

Unedited transcript of

## **Financial Analysis and Fact Gathering**

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### **Speaker(s)**

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>>: Yeah, I'd love to. So now really, this is titled Financial Economic and Industry Analysis. In reality, like, this is almost, like, our due diligence stage, OK? So we've scoped this thing out. We know why we're doing it. And now, we really got to just dig in. And so this is going to get into, like, looking at financials, you know, looking at business documents, performing, you know, research - you know, to the extent we've got relevant research out there and then things like making management answer all of our annoying questions at the end of the day, right? And so if we could turn to the next slide for a second. So really, we kick this off with a document request list again. And - well, I guess I would say from two angles, right? We're going to go get some documents, OK? And then, you know, to the extent we also have, like, public-facing information, like, we never want to forget that as well, right? You might have a website, right? Or we might have, you know, company LinkedIn pages and Facebook pages and things like state-level filings that you can go find publicly and then probably missing some stuff here. But it's almost like, you know, there is an element of private versus publicly available due diligence. So now we start with the hard part. It's that private side of things, that document request list. And so, you know, typically, you know, in many situations, it's somewhat of a custom matter depending on what we're looking at and why we're looking at. But what is at least a regular occurrence - you know, we're going to go, and we're going to ask for I'll just call it three different types of documents for a second. Get this 30,000-foot view of the historical financial situation, right? So oh, let's go get some corporate tax returns. Or if it's a business that reports on a personal schedule, see all the Schedule

C data for the last few years. You know, if there are things like audits or reviewed financial statements, you know, or sometimes even just they can generate some historical financial reports out of QuickBooks, you can go get those top-level things like income statements and balance sheets on an annual basis for a few years. And then to round out, like, the 30,000-foot view or - you know, what are their top-level, like, financial projections or budgets or forecasts. And in our world, that's actually somewhat of the exception, not the norm. You know, the - looking at small businesses, most small business owners don't really know where to start with things like that, or they kind of see it as a useless exercise or were kind of just, like, making stuff up that that's not going to come true. So it's not always typical, but you always want to look at, you know, even things that are sort of their projection of the future if they have it at the ready. You know, and then you go from sort of the overall financial picture, and you drill down into supplemental stuff. So, you know, if it might be relevant, can I go get, like, a general ledger document, for example, that's going to tell us, well, if we see that certain expenses look a little odd, we can actually go dig in and find some transactions and make some relevant observations about what's going on there. Or you're getting a breakdown of revenues by customer or fixed asset lists, you know, if it's a capital-intensive business. So there's sort of that second tier to try to dig into, you know, sort of the relevant material issues from a financial perspective. But go, like, a layer deeper to be better informed. And then we have a sort of a third category. It's almost everything else, you know. And it's usually not - you know, it's not typically the financial stuff we're getting into, you know, agreements or org charts or, you know, past valuations. You're probably missing some stuff here. Or like, if you've got past...

>>: Don't forget debt agreements, especially, you know, the PPP money that we see recently.

>>: Definitely. Like, hey, can you get us the correspondence on forgiveness, you know, if there is any. So like, there's a lot of stuff that's, you know, sometimes there's a little bit of a financial link, but it's more of like qualitative, you know, business documents, that give us a little bit more context on top of the financial picture is sort of that third category. So then we can do all this sort of desktop diligence - right? - like in-house, right?

We don't need, you know, human interaction outside of the appraisal team, for example, or talking from, like, an attorney-client perspective, right? But really, at that stage, it's super critical to do all this stuff. What's also really important is adding in the human element of, say, a management interview - right? - or a site visit, if one is warranted. It's, you know, something that's at least suggested by, I believe, all of the professional standards that we follow. And, you know, at a minimum - you know, it says here on the slide, should you attend? I think there's a question mark there. The answer is you should at least ask, right? Like, I think we never want to get caught not asking if we can have that forum to talk or visit a facility even and ask questions. You know, if it's, you know, more of a physical business, for example. Like, we're more inclined to push to say, well, we want to see that 100,000 square foot manufacturing facility than we might be if we're talking to somebody who, you know, runs a tiny CPA practice, for example, you know, or a service business. It might not be as important. We might still try to visit the office. And you know, obviously, COVID, to an extent, has kind of factored into thought processes around this in the last couple of years, you know, whether you do something over Zoom or you actually can go out and feel the necessity to go like physically visit. But, you know, I think one of the ways we like to view the interview sort of site visit function is you can read the documents and read the web pages and the professional bios all you want. You might miss context if you don't actually talk to a human involved in the business day to day. Now, you - the question might come in, do you trust the individual that you're talking to, obviously? Right? It might be situation-specific and the example would be, let's say Mark gets hired by the spouse of a business owner in a divorce and then Mark has to go talk to the business owner. You know, it's somewhat of an adverse - adversarial situation. You have to be able to gauge, you know, is there a good baseline of information that I'm getting here or are they kind of selling us a lot of nonsense at the end of the day, or being perceptive or evasive and, you know, sometimes in a worst case scenario, even get to a situation where you cut it short and say, OK, this hasn't been productive. We need to find an alternative avenue to sort of getting the information we were trying to get in this sort of personal context.

>>: And Jesse, I'll also say, like a visual is important. You know, when you

get the documents upfront and you expect the layout of a manufacturing plant, you expect a layout of a process center, and you want to know how many square feet they have and you can go out and inspect, are they using all the square footage? How does the equipment look? You know, if you deal with heavy equipment, you know, where's the lot where you keep all the equipment? Is there anything else on there? I can't tell you how many times I've gone out and you'd be like, OK, where's the second warehouse or what's in that trailer? And you know, you can find parts of the appraisal that by physically being on the premise that you would not gain insight on unless you're physically there. You know, I always tell this story. I've been in a situation where a company was really doing well on the production side of things. I showed up on a Wednesday morning for a site visit to tour the facilities, and it was quiet. There was - over 50% of the equipment was shut down, 25% of the people were there. And it wasn't until I was leaving - on the way out, I happened to say goodbye to the receptionist. And I said, looked awful quiet here today. And she goes, yeah. An email came around. The boss gave most of the staff the day off today, and so it had nothing to do with the shortage of production. It was trying to manipulate the process. So physical presence identity is super important. I think once you - the - oh, the only other thing that, Jesse, I think we should add in talk about document production and talk about timing, you have to understand the case. How difficult is it to get documents? You know, will there be a second round of document request list, and how long does it take to process? You know, as we look on the next slide and we talk about connecting with the expert here, I think just touching base, Jesse, making sure that all deadlines are going to be hit and what are the next steps, you know, as you're working behind the scenes to get the appraisal done.

>>: That's right. And the other behind the scenes stuff being - like we've got all sorts of lists and tracking of open items going on, making sure we go back and timely follow up on loose ends, you know. You like to think that by the time you've seen all the documents and you've talked to management, that you're like 99% of the way there to go now finish the work. But time and again, there's always a few extra things that we just need to be mindful of and make sure that we get sort of the last bite at the informational apple here.

>>: So, you know, with that being said, now we're hoping we've - we're gone through and we're, you know, talking about processes and we're starting to get into the nuts and bolts of what constitutes or what's going to go into the appraisal. And Jesse talked about gathering tiers of information. What type of financial information are we going to look at? Now, that information has been analyzed and spread. Let's say that the initial site visit has taken place. What you're going to start to now look at is what has been the historical operations of the business. And what we want to do here is talk about the next step, when there's a concept in valuation called normalizing adjustments. And what normalizing adjustments constitutes is recognizing expenses incurred by the business, revenue earned by the business that, you know, may be a one-time event, may be at the discretion of an owner. Owners decide if they want to pay children, spouses who don't work at the business. They might work with setting a compensation level that's below market. They might take advantage of buying equipment and accelerating depreciation. There might be a one-time move or relocation cost that has taken place during the time period you're analyzing financials. So these normalizing adjustments are a section in the appraisal where the business valuation expert is going to go through identifying these types of expenses that they try to adjust to - let's call it a hypothetical owner, a passive owner who wants to run an efficient, expected, ongoing operation. What would that look like? And the categories that we've listed here, like owner's compensation, depreciation, related party transactions. Well, what does that mean for attorneys, how to identify what you're looking at? Well, let's run through an example. And let's say - and, you know, I know no attorney here ever went to law school to crunch numbers. You know, there's a reason you're attorneys versus accountants. And this will probably be one of the slides that has the most numbers you'll see. But let's take it as this is a sample profit and loss. And we have a company that has some volatility in sales, but we're really - what we really want to key on is some operating expenses. And you look at the first line, you see depreciation. We have, you know, depreciation expense. It has ranged from \$5,000 in three out of the five years, was \$20,000. But bam, in 2019, there's \$120,000 of depreciation. That looks like a one-time trigger that would need to be adjusted for. How about owner's compensation? It's all over the place. If we're valuing a company on a

controlling basis, and maybe let's for simplicity say there's one owner who owns 100% of the company, what are they paying themselves? How are they paying themselves and why are they paying themselves? You know, what has been the fluctuation of amounts that they take a change in salary, but their roles and responsibility haven't changed? They're putting money into 401k plans, paying related parties who don't work there. How would we group those into one category to adjust? And then finally, if there's related party rent. Very common is if an operating business also owns the property where the business is running, you know, the actual monthly rental payments may not be reflective of market value. So let's just look at an illustration, and what I kind of want to do here is just provide to you when you start with the operating income of the business. You know, this was the reported profits before we start normalizing anything. You'll see that the company could be anywhere from 4% profitable to a loss in one year. And let's break down four normalization expenses quickly. Going right in order here - how about depreciation? You know, we had that one year where the company may have bought a lot of equipment - let's keep it simple, 120,000 - and they were able to expense all of it in one year. Well, as an appraiser, we might adjust it that says, look, over seven years, the company put in \$140,000 of equipment. Let's smooth out depreciation. Pretty straightforward. The second adjustment looks at owner's comp and what they pay related parties, and, you know, we go anywhere from close to \$600,000 in annual comp. Now, think about it. What these two lines represent - if one individual owns 100% of the company and they're an active owner, they're paying as - they're paying family members who don't work there additional compensation. All that money really goes to the owner, and what does an appraiser determine? Well, the appraiser's job is to look from the outside in and say, this owner really performs the job of a CEO, president, head salesperson, customer relation, plant manager. What compensation should be paid for those responsibilities? And there's your answer. Based on some research on an annual basis, that owner's education, experience, roles and responsibilities tell us they should be paid \$325,000 a year, not in the range of 378 to almost \$600,000. So what we're doing is we're projecting a realistic market compensation for the roles and responsibilities of that controlling owner. Third, looking at related party rents. We come back in and the question is we've gotten an appraisal on the real estate, and that says market rents are somewhere around

\$45,000. Let's put in what should be market rent if it wasn't owned by the related party. And then you'll see at the end of the day, we've smoothed out the business. You know, we've gone in as business valuation individuals and say we've gone from a company that's been a loss of 1% to a 4% margin to now a company that has run anywhere from a loss, which we all know in 2020 could have been related to COVID factors, where the expected profitability is somewhere between 20 and 24% based on ongoing operations. So as attorneys - and jumping ahead and staying where we are - understanding when you see ebbing flows of these expenses, and these four are, again, common aspects of decisions, what an owner pays themselves, when a business owner decides to buy equipment, when that controlling business owner decides to add family members to the payroll and finally, what is the amount of market rent? So from a business standpoint, now we can see some normalized margins here. And these types of adjustments kind of culminate step two.