gov/form1120s](http://www.irs.gov/form1120s).

**2012**

For calendar year 2012 or tax year beginning \_\_\_\_\_ and ending \_\_\_\_\_

<b>A</b> S election effective date <b>01/01/2002</b>	TYPE OR PRINT	Name <b>JASON AND SANDRA ENTERPRISES</b>	<b>D</b> Employer identification number <b>12-3456789</b>
<b>B</b> Business activity code number (see instructions) <b>238900</b>		Number, street, and room or suite no. If a P.O. box, see instructions. <b>24 MAIN ST</b>	<b>E</b> Date incorporated <b>05/14/1991</b>
<b>C</b> Check if Sch. M-3 attached <input type="checkbox"/>		City or town, state, and ZIP code <b>BUSYPLACE MA 02456</b>	<b>F</b> Total assets (see instructions) <b>\$ 82,398.</b>

**G** Is the corporation electing to be an S corporation beginning with this tax year?  Yes  No If "Yes," attach Form 2553 if not already filed

**H** Check if: (1)  Final return (2)  Name change (3)  Address change (4)  Amended return (5)  Selection termination or revocation

	5	Other income (loss) (attach statement) .....	5	
	6	<b>Total income (loss). Add lines 3 through 5</b> .....	6	124,000.
ns for limitations)	7	Compensation of officers .....	7	50,000.
	8	Salaries and wages (less employment credits) .....	8	10,000.
	9	Repairs and maintenance .....	9	
	10	Bad debts .....	10	
	11	Rents .....	11	1,200.
	12	Taxes and licenses .....	12	956.

JASON AND SANDRA ENTERPRISES

12-3456789

FORM 1120S

COMPENSATION OF OFFICERS

STATEMENT 1

NAME OF OFFICER	SOCIAL SECURITY NUMBER	TIME DEVOTED TO BUSINESS	PCT OF STOCK	AMOUNT OF COMPENSATION
JASON MERIWEATHER	254-31-7890	100%	50.00%	75,000.
SANDRA MERIWEATHER	987-65-4321	100%	50.00%	10,000.
TOTAL COMPENSATION OF OFFICERS				85,000.
LESS: COMPENSATION CLAIMED ELSEWHERE EMPLOYMENT CREDIT REDUCTION				35,000.
TOTAL TO FORM 1120S, PAGE 1, LINE 7				50,000.



Schedule L	Balance Sheets per Books	Beginning of tax year		End of tax year	
		(a)	(b)	(c)	(d)
	<b>Assets</b>				
1	Cash .....		50,000.		5,000.
2 a	Trade notes and accounts receivable .....				
b	Less allowance for bad debts .....				
3	Inventories .....				
4	U.S. government obligations .....				
	Indebtedness				
	U.S. government securities .....				
6	Other current assets (att. stmt.) .....				
7	Loans to shareholders .....		4,000.		4,000.
8	Mortgage and real estate loans .....				
9	Other investments (att. stmt.) .....		0.		35,000.
10 a	Buildings and other depreciable assets .....	41,000.		50,000.	
b	Less accumulated depreciation .....	31,517.	9,483.	31,602.	18,398.
11 a	Depletable assets .....				
b	Less accumulated depletion .....				
12	Land (net of any amortization) .....		20,000.		20,000.
13 a	Intangible assets (amortizable only) .....				
b	Less accumulated amortization .....				
14	Other assets (att. stmt.) .....				
15	Total assets .....		83,483.		82,398.

4 Add lines 1 through 3 ..... | 12,753. | 8 Income (loss) (Schedule K, line 18). Line 4 less line 7 ..... | 10,753.

**Schedule M-2** **Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed** (see instructions)

	(a) Accumulated adjustments account	(b) Other adjustments account	(c) Shareholders' undistributed taxable income previously taxed
1 Balance at beginning of tax year .....	48,383.		
2 Ordinary income from page 1, line 21 .....	10,753.		
3 Other additions .....		2,000.	
4 Loss from page 1, line 21 .....	( )		
5 Other reductions .....	( )	( )	
6 Combine lines 1 through 5 .....	59,136.	2,000.	
7 Distributions other than dividend distributions .....	8,838.		
8 Balance at end of tax year. Subtract line 7 from line 6 .....	50,298.	2,000.	

JWA

Form **1120S** (2012)

# Questions



# The Well Run Business

- Profitable
- Well organized business records
- Timely filing of tax returns
- Accurate internal statements
- Numbers make sense

# Poorly Run Business

- None of the good attributes
- Commingling of personal and business cash
- Business expenses out of line with other similar businesses

# Issues in Divorce

- Underreporting income
- Ownership issues
- When may a business have value?
- Filing of income taxes

# What to expect

- Financial statements\* or tax returns for at least three years, ask for five
- Should be completed through the most current fiscal year
- Interim statements to date

# Underreporting income

- Almost always present to some degree – do reported results make sense?
- Understate sales – e.g. cash sales
- Overstating expenses
  - Personal expenses
  - Expensing non-expense items
    - Loans
    - Assets



# Under reporting income – tax issues

- Potential liability to both spouses
- Reporting by judge to IRS
- Under reporting of income by more than 25% may be investigated by Criminal Investigation Division
- Innocent Spouse Relief

# Ownership Issues

- Single versus multiple owners
- Spouse is an owner/partner
- Restrictions on ownership
- Minority vs. majority interest

Questions?

# What is value?

- Sentimental/emotional value
- Monetary value
  - Loan value
  - Insurance value
  - Acquisition value
  - Value to owner
- Monetary value is always an estimate of future income – misunderstood

# What is value?

- What is the value of a rusty 1997 Ford Galaxy?
- Suppose the owner is a worker who uses it to get to work everyday?

# What is value?

- Fair market value – based on a *hypothetical* transaction between a hypothetical willing buyer and a hypothetical willing seller...
- Fair value – proportionate share of the enterprise value (less debt)

# Business Value

- Indications of value
  - Consistently profitable
  - Asset intensive – e.g. construction equipment
  - High compensation
  - Intangible proprietary assets (patents)

# Business Value

- Indications of no or lower value
  - Pays living wage only – may have “buy-a-job” value
  - Professional or personal goodwill
  - Small ownership interest
- Be careful of temporary conditions
  - Temporarily reduced income



# Temporarily reduced income

- Almost always down at time of divorce
- Business cycle downturns
- Loss of major customer
- May be other legitimate reasons or not

# Warning Flags

- Reported income does not support lifestyle
  - Recent rapid increases in debt
  - Consistent year-to-year increases in debt
- Reported income does not support increases in net worth
  - Inheritance
  - Unreported income

# Valuation Approaches

- Income Approach – based on some measure of income
- Asset Approach – based on the value of the assets less liabilities
- Market Approach – based on publicly traded companies or actual transactions

# Valuation Approaches

- Income Approach Methodologies
  - Capitalization of earnings
  - Discounted cash flow
  - Multiple of earnings – sometimes called the merger and acquisitions method – generally not considered best suited for valuations in divorce.

# Valuation Approaches

<u>Capitalization of Earnings</u>	
Earnings	\$ 2,000
Discount rate	20%
Growth rate	2%
Capitalization rate	18%
Capitalized value (earnings ÷ cap rate)	<u>\$ 11,100</u>

# Valuation Approaches

## Discounted cash flow

Year	1	2	3	4	Terminal Value*	
Earnings	1,000	1,100	1,200	1,300	1,326	
<i>Growth</i>		10%	9%	8%	2%	
Discount rate/cap rate	18%	18%	18%	18%	16%	**
Present value factor	1.1800	1.3924	1.6430	1.9388		
Present value	847	790	730	671	8,288	
Total present value	11,326					
* terminal value is equal to the expected future earnings divided by the capitalization rate						
** discount rate less growth rate equals the capitalization rate.						

# Valuation Approaches

- Asset Approach
  - Most common method is Adjusted Net Asset Value (NAV)
  - NAV is the fair market value of the assets less the fair market value of the liabilities
  - Generally used for holding companies or companies with little earnings
  - *May require equipment and/or real estate appraisals*

# Valuation Approaches

- Market Approach
  - Guideline Public Company
  - Guideline transaction (direct market transactions)
    - Goal is to determine the market for the subject company
    - Most common databases are *BizComps* and *Deal Stats* (formerly *Pratt's Stats*)



# Valuation Approaches

- Market Approach
  - Guideline transaction (direct market transactions)
    - Often criticized and confused
    - Can be a primary valuation methodology but used by most valuation experts as a secondary methodology.
  - Results in a multiple(s) which are applied to the subject company
    - Price to revenue
    - Price to earnings

# Business Valuation Standards

- Business valuation standards (AICPA, ASA, NACVA, USPAP) require consideration of the three approaches.
- BV standards require the appraiser consider various factors and information in reaching their conclusions.
- BV standards require the appraiser comply with ethical and competency standards.

# Business Valuation Standards

- Many courts have quoted IRS Revenue Ruling 59-60
  - Somewhat dated, but an elegant description of business valuation

# Goodwill

- Goodwill is that value which causes customers to come to the business and return to the business.
- In economic terms, it is the value of the business in excess of the value of the tangible assets.
- Goodwill may be *enterprise* goodwill or *personal* goodwill.

# Goodwill

- Enterprise goodwill is that which belongs to the business and may be transferred to a new owner.
- Personal goodwill is that which belongs to the individual and cannot be transferred to a new owner.

# Goodwill

- Know the rules for your state
  - 32 states exclude personal goodwill from the marital estate.
  - In 3 states all goodwill is excluded from the marital estate.
  - In the other states all goodwill is part of the marital estate or the courts cannot make up their minds.

# Goodwill

- Appraisers can value personal goodwill and exclude it from their valuation.
- Most common methods are:
  - Increasing compensation (increases income for alimony and decreases value of business)
  - Compute value with and without key person
  - Analytical approach that looks at the goodwill attributes present

# Questions





# A little bit of knowledge...

- Know when you need help
- Do not try to value a business yourself
- Maintain a certain professional skepticism
  - Do numbers and explanations make sense?

# Congratulations

- You made it.
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