Importance of Financials in Selling a Company

Kevin Swanson

In a company sale the most important information for achieving a successful outcome are the historical and projected financial statements. These statements tell the story of the company's past performance and future prospects and their quality determines whether the story is interpreted as reliable. From a potential buyer's perspective the financials largely determine their willingness and ability to pursue a transaction and pay the maximum achievable price.

With respect to historical financials the numbers are expected to be factually accurate and ideally presented in accordance with GAAP. Some companies, particularly small family-owned businesses, use simpler and from their perspective more relevant financial information (e.g., a cash-basis as opposed to accrual-basis presentation). On the other hand, buyers usually prefer GAAP financials since GAAP accounting principles are well-established, widely used, and universally accepted. While buyers prefer audited financials, small companies often dismiss audits as they perceive little value in them. Audited financials are strongly encouraged whenever possible but are not an absolute requirement for a successful sale. Think of an audit as a marketing cost that positions the company as well-managed and financially sound.

In acquisitions of private companies buyers today typically require a Quality of Earnings ("QOE") analysis by a reliable accounting firm, either in place of or in addition to audited financials. The intent of a QOE report is to objectively present the accuracy and quality of a company's assets and historical earnings, as well as the sustainability of those results. The primary features of the typical report include a summary of the business (location, market, products, customers), a breakdown of revenue, an income statement analysis, an evaluation of the balance sheet, including debt and working capital, a thorough analysis of EBITDA and capital expenditures, and an evaluation of tax filings. In addition the QOE report considers the company's internal controls and other relevant financial practices such as unusual trends in how the company prepared its income

statements, abnormal accounting policies, changes to accounting procedures and practices, and related party transactions. QOE reports are most frequently commissioned by the buyer after signing a letter of intent; however, they may be utilized by sellers in advance of a sale process. QOE reports provide sellers with an objective look at their business in preparation for going to market and highlight potential risks. The report highlights inconsistencies in financial data and areas of concern that must be addressed. Mostly, the QOE helps eliminate surprises that could impact the sales price or derail the transaction entirely.

As an example, an owner of a medical services business decided to sell his company. Through a challenging process, he negotiated a transaction with a private equity firm. Both sides were satisfied with the terms, although they had taken a long time to agree due to the limited nature and quality of the financial information. Indeed, the transaction probably would have never reached an LOI if not for the fact that the company was in the healthcare industry and therefore had detailed medical and billing records. Nevertheless, the parties agreed to a deal and the due diligence process began. Since the historical financials were not audited nor presented in accordance with GAAP, the QOE represented the only reliable look at the company's historical financial performance. Unfortunately, the QOE report delivered a result which prevented the buyer from completing an acquisition. Without reliable financials the risk to a successful transaction is high. In this case the seller invested over a year in the process before concluding that it could not be completed. Had the seller obtained a Seller QOE in advance, they could have avoided lost time and hurt feelings and implemented their growth strategy sooner. This is a common mistake made by sellers to avoid what they view as an unproductive expense. However, in this case, the decision turned out to be "penny wise and pound foolish".

Regarding projected financials, the typical seller prepares a forecast that is optimistic, which obviously makes sense when attempting to maximize price. However, many times the result is a forecast that buyers describe as a "hockey stick". That generally causes those buyers to heavily discount management's projections and develop their own more conservative numbers. While that game is common in Mergers and Acquisitions, it behooves sellers to develop their forecasts carefully. Optimism is appropriate and even desirable, but a forecast

must be based on reality with assumptions that are defensible both with respect to historical results and future prospects. Growth rates higher than those of the overall economy must be supported with reasonable trends specific to an industry and/or company. Cost assumptions must fit the revenue forecast; aggressive topline growth with declining expenses will surely raise a red flag. Once buyers lose confidence in the assumptions, they are likely to discount the forecast heavily. Although they may discount any forecast, it is certain to be substantially greater when seller assumptions are unreasonable.

The owners of a small consumer products company decided to sell. They elected to engage an accounting firm to perform a seller's QOE analysis to develop a strong case for their historical financial presentation However, they did not exercise such care in developing their financial forecast. Given a history of consistently overestimating in budgeting, they made no allowance and had to revise their forecast down in the middle of the sale process. As a result, buyers lost confidence in their assumptions, drastically affecting the proposed bids. Ultimately the transaction was not completed because the seller was uncomfortable selling at the lower, revised prices. The process took over a year to complete and yielded nothing to the seller and potential buyers. It was a disappointing exercise that may have been avoided with more care in the forecasting process.

When considering the sale of a business, owners should allocate adequate resources to developing their financial presentation. It is not a project to be done by one person over a weekend. It should have buy-in at multiple levels and be embraced by the entire management team. While buyers will approach due diligence carefully regarding all aspects of a target, they will exercise particular care with respect to the historical and projected financials. Financial buyers, who have become a substantial part of the M&A market for virtually every business, will be especially concerned about this part of due diligence. It pays dividends for owners considering a sale to carefully consider their financial presentation.