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Valuation Report

Business Valuation Trends and Strategies

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2018 ACFE Report to the Nations Fraud and Its Effect on Value

Five percent may not sound like a lot in the abstract. But when you're talking about businesses losing 5 percent of their annual revenues to fraud each year, that number becomes quite significant.

Indeed, in the 10th edition of its "Report to the Nations: 2018 Global Study on Occupational Fraud and Abuse," the Association of Fraud Examiners (ACFE) estimates that businesses lose an *average* of 5 percent of annual revenues to occupational fraud, with smaller companies generally suffering greater losses.

Consider how this impacts value: If a company earns $8 million in revenues, 5 percent equals a loss of $400,000—and that's just the dollar value being stolen from the company every year. Fraud may also cost the company in terms of reputation, plus legal and forensic accounting fees. Also, when it comes to selling the company, a valuation based on the company's revenues will be diminished. The bottom line is that fraud destroys value.

Three Types of Fraud

The ACFE identifies three types of occupational fraud:

Asset misappropriation: The most common type of occupational fraud, asset misappropriation is also the least costly, with a median loss of $114,000. Asset misappropriation schemes range from theft of cash and skimming to billing schemes and fictitious expenses to inventory misuse and theft.

Corruption: These schemes incur a median loss of $250,000 and include sales and purchasing schemes; bribery, kickbacks, and bid rigging; illegal gratuities; and economic extortion.

Financial statement fraud: This is the least common but most costly form of fraud, with a median loss of $800,000. Financial statement fraud schemes include income overstatements such as fictitious revenues, improper asset valuations and concealed liabilities, as well as income understatements, such as understated revenues and overstated expenses.

Fraudsters often commit more than one type of occupational fraud at a time. The median duration of all types of fraud in the ACFE report was 16 months. Most fraudsters start small and then increase their frauds as they continue to be successful over time. Obviously, the longer the fraud continues, the more severe the losses.

As expected, to cover their tracks, fraudsters often use concealment methods such as altering documents or creating fraudulent documents, creating fraudulent transactions in the accounting system, or destroying physical documents. It can take months—or sometimes years—to discover these clever cover-ups.

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Technical Topics

Valuation Considerations for Craft Breweries

The craft beer industry is exploding, with two new craft breweries being launched every day in the U.S.

According to the Brewers Association, craft breweries are defined as "small, independent and traditional." But the industry is anything but small: The craft beer market is $26 billion. It's an extremely competitive industry that's growing by about 18 percent per year.

All valuations hinge on cash flow, and craft brewery valuations are no different. But here are some other issues that analysts consider when valuing a craft brewery:

Production capacity: How much beer can the business brew using its existing equipment? Will it need more or different equipment to support growth and innovation?

Analysts also look at brewing cycle times. Some breweries process their beers faster than others, which impacts overall output and capability. If the brewery is known for a specific beer or beers, it's key that operations can support ongoing or increased production of its top offerings.

Key personnel: Where is the expertise in the business? Is an owner-brewmaster not only making business decisions, but also driving formulas and flavor decisions? Or is the brewmaster a non-owner who is at risk of leaving?

For the brewery to grow, it must have a sustainable model for consistent quality. A stable team—and a superstar brewmaster who will stay with a new owner—drives value.

Distribution: After the repeal of Prohibition in 1933, breweries were required to follow a three-tiered system that kept brewers, distributors, and retailers separate. This meant that breweries were required to use distributors to get their offerings to market.

While most of these laws have changed somewhat—breweries can now sell beer in tasting rooms in most states—distributors still play an extremely important role in getting various beers into grocery stores, bars, and restaurants.

Laws regarding distributor agreements vary by state. Will the target company's relationship with its distributor be affected—either negatively or positively—by a sale?

Product offerings: What's hot in the market this company serves? Is it IPAs, sour beers, or golden ales? Does the product mix meet the demographic? Is there a unique or local ingredient that distinguishes this beer? If so, what is the nature of the supply chain for this distinctive component?

Most craft breweries pride themselves on innovation. But that innovation must be tempered with business intelligence to ensure a healthy market and growth potential.

Tax issues: In December 2017, Congress passed legislation that included the Craft Beverage Modernization and Tax Reform Act, which lowered the federal excise tax for breweries. While this is good news for brewery owners, the legislation expires at the end of 2019.

With the rise of the industry and its growth pattern, craft breweries are now on legislators' radar, for better or for worse. Conventional wisdom says that the tax landscape will continue to morph.

It's clear that craft beer is an industry with staying power and not just a fad. Acquisition interest from huge beverage companies seems to indicate that craft brewers are onto something big.

Our professionals are experienced in valuation across many industries. Let us know how we can help you.

How Fraud Affects Valuation

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Who's Responsible?

Not surprisingly, fraud committed by employees in prominent positions tend to result in bigger losses. For example, owners and executives commit only 19 percent of frauds, but their schemes incur the highest median losses—$850,000.

Owners and executives are also more likely to collude with others. Owner or executive perpetrators also tend to be engaged in non-fraud-related misconduct more often, such as bullying or intimidation. Fraudsters with longer tenure typically hatch more costly schemes.

Next to frauds committed by owners and executives, frauds committed by those in the accounting, information technology, manufacturing/production, and warehousing/inventory departments are typically the most costly. Conversely, frauds committed by those in customer service are the least costly relative to other departments.

Gender, age, and education are also factors. Most fraudsters are male (69 percent), and men cause much larger median losses ($156,000) than women ($89,000). Older fraudsters (age 56+) cause much more damage than younger ones (under 30). Those who are highly educated cause higher median losses than those with a high school degree or less.

Interestingly, most fraudsters have no prior history of criminal fraud convictions. It's unclear whether this indicates that most fraudsters are first-time criminals or that they simply haven't been caught or turned over to law enforcement. Sometimes, business owners are embarrassed by the fraud or are hesitant to report it due to the risk of reputation damage, either to the business or, strangely, to the perpetrator.

To Catch a Thief

How do fraudsters get caught? The most common method (40 percent) is by tip, and more than half of these tips come from company employees. About a third of tips come from sources outside the company, including customers, vendors, and competitors. Promoting a whistleblower hotline—especially an anonymous one—is a powerful way to generate and encourage fraud reporting. Fraud losses at companies with hotlines were 50 percent smaller than at those without hotlines.

Internal audit is the second most common means of detection, with management review in third place. More active detection methods involving deliberate searches for misconduct, such as IT controls and surveillance or monitoring, typically result in shorter duration and less costly frauds. Passive detection methods have opposite results: discovering fraud by accident, by confession, or via law enforcement notification means more costly losses and longer duration of the scheme.

Improving internal controls is an effective—and usually relatively easy—way to keep fraud at bay on an ongoing basis.

Protecting Value

Fraud isn't always easy to detect—and often, owners have no idea fraud is occurring right under their noses. Remember that valuation reports typically include a list of "assumptions and limiting conditions" describing the engagement. Usually the report includes verbiage saying that the valuation is based on financial statements and other information provided by the target company. Until an accounting or valuation professional digs into the numbers, the owner may be completely in the dark.

However, sometimes owners are perpetrators. They may excuse their bad behavior as "doing what everyone else does" or using what they call "aggressive" accounting methods. As a valuation gets under way, scheming owners might suggest that the financial statements aren't really reflective of the company's earnings, hinting at profit skimming or at inflated or personal expenses, which are always red flags to valuation analysts.

Or, in the course of a valuation, an analyst may notice that the company's earnings are unusually low or don't meet typical industry benchmarks. If a seemingly healthy company is losing money or has negative cash flow, this is cause for further investigation. Fraud isn't always the reason for these issues, but a forensic accountant should be called in if the numbers aren't making sense.

Preparing for Sale

Improving internal controls is an effective—and usually relatively easy—way to keep fraud at bay on an ongoing basis. An internal controls study can illuminate various steps owners can implement to deter theft.

And as an owner prepares to sell his or her company, there are several steps to take to ensure an accurate valuation. One key activity is to scrub the company's finances so that the financial statements are indeed a good representation of the company's financial position. This involves steps such as removing personal expenses, adjusting owner's compensation to reflect market salary, getting non-contributing relatives off the payroll, and, obviously, taking action to correct, report, and account for any fraudulent activity.

As the ACFE report makes clear, when it comes to occupational fraud, acting sooner rather than later results in fewer losses and less damage to the company overall.

Interested in discussing fraud and value? Our valuation team is happy to discuss this topic further with you.

Source: ACFE 2018 Report to the Nations

DLOM Always on IRS Radar

When assessing the value of closely held companies, valuation analysts typically include a discount for lack of marketability (DLOM). This discount reflects the fact that interest in a closely held company is difficult to "market" or sell, which reduces the value of the interest.

While the IRS acknowledges that a DLOM results in a reduced value, the agency often takes issue with the *extent* of the reduction in value.

An IRS job aid on the topic was made available to the valuation community several years ago. In the aid, the agency points out what it considers to be significant flaws in the widely used FMV Restricted Stock Study and discusses how courts are somewhat reluctant to accept DLOMs derived from restricted stock studies without detailed analysis of study data.

More recently, a group of valuation professionals led by respected valuation analyst and educator James Hitchner created a new reference, "Discount for Lack of Marketability Guide and Toolkit."

The new guide is designed to help valuation analysts calculate and support the DLOMs in their valuation reports using detailed documentation of current theories, empirical studies, databases, and methodologies. It includes qualitative and quantitative methods, shareholder cash flow adjustment models, and other models, discussing the relative merits of each, along with landmark tax court cases.

The primary model in the toolkit involves restricted stock studies and allows valuation analysts to adjust restricted stock discount data based on differences in volatility, holding periods, dividends, and other factors. This is crucial input because providing adequate support for their DLOM calculations can be challenging for analysts.

While calculating DLOMs will never be an exact science, references like this new guide assist the profession by providing data and insight that analysts can use to support their valuation opinions.

DLOMs are among our favorite topics! Contact us if you have any valuation-related questions.