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Valuation Report

Business Valuation Trends and Strategies

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Valuation Insights

The Red Flags of Fraud

Business valuations often uncover questions about the choices made by business owners. Unfortunately, sometimes the questions lead to a determination of financial statement fraud.

According to the Association of Certified Fraud Examiners (ACFE) Report to the Nations on Occupational Fraud and Abuse, financial statement fraud is the least common type of occupational fraud. However, it causes the greatest financial impact by far, with a median loss of $1 million.

Valuation ≠ Audit

Under normal circumstances in a valuation, the valuation professional takes the company's financial statements at face value. In other words, there is no audit, review or compilation involved in a typical valuation.

In fact, the valuation analyst's "assumptions and limiting conditions" included in the valuation report acknowledge that the analyst has accepted "without further verification" the client's financial statements and related information. But every now and then something gives the valuation professional a reason to believe the numbers aren't right. This might include signs of unreported income like:

- A business that continues to operate despite losses year after year, with no real attempt to correct the situation.
- Bank balances and liquid investments that continue to increase annually, despite low profits or losses.
- Unusually low sales for the type of business, or a significant difference between the taxpayer's gross profit margin and that of the industry.
- A lifestyle that can't be supported by reported income.

Skimming and Personal Expenses

Among the financial statement fraud schemes most often brought to light in a valuation are skimming and running personal expenses through the business. Both of these decrease the value of the business by reducing net income.

Skimming is a scheme in which payment (usually cash) is pocketed before it's recorded on the company's books. It is particularly problematic in cash-based businesses like restaurants, bars, taxi companies and repair shops. In fact, skimming is so widespread in these types of businesses that the IRS publishes industry-specific guides to alert agents to signs of skimming.

To address the valuation issues involved in skimming, analysts refer to industry benchmarks and statistics. For example, in a restaurant valuation, the analyst might look at the cost of goods sold and compare that to industry standards. A big difference might indicate that the owner isn't recording cash receipts.

In terms of personal expenses, it's not uncommon for owners who cheat on their taxes to have the company pay for everything from club dues to travel, vacation homes and vehicles. Of course, these expenses are not legally deductible to the company, but some owners try anyway.

The Spouse Knows

The problem with these schemes is that the spouse or business partner is often aware of the fraud and will spill the beans in litigation. This is

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Veluchamy Bankruptcy

Huge Bankruptcy Case Involves Many Valuation Questions

Rarely do judges get quite so heated. But one district judge was so disgusted during a prior proceeding involving Pethinaidu and Parameswari Veluchamy that he said, "The Veluchamy family members may perhaps be … the most pervasively corrupt litigants that I have been exposed to in something more than three decades that I have been on the bench." Wow.

With that as background, the most recent litigation involving the Veluchamys is a bankruptcy case that involved interesting valuation questions. The facts: The Veluchamy family, including husband and wife Pethinaidu and Parameswari, and their two grown children, Arun and Anu, owned Chicago's Mutual Bank of Harvey (among other businesses), which collapsed in 2009 in the costliest bank failure in the U.S. in 30 years. The Veluchamy parents filed for Chapter 7 bankruptcy.

A Question of Value

The most recent case was brought on behalf of their bankrupt estate. It alleged that the couple engaged in a "wide ranging scheme to hinder, delay or defraud their creditors, principally by transferring cash and other assets to their son and daughter." Before the Veluchamys defaulted on their loans, their net worth was nearly $500 million. At the time of their bankruptcy, they reported a negative net worth of about $55 million.

Even the most experienced valuation experts' assumptions and conclusions will be challenged in litigation.

The Veluchamys transferred assets — cash, stock, jewelry and real estate — to their children either at no cost or for much less than their fair market value during the two-year "lookback" period prior to declaring bankruptcy. Many examples of fraudulent transfers were disclosed at the trial.

For example, the couple twice sold stock in one of their companies, VMark, to their children for a fraction of its value. The first transfer was worth $2.75 per share, but Arun and Anu bought it for between $0.61 and $0.63 per share.

In Come the Experts

The estate's noted expert, G. William Kennedy, offered two ways to determine the value of the VMark shares. Using the market approach, Kennedy computed VMark's value using comparable transactions. The opposing expert, well-known valuation analyst Daniel Van Vleet, challenged these as not truly comparable. Van Vleet also questioned the multiples used to compute value.

Kennedy's other approach, income capitalization, was also questioned by Van Vleet — including challenges regarding future capital expenditures, family salaries included in the cash flow, and the need to tax-effect the value. Eventually the court used the midpoint between the experts' two conclusions based on income capitalization. The court also considered a discount for lack of marketability.

After much disagreement about value of this stock transfer and many other issues, the 23 counts of the indictment were decided. The result: a judgment against Arun and Anu for restitution of more than $50 million.

Lessons Learned

The most obvious lesson learned in this case is that transferring assets in an effort to hide them from creditors rarely works. More subtly, determining value often involves back and forth, with the court agreeing with parts of each expert's assessment and methodology.

Even the most experienced valuation experts' assumptions and conclusions will be challenged in litigation. ■

Looking for valuation support in litigation? Contact our firm for assistance.

TEEM: How to Value a Business with Real Estate

Business valuation is rarely easy. Add owned real estate into the mix and a valuation can become even more complex.

In many valuations, the target company pays rent on its office or warehouse space to a separate entity. But in some valuations, real estate owned by the business is integral to its value.

For example, the success of a convenience store is based in large part on its location. The same is true with a quarry, a power plant, and many restaurants and hotels. In these cases, it's not reasonable to value the real estate separate from the business.

Real Estate-Centered Enterprises

Valuation expert Franz Ross, who specializes in these types of valuations, calls these businesses "real estate-centered enterprises" or RECEs. The challenge in RECE valuation is allocating the overall value into its components: the "going concern" business itself, the real estate, and the furniture, fixtures and equipment (FF&E). While a buyer might not really care about these allocations, they are important for accounting, reporting and financing purposes.

Ross suggests a methodology that uses comparable transaction data — specifically from the Pratt's Stats database — to put together a matrix that helps determine the factors in these complicated valuations. Pratt's Stats includes a fair number of comps where the real estate was acquired with the business's operational assets.

In these cases, the valuation professional adds the real estate price to the market value of invested capital (MVIC) to get the total price. If there is rent paid, the rent must be added back to EBITDA to arrive at EBITDAR, with the "R" representing rent costs. The RECE's cap rate can then be found by dividing EBITDAR by the MVIC plus the rent price.

Ross offers several cautions: When making adjustments to arrive at EBITDAR, it might be necessary to normalize owner's compensation to represent the expense of hiring a person to take on the management role usually played by the owner in RECEs. Also, the allocation might be skewed by the owner's desire to maximize or minimize the real estate value for tax or loan purposes, so those numbers should be scrutinized.

Allocating Total Value

Ross has designed an excess earnings model called "TEEM" which shows the source of each value, income component and cap rate for the real estate, FF&E, goodwill and the total RECE value. The model is logical, flexible and synergistic. Like a sudoku, when certain pieces are filled in with reasonable assumptions, others follow.

Many valuation professionals are attracted to this model because of its inherent checks and balances. It's easy to see if a number is out of whack, and it gives owners a head start on purchase price allocation calculations.

Remember that most valuation professionals are not credentialed real estate appraisers. Therefore, when the circumstances dictate a separate real estate appraisal, analysts are likely to partner with someone experienced in that area.

But in many cases, analysts working on transactions can arrive at a total value, as well as allocated values, using Ross's model. ■

Source: Business Valuation Update, September 2014

Red Flags of Fraud

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particularly true in the case of a minority shareholder dispute or divorce. And despite the fact that the spouse or partner may be implicated in tax fraud, he or she is often driven by anger and will tattle out of spite or fear of being cheated out of the "true value" of the business.

Because many businesses are S corporations, business income and personal income are tied together through the flow-through entity. In one case, an angry spouse shared that the soon-to-be-ex had filed a tax return with the IRS showing $80,000 in income, but had shown the bank a tax return reporting $350,000 in income. This is the type of information a valuation analyst can't ignore.

Because valuations depend on good financial inputs, the "garbage in-garbage out" rule applies. In most cases, the valuation process should be suspended until a forensic accounting investigation can clear up the situation and provide "real" numbers on which to base a valuation. ■

Interested in finding out more about valuation and fraud? Our experienced valuation and forensic accounting team can answer your questions.

Considering an Exit? Close the Value Gap Now

Approximately 44 million people in the U.S. are age 65 or older. This means a whole generation of business owners will be retiring in the coming years — and their businesses are likely their most valuable assets.

However, many owners don't know what their businesses are worth or whether the value will be enough to fund their retirement. To maximize their proceeds, owners need an exit plan that defines personal and business objectives related to selling the business and identifies tactics to achieve them.

An exit plan can also help owners close the gap between the company's current value and the desired value at the time of exit. Tactics to do so might include a combination of changes in revenues, costs, capital and risks, which are interrelated and must be considered together.

Building value generally means increasing "expected benefits" such as revenues and decreasing risk — and the two must be balanced. For example, expanding a product line may add revenues, but it may also result in unforeseen costs or require significant additional capital. Developing a deeper management team may increase costs but decrease risk, while reducing the supplier base may decrease costs but increase risk.

Similarly, expanding the customer base may increase income and decrease risk, but could also bump up sales costs. In this case, a company may consider "firing" less-profitable customers to free up capital to pursue opportunities with more upside potential. In all of these cases, the pluses and minuses must be weighed to determine whether action should be taken.

Building value may take significant time. The sooner business owners begin the exit planning process, the more time they will have to close the value gap and achieve a successful exit. ■

Our valuation professionals know how to create value in businesses. Let us help you with next steps.