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Valuing Businesses Amidst Economic Chaos: Any Value Left?

(Hint: Yes)



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Speaker



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George served six years as the head of the International Board of Examiners of the American Society of Appraisers in business valuation, which approves reports and candidates for accreditation. He also served six years as an elected member of the ASA's Business Valuation Committee. George received a degree in Economics from the University of North Carolina at Chapel Hill and an MBA from Wake Forest University. Prior to becoming a valuator, George was a banker, financing corporate transactions for Bank of America and First Citizens.

The “Bad” Economy Myths

- All business values are down
- All valuation multiples are down
- All company earnings are down or uncertain
- Things are so bad it will take years for companies to recover
- Housing demand and values may never recover, nor the companies that serve the industry
- 2008 to 2010 was a “normal” economic cycle (I doubt you believe that one!)

The “Good” Economy Myths

- All business values are up
- All valuation multiples are up
- All company earnings are up or improving
- Things are great. This is not ending soon!
- Housing values will keep going up, up, up!

Effects of a “Good” or “Bad” Economy

- Our future expectations are conditioned by our most recent past- we extrapolate the past into the future
- Economists miss economic turning points
- The result- we think booms will continue and downturns will never end
- This myopic human tendency has business valuation implications!

Effects of a “Good” or “Bad” Economy (cont.)

- “Bad” economies put many competitors out of business- sets up the chance for those remaining to “ton it” when conditions turn around!
- “Bad” economies cause companies to get rid of unnecessary fat/expenses so they can do well when things rebound
- “Good” economies mask inefficiencies and excesses
- Good economies make all managers look like geniuses, even the mediocre ones

Implications: Valuations in Divorce

- Susceptible to believing the business owning spouse with an unfairly negative view of the outlook or of the non-owner spouse who paints an overly optimistic outlook in a boom
- The business owning spouse may be honest but have their views colored by their most recent past
- Simply put: we believe because we want to. Our own biases and extrapolation of the past into the future cause us to miss the forest for the trees
- BUT... the outlook may really be negative or positive for their company

What to Do?

- Back to basics- it is really that simple!
- Every co., industry is unique- lots of cos. do great in a “bad” economy, lots fail in a “good” economy
- Business valuation is no different- we just have to overwhelm our natural biases with a return to the fundamentals
- Fundamentals- ask the detailed questions to fully understand the co., its customers, industry, and forces that impact it, its earnings, and its outlook
- Will provide a framework and questions to do so, whether via interview or deposition

Before the Fundamentals- Warning Signs a Co. May Really Be in Distress

- **Having tax liens filed for payroll taxes- a lender of last resort**
- **Payments to suppliers (in days of turnover) very slow and way beyond terms. Risks suppliers will stop shipping to the co.**
- **Abnormally late issuance of financial statements**
- **Officers advancing loans from co. to themselves (which they took directly as salary in the past) to avoid co. falling below minimum shareholder equity or debt to total net worth bank loan covenants**
- **Departures of key personnel**

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Before the Fundamentals- Warning Signs (cont.)

- **Large losses**
- **At or near limits on line of credit**
- **Non-compliance with loan covenants that may lead to a cutoff of credit**
- **Frosty banking relationship**
- **Losses of long-time or key customers or suppliers**
- **In contractors: difficulty obtaining project bonding**
- **In contractors: a shrinking backlog**
- **Books show large negative cash balances, but positive cash balances in the bank**

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Additional steps if you are concerned

- Obtain/subpoena bank records, credit files- the bank will probably document problems before others know about them, and if the Co. is a “watch” credit.
- What steps are being taken to change its fortunes? What conditions are necessary, internally or externally, to rebound?
- If no rebound is likely and appropriate valuation method is in liquidation, don't overlook patents, trademarks, intangible assets that might have value.
- If you represent the non-owner spouse, are they on the hook for loan guarantees? If so, how can you get them released from their guarantees?

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A Warning: Take All the Bad News Now

- Banks and suppliers more likely to accept taking the bad new of an earnings hit to a co. in a recession
- Beware owners taking one-time expenses for inventory write-downs (look at the details of costs of goods sold), restructuring costs, etc.
- These non-recurring expenses may make the co. look worse off than it actually is.
- Remember- you are willing to believe, so do not let the owner spouse take advantage of this to get all the bad news out and make the co. look even worse than it is.

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The Fundamentals- Digging for the Truth

- The detailed list of following questions is excerpted our book, *The CCH Business Valuation Guide*. The manuscript also contains a reprint of the chapter on valuation interviews and the interview list itself.
- While every business is unique, if you ask these questions you will understand the co. at issue.
- In preparing for the interview/deposition, consider what what might be unique about the co. and add those questions.
- While some questions are geared to manufacturing and distributors, the same logic applies to questions for service, software cos.

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Interview/Deposition Questions

■ SPECIAL THANKS TO CCH FOR REPRINT

- The following interview/deposition questions are based in part on questions in our book, *The CCH Business Valuation Guide*, co-authored by George Hawkins, ASA, CFA, and Michael Paschall, ASA, CFA, JD, both of Banister Financial, Inc., Charlotte, NC. © Copyright 2011, CCH Incorporated. Reprinted with permission.
- The interview questions are also included at the end of the manuscript. The manuscript contains two chapters from *The CCH Business Valuation Guide* on “Preparing to Interview a Company’s Management” and “Interviewing a Company’s Management.” This will also assist in preparing for a deposition.
- For information on *The CCH Business Valuation Guide*, visit Banister Financial’s website (www.businessvalue.com) (“Book” tab). Includes table of contents, index and purchase details.

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Topics for Interview/Deposition

- Background and history of the Co.
- Product lines (services) and marketing
- Customers, customer relationships
- Supplier relationships
- Management and personnel
- Ownership
- Past and future transactions in the shares
- Competitors in the industry
- General industry information- identifying resources

Topics for Interview/Deposition (cont.)

- Accounting methods
- Financial results and information
- Banking and financing relationships
- Contractual relationships
- Outlook and forecasts at the valuation date
- Litigation and material factors
- Corporate insurance
- Wrap up of interview/deposition
- Remaining items to complete valuation

Interview/Deposition Questions

■ BACKGROUND AND HISTORY

- History of the Co. including:
 - Length of time Co. has been in business?
 - Who founded?
 - When incorporated and where?
 - Current entity status (corporation, partnership, LLC, sole proprietorship)?
 - Current tax status/anticipated changes)(i.e., C corporation, S corporation, LLC)?
 - Initial lines of business?
 - Evolution of the lines of business over time?
 - Current lines of business?
 - Background/history of key management, shareholders?

Interview/Deposition Questions (Cont.)

■ Product Line/Services and Marketing

- Overview of the Co.'s business/operations, including:
 - Products manufactured and/or sold?
 - Services provided?
- Manufacturing process (if not purchased from others):
 - Explanation of how manufactured (if not purchased from others)?
 - Locations of manufacturing facilities?
- Rate of change in manufacturing technology?
- Effect on Co. of manufacturing technology changes?
- Overview of the Co.'s business/operations, including:
 - Products manufactured and/or sold?
 - Services provided?

Interview/Deposition Questions (Cont.)

■ Product Line/Services and Marketing (cont.)

- Manufacturing process (if not purchased from others):
 - How manufactured (if not purchased from others)?
 - Locations of manufacturing facilities?
 - Rate of change in manufacturing technology?
- Amount and nature of research and development (R&D) undertaken/required?
- Profitability/profit margins by product line and why?
- Types of customers by product line?
- How does the Co. market and distribute its products?
 - Marketing strategy?
 - Advertising strategy?
 - How is the product actually sold?
 - Method of distribution and delivery?

Interview/Deposition Questions (Cont.)

■ Product Line/Services and Marketing (cont.)

- Are methods above subject to disruption?
- Trends in the demand for product line (s) or services?
- Details on life cycle of product line(s)?
- Competing tech., products/services that might threaten the demand for product/service in the future?
- New products planned?
 - Size of the potential market, demand, pricing, profitability?
 - New capital/investments in people/distribution facilities/working capital?

Interview/Deposition Questions (Cont.)

■ Customers

- What attracts customers to the Co.'s product/service?
- What drives the purchase decisions of customers?
- Employee(s) who developed relationships?
- Whether relationships are competitively bid or not?
- Reasons for Co. selection (e.g., lowest bidder, pers. relationship, proprietary technology, etc.)?
- Any customers whose annual volume equals or exceeds 10% of total sales volume?
 - Who, risk of losing?
 - Impact of key customer loss on Co.?
 - Changes in the concentration by customer over time?
 - Significant customer addition/loss recently/expected?

Interview/Deposition Questions (Cont.)

■ Customer Relationships (Cont.)

- Is one key customer disproportionately profitable? Why?
- Breakdown of sales:
 - Geographically?
 - By product line?
- Co, revenues on a contract basis, including:
 - Structure of contracts (fixed cost, cost plus, etc.)?
 - Exclusive relationship contracts?
 - Guaranteed volume contracts?
- What projects or orders are pending?
- Significant change up or down expected in the backlog and why?
- How does the current outlook compare to other time periods in the past?

Interview/Deposition Questions (Cont.)

■ Customer Relationships (Cont.)

- Cyclical forces:
 - Is demand for the product or service cyclical? How?
 - Where does the industry stand in the industry cycle?
 - Year of last bottom of cycle and how it impacted Co.?
 - What is management's early warning signal of downturn/upturn in the industry?
- Customer terms of sale:
 - Details on terms (net 30, net 60, etc.)
 - Expected shifts in terms/discounts customers?
 - Does the Co require customers to pay on a pre-set date through electronic data interchange (EDI)?

Interview/Deposition Questions (Cont.)

■ Customer Relationships (Cont.)

- Bad debt experience
 - Any expected bad debts (go over receivables aging)?
- Pricing decisions:
 - What drives industry pricing?
 - Co. bargaining power in setting prices?
- How does the Co. set prices? Marketing research? Input by salesforce? Is the Co. a pricing leader/follower?
- How price elastic/inelastic is demand for product: how do changes in price impact demand?
- Substitute products that cap how far the Co. can raise prices?

Interview/Deposition Questions (Cont.)

■ Customer Relationships (Cont.)

- Are just-in-time inventory order methods required to meet customer needs or demands?
 - Days of inventory required in days of sales/dollars?
 - Any shifts occurring that will increase or decrease working capital requirements to meet customer needs?
- Details on receivables of questionable quality:
 - Reasons for/dollar amts. of anticipated write-offs?
 - Reasons for patterns in the receivables aging?
 - Reasons for variations in receivables turnover (days) in financial statement ratio analysis?
 - Details on historic trends in charge-offs?
 - Are any receivables contract receivables? When is receivable earned and due?

Interview/Deposition Questions (Continued)

■ Suppliers

- Suppliers to Co:
 - What is purchased from whom?
 - Bargaining power of Co.?
 - Why selected: quality, price, unique abilities?
- Any contractual supply relationships?
- Do relationships impart competitive advantage to Co.?
- Co. dependence on key suppliers:
 - Who?
 - Reasons supplier replaceable/irreplaceable?
 - Impact on Co from the loss of a key supplier?
 - Has the Co. recently lost a key supplier? Expected loss of key supplier? Impact?

Interview/Deposition Questions (Cont.)

■ Suppliers (cont.)

- Details on typical terms offered by trade suppliers.
 - Net 30 days? 2% 10 net 30? Etc. Any extended terms?
 - How fast is Co. actually paying suppliers? Any suppliers unhappy? How might this impact Co.?
- Expected shifts in terms offered by suppliers? Impacts to Co?
- Long-term contracts at advantageous/disadvantageous prices?
- How long for suppliers to ship needed products?
- Does Co. commit to purchases in advance of knowing demand for its products? Will supplier take excess purchases back?
- Risk of disruption (supplier/shippers, shortages, etc.)?
- Alternatives to current suppliers?
- Long-term outlook for supply availability, prices?
- Possibility of future competition from Co. suppliers?

Interview/Deposition Questions (Cont.)

■ Management and Personnel

- Describe the Co.'s management structure:
 - Company overall?
 - Sales?
 - Marketing?
 - Finance?
 - Production?
 - Final key decision-maker, regardless of title?
- Key officers, management, and employees:
 - What individuals are key and why?
 - Impact to Co.'s customer, supplier or financing relations if something happened to a key person?

Interview/Deposition Questions (Cont.)

■ Management and Personnel (cont.)

- Key officers, management, and employees (cont.):
 - Key personnel in poor health/expected to leave Co? Any key personnel recently died/left the Co? Impact?
 - Key person life insurance, in what amounts, whom?
 - Successor management to take over in the event of the loss of a key person? Experience in the Co. and readiness for the role?
 - Job title, position, and duties?
 - Approximate tenure with Co.?
 - Education, industry experience, age?
 - Key employees covered by employment agreements, or covenants-not-to-compete?

Interview/Deposition Questions (Cont.)

■ Management and Personnel (cont.)

- Key officers, management, and employees (cont.):
 - Typical day; average hours worked per week?
 - Salaries, bonuses, commissions, benefits paid? Are they at a market rate and why? How is compensation set? Any formula or contractual arrangements?
 - Cars, allowances, club dues, life/disability insurance and other benefits provided key officers and what do these items cost/ year? Are they necessary business expenses?
- Key strengths/weaknesses of Co. management, impact?
- Officers/shareholders/related parties receiving pay who are:
 - Not active on a day-to-day basis?
 - Not integral to the business?
- Additional personnel needed for Co. future growth?

Interview/Deposition Questions (Cont.)

■ Management and Personnel (cont.)

- Employee needs fixed in the short/intermediate term, versus variable with growth in volume/revenues and why?
- Merit/inflationary pay increases typically given?
- Unionization:
 - Is the Co.'s workforce unionized? Attempted in the past?
 - Risk of unionization in the future?
 - Are competitors unionized?
- Benefit plan financial obligations/contingent liability to the Co. (e.g., defined benefit plans, deferred comp, retiree health insurance, unfunded plans, self-funded health insurance, etc.)? Impact to Co. now/in future?
- Labor supply/pricing constraints that will impact Co.?

Interview/Deposition Questions (Cont.)

■ Ownership

- Stockholders (member interests if LLC, LP or GP interests if partnership): # of shares (or %) owned by each?
- Classes of Co. stock financial instruments:
- Common stock (or membership/partnership units):
 - Voting/non-voting and differences in rights?
 - Special “pass through” voting for non-voting shares (e.g., two-thirds to approve merger, sale or liquidation, etc.) under Co. bylaws (operating agreement/partnership) or state law?
- Stock options, warrants? Who holds them? Terms?
- Preferred stock:
 - Voting rights?
 - Liquidation Preference?
 - Stated dividend? Ever actually paid? Cumulative/non-cumulative? If cumulative, amt. accrued?

Interview/Deposition Questions (Cont.)

■ Ownership (cont.)

- Preferred stock (cont.)
 - Basis and circumstances for Co. redemption?
 - Is preferred convertible into common? Terms?
- Subordinated or convertible debt outstanding?
 - Voting rights?
 - Liquidation or other preferences?
 - How/when converted into common equity?
- Board representation- any holders have special rights on Board?
- Phantom stock?
- Put rights- Do any of the Co.'s securities have any "put rights" which enable the holder to require Co to redeem them? Terms?
- Bylaws (Operating Agreement if LLC)- Unusual factors/ implications to the value, e.g., voting requirements, etc.

Interview/Deposition Questions (Cont.)

■ Ownership (cont.)

- Restrictive shareholder, buy-sell or similar agreements:
 - Unusual factors, implications to value of the shares, e.g., voting requirements, etc.?
 - Do restrictions apply to all shares, just the Co. shares being valued, or what?
 - If the restrictions set value/formula, how was this set? Arm's length/market evidence was used in developing?
 - Has value/formula actually been followed?
 - Any amendments that have subsequently been made?
 - Do new agreements or restrictions apply to the shares being valued?
- Have valuation provisions challenged by IRS for estates/gifts?
- Other agreements that impact the shares of Co. and value: rights of first refusal, trust agreements, etc.?

Interview/Deposition Questions (Cont.)

■ Ownership (cont.)

- If the Co. is an S corporation, partnership, LLC:
 - Buy-sell/partnership/bylaws/other agreement that requires Co. make distribution to pay personal taxes?
 - Has Co. historically distributed sufficiently to pay taxes?
 - Loan covenants preclude sufficient distributions?
 - Shareholder disputes that have arisen re: distributions?
- Distribution of ownership:
 - Relationships between family owners (if any)?
 - Are there any swing blocks held?
 - Do shares valued have the potential for influence?
 - What changes in the distribution are possibly/likely?
- Shareholder contentment/contentment?
- Employee Stock Option Plan (see detailed list for questions)?

Interview/Deposition Questions (Cont.)

■ Past/Future Transactions in the Shares

- Info. on prior transactions in the shares and details:
 - Buyer/seller involved and the number of shares?
 - Date of transaction?
 - Price, terms?
 - How was price determined: valuation, negotiation? Advice?
 - Buyer/seller fully informed about Co., prospects, risks, financial performance, etc.?
 - Arm's length or a device to transfer interest at other than fair market value?
 - Distress sale?
- Offers/discussions for purchase/sale of Co./assets/all/portion of shares?
- Current/future plans to implement share liquidity program?

Interview/Deposition Questions (Cont.)

■ Past/Future Transactions in the Shares (cont.)

- Has the Co. ever considered, is it currently contemplating, or might it consider in the future, a public or private offering of the Co.'s shares or an outright sale?
- Aware of any sales of similar companies? Who? Details?
- Business brokers/merger/acquisition specialists who have sold companies in your industry or who specialize in their sale?
- Determine if the Co. has any of the following and review:
 - Strategic plan, management/succession plans?
 - Consultant report?
 - Business plan?
 - Offering Memorandum?
 - Other similar documents?

Interview/Deposition Questions (Cont.)

■ Competitors

- Obtain understanding of the following:
 - Major, minor competitors?
 - Locations?
 - Product lines?
 - Strengths/weaknesses relative to Co.?
 - Marketing and pricing strategies employed?
 - How does Co. differentiate itself from competition?
 - Any competitors publicly traded? Similar to the Co.?
- What is the Co.'s market share versus competitors?
- Size of overall market? Sources of data on subject?

Interview/Deposition Questions (Cont.)

■ Competitors (cont.)

- Barriers to industry entry by new competitors (e.g.):
 - Licensing?
 - Patents, proprietary technology or knowledge?
 - Skilled workforce? Governmental (e.g., Certificate of Need)?
 - Capital requirements?
 - Economies of scale by Co. or competition?
- Coming changes in industry/competition creating risks or opportunities for Co.?

Interview/Deposition Questions (Cont.)

■ General Industry Information

- Industry trade associations the Co. does (or could) belong to that have information on industry, financial performance, officer compensation or outlook?
- What key trade publications do you read to keep up on your industry, outlook, and trends? Do you have any old issues I can borrow?
- Financial performance, officer compensation studies in the industry:
 - Are you aware of any? How can I obtain a copy?
 - Have you ever participated in one?

Interview/Deposition Questions (Cont.)

■ Accounting Information

- Recognition of revenues, expenses:
 - When does the Co. recognize a sale/expense on year-end financial statements?
 - How differing for interim financial statements?
- Cash versus accrual basis- Are year-end and interim YTD financials on a cash or accrual basis?
- What adjustments are made to year-end financial statements that are not reflected in interim results?
- How reliable are YTD year-end internally prepared financials?
- Historic changes in accounting methods?
- What kinds of reports, financial information do you use to help manage your business and why?
- Strengths/weaknesses of the information system?

Interview/Deposition Questions (Cont.)

■ Accounting Information (cont.)

- Management letter from CPA- Go over any weaknesses raised in CPA management letter with Co.
- Any changes in accounting firms? Why? This can be a red flag over disagreements on accounting issues?

Interview/Deposition Questions (Cont.)

■ Financial Results, Information

- **Must have historic financial statements spread before the interview/deposition- otherwise you're flying blind! Pages 7015 through 7020 in the manuscript contain a simple example of spreads, with the chapter also discussing an analysis of them.**
- Income statement and profitability analysis – Go over key factors in historic income statements, including:
 - Overview of key factors impacting past results
 - Revenues:
 - Trends and growth rates?
 - Variability in individual items, overall results?
 - Factors which led to historic results?
 - Any unusual/non-recurring revenue?
 - Anticipated future growth rate? Short, long term- why?

Interview/Deposition Questions (Cont.)

■ Financial Results, Information

- Gross profit margins:
 - Trends and growth rate?
 - Variability in individual items, overall results?
 - Factors which led to historic results?
 - Is the Company on LIFO inventory (if not apparent from notes to financial statements)?
 - What would the Company's gross profit margin and profitability be on a FIFO basis? If not included in the financials, obtain the total of the LIFO reserve at the end of each year so that approximate FIFO basis results can be estimated for analytical purposes
 - Anticipated outlook short and long term and why?

Interview/Deposition Questions (Cont.)

■ Financial Results, Information (cont.)

- Operating expenses:
 - Trends and growth rates?
 - Variability in individual items and overall observed results?
 - Factors which led to historic results?
 - Unusual/non-recurring/extraordinary expenses (lawsuit, environmental cleanup, etc.) that impacted results?
 - Any discretionary expenses which impacted results or are not needed in the day-to-day operations of the Co.?
 - Level of bad debts:
 - Any unusual past bad debts in a given year? What is a normal bad debt experience?
 - Does Co. accrue a reserve for bad debts? Is the reserve adequate? Are any large bad debts expected?

Interview/Deposition Questions (Cont.)

■ Financial Results, Information (cont.)

- Operating expenses:
 - Officer compensation levels, impact on reported expenses? How does management comp. compare to the industry?
 - Explain the fixed/variable nature of expenses, impact of increasing/decreasing revenues?
 - What is the Co.'s break-even level of revenues to cover expenses?
 - Are there any changes underway which will reduce or increase the Co.'s cost of operations? Financial impact
 - Identify expenses of a personal nature paid by Co.? Which of these are buried in broad accounting categories- where?
 - Anticipated outlook for expenses?

Interview/Deposition Questions (Cont.)

■ Financial Results, Information (cont.)

- Operating profits:
 - Trends? Variability?
 - Factors which led to historic results?
 - Anticipated outlook short and long term and why?
- Other income (expenses):
 - Trends? Variability?
 - Factors which led to historic results?
 - Any non-operating income/expense items?
 - Income/expenses in historic results changing in future, e.g.:
 - Interest income decrease because excess cash will be used to invest in capital equipment?
 - interest expense increase/decrease due to greater/ lesser-planned borrowing/change in the cost of debt?
 - Outlook short and long term and why?

Interview/Deposition Questions (Cont.)

■ Financial Results, Information (cont.)

- Pre-tax profitability:
 - Trends, variability?
 - Factors which led to historic results?
 - Anticipated outlook short and long term and why?
- Income Taxes:
 - Trends in observed effective rates and what has given rise to changes?
 - Has/will the Co. change its tax status (e.g., C to S corp.)?
 - Does the Co. have net operating loss carry-forwards (NOL) that have historically sheltered past income or will be available in the future to do so? If so, gain full understanding of the amount of NOLs remaining, when they expire and in what amounts, and what earnings they can shelter.

Interview/Deposition Questions (Cont.)

■ Financial Results, Information (cont.)

Balance Sheet Analysis-Go over key factors affecting results observed in the balance sheets, including:

- Current assets:
 - Working capital needed as a minimum to operate?
 - Seasonal influences during year that cause working capital needs to materially vary?
 - Trends observed in current assets and why?
 - Variability of individual items?
 - Receivables:
 - Compare turnover with industry
 - Any changes in turnover anticipated in the future, why?
 - Accounts/notes receivable- Officers/shareholders/affiliates:
 - How long outstanding and when to be repaid?

Interview/Deposition Questions (Cont.)

■ Financial Results, Information (cont.)

- Accounts/notes receivable- officers/shareholders/affiliates (cont.):
 - How long outstanding and when to be repaid?
 - Who is the obligor on the note and what gave rise to its existence?
 - Evidenced by a written promissory note? Legally enforceable? Repayment terms, interest rate, security? Is the interest rate a market rate or is it based on the “applicable federal rate” set by the Treasury, which is a risk free rate?
 - Is interest actually paid on the note or does it simply accrue? When, if ever, will the interest be paid?

Interview/Deposition Questions (Cont.)

■ Financial Results, Information (cont.)

- Inventory:
 - Quality? Any obsolete inventory? Are inventory values under or overstated on the balance sheet?
 - Method of accounting (e.g., LIFO, FIFO, etc.)?
 - How often does the Company take inventory? Is the Company on a perpetual inventory system? How reliable are interim year-to-date inventory figures?
 - Historic trends observed in inventory turnover (in days), unusual factors that led to the results, and any expected changes in the future?
 - Compare the turnover with that of the industry?
 - Are any changes in turnover anticipated in the future and why?

Interview/Deposition Questions (Cont.)

■ Financial Results, Information (cont.)

- Inventory (cont.)
 - Trend to just-in-time inventory requiring more inventory on hand to meet customer needs? How much will this increase dollar investment in inventory, working capital?
 - Other:
 - Are any assets classified as “current” not expected to be collected or liquefied in the next 12 months?
 - Go over any other current assets that are not understood
- Fixed assets, equipment, real property:
 - Does the Co. own/lease from a related or third party? How is the lease rate set if from a related party? Is it arms length?
 - Excess or non-operating assets or real property not needed in the day-to-day operations of the business and why? Are appraisals available? Are any assets to be sold?

Interview/Deposition Questions (Cont.)

■ Financial Results, Information (cont.)

- Overview of the Co.'s investment in fixed assets, equipment and real property. How changed over time, why? Go over key changes observed in the balance sheet
- Any assets obsolete/need of replacing due to age, technological obsolescence, etc.?
- How do your needs for equipment and fixed assets vary with growth in revenues? How much further can you grow without material expansion of this asset base?
- What is your expected level of capital expenditures by year in the future (short term, intermediate, long term)?
- What depreciation policies are used (If not in the notes to the financial statements)? Are any accelerated or tax basis? Do the depreciation policies approximate the useful life of the assets, or over or understate them and why?

Interview/Deposition Questions (Cont.)

■ Financial Results, Information (cont.)

- Any assets not on the balance sheet, or that have been fully depreciated, but which are still used?
- Recent appraisals of any company assets or equipment?
- Other assets:
 - Identify each “other asset”- Go over each individual asset to make sure what each is.
 - Note- Many times the heading “other assets” is a catch-all that can sometimes elicit information about assets of major significance, such as marketable securities, investments in the stock of other companies, etc.
 - Marketable securities? Are the funds ultimately needed in the business (e.g., shares in a buying group or cooperative), or are they non-operating in nature?
 - Patents, trademarks or intangibles not on balance sheet?

Interview/Deposition Questions (Cont.)

■ Financial Results, Information (cont.)

- Investments:
 - What the investments represent, ownership?
 - How does the Co. account for the investment (equity method, cost method)?
 - Do the investments generate a current return, or are there provisions for capital calls where Co. may have to make additional cash infusions?
 - What do you believe the investments are worth and why? Have there been any valuations or appraisals of them?
 - Does Co. have any other investments or subsidiaries not shown on the balance sheet?
- Current liabilities:
 - Trends observed in current liabilities and why?

Interview/Deposition Questions (Cont.)

■ Financial Results, Information (cont.)

- Current liabilities (cont.):
 - Variability of individual items?
 - Accounts payable:
 - Historic trends observed in accounts payable turnover (in days), unusual factors that led to the results, and any expected changes in the future in the turnover pattern?
 - Compare the turnover with that of the industry
- Notes payable- banks/financial Institutions (see banking section)
- Accounts/notes payable- officers, shareholders, affiliates:
 - How long have these been outstanding, when to be repaid?
 - To whom is the note payable, what gave rise to it?
 - Evidenced by a written promissory note? Rate? Collateral? Terms? Enforceability?

Interview/Deposition Questions (Cont.)

■ Financial Results, Information (cont.)

- Accounts/notes payable- officers, shareholders, affiliates (cont.):
 - Is the interest rate a market rate or based on the “applicable federal rate” set by the Treasury, which is a risk free rate?
 - Interest actually paid on the note, or simply accrue? When, if ever, will the interest be paid?
- Any liabilities classified as current that really are not? This is a common issue in co.-prepared, unaudited financial statements.
- Long-term liabilities:
 - Trends observed and why?
 - Variability of individual items?
 - Long-term- banks/financial Institutions (see banking section)
 - Long-term debt- officers, shareholders, affiliates (see earlier questions on current notes payable)

Interview/Deposition Questions (Cont.)

■ Financial Results, Information (cont.)

- Go over any other current assets that are not understood.
- Are there any liabilities classified as long-term which really are not? This is a common issue in company-prepared, unaudited financial statements.
- Shareholders' equity:
 - Are there any un-reconciled changes in shareholders' equity? If so, find out why?
 - Go over the nature, reasons for any items that are passed through as changes to shareholders' equity without impacting the income statement (e.g., foreign exchange gains, losses).
 - If an amount is shown for treasury stock, inquire as to the transaction that gave rise to the existence of treasury stock.

Interview/Deposition Questions (Cont.)

■ Financial Results, Information (cont.)

- Statement of Changes in Cash Flows, Shareholders' Equity – Go over any unusual changes observed.
- Subsidiaries- Go over all previous questions related to each.

Interview/Deposition Questions (Cont.)

■ Banking, Financial Relationships:

- Details on total amount of bank lines, loans including:
 - Identity of lenders?
 - Amount outstanding under each?
 - Advance rate against receivables, inventory, or other assets?
 - Permissible borrowings at advance rate at valuation date?
 - Any Co. lines of credit seasonal in nature, and does the bank require them to be “cleaned-up” (paid off) for a consecutive number of days annually (if so, how many)?
 - Usage of the lines/revolving credits throughout the year?
Collateral- What assets secure the loan? What personal/ non-company assets secure? If a buyer were to buy Co. without support provided by the personal assets, would the bank continue its lending relationship?

Interview/Deposition Questions (Cont.)

■ Banking, Financial Relationships (cont.):

- Loan covenants and the Company's compliance with them?
- Negative pledges that would preclude Co. from using un-collateralized assets to obtain additional borrowings?
- Limitations on dividends, distributions and capital expenditures, and impact on Co. ability to operate/pay returns to owners?
- Any factors that place the Co. in jeopardy of possibly not meeting covenants or other factors that may cause it to default on its loan or financing agreements? Possible bank action?
- Any pending or threatened acceleration of loans?
- History of banking relationships, including:
 - Willingness of lenders to supply additional credit needed?
 - Character of relationship (good or bad) and why?
 - Increase in financing needed for growth? Will bank provide?

Interview/Deposition Questions (Cont.)

■ Banking, Financial Relationships (cont.):

- Any personal guarantees required on loans, including:
 - Identity of guarantors?
 - Are there one or several guarantors that the Company's banks look to in order to make its credit granting viable?
 - If something were to happen to these key guarantors, would the banks continue to extend credit?
- Refinancings, restructurings of banking relationships:
 - Currently restructuring or changing credit relationships or structures that would result in changes in terms, increases or decreases in credit availability, interest rates, and so on? How will these changes Co.?
 - Has Co. been told (or urged) by its present bank to look for another bank, even if not in default of current banking relationships? Why? Status?

Interview/Deposition Questions (Cont.)

■ Contractual relationships:

- Explanations of any existing contracts such as:
 - Employment agreements?
 - Covenants not-to-compete? Who/duration/geographic scope?
 - Supplier and franchise agreements?
 - Customer agreements- terms, ability to cancel and on what notice, status of any renewal, changes in terms and impact?
 - Royalty agreements?
 - Equipment lease or rental contracts? If with related parties, how is the rate determined and is it arms length?
 - Real property leases. If with related parties, how is the rate determined and is it arms length?
 - Labor contracts?

Interview/Deposition Questions (Cont.)

■ Contractual relationships (cont.):

- Management agreements or contracts?
- Any other significant contracts?
- Distributorship, dealership, or franchise agreements:
 - Term of relationship? How long a relationship in place?
 - When does it terminate or come up for renewal? Is renewal likely? Has the supplier expressed any discontent or given any indication that the renewal is in possible jeopardy?
 - Territory or product line exclusivity?
 - What kinds of reporting information must be provided periodically to the supplier?
 - What kinds of support does the supplier provide the distributor (financial, national cooperative advertising, promotional materials, etc.), and what is the distributor required to pay for it?

Interview/Deposition Questions (Cont.)

■ Contractual relationships (cont.):

- Distributorship, dealership, or franchise agreements (cont.):
 - Does the supplier prepare financial ratio and performance studies that it periodically sends to its dealers?
 - Does the supplier sell directly to large “national accounts” in the distributor’s territory? If so, what kind of fee does the distributor receive, if any, for the sale? What servicing of the account is the distributor expected to provide, and how is the distributor reimbursed for it?
 - Are there any required performance goals? Is the Co. in compliance with them?
 - Any pending or threatened loss of rights?
 - Can they be assigned? Under what circumstances?

Interview/Deposition Questions (Cont.)

■ Contractual relationships (cont.):

- Distributorship, dealership, or franchise agreements (cont.):
 - If the Co. assets or stock are sold, is the consent of the supplier required? Would they likely give it? To whom would they likely give it? To whom would they likely not give it?
 - A named individual as the approved dealer? If something were to happen to this individual, what would the reaction of the supplier be?
 - Are supplier’s relationships good?
 - Is financial information available concerning the supplier to assess its financial strength and risk?
 - Has supplier bought any of its distributors? Is it possible to obtain information about the transactions, prices paid?
 - Does supplier compete with its distributors? Risk in future?

Interview/Deposition Questions (Cont.)

■ Contractual relationships (cont.):

- Distributorship, dealership, or franchise agreements (cont.):
 - Changes anticipated or possible?
 - Are any new distributorship relationships likely to be added? What will be the impact on Co.?
 - Termination of existing relationships- Are any current distributorship relationships likely to be ended? What will be the impact on the Co.?

Interview/Deposition Questions (Cont.)

■ Outlook and Forecast at Valuation Date:

- Current order backlog and comparison to prior years? What does it say about the current near term outlook?
- Any pending sales or project proposals outstanding that have not yet been awarded to the Co., but which could have a major impact on results if awarded?
- Any forecasts or budgets? Go over details, basis of assumptions
- Developing forecasts- Use following as a starting point to develop valuation forecasts for the next 5 to 7 years (or more or less as indicated):
 - Revenues:
 - Percentage growth by year?
 - Unit volume growth by year by product line?
 - Changes in unit prices by year by product line?

Interview/Deposition Questions (Cont.)

■ Outlook and Forecast at Valuation Date (cont.):

- Developing forecasts (cont.)
 - Revenues (cont.):
 - Large or unusual factors contributing to future revenues?
 - Likelihood of achieving forecast?
 - Breakdown of anticipated growth between growth of market in total and Co.'s growth in market share?
 - Gross profit:
 - Gross profit margin percentage trends by year, product?
 - Comparison to past actual performance?
 - Selling, general and administrative expense:
 - Fixed/semi-fixed costs (do not vary proportionately with volume or revenues)?
 - Variable costs?

Interview/Deposition Questions (Cont.)

■ Outlook and Forecast at Valuation Date (cont.)

- Developing forecasts (cont.)
 - Interest expense?
 - Pre-tax profit and profit margins?
 - Tax rate changes?
 - Capital expenditures:
 - Annual dollar amounts required over the next 5 years?
 - Purpose of expenditures?
 - Method of funding expenditures (internally/externally)?
 - How far (revenues) Co. can go with current physical capacity?
 - Amount of excess capacity at valuation date?
 - Working capital needs to fund growth?
 - Borrowing, repayment schedule of debt?

Interview/Deposition Questions (Cont.)

■ Litigation and Other Material Factors

- Details on any contingent or off-balance sheet assets or liabilities, including:
 - Pending or threatened lawsuits?
 - ERISA compliance requirements?
 - Warranty or other product liability?
 - Workers' compensation claims not covered by insurance?
 - Hazardous waste, other environmental problems?
 - Regulatory compliance issues/problems (OSHA, EPA, etc.)?
 - Letter of credit liabilities?
 - Guarantees of other indebtedness?
 - Other material factors?
 - Status of current or past IRS, state, or local audits?
 - Judgments or filings of record and status?

Interview/Deposition Questions (Cont.)

■ Corporate insurance

- Co. business interruption insurance in force? When would it start paying (timing) and under what circumstances?
- Does Co. maintain liability and product liability insurance?
 - Amounts?
 - What is covered and not covered?
 - Any material anticipated change in upcoming renewal premiums?
- Does Co. "self insure" any of its insurance needs (e.g., workers' compensation, health insurance, liability, casualty, etc.) where it takes the risk of claims payment? If so, how large a claim obligation is it exposed to, and does it reinsure against any of the risk with insurance carriers?

Interview/Deposition Questions (Cont.)

■ Wrap-Up

- What do you believe the Company is worth and why?
- What do you believe are the top five most important positive and negative factors affecting the Company's value, its risks, and opportunities and why?
- Are there any other positive or negative material factors of any kind affecting the Company that have not been discussed but which you feel are important?

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Questions

