What Appraisers Learn from Your Financials

The purpose of a valuation is to determine what financial benefits an owner can expect from a business. The best tool to predict the future is past performance. Appraisers gather information from dealership financials and operational reports, as well as what is happening outside the dealership that affects its operations, to determine its ability to produce revenues into the future.

Balance Sheets: The Balance Sheet answers questions such as: Is there enough cash to pay short term liabilities? Are overall assets larger than liabilities? The Balance Sheet also provides information to calculate several financial ratios. Ratios tell how well a dealership is performing based on the relationships between two metrics. The amount of debt is not as important as the amount of debt RELATIVE to income and assets. Ratios enable us to assess the financial health of a dealership, as well as compare it to other dealerships.

Income Statements: How much income does this business generate and how much could be expected in the future? Valuation analysts look at gross sales volume, expenses, net income, and financial ratios. We compare an individual dealership's performance and trends to the industry norms and economic indicators. For instance, appraisers compare sales trends with other dealerships in the industry and compare the change in sales with the local, state and national economic trends.

Cash Flow Statements: A Cash Flow Statement is as simple as it sounds – it tracks cash as it comes in and goes out. It will differ from the Income Statement for dealerships that are on an accrual basis. In accrual accounting, a sale or recorded income does not mean that cash came in at the same time and a booked expense does not mean that cash went out at that moment. Along with the other statements, the Cash Flow Statement helps us understand how the dealership makes financial and capital decisions. It is important to understand how a dealership operates relative to its peers and analyze how that affects the riskiness of its revenue stream in order to complete a reliable valuation.

Tax Returns: Tax returns help verify information provided in other reports. Schedules (such as depreciation) provide detail not contained in the financial statements. Since these schedules are already prepared and included in tax returns, it is often easier for dealers to provide the dealership tax returns rather than pulling additional reports.

Manufacturer Reports: Original Equipment Manufacturer reports help complete the picture. OEM's subscribe to competitive industry data and provide the dealer with detailed market reports that provide critical information on competition and the overall market. Many OEM reports rank a dealership's performance relative to dealerships representing the same manufacturers. A higher ranking can help drive dealership value higher.

Internal Sales & Operational Reports: Internal dealership reports help valuation analysts understand the internal procedures and systems working in the dealership. The amount, quality and consistency of internal reports is very important. Risk is

quantified by volatility. Strong procedures that are consistently implemented and tracked should reduce volatility, which reduces risk, which helps increase value.

Corporate documents: Appraisers must verify who owns the company and the rights of each owner. There may be a majority owner and a minority owner with only one having the rights to perform certain actions such as selling the company. An appraiser verifies the legal status of the company to value the business in accordance with its legal and tax structure.

Management projections: As good as valuation analysts can be, dealership owners and managers know their businesses best. Management projections provide an basis for predicting future performance when they have been produced and tracked on a regular basis.

Audited vs. Reviewed vs. Internal Statements: The difference is simply the level of assurance provided by an outside accounting firm that the dealership financial statements are accurate and comply with accounting standards. Audited financial statements are the most reliable of the three, because an accounting firm examined the financials enough to provide a reasonable level of assurance. Reviewed statements provide less assurance and internal statements have not been reviewed by an outside accounting firm to provide any assurances. Appraisers prefer audited financial statements but will attempt to work with what the dealership has available. If the appraiser has questions about the reliability of the financials, the appraiser may have to delay the appraisal assignment until reliable financial statements can be provided.

Real Estate: A business appraisal is separate from a commercial real estate appraisal. Real Estate information is necessary to determine if a dealership's occupancy expenses such as rent or mortgage, are in line with commercial market rates. The information also allows a valuation analyst to compare the type and size of dealership facilities with industry norms.

Leases and other financial obligations: Leases can have an impact on the overall value of the dealership. A copier lease may not be significant, but if a dealership leases most of its major equipment, the appraiser may require some normalizing adjustments in order to compare with dealerships that own all of their equipment.

Pending events: The business owner may have information on pending legal action, assessments due, or obligations that could affect the business. Pending events could also include growth happening nearby, such as retail developments or freeway construction, that will increase or inhibit traffic. Appraisers need to know this kind of information as it could affect the future revenue streams.

How many years? There is no set requirement for the number of years of financials required. Appraisers need data for enough years to understand your dealership, its performance over time and how your business is trending relative to the industry and economy. Five years is typically enough to provide valid comparisons.

Perquisites: There are many benefits to owning a business that are not accounted for on financial statements. These will vary from one person to another, which is why an appraisal report must state the definition of value used. An appraiser

determining fair market value is tasked with determining the value for a hypothetical willing buyer and hypothetical willing seller, basically an average market situation. If a specific buyer has unique circumstances that would influence the value to them for an acquisition, their definition of value would not be fair market value, but investment value for a specific investor.

To summarize, an appraiser must have a strong understanding of standard dealership operational procedures and financial metrics. Analyzing the statements and information mentioned in this paper allows the appraiser to assess the subject dealership and determine how it varies from standards or norms. For some of those differences, it is appropriate to adjust the financials to normalize them. For other differences, appraisers may work to determine how much each variance increases or decreases risk in order to adjust the capitalization rate accordingly. Appraisers conduct an analysis that enables them to apply the suitable capitalization rate to the appropriate revenue stream to determine a substantiated value of the dealership.

If you have any questions about this report or about dealership appraisals, please contact Laura for a free, confidential consultation.

Laura@DealershipValuations.com www.DealershipValuations.com (303) 994-6919