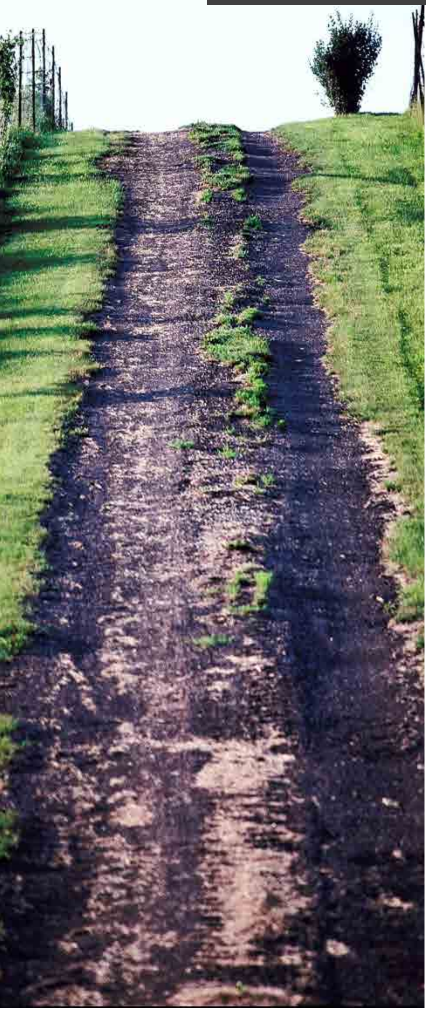
Succession Planning

Guiding You Down the Path of Success

Mike Tobiason, CPA, Shareholder
Anderson ZurMuehlen & Co., P.C.

Last Revision Date: January 2015.   Printed in the United States of America.



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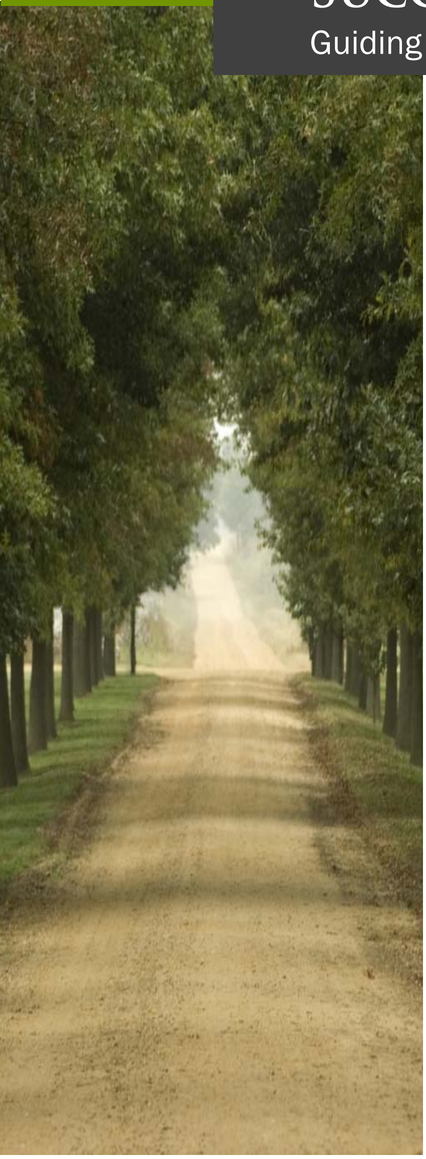
Succession Planning

Guiding You Down the Path of Success: Introduction



If you've been at all successful in your bank, you've most likely put tremendous amounts of time, energy and plain old hard work into it. It's probably one of your proudest achievements. However, at some point you're going to have to answer a question that may seem completely foreign to you: *What's the best way to untangle myself from the bank I've spent so much time leading and managing?*

You may already be thinking in this direction for a number of reasons. Perhaps you're looking forward to retiring in a more agreeable climate. Or maybe you've gotten a purchase offer you want to consider, or your bank investment has done so well that you want to pass it on to your children. Perhaps you hope to die in the saddle, but you want the bank investment to continue beyond your lifetime—and you don't want the IRS to confiscate your hard-earned gains through estate taxes.

On the other hand, your bank may not be doing as well as you hoped, or maybe it's doing well but you're getting tired of all the time and energy it requires and increasingly complex regulatory environment. Other reasons for getting out could include the death of a key manager or shareholder, your realization that the competition is winning, pressure from family members or employees who think you ought to retire, or your own health.

Don't wait until one of these events hits you over the head. Start thinking about your exit strategy now, even if it may be a long time before you actually need to get out. That way, you'll have plenty of time to consult your advisors, put your plan in place, and optimize your chances for getting the most financial and personal satisfaction from the results.

A Broader View of Succession Planning

Simply put, succession planning is preparing your company for the future. True succession planning goes far beyond identifying and preparing your bank for sale or transfer to others. It encompasses all of the following steps and more:

- **Evaluate your position:** This is the first stage of the process, where the bank's current position is examined. This evaluation considers not only bank goals and objectives, but also where the owners/leaders are personally at that point in time.
- **Set your goals:** Owners must set goals for themselves and for the bank, giving consideration to such things as lifestyle/life balance, risk profile, family agenda, regulatory issues and the financial needs of the owners and the bank.
- **Plan your strategy:** Succession planning for most community banks can take two different paths, and owners must evaluate which path is most appropriate for their situation. The two paths are (1) selling or merging the bank with an outsider, and (2) selling your investment to another existing shareholder or insider(s).
- **Selling to an Outsider:** If the decision is to sell to an outsider, a host of key topics must be addressed to ensure you attract the right buyer, maintain bank performance during the process, achieve your desired after-tax outcome and comply with the significant regulatory issues that arise.
- **Selling to an Insider(s):** If the decision is to sell to an insider, many of the same issues arise as selling to an outsider but also include an assessment of the buyer(s) ability and interest in continuing to manage and run the bank as well as their financial capability to complete the purchase without deteriorating the capital of the bank.

- **Funding your strategy:** Regardless of which strategy is chosen, retirement and personal financial needs are a major topic to be considered if the goals set earlier are to be achieved.
- **Managing your exit plan:** The three key areas in managing your exit plan are risk management, project management, and stakeholder management.

Succession Planning Questions

- What's my bank's current position?
- Am I setting goals for myself and my bank?
- What's my strategy?
- Should I sell to outsider or would it be best to find an inside buyer? How do I do this?
- What are my retirement and financial needs?
- How can I manage my succession plan?

The Eight Most Common Planning Mistakes

Succession planning can be both difficult and time consuming. However, your difficulties will be reduced if you avoid the following common mistakes as you prepare your plan.

1. **Thinking of succession planning as an event, not a process.** Succession planning shouldn't be built around an event or date; instead, it should be viewed as a process. Getting all the right pieces in place to produce the outcome you want takes time, forethought, commitment, and continual review.

2. **Putting off the development of an succession plan.** Procrastination—also known as the "I'll start later" syndrome—is one of the most universally regretted failings of both individuals and institutions. Waiting too long may limit your options and make it impossible to achieve your desired results.

3. **Not being personally prepared for succession.** Owners and leaders tend to identify very strongly with their bank, and some experience great difficulty letting go when the time comes. Preparing yourself includes the following:
   a. being ready to give up control,
   b. being satisfied with your accomplishments,
   c. feeling confident the bank can do well with someone else in your position, and
   d. having a vision of your life beyond the bank.

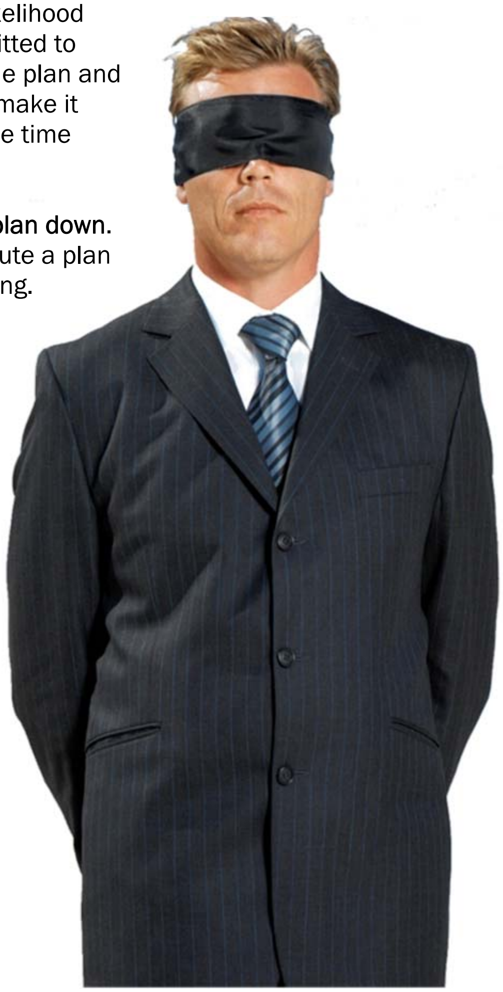
4. **Failing to prepare your successor.** Some owners seem to believe no one could possibly do things quite as well as they can—which may or may not be true. Whoever takes your place will likely have his or her own way of doing things, and it may be quite different from your way. Your responsibility is to prepare your successor by ensuring he or she:
   a. has a good understanding of the bank,
   b. is as capable as the people leading your major competitors, and
   c. has sufficient authority and credibility within the bank to be accepted and respected as your successor.

5. **Failing to prepare your bank.** If you've been a strong hands-on leader, your bank may be dependent upon you to make all the important decisions. It may also look to you as the primary source of vision and strategy. The reality is the bank must be able to grow and prosper without you. One of the most important things you can do to prepare your bank for the future is to ensure effective processes for making decisions are in place and functioning well.

6. **Hanging on too long.** Capable, well respected individuals often remain in positions of leadership too long. A successor to a key leader needs to be selected early enough to have enough time to be prepared for his/her new role.

7. **Not involving successors in developing the plan.** It's always dangerous to assume you know what other people think, need, or want. If successors are appropriately involved in developing the plan, there's a much greater likelihood they'll be committed to implementing the plan and will be ready to make it happen when the time comes.

8. **Not writing the plan down.** It's hard to execute a plan that isn't in writing. Plans are documented so they can be shared, so there is something actions and decisions can be measured against, and so others know what to do if you're not around.



Getting Off to A Solid Start

As you study this material, you'll learn many exciting things. You'll undoubtedly be energized and enthusiastic about implementing what you've learned. One of your greatest challenges will be to pace yourself as you move forward.

It's important to recognize that there is a limit to how many goals you can or should be working on in your bank at any given time. Be careful not to try to accomplish too much in too short a period of time. As a leader, you may have a natural tendency to move forward too rapidly to achieve a desired goal. You'll be much more successful if you focus on fewer goals and rally the necessary resources to accomplish those goals in the shortest time period possible.

Seek to have success early and build on it. Set goals for your first goal period that are clearly reachable. As you accomplish these goals, set goals for the next period, goals that will stretch you a little bit more. With each additional period, continue to set stretch goals as you guide your bank toward greater success.

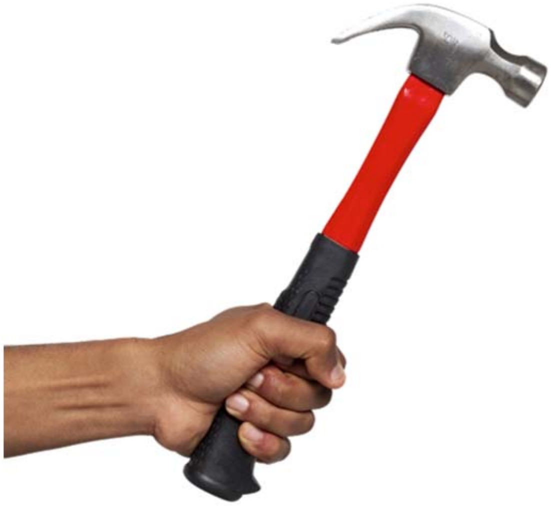
One of the most effective ways to pace yourself and get off to a solid start is to harness the power of teamwork. There is great power in working together to accomplish a goal.

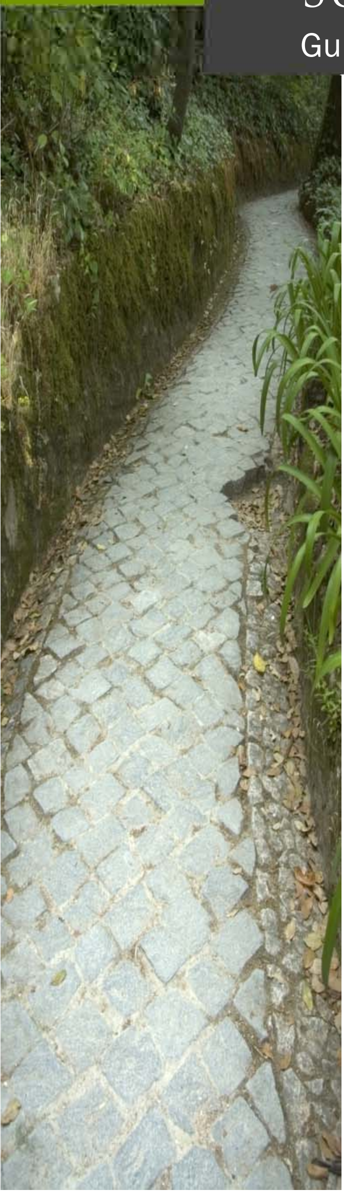
The Tools of Succession Planning

As you embark on this process of building an exit plan for you and your bank, there are a number of tools you'll probably need to implement your plan and achieve the desired results. Here are some of those tools.

- Financial statements. Financial statements are a picture of the bank's financial condition on the date of the statement. The ultimate value of the exit plan depends on how well the financial statements reflect and report the true condition of the bank.
- Budget projections. If financial statements are pictures, budget projections are paintings. Budget projections show what the creators—the owners and managers—expect to see in future financial statements.
- Bank valuation. A realistic and impartial valuation completes the financial picture of the bank. A periodic valuation by a certified business appraiser is necessary to ensure the financial goals of the succession plan are realistic.
- Form of ownership. The form of legal ownership and tax implications of the various entity types must be evaluated in light of the exit strategy.
- Gifts, sales, wills, trusts, and employee stock ownership plans. These are a few of the tools that may be used to accomplish the most financially and tax efficient transfer of the bank's value.
- Funding vehicles. Insurance products, annuities, deferred compensation and other funding vehicles should be considered to ensure the financial rewards anticipated from the exit are realized.
- Mediation. Exiting from a business is often an emotional issue for managers, owners and their families. Professionals who are independent of the family and employee dynamics may be necessary to facilitate effective communication and deal with conflicts that may arise.

Your bank is your life's work. Will it continue in the manner in which you desire? Will you be able to maximize your return on your life's work by selling to an insider or an outsider? Do you have the personnel in place to lead the bank into the future? Bank succession planning is about all of these things, and more. Succession planning is an investment in the future for owners, the bank, the employees and the clientele of the bank.





While you may be tired of dealing with the daily challenges of running and/or owning a bank and believe you're ready to close the doors at any minute, there are significant financial, personal and regulatory issues to be considered as you plan your exit. The recent economic turmoil has put significant strain on many individuals' financial nest eggs and on their bank's ability to generate reasonable profits. In addition, stresses in our lives have multiplied and we often feel consumed by the many demands made on our time each day.

The decision to exit needs to be driven by more than a sense of fatigue. Your bank is a means to multiple ends: financial security, a feeling of accomplishment, helping others experience success, etc. Because of this, you need to know where you are today—individually and as a bank—before you can map out where you're going with your exit plans.

A little later, we'll have the opportunity to explore the current position and potential value of your bank. For now, let's focus our attention on evaluating your personal position, both financially and mentally.

Evaluating Your Personal Position

Often times, succession planning is focused solely on the need for the owners to achieve some level of financial reward for their many years of effort, investment and commitment to their bank. While this is clearly a top priority, we often see successful banks fail in their succession planning because the owners did not adequately assess their personal financial position or their non-financial needs.

Personal Financial Position

Let's start by looking at your current financial position. At this point, it's common for owners to say, "I plan to sell my business for millions, so I don't have any financial concerns nor do I care where I am currently." As you might suspect, this is a dangerous statement to make at this stage in the planning process. Statistics show that a small fraction of community banks are successful in finding buyers to take out the owner for cash at their desired price. The rest are left with a slow agonizing decline in their bank, liquidating assets, or passing the bank investment along (at a much lower price than hoped for) to an insider or family member, often with limited or no cash down.

Given the low probability of selling your bank at a price sufficient to meet all your current and future financial needs, it's important to build retirement assets and sources of income that are not dependent upon the sale of the bank or its ability to pay you an ongoing income. Here are some critical steps you need to follow as you evaluate your personal financial position:

- **Review your personal net worth:** List all of your personal assets and obligations. No matter what the amount is, review your asset mix to determine how much diversity exists in your net worth. You should have equity in your home, retirement accounts, savings, investments, and personal property that can be utilized if necessary to support you should the bank fail to meet all of your needs.

- **Prepare and/or review your personal budget:** The more detailed this review is, the better. Be realistic about what it will take for you to have the lifestyle you desire. Likewise, be consistent. If you have lived a rich lifestyle, it's likely you'll want to continue that style of living. If, on the other hand, you've lived modestly, it's unlikely you will all of sudden become a high spender.

- **Prepare and/or review your will:** A will is critical to the protection of your wealth and to the disposition of your assets upon your death. Preparing and/or reviewing your will gives you the opportunity to determine how to best distribute your wealth and take care of loved ones after you're gone. The bank should be knowledgeable of the plans of all significant shareholders.

- **Seek financial counsel:** Getting an independent financial planner to review the above information with you helps to ensure you haven't overlooked any critical elements for you and your family.

Personal Frame of Mind

Having assessed your current personal financial position, you need to turn to the more challenging task of evaluating your frame of mind with regard to leaving or selling your bank.

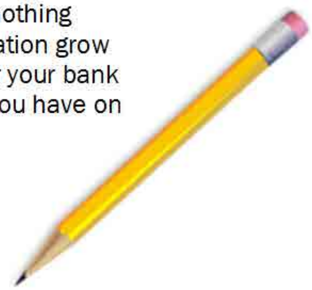
Many owners say, "I could leave this place tomorrow and not look back." For most, this statement doesn't mean they don't enjoy their bank or that it has been unrewarding. More likely, it means they're simply exhausted from the demands placed on them. Despite this feeling of exhaustion, we've often observed that after a brief period of time away from the bank, many owners have a difficult time settling into new routines and find it hard to stay away.

While it's obvious that owning a bank is primarily intended to provide owners and their families with a source of income and financial security, we also know that bank ownership and management meets a number of other non-financial needs. The following are some of the non-financial benefits of owning a bank:

- **Sense of purpose:** Ownership gives you the opportunity to make a difference in your bank and in your employees' lives every day. While it is certainly exhausting to own and operate a bank, it's also nice to know you're needed.

- **Control:** While there's considerable debate over just how much control owners really have, few would deny they have significant control over their schedules, the direction of their bank, who they work with, how much they make, and the hours they keep. After all, if you're the owner you <u>are</u> the boss!

- **Pride:** Like raising children, there is nothing more satisfying than seeing your creation grow and flourish. It's always a joy to hear your bank talked about and to see the impact you have on your employees and clients' lives.



Jot down some concerns you may have with stepping away from your bank and participation in its management.

It's important to recognize that stepping away from your bank involves some significant changes in your daily routine and your state of mind. Whether you're able to walk away with significant or only marginal financial resources, you can be assured you'll be faced with the task of filling emotional needs that are no longer being met by ownership and daily involvement in your bank.

As we'll discuss later, family involvement in the development of a succession plan is critical. Your family members will have to deal with changes in routines and will need to help each other find new ways to feel purpose, pride, and control in their lives.

Evaluating Your Business Position

All bank owners think about the value of their bank. The value impression in most owners' minds has been rationalized a number of different ways, with little or no review of the financial performance of the bank and no real consideration of the talent (or lack of same) in the management and employee base. A realistic view of the value of the bank, including the talents of existing employees, sets the stage for evaluating the best strategy for exiting the bank.

As you proceed through this process of evaluating the potential value of your bank, please remember that value is in the eye of the beholder. Value is a relative term and while there are commonly accepted methods to estimate the value of your bank, each buyer and each seller has his or her own unique objectives regarding the purchase or sale of a bank. Because of this, the value estimate derived internally or through an independent appraiser is just that—an estimate. The price ultimately agreed upon in the sale or transfer of a bank is always a subject for negotiation.

Estimating the Value of Your Bank

Below are some questions a hypothetical willing investor in a closely-held financial institution would likely ask before making his or her original investment or continuing to hold onto the investment:

- What will be the return on my investment (i.e., dividends, capital gains)?
- When will I get my money back from this investment?
- What is the risk that I may not get my investment back?
- How does investing in a bank that has no active market for a future sale compare with alternative investments currently available to me?
- Is there a possibility I will have a personal need sometime in the future to convert this non-marketable investment to cash at an unfavorable time?
- What is my required return relative to my purchase of a non-marketable investment, given the uncertainties that exist about the investment?

Investors in the freely-traded public marketplace have questions similar to those that are asked by hypothetical willing investors in a closely-held company. In addition, an investment in a closely-held (non-marketable) company also requires the investor to consider the risks associated with the acquisition of an illiquid investment.

While in theory investors will act rationally in making their value conclusions, we have already discussed that there are significant non-financial needs (rational and irrational) that investors consider when acquiring a business. Remember, however, that your non-financial needs for owning and operating a business are likely to be quite different from your successor owner's needs. You will want to be very cautious about reaching a value conclusion or assuming that all others will come to the same conclusion you did.

Arithmetically, the value of your business can be estimated by dividing the annual economic benefits (generally known as investor or owner discretionary cash flow) by an expected rate of return on the investment:

Annual economic benefit (owner discretionary cash flow) ÷ investor required rate of return = business value

Exhibit 1 provides you with a work sheet for developing an estimate of owner discretionary cash flow. Exhibit 2 offers some guidance in building an estimate of investor required rate of return.

The valuation of your business is a complex and very important matter to consider in the exit planning process.

Evaluating Your Business Attributes

As noted in Exhibit 2, investors will consider a number of business attributes in arriving at their desired rate of return for investing in your business. As the owner, you have the ability to significantly affect the value of your business by ensuring it has developed all possible positive attributes and by making those attributes easy for an investor to identify. The following attributes are generally regarded as having the highest value in the eyes of potential investors/buyers:

1. **Bench strength inside the company:** Once you (the owner) are gone, do the remaining employees have the necessary management skill and business knowledge to continue the success of the business with little or no drop in profitability? Remember, the buyer wants to acquire a business investment, not a job that demands 24-hour attention. Investors need some assurance that business will not drop dramatically as they take control of daily operations.

2. **Reliable financial information:** Buyers are naturally skeptical of historical financial performance when they're performing their due diligence. Care should be taken to ensure that your financial records are clean, understandable, and readily available. If you have managed your income for tax reasons, consideration should be given to adjusting your practices to show the full economic benefits the bank generates.

Thoughts to Ponder

Business, more than any other occupation, is a continual dealing with the future; it is a continual calculation, an instinctive exercise in foresight.

Henry R. Luce

In modern business it is not the crook who is to be feared most, it is the honest man who doesn't know what he is doing.

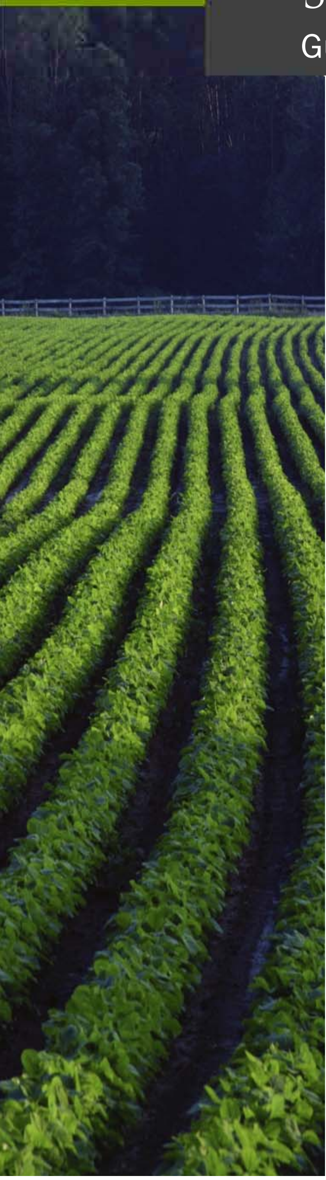
William Wordsworth

3. **Stable or growing financial performance:** Admittedly, market conditions heavily influence your ability to demonstrate stable or growing financial performance in your bank. The extent to which you can show positive or stable trends in profitability will heavily influence the value of your bank. However, don't be overly concerned if your bank is in a downturn, and don't try to hide it. Instead, point to the positive attributes that exist in your bank.

4. **Weak or limited competition:** The extent to which your competition is weak or limited helps alleviate buyers' concerns about losing customers to the competition, particularly early in the transition of ownership.

5. **Opportunity for growth and expansion:** Oftentimes, buyers are looking to take a bank to new levels of revenue and profitability. The more you have been able to open doors for expansion and growth, the more likely a buyer will pay a premium. Solid, repeatable processes that can be duplicated with ease in will help sell the bank's expansion and growth potential to a prospective buyer.

No one would think to try to map out a course for getting to Chicago without first determining whether he or she was currently in San Diego, Dallas, Baltimore, or some other location. Succession planning is no different; to get where you want to go, you must first know where you are.



As a bank owner, you'll need to decide when is the right time to step out of the family business and how you'll do it. There are many exit planning tools you can use to transfer your business. Selecting the right one will depend on whether you plan to sell your interest in the bank, sell the bank outright or transfer your interest to a family member or insider.

As you will recall from the previous section, your evaluation of where you and your business sit today has a significant impact on the two possible paths to exiting your business. The two paths are (1) selling or merging the bank with an outsider, and (2) selling your investment to another existing shareholder or insider(s).

Selling your Bank to an Outsider

There are a number of reasons why the owner(s) might choose or even need to sell their bank or investment in the bank to an outsider. The following conditions are likely to lead owner(s) to that conclusion:

- **Shortage of remaining shareholders interested in buying exiting owner(s) interests.** This situation is all too common in today's difficult banking environment. While some owners may wish to maintain an interest and ownership in the bank, they are often unwilling or unable to pay the price the exiting shareholder desires. Even if there are a significant number of remaining shareholders interested in purchasing the exiting shares they are unlikely to use personal resources for the acquisition. Instead they will often look to the bank or bank holding company to purchase the shares; putting strain on the banks capital and earning assets.

- **Exiting shareholder(s) are key members of management and/or significant bank customers.** The loss of certain shareholders who hold key positions in the bank and are significant bank customers. The loss of this type of shareholder makes it even more difficult for the remaining shareholders to justify the purchase of the exit shares.

- **Family members are not interested in retaining ownership upon your passing or retirement (they just want the cash).** This also is a common situation. Family members inheriting the banks stock typically have or have had little to no direct working relationship with the bank. Oftentimes, they have moved away from the banks market area and have no perceived vested interest in growing the bank. This critical situation is dangerous for community/family owned banks and it's important for owners and managers to constantly monitor and evaluate the potential of this happening with their bank.

Selling or Transferring Ownership to an Insider

Sale or transfer of ownership to an insider is the most common method used, as well as the most successful in terms of bank continuity. After all, who is better prepared to ensure that the bank continues—at least in the short run—than existing employees or family members already involved in the day-to-day operation of the bank?

If you have decided that sale to an outsider buyer is the best course for you, then the following are some of the things you'll need to consider as you put your plan together:

- Should I engage a broker to sell the bank? Brokers are paid to get your bank sold. If the bank isn't sold, there are usually no or limited fees. Brokers' fees can be anywhere from 5 to 10% of the gross sales proceeds.

- Do I list the bank for a specific amount? In the art of negotiation, there is a common belief that he or she who speaks first always loses. An owner may wish to withhold the desired price range and ask the prospective buyer to provide a price for consideration. As previously mentioned, the owner needs to determine a reasonable price for the bank ahead of time.

- Am I selling the assets or the stock of the bank? The tax implications are significant if you are a C Corporation and you are selling assets. Most buyers are unwilling to purchase the stock because of the liabilities they assume. Proper advance planning can help minimize the tax implications.

- Am I willing to carry a portion of the purchase price on a contract or receive stock in the acquirer? Realistically, the number of buyers able or willing to buy a bank outright (with or without financing) is very small. Your ability and/or willingness to carry some portion of the purchase price or continued some investment in the acquirer can bring more prospective buyers to the table and help you achieve a higher price for your bank.

- Is real estate involved? Do you want to sell the real estate with the bank or are there reasons to keep it? If you insist on the real estate being acquired as part of the business purchase, the number of qualified buyers is likely to diminish because of the increased financial requirement and the likelihood the buyer has existing facilities they can use.

- Do I notify my employees and/or customers regarding the sale of the bank? Like you, your employees and customers are likely to have some very strong feelings, fears and concerns about the sale of the bank. If managed properly, they can become the greatest resource you have for completing the transaction efficiently and effectively.

List some of your initial ideas on how to structure the sale of your business

Many of the same issues and questions addressed in the sale of the bank to an outsider are applicable in the case of sale or transfer to an insider. There are, however, a few additional items to consider:

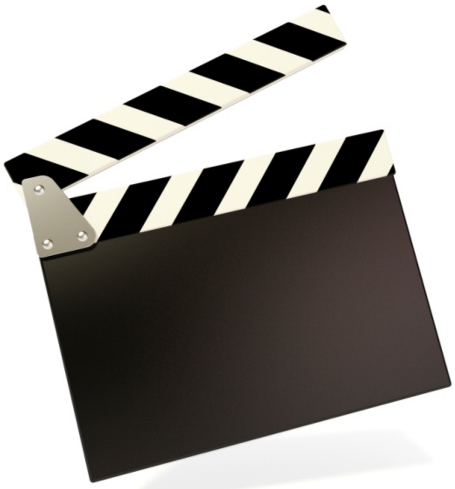
- Does the sale or transfer have any anticipated or unanticipated gift tax considerations? If the bank investment is sold at less than fair market value or is simply transferred to a family member, there may be gift tax implications to the seller. A professional valuation of the bank may be necessary to adequately document the value of the bank and assist in evaluating the gift tax impacts on the seller. One of the goals of transferring the bank may be to minimize the seller's estate. Proper planning can help to significantly reduce the taxable estate of the seller.

- What is the anticipated involvement of the seller going forward? Depending upon the terms reached in the sale or transfer of the bank, the seller oftentimes remains involved in certain aspects of the bank, both operationally and financially. A clear understanding between all parties regarding this involvement (including time frame) can avoid considerable grief down the road. Commitments from both parties should be documented as memories are frequently short.

- What kind of family and/or employee dynamics exist regarding the sale or transfer? Whether it be a family member or key employee, someone is likely to feel slighted. Care should be taken to ensure that key business personnel do not become disenfranchised, as they are critical to the future success of the business.

Liquidation of the Bank

The closing of a bank and liquidation of its assets and liabilities is uncommon. However, there have been instances where the bank simply ran out of options and ultimately entered a period of time where certain assets and liabilities were sold off and the bank simply closed its doors.

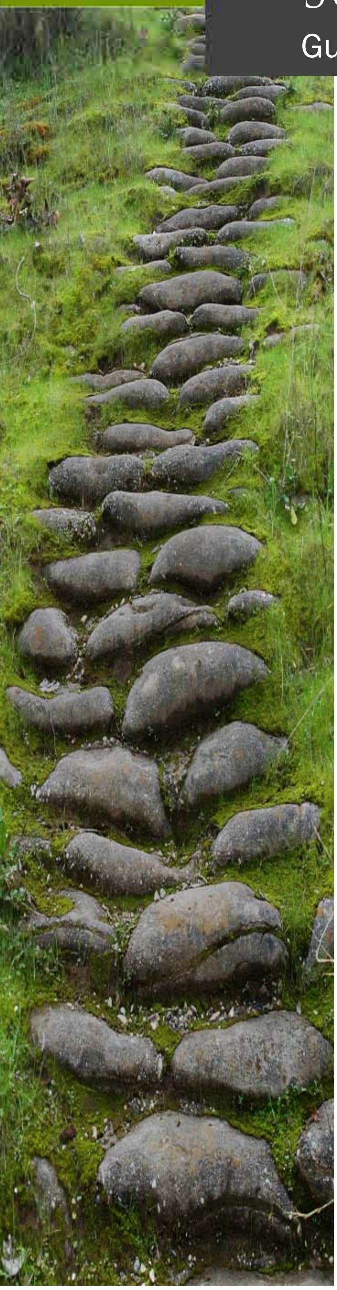


A Call to Action

We've discussed the two paths to exiting your bank: (1) selling or merging the bank with an outsider, and (2) selling your investment to another existing shareholder or insider(s). While you may not be in a position today to know which path is best for you, taking steps in one direction or the other will likely bring clarity and help you identify the proper course. Because time is still on your side, a course correction should be possible if you determine the path you've chosen is no longer appropriate or available.

Succession planning is a process, ultimately culminating with the achievement of your exit objectives. It's important to remember "planning" is a verb, implying action. As such, it's vital you take your first action in putting your plan together. That first step could be as simple as sitting down with your board, your shareholders, your advisors, your trusted employees or by yourself and jotting down some initial thoughts about the direction you wish to take regarding your exit. As the old adage goes, "Failing to plan is really a plan to fail."

WHAT ARE THE NEXT STEPS I AM WILLING TO TAKE FOR A SOLID START?



If you're only a few years away from retirement and this is the first opportunity you've taken to consider how to fund your retirement, you may have a sizable mountain to climb. Don't give up hope; you're not that different from a lot of small bank owners who simply have not had the time or expert assistance necessary to address their retirement. The potential financial resources available from your small bank, a solid exit plan, and sound financial counsel all offer you an incredible opportunity to secure your financial well-being as you look to retirement.

We've previously discussed the need for bank owners to evaluate their ability to step away from their businesses as they consider their exit strategies. Along with evaluating your ability to step away from the bank, you must also consider two other key questions: 1) are you ready to retire, and 2) what does retirement mean to you?

Are You Ready to Retire?

This question is actually more complicated than it first appears because it must be considered on two levels. First, there's the emotional component. Are you ready to enter a new phase of life? Do you have a plan for what you would like to accomplish or do in retirement? Second, there's the financial component. Can you afford to retire? Will your financial resources support the retirement lifestyle you want? Do you have a retirement income plan in place?

What Does Retirement Mean to You?

When you close your eyes and think about your retirement years, what do you see? Oftentimes, people have only a vague concept of retirement being a period of time when they can enjoy the "good life" and not have to show up at their place of business anymore. To enjoy the retirement you desire, it's essential to clearly define what retirement means to you and then carefully put together a plan to achieve your goals. Do you see yourself pursuing hobbies or travel? Have you thought about volunteering your time or using retirement as an opportunity to pursue other business interests or even a new career? If you haven't considered these questions, discussed them with your family, and assembled a plan, you're not ready to retire.

Don't underestimate the emotional aspect of retirement. Many people define themselves by their profession or business. Affirmation and your sense of worth have probably come largely from the success of your business or profession. Giving up your business or profession can be disconcerting on a number of levels. Consider also that your job or business provides a certain structure to your daily life. Without something concrete to fill the void, you may find yourself scrambling to address unmet emotional needs.

Timing Is Everything

When it comes to transitioning into retirement, timing really is everything. The age at which you retire can have an enormous impact on your overall retirement income situation, so you'll want to make sure you've considered your decision from every angle. In fact, you'll probably find that deciding when to retire is actually the product of a series of smaller decisions and calculations.

The good news is that, statistically, you're going to live for a long time. That's also the bad news, though, because it means your retirement income plan is going to have to be sufficient to provide for your needs over (potentially) a long period of time. The average 65-year old American can expect to live for an additional 19+ years. The bottom line is that it's not unreasonable to plan for a retirement period lasting 30 years or more.

Retiring early can be wonderful if you're ready both emotionally and financially. Consider the financial aspect of an early retirement with great care, though. Early retirement can dramatically change your retirement finances because it affects your income plan in two major ways. First, you're giving up what could be prime earning years in which you could be adding to your retirement savings. More importantly, though, you're increasing the number of years your retirement savings will need to cover your expenses. A few years can make a tremendous difference. Postponing retirement lets you continue to add to your retirement savings.

That's especially advantageous if you're participating in tax-deferred savings accounts and your employer or business provides matching contributions or profit sharing. Even if you're no longer adding to your retirement savings, delaying retirement postpones the date you'll need to start withdrawing from your savings. That could significantly enhance your savings' potential to last throughout your lifetime.

If you're thinking of working during a portion of your retirement, you'll want to consider carefully how it might affect your overall retirement income plan. For example:

- If you continue to work, will you have access to affordable health care?
- Will working in retirement allow you to delay receiving Social Security retirement benefits? If so, your annual benefit (when you begin receiving benefits) may be higher.
- If you'll be receiving Social Security benefits while working, how will your work income affect the amount of benefits you receive?

What are my plans for retirement? List some things you would like to do with your time and money.

Retirement Income: The "Three-Legged Stool"

Traditionally, retirement income has been described as a "three-legged stool" comprised of Social Security, traditional employer pension income, and individual savings and investments (e.g., business interests). However, fewer and fewer individuals are covered by employer-provided pension plans, and the analogy of the three-legged stool doesn't hold up very well today.

Social Security Retirement Income

The amount of Social Security retirement benefit you're entitled to is based on the number of years you've been working and the amount you've earned. Your benefit is calculated using a formula that takes into account your 35 highest earning years.

The earliest you can begin receiving Social Security retirement benefits is age 62. If you decide to start collecting benefits before your full retirement age (which ranges from 65 to 67, depending upon the year you were born), there is a major drawback to consider: your monthly benefit will be permanently reduced by as much as 20% to 30% compared to what you would have received if you had waited until full retirement age. However, because you'll be drawing benefits earlier, you'll receive more benefit checks during your lifetime.

Traditional Employer Pensions

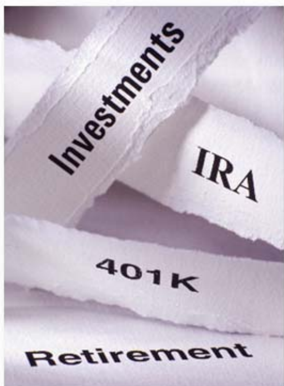
If you're entitled to a traditional pension, you're lucky; fewer Americans are covered by them every year. In fact, most small bank owners don't have pension plans. If you or your spouse are fortunate enough to have an employer pension plan available for retirement income, there are a number of issues that need to be addressed regarding when you receive those funds. Each plan is different, and we encourage you to seek advice from your financial advisors before making any decisions regarding the withdrawal of pension funds.

Personal Savings

Most people are not going to be able to rely on Social Security retirement benefits to provide for all their retirement needs, and, as noted earlier, traditional pensions are becoming rare. That leaves the last leg of the three-legged stool—personal savings—to carry most of the burden when it comes to your retirement income plan.

Your personal savings are funds you've accumulated in tax-advantaged retirement accounts such as 401(k) plans, 403(b) plans, 457(b) plans, and IRAs, as well as any investments you hold outside of tax-advantaged accounts. Oftentimes, we find that the largest personal savings item a small business owner has is his or her business interest. The challenge with this situation is that the business interest is not readily convertible to cash. Proper planning to ensure that other liquid assets are available to take care of early retirement income needs is critical, particularly if the business is sold on a contract with limited amounts down or contingencies based on future performance of the business.

Until now, when it came to personal savings your focus was probably on accumulation—building as large a nest egg or business value as possible. As you start to transition into retirement, you're going to need to look at your personal savings in terms of distribution (or access to it) and income potential. When putting your retirement income plan together, you will need to maximize the ability of your personal savings to provide annual income during your retirement years, closing the gap between your annual need and the projected funds you will be receiving from Social Security and other sources of retirement income.



The Bottom Line

The worst thing that can happen to you and your family is for your retirement income sources to fall short of your needs. Small business owners have considerably more planning considerations compared to employed individuals as they must deal with the conversion of their business to a retirement income source.

If it's not evident yet, planning for the succession of your business is something that can't be started too early. As advisors to many small business owners, we encourage owners to begin the process of exit or succession planning the second the business is opened or purchased.

When it comes to retirement income planning, don't go it alone! Having the correct team of individuals—your accountant and business advisor, your financial advisor, your legal counsel and your family—is essential to successfully navigating your way through this process and ensuring successful completion of a written plan.

What are some other questions or concerns that come to mind?

Net Income (loss) (1)		______
Interest	______	
Income taxes	______	
Depreciation	______	
Amortization	______	
Unadjusted EBITDA		______
Discretionary Expenses (2) :		
Meals and entertainment	______	
Auto	______	
Travel	______	
Owner/family salaries	______	
______	______	
______	______	
______	______	
______	______	
______	______	
Total		______
Adjusted EBITDA		
Estimated Required Rate of Return (3)	÷	______
Estimated Enterprise Value		______

(1) Consideration should be given to using an average or weighted average of the net income (loss) from the business for the past five years as opposed to any one single year. If future annual net income (loss) is expected to be dramatically different than historical, then a budgeted amount should be considered and documented.

(2) Discretionary expenses are those that are not deemed necessary for the successful and profitable operation of the business. Adjustments may be positive or negative depending upon your specific situation.

(3) See Exhibit 2 for assistance in developing an estimated required rate of return. Consideration should be given to seeking advice from a qualified valuation professional.

		Your Estimate	Example
Risk-free rate (20-year Treasury bond) (1)			4.6%
Long-horizon equity risk premium (2)	+		6.5%
Small stock equity risk premium (3)	+		5.8%
Company-specific equity risk premium (4)	+		3.0%
Estimated required rate of return on equity – after tax	=		19.9%
1 minus (-) estimated effective tax rate (5)	÷		65.00%
Estimated required rate of return on equity – before tax	=		30.6%

Observation

Required rates of return (before tax) observed in the marketplace generally fall between 20% and 45%. Companies that have a strong earnings history, strong market position, depth of management, mature business and industry, protected market territories because of franchise agreements or distributor agreements, and good growth opportunities will be closer to the low end of the range than companies without those attributes.

(1) Rate available as of valuation date per Wall Street Journal or via the Internet at *http://www.treasury.gov/offices/domestic-finance/debt-management/interest-rate/ltcompositeindex.shtml*

(2) Represents the large company stock total returns minus long-term government bond income returns, as presented in Ibbotson Associates *Stocks, Bonds, Bills and Inflation Yearbook*.

(3) Represents the small company stock total returns minus the large company stock total returns, as presented in Ibbotson Associates *Stocks, Bonds, Bills and Inflation Yearbook*.

(4) Estimated based on consideration of your company-specific factors, including size, financial condition, earnings history, market position, depth of management, maturity of business and industry.

(5) Rate is specific to the buyer and their tax position. Estimate is based on assumed federal and state income tax rates that an investor may be subject to on the income derived from the business.

Notes

Notes

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