

Commercial Litigation Insights

THE IMPORTANCE OF FINANCIAL STATEMENT ANALYSIS IN BUSINESS VALUATIONS PERFORMED DURING THE COURSE OF COMMERCIAL LITIGATION

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The rigorous analysis of financial statements is an important procedure in any business valuation analysis. This analysis becomes even more important for a business valuation performed in a litigation context. This discussion summarizes a recent judicial decision in which a valuation expert was disqualified for naively utilizing the company-provided financial statements. And, this discussion presents the type of financial analysis procedures that can help the valuation analyst/expert witness to avoid such expert qualification problems.

INTRODUCTION

The valuation of a closely held business for litigation support and expert testimony requires a rigorous and comprehensive financial analysis. This financial analysis (and the associated due diligence) often results in uncovering instances of either (1) transactions that may be properly reported but that do not reflect economic reality or (2) financial reporting that is intended to distort a company's financial position and results of operations.

The financial analysis phase of the valuation often helps the valuation analyst to discover critical issues that may directly affect the trier of fact's decision with respect to the contested valuation.

The valuation analyst should not naively accept subject company financial statements and other financial data without performing the appropriate financial analysis procedures on this data. This analysis may help the analyst to uncover accounting or reporting problems that may ultimately affect the valuation conclusion.

These financial analysis procedures are particularly important when the valuation of a closely held business is based on unaudited financial statements (i.e., reviewed or compiled financial statements). This is because these unaudited financial statements are not subject to the scrutiny of an audit performed in accordance with generally accepted auditing standards (GAAS).

Furthermore, many closely held businesses do not prepare formal financial statements. In these instances, the only available compilation of data reflecting the sub-

ject business results of operation and financial position are reported in the company's federal income tax returns. Income tax returns often do not conform with generally accepted accounting principles (GAAP).

For example, the income tax returns of smaller business entities usually report on the cash basis of accounting as opposed to the accrual basis of accounting. Accordingly, the analyst may want to convert the cash basis data to the accrual basis to more accurately reflect economic reality.

In addition, it is not uncommon in the case of a closely held business for the litigant to manage financial statement data and reporting so as to satisfy personal economic needs and/or litigation positions. In other words, the reported financial data may not reflect the true financial

position and results of operations of the subject closely held business.

In addition, litigants often embark on income tax minimization strategies which over time can substantially distort the financial position and results of operation of the company. An analyst may be able to uncover misstatements of company assets, revenue, and expenditures by performing common financial statement analysis procedures. And, these misstatements may have a significant impact on the final business value conclusion.

THE DAUBERT STANDARD

The analyst should be aware of the so-called *Daubert* standard¹ if the analyst is going to be called as an expert witness

"The valuation analyst should not naively accept subject company financial statements. . . ."

in the subject litigation. *Daubert* (and several companion cases) provide guidance to the analyst as to how the court will view expert witness qualifications and expert analyses and procedures.

In a business valuation prepared for litigation purposes, the analyst should consider including a discussion of the following topics in the business valuation report:

- relevant professional standards,
- relevant professional literature,
- generally accepted analytical methods,
- consideration of alternate valuation approaches and methods,
- peer review of the selected valuation methodology,
- all significant analytical assumptions and valuation variables, and
- testing of the value conclusion for reasonableness

In light of the contrarian review that the analyst should expect in a litigation environment, how can the valuation analyst meet these challenges? Should the analyst naively accept the subject company tax returns and unaudited financial statements without further investigation? Or, should the analyst perform due diligence procedures to go behind the numbers in order to determine whether there are any aberrations, distortions, inconsistencies, and/or questionable items in the underlying company financial data?

The recent case of *Gary Price Studios Inc. v. Randolph Rose Collection Inc.*, decided in the U.S. District Court, Southern District of New York, highlights the hurdle that analysts have to overcome to have their expert testimony accepted by the court.

In this case, the expert assumed the correctness of the plaintiff's financial statements and calculations. The analyst did not scrutinize the company-provided financial data in order to assess this information in light of (1) guideline empirical data or (2) the analyst's previous experience.

The judge in the *Gary Price Studios* case concluded that "there is simply too great an analytical gap between the data and the opinion offered."² The judge ruled that the valuation expert's testimony should not be admitted as evidence in the trial because that testimony did not pass the *Daubert* tests.

The *Gary Price Studios* decision should indicate to the valuation analyst/expert witness that he/she cannot naively accept the financial information received in the discovery process. Rather, the analyst should subject that data to generally accepted financial analytical techniques.

ANALYSIS OF THE FINANCIAL STATEMENTS

In order to determine if there are underlying problems in the subject financial data, the analyst should analyze the subject company financial statements. If the basic financial analysis indicates unusual trends or relationships within the reported financial data, further investigation may be required by a forensic accounting specialist.

This forensic investigation may include analysis of specific transactions, journal entries, accounting work papers, and other underlying documentary evidence supporting the financial statements. This type of forensic investigation (1) is very focused and (2) is different from an audit conducted in accordance with GAAS.

The analyst should have a working knowledge of GAAP in order to analyze the financial statements to determine if certain aberrations, inconsistencies, or questionable financial relationships exist which require further investigation. Recognizing the specific accounting issues that are typical in the subject industry may be an important factor in the business valuation process.

"... the analyst should subject that data to generally accepted financial analytical techniques."

If the subject company's financial statements do not comply with GAAP, this should be an automatic red flag to the analyst. The analyst may have to restate these financial statements on a pro forma basis (in accordance with GAAP) in order to complete the valuation. The analyst should read the entire

financial statement, especially the footnotes to the financial statement, for any information relating to issues that could affect the value.

Specifically, the analyst should pay attention to any disclosures relating to accounting methods, loan agreements, fixed assets, intangible assets, depreciation, extraordinary items, interest, retirement plans, tax deferrals, leasing agreements, related parties, the termination of segments of the business, and the company's ability to continue as a going concern.

These financial statement footnotes and disclosures may provide valuable insight into (1) critical factors to be considered in the valuation process and (2) the company's competitive strengths and weaknesses.

The consideration and reconciliation of (1) the subject company's income tax returns to (2) the subject company's financial statements may bring valuable insight to the subject company financial intricacies. It is not uncommon for a company to follow different accounting rules (1) for their internal bookkeeping records and (2) for their financial statements.

Therefore, a basic financial analysis can evaluate the differences in accounting policies for internal and external reporting purposes. The analyst may also reconcile the

interim financial statements (if available) and the year-end financial statements with the income tax returns, noting any significant variances.

On all income tax returns, there is a section that reconciles income per books (financial statements) with income per the tax returns. Often such variances are nothing more than permitted differences between income tax and financial statement accounting treatments. Sometimes, however, the discrepancies may indicate improper income tax treatment or fraud.

After thorough analysis, if any tax fraud or serious wrongdoing is suspected, counsel should be notified of this situation. Counsel may decide to use this information in negotiations.

It should be noted in this context that public company financial statements are under more scrutiny than private company financial statements. This is because public companies are required to follow GAAP accounting and reporting standards. Private company accounting policies tend to be more focused on the income tax minimization needs of the company owners.

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FINANCIAL STATEMENT ANALYSIS PROCEDURES

Common financial statement analysis procedures includes the following:

- vertical analysis,
- horizontal analysis, and
- financial ratio analysis.

Vertical and Horizontal Analysis

Vertical and horizontal analysis is the starting point for the analyst to begin delving into the financial statements by presenting them on a common size basis. Common size analyses involves displaying each account on the financial statement as a percentage of a common base figure.

Typically, each item on the income statement is expressed as a percentage of total revenue. Typically, each item on the balance sheet is expressed as a percentage of total assets. This type of financial statement analysis allows for easy comparison between (1) different companies as of the same time or (2) one company over different time periods.

Exhibit 1 presents illustrative examples of both vertical analysis and horizontal analysis of The Hypothetical Company. This type of analysis will assist the analyst in

identifying trends in the subject business that appear to be aberrant or abnormal (1) when compared to prior years (for horizontal analysis) and (2) when compared to a single year (for vertical analysis).

It is important for the analyst to note items that appear to be relatively higher/lower than other years, seeing if the difference is part of a trend. It is important for the analyst to determine whether there is an explanation for those items.

As presented in Exhibit 1, expressing the income statement and balance sheet in both absolute values and as percentages allows the analyst to quickly evaluate any inconsistencies that may have been created by the litigant in the pending litigation. The goal of this type of financial analysis is to focus on areas that show unusual patterns in the financial statements that may require adjustments in the business valuation process.

In Exhibit 1, The Hypothetical Company accounts payable in the first year represented 35 percent of total liabilities. In the second year, this percentage increased to 54 percent of total liabilities. This significant change may be a starting point to investigate, although the increase may be explained by factors such as an increase in sales.

This type of financial analysis should alert the valuation analyst to areas of inquiry. For example, why was there a 50 percent increase in sales in year two?

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For valuation purposes, it is important to examine whether that rate of growth is sustainable. What would a “normal” growth rate be for this company? Does the increase in the cost of goods sold mean that the goods are more expensive, or that the company is operating in a different market place?

These are the types of inferences that could be made from this type of financial analysis. The results can then be compared to selected guideline companies to see if similar activity is happening there.

Financial Ratio Analysis

Another type of financial statement analysis is financial ratio analysis. This is a procedure used by analysts to conduct a quantitative analysis of information in a company’s financial statements.

Financial ratios are calculated from current year data of the subject company and compared to (1) the previous years of the subject company, (2) comparable companies

Exhibit 1
The Hypothetical Company
Illustrative Financial Statement Analysis
As of December 31, 2005

BALANCE SHEET

	Vertical Analysis				Horizontal Analysis	
	Year One	%	Year Two	%	\$ Change	% Change
ASSETS						
Current Assets:						
Cash	\$ 45,000	14%	\$ 20,000	5%	\$ (25,000)	-56%
Accounts Receivable	150,000	45%	180,000	44%	30,000	20%
Inventory	75,000	23%	150,000	37%	75,000	100%
Fixed Assets	60,000	18%	60,000	15%	-	0%
Total Assets	<u>\$ 330,000</u>	<u>100%</u>	<u>\$ 410,000</u>	<u>100%</u>	<u>\$ 80,000</u>	100%
LIABILITIES & SHAREHOLDERS' EQUITY						
Accounts Payable	\$ 115,000	35%	\$ 220,000	54%	\$ 105,000	91%
Long-Term Debt	70,000	21%	65,000	16%	(5,000)	-7%
Shareholders' Equity:						
Common Stock	20,000	6%	20,000	5%	-	0%
Paid-in Capital	30,000	9%	30,000	7%	-	0%
Retained Earnings	95,000	29%	75,000	18%	(20,000)	-21%
Total Liabilities and Equity	<u>\$ 330,000</u>	<u>100%</u>	<u>\$ 410,000</u>	<u>100%</u>	<u>\$ 80,000</u>	100%

INCOME STATEMENT

	Vertical Analysis				Horizontal Analysis	
	Year One	%	Year Two	%	\$ Change	% Change
Net Sales	\$ 300,000	100%	\$ 450,000	100%	\$ 150,000	50%
Cost of Goods Sold	150,000	50%	275,000	61%	125,000	83%
Gross Margin	150,000	50%	175,000	58%	25,000	17%
Operating Expenses:						
Selling Expense	70,000	23%	85,000	28%	15,000	21%
Administrative Expense	60,000	20%	100,000	33%	40,000	67%
Net Income	<u>\$ 20,000</u>	<u>7%</u>	<u>\$ (10,000)</u>	<u>-3%</u>	<u>\$ (30,000)</u>	-150%

data, and (3) industrywide data. These financial ratios indicate the performance and health of the subject company, as well as the strengths, weakness and risks to be considered in the determination of the discount rate or capitalization rate in the valuation.

As previously stated, it is important when preparing a guideline company analysis for the analyst to understand the industry norms, accounting issues, and value drivers.

The basic categories of financial ratio analysis which determine the health of a company may be grouped into the following categories: (1) liquidity, (2) activity, (3) leverage, and (4) profitability ratios.

Liquidity Ratios

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$\text{Quick Ratio} = \frac{\text{Cash} + \text{Accounts Receivable}}{\text{Current Liabilities}}$$

The current and the quick ratios are two common financial ratios used to determine a company's ability to meet their short-term obligations. In Exhibit 1, the current ratio in year two is 1.59.

This ratio indicates the number of times that the total current assets exceed the current liabilities. This indicates the financial strength by the subject company's ability to pay its obligations quickly if it needed to. A decrease in liquidity indicates a cash drain, the reason for which should be identified by the analyst.

The quick ratio at 0.91 demonstrates the relative liquidity of the company if it needed cash to immediately pay its short-term obligations.

Activity Ratios

$$\text{A/R Turnover} = \frac{\text{Sales}}{\text{Average A/R}}$$

$$\text{Inventory Turnover} = \frac{\text{COGS}}{\text{Inventory}}$$

The activity ratios measure a company's ability to convert different accounts within the balance sheets into cash or sales. These financial ratios illustrate how efficiently a company uses its assets.

Companies will typically try to turn their production into cash or sales as fast as possible. This is because this procedure will generally lead to higher revenue. The accounts receivable turnover ratio measures how long it takes to collect outstanding accounts receivable.

A high accounts receivable turnover ratio implies either that (1) a company operates on a cash basis or (2) its extension of credit and collection of accounts receivable is efficient. A low accounts receivable turnover ratio implies the company should re-assess its credit policies in order to ensure the timely collection of credit that is not earning interest for the company.

Exhibit 1 indicates that The Hypothetical Company inventory turnover is 1.83. High inventory turnover indicates that the product is selling and that inventory levels are in line with the stock. The inventory should be at a manageable level and not too low as to disappoint customers in the selection of product. Growth in sales and the opening of additional stores may correlate with higher inventory levels.

The inventory turnover ratio should be compared against industry averages. A low inventory turnover implies poor sales and, therefore, excess inventory. A high inventory turnover ratio implies either strong sales or inefficient buying. Analysts can also convert these turnover ratios into the number of day's sales which can be compared to comparable industry data.

Leverage Ratio

$$\text{Debt to Equity} = \frac{\text{Total Debt}}{\text{Total Equity}}$$

Financial leverage evaluates a company's long-term ability (1) to pay its debt obligations and (2) to handle any financial problems in the future. The main financial leverage ratio used is debt to equity. It indicates what proportion of equity and debt the company is using to finance its assets. The debt to equity ratio will also vary depending on the industry in which the company operates.

For example, Exhibit 1 shows The Hypothetical Company debt to equity ratio of 0.52. In contrast, companies in capital-intensive industries, such as auto manufacturing, tend to have a debt to equity ratio above 2.

Profitability Ratios

$$\text{Profit Margin} = \frac{\text{Net Income}}{\text{Sales}}$$

$$\text{Return on Equity} = \frac{\text{Net Income}}{\text{Equity}}$$

The two main profitability financial ratios are (1) profit margin and (2) return on equity. Profit margin measures how much out of every dollar of sales a company actually keeps in earnings. A higher profit margin indicates a more profitable company that has better control over its costs as compared to its competitors.

In Exhibit 1, The Hypothetical Company profit margin from the first year is 6.67 percent. This margin is in line with the industry average profit margin of 6.72 percent.

The return on equity (ROE) ratio essentially reveals how much profit a company generates with the money shareholders have invested. Again using Exhibit 1, The Hypothetical Company ROE ratio is 14 percent. This 14 percent ROE ratio is a little low compared to the competitor ROE ratio of 18 percent.

As with all of the financial ratios mentioned, the ratios are most useful when comparing the target company to companies in the similar industry. The analyst's findings from the horizontal, vertical, and ratio analysis may lead to potential areas of misstatement that should be addressed in the business valuation.

The analyst's findings after applying horizontal, vertical, and financial ratio analysis will enable the analyst to identify patterns and trends that will likely have an impact on the valuation. The analyst may not have all the answers after these analyses. However, the analyst will be in a better position to ask the necessary questions and then obtain the necessary information.

FINANCIAL ANALYSIS "RED FLAGS"

In performing financial statement analysis as indicated above, the analyst may become aware of certain circum-

stances, issues and areas that require further in-depth investigation. There are many basic warning signs or “red flags.”

The analyst should combine quantitative analysis with judgment and experience in order to determine the additional procedures to be performed when these red flags appear. Some of the common red flag areas follow.

A sudden decline in profits and liquidity immediately prior to litigation may be indicative of a litigant trying to minimize net worth and maximize cash flow by temporarily draining the company that is under his or her control. On the other hand, it is possible that the subject company has fallen on hard times.

The subject business may have a complex structure with interrelated companies such as vendors or customers, and the related company’s financial data may be unavailable. This may indicate an attempt by the litigant to show the business in a certain light without disclosing the economic impact of the related entities.

The certified public accountant may issue a qualified or adverse audit opinion on the subject entity’s financial statements. That particular situation requires:

1. a careful reading of the footnotes and reasons for qualification or adverse determination and
2. a determination as to the materiality of those issues to the valuation assignment.

A rapid increase or decrease in sales and the cost of goods would signal another area to investigate. The analyst should determine if these changes are temporary or permanent, and to what extent they affect the risk inherent in the capitalization rate or discount rate.

The failure to report an increase in fixed assets in a capital intense, growing company would signal a red flag. This increase may be indicative of (1) an aggressive expensing policy (intended for income tax purposes), or (2) a company which will be in need of a major fixed asset replacement program.

The company’s failure to prepare financial statements in accordance with GAAP is a potential indication of major problems. The analyst should determine what adjustments are necessary so the financial statements reflect economic reality.

Finally, if the subject company’s financial ratios and common-size relationships are dramatically different than its industry peers, this should be a red flag. This difference may require the analyst to determine:

1. what significant operating factors have been responsible for the discrepancy and
2. whether these factors affect the valuation (either negatively or positively).

This is just a sample of the multitude of red flags that the analyst may encounter and integrate into the valuation process. This integration should occur subsequent to the application of the aforementioned financial analytical procedures.

SUMMARY AND CONCLUSION

A valuation prepared during the course of litigation is subject to intense scrutiny by the trier of fact, opposing valuation experts, and opposing legal counsel. It is important for the analyst to recognize that the valuation analysis and conclusions will be subject to a contrarian review. This review may relate (1) to the *Daubert* line of cases and/or (2) to the subject jurisdiction’s rules of evidence.

Therefore, in order to increase the chances of the analyst’s findings and conclusions being accepted by the courts, the analyst should perform a rigorous analysis of the subject company’s financial statements by applying generally accepted financial analysis procedures.

The analyst should carefully read the financial statements and be aware of the disclosures contained within. The analyst should be mindful of those red flags conditions which may affect the scope of the procedures performed.

The proper application of financial analysis requires both quantitative and qualitative procedures. The analyst should (1) fully understand the implications of the financial analysis calculations and (2) perform the necessary sensitivity analyses where appropriate.

Notes:

1. *Daubert v. Merrell Dow Pharmaceuticals*, 509 U.S. 579 (1993).
2. *Gary Price Studios, Inc. v. Randolph Rose Collection Inc.*, 2005 WL 1924733 (S.D.N.Y. August 9, 2005).

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