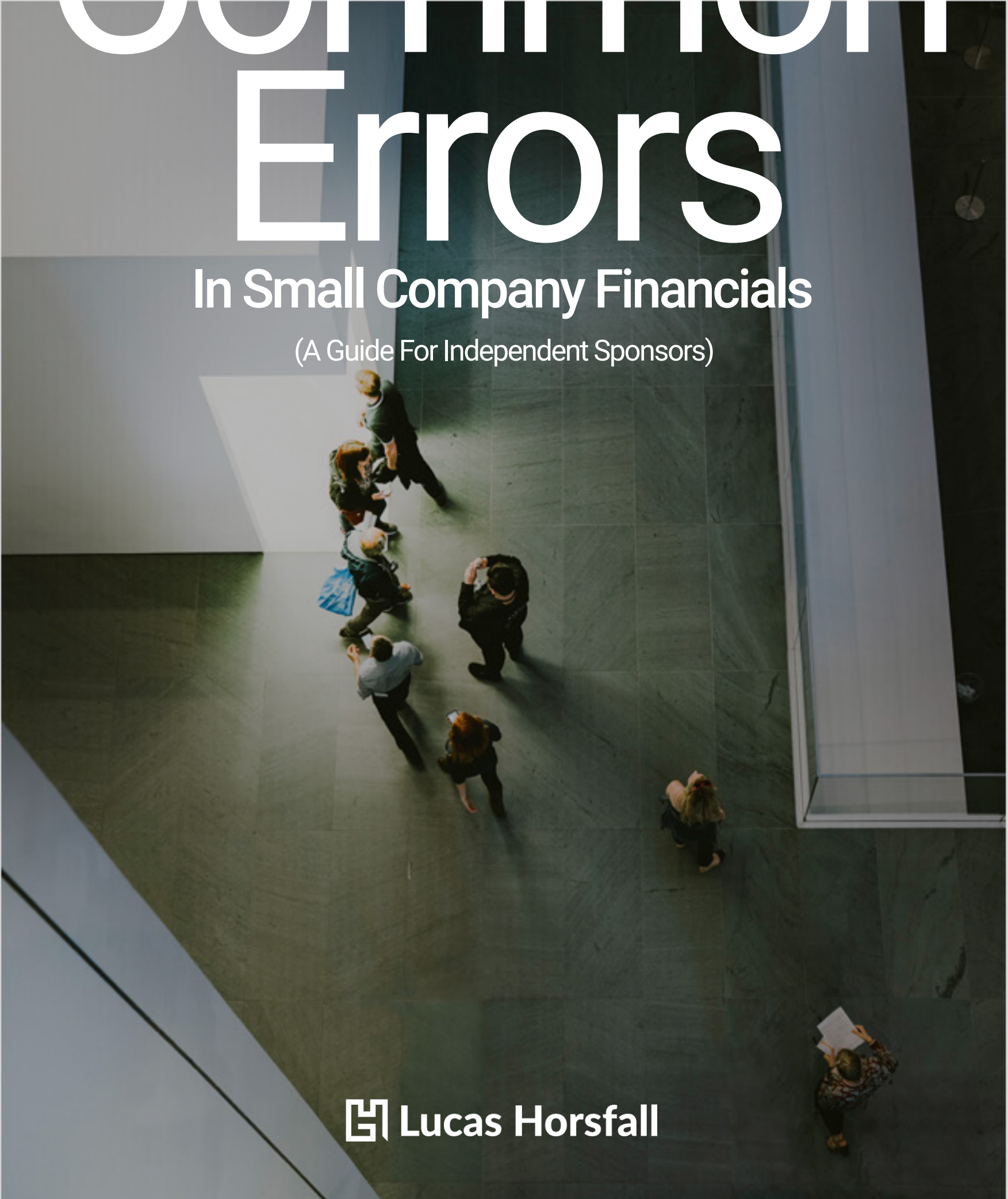



# Common Errors

In Small Company Financials

(A Guide For Independent Sponsors)



 Lucas Horsfall

# Overview

Evaluating financials ahead of a small business acquisition can be deceptively challenging. Small businesses often lack the rigorous processes and controls of larger companies, opening the door to a host of mistakes and misrepresentations that can significantly obscure the reality of the company's profitability and health.

Knowing which mistakes to look out for is an important part of making a sound evaluation. This guide briefly outlines some of the most common errors and misrepresentations that independent sponsors must be aware of when evaluating a small company.



# Part I: The Most Common Errors

## Inaccurate Revenue Recognition

Significant changes have been made to revenue recognition under GAAP in recent years. Small companies sometimes struggle with recognizing revenue at the correct time. This can stem from a lack of understanding of accounting standards or an intent to make the financials appear more robust than they are. Overstated revenue can inflate the perceived value of the business, while understated revenue can hide its true potential.

### What to Watch For:

- Revenue is recorded without the corresponding delivery of goods or services.
- Inconsistent revenue recognition methods.
- Unusual spikes in revenue over a period of time.
- Inconsistent gross margins.



# Misclassified Expenses

Misclassifying expenses or recording them in the wrong periods (both common errors) can lead to distorted profit margins and operational efficiency metrics. This can create a dangerously misleading image of the company's efficiency and profitability.

## What to Watch For:

- Capital expenses are recorded as operating expenses or vice versa.
- Cost of goods sold items classified under general administrative expenses.
- Inconsistencies in expense categorization over time.
- Ballooning of expenses close to or after year-end.
- Swings in expenses over comparable periods.

# Improper Inventory Valuation

Small businesses may use improper methods to value inventory, either by accident or to manipulate financial outcomes. The result is skewed financial ratios and profitability analysis.

## What to Watch For:

- Significant variances in inventory turnover rates.
- Inconsistencies between physical inventory counts and inventory records.
- Obsolete or slow-moving inventory is not appropriately written down.
- Missing work in process for a manufacturing business.
- No overhead allocation into inventory.



## Inaccurate Accounts Receivable

Errors in accounts receivable often occur when a business records revenue without a realistic assessment of whether the payment will be collected. This can be hard to spot at first glance if you have limited knowledge of the payors involved, but it's essential for an accurate view of liquidity and profitability.

### What to Watch For:

- High accounts receivable balances relative to sales.
- Aging receivables are not adequately provisioned for bad debts.
- Discrepancies between accounts receivable and cash flow from operations.
- Slow accounts receivable turns.

## Unreliable Cash Flow Statements

Misleading cash flow statements may obscure liquidity issues. This could result in having to take out unanticipated financing to sustain operations in the future.

### What to Watch For:

- Cash flows from operations that don't align with net income.
- Significant discrepancies between reported cash flows and bank statements.
- Large and unexplained variances in cash flow from one period to the next.

## Inconsistent Use of Accounting Methods

Small businesses sometimes switch between accounting methods (e.g., cash vs. accrual) without clear rationale or consistency. This can lead to confusion, inaccuracies, and erratic financial statements, obscuring the company's actual performance and trends over time.

### What to Watch For:

- Changes in accounting methods without clear disclosure or justification.
- Inconsistent application of accounting policies from year to year.
- Financials that don't comply with generally accepted accounting principles (GAAP).



## Underreporting of Liabilities

A small business may underreport liabilities to present a stronger balance sheet, either through oversight or intentional omission. This can lead to overstated EBITDA, equity, and distorted financial ratios, potentially hiding financial obligations that could impact future cash flows and profitability.

### What to Watch For:

- Off-balance sheet financing or unrecorded contingent liabilities.
- Significant and unexplained variances between accounts payable and purchase records.
- Discrepancies in loan agreements or other contractual obligations.
- Loans from multiple banks.

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## Errors in Tax Accounting

Small companies might make mistakes in their tax accounting. It is not uncommon for owners to deduct non-business expenses or manipulate inventory levels to reduce tax liabilities. In the event of a stock transaction, these tax positions can become a liability for the buyer.

### What to Watch For:

- Significant and unexplained difference between book and tax income.
- Disproportionate distributions to shareholders.
- Lack of filings in required jurisdictions.

## Part II:

# Lesser Known Errors That Can Create Problems

The preceding section covers the errors that are most commonly encountered, and a thorough analysis of financial records are likely to uncover most if not all of them. However, there are some lesser known mistakes and misrepresentations that can be harder to spot, but also have the potential to significantly distort the picture of a company's financial health. Here are several of these "under the radar" errors.

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## Improper Treatment of Intangible Assets

Intangible assets are notoriously difficult to value, and small businesses may incorrectly value or amortize things like patents, trademarks, or goodwill.

### What to Watch For:

- Intangible assets are not regularly revalued or amortized.
- Lack of documentation supporting the value of intangible assets.
- Discrepancies between the value of intangible assets and the company's performance.
- Goodwill arises out of acquisition accounting. This is to be questioned, always.
- Other intangibles could be hiding expenses that do not qualify to be capitalized.

## Misreporting of Deferred Revenue

Intangible assets are notoriously difficult to value, and small businesses may incorrectly value or amortize things like patents, trademarks, or goodwill.

### What to Watch For:

- Large swings in revenue.
- Inconsistent treatment of advance payments.
- Unpredictable gross margins resulting from a timing difference between revenue and expense recognition.

## Inaccurate Cost Allocations

Costs that should be allocated to specific projects, departments, or products are sometimes spread evenly across the business. This can lead to inaccurate costing and profitability analysis for individual segments of the business, impacting decision-making.

### What to Watch For:

- Indirect costs incorrectly allocated to direct costs.
- Inconsistent cost allocation methods.
- Projects or departments with inexplicable cost patterns.

## Failure to Accrue for Future Expenses

Small businesses might not accrue for expenses that are anticipated but not yet incurred, such as bonuses, repairs, or legal fees. This can understate liabilities and expenses, overstate net income, and set the stage for acute cash flow issues.

### What to Watch For:

- Significant upcoming expenses not reflected in the current financials.
- Large variances in expense recognition timing.
- Lack of accruals for known future obligations.



# Errors in Foreign Currency Transactions

For businesses involved in international trade, inaccuracies in recording foreign currency transactions can occur. Exchange rate fluctuations can significantly impact financial results if not properly accounted for, leading to misstatements in revenue, expenses, and net income.

## What to Watch For:

- Inconsistent exchange rates used for transactions.
- Lack of hedging strategies for foreign currency risk.
- Significant unrealized foreign exchange gains or losses.

# Unrecorded Contingent Liabilities

Contingent liabilities, such as potential legal settlements or warranty obligations, might not be recorded. These hidden liabilities can become significant future expenses.

## What to Watch For:

- Legal issues or potential settlements not disclosed.
- Warranty claims or product returns are not adequately provisioned.
- Significant contingent liabilities are mentioned in the notes but are not reflected in the financials.

# Inadequate Disclosure of Related-Party Transactions

Transactions with related parties (e.g., owners, family members, or other businesses owned by the same owners) might not be properly disclosed or documented. These transactions can distort financial statements and hide potential conflicts of interest or unfair advantages.

## What to Watch For:

- Significant transactions with entities or individuals closely related to the business.
- Unusual terms or conditions in related-party transactions.
- Lack of transparency or documentation for related-party dealings.

# Who Do You Have on Your Side?

Accurately evaluating small business financials requires a very broad knowledge base in accounting, tax, and general financial practices. Given the stakes in M&A transactions, it pays to have a team of specialists to help you make sure you're making the right decision.

The accounting team at Lucas Horsfall has extensive experience in M&A financial analysis. When you work with us, you'll have the peace of mind that comes from knowing your valuation is spot on, so you can move forward decisively.

**Contact us today** to discuss how we can help you.