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VALUE ADDED™

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Assessing the Quality of Company Earnings

A critical aspect of any valuation analysis is the appraiser's ability to read, understand and interpret a company's financial statements - a skill vital to making an accurate assessment of the value of any company. This is because most valuation methodologies incorporate adjustments to value based on facts discovered during the course of the appraisal process, many of which relate to the company's financial statements. In addition, when valuing a business, the appraiser assesses the quality of the company's historical and projected future earnings, which in most companies is a key component of value.

What are some of the basic factors an appraiser must assess in the analysis of the quality of a company's earnings? The following items are not all-encompassing, but discuss a few balance sheet and income statement considerations appraisers examine in the determination of earnings trends and quality.

- **Receivables.** Receivables on an upward trend can be the result of rising sales, or an indication of slow collections, or an acceleration of future sales. If revenues are growing rapidly, it naturally follows that a higher level of receivables can be anticipated, which is positive. However, a high level of receivables can also be an indication of a longer collection period which can be caused by a number of factors including internal organization problems (the absence of a collections person or department), factors related to the customer base which may be slowing payments (such as bankruptcies or financial difficulties), or an economic slowdown in general. The company could also be accelerating future revenue by offering incentives and price cuts to customers if purchases are made early.
- **Inventories.** Swelling inventories may be an indicator of a number of factors, not all of which are necessarily negative. High growth companies tend to have rapidly increasing inventory levels (which are necessary to accommodate increased sales). However, this could be a warning sign depending on the nature of the business. Stockpiles of perishable inventories or those that become obsolete quickly may present a problem given a rapid downturn in sales or the development by a competitor of a better product.

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Understanding the quality of a company's earnings is an important component to any valuation . . .

Publicly Traded Securities, Market Prices, Discounts and Fair Market Value

The quoted unit price of a publicly traded security is sometimes *not* definitive of fair market value for a specific block of the shares or bonds. Such a condition typically arises when the subject holding has impaired marketability. In such a circumstance the exchange quoted price of the security *overstates* the fair market value of the subject block. That is, the value of a block of stock or bonds may be less than the product of the number of units and the price per share or per bond in the public market. In other words, a discount (that is, a marketability discount) from the market price is indicated for the shares or bonds in the subject block.

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High inventory levels represent the potential for decreased production or a need to decrease prices to move inventory (which affects gross margin). An appraiser should compare balance sheet inventories (which represent a picture of inventories at a point in time) with the average inventory turnover ratio (which is a better measurement of how inventories have moved during the course of the year). Inventory turns should be also compared to similar companies in the industry for an accurate picture.

- **Fixed Assets.** Trends in a company's property, plant and equipment are typically examined to determine whether capital expenditures have been deferred and if significant expenditures can be anticipated. If this is the case, financing is generally required (which increases debt service and impacts earnings). Recent increases may be an indication of recent expenditures to accommodate growth or to upgrade property or equipment (which affects cash flow). Information contained in the cash flow statement indicates annual capital expenditure requirements or those that may be necessary on an ongoing basis. If a significant decrease in the trend of capital expenditures occurs, it can be interpreted as neglect or deferred expenditures. Appraisers typically adjust cash flow and earnings proxies for known upcoming capital expenditures and the associated depreciation.
- **Revenue.** "What constitutes revenue and when and how is it recorded?" is an important question asked by appraisers. Revenue recognition practices may distort a company's revenue. Sales of customized products or services that require additional consulting services to adapt the product or service to the needs of the user long after the sale, probably should not be recorded in full immediately upon sale or shipment. If the sale is subject to returns, allowances, or rebates, a reduction in sales should also be recorded. Service and construction companies record revenues

either on a completed contract method (revenues and costs are recorded upon completion of the project) or the percentage of completion method (revenues and costs are recorded based on the portion of the work completed at fiscal year end). Appraisers should be aware of accelerating revenues. Revenue received as the result of deep discounts can adversely affect future projected revenue. The keys are understanding what actual recorded revenue is, reading the notes to the financial statements about revenue recognition policies, obtaining a detailed explanation about how revenues are recorded.

A critical aspect of any valuation analysis is the appraiser's ability to read, understand and interpret a company's financial statements

- **Pension Plan Expenses.** Companies with defined benefit pension plans must record expenses for projected future benefits. The determination of this cost is complicated and dependent on a number of assumptions and facts including projected future benefits, the expected return on plan assets, interest costs, gains and losses in the plan and amortization of prior service costs. The assumptions in this calculation, if not realistic, can inflate earnings by putting less in the plan than is necessary to meet future obligations. The footnotes to the financial statements usually contain these calculations and are a starting point to determine whether the assumptions are reasonable. If they are not reasonable, the appraiser may make adjustments to a company's earnings to normalize pension plan expense.
- **Gains on Asset Sales.** Specific types of companies have recurring gains or losses on asset sales (particularly those with rolling stock or equipment that must be replaced to keep the assets in good condition). This item of

"Other Income" is examined closely by the appraiser to determine whether asset sales are recurring or if earnings have been distorted in any year by the sale of an asset which is considered nonrecurring. An asset sale, which is a sale of a significant segment of the business, may require deeper examination and a projection of earnings absent the segment. If a company has sold off a subsidiary in an effort to reduce debt, while interest expense may be less, the company may then be dependent on a mature, slow growing subsidiary which may negatively impact earnings going forward.

- **Nonrecurring Operating Items.** Earnings are generally examined closely for nonrecurring expenses (or income) which will not occur again in the normal course of business. Sometimes this concept is not quite understood by appraisers or business owners. Some businesses tend to have a series of nonrecurring events. Identifying a nonrecurring event is sometimes tricky. The difference in extraordinary income related insurance proceeds from a fire loss is clearly more easily recognized as nonrecurring than bad debt expense in a period of time when the economy is depressed. In a time of continual downsizing in many industries, restructuring charges or consulting expenses cannot be considered nonrecurring when they tend to occur every year. Some gains or losses are appropriately adjusted for in prior years because they tend to result from problems a business experiences over a period of time. Fires, tornadoes and hurricanes are a sudden occurrence; however, slipping margins in a particular business segment as a result of increased competition and consolidation generally occur over time and, analytically, it may make sense to spread losses out over a period of years.
- **Compressed Margins.** An appraiser will always examine growth in revenues relative to growth in earnings. If the two are not growing in tandem and revenues are rising

much faster than earnings, profit margins may be declining. On the other hand, if earnings are rising much more rapidly than revenues, an appraiser must question whether growth in revenue is sustainable or if earnings are the result of severe cost cutting measures. In other words, how will the factors that impact profit margins now affect them in the future?

These are just a few of the considerations appraisers examine to determine the quality of a company's earnings. There are certainly other factors that merit scrutiny such as tax planning, how a company calculates earnings per share, stock options, research and development expenses, and the impact of intangible assets. Understanding the quality of a company's earnings is an important component to any valuation and the appraiser must have the knowledge and skill to assess the dynamics of the financial statements as a whole and the ability that is derived from experience to know when adjustments to earnings are warranted and when reported earnings are solid.

If you have an issue related to the quality of your company's earnings and how an appraiser would consider it, please call. We will be glad to discuss any valuation issue with you in confidence. ♦

Publicly Traded Securities

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Impairments to the marketability of the securities of public companies commonly result from the following factors:

- The absence of registration under Securities and Exchange Commission Rule 144
- The presence of a contractual restriction on resale, such as a

lock-up agreement

- Thin trading volume of the public security relative to the number of shares or bonds in the subject block

SEC Rule 144 imposes restrictions on the resale of securities of public companies that are issued without the benefit of a registration statement. The unregistered shares of a public company must typically be held by an investor for a minimum of one year before they can be sold into the public market. After the one year holding period is satisfied, public sales of the unregistered shares are subject to volume limitations for an additional year. Sales in private placement transactions of unregistered securities to entities qualifying as sophisticated investors under SEC regulations are permitted, but the minimum holding period and volume limitations regarding resale in the public markets start anew each time the securities change hands.

Lock-up agreements frequently apply to shares received by sellers in mergers and acquisitions. Such agreements specify conditions under which the subject shares may be resold and may impose outright prohibitions on any resale for some specified period.

Volume blockage issues arise when the number of shares or bonds in the subject block is large relative to the daily trading volume in the public market. Such a circumstance often implies that liquidation of the block would likely have to occur over a protracted period in order to avoid creating an oversupply which would depress the market price of the security. Liquidity may be impaired due to block size even if the subject shares are registered and no contractual restrictions on resale apply.

One, two or all three of the preceding impairments to liquidity may apply to any given block of securities. For example, the marketability of a block of registered shares may be impaired by the presence of a lock-up agreement or other contractual restriction as

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well as large size relative to recent trading volume. By the same token, a block of stock for which volume blockage or contractual restrictions are not present may not be freely tradable in the public market due to lack of registration under Rule 144.

Guidance on valuing unregistered or restricted securities of public companies for Federal tax purposes is provided in Revenue Ruling 77-287. A valuation under this pronouncement (essentially the determination of the appropriate discount from the quoted market price) requires consideration of the various limitations and enhanced rights attaching to the subject block and the financial condition of the issuer. The marketability discount is quantified by reference to the discounts documented in various published restricted stock studies which

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analyze the pricing of sales of restricted stock relative to the market prices of otherwise identical freely tradable shares in historical, publicly reported transactions.

An alternative methodology for quantifying the discount relative to the market price of the subject security is the use of an option pricing model to estimate the cost of hedging the price of the security during the period of illiquidity implied by Rule 144 or by any contract or during the period required to conduct an orderly liquidation in the case of volume blockage.

In addition to impaired marketability, a subject holding of securities issued by a public company may carry with it features which further distinguish it from the issuer's registered securities. Common and preferred shares may lack voting rights. Debt securities and preferred stock may lack the protective covenants or priority of claims attaching to their registered counterparts. Conversion rights and redemption provisions may differ. When valuing non-registered securities, it is important to consider all characteristics of the subject security which may differ from the issuer's publicly traded stocks and

bonds and reflect those differences in the valuation of the subject security. In these cases it may be necessary to go beyond merely applying a marketability discount to the quoted exchange price of a stock. [For example, if the issuer's public debt is better secured or has better call protection, pricing a privately issued note to yield a rate representative of an incremental return for lack of marketability plus the market yield on the issuer's publicly traded debt securities of similar maturity may overstate the note's fair market value.]

Clarity regarding the fair market value of privately issued securities of public companies is essential in the following situations:

- **Estates and Gifts.** The presence of a block of such securities in an estate and a transfer of same may entail an overpayment of taxes if the quoted market price is applied without consideration of impaired marketability or of other differences relative to the issuer's public securities.
- **Mergers and Acquisitions (1).** If the securities issued by the purchaser to the seller do not qualify for a capital gains rollover and a

capital gains tax liability is realized at the closing of the transaction, an excessive capital gains tax liability may be calculated if the quoted market price is applied without consideration of impaired marketability or of other differences relative to the issuer's public securities.

- **Mergers and Acquisitions (2).** Comparisons of offers by competing bidders or comparisons with the pricing of other transactions may be misleading if quoted market prices are applied to securities offered as purchase consideration without considering impaired marketability or other differences relative to the issuer's public securities.

Similar valuation issues may also arise in a variety of other situations, including corporate reorganization transactions, marital dissolution, bankruptcies and transactions involving trusts.

Simply applying the market price of an issuer's publicly traded securities to the shares or bonds in a given block may provide a deceptive indication of value leading to faulty tax and investment decisions. ♦

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