# VIEWPOINT ON VALUE


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# Finding hidden assets and unreported income

The business valuation and forensic accounting disciplines often intersect when valuing a business for divorce or shareholder disputes. Controlling shareholders may, for example, try to hide assets or downplay cash flow to minimize buyouts of their spouses or minority shareholders. Valuation experts are on the lookout for these situations and know how to unearth and adjust for financial misstatement.

## Look beyond the financials

Financial statements and tax returns are important sources of information when valuing a business. But it's also important to look for public sources of information, as well as to conduct site visits and management interviews. These steps can be especially important in adversarial situations to ensure that controlling shareholders aren't hiding assets, underreporting income, or overstating liabilities and expenses.

Nowadays, Internet and social media searches can help reveal financial misstatement. Take this example: A valuation expert discovers that her client's spouse had secretly set up a separate corporation to expand his business into a neighboring town. How is this scam revealed?

The valuation expert follows the company on social media for about a month, shortly after she's been assigned to the case. When the company posts an invitation to the grand opening of a new facility on Facebook, along with a promotional coupon, the expert calls her client, who is shocked by the news.

Further investigation reveals that the controlling shareholder has run more than $25,000 in start-up expenses for the new location through his old business, which is part of his marital estate. To make matters worse, the old corporation has purchased equipment for the new location, taken on additional debt and then leased the equipment to the new business at below-market rates. In short, the controlling shareholder is draining resources from the old business to benefit the new business his spouse was unaware of.

## Involve experts early on

Patience and diligence are key elements to unearthing hidden assets and income. So, it's critical to involve a financial expert during the discovery phase of the case. Even if a divorce or shareholder dispute starts out amicably, the situation can quickly change as the details of the case unfold and the parties see how much money is at stake.

Early on, the expert can provide a comprehensive list of documents to request. In addition, it's often helpful for minority shareholders and spouses that don't control the business to obtain a court order, allowing their experts to tour the facilities and interview management. If an expert is hired late in the case, he or she may be denied physical access to these resources.

## Understand the warning signs

Controlling shareholders aren't always dishonest. But experienced valuation experts know the warning signs that something's awry. During site visit and management interviews, experts consider a variety of factors. This includes asking certain key questions:

- Do company personnel seem uncooperative or reluctant to answer questions?
- Does the interviewee seem agitated or nervous — for example, sweating profusely or avoiding eye contact?
- Do members of the management team provide conflicting answers?
- Does an answer to a question contradict the interviewee's previous responses or what's reported on the financial statements?
- Was the valuation expert denied access to certain parts of the facilities?

In addition to these qualitative factors, valuation experts evaluate quantitative signals of impropriety. Benchmarking performance over time and against competitors, which is a standard part of the valuation process, can also help identify hidden items. To illustrate, if profit margins have deteriorated since a lawsuit was filed or are below industry norms, the change could suggest that revenues are understated or expenses are overstated.

Experts also look for new line items that appear on the financial statements after the lawsuit is filed. Examples include loans, contingent liabilities, management fees, rent or lease expense paid to related parties, phantom employees on the payroll, and excessive professional fees, which may include the controlling shareholder's personal legal fees.

## Consider unreported assets and liabilities

A company's balance sheet tells only part of the story about a company's financial condition. There may be other assets and liabilities that aren't reported, such as pending litigation or regulatory inquiries, warranties, bad debts and built-in capital gains tax obligations.

These items may not necessarily be hidden because management is intentionally misrepresenting the truth. In some instances, they're not required to be reported under U.S. Generally Accepted Accounting Principles (GAAP) — or a private company's financial statements may not conform to GAAP.

Although unreported, these items can impact future cash flows and, therefore, the value of a business interest. If investors would consider a hidden item, it should generally be factored into a valuation expert's analysis.

Financial statement footnotes and management interviews can help reveal these hidden items. Additionally, valuation experts who specialize in a niche tend to be familiar with what other industry participants report on their balance sheets, helping them to identify possible omissions.

## Expand the assignment

Valuation experts employ professional skepticism, but they're *not* responsible for unearthing fraud unless a client specifically hires them to conduct a forensic investigation. In cases where the controlling shareholder has a financial incentive to hide assets or downplay cash flow, consider expanding the scope of the engagement from the get-go to include additional forensic procedures. ■

# Beyond beta

## Assessing industry risk is a critical part of the valuation process

Valuation professionals typically factor industry risk into the cost of capital, using a "beta" or other industry-specific risk premium. But industry risk isn't something you factor in once and then forget about. It's something the pros consider *throughout* the valuation process — and its relevance even extends *beyond* the income approach. Here are some questions your expert considers when evaluating industry risk.

### What's the correct industry?

Simply put, an "industry" is a group of people or companies engaged in a particular kind of commercial enterprise. Industries are broadly defined, for example, as retail, manufacturing, hospitality or agriculture. Then they're subdivided into more discrete categories, such as fast food establishments, pizzerias and full-service restaurants.

When considering industry risks, the first step is to identify the products and services the subject company produces. Then the expert defines the industry (or industries) the business operates in. For a complete list of industry codes for North America, visit the North American Industry Classification System codes and titles at naics.com.

Defining a company's industry can be critical when benchmarking performance or selecting comparable transactions to use under the market approach. This information can also be helpful when forecasting future cash flow, including, for example, any adjustments for accounting methods that differ from industry norms.

Keep in mind, though, that some businesses are generalists while others serve a narrow market niche. If you're valuing a management consulting firm, for instance, it might provide a full menu of financial services, such as tax, audit, financial advising and employee benefits consulting. Alternatively, it might be a boutique firm that specializes solely in preparing tax returns. Direct comparisons between these two professional services providers may not be meaningful.

### What's the state of the industry?

Like products, industries go through a life cycle: start-up, growth, maturity and decline. Experts evaluate historic performance to see where a company's industry falls along this continuum.

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Pinpointing the industry's life cycle phase helps gauge where the company is headed and helps identify potential threats and opportunities. It can even impact the company's future capital structure. An industry in the growth phase, for instance, faces rising demand for products and services, which may cause a subject company that participates in the industry to take on debt to fund growth. Conversely, a mature industry might mean that the subject company is a "cash cow" that can afford to pay down debt, thereby increasing the percentage of equity in its capital structure.

A surface-level understanding of how the industry works won't suffice. Valuation experts who make broad-sweeping conclusions based on generic market trends are likely to under- or over-value the business. For example, companies that operate in a declining market can still grow. In fact, some even gain market share as competitors go out of business.

### Who's participating?

It's also important to research companies that sell similar products and services. Are there any new competitors on the horizon? Often valuators try to understand competitors' products, pricing, reputation, financial position, channels of distribution, technology, market share and business models. Then they assess how the subject company measures up in terms of its strengths and weaknesses.

From there, valuators assess how the business competes within its industry. Price is vital for commodity or retail sales, but delivery, quality and reliability might be more relevant criteria for manufacturers or contractors. Alternatively, emerging competitors might steal market share due to technological advantages, cheaper prices or more efficient distribution models.

Valuators also look up and down the supply chain to gauge the relative power of suppliers and customers. Businesses with few partners may possess concentration risks. If a major supplier or customer discontinues its relationship with the subject company or merges with


another company, it could interrupt normal business operations significantly.

### A team effort

An industry with a bright outlook could well enhance the value of a subject company — conversely, a declining industry could also impair a company's value. By working with clients and attorneys, valuation experts can select the correct industry and assess how industry risk affects value. Accurate valuations hinge on taking the time to thoroughly understand the subject industry and where the subject company fits within that group. ■

# Deal price doesn't always represent fair value

Many states have enacted laws that grant dissenting minority shareholders the right to receive "fair value" for their shares. Appraisal rights provisions protect investors — who may not be "willing" sellers — from being shortchanged in minority shareholder squeeze-outs, going-private transactions and leveraged buyouts, especially when a deal involves related parties.

A fundamental question in appraisal rights litigation is: Does the price paid in the transaction represent "fair value"? A recent Delaware Court of Chancery case — *Dunmire v. Farmers & Merchants Bancorp of Western Pennsylvania* — provides guidance on the use of merger price and other valuation methods in shareholder buyouts.

### Background

In 2014, Farmers & Merchants Bancorp of Western Pennsylvania (F&M) merged into NexTier. Prior to the merger, both parties were community banks located in Pennsylvania that were controlled by members of the same family. The stock-for-stock merger took place at a 2.17 exchange ratio that implicitly valued F&M at $83 per share and NexTier at $180 per share. The transaction price wasn't the result of a "robust sale process." In fact, no other bids for F&M were solicited.

Minority shareholders in F&M filed an appraisal rights claim, contending that their interests were worth $137.97 per share, approximately 66% above the deal price. F&M's expert estimated that the fair value was $76.45 per share, almost 8% below the deal price.

## Court opinion

Under Delaware law, fair value is "the going concern value of the enterprise as of the merger date exclusive of any element of value — such as the value of achieving expected synergies — from the accomplishment of the merger." The court generally has significant discretion to use the valuation methods it deems appropriate in appraisal rights cases.

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Here, the judge rejected the deal price and valuation estimates based on stock prices of comparable transactions involving community banks. Instead, it relied exclusively on the discounted net income method to value the shares at $91.90 each.

The court's valuation was based on four inputs:

1. F&M's projected annual net income (roughly $5.1 million for the 12-month period ending September 30, 2015),
2. An 11.07% discount rate derived from the capital asset pricing model,


3. A 3% long-term annual growth rate, and
4. An adjustment for excess capital of approximately $4.4 million.

In many recent cases, the Delaware Chancery Court has relied on deal price as the best evidence of fair value. But, in *Dunmire*, the parties on both sides of the deal were commonly controlled, and the deal price did *not* result from "a competitive and fair auction, which followed a more-than-adequate sales process and involved broad dissemination of confidential information to a large number of prospective buyers."

## The lesson

Deal price is an important indicator of fair value only if it's the result of a reliable negotiation process that involves multiple, informed third-party bidders. In *Dunmire*, the court turned to other methods due to the lack of 1) a competitive bidding process and 2) independence between the parties.

Valuation experts can help shareholders analyze internal and external financial data during merger negotiations to achieve a fair price. Moreover, at trial, they can provide alternative analyses under the cost, market and income approaches that a judge may use during deliberations to evaluate the fairness of the deal price. ■

Ready, set, sell

# 4 ways to add value before selling a business

Investors want to buy a company that's well positioned for future growth. Here are some strategies for making a business more attractive to potential buyers.

## 1. Obtain a professional valuation

Many business owners overestimate how much their business is worth. A professional valuation can provide objective market evidence of what similar businesses have sold for and key value drivers.

Knowing the company's strengths and weaknesses can help maximize the price when it's time to sell. But preparing the company for sale often takes years, so work with a valuation pro early on.

## 2. Relinquish control to employees

A common turnoff to potential buyers is dependence on key people. All too often the owner has held tight reins on the company's strategic direction and day-to-day operations, acting as CEO, plant manager, product development head and lead salesman.

When it's time to sell, the business needs a solid management team that's capable of replacing the owner and all the roles he or she plays. Hiring qualified people and learning to trust them doesn't happen overnight. Some people won't have what it takes; others may leave for greener pastures after you've invested time and money in training. But the payoff for assembling a competent management team can be substantial in terms of receiving a premium price and minimizing the need for the seller to provide postdeal consulting.

## 3. Review contracts

Most buyers want all administrative issues squared away prior to negotiating a deal. Before putting the company up for sale, review all contracts, including:

- Employment and noncompete agreements,
- Equipment and facility leases,
- Franchise agreements,
- Annual audit engagements,
- Insurance policies,
- Loans, and
- Customer contracts.

Agreements that are unsigned, outdated, nontransferable or expired — as well as relationships that are based on a handshake with the seller — may be seen as risk factors to potential buyers. Sometimes, the seller may find that the company has matured or market conditions have changed, putting the company in a better position to negotiate more favorable contract terms.

## 4. Invest in the future

A business's ability to generate future cash flow requires continued investment in new equipment, maintenance and repairs, and updated technology. Although many business owners don't want to make these major investments prior to selling the business, doing so can make the company more competitive, reduce costs and lower risks.

These steps are just a few of the ways owners can prepare for a sale. With the help of a valuation pro, business owners can correct weaknesses and showcase strengths, thereby maximizing their bargaining position with buyers. ■

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Michael has more than 30 years of experience with a focus on valuation, litigation support, and taxation issues. He has additional expertise in auditing, financial statement analysis and consulting. His traditional accounting experience, includes taxation and financial statement reporting for closely held businesses, with a concentration on professional practitioners, real estate developers, construction contractors, retailers, manufacturers, and computer hardware and software providers.

Michael earned his Bachelor of Science Degree from the University of Delaware. He holds accounting certifications in both New Jersey and New York. Michael is a member of the American Institute of Certified Public Accountants (AICPA), a recipient of the AICPA's Accredited in Business Valuation (ABV), and Certified in Financial Forensics (CFF) designations. Michael is a member of the New Jersey Society of Certified Public Accountants (NJSCPA), where he was the Group Leader of the Business Valuation, Forensic & Litigation Services Interest Group, and is currently on the Steering Work Group. He is certified by the National Association of Certified Valuation Analysts (NACVA), and holds that organization's highest designation as a Certified Valuation Analyst (CVA). He is accredited as a Certified Fraud Examiner (CFE). In addition, Michael is an Accredited Senior Appraiser of the American Society of Appraisers (ASA).

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