BANISTER FINANCIAL, INC.
Business Valuation Specialists
www.businessvalue.com

1338 HARDING PLACE • SUITE 200
CHARLOTTE, NORTH CAROLINA 28204
PHONE: 704-334-4932 FAX: 704-334-5770
Contact: George B. Hawkins, ASA, CFA, President

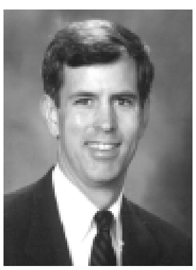
FAIR VALUE™

Reprinted from the Winter/Spring 1999 Issue

COMPANY FINANCIAL RISK (AND WHY ATTORNEYS MUST UNDERSTAND IT)

By: George B. Hawkins, ASA, CFA

Introduction. Attorneys do not go to law school to become financial analysts. Nonetheless, lawyers in the fields of estate planning, family law and business law frequently must review a business valuation in order to determine if the value makes sense. The family law attorney might want to know how to take the valuation expert's deposition and needs to know where the flaws in the valuation may be present. The estate-planning attorney wants to ensure that his or her client has the lowest possible value to minimize estate or gift taxes. To achieve these goals, it is crucial that the attorney broadly understands the role of financial analysis since it impacts the business valuator's determination of risk (captured through a discount rate) and the prospective future earnings of the company. Both of these factors are ultimately brought together to arrive a value in the commonly used income valuation approach (e.g., capitalization of earnings, excess earnings, and discounted cash flow methods). Additionally, if a company has poor performance or a high degree of financial risk, this may also make its shares less attractive. This could lead to a higher discount for lack of marketability, an issue of particular importance to the estate planning attorney.



George Hawkins

As may be remembered from earlier *Fair Value* articles "Critically Assessing a Business Valuation: Is the Capitalization Rate Used Reasonable?" (June 1996) and "Discounted Cash Flow Valuation Techniques" (December 1994), when utilizing the income valuation approach, the higher the risk, the higher the discount and capitalization rates, and therefore the lower the value of a company's income stream. Another article in this issue of *Fair Value* deals with internal and external business risks that impact companies. Bringing these two categories of risk (financial and business risk) together enables the valuator to arrive at a reasonable and supported assessment of the company's overall risk. This overall risk is reflected in a discount rate which is the annual required rate of return for risk that an investor would require for investing in the company's shares. This discount rate is used to develop the all important capitalization rate that is a crucial part of the income valuation approach. Therefore, the attorney must be able to assess whether or not the valuator has undertaken the appropriate steps to determine financial and business risks. Only through making this assessment will the attorney be able to conclude if the relevant risks were accurately identified and appropriately reflected in the discount and cap rate used.

Therefore, if the estate planning attorney believes the valuation fails to capture a key risk, this should be pointed out to the valuator for his or her consideration since the inclusion of that risk would have the impact of lowering company value for estate or gift tax purposes. Similarly, a family law attorney may conclude that the opposing expert has painted an overly pessimistic picture of a company, resulting in the use of too high a capitalization rate, and therefore, too low a value. By understanding the elements that comprise risk, the attorney will be in a better position to effectively cross-examine the valuation expert.

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This article provides an overview of the important role of financial analysis in the valuation process. This article also illustrates how financial analysis provides insight into a company's operations, its risks and its opportunities.

Financial Analysis. A thorough financial analysis is an important aspect of any valuation assignment. Examining the financial condition and performance of a company provides crucial insight into its financial risks, the factors that impacted its historic results, and what this portends about the future. It is important to remember that the purchaser of a company is always looking forward and makes an assessment about the risks and rewards associated with owning shares in the business. While a company's history is not guaranteed to repeat itself, the analysis of past results assists in identifying forces internal and external to the business that impact how well or poorly the company performs. This analysis provides insight into the inquiries that need to be made of the company's management to identify financial and other risks. This analysis also assists in the development of meaningful and supported valuation forecasts.

How Much History Is Enough? In order to begin a financial analysis, the valuator needs a sufficient number of years of historical financial statements to provide an accurate picture of the business and to identify positive or negative trends. Valuation firms, banks, and other creditors often request the last five years financial statements. However, this is an arbitrary number and is sometimes insufficient to gain perspective on broad and long-term financial trends.

For example, if the company is in a cyclical industry, five years may not be long enough to see all aspects of the cycle, including the peak and the trough. A good example of a cyclical industry is homebuilding, which tends to have periods of booms and busts tied to the general economy, interest rates, and other macroeconomic forces. Suppose the last five years represented the "boom" part of the cycle. If only five years of information is requested, the valuator might erroneously conclude that the financial trends are always onward and upward. Another problem is that abnormally long economic expansions obscure the presence of cycles.

The Types of Financial Statement Spreads and Their Use. Looking at a company's printed financial statements, it is difficult to easily discern broad trends over time or to put the results in perspective. "Spreading" a company's historic financial statements brings this added level of insight in a simple, yet powerful way. Spreading financial statements involves putting the results in a common format that is more easily reviewed and analyzed. Financial spreadsheet reports include actual and common-sized income statements and balance sheets, financial statement ratios, and trend analysis. These reports are explained in the following sections.

Actual and Common Size Financial Statements. Placing a company's historic annual income statements side-by-side enables the trends and variations over time to be identified. Common-sized means that each revenue and expense item is shown in terms of its relationship to the overall revenues of the business, expressed as a percentage of total annual net revenues. Coming down the common-sized report, revenues, costs of good sold, and later operating expenses are shown, both in dollar terms and as a percentage of net revenues. Following this, other income and expense items are detailed (usually interest income and interest expense), followed by the net profit of the company. Common-sized balance sheets are much like their income statement counterpart with the only difference being that each asset, liability and shareholders' equity dollar item is shown as a percentage of the company's total assets.

Financial Statement Ratios. Financial statement ratios, such as the percentage profit margin, return on equity, leverage (a measure of the dependence on debt), liquidity (a measure of the resources on hand to meet short term obligations) and other ratios, enable the valuator to spot the individual results of the income statement and the balance sheet, both separately and in terms of how the statements are linked together. The ratios facilitate an assessment of the company's performance, its financial risks, and to help to isolate positive and negative trends

While there may be any number of reasons for the trends noted in a given company, the valuator cannot know what the relevant questions are to be of management if the trends are not first identified. Common-sized financial statements and ratios facilitate this analysis. The goal of financial analysis is to develop useful questions for the interview of company management. The aim is not to develop answers and conclusions about the company. What may appear to be unusual or disturbing trends in the preliminary analysis may later be found in the interview to be minor issues that are readily explained. At the same time, other new issues may emerge as a result of the analysis. Without this preliminary framework, the valuator has no basis to focus the interview effort.

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Revenues. Revenues are the rocket fuel that drives everything else in an organization. Without revenues there is ultimately no business, no need for employees, and no reason to exist. Additionally, many of a company's expenses are directly or indirectly tied to generating revenues. Given this important role, it is essential that the factors that influence a company's historic actual revenues be understood, along with what they suggest about the future. Before delving into the detail behind a company's actual reported revenue numbers, it is first helpful to look at historic trends from an overall perspective. This helps frame the nature of individual questions.

Operating Expenses. A company's ability to manage operating expenses can be a critical variable impacting its overall profitability. Even if the company has a strong revenue base and gross profit margins on its sales, if it does not control its operating expenses it will experience poor operating profits, or perhaps even losses. In the adjustments to the income measure used for valuation purposes, the valuator will want to determine if there are unusual expenses that are non-recurring and should therefore be added back to increase reported income for valuation purposes. Determining the extent of the expenses and the likelihood they will continue will lead to the answer.

The Importance of Analyzing a Company's Earnings. At the broadest level, a company's net profit (or net earnings) on its income statement is the end result of its revenues, the costs of the goods it sells (or the services it provides), and its level of operating expenses. How these elements combine to produce the resulting net income depends on a number of factors. These factors include management's skill, the impact of competition, industry forces, the economy, pressures from its customers and suppliers, and other issues that may affect all companies, or are unique to a specific company. The goal of income statement profitability analysis is to:

- Enable the valuator to make judgments about the historic performance of the company, and the variability of its results. This provides insight into the risks associated with the business and the likelihood of the earnings outlook in the future.
- Provide results against which to assess management's strengths and weaknesses, and how this would impact an investor's perception of the shares as an investment, and their associated risk.
- Give an objective basis for comparing a company's performance relative to its industry peers. This assists in discerning the relative attractiveness of the company as an investment.
- Offer insight into a company's economics, and how the company achieves its net profit on a given level of revenues. This assists in identifying fixed and variable cost components in the company's operating structure. This also assists in the preparation of more reliable forecasts of earnings and cash flow for use in the discounted future income valuation method.
- Obtain clues concerning the internal and external forces that affect the company and what this suggests about risk, future threats, and opportunities.

Balance Sheet Analysis. Balance sheet analysis includes a review of a company's levels of liquidity and working capital, factors that are indicative of its ability to meet short-term obligations and support operating cash requirements. Additionally, this analysis also includes an examination of individual items that comprise current assets and liabilities, including the quality and turnover of receivables and inventory, and a company's degree of reliance on trade supplier terms.

Another factor reviewed as an indicator of financial risk is a company's degree of financial leverage. This includes the degree of reliance on interest-bearing debt to finance company operations, along with the company's ability to service those obligations through cash flows generated by the business. If a company has a strong ability to service debt, it may be more likely to obtain additional bank credit needed to support growth. Alternatively, if a company's servicing ability is poor, it may not be able to obtain more credit, and may even deteriorate to the point that its banks might force repayment of existing debt, causing a financial crisis. Finally, a company's return on equity is examined to determine the degree of financial returns provided to shareholders and the elements that comprised that return, including profit margins, asset utilization (turnover), and leverage.

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 includes the factors such as:

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- **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.
- **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?
- **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, a change can sometimes be a red flag over disagreements in accounting policy.

Conclusion. Reaching an assessment of a company's financial risk is an important part of the determination of the company's overall risk. Unless the attorney understands the elements that make a company more or less risky, he or she will have no idea how to effectively critique a valuation report or cross examine the valuation expert. This and another article in this issue provide an introduction to the two key elements of risk: business and financial risk. By understanding these two key components the attorney will be in a better position to effectively understand, critique, and perhaps challenge the findings of a business valuation. ♦

George B. Hawkins is co-author of the *CCH Business Valuation Guide* and a Managing Director of Banister Financial, Inc., a business valuation firm in Charlotte, North Carolina. He can be reached at ghawkins@businessvalue.com or 704-334-4932.