StatonWalsh

Financial Clarity Through Transparency

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Table of Contents

Financing the Replacement of a Key Employee

Replacing an employee – particularly a key employee – can be expensive. It is better to prepare ahead of time for this potential cost. There are a number of methods commonly used to finance the hiring and training of a new key employee:

- **Pay in cash:** However, most businesses do not keep large amounts of cash sitting idle; the money is typically working in the business. The need to raise cash quickly may result in “distress sales” of valuable assets, at a price below fair market value.
- **Establish a sinking fund:** However, dollars kept in a savings account represent lost business opportunities. For example, if each $1.00 put into a marketing campaign returns $10.00 in sales and the company has a 15% profit margin, the return on each $1.00 invested in marketing is $1.50. On an annual basis, this would be a 50% return. If the same dollar (along with the profits) were reinvested two or three times a year, with a similar increase, the ultimate return would be many times that earned in a bank account.
  Therefore, a sinking fund may be very costly when one considers the loss of business opportunities.
- **Borrow the funds:** This option assumes that the loss of a key employee does not seriously damage the firm’s credit worthiness. Each dollar borrowed must be repaid, with interest. If the loan were amortized over a 10-year period, at 8% interest, for each $1,000 borrowed the company would repay a total of $1,440.
  Here, too, the business owner must take into account the “opportunity cost” of missed growth and profits, had the money used to repay the loan been invested in the company instead.
- **Life insurance policies:** Many business owners choose life insurance to protect against the loss of a key employee. The premiums are small compared to the lump sum which would have to be quickly raised, either out of earnings or by borrowing, when a death does occur.[1]

If permanent-type policies are used there will also be a cash value build up, which can be available for the business in time of need, regardless of the firm’s credit worthiness.

[1] Under the provisions of IRC Sec. 101(j), death proceeds from a life insurance policy owned by an employer on the life of an employee are generally includable in income, unless certain requirements are met. The law was effective for contracts issued after August 17, 2006, except for contracts acquired under an IRC Sec. 1035 Exchange. State or local law may vary. Professional legal and tax guidance are strongly recommended.

Key Employee Coverage Issues

Both the IRS and the courts have long recognized that the loss of a manager, scientist, salesperson or other key individual will almost always have a serious effect on the earning power and sometimes on the very stability of a business. Although the principle applies in publicly held businesses, it is particularly true in a closely held corporation where profits are dependent on the ability, initiative, judgment or business connections of a single person or small group of owner/employees. The death or disability of a key person at the wrong time can have a dramatic impact in a smaller business.

There is no universally recognized and accepted formula for computing the economic effect of the loss of a key person. One method used in several court cases utilizes a discount approach in which a percentage discount is taken from the going concern value of the business.

Some authorities feel that if the business will survive the death of the key employee and, in time, a competent successor can be found, a discount factor of from 15% - 20% should be used. Where the business is likely to fail or be placed in serious jeopardy upon the death (or disability) of the key employee, a discount of from 20% - 45% is more appropriate. The exact discount factor should be arrived at through consultation with the officers of the company and the firm's accounting and legal advisers.

Some questions to ask in determining the factor (or range of factors) to be used include the following:

- How long will it take for a new person to reach the efficiency of the key individual?
- How much will it cost to locate and situate a replacement?
- Will the new employee demand more salary?
- How much will it cost to train the new person?
- What mistakes is a replacement likely to make during the break-in period and how much are those mistakes likely to cost the company?
- What proportion of the firm's current net profit is attributable to the key employee?
- Is the employee engaged in any projects that, if left unfinished at death or disability, would prove costly to the business? If so, how costly?

- Would a potentially profitable project have to be abandoned or would a productive department have to be closed?
- Would the employee's death result in the loss of clientele or personnel attracted to the business because of his or her personality, social contacts, unique skills, talents or managerial ability?
- What effect would the key employee's death have on the firm's credit standing?
- What proportion of the firm's actual loss is it willing to self-insure, if any?

Key Employee Insurance

The untimely death of a key employee or a business owner who is also a key employee can have a disastrous effect on a business. Some of the "costs" of such an event might include the following:

- A weakening of the company's credit rating.
- The financial cost (in time and dollars) to find, hire, and train a replacement.
- The distraction of other employees, resulting in deadlines not met, deteriorating morale, or a higher level of personality conflicts.
- A need for cash to fulfill promises made to the deceased employee's spouse or family, such as salary continuation or deferred compensation.
- The inability to seize a business opportunity, because cash reserves are being used to recruit and train a new employee.
- A loss of confidence among both suppliers and customers.

Additional problems may exist if key employee is also an owner.

- Disagreements between the heirs and the surviving business owners or key employees.
- Lack of cash to buy the interest of a deceased owner, requiring a sale of the business to an unknown, outside third party.
- Surviving owners may be forced to work with someone who is either not competent or not motivated enough to make the business thrive.
- The business may have to be sold to pay estate taxes.

Key Employee Disability Plans

Frequently a business will purchase key employee life insurance coverage. In doing so, the owners express their understanding that a business may suffer financially if a key person dies.

Often overlooked in their decision, however, is what will happen to the business if a key person is disabled. In this instance, the business may confront the same financial issues it would face if the key employee were to die. Some of these issues include the following:

- The costs to recruit a replacement.
- The costs to train a replacement.
- The opportunity costs of lost business from the disability of the key employee.

The key person disability plan will protect the business by providing funds to help cover the potential lost profits and the costs of finding and training a replacement.

Some of these plans offer a replacement benefit which will reimburse the company for some percentage of the replacement costs, up to certain limits, for the first 12 to 24 months after the key person's disability occurs.

Sometimes the key person disability plan will be convertible to individual coverage if the business has no further need for the coverage, the insured needs additional individual coverage and the insured meets certain income and, possibly, physical requirements.

Note: Key employee disability insurance has become a specialty product and providers of this important coverage are becoming more difficult to find.

Methods of Valuing a Key Employee

There is no easy mathematical formula to determine the value of a key employee. However, over the years business owners have frequently used three different methods to estimate the worth of an employee to their company.

- **The cost of replacement method:** Totals the direct, out-of-pocket costs involved in finding, hiring and training a replacement, as well as the estimated loss-of-opportunity costs.

- **The contribution to profits method:** Estimates the impact a key employee has on the company's net profit. The firm first calculates the expected profit from a normal return on capital, e.g., the net book value of assets. Profit in excess of this normal return is assumed to result from the efforts of the key employees. An estimate is made of the percentage of profit attributable to each key employee. This percentage is then multiplied by total excess profit, to determine the dollar amount of excess profit from each key employee. This sum is then multiplied times the number of years needed to find and train a competent replacement.

- **The multiple of compensation method:** Assumes that an employee's value is accurately reflected in his or her total compensation package. The multiple that is used (for example: 2 x annual compensation), will depend on the type of business and the estimated difficulty in finding a qualified replacement. This method is perhaps the easiest way to estimate the potential loss to the firm.

Protecting Against the Loss of a Key Employee

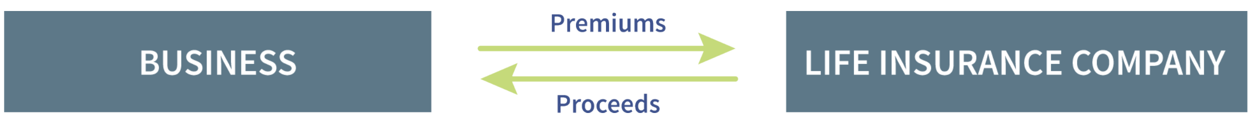
Business owners frequently use life insurance to protect their company from many of the potential problems which may otherwise damage or destroy what has taken years to build.

Life insurance is unique in that it will generally pay the pre-determined amount no matter when the death occurs.

The premiums are usually small compared to the potential death benefit. Also, if policies are used which develop cash values, they can be shown as business assets on the balance sheet, contributing to the value of the business and potentially to its borrowing power.

Borrowing against cash values may also be a lifesaving source in times of financial crisis.[1]

How Key Employee Insurance Works



- Company owns the policy.
- Company pays the premiums.
- After death, the company collects the policy proceeds.[2]

Potential Uses for Proceeds

- Purchasing stock from the decedent's estate.
- Honoring salary continuation arrangements to surviving spouse.
- Finding, recruiting, and training a new employee.
- Paying any necessary bills and strengthening the credit position.
- Funding expansion of the business.
- Adding income-tax free corporate surplus.

[1] Policy loans and interest will reduce the payable death benefit of a policy. If a policy lapses or is surrendered with a loan outstanding, the loan will be treated as taxable income in the current year, to the extent of gain in the policy.

[2] Under the provisions of IRC Sec. 101(j), death proceeds from a life insurance policy owned by an employer on the life of an employee are generally includable in income, unless certain requirements are met. State or local law may vary. Professional legal and tax guidance is strongly recommended.

Important Notice

This report is intended to serve as a basis for further discussion with your other professional advisors. Although great effort has been taken to provide accurate numbers and explanations, the information in this report should not be relied upon for preparing tax returns or making investment decisions.

Assumed rates of return are not in any way to be taken as guaranteed projections of actual returns from any recommended investment opportunity. The actual application of some of these concepts may be the practice of law and is the proper responsibility of your attorney.

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