UNDERSTANDING AND USING
FINANCIAL STATEMENTS

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# TABLE OF CONTENTS

UNDERSTANDING AND USING FINANCIAL STATEMENTS  
---  
GAAP AND AUTHORITATIVE ACCOUNTING BODIES  
- Securities and Exchange Commission  
- American Institute of Certified Public Accountants  
- Financial Accounting Standards Board  
- Governmental Accounting Standards Board  
---  
THE FINANCIAL STATEMENTS  
- The Balance Sheet  
- Income Statement  
- Statement of Retained Earnings  
- Statement of Cash Flows  
---  
NOTES TO FINANCIAL STATEMENTS AND OTHER DISCLOSURES  
---  
ACCRUAL-BASIS VS. CASH-BASIS ACCOUNTING  
---  
REVENUE RECOGNITION PRINCIPLE  
---  
RATIO ANALYSIS  
- Liquidity Ratio  
- Activity/Efficiency Ratios  
- Profitability Ratios  
- Leverage Ratios  
---  
FINANCIAL REPORTING AND TYPES OF ENGAGEMENTS  
- Internal Financial States  
- Compiled Financial Statements  
- Reviewed Financial Statements  
- Audited Financial Statements  
---  
AUDITED FINANCIAL STATEMENTS AND THE UFOC  
- Reviewing the Financial Statement Footnotes  
- Balance Sheet  
- Other Parts of the Audit  
---  
HELPING FRANCHISOR CLIENTS PREPARE ITEM 19 EARNINGS CLAIMS  
---  
BUYING AND SELLING BUSINESS  
- Adjusted EBITDA  
- Multiplying EBITDA  
- Additional Considerations  
- A Final Look at the Financial Statements
UNDERSTANDING AND USING FINANCIAL STATEMENTS

Few law schools offer extensive training to lawyers on accounting issues, or even on how to read a financial statement. Nevertheless, business lawyers, and franchise lawyers in particular, have numerous occasions on which an understanding of financial statements and accounting procedures can be invaluable in assisting their clients.

Several examples of situations that require an understanding of financial statements might help put into perspective the principles to be discussed in this paper. Any transaction lawyer who prepares franchise Offering Circulards for clients must include in those Offering Circulards the audited financial statements (and sometimes updated, interim financial statements) of the franchisor. This paper will discuss a number of reasons franchise counsel should not blindly include anything he/she receives from the client’s accountant in the Offering Circular. On the other side of the table, an attorney representing a prospective franchisee must be able to read those financial statements in order to properly advise his/her client.

The audited financial statements are not the only places in the Offering Circular that “numbers” will appear. Item 19 of the Offering Circular may contain historical earnings information, or projections based on historical earnings statements. Without understanding the information that is included, a practitioner cannot counsel his/her client with respect to the information included in the Offering Circular, let alone respond to comments about these submissions from state regulatory authorities.

Apart from representing franchisors or franchisees in connection with the review of disclosure documents, franchise practitioners also come across financial information in other areas of their practice. If you represent a client who is buying or selling a business, an understanding of terms such as “EBITDA,” “adjusted EBITDA” and “quality of income” is critical to providing proper representation to your client. In addition, without an understanding of financial statements, how can litigation counsel initially assess the damages that may exist in a lawsuit for lost profits from a business venture?

Therefore, it is imperative to be able to read financial statements contained with a level of familiarity, and to have a handle on a number of basic terms and ratios that will allow the reader to scratch the surface of the presented financial performance. This paper provides a high-level discussion of some general accounting terms and principles that are beneficial to understand when reviewing an entity’s financial reporting.

GAAP AND AUTHORITATIVE ACCOUNTING BODIES

Accounting rules and regulations are established and practiced using a set of Generally Accepted Accounting Principles, or GAAP. The term “generally accepted” means that either an authoritative body has established a principle of reporting in a given area or that over time a given practice has been accepted as appropriate because of its universal application. Four primary organizations are instrumental in the development of GAAP:

- Securities and Exchange Commission (SEC);
- American Institute of Certified Public Accountants (AICPA);
• Financial Accounting Standards Board (FASB); and
• Governmental Accounting Standards Board (GASB).

Securities and Exchange Commission

The SEC is a federal agency that helps to develop and standardize financial information presented to companies’ stockholders. Most companies that issue securities to the public and/or are listed on a stock exchange are required to file audited financial statements with the SEC. The SEC maintains the power to prescribe the accounting practices and standards to be employed by companies that fall within its jurisdiction and requires registrants to adhere to GAAP. For example, if the SEC believes that an accounting or disclosure irregularity exists regarding the form or content of the financial statements, it may send a deficiency letter to the infracting company. Additionally, the SEC has the authority to prevent the registrant from issuing further securities on the exchanges.

While the SEC is not involved in regulating financial statements of franchisors (other than franchisors that are publicly held, in connection with that company’s securities filings, rather than its franchise filings), state franchise regulators also review these financial statements in connection with their review of a franchisor’s Uniform Franchise Offering Circular. While those regulators typically will not point out irregularities in the form of content of the financial statements, they do have the authority to prevent the applicant from registering its franchise offerings in their states.

American Institute of Certified Public Accountants

The AICPA is the national professional organization of practicing CPAs and helps to set generally accepted professional and technical standards, including financial statement auditing, professional ethics and attest services. Until the 1970s, the AICPA was the only governing body in this field, using the Accounting Principles Board (APB) whose major purpose was to develop an overall conceptual framework to assist in the resolution of problems as they became evident. In 1973, the APB was dissolved and responsibility for setting GAAP was transferred through the formation of the FASB. However, the AICPA continues to provide guidance in the industry and its primary responsibility is to promote and protect the profession of accounting.

Financial Accounting Standards Board

The FASB is a major organization whose mission is to establish and improve standards of financial accounting and reporting for the guidance and education of the public. Although the SEC has statutory authority to establish financial accounting and reporting standards for publicly held companies, the SEC relies on the private sector for this function. The SEC designated the FASB as the organization responsible for setting GAAP for companies in the United States. The major types of pronouncements issued by the FASB are: Standards and Interpretations; Financial Accounting Concept Statements; and Technical Bulletins and Emerging Issues Task Force Statements.
Governmental Accounting Standards Board

The GASB is similar to FASB, except it handles accounting by state and local government entities.

THE FINANCIAL STATEMENTS

The financial statements are the means in which financial information is communicated. The financial statements most frequently provided are: the Balance Sheet; the Income Statement; the Statement of Retained Earnings; and the Statement of Cash Flows.

The Balance Sheet

The balance sheet describes the financial condition of a company at a specific point in time, or on a particular date. The balance sheet is the statement that lists the assets of a business and the corresponding claims, liabilities and equity, on those assets. The ultimate value of the assets is determined by balancing them against the liabilities plus the equity, which is represented by the following formula:

• **ASSETS = LIABILITIES + STOCKHOLDERS’ EQUITY**

A company’s assets have to equal, or balance, the sum of its liabilities and stockholders’ equity.

Balance sheet accounts are classified and sub-classified so that similar items are grouped together and are arranged to show important relationships. Primarily, assets and liabilities are segregated into current and long-term items.

Current, or short-term, assets are assets that can be converted to cash or consumed within one year or an operating cycle. An operating cycle is the average time it takes a business to convert cash to inventory, inventory to accounts receivable and accounts receivable back into cash. Current assets are presented in the balance sheet in order of liquidity. The five major items found in the current assets section are cash, short-term investments, receivables, inventories and prepayments.

Long-term assets are assets used in operating activities that span several accounting periods. The most typical long-term assets are long-term investments in securities, tangible fixed assets, such as property, plant and equipment and intangible assets, such as goodwill, trademarks and other intellectual property.

Short-term liabilities, or current liabilities, are the obligations that are expected to be liquidated either through the use of current assets or the creation of other current liabilities. Current liabilities are not reported in any consistent order and include such items as trade notes, accounts payable and current maturities of long-term debt. There is an exception to the general rule for determining which liabilities should be listed as short-term: if a business does not plan to use any of its current assets to repay debt, then the debt is listed as long-term even if it’s due within one year.

Long-term liabilities are obligations that are not reasonably expected to be liquidated within the normal operating cycle but, instead, are payable at some time
beyond that. Items include bonds payable, notes payable, deferred income taxes, lease obligations and pension obligations.

Within assets and liabilities are accounts receivable (A/R) and accounts payable (A/P), respectively. A/R represents future cash receipts that are due from customers. That is, revenue from customers that has been recognized, but the cash has not yet been collected. Often offsetting A/R is an allowance for bad debt which is an estimate of the expected uncollectible accounts from all sales made on account or from the total of outstanding receivables.1

A/P represent balances owed to others for goods, supplies or services purchased on open account. A/P arises because of the time lag between the receipt of services or acquisition of title to assets and the payment for them.

Income Statement

An income statement measures the success of a company for a given period of time by calculating the difference between the asset increases and the asset decreases associated with running the business. The income statement can be used to both evaluate the past performance of the entity, as well as provide a basis for predicting its future. An income statement reports net income for an entity and net income results from revenue, expense, gain and loss transactions.

Revenues are inflows or other enhancements of assets of an entity during a period from delivering or producing goods, rendering services or other activities that constitute a company’s central operations. Revenues take many forms, such as sales, fees, interest, dividends and rents.

Expenses are outflows or other using-up of assets or incurrences of liabilities during a period from delivering or producing goods, rendering services or carrying out other activities that constitute a company’s central operations. Expenses include items such as cost of goods sold, depreciation, interest, rent, salaries and taxes.

Gains are increases in equity from peripheral or incidental transactions and losses are decreases in equity from peripheral or incidental transactions. Gains and losses may result from the sale of investments, sale of plant assets, settlement of liabilities, write-offs of assets due to obsolescence or casualty or theft.

A multiple-step income statement is used to recognize income statement relationships. It illustrates a separation of operating transactions from non-operating transactions and matches costs and expenses with related revenues. The multiple-step income statement contains the following sections:

- Operating Section – a report of the revenues/expenses from principal operations

1 This estimate of uncollectible amounts can be illustrated either as described herein, as a Balance Sheet approach called an Allowance for Bad Debt which represents a percent of A/R, or as an Income Statement approach called a Bad Debt Expense which represents a percent of credit sales.
Sales/Revenue
Cost of Goods Sold
Selling Expenses, a subsection that lists expenses resulting from the company’s efforts to make sales (commissions, etc)
Administrative or General, a reporting of expenses of general administration (overhead, etc)

Non-operating Section – a report of revenues/expenses resulting from secondary activities
Dividend Revenue
Rental Revenue
Interest

Income Tax
Discontinued Operations
Extraordinary Items, or unusual and infrequent gains and losses
Any Cumulative Effect of a Change in Accounting Principle
Earnings Per Share (EPS), a measurement of net income earned on each share of common stock

Statement of Retained Earnings

The net income earned by a company may be retained in the business, or it may be distributed to stockholders through payment of dividends. Retained earnings represent the company’s undistributed earnings, which may be reinvested back into the company. The statement of retained earnings reconciles the balance of the retained earnings account from the beginning of a period to the end. The reconciliation of the beginning to the ending balance in retained earnings provides information about why net assets increased or decreased during the year.

Statement of Cash Flows

The primary purpose of the statement of cash flows is to provide relevant information about the cash receipts and cash payments of an enterprise during a period. Reporting the sources, uses and net increase or decrease in cash helps investors, creditors and other know what is happening to a company’s most liquid resource.

Cash receipts and payments during a period are classified in the statement of cash flows into three different sections: operating, investing and financing activities. Operating activities involve the cash effects of transactions that factor into the determination of net income, for example cash spent on inventory, payment of accounts payable and receipts of accounts receivables. Investing activities include making and
collecting loans and acquiring and disposing of investments (both debt and equity) and property, plant and equipment. Financing activities involve liability and owners’ equity items, including borrowing money from creditors and repaying the amounts borrowed.

As stated earlier, the income statement helps to measure the long-term success of a company and illustrates a company’s profitability. However, the statement of cash flows helps users evaluate the liquidity, solvency and financial flexibility of an entity. For example, a high amount of net cash through operating activities indicates that a company is able to generate sufficient cash from its primary operations to pay its bills without further borrowing. Conversely, a low amount of cash provided by operating activities may indicate that a company cannot generate enough cash and must borrow or issue equity to acquire additional cash.

NOTES TO FINANCIAL STATEMENTS AND OTHER DISCLOSURES

The notes to the financial statements are the company’s means of amplifying or explaining the items presented in the main body of the statements. Information pertinent to specific financial statement items can be explained in qualitative terms, and supplementary data of a quantitative nature can be provided to expand the information in the statements.

The most prominent, and typically the first, note to the financial statements is the Significant Accounting Policies note. This disclosure answers questions regarding the company’s methodologies in its accounting procedures, including how revenue is reported, what method of depreciation is used, how are investments classified, etc. The note should identify and describe the accounting principles followed by the entity and the methods of applying those principles that materially affect the determination of financial position, cash flows or results of operations.

In addition to the Significant Accounting Policies note, the company should disclose information in the notes to the financial statements regarding risks and uncertainties that exist as of the date of the financial statements, specifically current vulnerabilities, use of estimates and any contingencies. Further, other items including related party transactions, subsequent events and segment reporting should also be demonstrated.

ACCRUAL-BASED VS. CASH-BASED ACCOUNTING

Under GAAP, the primary method of recording income and expense by a company is the accrual method. The accrual method allows an entity to recognize revenue when it is earned and recognize expense in the period incurred – without regard to the time of the receipt or the payment of cash. Conversely, a number of smaller companies, and often an individual taxpayer, utilize a cash basis approach. Under the cash basis, revenue is recorded only when the cash is received, and expenses are recorded only when the cash is paid. The determination of income on the cash basis rests upon the collection of revenue and the payment of expenses. Cash basis financial statements are not in conformity with GAAP, rather they are an Other Comprehensive Basis of Accounting (OCBOA).

To illustrate the difference between accrual and cash basis accounting, imagine that ABC Co. agrees to provide services to XYZ Inc. for $10,000. In January, ABC
begins to provide services and incurs $5,000 in expenses on credit (i.e. – ABC has not yet paid its suppliers). By the end of January, ABC completes its services. In February, ABC collects from XYZ the $10,000. In March, ABC pays its suppliers to $5,000 in expenses. Under the accrual method, ABC would recognize both the revenue and the expense of the services in January, since that was the period in which the income and expense were incurred, providing for a gross profit of $5,000. Under the cash method, ABC would not recognize the revenue until February (when XYZ paid) and the expense in March (when ABC paid its vendors). Under both methodologies, the gross profit is $5,000; however the difference is in the timing of the recognition of the profit. Accrual basis accounting aids in predicting future cash flows by reporting transactions and other events with cash consequences at the time the transactions and events occur, rather than when the cash is received and paid.

REVENUE RECOGNITION PRINCIPLE

One of the major principles and building blocks of GAAP is the revenue recognition principle: revenues are recognized when realized and when earned. Revenue is considered realized when goods or services are exchanged for cash or for claims to cash (i.e. on credit). Revenue is considered earned when an entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues.

Franchise arrangements generally provide for franchise fees, which are payments that the franchisee makes to the franchisor for the “right” to the franchise. Specifically, there is the initial franchise fee, which is usually a large flat fee and represents the cost of joining the franchise, and there are ongoing royalty-like fees that the franchisee pays to stay in “the system,” typically calculated as a percent of franchise sales. Further, there is often an additional routine fee: the advertising fee. This is the payment a franchisee will likely make on an on-going basis as a contribution to an advertising fund. The franchisor manages the fund for the benefit of the franchise system, and will use the fund to create advertising and marketing materials.

Recognition of the franchise fees follows the same basic principles as any other revenue recognition. Revenue is considered earned by a franchisor when the franchisor has substantially satisfied his/her obligations under the arrangement. Specifically, the revenue from franchise fees, both the initial and the recurring fees, should be recognized, with a provision for estimated uncollectible amounts, when all material services or conditions relating to the sale have been substantially performed or satisfied by the franchisor. This means that the franchisor should have no remaining obligations, not have any intent to refund any cash received or to forgive any unpaid amounts by the franchisee. Additionally, substantially all of the initial services of the franchisor as required by the franchise agreement must be performed prior to revenue recognition.2

RATIO ANALYSIS

Qualitative information from financial statements can be gathered by examining relationships between items on the statements and identifying trends in those relationships. Ratio analysis expresses the relationship among selected financial statement data. There are four major categories of financial statement ratios: liquidity ratios; activity or efficiency ratios; profitability ratios; and leverage ratios.

Liquidity Ratios

Liquidity ratios measure a company’s short-term ability to pay its maturing obligations. Examples include:

- **Current Ratio** = Current Assets ÷ Current Liabilities
  - Measures the short-term debt-paying ability of an entity
- **Quick Ratio** = (Cash, Marketable Securities and A/R) ÷ Current Liabilities
  - Measures immediate short-term liquidity

Activity/Efficiency Ratios

Activity, or efficiency, ratios measure how effectively a company is using the assets employed. Examples include:

- **Asset Turnover** = Net Sales ÷ Average Total Assets
  - Measures how efficiently assets are used to generate sales
- **Gross Profit Margin** = (Sales – Cost of Goods Sold) ÷ Sales
  - Measures how efficiently management uses labor and supplies in the production process

Profitability Ratios

Profitability ratios measure the degree of success or failure of a company for a given period of time. Examples include:

- **Return on Assets** = (Net Income + Interest) ÷ Average Total Assets
  - Measures overall profitability of assets
- **Return on Equity** = (Net Income – Preferred Dividends) ÷ Average Stockholders’ Equity
  - Measures profitability of owners’ investment
- **Earnings Per Share (EPS)** = (Net Income – Preferred Dividends) ÷ Weighted Shares Outstanding
Measures net income earned on each share of common stock

- **Operating Profit Percentage** = \( \frac{\text{Sales} - (\text{COGS} + \text{SG&A Expenses})}{\text{Sales}} \)
  - Measures the extent to which a company is making a profit from standard operations

- **Net Profit Margin** = \( \frac{\text{Net Income}}{\text{Sales}} \)
  - Measures net income generated by each dollar of sales

**Leverage Ratios**

Leverage ratios measure the degree of protection for long-term creditors and investors. Examples include:

- **Debt to Equity** = \( \frac{\text{Total Debt}}{\text{Total Equity}} \)
  - Measures the equity's long-term debt-paying ability

- **Times Interest Earned** = \( \frac{\text{Income before Interest and Taxes}}{\text{Interest}} \)
  - Measures the ability to meet interest payments as they come due

**FINANCIAL REPORTING AND TYPES OF ENGAGEMENTS**

One major factor in reviewing a company’s financial statements or other financial information provided by a company is to understand both the source and level of review of the information. There are several types of financial statements that exist, all with varying degrees of review and assurance provided. The following is a discussion of the more prevalent types of financial statements and engagements.

**Internal Financial Statements**

Internal financial statements are typically those financial statements that have been prepared, compiled and presented by and for the company itself. They are not independently reviewed or audited; they are solely the representation of management and generally used for internal company reporting.

**Compiled Financial Statements**

In a compilation engagement, the accountant’s responsibility is to present, in the form of financial statements, information that is the representation of management, without expressing any assurance on the statements. There is no inquiry necessary and this service is only provided for non-public, or private, companies. Any known departures from GAAP must be disclosed in the compilation report prepared by the accountant.

**Reviewed Financial Statements**

In a review engagement, the accountant’s responsibility is to perform inquiry and analytical procedures that provide the accountant with a reasonable basis for expressing
limited assurance that there are no material modifications that should be made to the statements for them to be in conformity with GAAP. An accountant may only provide this service for non-public entities and any known departures from GAAP must be disclosed in a review report.

**Audited Financial Statements**

An audit is an examination of financial statements by an independent CPA for the purpose of expressing an opinion on the fairness with which the statements present a company’s financial position, results of operations and cash flows in conformity with GAAP. A “clean” audit report assumes that the statements are free from material error and omissions, the financial statements are not misleading to the reader, and all items that a reasonable reader of the financial statements would consider important have been adequately disclosed. An independent auditor plans, conducts and reports the results of an audit in accordance with Generally Accepted Auditing Standards (GAAS) and under the authority of the Public Company Accounting Oversight Board, or PCAOB.³

For purposes of compliance with the requirements for preparation of franchise Offering Circulars, annual financial statements must be audited.⁴ In addition, there are many benefits to franchise companies preparing audited financial statements, including credibility of the auditor and freedom from any bias. However, it should be noted that the auditor’s knowledge of the entity’s financial statements is limited to the knowledge acquired during the course of the audit, and the auditor is limited to the expression of an opinion of reasonable assurance on the financial statements; the financial statements remain the representation of the company’s management.

At the completion of an audit, the accountant produces his/her audit opinion. The opinion is a report by the auditor regarding the independent examination of the accounting data presented by the company; the report states whether the financial statements present in accordance with GAAP. The report contains an opinion regarding the financial statements taken as a whole, or an assertion that an opinion cannot be expressed, in which case the reason is stated. There are four types of audit opinions that may be expressed:

- **Unqualified** – represents a “clean” opinion and that the financial statements present fairly, in all material respects and are in conformity with GAAP;

- **Qualified** – contains an exception to the unqualified opinion, typically a scope limitation, inadequate disclosure or a lack of conformity with GAAP in a certain aspect;

- **Adverse** – the exceptions to fair presentation and departures from GAAP are so material that the auditor cannot qualify the opinion; and

³ The PCAOB is a private-sector, non-profit corporation created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies.

⁴ Guidelines for Preparation of the Uniform Franchise Offering Circular and Related Documents, Item 21.
Disclaimer of Opinion – the auditor has gathered so little information on the statements that no opinion can be expressed.

AUDITED FINANCIAL STATEMENTS AND THE UFOC

As previously mentioned, the Uniform Franchise Offering Circular, or the UFOC, used by franchisors in the sale of franchises, must contain audited financial statements of the franchise business including, balance sheets for the past two years, statement of earnings for past three years, statement of cash flows for past three years and a statement of stockholders’ equity. The financial statements must be audited by a CPA and contain extensive notes that provide explanations about the franchisor and its financial condition not found anywhere else in the offering document.

In order to include the audited financial statements in the UFOC, the franchise registration states require the franchisor obtain an audit consent letter from its auditor. The audit consent letter is a letter from the auditor of the franchisor’s financial statements, permitting the franchisor to use the audited financial statements within the UFOC; the UFOC cannot be issued without this consent from the auditor. In the event that changes are made to the financial statements subsequent to the issuance of the original consent letter, the auditor must review the changes for materiality and re-issue his/her consent of the franchise’s financial statements.

REVIEWING AUDITED FINANCIAL STATEMENTS

With this basic understanding of financial statements, we can turn to how a basic knowledge of this information can be helpful to franchise lawyers. How often do practitioners prepare Offering Circulars, have them ready to be filed, leaving a place only for delivery of the year-end audit? When the audit arrives, it is placed in the Offering Circular, perhaps never having been read by the client, let alone by franchise counsel. If this practice occurs in your office, you are doing your client, and yourself, a serious disservice.

Counsel should review the audit for a number of purposes before inserting it in the Offering Circular. In fact, counsel should review a draft of the audit before it is finalized, as there may be changes that can or must be made to the audit, which only knowledgeable counsel can identify. Once the financial statements have been finalized, and the auditor has issued its opinion on those statements, the action required to have the auditor’s opinion withdrawn and the financial statements revised, may be surpassed only by the action needed to amend the United States Constitution.

Reviewing the Financial Statement Footnotes:

Counsel can begin its review of the draft of the audited financial statements with the footnotes, those innocuous provisions at the end that “nobody” reads. Although the footnotes will describe a number of accounting principles with which counsel may be unfamiliar, and even financial transactions of which counsel has no knowledge, they will also describe the overall business and activities of the franchise company that may be

5 Id.
more familiar to franchise counsel than to the auditors. The following are examples of issues spotted in various audits over the years by just one of the authors of this paper:

1. The footnotes frequently summarize the services provided to franchisees of the franchise company. Does that description match the provisions of the franchise agreement? Particularly in circumstances where there have been recent changes to the franchise agreement, and the franchisor’s obligations thereunder, the auditors may not be aware of those changes and the company may be describing obligations that no longer exist.

2. Does the description of the relationship the franchisor has with the franchisee match the terms of the franchise agreement, or the obligations imposed under the law? If the notes state that the franchise relationship is a fiduciary relationship, or that the franchisor has obligations of good faith and fair dealing with respect to its franchisees, the franchisor may be hard-pressed to subsequently argue in court that those statements do not accurately reflect the relationship of the parties. (While this section of the paper purports to contain advice for the franchisor’s counsel on issues to review before the financial statements are inserted in the Offering Circular, counsel representing disgruntled franchisees should certainly be able to use this advice in looking for “smoking guns” in subsequent litigation.)

3. The footnotes frequently state the number of franchise agreements in effect, and the number of company-owned stores in existence, as of the end of the fiscal year. Do these numbers match the information contained in Items 1 and 20 of the Offering Circular?

4. Footnotes to financial statements will discuss material litigation, sometimes under the heading of “contingencies.” Is this litigation disclosed in Item 3 of the Offering Circular, and, if so, are the descriptions consistent?

5. Franchisors that collect advertising fees from franchisees must account for these fees. Do the footnotes properly describe the franchisor’s obligations to manage this fund, and any obligation of the franchisor to make up deficits in the fund? (The issue of accounting for advertising, promotional or marketing fees will also be addressed later in this section in terms of how they are reported on the balance sheet.)

Once again, these are only a few examples of issues that may require clarification in audits (or changes in agreements or Offering Circulars). A thorough review of the footnotes, before the audit is finalized, may disclose other areas that should be corrected or clarified before the audit is issued.

Balance Sheet:

Under many of the state franchise laws, franchise regulators have the ability to require the franchisor to provide assurances of financial capability if they believe, based on the franchisor’s financial statements, that doing so “is necessary and appropriate for
the protection of prospective franchisees\textsuperscript{6} or “the franchisor will depend primarily on the initial franchise fees paid by franchisees” to fund their obligations to franchisees.\textsuperscript{7} Most franchise registration states give their franchise administrators the authority to allow registration, but to require the franchisor to defer or escrow all fees to be received from franchisees in that state until the franchised business is operational,\textsuperscript{8} or in the alternative, to obtain a bond to assure the franchisor’s performance to the franchisee.\textsuperscript{9, 10}

Only one state has published the criteria to be considered by state regulators in considering the financial wherewithal of the franchise company. Illinois provides that the regulators should look to the applicant’s recent financial statements, using practically everything in that statement to make their consideration. Specifically, the Illinois statute sets forth the following criteria to be considered in making the determination: “The auditor’s opinion letter or review report, notes to the financial statement, the current ratio, the quick ratio, the amount of working capital, the proportion of tangible and intangible assets, the amount and maturities of debt, the debt/equity ratio, the amount of equity, the earnings history, the proportion of receivables compared to other assets, and the quality of receivables.”\textsuperscript{11} Unfortunately, most states, including Illinois, do not have a hard and fast published rule as to when they will find the financial statements to be deficient. However, many states will begin with the balance sheet, which not coincidentally is where many of the items noted in the Illinois regulations will be found. There are several areas of the balance sheet that may be determinative in a state regulator’s review of the financial statements.

1. Does the franchisor have a positive net worth?

There will be a line near the bottom of the balance sheet, which in the case of a corporate franchisor would be entitled “Total Stockholder Equity.” It is simply a mathematical calculation that takes total assets, and subtracts from that number the amount of the company’s total liabilities. If the amount is positive, then the franchisor has a “positive net worth.” If it is negative, then the franchisor has a “negative net worth.”

If a franchisor has a negative net worth, it can be expected that, at a minimum, the state will require deferral or escrow franchise fees. If the negative net worth is significant, the state may not allow the franchisor to register. However, while some states may be satisfied with a positive net worth, most will expect the net worth to be more than nominal.

\textsuperscript{6} Code of Maryland Regulations, Section 02.02.08.08.A.

\textsuperscript{7} Regulations under the Illinois Franchise Disclosure Act of 1987, Section 200.500(a).

\textsuperscript{8} See e.g. Minnesota Regulations, Sections 2860.1800.

\textsuperscript{9} \textit{Id.}, Section 2860.1900.

\textsuperscript{10} In Virginia, there is no statutory alternative available to state regulators when they do not believe the franchise company has the financial wherewithal to fulfill its obligations to franchisees, and registration therefore will be refused.

\textsuperscript{11} Regulations under the Illinois Franchise Disclosure Act of 1987, Section 200.500(b).
a. Some states compare the information disclosed in the Supplemental Information Sheet as to the franchisor’s cost of fulfilling its obligations to franchisees prior to the opening of the franchised business, to the number of franchises disclosed in Item 20 as expected to be opened in the current year, and require the franchisor’s net worth be sufficient to fund these expenditures.

b. Some states may look also at the franchisor’s Statement of Income to determine whether the business was profitable in the prior year. If it was not, some states may expect the franchisor’s net worth to be at least sufficient to cover another year of similar losses as were incurred in the prior year.

c. Expect that some states will review the assets to consider the “strength” of those assets. If intangible assets created the franchisor’s positive net worth, a state may exclude those assets in considering the net worth of the franchisor. Likewise, if a significant portion of the assets consist of receivables from affiliated companies, the state may discount those assets when considering the franchisor’s net worth.

2. Does the franchisor have a “positive” current ratio?

The Illinois regulations, cited above, mention “current ratio.” This ratio has been a determining factor for Minnesota regulators for quite some time, as they look at whether or not the franchisor has a “positive” current ratio. This test focuses not on all assets and all liabilities, but only on current assets and current liabilities. If current assets exceed current liabilities, that means the franchisor has a positive current ratio, or a ratio greater than 1.0.

A “current ratio” test is one that can trip up not only start-up companies with little cash or accounts receivable, but also large companies with a significant net worth. This is particularly true when a significant portion of the assets of franchisor is in real estate. Real estate is not a current asset, but a long-term asset. However, to the extent such real estate has been financed, the payments due on that financing in the current year represent current liabilities. Consider the following example. Assume a company has $1,000,000 of cash and accounts receivable, and $20,000,000 of equipment and real estate. Assume that its only debts are $100,000 in current trade payables, and $10,000,000 of financing against its equipment and real estate, which it is paying, with interest, over a period of ten years. With interest, the payments might be in the neighborhood of $1,500,000 per year. The net worth of this company is substantial. It has $21,000,000 of assets, and $10,100,000 of liabilities, or a positive net worth of $10,900,000. However, it also has a negative current ratio. Its current assets are $1,000,000, and its current liabilities are $1,600,000 (trade payables, plus one year of debt on the equipment and real estate financing). In a state that looks for a positive current ratio, this franchisor would expect to have to defer or escrow the initial fees it receives from franchisees.

3. What is the franchisor’s debt-to-equity ratio?

Once again, there are no hard and fast rules regarding the amount of debt versus equity an entity uses to fund its operations. An auditor, looking at the health of a
franchisor, will not be concerned about a debt to equity ratio of 1.0 or less, meaning that a franchisor’s total debt is equal to or less than the amount of equity used. The more a company borrows to meet its obligations, the higher its debt to equity ratio, and as the debt to equity ratio rises, questions may arise as to the franchisor’s ability to meet its debt obligations. For example, a debt-to-equity ratio of 3.0 means that a company is incurring three times as much debt as equity with which to pay its bills and other obligations and a ratio this high may start to set off alarms for an auditor (or state examiner). However, there are particular industries and companies for which a higher debt-to-equity ratio is considered normal and healthy. For example, many capital intensive organizations, such as auto manufacturing, often have debt-to-equity ratios of 3.0 or higher.

4. Show Me the Money!

The Illinois regulations included a reference to working capital and quality of receivables. In essence, these tests go to the ultimate question; is there sufficient cash or cash equivalents to fund the operations of the franchisor? This is perhaps the most simplistic, and important question that needs to be considered.

5. Advice to Franchisee Counsel.

While the foregoing are by no means intended to be an exhaustive list of factors state regulators will consider in determining the financial wherewithal of a franchisor, they do account for most of the factors that have been cited to this author in the last several years. Likewise, some of these issues should be red flags to prospective franchisees (and their counsel) when assessing the ability of a franchisor to fulfill its obligations to a franchisee (or her counsel).


If it is clear from a review of the balance sheet that the franchisor will not be able to satisfy state regulators (or prospective franchisees) as to the financial wherewithal of a franchisor client, counsel should discuss with the franchisor whether the offering should go forward, and if it should, whether a deferral of fees should be considered, or escrow arrangements made, before submission of the Offering Circular to state regulators. However, counsel may also be able to help the franchisor restructure its financial statements, within the guidelines of GAAP, to address deficiencies prior to filing, thereby avoiding an escrow requirement, or a rejection of a franchise application by state regulators (or rejection of the franchise by prospective franchisees).

a. Deficient Net Worth

In most cases, concerns about a franchisor’s financial statements will revolve around the net worth of the franchisor; the net worth will either be perceived as too low, or worse, there will be a negative net worth. The most obvious way to correct this problem is for the franchisor’s owners to infuse capital, in the form of equity, into the business. While this may be a solution for some franchisors, others may not have the money to do so. Moreover, at the time anyone looks at a draft of the audit, the franchisor’s year will be long completed, and infusion of capital in, for example, March, will do nothing to change the net worth of the business as of December 31. If, however, the capital infusion is significant, it may behoove the franchisor to make that contribution,
and then prepare updated, interim unaudited financial statements to submit with its application. More likely than not, such an infusion will keep the states from refusing registration of the offering. It will also provide a significant comfort to prospective franchisees. However, experience shows that if a capital infusion is made after year end, most states will still require an escrow or deferral until the new net worth has been audited. Therefore, for this solution to completely address the issue, the franchisor would need to have its first quarter financial statements audited.

A company’s problem with its net worth may not always be a lack of assets. In these times of leveraged buyouts, the franchisor may be carrying too much debt which, when subtracted from the book value of the assets, yields a very low, or negative, net worth. In those cases, it may be possible to restructure the debt. This is particularly so when the debt is owed to principals of the franchisor. In those circumstances, the principals can simply contribute all or part of the debt as capital (equity), thus removing that debt as a liability of the business. There will, however, be an issue as to the timing of this equity contribution since, in most cases the issue once again will not even be discovered until two months after the fiscal year end. However, nothing prevents a company from reaching an agreement with its creditors to restructure debt on one day, but effective as of December 31 of the prior year. In those circumstances, the debt will be considered equity as of the end of the fiscal year, and the year-end audit will reflect a stronger net worth as a result of this restructuring.

If the major debt on the balance sheet is not owed to a stockholder or other individual who is willing to convert it to equity, there still may be an option available to the franchisor to remove a portion of this debt from its liabilities. To qualify as “equity,” rather than a “liability,” the debt does not have to be converted into common stock. There are other forms of “equity,” such as preferred stock, or subordinated debt. Even an outside creditor may be willing to discuss a conversion of its debt to subordinated debt (which, from a priority standpoint, comes behind all secured and unsecured creditors, but ahead of all stockholders), or even preferred stock (which also comes behind all creditors, but can be structured to otherwise look like debt, including having a dividend, and regular, scheduled payments for “redemption” of the stock). The creditor will certainly expect something for giving up its prior, more senior position, but there may be several alternative forms of consideration available to entice a creditor to change its position. If the debt is not already personally guaranteed, the creditor may be willing to accept a personal guaranty as consideration for restructuring its debt. The creditor may also be willing to accept a pledge of collateral not previously pledged to secure the debt as consideration for moving the debt to a subordinate position. In both these cases, the creditor will be giving up a position vis-à-vis other creditors, but it may be strengthening its ultimate ability to be repaid from assets that were not originally available for repayment. In the alternative, the franchisor could compensate the creditors by increasing the interest rate on the obligation.

Each of the foregoing ideas will also help address a situation where a company has an unusually high debt to equity ratio. In each circumstance, the company will have converted debt into equity, thus more likely than not dramatically affecting its debt to equity ratio.

There is yet another possibility for increasing net worth that might be appropriate for smaller, start-up companies. There are some expenditures a company will make that it can either expense in one year, or capitalize over several years. These types of
expenditures are those that are used to acquire assets that have a useful life of more than one year, as well as costs associated with a new or “start-up” company. Typical of such expenditures are certain equipment purchases, costs related to the development of the franchise program, operations manual, marketing materials, legal fees incurred in developing a franchise agreement, research and development costs and other expenses incurred in developing a business or product. Most companies that do not need to show any specific level of profits to investors will want to keep these items as expenses, deductible in one year, for tax purposes, as that reduces the company’s taxable income, and therefore also its taxes. However, GAAP does not require treatment of these expenditures the same way as the tax laws; it may be possible to capitalize some of these expenditures. Instead of writing off the expense in one year, thus eliminating the asset from the balance sheet, the franchisor may have the option of taking the expense over several years, which means that a portion of the value of the asset will remain on the balance sheet until it has been fully amortized. For a start-up franchisor, capitalizing initial development costs, and even certain equipment, instead of expensing them can add tens of thousands of dollars to the asset side of the balance sheet.

b. Affecting Current Ratios

Another test mentioned above is the current ratio of the franchisor. Do current assets exceed current liabilities? If they do not, consider converting some current liabilities into long-term liabilities, again through action taken today that is effective as of the last day of the prior fiscal year. If there are any “due on demand” promissory notes, whether owing to insiders or to third party creditors, a renegotiation of those obligations to installment loans, payable over more than one year, will move all of the debt that is not scheduled to be repaid in the current year into long-term liabilities. The same is true for any promissory notes that have due dates within the current year. If the due date is moved to the next fiscal year (even if only a few days into the next fiscal year), the entire debt (or any portion not then required to be paid during the current year) will become a long-term liability.

7. Advertising Fees

Before completing your review of the balance sheet, if your client collects advertising fees from franchisees, look at how the franchisor has accounted for these advertising fees in its financial statements. While this issue has nothing to do with a state’s review of a client’s financial statements, the balance sheet is also the place to start in determining whether the franchisor has properly accounted for advertising contributions.

Companies do not always properly explain these fees to their auditors (and not all auditors understand what franchisors do with advertising contributions paid by the franchisees). If these fees are not kept in a separate trust account, any amounts collected should simply be recorded as part of the cash in the franchisor’s balance sheet. However, to the extent the cash collected exceeded the amount spent, the resulting amount would be carried forward for future advertising (and Item 11 of the Offering Circular should disclose this fact), but there should be a corresponding liability recorded on the balance sheet. On the other hand, if the cash expended exceeds the amount collected for advertising contributions, and the franchisor wants to ultimately repay itself from future contributions, then the asset portion of the balance sheet should show a receivable owing to the company. (It would be rare that a separate entity would
be formed for collection and disbursement of advertising funds, but if that is the case, then there should be no asset or liability recorded on the balance sheet with respect to advertising funds unless the franchisor has loaned money to, or borrowed money from, the separate entity.)

Other Parts of the Audit:

Before the audit is included in the Offering Circular, counsel should review a few other areas:

1. The Auditor’s Opinion

At the front of the audit will be a cover page, from the auditor, providing its opinion on the financial statements. As stated earlier, the letter will typically state that in the auditor’s opinion, the financial statements present fairly, in all material respects, the financial position of the franchisor as of the date of the balance sheet, and the results of its operation and cash flows for each year included in the audit, in conformity with GAAP. There are, however, situations where an auditor issues “a qualified opinion.” There are several types of qualifications, and each of them should raise red flags and should be discussed with the auditor before simply including the audit in the Offering Circular.

The most typical qualification is the “going concern qualification.” Essentially, the auditor includes in its opinion a statement that it has concerns as to whether the franchisor can continue as a “going concern.” If this statement is included in an auditor’s opinion, the franchisor should assume that if it is allowed to register its franchise, it will be required to defer or escrow initial fees. Given the “if” in the preceding sentence, it is recommended that if an initial draft of an audit shows a “going concern” qualification, counsel should discuss with the auditor and with the franchisor what steps might be taken to eliminate the qualification. If the qualification remains in the audit, counsel representing prospective franchisees should warn their clients that the outside auditors have a concern as to whether the franchisor will be in business a year from now, and franchisees should seriously consider that concern when determining whether to purchase the franchise.

Another type of qualification is one that indicates the franchisor has refused to make certain disclosures, or to follow certain accounting principles, in preparing the financial statements. Many companies that have their financial statements audited may have their accountants prepare the statements, but the fact is that audited financial statements are still the financial statements of the company, and not the financial statements of the auditor. The task of the auditor is simply to review and test the company’s procedures, and to issue its opinion as to whether those financial statements have been prepared in accordance with GAAP. There may be situations where a company has adopted accounting principles that do not meet those standards. Likewise, there may be situations where a company is not willing to make a disclosure that the auditor feels is necessary to be included in the financial statements (perhaps in the footnotes). In those circumstances, the auditor can still issue its opinion on the financial statements, and thus the financial statements will be deemed to be “audited,” but the opinion will indicate that the franchisor has refused to make certain disclosures required to comply with GAAP. If counsel sees such a statement in the auditor’s opinion letter, it is important that counsel discuss these issues with his/her client. If the client cannot be persuaded to change its position, then once again, it should be assumed that
a regulator or prospective franchisee will raise questions about the audit. (Even if regulators or prospective franchisees do not raise an issue, the Offering Circular will be defective, as the law requires that the financial statements be prepared in accordance with GAAP\textsuperscript{12}. Moreover, if the franchisor is not willing to make certain disclosures, counsel might start considering whether the client has made all necessary disclosures to its lawyer to allow the lawyer to prepare a complete Offering Circular.

2. Statement of Income

The Statement of Income details the revenues and expenses of the franchisor. GAAP permits the statement to be presented in summary form. The typical franchisor’s Statement of Income will list initial franchise fees, royalty fees, sale of products, and perhaps interest, as the only revenue categories. Expenses will typically show the costs of goods sold, general and administrative expenses, and interest paid. However, some auditors will provide a further breakdown, particularly of costs and expenses, that include rent, management salaries, travel and entertainment, and other items a franchisor may not want disclosed to the world. There is no reason such a breakdown must be included in the financial statements. There is no requirement of state law, and no requirement under GAAP that requires inclusion of such detail. More likely than not, an auditor may be trying to help its client by providing such detail as a management tool (for example, to allow for meaningful year-to-year expense comparisons). However, unless the franchisor wants the rest of the world to see this kind of detail concerning its operations, most of this detail should be collapsed into general and administrative expenses, without any breakdown. (At the end of some audits, auditors will include “Supplemental Information” that also provides extensive detail as to the revenues and expenses of the company. This information can also be very helpful to a company, but it is \textbf{not} a part of the audit and should never be included in the Offering Circular.)

HELPING FRANCHISOR CLIENTS PREPARE
ITEM 19 EARNINGS CLAIMS

The Guidelines for preparation of Item 19 of the UFOC, allow franchisors to present historic or projected revenues and expenses to prospective franchisees.\textsuperscript{13} If a franchisor elects to include this information, most often, the franchisor and its accountant will prepare drafts of this material, but franchisor counsel still needs to understand profit and loss statements to provide a meaningful review of these statements. This section of the paper does not focus on how to prepare such statements, as numerous separate programs have discussed such issues.\textsuperscript{14} Rather, we wish to point out areas of these statements that should be reviewed to confirm the statements are consistent with the rest of the Offering Circular and any agreements franchisees will be expected to sign. There are several such areas.

\textsuperscript{12} Guidelines for Preparation of the Uniform Franchise Offering Circular and Related Documents, Item 21.

\textsuperscript{13} Guidelines for Preparation of the Uniform Franchise Offering Circular and Related Documents, Item 19.

\textsuperscript{14} See, \textit{e.g.} Gilbert, Hershman, and Seidler, Earnings Claims - A Practitioner’s Approach, International Franchise Association Annual Legal Symposium, 2005; Davidson, Kolton and Modell, Effectively Structuring Earnings Disclosures: What to Disclose and How to Disclose It Without Creating Additional Liability for the Franchisor, International Franchise Association Annual Legal Symposium, 1999.
1. Item 7 of the Offering Circular discusses the range of rent that will be paid by franchisees. Is the rent projection in the earnings claim consistent with the disclosures in Item 7?

2. Item 7 of the Offering Circular contains a range of working capital expenses anticipated to be incurred in the initial phase of operation of the business. This is typically a three-month period. Assuming that is the case, if one were to multiply the range shown in Item 7 by four, will the Item 19 projected annual expenses for the business fall within that range?

3. Do the projected expenses match the obligations imposed on the franchisee in the franchise agreement? Does the amount projected for royalties represent the same percentage of sales as a franchisee is required to pay under the franchise agreement? Does the amount projected for advertising expenses match the obligations imposed on the franchisee for advertising in the franchise agreement (both for national advertising contributions and for local or co-op advertising expenditures)? Are there other expenses specifically imposed on the franchisee under the terms of the franchise agreement or other agreements, such as software licenses, or equipment rental agreements, which are not included in the earnings claim. (If the earnings claim is based on actual earnings, it is possible the amounts spent by the businesses being disclosed are different than provided for under the current agreements, but the franchisor should footnote these differences to avoid misleading prospective franchisees.)

This list is certainly not intended to be exhaustive. Rather, it is provided to make the point that even when counsel receives earnings claims for inclusion in the Offering Circular, counsel needs to understand the statements and test them against his knowledge of GAAP, and the remaining terms of the Offering Circular.

BUYING AND SELLING BUSINESSES

Up to this point, this paper has focused on financial issues that are unique to franchising. However, transaction lawyers who represent franchisors and franchisees also have a need to be able to read and understand financial statements, as well as the underlying financial terms and concepts, when representing clients looking to purchase or sell a business. This is true whether one represents a franchisee looking to sell his/her business, a franchisor looking to buy one of its franchisee’s businesses, a franchisor looking to buy a competitor, or even a franchisor looking to sell its franchise system.

Larger “M&A” transactions will involve accountants and investment bankers who will no doubt assist the client in valuing the target business, whether they represent the buyer or the seller. In smaller transactions, the attorney may be the client’s only advisor, at least in the initial stages of negotiations. In those cases, it is helpful to understand the way businesses are valued.

Adjusted EBITDA

The most common way of valuing a business is on the earnings value of business. Buyers are acquiring an income stream, and will pay a price for the business based on the value of that income stream. This information can generally be gleaned
from the Statement of Income. However, there is cash flow information shown in lines identified as “net sales,” “gross profit,” and “net income.” How does one determine income stream for the business?

Most often, the key number in determining the earnings value of the business is “adjusted EBITDA.” EBITDA is an acronym for Earnings Before Interest, Taxes, Depreciation, and Amortization. As the name suggests, EBITDA represents earnings excluding expenses from depreciation, amortization, interest and taxes, in the order they usually appear on the income statement. EBITDA can be used to analyze and compare profitability between companies because it eliminates the effects of financing and accounting decisions. Because EBITDA is an earnings measure before interest and taxes, it approximates a company’s earning potential if financed with no debt.

To determine EBITDA, look first at the Statement of Income to determine the net income before taxes. Next, looking again at the Statement of Income, add back all expenses that were deducted for interest, depreciation and amortization in calculating the net profit. Finally, since all interest needs to be ignored in arriving at EBITDA, look at the revenue portion of the Statement of Income, and deduct any interest that was included in revenues. The result is the “EBITDA” of the business.\textsuperscript{15}

Once “EBITDA” is determined, there will be adjustments required to EBITDA in order to give a buyer a true picture of the true cash flow it can expect to aggregate from operating the business. Some of these are “buyer” adjustment, and some are “seller” adjustments.

Beginning with seller’s adjustments, most sellers, particularly small business owners, will operate the business in a manner designed not to maximize earnings, but to minimize earnings and thereby minimize taxes. It is therefore appropriate to adjust EBITDA by adding back into earnings any “excess compensation” or “excess expenses,” taken by the owners. While the seller may want to add back all salaries paid to the owners of the business, and their families, as well as all “perks,” benefits, travel and entertainment expenses, the real question that needs to be asked is how much of the salaries and expenses paid to the owners and their family would have to be paid to others to perform similar functions in the future. Only the excess salaries and expenses paid to or on behalf of the owners and their families should be considered adjustments to EBITDA, and added to the income of the business. (In some cases, when the owners of the business have taken very little in salary, perhaps to try to increase EBITDA in preparation for a sale, this adjustment might actually be a negative adjustment, as additional costs would have to be paid to outsiders to perform the same duties.)

To the extent the business incurred any extraordinary, or one-time expenses, these expenses should also be eliminated in determining adjusted EBITDA. Thus, for example, if the business had recently been subject to litigation, or other extraordinary expense (perhaps even investment banker or consulting expenses preparing the business for sale), these expenses should also be eliminated in determining adjusted EBITDA.

\textsuperscript{15} For companies with audited financial statements, there will also be a Statement of Cash Flows, which will have a line entitled “Net Cash Provided by Operating Activities.” This line is essentially the EBITDA of the business.
Other typical adjustments are downward adjustments, or “buyer adjustments.” To the extent the business had any significant revenues that are not recurring, such as perhaps from a franchisor’s one-time sale of a foreign master franchise, these revenues need to be eliminated (net of any corresponding expenses) in determining adjusted EBITDA.

**Multiplying EBITDA**

The less “scientific” factor in valuing a business is determining the appropriate multiple of EBITDA a person would pay for a business. It is far beyond the scope of this paper to suggest appropriate multiples, but counsel should understand that when a business is valued based on EBITDA, a buyer will pay some multiple of EBITDA. To understand this concept, consider a simple transaction. Assume a company’s adjusted EBITDA was $100,000. Assume also that a buyer financed the transaction (as unrealistic as this may be) paying interest-only, at 10% per annum and that the buyer expected the business would produce the same EBITDA in the future. (Assume also that there are no individual assets of the business that have separate value, a concept that will be discussed later in this section.) If a buyer paid $1 million for that business, or ten times adjusted EBITDA, the interest that would be paid on its loan would equal the interest payments, leaving nothing left for any risk the buyer was taking. Clearly, no buyer would pay ten times adjusted EBITDA for this business, using this financing arrangement.

Notwithstanding the foregoing, businesses are sometimes sold at multiples that exceed 10 or even 15 times adjusted EBITDA. In those circumstances, the buyer might be looking at adjusted EBITDA that had been rapidly increasing from year to year, thus suggesting that earnings will continue to increase rapidly in the future, so that increases in future EBITDA will allow the buyer to pay its financing costs and also receive a return on its investment. This can also happen when the buyer is a “strategic buyer,” who already has a business that will either benefit from acquiring this business (such as a company purchasing the business of its supplier), or will have an ability to merge systems, merge personnel, and otherwise reduce costs. In these instances, the same level of revenues generated by the seller in the past will produce a larger future EBITDA that will be sufficient to pay the financing costs for acquisition of the business and produce a return on the buyer’s investment. If, for example, this buyer can produce 5% greater EBITDA than the seller produced on similar revenues, payment, for example, of nine times the seller’s EBITDA translates into only six times the buyer’s EBITDA.

The foregoing is not to suggest that most businesses, particularly small businesses, will sell for 10 or 15 times earnings -- they will not. Another example will demonstrate the reason. Assume the same business discussed above, but the buyer is purchasing the business for cash, using money that has been invested in the stock market. Assume also that this buyer has enjoyed an average, 8% return on his investment in prior years. Before a buyer trades this "passive" investment for one that will require much more time and energy, the buyer would expect to increase his/her return to 15%, 20%, or more. Thus, this buyer would be hard pressed to pay more than 5 to 7 times EBITDA for the business.

In determining the appropriate multiplier, a buyer needs to take into account the direction of a company’s revenues, the direction of its expenses, and any extra efficiencies or profits the buyer might earn by bringing in a management team. Suffice it
to say, the greater the EBITDA the buyer believes it can generate from the business, the higher the multiple it will pay to purchase the business. Conversely, a person seeking to sell a business that has seen EBITDA deteriorate from year to year, or where EBITDA has been very unpredictable for future earnings, will be hard pressed to sell the business for a significant multiple of the prior year’s adjusted EBITDA. For all these reasons, buyers will look not only at EBITDA for the last twelve months, but perhaps for several years, and even projected future EBITDA.

Additional Considerations

Even when businesses are valued on the basis of a multiple of adjusted EBITDA, there will frequently be further adjustments to this number. A seller might ask that in addition to purchasing the cash flow of the business, the buyer should pay for the assets on the balance sheet. To the extent those assets are needed to produce the cash flow already being purchased, it would not be appropriate for a buyer to pay separately for these assets. On the other hand, if there are assets in the business that are not producing income, such as significant cash, investments, or real estate, the value of these assets will typically represent an increase in purchase price. Likewise, if the business has significant liabilities that a buyer must assume (including any loans against the business or contingencies caused by past improprieties in the operation of the business), these liabilities will result in downward adjustments to the purchase price.

One question typically asked is whether there should be adjustments for inventory or accounts receivable. To the extent the buyer assumes any payables of the business, those payables should certainly offset any proposed adjustments for inventory or accounts receivable. Moreover, as indicated above, any of the assets that are needed to operate the business, and produce the expected cash flow, should not require extra payment. Most buyers therefore will expect not to pay anything extra for these assets. On the other hand, to the extent there is excess inventory (perhaps because of the seasonality of the business), or excess accounts receivable, the value of these assets should represent an increase in the purchase price of the business. More often than not, buyers and sellers will negotiate an appropriate “net current asset” figure for a closing balance sheet (the net amount of current assets the buyer expects to receive above current liabilities assumed), and the buyer will pay additional amounts to the extent the net assets are higher than negotiated (or a lower amount to the extent that net assets are lower than agreed).

Finally, one cannot overemphasize the need to work from financial statements prepared in accordance with GAAP, consistently applied, when trying to value a business. This is not always easy when dealing with a small business that does not have audited financial statements. However, it is the use of GAAP that assures revenues are matched to expenses (and vice versa). Otherwise, it would be easy to skew EBITDA by including, for example, 13 months of revenue in the Statement of Operations, or by deferring the recognition of expenses.

A Final Look at the Financial Statements

Understanding the financial statements can also be helpful to buyers and sellers of a business in negotiating a purchase agreement. At this point, you should have a general appreciation of how to read a financial statement, and areas on which to focus in assuring the financial statements give an accurate picture of business. Some additional
areas should be self-evident in terms of their affect on the purchase agreement (and perhaps even the valuation of the business):

1. Is a large percentage of purchases from one vendor, or a large percentage of sales to one customer? (This information will typically be documented in footnotes to the audited financial statements.) If that is the case, the purchase agreement will need to include significant warranties concerning these purchasers and suppliers (and/or a discounted purchase price to reflect the risk of losing this supplier or customer).

2. The notes to the financial statements will typically show significant transactions with affiliates. Typical among such transactions will be the lease of real estate or other property. Particular attention will need to be paid to the terms of such leases to confirm they are reasonable to the company being purchased, and do not have escalators that will take effect upon sale. To the extent these transactions have been beneficial, the purchase agreement should provide some assurances they will continue in the future. (In the alternative, the purchase agreement might provide a mechanism for adjustments, even an “earn out,” depending on the future of such transactions.)

3. Does the business have liabilities that will carry forward to the purchaser, particularly liabilities that may not be recorded on the financial statements? In the franchise context, a purchaser of a franchisor needs to understand any liability for advertising contributions previously collected. However, the footnotes may also indicate other potential, contingent liabilities that should be addressed in the purchase agreement.

4. Have there been prepayments that will affect future income? For example, has a supplier made prepayments to a company in order to lock that company into the supplier for years in the future? In the case of a franchise company, have franchisees “bought down” or prepaid royalties?

5. Are there any unusual accounting procedures identified either in the auditor’s opinion or in the footnotes to financial statements? These accounting procedures could have a significant effect on adjustments needed to EBITDA.

6. If there are significant accounts receivable, how do you account for the possibility that some of these accounts receivable may not be collected?

7. Audited financial statements show comparisons from year to year. These comparisons can be very helpful in determining unusual patterns, or even significant changes that may affect the future of the business. For example, assume that EBITDA has increased 10% a year for each of the last two years. One would expect that most line items would have likewise increased in the vicinity of 10% over each of those years. However, if, for example, revenues are down 20% over that period, at best, a buyer should discount the improved EBITDA, and at worst, be concerned whether there has been a serious reduction in services that will have a detrimental long-term effect on the business. The year-to-year numbers should be questioned, and the answers perhaps even included in the representations in the purchase agreement.
Every business will have its own unique financial issues, some of which may be apparent from reviewing the financial statements, and others of which may only be apparent to someone who understands what might be missing from the financial statements. It is, therefore, important that counsel advising a client in selling a business, or in particular, buying a business, needs to either retain an accountant to assist with these issues, or have a thorough understanding of how to read financial statements and how to identify these issues (or both).
DEIRDRE A. FLAHERTY

Deirdre Flaherty is a partner in the Boston office of StoneTurn Group. She specializes in forensic accounting investigations. Deirdre is a certified public accountant and has been providing financial consulting advice to clients for over ten years. She has been involved in a variety of investigations working on behalf of Special Committees formed by the Board of Directors, named directors and officers and/or senior management. These investigations have included analysis of various SEC reporting matters including revenue recognition matters (for software companies under SOP 91-1 and SOP 97-2 as well as various manufacturers, distributors and retailers), the accounting for promotional marketing allowances, the adequacy of various reserves, market timing and late trading matters, inventory manipulations and various other issues revolving around the interpretation and application of generally accepted accounting principles. In addition, Deirdre has participated in a variety of other matters including purchase price disputes, the investigation of collateral borrowing base irregularities, the investigation of employee improprieties and/or defalcations and various analyses pertaining to breach of contract disputes.

Deirdre has participated in audits of companies in a variety of industries including high-tech manufacturing, real estate, distribution entities and service entities. Additionally, she has spent significant time working on behalf of the National Office of Deloitte & Touche LLP to incorporate forensic accounting methodologies into the audit approach in response to SAS 99 and the Sarbanes-Oxley Act. Deirdre has also participated in several engagements to evaluate and enhance the internal control structure of entities in light of the new requirements under section 404 of the Sarbanes-Oxley Act.
Charles S. Modell

Mr. Modell is the founder and chairman of the franchise practice group of Larkin Hoffman Daly & Lindgren Ltd., Minneapolis, Minnesota. He has been an active and highly respected member of the franchise legal community for nearly three decades. Mr. Modell’s practice consists primarily of representing franchisors concerning the business aspects of franchising, including the structuring of the franchise relationship; drafting franchise agreements and Offering Circulars; compliance with state and federal franchise laws and regulations; negotiations with franchisees; terminations and non-renewals; and the purchase and sale of franchise companies.

Mr. Modell’s clients rely on him as much for his business and financial acumen as for his knowledge of the law, and look to him for business advice as they make decisions in their own businesses. Mr. Modell is the only practicing attorney in the Midwest to have received the designation of Certified Franchise Executive from the International Franchise Association. He has served on the Larkin Hoffman Board of Directors for more than ten years, and was previously the firm’s Chief Financial Officer.

Mr. Modell is also active in the national franchise community. He is a member of the Governing Committee of the American Bar Association’s Forum on Franchising, and serves as the Forum’s Finance Officer. He has also been active in the IFA for more than two decades, having served on the Legal/Legislative Committee, the Franchise Relations Committee, and the Board of the Council of Franchise Suppliers. He is a certified commercial arbitrator for the American Arbitration Association, and is listed in the International Who’s Who of Franchise Lawyers.

Mr. Modell received a Bachelor of Science degree from the University of Florida in 1974. He graduated with high honors from the University of Florida College of Law in 1977, and served as Managing Editor of the Florida Law Review.