The Top 10 Questions to Determining Financial Statement Health

If you're thinking about selling your business, it's important to understand how your financial statements impact the valuation a prospective buyer places on your company. Your reports—in terms of depth, breadth, and quality—deliver a message about how you run your company. If there are shortcomings, a sale can be delayed, value discounted, or broken off if a prospective buyer has trouble gaining confidence in the numbers.

The following 10 questions will help you assess where you stand in terms of your financial statement readiness and understand the role that reports play in valuation. Importantly, your responses can provide direction in identifying areas that require fine tuning before providing to a potential investor/buyer.

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1. What's the highest level at which financial statements are prepared?

a. Audited.
b. Reviewed.
c. Compiled.
d. Assembled.
e. Prepared by your accounting department.
f. Prepared by you (the business owner).

Audited financial statements give buyers comfort that your numbers are accurate and subjected to the highest level of review. A prospective buyer may find a transaction to be less valuable if work must be done during due diligence to adjust your financials.

2. On what basis are your financials reported?

a. Accrual.
b. Cash basis.
c. Income tax basis.

Any valuation of your company by a prospective buyer will be done on an accrual basis. If your reporting is done on any other basis, your financials will have to be modified before a valuation is performed.

3. How frequently are your financial statements prepared?

a. Monthly.
b. Quarterly.
c. Annually.

The more frequently financial statements are prepared, the better. Few transactions are done at the end of the year, so having monthly statements available makes it easier for buyers to analyze your company.

4. What types of financial statements are prepared?

a. Income statement, balance sheet, statement of changes in owners' equity, statement of cash flow, supporting schedules and reference notes.
b. Income statement, balance sheet, statement of cash flows.
c. Income statement and balance sheet.
d. Income statement only.

If you have comprehensive financial statements and accompanying explanatory details, a buyer can more easily understand your company and its nuances. A more complete set of statements can speed up and improve the analysis that a buyer must undertake.

5. Do your income tax returns accurately reflect your company's financial statements?

a. Yes.

b. Yes, but with reconciling schedules supporting the financial statements and tax differences.

c. There are material differences that are not easily reconcilable.

d. Tax returns and financial statements are virtually unreconcilable.

Buyers don't want to be stuck with overly aggressive tax strategies, and they may be uncomfortable if significant adjustments must be made to reconcile your tax returns with your financial statements. If the transaction is a stock sale, a buyer will have to figure out the impact of any tax exposure.

6. How effectively do you manage accounts receivable and past dues?

a. Our customers typically pay within 30 days, and there are no past dues over 60 days.

b. Most customers pay within 60 days, although it's a challenge for some customers.

c. Few customers pay on time, and we really have to hound some of them when past dues go beyond 90 days.

The collectability of your accounts receivable will be a major area of concern for a buyer. Expect a deep dive into your receivables, especially those on which you are having trouble collecting.

7. Does your inventory book value closely correlate with fair market value?

a. Yes. We do cycle counting and track inventory obsolescence.

b. Maybe. We count 100% of our inventory annually and track inventory obsolescence.

c. No. We spot check inventory annually.

d. Not applicable. Inventory isn't significant in our business.

When it comes to inventory, the biggest concern in an acquisition is obsolescence. A buyer will want to understand how inventory is controlled and tracked along with the impact of obsolescence on the value of your company.

8. Do you have a strong understanding of your fixed assets and the real value of each asset?

a. Yes. We have a list of all fixed assets and know the approximate values of each. We update the values whenever we add assets.

b. Maybe. We have a list of all fixed assets but update it once every three years.

c. Not sure. Our CPA maintains our fixed asset listing.

d. Not applicable. Fixed assets aren't significant in our business.

A buyer needs to understand the fair market value of your fixed assets, which can make a big difference in how the transaction is taxed. Lots of time could be spent in determining how much your fixed assets are worth if you don't have up-to-date schedules.

9. Are all liabilities accurately recorded?

a. Annual liabilities are accrued monthly to ensure financial statements are accurate.

b. We use accrual accounting and record a liability on our financial statements when the invoice is received.

c. We use cash accounting and expense invoices when received.

Buyers fear unrecorded liabilities and want to be comfortable that all liabilities are precisely recorded. Purchase agreements often include indemnifications to address any concerns.

10. Do you track EBITDA (earnings before interest, taxes, depreciation, and amortization) on an annual basis?

a. We know what our EBITDA is and track it, and we make normalized adjustments annually.

b. We could calculate EBITDA if we had to.

c. What's EBITDA?

EBITDA is often used to help buyers determine the value of your business. Knowing your company's EBITDA and its trends also demonstrates a level of professionalism and sophistication. Professionalism and sophistication add to the intangible asset value of your business.

The bottom line

Don’t underestimate the important role your financial statements, including your balance sheet, play in valuations and take steps to address any shortcomings before you look to sell your business.

To learn more, contact your KeyBank Commercial Relationship Manager or Key Private Bank Relationship Manager, or visit key.com/familywealth.