

FAIR VALUE™

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THE EFFECTIVE VALUATION INTERVIEW

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Introduction. The interview of company management is a crucial part of the valuation process needed to fully understand the company and arrive at a sound and supported value that will withstand scrutiny. While the subject of how to perform a valuation interview is not the most exciting issue to read about, is it nonetheless critical that all who deal with valuation issues (e.g., estate planning and family law attorneys, litigators and judges) understand the process and the goals that must be accomplished to arrive at a valid and meaningful valuation.

This article does *not* deal with an interview in the context of a deposition, which has its own unique issues and challenges, although the goals in the deposition are still the same- to gain a thorough understanding of the business and its risk and opportunities to arrive at a logical, unbiased and valid valuation that is defensible. This article will still provide valuable insight for any attorney preparing to depose a company owner on valuation issues.

Detailed Resources for Further

Information. This article cannot cover all of the many issues that need to be covered in a valuation interview. The *Banister Financial Business Valuation Disc™* (available free to clients and friends) contains a detailed 78 page list of potential questions for interviews and depositions, along with hundreds of other valuation articles, cases and information needs checklists for various kinds of companies and

professional practices. If you do not have a copy of the latest 2006 edition of the *Disc*, let us know and we will be glad to send it to you.

A Broad Framework for the Valuation

Interview. The following sections address the key elements of the company interview and the broad areas that should be considered in any valuation engagement. Through experience, we at Banister Financial have found that a “top down, macro then micro” interview approach works the best, focusing first on the big picture view of the company, then narrowing the questions to more specifically targeted and defined issues as the visit progresses. Our interviews typically follow the subjects in the order similar to that shown in **Table A**, with detailed questions developed in advance for each specific company being valued. The questions are designed to insure that the valuator gains a thorough understanding of

Table A
Overview of the Company Interview Process

1. Background and History
2. Products and/or Services and Marketing
3. Customer Relationships
4. Supplier Relationships
5. Management and Personnel
6. Ownership
7. Past Transactions in the Shares
8. Competitors in the Industry
9. General Industry Information
10. Accounting Methods
11. Financial Results and Information
12. Banking and Financing Relationships
13. Contractual Relationships
14. Outlook and Forecasts at the Valuation Date
15. Litigation and Material Factors
16. Corporate Insurance
17. Wrap-up of Interview
18. Remaining Information Needs to Complete Valuation

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the company and identifies relevant issues and risks.

This article will cover each of these areas from a broad perspective in assessing the risks and potential of the business being valued.

Tips on Conducting the Interview. While the following sections tell what to ask, it is equally important to identify who in management should be interviewed, how to interpret what is said, and how to deal with problem situations. In an ideal world the valuator would have ready access to all of the top management team. Ideally this would include interviews of the President or Chairman of the company, the Chief Financial Officer and/or Controller, and, possibly, the heads of various functional areas (e.g., sales, marketing, manufacturing). Each adds unique insight that leads to a better understanding of the business, its risks and opportunities. However, there are some important exceptions where access may be restricted.

One such example is where the valuation is for the consideration of a possible purchase or sale. The valuator may encounter resistance to access over a fear that employees will get suspicious and word of a possible sale will leak out, causing employee morale problems, industry rumors, and concern among customers and suppliers. In this instance, both the President and the Chief Financial Officer (CFO) may be the only two persons to which interviews may be granted. In some rare cases the President may even wish to keep the CFO out of the loop. However, unless the President really understands company finances, the absence of the CFO may make it more difficult to obtain necessary answers to important finance-related questions.

Another example where access may be restricted involves valuations for litigation-related purposes such as divorce, dissenting minority shareholder actions, and business damages. The client may be a shareholder who is not even involved in the company's management and has no ability to force management to grant an interview. This type of situation may require the client's attorney to either take the depositions of management and/or ask interview questions via written interrogatories.

It is also crucial to understand how the perspective of the interviewee can influence the answers

given the valuator to questions about the business. Often the interviewee (such as a company President) is a non-financial person and speaks a different language than the valuator. Therefore, the valuator needs to avoid the use of financial or valuation jargon, and to be clear and explicit about what is being asked and why so that questions will be appropriately answered.

Bias in Answers Related to the Valuation

Purpose. The purpose of the valuation will unfortunately sometimes lead some clients to tell the valuator the answer they want him or her to hear, hoping to influence the outcome of the valuation result in one way or another, or to give a distorted view of the company and its prospects. **Table B** provides a few examples of how the purpose can sometimes impact the answers given the valuator.

<u>Purpose of Valuation</u>	<u>Value Motivation of Client</u>	<u>Bias on Answers Given the Valuator</u>
Estate tax	Reduce the value to pay as little estate tax as possible	Paint a pessimistic view of the business, its prospects and risks
Gift tax	Reduce the value to pay as little gift tax as possible	Paint a pessimistic view of the business, its prospects and risks
Charitable contribution	Obtain a high value to take a large tax deduction	Portray a rosy, highly optimistic business outlook
Divorce where the client is the non-shareholder spouse	Obtain a high value to obtain a large divorce settlement	Non-shareholder spouse portrays a rosy, optimistic business outlook
Divorce where the client is the shareholder spouse	Obtain a low a value to reduce the divorce settlement	Shareholder spouse portrays a pessimistic outlook
Dissenting minority shareholder litigation where client is the minority shareholder	Obtain a high a value to obtain a large court award	The minority shareholder portrays an optimistic, rosy outlook

The examples mentioned in **Table B** are not to suggest that bias is always present, rather that the valuator needs to listen carefully to the answers given and be alert for the presence of an agenda. All companies have numerous good and bad issues present. By carefully listening to how the answers are given, the valuator can start to instinctively gauge if the interviewee is attempting to give a fair view or a distorted one. Additionally, just because the interviewee sees mostly either optimism or gloom does not mean the individual is being dishonest in his or her answers. After many years in a company it is possible to develop defense mechanisms to ignore or overlook the risks, or to become comfortable with risks one should not be comfortable with, simply because the person is too close to the situation. Alternatively, the official without a great deal of industry experience might

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lack the seasoning to understand the full range of company and industry risks and opportunities which leads to a distorted view. Furthermore, just because the interviewee presents an outlook that is disproportionately bad or good does not necessarily mean they are biased or wrong- it may really be that way! Finally, how a buyer would look at the situation is relevant, a view that might be very different from the honest views of incumbent management.

If the valuator genuinely attempts a comprehensive interview the questions will force the interviewee to address a wide variety of risks and opportunities. When such a broad range of issues are posed to management, it is very difficult (even when attempting to mislead the valuator) not to let some, and perhaps many, grains of truth slip out. Regardless of the interviewee's potential agenda, the valuator should not rely on answers alone to reach conclusions about the company, its performance, the industry, and its outlook. Financial statement and ratio analysis, and industry research provide additional resources against which to gauge management's answers and for the valuator to ultimately reach his or her own reasoned and supported view.

Background and History. An excellent way to build a foundation for understanding the business, as well as to establish rapport, is to ask management to give a brief history of the company. This builds a perspective of who founded the business, the challenges it has faced, how it has evolved over time, its activities, and the risks, and ups and downs it has faced over a longer time horizon. Broadly speaking, the following issues will go a long way towards getting the overview portion of the interview underway:

- Who founded the company and when? What led to its founding and who were the initial owners?
- What is it that the company does and sells?
- What were the company's initial lines of business?
- How have its lines of business evolved over time and why?
- What does the company do today, and hope to do in the future?
- What are biggest setbacks the company has faced and what were their impacts?
- How has the company's management and ownership changed over time and why?

As is almost always the case, the answers to these questions will invariably begin to create a path of new issues down which the valuator will want to tread and explore in more detail.

Product Lines and Marketing. This part of the interview should be self explanatory and is aimed at understanding what the company does or sells, how it purchases (or manufactures), markets and prices the product. For example, if the company manufactures a product, the following broad questions help:

1. How does the company manufacture its products? If the company is a manufacturer, it is often helpful to take a plant tour early during the interview to see the company in action. This will enable the appraiser to relate much more effectively to what the company does and is almost guaranteed to lead to many new questions.

2. Is the manufacturing process labor intensive, or does it require a large investment in capital equipment? If it is capital intensive, is the technology used subject to continuing change so that the company must continually re-invest a large amount of its cash flow into purchasing new equipment?

3. How far can the company's current manufacturing capabilities support revenues before it must add additional plant capacity? Even if the company does not need to add new equipment to expand, what is the productive life of its existing equipment and how often must it be replaced and at what cost? Are there technological innovations coming in the industry which could radically reshape the manufacturing process, or that might be proprietary to a competitor and not available to the company? If so, does that threaten the future viability of the company?

4. Is cheap overseas competition a threat and can those competitors make the product much more inexpensively using cheaper labor? Is the company faced with having to outsource production in the future to overseas contractors or move its own facilities abroad?

On the other hand, most distributors and wholesalers merely stock products made and shipped to them by their suppliers. Therefore, the first focus in these types of enterprises is to identify the brands and specific products carried and the related factors impacting those issues, such as:

1. Competitive Position- Where do the company's products stand in the price and quality spectrum versus competing products? Do the products carry a high or low market share and why?

2. Contractual Distribution Rights- Distributors often hold contractual distributorship rights to exclusively market a product, typically in a defined geographic area such as a county or state. For a strong brand this is a positive attribute since it provides a barrier

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to entry that prevents competition from selling the same product. Since similar competitive distributors will likely carry competing brands, the focus becomes reaching a determination of how well this company's brand compares to those carried by competing distributors.

3. Marketing and Sales of Products- How does the company market its products or services? For example, if a company relies on independent distributors to sell its products, do they also sell competing products? How does the company differentiate its products versus others? If the product is a commodity (e.g., sugar, lumber) the company's ability to sell its product may be solely determined on having the lowest price. This would suggest that there is little customer loyalty and that unless the company is a low cost producer it may not survive on a long-term basis. If a company uses independent sales representatives or agents to sell its products or services, is there a large reliance on any one of them for a significant portion of the sales generated? If this is the case, the agent's abandonment of the line, perhaps of favor of a competing product, could be devastating. When concentrations are evident, the length and stability of the relationship should be explored, and the valuator should determine if any contracts tie the parties together, in order to assess risk.

Many companies that sell a product or a service are subject to the forces of a product life cycle, which may be growing, mature, or declining. It is important to find out where the company's individual products stand in their respective life cycles and what this implies about risk and product pricing in the future. Tied to the life cycle issue is the need to identify the degree to which a company's products or services are subject to the impact of technological change and the risks this presents. For instance, a company that manufactures computer hardware may have to spend a large amount on research and development to attempt to keep its products technologically current. The inability to remain current may spell disaster since the company's products are no longer competitive. Additionally, a competitor could develop and patent a new technology that could make the company's product obsolete with the company unable to develop an effective product in response. In general, companies whose products or services are subject to rapid technological change tend to have a higher degree of financial and business risk.

Customers. Without customers there would be no company. Therefore, it is important to understand the nature of a company's customer relationships and what they indicate about its risk. The reliability, volatility and continuity of customer relationships affect the risk

associated with a company's ability to generate revenues and earnings. A buyer is concerned with the future results that the business will generate, and is therefore interested in how the customer base impacts the returns to be realized.

The type and stability of a customer relationship is an important issue. Some businesses have transactional customers who have a non-recurring need for the company's product or service. This means that at the conclusion of the sale the company cannot count on a future purchase by the customer. Therefore, this type of company must continually generate new customers in order to maintain its revenues, leading to less predictable financial results, greater volatility, and risk. A general building contractor is a good example of a company with transactional customers. The contractor places a bid to win a construction project where the low price (bid) is a key factor, and perhaps the only one, driving the customer's selection of a contractor. After winning and completing the project the contractor must then find a new project to take its place or company revenues will drop. By contrast, a company with recurrent customers generally has more predictable revenues. An office products wholesaler is a good example of this type of company since businesses will buy office supplies frequently as a continuing need.

In reality many companies have customer bases that possess both transactional and continuing purchase attributes, so the valuator will need to inquire of management about which predominates and why. For example, most of a general contractor's work may be non-recurring. However, the company may have certain customers for whom it continually builds new projects. A wholesaler of materials handling equipment might sell new forklifts to most of its customers only every several years, thus making the orders infrequent, or transactional in nature. However, those some customers may make recurring purchases of parts, supplies and service to maintain the equipment. In a recession the customers may opt to hold off on replacing old equipment, although they may continue to keep the old equipment going by increasing parts, supplies and service purchases. Therefore, while new equipment sales may be infrequent and volatile, this is stabilized to a degree by parts and service. Car dealerships sometimes exhibit similar patterns.

The factors that drive the customer purchase decision impact risk. If the customer is largely driven by price, as with a commodity, the customer may have little loyalty to a given supplier, leading to greater risk. If the customer buys the product because of its attributes,

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perhaps proprietary, the customer base may be more stable.

The length of customer relationships is an important indicator of the stability of revenues. Companies that have long, enduring relationships with customers tend to be less risky. It is important to discern why the relationships are enduring. It may be due to something unique that competitors cannot provide, or the result of a low price, better service, or personal relationships with customers. The latter factor, personal relationships with customers, while solidifying ties, also presents a risk factor in many closely held companies. A customer may have dealt with the company because of close personal ties to the owner or a key salesperson. If either individual at the company were to die or leave the company the personal relationship would no longer exist and the customer might go elsewhere. Additionally, in a sale there is no assurance that the selling shareholder will be able to transition this relationship over to the buyer of the business. The chemistry might not be right and the customer may no longer deal with the company.

The degree to which one or several customers account for a significant portion of a company's revenues can be a significant risk factor and is common in many closely held companies. For example, if one customer accounts for 50% of a company's revenues, the loss of that customer could be devastating. In situations where larger concentrations exist the valuator should explore the longevity of the relationship, the degree to which any long-term contracts exist which tie the customer to the company, and the volatility of the revenues the customer generates from one year to the next. A subjective question is at what point a customer is considered to be a significant concentration. There is no definitive answer, however, many valuers believe a customer that accounts for 10% or more of annual revenues is considered to be a significant account whose loss could materially impact results. Requesting a report of revenues by customer for the latest fiscal year is helpful in identifying customer concentrations. Since the importance of customers can change over time, it is helpful to get this same report for at least several years to observe shifts in concentrations that occur over time.

Identification of the specific "customer" is an important factor to determine, and may not always be as obvious as it appears. For example, in one sense, a general surgeon's patients are his customers as they are the direct beneficiaries of the surgical procedures. However, the surgeries themselves are transactional in nature (a patient cannot have his gall bladder removed twice). The surgeon depends almost completely on

continuing referrals of new patients from local primary care physicians. Since they create a continuing stream of patients, the referring physicians are really the "customers." In this type of circumstance the amount of risk is impacted by the degree to which referrals can be expected to continue, and what factors might lead to their disruption.

Customer lines can be similarly blurred in industrial companies as well. ABC Metal Fabricating Company manufactures custom-designed industrial air handling systems. These systems are used in pharmaceutical clean rooms to filter out impurities that might contaminate the manufacturing of medicines. The valuator requests a list of annual revenues by customer and finds a number of pharmaceutical companies listed. While the purchases tend to be transactional (i.e., once at the time a pharmaceutical plant is constructed) in nature, the customer base is broad. Additionally, there are no significant concentrations of sales to any one company. This leads the valuator to conclude that there is relatively limited risk associated with the customer base. A valuation is prepared and another air handling manufacturer, XYZ Air Equipment, buys the company. Six months later the acquired company loses all of its customers and revenues dry up. What did the valuator miss?

Yes, the ultimate "customers" were the pharmaceutical companies for whom the work was performed. What the valuator failed to ask was how ABC Metal Fabricating secured its jobs. It turns out that all of the jobs were referred to ABC by an electrical and industrial engineering firm that designed the specifications for the systems its customers, the pharmaceutical companies, would need. Because the engineering firm had good success with ABC and few problems with the systems ABC built, the engineering firm would refer the pharmaceutical companies to ABC when there was a need. On the other hand, the engineering firm had at one time referred clients to XYZ Air Equipment, but because of quality control problems had stopped doing so. Once XYZ acquired ABC, the engineering firm, because of its bad past experience with XYZ, chose to refer all of its clients to another air handling equipment manufacturer. As with the medical practice example, the literal and the real "customer" are different parties. Therefore, it is essential that the valuator think more broadly about what constitutes a customer and to look at what is the real source of a company or professional practice's revenues.

The way sales to customers are priced is a risk consideration. For example, project oriented companies,

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such as contractors and engineering firms, price assignments in a variety of ways, such as fixed price, cost-plus, or in some other manner. For example, in a fixed price contract, a defense contractor agrees to a set a fixed price for a new missile defense system that it will build for the U.S. Air Force. It sets the price at \$30,000,000 after its internal cost estimators estimates the cost to make the system is \$25,000,000, leaving an expected profit of \$5,000,000. Halfway into the project the company encounters technical problems in developing a heat-seeking missile detection device, requiring much more research and development costs than anticipated. By the time the hurdles are overcome the company has spent \$40,000,000, and has lost \$10,000,000 on the assignment.

In project-oriented companies where fixed pricing is common it is important to examine the reliability of the company's estimating process, and the degree to which it has historically overestimated or underestimated the costs on its assignments. This information is typically available in historic project profitability reports from the company. Additionally, it is equally important to review the same reports for projects currently underway to determine if any may result in losses for the company. The risk of guessing wrong on a fixed price bid may be reduced in companies where individual projects themselves are small and diverse, so that an estimating error on any one project will not have a material impact on the company overall.

The geographical distribution of the customer base can increase or reduce risk. A company whose customer base is concentrated in one geographic area may be more susceptible to downturns in that area's economy that impact its customers. A company that has a geographically diverse customer base may be less threatened since one area's economy may do well, offsetting or mitigating the full effect of an area where the economy is doing poorly.

Customers whose willingness and ability to purchase might be subject to quick or unexpected disruption may increase a company's risk. Two examples include strikes by unions, and the impact of weather, neither of which the company can control. A large auto manufacturer hit by a massive strike will probably delay or stop buying brake pads temporarily from its supplier until the strike is settled. A theme park depends on good weather for its customers to attend the park. Two weeks of rain in the summer season, the only season in which the park is open, could materially impact revenues for the year.

The degree to which a company's customers are

themselves in cyclical businesses can impact the demand for a company's products or services. If a downturn materially impacts a customer, that customer may cut on purchases from the company. For example, the demand for heavy trucks is highly cyclical. When the economy is poor companies tend to delay new truck purchases until a recovery. The company that makes and sells truck mirrors to truck manufacturers will have its revenues tied closed to the cyclical forces that affect its customers.

It is also helpful to find out if there are unusual or seasonal types of sales patterns experienced by a company. This enables the valuator to determine the cash needs of the business at different times in the year, and to be able to assess whether a specific period's balance sheet is actually indicative of the borrowing and working capital needs during the year. For example, retailers often have year-ends in January or February, just after the end of the Christmas selling season. Their cash coffers are full, inventory low, and bank debt minimal to none. However, this is a very distorted picture of the true picture of the business throughout the year. As the year progresses, the retailer might show poor earnings or losses through most of the year (except Christmas), and use up cash building up inventory as the Christmas selling season nears, then have to use bank lines of credit heavily. When evidence of seasonality is present, a more accurate view of these needs can be obtained by requesting copies of month-by-month financial statements for prior years.

Customer terms of sale are important to ascertain for several reasons. First, they give an indication of the length of financing the company must provide its customers and how this impacts working capital requirements. Second, it enables a comparison with how long customers actually take to pay (e.g., customers actually pay in 45 days, on average, versus terms of net 30 days) to gauge the risks of extending customer credit and whether some receivables might be uncollectible. Obtaining and reviewing a detailed accounts receivable aging by customer with management enables the valuator to determine if any specific customer accounts which are significantly past due are vulnerable to becoming bad debts.

Supplier Relationships. If customers push the throttle, the suppliers furnish the gas. A company cannot sell its products to customers if it cannot secure what it needs from suppliers to do so. Therefore, the nature and stability of suppliers is an important consideration in identifying a company's risk.

If a company is heavily dependent upon a particular supplier, or cannot find the product elsewhere,

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it is important to know if the company-supplier relationship is a good one and not in jeopardy of being lost. It is also helpful to know if a company has long-term supply contracts with a key supplier which give it a competitive advantage by locking in a favorable cost for a product, or alternatively, a disadvantage by being at a price which is now well above market levels.

Suppliers can sometimes become future competitors of their customer (e.g., a distributor), and cut them out entirely, going straight to the end customer with the product at a lower price. Whenever a valuation involves a wholesaler or distributor, this is an issue to consider. Many wholesaling and distribution industries are experiencing a compression of the distance between the manufacturer and the customer, with levels of intermediaries being eliminated. Even if this has not yet occurred in an industry it does not mean that the risk is not present in the future.

The bargaining power of suppliers also is an indication of the vulnerabilities of a company. This refers to factors that give the customer or the supplier the ability to partially, or fully, dictate the terms of the relationship to the advantage of one or the other. For example, a company that buys a majority of its raw materials from the only supplier in the region might have little ability to bargain over price and may be vulnerable to having to pay more rapidly for its products, increasing working capital needs.

The terms of purchase offered by suppliers and any shifts in these terms are important factors since much of company's working capital needs are financed by supplier credit. Additionally, it is important to determine if a company is materially past due on its payments to trade suppliers to the point that there is a risk it will no longer be able to purchase on credit, or at all. One tool to assist in determining the degree to which suppliers are overdue on payments is to request and review an aging of the company's trade payables.

Finally, some suppliers are moving towards the use of electronic data interchange (EDI) to collect customer payments. On a given date the supplier automatically drafts the company's bank account for payment. If the terms of sale are net 30 days and the supplier moves to requiring EDI, the company that had previously stretched its supplier payments to 45 days will no longer have that luxury. This may require an infusion of additional equity capital into the business to operate and/or the use of extra bank financing, if it can be obtained. The valuator should inquire about changes in supplier terms that might occur and identify their financial impact on the business.

Management and Personnel. The quality and continuity of management often differentiates successful companies from those that perform poorly. Additionally, the degree of a company's reliance on one or several people can materially impact a company's risk since the death or departure of these individuals could hurt the company. It is important that the valuator assess these issues in a closely held company valuation.

To start with this assessment the valuator must first gain a clear picture of the management structure of the company, including who makes final overall decisions, as well as the individuals responsible for sales, marketing, finance, manufacturing and personnel. As a part of the interview process the valuator should attempt to obtain an organizational chart and resumes on key officers, if available. This provides a clear picture of the structure of the company's management, and allows an assessment of the background, experience and training of key officials.

In the smaller closely held business there is often no organizational chart available, so the company president may need to give an oral overview of the management structure. Even when there is a chart, the reality in many smaller companies is that the company owner often makes many of the major functional decisions, even when each department has an official head. Often the owner may be too emotionally tied to the business he or she created to effectively delegate authority. For example, even though salespeople handle the sales effort, the owner may play a major role in securing business for the company. This gives rise to key person risk, usually one of the most significant risks in many closely held companies. If something were to happen to this individual, the company might be rudderless, and its internal staff may not have the experience or ability to continue the business successfully.

Other sources of key person risk can arise if there are other individuals whose loss could harm the company. A key salesperson might be responsible for the company's two largest accounts. If she leaves to go to a competitor the customers may leave also. A company's chief financial officer may be largely responsible for the continuing ability of a company to retain the confidence and financing from its banks. This individual's departure might cause a crisis of confidence by the banks and lead to a loss of the company's credit lines. The potential for key person risk can be found by examining the roles various individuals play in the company and where their loss would damage the business.

The continuity of a company's management is

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another factor that can indicate risk. Companies with continuing high turnover rates of management and personnel may be indicative of underlying problems that need to be identified. Additionally, some companies try to reduce key person risk by using employment contracts and covenants-not-compete to prevent the departure of valued individuals. The valuator should inquire if the company uses these contracts, to whom they apply, and the geographic scope and time frame for which they provide protection. For example, the enforceability of covenants not to compete varies by state based on law and case law. A contract may be enforceable if it is reasonable in its geographic coverage and duration, for example covering the geographic area where the customer does business, and for a year after leaving the company. On the other hand, a contract which is overly broad, for example covering the entire United States, when the company only does business in one county, and for ten years, is probably not enforceable.

The business valuator often must make the delicate yet essential determination of management's ability and its impact on the risk of owning the company's stock. It is astounding how many private companies do not survive past the second or third generation. Poor intra-family management transition is often the reason. Public companies, meanwhile, have a harder time perpetuating incompetent management under the constant glare of securities analysts and investors looking for those businesses with the brightest futures. If management is the problem these investors vote their displeasure by selling their shares, driving down the stock price, thus placing greater pressure on the company to act. Nonetheless, many private companies are well managed and do a superb job of acting creatively and strategically to a changing business environment. Since management can play a key element in overall risk, the business valuator must be attuned to factors in closely held companies which can sometimes give rise to enhanced risk. Finally, the age of senior management can present a risk factor, particularly when there is no qualified successor management in place.

Besides management issues, the valuator needs to consider other personnel risks. For example, is the company unionized, or is there a threat that it might be unionized? If unionization were to occur how would this impact the competitiveness of the company? Additionally, turnover of labor might be common in an industry or it may be a sign of a management problem, or that a company does not provide competitive pay and benefits, increasing risk.

The availability of labor, skilled and unskilled,

can present both an opportunity and a risk. If a company is located in a region with very low unemployment, it may have difficulty attracting and retaining workers to meet demand, making its ability to generate optimal revenues more uncertain, and possibly resulting in future upward pressure on wages and benefits. Alternatively, a company located in an area of high unemployment may have access to a vast pool of inexpensive labor, conferring a competitive advantage and reducing risk. Finally, if the company is subject to competition from companies using cheaper labor overseas it may soon be unable to compete unless it too is able to outsource its labor needs abroad. Witness what has happened to the domestic production of furniture. Ten years ago very little furniture was made abroad. Now, due to foreign competition, most U.S. based furniture companies have rapidly moved to outsourcing their products from China and other Asian countries. The companies that either have not, could not or will not do so may soon be out of business unless they serve a particular niche or product less vulnerable to overseas competition.

Finally, financial risks can arise as a result of benefits packages provided to a company's current and retired employees. The valuator should inquire if the company has defined benefit pension plans, deferred compensation packages, or retiree health care benefits that create a present or contingent future financial obligation for the company. When a company has audited financial statements these liabilities will often be disclosed in the notes to the financial statements. However, many private companies have unaudited financials and often lack full notes to the financial statements, if there are any at all.

Ownership. The valuator needs a clear understanding of the ownership of a company. In valuing less than a 100% controlling interest, the distribution of ownership, shareholder rights, the impact of state law, and other factors impact the applicability and size of control premiums, or minority and lack of marketability discounts that are warranted.

Beyond the above considerations, when there are multiple shareholders the valuator should be attuned to evidence of discord among existing shareholders that may impact the company's present or future performance. If the shareholders do not get along, there is a chance the financial results of the company will suffer. Management attention will be diverted, and there may be a lack of clear direction, increasing the risk that the company will experience difficulties.

The nature of a company's ownership can sometimes create financial risks. Shareholder or other

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agreements may give a shareholder the right to require a company to repurchase its shares upon giving due notice. For example, under Employee Stock Ownership Plans (ESOP's), which own shares in a company in a benefit plan, ERISA requires that the plan or the company be required to repurchase the shares if an employee desires to do so upon leaving the company or as a result of death. The ESOP "put agreement" might specify that this repurchase be made immediately or in installments, perhaps over five years. This creates a contingent financial obligation on the part of the company, potentially requiring it to deplete its cash or borrow to fund the commitment, increasing its risk. For a company in a cyclical business with an ESOP, this requirement to repurchase could come precisely when it can least afford it. When business turns down it may have to reduce staffing to cut costs to survive. However, those departing employees must now be paid for their ESOP shares at a time when cash is tight, earnings are down, and the company can least afford it.

Past Transactions in the Shares. Have there been past transactions in the shares of a company that might serve as valid indicators of the current fair market value of the shares? If so, the appraiser must carefully understand how the transactions came about, the pricing and terms involved and how they were determined, and whether or not the transactions were actually reflective of fair market value. Were any of the transactions distress sales where a party needed money and sold at a less than fair market value price? Additionally, in private companies sales of shares within families are sometimes not made on an arms length basis, and may be a part of gifting and estate planning, and not reflective of fair market value. The appraiser should inquire as to what gave rise to the transaction and whether or not management believes it is indicative of the current value, and why or why not. Even if there have been sales that are arms length, they are often dated in time and may not be relevant to the current size and operations of the company, which may be markedly different.

A frequently overlooked issue in the interview is the failure to ask management if it is currently considering a possible sale of the company, if it has recently received offers for the company's purchase, or if it is in negotiations with a prospective buyer. Management often does not mention this, hoping not to cloud the valuator's opinion of value. However, the knowledge that there are discussions underway with a buyer could nonetheless be highly relevant. Suppose the assignment were to value a minority interest for gifting

purposes. Without knowledge of a possible transaction the shares might be discounted for their minority interest status and lack of marketability, and are worth \$30.00 per share. What if the company were in negotiations to sell all shares to a buyer for \$100.00 per share, a 100% control price? A willing seller of the shares, having all knowledge of the relevant facts, would be very unlikely to part with their shares for the minority price knowing the control price was likely. Failure to discuss these issues in the interview could lead to an inaccurate valuation of the shares.

Competitors in the Industry. Companies do not live in a vacuum and are influenced to a significant degree by the competitive environment they face. The degree of competition and the company's relative strengths and weaknesses versus its competitors can have significant influences on its financial performance and risk. Therefore, the valuator needs a clear understanding of a company's competition. The valuator should try to obtain an understanding of the following competitive issues:

- **Identify of Competition-** Who is the competition? Where are they headquartered and how large are they? Do competitors have size advantages over the company?
- **Strengths and Weaknesses-** What are the relative strengths and weaknesses of competitors versus the subject company? Do competitors have a better product or service, access to cheaper capital, proprietary techniques, patents or trade secrets, or other factors that place them at an advantage? The company being valued might also possess certain of these attributes that might enhance its ability to compete.
- **Market Share-** What is the market share of the company and its competitors? A company with a high market share may have economies of scale and be able to produce or distribute its product or service more cheaply, giving a competitive advantage. One difficulty is that many closely held businesses that are valued are in smaller industries or finite niches of limited size. Market share studies and data are often not available. Therefore, in the absence of the ability to locate this kind of data from trade or other associations, the valuator may have to rely upon management's estimates of market shares.
- **Competitive Strategy Employed-** Different companies use different strategies to compete. It is helpful to know a company's strategies to help see what makes it successful and to identify its possible

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vulnerabilities. For example, the company may sell a premium version of a product at a high price. To do so it may have a more expensive manufacturing process. If market demand shifts toward lower priced brands due to an economic downturn and tight times, the company's revenues may be hard hit, and its higher cost of manufacturing may not enable a ready shift to producing lower cost versions.

- **Barriers to Entry-** Are there any barriers to entry into the industry which serve to limit competition? Barriers can stem from a variety of factors such as licensing, large capital requirements to operate, exclusive distribution rights, possessing proprietary patents or technology, to name a few. The presence of these factors may serve to reduce the risk of competition. In some types of businesses the limits to potential competitors are negligible. On the Internet innovators will frequently be found marketing a product on-line. Unless a company has a proprietary product, imitators quickly spring up, copying the idea. In many cases, Internet commerce requires little more than a computer, the ability to design a web page, and limited capital to get started.

General Industry Information. Industry trends and factors impact participants. A smart company owner and the best-laid business strategy may not overcome a poor industry demand outlook or the threat of regulatory problems. The valuator should attempt to identify positive and negative factors impacting the industry, information on any short or long-term growth forecasts, industry participants, and any threats.

Accounting Methods. Central to the ability to make sense of a company's financial statements is a knowledge of the accounting methods used and what this says about the quality and reliability of a company's financial information and earnings. This might include consideration of factors such as the following:

- **Recognition of Revenues and Expenses-** At what point does the company recognize a sale and an expense on its financial statements? In unaudited financial statements, some companies aggressively count sales of product as revenues, even when they are made on consignment, with the customer having no obligation to keep the item. Therefore, it is important to determine at what point a company recognizes revenues and expense, and if this is reasonable.
- **Cash versus Accrual Basis-** Are year-end financial statements and interim year to date financials on a cash or an accrual basis?
- **Inventory Accounting Methods-** Does the company

account for inventory using First-In-First Out (FIFO) or Last-In-First-Out (LIFO), or some other method? How does this affect reported financial results and is it accurate?

- **Year-end adjustments-** What adjustments are made to year-end financial statements that are not reflected in interim results?
- **Interim Versus Year End Accounting Differences-** Are there any differences in how the company accounts for items on interim versus year end financial statements that would make contrasting the two an apples to oranges comparison? For example, a company that uses LIFO accounting for inventory will often compute income on a LIFO basis at year end, while interim financials are on a FIFO basis.
- **Reliability-** Does management believe interim and internally prepared year-end financial statements are reliable? Why or why not?
- **Changes in Accounting Methods-** What changes have been made historically in the accounting methods utilized and how did they impact results? What changes might be made in the future?
- **Changes in Accounting Firms-** Have there been frequent or recent changes in the company accounting firm that prepares the company's audit or tax work? The change may simply be due to price or other considerations. However, this can sometimes be a red flag over disagreements in accounting policy.

Financial Results and Information. In preparing for the interview, the appraiser should perform a preliminary analysis of the company's historic results so as to be prepared to ask detailed questions that deal with a company's past trends, volatility of results, the factors that led to the performance observed, good or bad, in given years. This will give the analyst insight into the financial risks of the business and should raise questions to be asked about what the future holds.

Banking and Financing Relationships. While large public companies have access to publicly traded debt and equity capital, the small and mid-sized private business is almost always totally reliant upon banks or asset based lenders (such as commercial finance companies) for the credit needed to grow. Unless a company is in an industry that requires limited capital (such as a professional practice) or has the luxury of a strong equity base, most companies could not survive without access to affordable bank credit. Therefore, it is important to make an assessment of the degree to which a company can rely on sufficient and continued credit in the future.

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This assessment might begin by examining the past history of banking relationships. If a company has made frequent changes of its principal banks, this is sometimes a red flag that there are underlying credit problems with the business, real or perceived. Has the company ever had its loans called (required to be paid off on demand) by its banks? If so, what led to the demand?

It is crucial to determine the status of the company's current credit availability, including the total amount of credit lines available, versus the actual amount currently outstanding. For example, if a company has \$2,950,000 outstanding under a \$3,000,000 line the valuator would need to determine if company will likely be able to have its credit line increased to support additional growth.

Are a company's available borrowings tied to set advance rates against receivables and inventory? For example, many credit lines will advance a set percentage against receivables (e.g., 80% against eligible receivables, being less than 90 days past due terms of sale) and inventory (e.g., 30% against raw materials and work-in-process, and 50% against finished goods). Therefore, the ability to use the line will be dependent on having certain amounts of collateral on hand, typically certified to the bank each month in a "borrowing base certificate" signed by the company's chief financial officer. Banks often use borrowing base formulas for companies they perceive to have moderate or higher risk, enabling the bank to maintain sufficient collateral to cover its loan exposure if the company has to be liquidated.

The company's loan covenants in its loan agreement with the bank should be understood and it should be determined if the company is in compliance with them. Covenants specify financial ratios and other terms and conditions to avoid being in default of the loan agreement. Are there any indications that the bank might accelerate the loan, requiring it to be paid off before its scheduled maturity date? Are banking relations good or tense? A consideration of these and earlier factors tells a lot about the company's risk, as perceived by banks and other creditors, and about the likelihood it can continue to count on bank financing in the near future.

One other important financing difference between public and private companies is that the shareholders in the latter are often required to sign personal, unconditional guarantees of the company's bank debts. This means that a buyer of the smaller private company automatically has more at risk. Not only is their investment in the company's shares at risk, but their personal net worth as well.

Contractual Relationships. Contractual

relationships can impact a company in a variety of ways, good and bad. This section will cover a few of the many ways in which these issues can impact a company and the key considerations involved.

Many valuations involve companies that have distributorship agreements with suppliers, giving the company the right to sell the suppliers' products. It is important to obtain and review a copy of distributorship agreements since the rights and protections they afford the company can vary enormously. Some agreements give a company the exclusive right to sell a product in a specified territory. For a strong brand this could be a valuable right, and may be the most valuable intangible asset of the company. If the brand is strong this reduces the company's risk by providing a barrier to entry into the industry by new competition. An example of a valuable right is a Coca Cola bottler who holds the exclusive ability to bottle Coke in its market area.

Not all distributorship rights provide the same degree of protection. Many are non-exclusive, or may be terminable on short notice without cause (e.g., 30 days). Additionally, many agreements specify that any change in the ownership without the prior written approval of the supplier results in a termination of the contract. Therefore, it is important to determine if a sale of the company would likely be approved. Otherwise an important contract right of the company may disappear. Other types of agreements name an approved manager of the company who may or may not be the owner. For example, many dealer franchise agreements that auto dealers have with auto manufacturers typically name an approved dealer manager.

Finally, distributorship agreements often require that the company meets sales goals or quotas, standards of service, and other requirements in order to avoid possible termination. It is important to ask company officials if these standards are being met, or if the company is in violation of any agreements which could lead to termination.

It is important to explore if there are other contracts with customers or suppliers that either increase or decrease risk. A long term contract with a customer can reduce risk if it brings stability to annual revenues. Alternatively, if the contract locks the company in to selling a product at very low prices, even though the company's cost of the product is subject to change, this could result in having to sell a product for far below a company's cost. Similarly, a contract to purchase a key raw material from a supplier can reduce risk by locking in access to a product subject to periodic shortages, but might also subject the company to continue to buy certain

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minimum amounts, even when customer demand is poor. The only way to gauge the implications of these types of agreements is to study them.

There are obviously a wide range of contracts a valuator might encounter in a given engagement. Listed below is a more comprehensive list of the ones most likely to become issues:

- Distributorship agreements
- Employment agreements
- Covenants-not-to-compete
- Supplier and franchise agreements
- Customer agreements
- Royalty agreements
- Equipment lease or rental contracts
- Labor contracts
- Employee benefit plans
- Any miscellaneous contracts, copyrights, patents, etc.
- Lease on premises, if any
- Contracts to purchase or sell assets or stock

Outlook and Forecasts at the Valuation Date.

The future financial outlook is important to determine since it is an integral part of using the income valuation approach. The company may already have prepared detailed forecasts for internal use, or as required by its bank or other parties. If this is the case the valuator needs to understand the basis behind the forecasts, the individual assumptions used, and reach a determination if they are reasonable. Just because they are management prepared does not mean the valuator should use them if they are not realistic. In the majority of cases, however, there are no forecasts available, leaving the burden of their development to the business appraiser.

One frequently overlooked issue is the impact that capacity constraints have on a company's ability to realize forecasted revenues. These constraints might be physical, such as the inability of a plant to produce more products without an increase in size, managerial depth, or a shortage of necessary capital, to name just a few. Each assumption made in developing forecasts should be considered in light of each company's unique constraints.

Litigation and Other Material Factors.

Pending or threatened litigation and other material factors, such as environmental waste problems, audits of the books by the Internal Revenue Service, and a host of potential factors could impact a company's risk, impact its current or future earnings, or deplete its financial resources. It is important that the valuator attempt to uncover any such problems if they exist, and determine the extent to which they might financially impact the

company. A sample listing of possible material factors is shown below:

- Pending or threatened lawsuits
- Regulatory compliance problems
- Warranty or other product liability
- Hazardous waste or other environmental problems
- Workers' compensation problems
- Letter of credit liabilities
- Liens or judgments of any kind
- Guarantees by the company of any obligations
- IRS problems
- Off balance-sheet assets or liabilities
- Pending/expected loss of a key customer/supplier
- Pending/expected loss of a key employee
- A breach/termination of an important contract
- Pending or possible acquisitions or purchases of other companies or assets, product lines, etc.
- Pending or possible sales or divestitures of company assets, product lines, etc.
- Any factor of any kind that might have a material impact, positively or negatively, on the company's financial or operating performance, or value

Once a material factor has been identified it may or may not be possible to quantify its financial impact. Therefore, the factor may represent an issue that increases risk, but whose effect is unknown. An example is the knowledge by the company that it has underground petroleum storage tanks. Even though they are no longer used, management believes it likely that the tanks leaked over time, but does not know the extent of the problem or the costs required for cleanup. Even if the company has hired an environmental consultant to prepare a study to define the extent of the contamination, the consultant may not be willing or able to estimate the probable cleanup costs. The best the valuator may be able to do is to increase the discount rate applied in the income approach to reflect this increased risk, but the question of how much to do so is ultimately very subjective.

Even if the effect of important issues cannot be quantified it is good policy to mention them in the report and state the problem involved in determining their impact. Someone other than the client may read or rely upon the report later for some unintended purposes and may be wholly unaware the issue exists. Equally important is the need to include an appropriate disclaimer in the report that the valuator has not undertaken an audit or due diligence review of the company.

Corporate Insurance. Most companies have general and product liability coverage, or in the case of

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professional practices, malpractice coverage. However, this is not always the case, so the valuator will need to inquire if the coverage is in force, if it is with a financially solvent carrier, and the amount of protection it provides. Equally important is a determination of whether or not management is aware if the coverage will be renewed at its expiration date, and if it will, determine if the premium expense will jump substantially, impacting the company's profitability.

As an example, private ambulance firms are subject to substantial potential liability arising from accidents when driving at high speed, the death of a patient on the way to the hospital, and other risks. Therefore, liability coverage may be very difficult or impossible to obtain, or may be very expensive. In a past assignment the author was analyzing just such a firm that made about in \$500,000 annual net profit, after paying over \$200,000 for liability coverage. In asking about the price of the coming renewal coverage, management indicated that the carrier was increasing the premiums to over \$1,000,000 annually, more than the company's entire profit. Management did not believe the municipality to whom the company provided services would enable the company to raise its prices accordingly, yet the municipality required all ambulance companies to maintain minimum coverage. Therefore, the company was faced with paying the premiums, incurring a loss and threatening its survival, or alternatively, not paying the premiums and having to shut its doors. This is why the valuator must be attuned to future factors, known or contingent, that may cause the historic results of a company to be a very poor indicator of what the future holds.

Many companies provide health insurance to their employees. It is important to ascertain if any of the risk of claims payment is borne by the company itself, called self-insurance. In an attempt to reduce health care costs, more private companies self insure against some or all of the risk. Also, in many industries companies (e.g., temporary agencies) are making greater use of self-insurance to reduce workers compensation insurance costs. If a company does self insure, the valuator needs to identify the limits on a company's exposure, and if it has purchased re-insurance to pay claims once they exceed a set amount. In a smaller company that self-insures all or part of its health coverage, merely having several employees endure catastrophic illnesses in an employee population of 200 could result in a severe hit to earnings.

Wrap-up of the Interview. Wrapping up the interview is an important part of the process. This allows the valuator to ask any questions that remain, as well to

summarize what he or she believes the crucial issues are impacting the business, and to solicit management's response as to their view of this summary and its validity. It is also helpful to ask management if they were buying the business today, what they would identify as the five most important positive and negative aspects of the company. It is amazing what this kind of open-ended question will often tell the valuator about the company.

Furthermore, it is important to ask management if there are any material positive or negative factors that might impact the company that have not been discussed. Sometimes issues that are important simply haven't been covered and this may result in them being addressed. Also, in the event management is attempting to conceal information, this question might make it less likely to omit an important consideration.

Finally, the valuation interview will often raise new issues unique to the company that require additional information. Ideally the business appraiser will note these items as the interview progresses and can obtain the information while on site at the company. If this is not possible, the valuator should be sure to clarify with the client any remaining needs, and identify who at the company will be responsible for providing them and when.

Conclusion. The key to a sound, supported and unbiased valuation is the level of professionalism of the inquiry and analysis made by the business appraiser. A company interview must be thorough and cover a wide variety of issues internal and external to the company that may increase or decrease its risk, or create future opportunities. This article provided a framework to guide and shape the interview to identify these issues and their importance to the valuation assignment. ♦

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