GROSSMAN YANAK & FORD LLP
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Analyzing Financial Statements and Their Impact on Value

AN ATTORNEY'S GUIDE TO UNDERSTANDING FINANCIAL STATEMENTS (PART II)

Attorney CLE Series – May 29, 2014

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INTRODUCTION

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Analyzing Financial Statements & Impact on Value

INTRODUCTION

- **Today's program is predicated upon the supposition that nearly all civil legal matters, as well as a number of criminal matters, are resolved through the economics associated with any particular fact pattern**

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INTRODUCTION

- **The economics of any particular fact pattern are generally built upon a foundation of financial information set forth in financial statements**

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INTRODUCTION

- **The problem is that much of the "real" information that might prove useful in any case is only available through an understanding of the mechanical structure of the financial statements, as well as through relationships**

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- **The relationships are those that relate one element of the financial statements to another, and to that company's history, as well as the relationship of that company's financial information to others in the industry**

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INTRODUCTION

- **This seminar builds upon the information presented in Part I several years ago**
- **Basic information will be reviewed as a refresher and/or primer for today's attendees**
- **Part II presented today will expand further upon analysis and interpretation of financial statements**

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INTRODUCTION

- **Understanding the information contained in financial statements and properly using it in decision-making is a process similar to learning another language**
  - ***"Double-entry" accounting***
  - ***Transactions***
  - ***Accounting practices and GAAP principles***

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INTRODUCTION

- **The goal of today's program is to introduce (or re-introduce) some of the more commonly-accepted analytical procedures used in interpreting financial statements**

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INTRODUCTION

- **Areas covered in today's program**
  - ***Financial Statement Basics***
  - ***Financial Statement Analysis***
  - ***Financial Ratios***
  - ***Assessing Company-Specific Risk***
  - ***Determining the Impact on Company Value***
  - ***Conclusion and Practical Observations***

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FIINANCIAL STATEMENT BASICS

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FINANCIAL STATEMENT BASICS

- **Key tool for understanding the financial health and direction of a business**
- **Properly prepared financial statements can inform the reader about a company's ability to:**
  - ***Meet its obligations***
  - ***Generate a profit***
  - ***Provide a return to its owners/investors***

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FINANCIAL STATEMENT BASICS

- **A complete financial statement presentation should include the following statements:**
  - *Balance sheet*
  - *Income statement*
  - *Statement of changes in equity*
  - *Statement of cash flows*
  - *Required footnote disclosures*

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FINANCIAL STATEMENT BASICS

- **Balance Sheet**
  - *Presents the assets, liabilities and equity of a company as of a specific point in time*
  - *Assets presented in order of liquidity, with current assets listed first, followed by noncurrent assets*
  - *Liabilities presented in order of their expected settlement*

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FINANCIAL STATEMENT BASICS

- **Balance Sheet – Assets**
  - ***Current assets are consumed or converted into cash within one year***
  - ***Noncurrent assets have a life in excess of one year***
  - ***Assets may also be tangible or intangible***
  - ***Liquidity considers all characteristics of the asset***

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FINANCIAL STATEMENT BASICS

- **Balance Sheet – Liabilities**
  - ***Liabilities often have payment terms that make their settlement readily determinable***
  - ***Liabilities may have both a current and long-term component that will be separated in the financial statements***

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- **Balance Sheet – Equity**
  - ***Excess of assets over liabilities is equity***
  - ***Derived from invested capital plus accumulated and undistributed earnings***
  - ***Equity is divided among ownership units***
  - ***Different owners and ownership groups may have different rights of ownership***

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FINANCIAL STATEMENT BASICS

- **Income Statement**
  - ***Presents the results of the company's revenue and expense transactions***
  - ***Covers a <u>period</u> of time rather than a <u>point</u> in time***

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FINANCIAL STATEMENT BASICS

- **Income Statement**
  - ***Process of reduction:***

    Gross profit = Total revenue from sales – Cost of goods sold

    Operating income = Gross profit – Operating expenses

    Pre-tax income = Operating income – Other expenses

    Net income = Pre-tax income – Income tax expense

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- **Statement of Changes in Equity**
  - ***A company's components of, and changes in, its equity must also be presented – in the balance sheet, in a separate statement of equity or in the footnotes***
  - ***A separate statement of changes in equity is often preferred when there is a complex equity structure or numerous equity transactions***

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FINANCIAL STATEMENT BASICS

- **Statement of Cash Flows**
  - *All activities broken down into three categories:*
    - Operating – relate to company's ongoing current operations
    - Investing – relate to use of cash for long-term investment; typically associated with the company's noncurrent assets
    - Financing – relate to transactions involving lenders or owners; typically associated with the company's debt obligations or equity

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- **Required Footnote Disclosures**
  - *A complete financial report must include certain required disclosures to supplement basic information*
  - *Footnotes are an integral part of the report*
  - *Footnotes provide explanatory information to supplement the raw numbers, frame the reader's perspective and clarify areas that may be ambiguous*

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FINANCIAL STATEMENT BASICS

- **Required Footnote Disclosures**
  - ***Description of the company***
    - First footnote should identify the legal structure of the company, where/when it was organized and its tax status
    - Should also describe nature of the company's operations, including product lines and their significance
  - ***Going concern disclosures***

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- **Required Footnote Disclosures**
  - ***Significant accounting policies***
    - Described in first or second footnote
    - Policy changes must be justified by management as resulting in better accounting practices – companies are not permitted to simply change accounting policies at their discretion
    - Can cover a wide range of financial statement areas

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FINANCIAL STATEMENT BASICS

- **Required Footnote Disclosures**
  - ***Also must be included in footnotes:***
    - Estimates – amounts susceptible to future refinement as additional facts and circumstances are presented
    - Contingencies – items dependent upon the occurrence of future events or those that are so uncertain as to amount that they cannot be recorded in the financial statements
    - Significant future obligations and related party transactions

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FINANCIAL STATEMENT ANALYSIS

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FINANCIAL STATEMENT ANALYSIS

- **A primary objective of financial statements is to assist in decision-making process for many purposes**
- **For complete analysis, must consider the full set of financial statements, including footnote disclosures**
- **Accrual basis provides a truer economic picture**

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FINANCIAL STATEMENT ANALYSIS

- **Financial statement users need to consider not only the amounts of assets, liabilities and earnings, but also the underlying detail of those balances to understand the imbedded strength, quality and risks**

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FINANCIAL STATEMENT ANALYSIS

- **Assets**
  - *Identify assets, along with value and associated risk*
  - *Investors and lenders are interested in how readily the company's assets can be converted into cash*
  - *Footnotes should be read to determine if there are any restrictions on the use of significant cash balances or other assets*

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FINANCIAL STATEMENT ANALYSIS

- **Assets – Receivables**
  - *Various categories, each with different risk related to timing of collection and potential for default*
  - *Must understand nature of receivables to properly assess the risk (may only be in footnote disclosures)*

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FINANCIAL STATEMENT ANALYSIS

- **Assets – Inventory**
  - ***Many important details may only be found in the footnote disclosures***
  - ***Method of recording inventory impacts carrying value and cost of sales (and as a result, net income)***

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FINANCIAL STATEMENT ANALYSIS

- **Assets – Inventory**
  - ***Composition of inventory and provision for obsolete or unsalable inventory should be considered to determine quality of overall inventory balance***
  - ***Refer to page 21 in your materials***

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FINANCIAL STATEMENT ANALYSIS

- **Assets – Noncurrent Assets**
  - ***Real and personal property can be recorded at cost or fair market value; subject to impairment estimates***
  - ***Intangible assets – most subjective and least liquid***
    - If impairment is indicated, important to understand the cause of the impairment

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- **Liabilities**
  - ***Analysis should consider two primary attributes:***
    - Value of outstanding debt obligations
    - Timing of the payments
  - ***A company's financial strength generally improves to the extent that it can defer liabilities to future dates***

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FINANCIAL STATEMENT ANALYSIS

- **Liabilities**
  - ***Greater reliance can be placed on a liability that is fixed in nature, versus one that is subject to estimation***
  - ***Reader should also consider whether there are any unrecorded liabilities that impact the financial analysis***

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- **Equity**
  - ***Known as "book value" of a company***
  - ***Different from fair market value***
  - ***Company's market value typically exceeds book value***

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FINANCIAL STATEMENT ANALYSIS

- **Quality of Earnings**
  - – ***Income statement should also be analyzed in detail by looking at the key components that drive net income***

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- **Going Concern**
  - – ***Readers should be alert for disclosures regarding the company's ability to continue as a going concern for a period of one year beyond the date of the balance sheet***
  - – ***Information generally in first footnote disclosure***

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- **Comparability**
  - ***Most financial reports presented on a dual-year basis (information for the two most recent reporting periods is presented together)***
  - ***Generally, presented side-by-side to facilitate reader's ability to compare the two reporting periods***

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FINANCIAL STATEMENT ANALYSIS

- **Comparability**
  - ***By comparing two, or ideally more, years against each other, financial statement users can identify positive or negative trends in the company's earnings, liquidity or other performance measures***
  - ***Reader must be aware of circumstances that may affect the comparability of multiple years' financial statements***

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- **Circumstances That May Affect Comparability**
  - ***Reclassifications***
  - ***New or discontinued operations***
  - ***Unusual or infrequent transactions***

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FINANCIAL RATIOS

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FINANCIAL RATIOS

- **Evaluation/interpretation of a company's financial data to determine a company's financial condition**
- **Numerous ratios can be calculated for a company**
- **Selecting the appropriate ratios will depend on the purpose of the exercise and the type**

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- **A ratio by itself is meaningless until it is compared to prior years' experience, projections and industry averages, as well as other ratios**
- **Ratio analysis used as a benchmark to measure company performance and identify potential problems**

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FINANCIAL RATIOS

- **4 Basic Classifications:**
  - ***Coverage***
  - ***Return***
  - ***Turnover***
  - ***Component percentage***

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FINANCIAL RATIOS

- **Operating performance and the financial condition of a company can be evaluated through:**
  - ***Liquidity ratios***
  - ***Activity ratios***
  - ***Leverage ratios***
  - ***Profitability ratios***

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FINANCIAL RATIOS

- **Liquidity Ratios: Short-Term Solvency**
  - *Indicate the ease of converting certain assets into cash*
  - *Are of interest to those extending short-term credit*
  - *Assets that may be converted into cash in a short time period are referred to as liquid assets and are listed on the financial statements as current assets*
  - *Net working capital = current assets – current liabilities*

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- **Liquidity Ratios: Current Ratio**
  - *Measure of the ability of a company to meet its debt requirements as they come due*
  - *Denominator is current liabilities – represent the most urgent debts requiring payment in one year or cycle*
  - *Minimum acceptable current ratio is 1:1; however, this relationship does not allow much margin for safety*

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FINANCIAL RATIOS

- **Liquidity Ratios: Current Ratio**

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{1{,}796{,}421}{644{,}233} = 2.79$$

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FINANCIAL RATIOS

- **Liquidity Ratios: Quick Ratio (Acid Test Ratio)**
  - *More rigorous test of short-term solvency*
  - *Eliminates inventory, which is considered the least liquid current asset and most likely source of loss*
  - *Acid test of 1:1 is considered satisfactory unless the majority of "quick assets" are in accounts receivable, and the pattern of collections lags behind schedule for payment of current liabilities*

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FINANCIAL RATIOS

- **Liquidity Ratios: Quick Ratio (Acid Test Ratio)**

$$\text{Quick Ratio} = \frac{\text{Current Assets – Inventory}}{\text{Current Liabilities}} = \frac{1{,}004{,}080}{644{,}233} = 1.56$$

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- **Liquidity Ratios: Cash Ratio**
  - ***Most conservative ratio – excludes all current assets except the most liquid: cash and equivalents***
  - ***Indicates company’s ability to satisfy current liabilities in event immediate payment is demanded***
  - ***Generally, the higher the ratio, the better the company is able to satisfy its obligations***

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FINANCIAL RATIOS

- **Liquidity Ratios: Cash Ratio**

$$\text{Cash Ratio} = \frac{\text{Cash + Marketable Securities}}{\text{Current Liabilities}} = \frac{193{,}658}{644{,}233} = .30$$

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FINANCIAL RATIOS

- **Liquidity Ratios: Working Capital**
  - *Measured in dollars rather than as a ratio*
  - *Calculated by subtracting total current liabilities from total current assets*
  - *Bankers focus on net working capital over time to determine company's ability to weather financial crises*
  - *Loans often tied to working capital requirements*

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FINANCIAL RATIOS

- **Activity Ratios**
  - *Measures how well assets are employed*
  - *Can be used to evaluate the benefits produced by specific assets, including AR and inventory*
  - *The greater the turnover, the more effective a company is at producing benefits from its investment*

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FINANCIAL RATIOS

- **Activity Ratios: AR Turnover**
  - *Indicates how many times, on average, accounts receivable are collected during the year*
  - *Turnover represents the number of times receivables convert to cash*
  - *Ratio is calculated using net accounts receivable (net of the allowance for doubtful accounts) and net sales*

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FINANCIAL RATIOS

- **Activity Ratios: AR Turnover**

$$\text{AR Turnover} = \frac{\text{Net Sales}}{\text{Average Accounts Receivable}} = \frac{6{,}799{,}900}{605{,}686} = 11.23$$

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FINANCIAL RATIOS

- **Activity Ratios: Inventory Turnover**
  - *Indicates how many times inventory is created and sold during a period*
  - *Measures how efficiently a company manages and sells inventory*
  - *Generally, high turnover indicates efficient inventory management; but, other factors should be considered*

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FINANCIAL RATIOS

- **Activity Ratios: Inventory Turnover**

$$\text{Inventory Turnover} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}} = \frac{4{,}483{,}081}{938{,}657} = 4.78$$

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FINANCIAL RATIOS

- **Leverage Ratios: Debt Financing and Coverage**
  - *Companies can finance their assets through equity, debt or a mix of both*
  - *Financial risk is the extent that debt financing is used relative to equity – the higher the proportion of debt, the greater the degree of risk*
  - *Leverage ratios are used to assess how much financial risk a company holds*

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FINANCIAL RATIOS

- **Leverage Ratios: Debt Financing and Coverage**
  - ***Component percentages compare a company's debt with its total capital (debt + equity) or its equity capital***
  - ***Coverage ratios reflect company's ability to satisfy fixed obligations including interest, principal repayment or lease payments***

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FINANCIAL RATIOS

- **Leverage Ratios: Debt Ratio**
  - ***Indicates the proportion of assets that are financed with debt (including both short- and long-term debt)***
  - ***Can be further refined to include only long-term debt rather than total debt***
  - ***Debt ratios depend on the classification of long-term leases and on classification of some items as long-term debt and equity***

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FINANCIAL RATIOS

- **Leverage Ratios: Debt Ratio**

$$\text{Debt Ratio} = \frac{\text{Total Debt}}{\text{Total Assets}} = \frac{3{,}121{,}744}{6{,}561{,}178} = 0.48$$

$$\text{Long-Term Debt to Total Assets} = \frac{\text{Long-Term Debt}}{\text{Total Assets}} = \frac{3{,}114{,}416}{6{,}561{,}178} = 0.47$$

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FINANCIAL RATIOS

- **Leverage Ratios: Debt-to-Equity Ratio**
  - *Indicates the relative uses of debt and equity as sources of capital to finance the company's assets*
  - *Typically evaluated using book values of the capital sources*
    - Caution: there is little to no relationship between a company's book value and market value

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FINANCIAL RATIOS

- **Leverage Ratios: Debt-to-Equity Ratio**

$$\text{Debt-to-Equity Ratio} = \frac{\text{Total Debt}}{\text{Total Shareholders' Equity}} = \frac{3{,}121{,}744}{2{,}169{,}196} = 1.44$$

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FINANCIAL RATIOS

- **Leverage Ratios: Financial Leverage Ratios**
  - ***Capture ability of company to satisfy debt obligations***
    - Debt-service coverage ratio
    - Fixed charge coverage ratio

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FINANCIAL RATIOS

- **Leverage Ratios: Debt-Service Coverage Ratio**
  - *Compares the earnings of a company available to meet the interest and principal payments on debt obligations*
  - *The more times a company can cover its annual interest and principal payments from operating earnings, the better the position for the equity holders*

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FINANCIAL RATIOS

- **Leverage Ratios: Debt-Service Coverage Ratio**

$$\text{Debt-Service Coverage} = \frac{\text{EBIT}}{\text{Total Debt Service}} = \frac{776{,}121}{826{,}967} = 0.94$$

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FINANCIAL RATIOS

- **Leverage Ratios: Fixed Charge Coverage Ratio**
  - *Broader measure of coverage capability – includes various fixed charges*
  - *Important for companies that operate extensively with leasing arrangements*
  - *Used in debt covenants to help protect creditors*

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- **Leverage Ratios: Fixed Charge Coverage Ratio**

$$\text{Fixed Charge Coverage} = \frac{\text{EBIT + Lease Payments}}{\text{Interest + Lease Payments}} = \frac{784{,}868}{578{,}744} = 1.36$$

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- **Profitability Ratios**
  - *Compares components of income with sales*
  - *Measures the success of a company to translate sales dollars into profits at different stages of measurement*

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FINANCIAL RATIOS

- **Profitability Ratios: Gross Profit Margin**
  - *Measures gross profits earned on sales*
  - *Shows relationship between sales and the cost of products sold*
  - *Measures ability of company to control costs and pass along price increases through sales*
  - *Some types of companies cannot use this calculation*

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FINANCIAL RATIOS

- **Profitability Ratios: Gross Profit Margin**

$$\text{Gross Profit Margin} = \frac{\text{Gross Profit}}{\text{Net Sales}} = \frac{2{,}316{,}819}{6{,}799{,}900} = 0.34 \text{ or } 34\%$$

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FINANCIAL RATIOS

- **Profitability Ratios: Operating Profit Margin**
  - *Measures overall operating efficiency*
  - *Incorporates all expenses associated with ordinary business activity*

$$\text{Operating Profit Margin} = \frac{\text{Operating Income}}{\text{Net Sales}} = \frac{776{,}121}{6{,}799{,}900} = 0.11 \text{ or } 11\%$$

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FINANCIAL RATIOS

- **Profitability Ratios: Return on Assets (Investment)**
  - ***Measures how effectively company's assets are used to generate profits***

$$\text{Return on Assets} = \frac{\text{Net Earnings}}{\text{Total Assets}} = \frac{(130{,}081)}{6{,}561{,}178} = (0.02) \text{ or } -2\%$$

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FINANCIAL RATIOS

- **Profitability Ratios: Return on Equity**
  - ***Bottom-line measure for shareholders***
  - ***Measures profits earned for each dollar invested***
  - ***Used by investors to gauge amount of cash generated from existing assets***

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FINANCIAL RATIOS

- **Profitability Ratios: Return on Equity**

$$\text{Return on Equity} = \frac{\text{Net Earnings}}{\text{Shareholders' Equity}} = \frac{(130{,}081)}{2{,}169{,}196} = (0.06) \text{ or } -6\%$$

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FINANCIAL RATIOS

- **Z-Scores**
  - *Used to predict corporate defaults*
  - *Uses multiple income and balance sheet values to measure company's financial health*
  - *Weights 5 ratios, sums the amounts to determine score*
  - *Each ratio captures different aspect of operations*
  - *Manufacturing companies have different weightings*

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FINANCIAL RATIOS

- **Growth Rates**
  - ***Measures change in a line item over a period of time***
    - Annual growth rate – growth from one year to the next
    - Compound annual growth rate (CAGR) – year-over-year growth over a specified period of time

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FINANCIAL RATIOS

- **Common Mistakes in Application**
  - ***Failing to use an average or weighted average when applicable can distort ratios***
  - ***Failure to recognize differences in accounting methods and business-specific factors can affect comparability***
  - ***Misinterpretation of certain trends and performance measures due to insufficient historical analysis***

Analyzing Financial Statements and Their Impact on Value

ASSESSING COMPANY-SPECIFIC RISKS

Analyzing Financial Statements & Impact on Value

ASSESSING COMPANY-SPECIFIC RISKS

- **Represent unsystematic risk – has 4 primary sources:**
  - ***Size***
  - ***Macroenvironment***
  - ***Industry***
  - ***Company-specific attributes***

Analyzing Financial Statements & Impact on Value

ASSESSING COMPANY-SPECIFIC RISKS

- **Company-Specific Risk Factors**
  - ***Abnormal present or pending competition;***
  - ***Concentration of the customer base;***
  - ***Dependence upon a key person;***
  - ***Dependence upon a key supplier;***
  - ***Financial forecasts or projections are biased high;***
  - ***Pending lawsuits; and***
  - ***Pending regulatory changes.***

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ASSESSING COMPANY-SPECIFIC RISKS

- **Challenges**
  - ***Privately-held companies may have less information available than public companies***
  - ***Quantifying company-specific risk can be difficult and controversial***

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ASSESSING COMPANY-SPECIFIC RISKS

- **Quantification**
  - ***Guidance for determining risk in a systematic way:***
    - Compare subject company to guideline companies or other industry information
    - Identify potential risk factors and apply adjustments
    - Thoughtful, well-developed analysis to support conclusions
    - Create rate of return based on benchmark and compare to risk attributes of subject to determine any adjustments

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ASSESSING COMPANY-SPECIFIC RISKS

- **Concluding Thoughts**
  - ***Valuation determines to what extent company-specific risks will affect value***
  - ***Conclusions should be presented in an organized, well-documented manner***

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Analyzing Financial Statements and Their Impact on Value

DETERMINING THE IMPACT ON COMPANY VALUE

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DETERMINING THE IMPACT ON COMPANY VALUE

- **To discern the impact of financial statements or matters of value, it is important to first understand the role of "stakeholders" and how they are rewarded for risk**

Analyzing Financial Statements & Impact on Value

DETERMINING THE IMPACT ON COMPANY VALUE

- **Stakeholders … in any enterprise**
  - ***Customers***
  - ***Employees***
  - ***Vendors/suppliers***
  - ***Lenders***
  - ***Government***
  - ***Shareholders***

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DETERMINING THE IMPACT ON COMPANY VALUE

- **Common Equity Investors**
  - ***All other stakeholders must be accommodated before any return is paid to equity investors***

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DETERMINING THE IMPACT ON COMPANY VALUE

- **Common Equity Investors**
  - ***When all stakeholders are optimized, remaining net free cash flow is key determinant of company's value***

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DETERMINING THE IMPACT ON COMPANY VALUE

- **Stakeholder Risk and Reward**
  - ***Ratios and analysis can be used to identify and quantify risk associated with various operational and financial aspect of the business***
  - ***Important to understand the mechanics of the calculation of value to appreciate the risks***

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DETERMINING THE IMPACT ON COMPANY VALUE

- **To understand how these analyses interplay with one another, it is important to first understand how a business valuation might work**

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DETERMINING THE IMPACT ON COMPANY VALUE

- **Recall, that there are three foundational valuation approaches:**
  – ***Income***
  – ***Market***
  – ***Cost/Asset***

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DETERMINING THE IMPACT ON COMPANY VALUE

- **Income approach**
  - ***Capitalized Cash Flow Method***

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DETERMINING THE IMPACT ON COMPANY VALUE

- **Capitalized Future Economic Benefit Model**
  - ***<u>Numerator</u> = expected future economic benefits (often defined as net free cash flows)***
  - ***<u>Denominator</u> = investment risk associated with future expected net free cash flows***
  - ***<u>Risk rate</u> = capitalization rate (includes expected long-term growth in future economic benefits)***

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DETERMINING THE IMPACT ON COMPANY VALUE

- **Capitalized Future Economic Benefit Model**
  – ***Economic benefit = $10,000***
  – ***Risk rate = 23%***
  – ***Growth rate = 3%***
  – ***Capitalization rate = 20%***
  – ***Value = $50,000 ($10,000/.20)***

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DETERMINING THE IMPACT ON COMPANY VALUE

- **Capitalized Future Economic Benefit Model**
  – ***Intent is to evaluate the credibility and propriety of both elements in the calculation***
  – ***All risk inherent in the business must be identified and quantified in one of the elements***
  – ***Value drivers are identified in the process***

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DETERMINING THE IMPACT ON COMPANY VALUE

- **Value Drivers**
  - ***Specific aspects of the business that have the greatest effect on valuation***
  - ***Vary widely from one business to the next***
  - ***If effects of value drivers are understood, can be incorporated into calculations***

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DETERMINING THE IMPACT ON COMPANY VALUE

- **Example**
  - ***Technology Business A develops Product X***
  - ***Company's most important value driver***
  - ***Annual growth averaging 18% over three years***

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DETERMINING THE IMPACT ON COMPANY VALUE

- **All value is forward-looking!**

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DETERMINING THE IMPACT ON COMPANY VALUE

- **Example**
  - ***Must assess if sales can continue at this rate and/or if there is potential for competitors to displace sales***
  - ***Compare Technology Business A's performance against historical, industry and competitors' results***
  - ***Specific attention paid to R&D costs***

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DETERMINING THE IMPACT ON COMPANY VALUE

- **Example**
  - ***Adjustments must be made in calculation of value to account for any potential changes to value drivers***
  - ***Modifications can be made to the numerator or denominator to reflect change***

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DETERMINING THE IMPACT ON COMPANY VALUE

- **Interpreting the Results**
  - ***Process of financial and ratio analysis attempts to identify strengths and weaknesses of subject company***
  - ***Results should be compared against the company's historical company (trend analysis), as well as to competitor and industry data***

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DETERMINING THE IMPACT ON COMPANY VALUE

- **Interpreting the Results**
  - *Discrepancies with competitor results should be understood and effects considered*
  - *Failure to align with industry data can be cause for greater concern (additional investment risk)*

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Analyzing Financial Statements and Their Impact on Value

CONCLUSION AND PRACTICAL OBSERVATIONS

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Analyzing Financial Statements & Impact on Value

CONCLUSION AND PRACTICAL OBSERVATIONS

- **Absolute numbers in financial statements are of little use for analysis on their own**
- **Must be transformed into meaningful relationships to assess company's financial performance and condition**
- **Footnotes to the financial statements are also essential to proper analysis of financial statements**

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Analyzing Financial Statements & Impact on Value

CONCLUSION AND PRACTICAL OBSERVATIONS

- **Financial statement users, including members of the legal community, must have a basic understanding of how to deconstruct the statements and focus in on relevant performance indicators**
- **Financial statements reflect a summary of real world events (transactions), as well as certain estimates and judgments on the part of management**

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Analyzing Financial Statements & Impact on Value

CONCLUSION AND PRACTICAL OBSERVATIONS

- **Awareness of the underlying realities, including what the company does (its products and/or services), the status of the industry in which it operates and how the economy impacts performance, will result in a more meaningful process**
- **Analysis of the financial statements provides a basis for valuation calculations undertaken and the application of valuation discounts**

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THANK YOU!