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Financial Analysis of Closely Held Businesses

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The financial analysis of a closely held business is a true mixture of art and science – typically the smaller the business, the more difficult the job. The purpose of the financial analysis in a business appraisal is to determine the level of risk associated with the company being appraised. The financial analysis is supposed to assist in determining whether the subject is stronger, weaker, or similar to the industry and whether or not the company is improving or declining.

Financial analysis of a publicly traded company or a large privately held company with audited financial statements make take a little time, but it is a relatively straight forward process. There are many financial ratios and other comparisons that can be made to industry data which will allow the analyst to reach conclusions about the strengths or weaknesses of the company under review.

The financial analysis of many small to medium-sized companies requires a different kind of experience and expertise for a number of reasons.

First, the quality of the available financial information for most small to medium-sized businesses varies considerably from that available for publicly traded or even some large privately held companies. I have occasionally received the available financial information on the back of an envelope or napkin at lunch. Often, the financial information received is a Quick Books printout of the “accounting” done by the owner. It is not unusual to have a mixture of personal and business expenses and other “fun” stuff included along with the business information.

Secondly, most small to medium-sized privately held businesses operate with primary motivation being to pay the least amount of income taxes possible. In order to accomplish this goal, frequently personal expenses are included “as if” they are business expenses, rent of property owned by related parties is often considerably above market, and salaries and other benefits paid to owners’ and relatives may be excessive.

Third, even when many small to medium-sized business owners are trying to present accurate financial information, they lack the sophistication and/or the assistance of qualified accountants needed to deal properly with such things as accounts receivable, inventory, fixed asset classification and proper depreciation, and often mix debt and equity. Owners of the small to medium-sized business typically have little to no training in accounting and while they may not mean to present the wrong picture, they simply may not know how to do so properly. Many of the firms that can afford a good CPA and use them, do not tell their accountant everything or lack the budget to have the amount of help they really need. I have encountered many times accounts receivable on the books of the company that is drastically different than what is really owed. Inventory control is often lacking and may simply not exist. It is relatively common to find end of the year inventory with exactly the same balance year after year after year.

Fourth, the nature of the entity formed for small to medium sized businesses can vary. Some are LLC's, some are S-corporations, some are C-corporations, and some are simply individuals doing business as. These alternative methods of operating a business can have a great impact on the valuation of the business, and can affect the adjustments and risks associated with the appraisal analysis. At times, small and medium sized businesses may be operated in a manner which is not typical within the industry, and at such times it is necessary to make adjustments to take this difference into account. It is important, as an appraiser, to compare apples and apples, instead of the proverbial apples to oranges or even apples to pomegrantes, and when insufficient market data exists, some assumptions must be made based on theories accepted within the appraisal world. At times this process can be quite challenging, and it is important that the appraiser is qualified to apply the techniques necessary.

If the financial analyst/business appraiser is not experienced and very familiar with how many small to medium-sized businesses actually operate, the calculation of some "typical" financial ratios and comparison of historical results to some industry source of data will likely be totally meaningless! Valuing small to medium-sized businesses is challenging work – but very interesting.

Valuations play a part in all strategic transactions, tax, and many litigation matters. For additional information or advice on a current situation, please do not hesitate to call. **We value real estate, businesses, and personal property including livestock and machinery & equipment.**

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