Understanding Financial Statements and Their Effects on Enhancing Value

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Main Objectives

1) Discussion of financial statements through the lens of an appraiser
2) How are financial statements used by appraisers in assessing value?
3) How Management can increase the company's value through enhanced financial performance and reporting?

Discussion Topics

1) Not all financial statements are created equal
2) How are financial statements used by appraisers in assessing value?
3) What impact do financial statements have on the primary drivers of value (i.e. – earnings, growth and risk)?
4) Value drivers – what Management can do to move the needle

   - Implement initiatives that impact earnings, growth & risk (“EGaR”)

Role of Financial Statements

- Financial statements (balance sheet, income statement and statement of cash flows) reflect a company’s past performance and current financial position - which in turn the investor uses to form an opinion about whether the company has the ability to earn profits and cash flow at a sustainable level in the future.
- The role of *financial reporting* is to provide financial statement users with information about a company’s performance and financial position.
- The role of *financial statement analysis* is to use the information to make an economic decision (invest, loan money).

Audited Financial Statements

- An audit performed by an accounting firm is an independent review of a company's financial statements.
- The objective of an audit is to enable the auditor to provide a certified opinion on the fairness and reliability of the financial statements.
- The auditor examines the company's accounting and internal control systems, confirms assets and liabilities, and generally tries to determine that there are no material errors in the financial statements.
- The standard auditor's opinion contains three (3) parts and states that:

  - Whereas the financial statements are prepared by management and its responsibility, the auditor has performed an independent review.

  - Generally accepted auditing standards were followed, thus providing reasonable assurance that the financials contain no material errors, and

  - The auditor is satisfied that the statements were prepared in accordance with generally accepted accounting principles.

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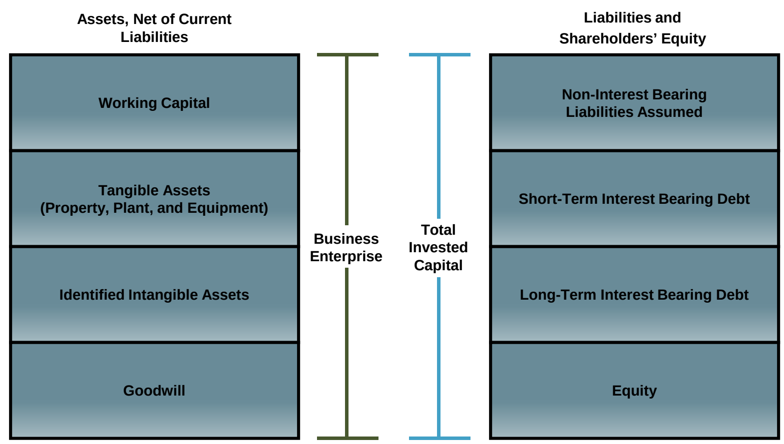
Underlying Financial Statements

- Audited vs. Unaudited Financial Statements
  - Corporate governance and risk management
  - Instructive process
- Accrual vs. Cash or Tax-Basis
  - Representative accrual basis is critical
- GAAP
  - Do the financials reflect the business model?
- Adjusted Financial Statements and Quality of Earnings
- **Financial Projections ~ Forward Looking Financial Statements**

Fair Market Value Balance Sheet



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Adjusted Financial Statements

- Typical Normalization Adjustments
  - Related party transactions (rent)
  - Intercompany transactions
  - Litigation
  - Restructuring
  - Significant one-time charges
  - Deferred taxes
- **But is the real cost of growth properly reflected – historically and proforma?**

DCF Case

Discounted Cash Flow Analysis

			Fiscal years ending:					Terminal
		Dec-31-2016	**Dec-31-2017**	**Dec-31-2018**	**Dec-31-2019**	**Dec-31-2020**	**Dec-31-2021**	**Period**
Revenue		$10,000	$10,500	$11,025	$11,576	$12,155	$12,763	$13,018
Annual growth	5.0%		*5.0%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*	*2.0%*
Cost of Goods Sold		6,000	6,300	6,615	6,946	7,293	7,658	$7,811
% of revenue		*60.0%*	*60.0%*	*60.0%*	*60.0%*	*60.0%*	*60.0%*	*60.0%*
Gross profit		$4,000	$4,200	$4,410	$4,631	$4,862	$5,105	$5,207
Operating expenses		$2,500	$2,625	$2,756	$2,894	$3,039	$3,191	$3,255
Operating income		$1,500	$1,575	$1,654	$1,736	$1,823	$1,914	$1,953
add: Depreciation		$500	$500	$500	$500	$500	$500	$500
EBITDA		$2,000	$2,075	$2,154	$2,236	$2,323	$2,414	$2,460
% of revenue		*20.0%*	*19.8%*	*19.5%*	*19.3%*	*19.1%*	*18.9%*	*18.9%*
less: Depreciation and amortization		($500)	($500)	($500)	($500)	($500)	($500)	($500)
EBIT		$1,500	$1,575	$1,654	$1,736	$1,823	$1,914	$1,960
Income tax expense	40.0%		$630	$662	$695	$729	$766	$784
Debt-free net income			$945	$992	$1,042	$1,094	$1,149	$1,176
Cash flow adjustments								
Depreciation			$500	$500	$500	$500	$500	$500
Capital expenditures			($500)	($500)	($500)	($500)	($500)	($500)
Incremental debt-free net working capital	20.0%		($100)	($105)	($110)	($116)	($122)	($51)
Debt-free net cash flow (DFNCF)			$845	$887	$932	$978	$1,027	$1,125
Present value (PV) factor	15.0%		0.9325	0.8109	0.7051	0.6131	0.5332	
PV of DFNCF			$788	$719	$657	$600	$548	

Net PV of interim period DFNCF	$3,312
Terminal value	$4,615
Business enterprise value (BEV)	**$7,926**
Rounded	**$7,900**
BEV/REVENUE	**0.79**
BEV/EBITDA	**3.95**

Terminal Value: Gordon Growth Model

DFNCF, 2022	$1,125
WACC	15.0%
LTG	2.0%
Capitalization rate	13.0%
Terminal value, 2021	$8,655
PV factor	0.5332
Terminal value	$4,615

DCF Sensitivity

Net Working Capital vs. Growth Rate

		Growth Rate		
		5.0%	7.5%	10.0%
Net Working Capital	15.0%	$8,100	$8,800	$9,500
	20.0%	**$7,900**	**$8,500**	**$9,200**
	25.0%	$7,800	$8,300	$8,900
2% Margin Erosion		**$6,800**	**$7,300**	**$7,800**

Quality of Earnings Analysis (Q of E)

- Vendor and customer concentration
- Deconstruct/ reconstruct revenue growth
- Industry and competitive factors
- IP dependence and defensibility
- Investment in growth/intangible assets
- Margin mix analysis (80/20 rule)
- Key-man risk/quality of management team

Market Approach

- How do financial statements and performance impact the market approach?
- How is a market multiple derived?
- Reconciling Income Approach (DCF) with a Market Approach
- How do we earn a high multiple?

Present Value =	Earnings (1 + g) / c	
Capitalization Rate (c) =	K - g	
K =	**Discount Rate (Cost of Capital)**	
g =	**LT Earnings Growth Rate**	

Market Multiple	6	
Cap Rate	17%	(1 / 6 = 17%)
Cap Rate	17% (20% - 3%)	
Discount Rate	20%	
LT Earnings Growth Rate	3%	

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Potential Value Drivers

- **Primary Drivers**
- Revenue size, growth, composition and stability
- Historical and projected cash flow
- Margin percentages
- Return of assets/ collateral base
- Working capital
- Intellectual property/ intangibles
- Customer diversification
- Management strength
- Degree of leverage

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Potential Value Drivers (cont-)

- **Secondary Drivers**
- Financial controls
- Asset quality
- Facilities/ infrastructure
- Staff / training/ development/ turnover
- Premise leases
- Competitor landscape
- Regulatory environment
- Environmental
- Quality control / safety record
- Insurance

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Key Takeaways for Business Owners/ Management

- Understand the Concept of a “Fair Market Value” Balance Sheet
- Understand the connection between financial statement elements and how day-to-day business decisions impact value
- Evaluate your operations, identify areas that can be improved, and implement changes that will enhance the value drivers and/or reduce risk

Remember – Value is What a Third Party Buyer Thinks Your Company is Worth

Quiz Question for Audience

Fill in the Blanks in the Following Sentence:

“ Valuation is……………..”

A. 100% Art

B. 100% Science

C. Half Art…Half Science

D. None of the Above

FAQ’s

- Are audited financial statements required to do a quality valuation?
- How do prior year financial projections impact a valuation?
- How are recent shocks to revenue and EBITDA (positive or negative) addressed in a valuation (for example - winning or losing a major account)?
- Should a company that doesn’t have a predictable revenue stream bother constructing a projection?
- Why don’t most financial projections include balance sheet accounts (net working capital and capex requirements)?
- What do you do if a company’s financials do not reflect important industry-specific economic factors (for example - SAAS or subscription revenue)?
- When might the fair market value of equity fall below book value?
- How are intangible assets and goodwill (unreported assets) reflected in the valuation?
- If a company fails to meet its projections, should it automatically expect the valuation to fall?

Your Presenters

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QUESTIONS & ANSWERS

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Financial Statements – Balance Sheet

- The balance sheet (or statement of financial position) reports the company's financial position at a point in time and consists of three (3) elements:

1. Assets are the resources controlled by a company as a result of past transactions that are expected to provide future economic benefits.
2. Liabilities are obligations as a result of past events that are expected to require an outflow of economic resources.
3. Owner's equity is the residual interest in the net assets of a company that remain after deducting its liabilities

The fundamental accounting equation holds that: *assets* = *liabilities* + *owner's equity*

Balance Sheet Elements

- Assets are the company's economic resources

  Examples include:

  - Cash and cash equivalents
  - Accounts receivable
  - Inventory
  - Fixed assets/equipment
  - Real Property
  - Intangible assets (customer lists, software, patents, tradename, goodwill)
  - Other investments

Balance Sheet Elements

- Liabilities are creditor claims on company resources. Examples include:
  - Trade and accounts payable
  - Short and long term debt payable
  - Income taxes payable
  - Unearned revenue
  - Other accrued liabilities
- Owner's equity is the residual claim on a company's resources, or the amount by which the assets exceed the liabilities; including:
  - Capital (par value of stock)
  - Additional paid-in capital
  - Retained earnings (cumulative net income not already distributed)
  - Other comprehensive income

Financial Statements – Income and Cash Flow Statement

- The income statement (profit & loss statement or statement of operations) reports on the financial performance of a company over a period of time.
- The elements of the income statement include: sales/revenue, expenses, and gains and losses. Under accrual-basis accounting, a company must recognize revenues when they are earned and expenses when they are incurred; regardless of whether the cash has actually been paid.
- The cash flow statement reports the company's cash receipts and payments, as classified as: operating cash flows, investing cash flows, and financing cash flows

Financial Statements – Basis of Measurement

- The amounts at which items are reported in the financial statement elements depend on their *measurement base.*
- Measurement bases include *historical cost* (the amount originally paid for the asset).
- *Amortizable cost* (historical cost adjusted for depreciation, amortization, depletion, or impairment).
- *Realizable value* (the amount for which the asset could be sold).
- *Present value* (the discounted value of the asset's expected future cash flows), and
- *Fair value* (the amount at which two parties would exchange the asset in an arm's length transaction).

Financial Reporting Standards

- Given the variety and complexity of company transactions and the estimates and assumptions a company must make when presenting its performance, financial statements could potentially take any form if there were no reporting standards.
- Thus, financial reporting standards are needed to provide consistency by narrowing the range of acceptable responses.
- However, the standards must remain flexible and allow for some management discretion to properly describe the economics of the company.
- Financial reporting is not designed solely for valuation purposes. However, it does provide important inputs.
- There are qualitative characteristics of financial information that makes it useful: relevant such that it can influence a user's economic decision; faithfully representative, comparable, verifiable, timely and understandable.