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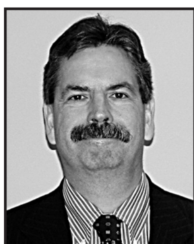
Focus Capital Advisers, Inc.

A wealth of information—Preparing & reviewing financial statements

By Kevin Simpson

Abstract: *M&A's generally hinge on the content and accuracy of the selling company's financial statements. Sellers are encouraged to engage a professional valuator to adjust the business's net income and cash flow so that buyers will know what they can reasonably expect after an acquisition. Buyers, too, should hire a valuator to help them identify risks and opportunities and to ensure the financial statements accurately represent the company's value.*



Kevin Simpson (CPA, MBA, CM&AA) is a principal with Focus Capital Advisors, Inc. Certified in merger & acquisitions by the Alliance of M&A Advisors, Kevin has completed a number of transactions over the last three years in a variety of industries. Additionally, he specializes in strategic planning and CFO services to a wide range of businesses.

Most companies prepare financial statements to minimize taxable net income. In the normal course of business, this is a smart strategy. But when a business is for sale, tax-adjusted income doesn't usually provide a true picture of financial health to potential buyers. Nor does it maximize the sale price for the seller.

If you're planning to sell your business, work with a professional valuator to adjust (or "normalize") your net income and cash flow so that buyers will know what they can reasonably expect after an acquisition. And if you're on the buy side, understand what to look for during due diligence to ensure you're getting the deal you expect.

Selling true value

When adjusting financials for a selling business, valuators pay particular attention to several items on the income statement and balance sheet. Many relate to the fact that owners of private businesses often enjoy salaries, benefits and perks that are not likely to be an issue after the company is acquired.

Principals' salaries may range from exorbitant to minimal, depending on factors such as the business's structure and whether it's more advantageous from a tax perspective for an owner to receive more income as salary or as investment return. A valuator will normalize executive compensation to amounts that are in line with what non-owners are paid. Other perks enjoyed by owners that an acquirer may not require include the cost of luxury cars, certain travel and entertainment expenses, substantial pension plans and key employee insurance policies.

Valuators also look at plant and equipment depreciation, which usually is recorded at book value (cost minus accumulated depreciation). Marketable securities, too, are often recorded at below-market value and require normalization.

Loan interest can be eliminated from current costs, because the buyer will have its own financing. And finally, a valuator can eliminate the cost of one-time liabilities such as moving costs or legal settlements.

Be (due) diligent

Most sellers operate in good faith and don't try to hide negative results. Nevertheless, buyers need to work with a valuator during the due diligence stage to assess financial statements and ensure they accurately represent the business's value. Accounting experts can also help buyers spot risks and opportunities. They pay particular attention to:

How costs are recorded. When it expenses costs, a company records the full cost of investments and takes the full tax write-off in that same year. When it capitalizes costs, it records only a portion of the investments' value over multiple years.

There may be good reasons for either approach, but it's important to know the accounting and tax methods used and how they compare to the buyer's own methods. The buyer may want to normalize the methods for comparison purposes. When two similar companies merge, for example, the buyer may want to establish which operation is more cost-efficient. The only way to do this is to compare apples to apples.

Inventories. Inventories might be undervalued, providing buyers with an opportunity to raise prices and increase profits. But inventory might also be obsolete, broken or slow-moving, and thus overvalued.

Off-balance-sheet financing. This may indicate that inventories or receivables have been sold to a third party in exchange for near-term cash. As a result, the company no longer owns the assets, and the buyer won't acquire them with the deal.

Contingencies. These might pose risks and may include pending lawsuits, employee benefits costs, severance pay, employment contracts, obligations for returned products, product warranties and debt guarantees.

Due diligence red flags

The due diligence stage is the time for buyers to look for unusual or suspicious items that could potentially kill a deal. Be wary and ask questions if you see:

- External or internal auditors have resigned,
- Accounting methods have recently changed,
- Insiders have sold stock,
- Employee turnover is unusually high or low, or
- Reporting of important non-financial programs is poor or inadequate.

Quality of earnings. Earnings may be inflated by one-time items including insurance claims, interest income, reversing accounting reserves (for bad debt, obsolete inventory or litigation), and gains and losses from selling assets. Buyers need to know how much operating profit they can realistically expect.

Shared goals

When it comes to financial statements, buyers and sellers share the same goal: an accurate view of the business's cash flow and profit-generating capabilities. Sellers need to normalize their financials. And buyers can benefit from scrutinizing statements during due diligence.

Quick Facts

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Focus Capital Advisors, Inc (FCA) provides its clients with powerful strategies for building wealth and value. Many of its clients have built great companies with solid products, good technologies and hard working people but don't have the ability to convert their largest investment into cash or greater value. The FCA team has the experience and systems to build that value.