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Apples and Oranges: Financial Reporting for a Sale or Merger

Small businesses facing a potential sale or merger need to ensure that their accounting methodologies and reporting can withstand intense scrutiny by prospective partners and provide the clearest, most effective financial picture of the organization.

In the world of mergers and acquisitions, U.S. Generally Accepted Accounting Principles (GAAP) in a sale or merger situation can mean something entirely different than GAAP for reporting and compliance purposes. The realm of investment bankers and transaction lawyers and its dizzying pace can confuse even an astute business owner with terms and phrases like "adjusted EBITDA," "transaction multiple," and "working capital peg." This column highlights some of the key differences in accounting methodology often found in the transaction environment and identifies issues to consider as you prepare your small business's financial reporting for a potential sale or merger.

Evaluate Your Business

EBITDA (earnings before interest, taxes, depreciation, and amortization) is the most widely used proxy to begin valuing your business. Potential investors and finance strategists will likely use a factor called a "multiple" and multiply EBITDA by this factor to approximate the value of your company. The factor can be based on a number of influences, but it's usually comparable to recent transactions of similar-sized companies and the industry in which you operate.

But the pure definition of EBITDA is hardly ever used; it's prudent for the owners and management of the company (often with the assistance of advisors or investment bankers) to estimate certain adjustments to EBITDA to more accurately reflect the business's operations after the transaction closes. For example, these adjustments may include what are considered "nonrecurring" expenses, such as excess legal fees relating to a litigation matter, severance paid to key employees, expenses related to a new facility or relocation, and so forth. Other adjustments could include profits or losses from discontinued business units or personal expenses run through the business. It's efficient and wise for management to begin estimating some of these adjustments prior to investigating the possibility of a sale because it can help set more pragmatic expectations in terms of valuation (selling price) and prepare you for smarter negotiations.

Prepare the Finances

Nonrecurring and nonoperating adjustments are relatively simple compared to what professionals in the mergers and acquisitions world will often refer to as "GAAP adjustments." Unless you're a business owner who's a trained CPA, you'll likely need your accounting and finance department's help in preparing for this category of adjustments.

Before diving into granular account-level detail, there are a few questions that must be addressed to develop the proper framework. First, how often are your financial statements prepared: monthly, quarterly, or annually? A seasoned investor will almost always want to see at least quarterly financial statements to gain confidence in the strength of your financial reporting function and to properly understand trends in your business. Second, are there multiple lines of business or legal entities accounted for on separate general ledgers? Is a financial statement consolidation prepared? Understand which entities are be-

ing sold, and prepare financial records to reflect only those included in the transaction. Third, are financial statements prepared on a cash, income tax, "modified accrual," or fully GAAP-compliant basis? If you use an external accountant for tax preparation, financial statement compilation, or even a review or an audit, make sure they're accessible and that you can lean on them with questions during the process.

From there, you could encounter myriad issues at the account level. Common areas of focus during due diligence include:

1. **Revenue Recognition.** A potential investor will examine recognition terms and if you have any bill-and-hold-type sales. Special revenue arrangements such as licensing or royalty agreements, deferred income arrangements, and percentage-of-completion accounting will also be heavily scrutinized.
2. **Inventory and Gross Margin.** Is financial reporting of cost of goods sold tax-motivated? Do you perform regular physical inventory counts or cycle counts? How quickly does your inventory turn over? And most importantly, can you segment gross margin by customer and by product type? Particularly in the consumer goods and manufacturing industries, these will be key focus areas that could make or break a deal. Anecdotally, the most common reason a transaction fails is because a seller is unable to support reported gross margin figures, can't segment those figures by product line, or can't explain fluctuations in profitability.
3. **Estimating Reserves.** Are you adequately reserved for uncollectible customer accounts, inventory excess and obsolescence, warranty claims, and sales allowances or chargebacks? If you aren't doing so already, it's highly recommended to use historical write-off data to estimate your exposure in all of these areas as soon as possible and to establish a reserve on your balance sheet. Make sure the reserve is adequate but not overly conservative.
4. **Accrued Liabilities.** Are regular accruals recorded for payroll-related (vacation, bonus, etc.) expenses? Are there accruals for any commission sales personnel? Is rent being appropriately straight-lined, deferred, and amortized into rent expense?

One of the biggest mistakes you can make if you're selling your business is to think that these areas shouldn't be of concern because your business is reviewed or audited by an external accountant. An audit or review is likely only going to shore up these accounts at your fiscal year-end date—and not on a monthly or quarterly basis! Potential investors will likely value your business using the earnings over the most-recent 12-month period, and they will gain comfort from knowing your interim financial statements are robust and reliable. After a transaction closes, large corporate or institutional investors rely on regular and accurate segment reporting from respective divisions or portfolio companies.

Prepare Yourself

During the initial phases of diligence by a potential suitor, it's easy to think one-dimensionally in terms of top-line or bottom-line. But if you're envisioning a valuation of $10 million or greater, a buyer will likely apply much greater scrutiny down to the transaction level on both your income statement and balance sheet. Management accountants understand that "the devil is in the details," and eyeing your business with a healthy dose of skepticism prior to exploring a sale can be the best thing you can do for yourself.

Investing in employees who are able to understand the "big picture" but can present complexities in a concise and simple manner can be crucial. Additionally, a strong general ledger and enterprise resource planning (ERP) system can be a vital resource to produce accurate and detailed historical reports. Cost-conscious business owners may raise concerns about bloating the finance function—which many view as a "cost center"—but there's a return to be realized from every investment. Equipping yourself and your business with the right tools, simplifying complex issues, understanding the value of each component of your business, and being prepared from a financial reporting perspective will maximize value. **SF**

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