A Newsletter from
Pershing Yoakley & Associates, P.C.
Valuation and Litigation Services Practice
VOLUME ONE 2010

Knowing value is half the battle

While baby boomers nationwide are considering selling their businesses in preparation for retirement, most of them are unaware of its true value. An objective business valuation engagement can help business owners prepare their company for sale and maximize its selling price.

According to a survey of 921 businesses conducted by George S. May International, a worldwide management consulting and research firm, 43% of small business owners plan to sell their interests in the next 10 years.

Unfortunately, 58% of the businesses surveyed hadn't been appraised by a valuation professional within the last 12 months. So, many of these uninformed sellers could face a rude awakening, especially in today's volatile marketplace.

Value is a moving target

Most business owners mistakenly believe that they need a formal appraisal only when it's time to sell. But every business owner should know the current value of his or her investment and understand how to build shareholder value. However, valuation expertise is also needed for ownership disputes, owner divorces, bankruptcy, devising an effective exit strategy, drafting a buy-sell agreement, or securing another round of debt or equity financing.

Get to know your intangibles

Increasingly, businesses rely on intangible assets, such as patents, copyrights, customer lists and goodwill, to generate value. But valuing these assets is much more complex and subjective than valuing hard assets. And many business owners aren't sure what their intangibles are, much less what they are worth.

For instance, many owners are surprised to find that goodwill acquired in a previous transaction has deteriorated (or become "impaired") as a result of the economic downturn. A valuation professional can value such intangible assets separately or allocate the entire company's value to specific assets, including identifiable intangibles and goodwill. Intangible asset valuations are important for infringement cases, licensing arrangements and accounting compliance purposes.

Value drivers vs. value drainers

Value is an important strategic planning tool. Owners who know the fair market value of their businesses — and who understand how to build value — will likely receive more when they eventually sell. In addition, informed owners who track valuation trends over time can turn around a distressed company before it spirals out of control.

To increase value, owners must understand how hypothetical buyers would perceive their business operations. The following are key factors investors look for when valuing a business interest;

Profits and cash flow. Investors prefer companies with high profits, positive operating cash flows, and consistent upward growth patterns.

Asset management. Potential buyers look for efficient collections and inventory management as well as effective use of property, plant and equipment (PPE) assets.

Reinvestment. Companies poised for future growth always appeal to potential investors. So managers should continually reinvest in PPE and research and development (R&D).

Management quality. Strong, decentralized management teams are valuable assets. If a company relies on key people, buyers may require an earnout or ongoing consulting agreements with the sellers as a condition of the sale.

Although these characteristics may seem obvious, many owners compromise business value with imprudent business practices. For example, small businesses commonly downplay revenues or exaggerate expenses to minimize taxes. But low taxable income makes a business less attractive to prospective buyers. Sometimes owners may find it hard to relinquish control, thus exposing potential investors to key-person risks.

Closing the gap

Often a significant gap exists between what an owner thinks his or her business interest is worth and what it realistically will sell for in today's volatile marketplace. That's because many business owners mistakenly rely on outdated appraisals or oversimplified industry "rules of thumb" to value their businesses.

An objective valuation professional keeps business owners in touch with economic reality and can coach them on ways to minimize risks — and maximize selling price. ■

How fraud affects value — and valuation

Businesses lose an average of 7% of their annual revenues to fraud each year, according to the 2008 Report to the Nation on Occupational Fraud & Abuse issued by the Association of Certified Fraud Examiners (ACFE). Appraisers need to beware of double-counting the effect of fraud risk on value, which may cause them to undervalue business interests.

Fraud cost to U.S. businesses was approximately $994 billion in 2008.

Beyond economic losses, fraud brings other adverse consequences, including tarnished public image and deflated morale. These side effects are harder to quantify and further diminish value.

3 forms of fraud

Before discussing the link between fraud and valuation, it's important to define and classify fraud. The ACFE defines occupational fraud as "the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets." And, according to the ACFE, fraud falls into three categories:

1. Corruption. Corrupt employees engage in fraudulent business transactions to obtain economic benefits for themselves or others. Examples include invoice kickbacks, conflicts of interest and illegal gratuities.

2. Asset misappropriation. Fraud may involve the embezzlement or misuse of an organization's resources. Most misappropriations — such as false invoicing, check tampering or skimming — involve cash. But some schemes target other desirable assets, such as computers or inventory. Some perpetrators don't physically remove assets. Instead, they use company property for personal purposes without permission.

3. Financial misstatements. Fraud perpetrators may intentionally misstate or omit material information from financial reports. Cooked books typically involve fictitious revenues or concealed expenses that artificially enhance earnings. These scams are the least common — but most costly — type of financial misstatement, according to the ACFE.

Understanding gray areas

Outside of these three categories is a gray area that includes such items as discretionary spending, "creative" accounting practices and quasi-business expenses. For example, a controlling shareholder might artificially lower earnings — say, by delaying revenue recognition or expensing personal legal fees — to minimize the value of his or her business interest for divorce purposes or to minimize taxable income.

Although these bookkeeping practices may not technically qualify as occupational fraud, they often require adjustment to arrive at an accurate value conclusion.

Bringing in the experts

Valuators rely on financial statements to estimate value. Unless it is specifically set forth in their engagement letters, appraisers customarily don't audit financial information or investigate for fraud. To the extent that financial statements contain fraud, an appraisal will be inaccurate, unless properly adjusted.

So what happens if management or the valuation professional suspects fraud? Some valuators are cross-trained in both valuation and forensic accounting. More likely, however, the valuator will bring in a co-worker or outside forensic accountant to investigate fraud predications. A forensic accounting specialist can help make the requisite adjustments to accurately value the business — and build a fraud case, if necessary.

Fraud can be a touchy subject. Unlike traditional CPAs, forensic accountants understand how to gather evidence without violating employee rights or destroying evidence. Their reports are designed to help resolve disputes and support formal fraud allegations.

If the scope of an appraisal assignment is expanded to include fraud work, the expert usually requires the client to sign a revised engagement letter or an addendum to the existing contract.

Quantifying fraud losses

Together, the valuator and the forensic specialist can estimate economic damages resulting from fraudulent activity. For example, damages may equal the difference in business value before and after the fraudulent behavior, adjusted for external factors beyond the fraud perpetrator's control.

Alternatively, they might compare the perpetrator's personal assets and expenditures to his or her known sources of income. In theory, any excess net worth equals the illicit gain.

Assessing fraud risks

Evaluating risk is part of valuing every business. One risk factor valuators consider is fraud. Some businesses are more vulnerable to fraud than others. When assessing fraud risks valuators consider issues such as:

Size. High-profile fraud cases — such as Enron or WorldCom — make front-page news. But the ACFE reports that companies with fewer than 100 employees suffer the highest median loss of all size groups ($200,000 in the 2008 study). Because private businesses also possess fewer fiscal and human resources than their public counterparts, they often struggle to rebound from fraud losses.

Internal controls. These are the policies and procedures companies use to protect assets, improve operating efficiency and ensure reliable financial statements. A strong system of internal controls, including fraud training programs and whistleblower hotlines, is a company's first line of defense against fraud. Other examples of internal controls that minimize fraud risks include:

- Restricted access to physical assets, including locks, passwords, electronic surveillance and security systems,
- Formal job descriptions, codes of conduct and employee manuals,
- Mandatory vacation and job rotation policies,
- Segregation of duties, such as record keeping, authorization and custody over assets,
- Duplicate signatures on checks above a preset dollar amount,
- Monthly bank reconciliations and physical inventory counts,
- Background and reference checks on prospective job candidates, and
- Annual (or surprise) audits conducted by internal auditors or a CPA firm.

Internal controls can be intentionally circumvented and thus are less effective if managers override the system or become lax in supervising subordinates. These loopholes undermine a company's efforts to detect and prevent fraud.

Factoring in fraud

High fraud risk equates with lower values. For example, when applying the income approach, valuators might increase their company-specific risk premiums, a component of the cost of equity, to account for significant fraud risks.

Similarly, under the market approach, fraud risk may come into play: 1) when choosing selection criteria to pick guideline companies, or 2) when adjusting median (or average) pricing multiples for differences between the subject company and the guidelines.

A subject company with significant fraud risk might appear less marketable to potential buyers or less desirable to potential minority interest owners. Accordingly, valuators might factor fraud risk into their valuation discounts.

Regardless of how valuators choose to account for these risk factors, it's important that they not double-count the effect of fraud risk on value. Otherwise, they risk undervaluing business interests.

Seeking the best advice

Public or private, all businesses are exposed to fraud risk. A competent valuator is aware of potential fraud risk and understands how it factors into a company's value. Furthermore, when an engagement extends beyond a valuator's area of expertise, he or she acknowledges that it's time to call in reinforcements — namely, a forensic accountant — to bridge the gap. ■

The 3 sides of the fraud triangle

Public or private, all businesses are exposed to fraud risk. A competent valuator is aware of potential fraud risk and understands how it factors into a company's value.

Fraud is more likely when particular conditions exist. Forensic experts refer to three elements — motive, opportunity and rationalization — as the "fraud triangle." Companies that understand the fraud triangle can lower their fraud risks by identifying and remedying high-risk individuals, relationships, policies and procedures.

To illustrate how the fraud triangle works, consider the case of Joe, a CFO for a small manufacturing firm. Because the fraud triangle was in place, Joe successfully stole $350,000 over the past two years. Here's how the three elements came into play:

1. MOTIVE. Before resorting to fraud, employees must have perceived financial or emotional needs that are difficult to share with others. Joe had several motives that led him to steal. He was in the midst of a long, expensive divorce and, new to the dating scene, was spending lavishly on his new girlfriend, who worked in the firm's purchasing department.

2. OPPORTUNITY. Employees who think they'll be caught rarely commit fraud. During his 20-year tenure, Joe had earned the trust of the firm's owners. He never took vacations, and was accustomed to juggling multiple tasks, including journal entries, bank reconciliations, cash deposits, invoicing, check writing and purchase-order approval.

In addition, the manufacturer's books were not audited, and physical inventory counts occurred at year end under Joe's supervision. Furthermore, Joe tested the waters by falsifying expense reimbursements, a relatively minor defalcation. When no one noticed, he and his girlfriend set up a fictitious vendor and charged embezzlements to inventory. Joe also paid personal legal fees with company funds.

3. RATIONALIZATION. Fraud perpetrators clear their consciences with excuses that justify their behavior. For example, Joe initially viewed his theft as a temporary "loan" that he'd repay once his divorce settled. As CFO, Joe also knew how much the owners took home in salaries and distributions. By comparison, he felt overworked and underpaid; in his mind, fraud evened the score.

UPCOMING EVENTS & PUBLICATIONS

JUNE 2010: Carol Carden is presenting *"Quality-Based Compensation in the New Era of Healthcare Reform"* with Ross Stromberg at the AHLA Annual Meeting June 28 – 30 in Seattle.

RECENT EVENTS

JANUARY 2010: Jim Lloyd and Carol Carden published an article in the American Health Lawyers Physicians Practice Group January 2010 Newsletter called *"An Overview of Physician-Hospital Alignment Strategies and Related Fair Market Value and Commercial Reasonableness Issues"*

FEBRUARY 24-25, 2010: PYA exhibited at the American Health Lawyers Association's Physicians and Physician Organizations Law Institute in Miami, Florida. Dr. Mark Browne will also be presenting at this event - *"Structuring Quality and Productivity Incentives for Physicians Today and for the Future"*

APRIL 2010: PYA exhibited at the American College of Physician Executives (ACPE) 2010 Annual Meeting on April 30 - May 4, in Washington, DC.

MAY 2010: Carol Carden served as an instructor in the AICPA National Business Valuation School on May 3rd – 7th, in Philadelphia, PA. This was a five day course for practitioners planning to attain the Accredited in Business Valuation (ABV) Credential.

Congratulations!

Jason Fleming and Michael Harvey, both senior consulting staff members in the Knoxville office, have now earned the Accredited in Business Valuation (ABV) Credential from the American Institute of Certified Public Accountants.

(800) 270-9629 | www.pyapc.com
Atlanta | Austin | Knoxville | Tampa Bay

Contact Information:

For additional information please contact
Jim Lloyd or Carol Carden at (800) 270-9629.