

UNDERSTANDING FINANCIAL DOCUMENTS AND WORKING WITH YOUR EXPERT

Presented by
Ms. Rachel Buse-Flaskey

I. Financial Statement Terminology Used in Business Valuation (see handouts)

A. The Basic Financial Statements

1. Balance Sheet: Assets, liabilities, and owner's equity at a point in time, all at book value (original, historical cost less depreciation and other non-cash charges) in accordance with accounting principles.
2. Income Statement: Revenues, expense and income over a period of time (fiscal period), usually a year.

B. Balance Sheet Concepts

1. *Common Equity* (at book value) is paid in capital plus retained earnings.
2. *Invested Capital* is equity plus interest-bearing debt.
3. *Capital Structure* is the relative proportions of the various elements of invested capital.
4. *Book Value* is the difference between the total assets and the total liabilities (otherwise known as book value of equity).
5. *Book Value per Share* is the value of common equity divided by the number of shares outstanding.
6. *Net Working Capital* is the current assets minus the current liabilities.

C. Expense Concepts

1. *Owner's Compensation* includes all elements of compensation, including salary, bonuses, retirement benefits, life and health insurance benefits, discretionary expenses, and value of stock options.
2. *Non-Cash Charges* are items that are charged as expenses on the income statement but do not require a cash outlay. Examples would include depreciation, depletion, amortization, and deferred taxes.

D. Levels of Economic Income

1. *Sales (Net Revenues)*
2. *Owner's Cash Flow* typically reflects earnings of a business enterprise prior to the following items: income taxes, non-operating income and expenses, non-recurring income and expenses, depreciation and amortization, interest expense or income, and owner's total compensation for those services (essentially EBITDA plus owner's compensation).
3. *Earnings before Interest, Taxes, Depreciation, and Amortization (EBITDA)* is computed as earnings before interest, taxes, and all non-cash charges, including depreciation, amortization, depletion, and deferred taxes.
4. *Gross Cash Flow* is defined as net income plus non-cash charges.
5. *Debt-Free Net Income* means what the net income would be if there were no debt. It is computed by adding the interest expense, net of the tax effect (income taxes saved because the interest is a tax-deductible expense) to the net income.
6. *Debt-Free Cash Flow* is debt-free net income plus non-cash charges. "Debt-Free" measures are used to make companies with significantly different capital structures more comparable to each other.
7. *Pre-Tax Income* is income after all expenses except income taxes.
8. *Net Income* is income after all expenses, including interest, owner's compensation, noncash charges, and income taxes.

9. *Net Cash Flow to Invested Capital* is the amount of cash available to distribute to owners and stakeholders of all components of the capital structure (preferred and common equity and interest-bearing debt) after leaving enough room for the capital expenditures and working capital necessary to sustain projected operations.
 10. *Net Cash Flow to Equity* is the amount of cash available to equity holders to withdraw from or distribute from the business after leaving enough for the capital expenditures and working capital necessary to sustain projected operations.
- E. Variable Affecting Net Cash Flow
1. *Capital Expenditures* are the amounts paid for assets expected to have a long-term economic life (usually more than one year), recorded on the balance sheet at the amount paid, and usually depreciated (or depleted or amortized) over time as expenses on the income statements and reductions to book value on the balance sheet. Expected capital expenditures must be estimated as a component in computing the net cash flow in the income approach, for the capital expenditure requirements represent a portion of the gross cash flow that must remain in the business to support projected operations.
 2. *Changes in Net Working Capital* are the amounts added to or subtracted from the net working capital needed to support the operations of the business. Changes in the net working capital must be estimated as one of the components in computing the net cash flow in the income approach, for it represents an amount of cash flow that must remain in the business to support projected operations.
 3. *Changes in Debt*
- F. Cash versus Accrual Basis Accounting
1. *Accrual Basis Accounting* is where revenues and expenses are recorded when they are earned or incurred.
 2. *Cash Basis Accounting* is where revenues and expenses are recorded when they are received or paid.

II. Personal Tax Returns – Broad Overview

- A. *Wages, Salaries, Tips and Other Income*. If there are questions regarding income, reported wages and income per the tax return should be matched to W-2s and 1099s, and also matched to deposits to determine whether all wages were used for the benefit of the couple or whether there are funds in another account.
- B. *Interest and Dividend Income*. A list of the source of the interest and dividend income is found on Schedule B of the personal tax return. This category reveals the existence of bank accounts, money market accounts, and stock/bond/trading accounts.
- C. *Tax Refunds*. A tax refund line should prompt a request for information about the current year's tax payments and how any expected refunds (or additional payments) will be split.
- D. *Alimony or Child Support Received or Paid*. Alimony is deductible to the payer, and is taxed as income to the payee. Child support received does not count as taxable income nor does child support paid count as a taxable deduction.
- E. *Pensions and Annuities*. Should prompt a question regarding retirement accounts and whether they are defined contribution versus defined benefit plans. In addition, statements from the retirement plans should be obtained to ascertain whether there are any loans against the retirement plans, when those funds were received, and into which account the funds were deposited.
- F. *Other Income*. Rental real estate, royalty, and business income should prompt further questions and possibly lead to consulting or valuation procedures with an accredited business appraiser. Farm income should prompt further questions regarding prepaid farm expenses, annual financial statements supplied to the bank, and land and equipment owned. Social security benefits can be valued to a net present value lump sum amount (similar to benefits to be received, or being received, from a defined benefit retirement plan).

- G. *IRAs and Other Retirement Contributions.* Deductions claimed for retirement contributions should be confirmed.
- H. *Other Adjustments to Income.* There can indicate the existence of such things as health insurance, student loans, and receipt of funds held in savings/CD accounts.
- I. *Tax Credits.* Credits can indicate the existence of other income not yet disclosed (i.e. you must have foreign income in order to claim a foreign tax credit).
- J. *Tax Payments.* All payments reported – whether estimated or withheld – should be accounted for. In addition, the source of the payments should be ascertained (i.e. were they paid from a company account or from an undisclosed bank account?).
- K. *Schedule A – Itemized Deductions.*
 - 1. Home Mortgage Interest Deduction – This should be matched to any 1098 form furnished by the lender. If more is being deducted this could indicate there is additional property owned by a spouse that has not been disclosed.
 - 2. State and Local Income Taxes – similar to federal income tax payments or refunds, the source of any payments or the status of any refunds should be ascertained.
 - 3. Real Estate Taxes – Similar to the home mortgage interest deduction, this should be matched to the property tax notice(s) received.
- L. *Schedule B – Interest and Dividends.* All interest and dividends should be matched to statements.
- M. *Schedule C - Business Income.* This form is for the reporting of business income not separately reported by a partnership or corporation. Additional records will be needed from the business owner if a valuation is to be performed as the tax schedules do not report any balance sheet (asset/liability) items.
- N. *Schedule F - Farm Income.* Reported income should be matched to corresponding bank deposits or statements from co-ops or governmental agencies. Expenses should be analyzed to determine whether any prepaid expenses (seed, fertilizer, chemical, etc for the next planting year) have been included on the tax return.
- O. *Schedule D – Capital Gains and Losses.* Investment and property sales are reported as capital gains or losses. Among the information disclosed on this schedule is the date a capital asset was purchased, its original cost, the date it was sold, and the proceeds received from the sale. It is important to ascertain an explanation of the source of cash used to purchase investments and the disposition of cash from the sale of investments. The Schedule D requests separate disclosure for capital gains or losses realized through partnerships, S corporations, estates, and other entities.
- P. *Schedule E – Rental Properties, Partnerships, and Other Arrangements.* Almost all partnerships and trusts are required to provide the IRS and taxpayers a K-1 annually. The K-1's will show the amount of income allocated to the owner, the ownership percentage owned, and the amount of distributions received for that year, if any. The rental real estate schedules will show the name of the properties rented in addition to the annual rental income and expenses for that property. It is important to obtain copies of any leases in effect in addition to considering the net cash flow (i.e. add back depreciation) to the owner and the financial condition of the renter.

III. Overview of Business Valuation Approaches, Methods, and Procedures

- A. *Income Approach* involves valuing the business or business interest on the basis of some form of expected economic income stream; in real estate appraisal usually called “capitalization.”
 - 1. *Discounted Cash Flows Method:* Projecting the expected economic income over the life of the investment and discounting each increment of that expected income back to a present value at a rate of return known as a discount rate.

2. *Capitalization of Earnings/Cash Flows Method*: Observing or estimating a single period's economic income and dividing it by a rate of return adjusted for expected growth known as a capitalization rate.
- B. *Market Approach* involves valuing the business or business interest by reference to other transactions; in real estate appraisal usually call the "comparable sales approach."
1. *Guideline public company method*: Derive valuation multiples from prices and financial data of company stocks traded in the public market and then applying the multiples to the appropriate financial data of the Subject company (such as EBITDA or Revenues).
 2. *Guideline transaction method*: Derives valuation multiples from prices and financial data of public or private companies that have been sold and applies the multiples to the appropriate financial data of the subject company.
 3. *Past transactions method*: Uses multiples of financial data from the company's own past transactions; however, the transactions utilized need to be arm's length transactions.
 4. *Buy-Sell Agreements*: These need to be arm's length agreements with some valuation basis for the formulas specified in the agreement. The weight to be accorded to the value indicated by a buy-sell agreement is usually determined on a case-by-case basis.
 5. *Rules of Thumb*. Employs "ballpark" ranges of possible values derived from simple formulas used in an industry. Typically these formulas do not form the entire basis for a valuation as they can be very vague, but can be useful "sanity checks" for the appraiser.
- C. *Asset Approach* involves valuing the business on the basis of assets and liabilities; somewhat analogous to the "cost approach" in real estate appraisal.
1. *Adjusted Net Asset Value Method*: Adjusts all the company's assets (both tangible and intangible) and liabilities to current value, usually fair market value, and subtracts the liabilities from the assets to arrive at the value of the equity of a business or business interest.
 2. *Excess Earnings Method*: Adjusts only the company's tangible assets to current value and subtracts the liabilities to obtain a net tangible asset value. The amount of income needed to support the net tangible assets is then estimated, and any excess income is divided by a capitalization rate to estimate the value of the company's intangible assets. The estimated value of the intangible assets is then added to the value of the tangible assets to arrive at a total net asset value.

IV. Overview of Business Valuation Reports

A. Introduction

1. *Who the Client Is*. The report will probably contain some type of cover letter or letter of transmittal that will be addressed to the client. The introduction usually includes an identification of the client and intended users.
2. *Intended Use of the Valuation*. The reader needs to know the intended use of the valuation to understand the standard of value used and other decisions made by the valuation analyst.
3. *What is Being Valued*. This section identifies whether an entire company or a partial ownership interest is being valued.
4. *Effective Valuation Date*. The date of the valuation. Generally, the valuation analyst only can use information that was available or could have become known at the date of the valuation. Statistical information released after this date that compiles information prior to this date usually is allowed.
5. *Degree of Control*. If the valuation is of a partial interest, the degree of control is important in normalization decisions, lack of control discounts, and/or control premium considerations.
6. *Marketability of the Interest*. The size of the company and its ability to go public, along with any restrictions by government regulation, supplier restrictions, or shareholder

agreements is provided for the reader to understand the valuation analyst's consideration of any lack of marketability discount.

7. *Standard of Value Being Utilized.* The standard of value used in the report must be stated and the source of that standard cited.
 8. *Scope of Work.* Any scope limitations experienced in conducting the valuation and the valuation analyst's assessment of the consequences of the opinion are disclosed.
 9. *Professional Standards Followed.* USPAP, AICPA, NACVA, etc.
- B. Sources of Information
1. *Extent to Which the Facilities Were Visited and Persons Interviewed.* The valuation analyst normally will have visited the company's facilities or if there are multiple locations the report will identify which facilities were visited. The report also will identify the names and positions of those who were interviewed.
 2. *Financial Information.* The sources of the financial information should be listed, such as compiled, reviewed, or audited financial statements, and/or tax returns. The valuation analyst should specify whether the valuation firm was associated with the financial statement or tax return preparation.
 3. *Economic Conditions.* The valuation analyst will report on general economic conditions that affect the risks associated with the company being valued. The sources, both government and private, should be identified in the report.
 4. *Industry Data.* The specific attributes of the company's industry should be researched by the valuation analyst to assess the risks that are inherent in the industry. The data obtained and its relevance should be discussed in the report.
 5. *Other Empirical Data.* There may be other information available the valuation analyst found meaningful that should be disclosed in the report.
- C. Company Analysis
1. *Background and History.* The history of the company along with the ownership and changes should be discussed. In addition, the organizations structure of the company and management depth will also be discussed.
 2. *Products and Services.* The primary products or services supplied by the company should be described.
 3. *Customers and Suppliers.* If there is any reliance on a small group of customers or suppliers should be disclosed. The company's attempts to differentiate itself in the marketplace may also be described here.
 4. *Market Area.* The geographical market targeted by the company should be described, in addition to the company's primary competition.
 5. *Strategic Plans.* The report should discuss the company's plans for the future. These should include revenue and income projections in addition to any new product lines or expected growth.
 6. *Various Company Risks.* Threat of new entrants to the market, technological risk, environmental risks, regulatory risks, product trends, and global risk should be discussed.
 7. *Staff.* Any primary management staff and their qualifications should be discussed as well as the size of the company workforce.
- D. Financial Analysis
1. *Liquidity Ratios.* These ratios measure the ability of the company to meet current obligations with cash or assets that can quickly be turned into cash.
 2. *Profitability Ratios.* These ratios measure the ability of the company to generate net income.
 3. *Leverage Ratios.* These ratios measure the degree the company relies on debt financing and the ability to survive a downturn in profitability.
 4. *Sales and Profit Trends.* The trends in the performance of the company should be presented and should help support the future projections of income used in the valuation.

E. Normalization Adjustments

1. *Related Party Transactions*. Many related-party transactions do not occur at arm's length (i.e. rent paid to an owner at above/below market rates).
2. *Non-recurring Items*. Some expenses each year are unusual and are not likely to reoccur. Since the purpose of valuation is forward looking these items are typically adjusted to reflect "normal" company operations.
3. *Non-operating Assets or Liabilities*. Certain assets or liabilities may not be relevant to operations. The valuation analyst would remove any related income/expense from the earnings stream and then add back the non-operating asset or liability. (example: excess cash or excessive life insurance that has cash value)
4. *Adjustments to Generally Accepted Accounting Principles (GAAP)*. Example: car dealership that uses LIFO inventory accounting versus FIFO.

F. Valuation Approaches and Methods

1. In a report that expresses an opinion or conclusion of value, all the valuation approaches and methods that were considered by the valuation analyst, including those that were rejected, should be discussed.
2. In a report that expresses a calculated value, just the approaches and methods agreed upon with the client will be discussed.

G. Discounts

1. *Lack of Marketability Discount*. The valuation analyst will determine if the value should be reduced because the interest lacks access to public markets and has illiquid characteristics.
2. *Lack of Control Discount*. Typically applied when the interest being valued is a minority interest and lacks control characteristics.
3. *Key Man Discount*. If there is an owner who is vital to the business this discount may be applicable.
4. *Trapped in Capital Gains Discount*. Typically seen in a C Corporation or in the first 10 years of an S Corporation election. This discount accounts for the built in gains tax that would need to be paid upon a sale of the assets based on the difference between their tax basis and the fair market value.
5. *Control Premium*. Controlling interests are typically more desirable than minority interests in a business. Thus, when valuing an entire business there may be a premium accorded (opposite a lack of control discount).

H. Representations of the Valuation Analyst

1. *Assumptions and Limiting Conditions*
2. *Reliability of the Sources Used*. Typically acknowledges the fact that the sources used are deemed reliable but that no independent validation was performed.
3. *Restricted Use*. Typically the report is restricted for the specific purpose and specific parties (i.e. parties to the marital dissolution).
4. *Fee*. Accredited appraisers must state that the fee received is independent of the conclusions arrived at in the valuation.
5. *Use of Any Outside Specialists*. The use of any outside specialist along with the degree of responsibility the valuation analyst is taking for the work should be disclosed.
6. *Updates*. Unless agreed to otherwise, the valuation analyst will state that there is no responsibility to update the report.

I. Qualifications of the Valuation Analyst

1. A summary of the background and qualifications of the valuation analyst should be provided.

V. Working Effectively With Your Expert

- A. Federal Rule of Civil Procedure: This disclosure requirement includes disclosure of a written report “prepared and signed by the witness” unless otherwise stipulated or ordered by the court. The required content of the written report as specified in the rule includes:
 1. A complete statement of the expert’s opinion
 2. The basis and reasons for the opinion
 3. The data and other information considered in forming the opinion
 4. The qualifications of the witness
 5. A list of all publications authored within the past 10 years
 6. The compensation to be paid
 7. A list of all cases the expert has testified in at trial or by deposition within the past four years
- B. Recent Changes to Rule 26
 1. Expert drafts are no longer discoverable; however, facts or data provided by the lawyer and opinions and assumptions provided to the expert by the lawyer that the expert considered in forming an opinion are still open to discovery. (example: a draft provided to an attorney is not discoverable; however, if that draft is returned to the expert with attorney corrections or suggested changes then that draft becomes discoverable)
- C. Involving the Expert in Discovery
 1. *Preparing Discovery Requests.* An important service of the business appraiser is the preparation of discovery requests for the information necessary for the appraisal or valuation.
 2. *Preparing Deposition and Interrogatory Questions.* The business appraisal expert can help formulate the initial questions to ask, as well as general lines of inquiry that will help gain important information about the opposing expert’s valuation conclusion and the business in question.
 3. *Presence at Opposing Expert’s Deposition.* Having your expert present can help to evaluate the other expert’s valuation work product and obtain the information needed for effective cross-examination and rebuttal testimony. Your expert can study the opposing expert’s work papers and report and develop questions that dive into the technical nature of what was covered in the appraisal. Your expert can also provide follow-up questions, depending on the answers given to the basic questions.
 4. *Involving Your Own Expert in Depositions of Opposing Experts.* There are a number of topics that should be addressed in the deposition, including the appraiser’s qualifications, who the appraiser interviewed, and what other information the expert needs to finish or double-check his or her report. Because opposing experts are relying on specialized knowledge, it usually requires the input of someone with comparable specialized knowledge to formulate initial and follow-up questions, and to determine when the line of questioning has been answered sufficiently for a complete understanding of the expert’s opinion and the basis for it. Your expert should then be able to replicate the work of the opposing expert and identify any flaws that may be present.
 5. *Rebutting the Opposition.*
 - a. Helping the lawyer prepare effective cross-examination. The weaknesses of the opposition’s expert should be brought to the court’s attention. Your expert can help to identify these weaknesses by listening to the other expert and helping the lawyer to formulate questions that will educate the court convincingly about such weaknesses.
 - b. Providing rebuttal testimony.

Ethical Considerations

**Professional responsibility, conflicts of interest, code of professional conduct and professional competence, scope of representation, communication, truthful testimony and other evidence



CPAs & BUSINESS ADVISORS

Preliminary Documents and Information Checklist for Business Valuation of a Typical Corporation

Financial Statements for Typical Corporation

- Balance sheets, income statements, statements of changes in cash flow, and statements of stockholders' equity for the past five fiscal years or economic cycle
- Income tax returns for the same years
- Latest interim statements and interim statements for comparable period(s) of previous year

Other Financial Data

- Summary property, plant, and equipment list, depreciation schedule, and capital budget
- Aged accounts receivable summary
- Aged accounts payable summary
- Summary of leases for facilities or equipment
- Copies of any other existing contracts (employment agreements, covenants not to compete, supplier agreements, customer agreements, loan agreements, etc)
- List of stockholders, with number of shares owned by each
- Budgets or projections or copies of any business or strategic plans, if available
- Listing of key personnel, including their compensation and benefits
- Details of any transactions with related parties

Company Documents

- Articles of Incorporation, By-Laws, and any amendments to either
- Any existing buy-sell agreements, shareholder agreements, or options to purchase stock

Other Information

- Brief history, including how long in business and details of any changes in ownership and/or any bona fide offers recently received
- Brief description of the business
- Marketing literature (catalogs, brochures, advertisements, etc)
- List of locations
- List of competitors
- Organizational chart
- Resumes of key personnel, with age, position, length of service, education, and prior experience
- Trade associations
- Information on prior transactions in the stock or any related-party transactions



XYZ Corporation Balance Sheet
Assets

Current Assets		
Cash		\$ 500,000
Accounts Receivable		1,000,000
Inventory		<u>1,500,000</u>
Total Current Assets		<u>3,000,000</u>
Plant & Equipment		
At Cost	\$ 5,000,000	
Less: Accumulated Depreciation	<u>3,000,000</u>	
Net Plant & Equipment		<u>2,000,000</u>
Total Assets		<u><u>\$ 5,000,000</u></u>

Liabilities and Equity

Current Liabilities		
Accounts Payable		\$ 500,000
Accrued Expenses		<u>500,000</u>
Total Current Liabilities		<u>1,000,000</u>
Long-Term Debt		<u>3,000,000</u>
Total Liabilities		<u>4,000,000</u>
Preferred Stock		-
Common Equity (1,000 shares outstanding)		<u>1,000,000</u>
Total Liabilities and Equity		<u><u>\$ 5,000,000</u></u>

XYZ Corporation Income Statement

Sales		\$ 10,000,000
Cost of Goods Sold		<u>6,000,000</u>
Gross Margin		<u>4,000,000</u>
Selling, General, and Administrative Expenses		<u>2,700,000</u>
Operating Income Before Interest and Taxes		<u>1,300,000</u>
Interest Expense		<u>300,000</u>
Income Before Taxes		<u>1,000,000</u>
Income Taxes		<u>300,000</u>
Net Income		<u><u>\$ 700,000</u></u>

XYZ Corporation Other Financial Data

The following data are derived from the Statement of Cash Flows, footnotes to the financial statements, and company books and records:

1. Interest rate on the long-term debt is 10%.
2. The selling, general and administrative expenses include depreciation of \$250,000.
3. The selling, general and administrative expenses include compensation for the president (who owns 100% of the stock and both manages the company and maintains all the key customer contacts) as follows:

Salary	\$ 500,000
Bonus	200,000
Retirement Plan Contribution	100,000
Health and Life Insurance	50,000
Discretionary Entertainment Expenses (golf club, yacht, etc.)	<u>100,000</u>
Total Owner's Compensation	<u>\$ 950,000</u>

4. Capital expenditures average about \$300,000 per year.
5. The company's sales are growing at about 10% per year.
6. The company maintains net working capital at about 20% of sales, typical for its industry.
7. No changes in the level of long-term debt are contemplated in the foreseeable future.