



Don't Be Fooled By the Numbers

Financial statements are often interpreted differently by prospective buyers than by management.

by Mark D. Working

For most private companies, financial statements are used to keep score, comparing performance from period to period. As long as the records are consistently prepared, that relative measure may be sufficient to manage the business. There are no penalties for imprecise or unclear presentations.

However, when it comes time to sell the business, financial statements take on a whole new meaning. Not only are they used to value the business, but they are also used to measure what the buyer will receive for that value.

Buyers tend to be skeptical. They are undertaking far more due diligence today than was generally conducted during the late 1990's. Part of this is forced by lenders but, make no mistake, before investors write a check, they will make a concerted effort to understand the business and the strategy to create the next increment of value.

The focus of a buyer's due diligence is typically concentrated in two areas: 1) gaining an understanding of how the business generates sales and profits by customer, product,

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and business segment; and 2) confirmation of the quality of the assets.

Confirming the quality of assets is accomplished by affirming the amount, condition and value as ascribed on the financial statements. Each account is closely evaluated. Among the most common issues are:

1. ACCOUNTS RECEIVABLE

An evaluation of accounts receivable

Balance Sheet Accounts

ACCOUNTS RECEIVABLE

INVENTORY

PREPAID EXPENSES

FIXED ASSETS

ACCRUED LIABILITIES

CONTINGENT LIABILITIES

typically begins with confirming that each of the obligations arose from a legitimate sale transaction. The investigation then turns to an evaluation of whether all of the accounts are collectable within customary terms. To the extent that they are not, the buyer will demand a discount, will carve out a portion of the purchase price, or will require an escrow or seller guarantee.

2. INVENTORY

The value of inventory is often a subject of significant controversy. A buyer's evaluation of inventory focuses on cost, quantity, condition and salability. Other than to confirm consistency, buyers have little interest in the costing methodology used for accounting purposes. Rather, they want to know that inventory is valued at the lowest possible cost at which the same items can currently be purchased. They want to know that all of the inventory that is currently on hand is salable in the ordinary course, and whether any is obsolete or stale dated. They will typically require a complete physical count at closing and will determine whether the quantities on hand are in excess of those required by current customer demand. Negative conclusions to these tests will give rise to a claim for a reduction in the purchase price.

3. FIXED ASSETS

Accounting standards require that fixed assets are recorded at their historical cost. That may or may not be a relevant measure today. In all but distressed situations, buyers are typically paying some premium over the value of the assets. However, buyers are always on the lookout for deferred maintenance or assets which are not used or useful in the conduct of the business. Buyers are always keen to assess the cost to maintain and replace the assets at the end of their useful lives. Excessive repair and maintenance expenses or significant capital investment required in the near term to maintain the productive capacity will be grounds for a price reduction.

4. PREPAID EXPENSES / ACCRUED LIABILITIES

If prepaid expenses are to be included in a sale, buyers will evaluate each to confirm that the goods or services subject to the accrual have not already benefited the seller. Any deferred revenue will be evaluated to ensure that the amounts are sufficient to fully cover the cost of providing the goods or services at the anticipated gross margin. Mis-

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matches in these accounts may give rise to a claim for adjustments to the purchase price.

5. CONTINGENT LIABILITIES

Although most businesses do not explicitly recognize or record them, nearly all have some type of contingent liabilities. The most common would include product warranties

or service guarantees. Buyers will expect a reserve that reflects actual experience. Often business contracts can give rise to contingent liabilities such as employment agreements, supply or purchase contracts. While businesses often deal with such matters as an on-going cost of business, buyers expect to assign value to these liabilities and deduct it from the purchase price.

The uninitiated may expect that an impairment of asset values would reduce the purchase price dollar for dollar. We have, on many occasions, worked with buyers that

have demanded price reductions in multiples of the adjustment amount. How is that result possible? It is justified on the fact that the asset impairment resulted from a systematic overstatement of earnings, which should be grossed up by the multiple implicit in the valuation of the business. The implication is that the profitability may not be as represented by historical financial statements and, therefore, that future expectations may also be lower. As one might imagine, this can come as a rude shock to the seller who thinks the price has already been negotiated.

So, while a private company that is not for sale may choose not to concern itself with these realities, we would advocate that business managers always treat financial reporting as if they were a buyer of the business. Businesses that adopt procedures to closely monitor balance sheet accounts will not only improve the result if there ever is a sale but, as important, they will not be fooling themselves as to the true financial performance of the business. ♦



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Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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