

# Viewpoint on Value

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# How valuers assess the rising risk of fraud

A weak economy provides countless fraud motives: A business in danger of loan covenant violations might overstate asset values or downplay liabilities to keep lenders at bay. A CFO might exaggerate earnings because she feels increased pressure from shareholders to meet performance goals. Or an employee might steal inventory or petty cash to pay his delinquent mortgage.

## Assessing fraud risks

The current economic downturn has produced an upswing in incidents of occupational fraud, so it's imperative for businesses to step up efforts to deter and detect it. An important part of the valuation process is identifying potential risks and gauging whether management has taken appropriate action to mitigate those risks.

Not only does fraud drain company resources, but it also tarnishes management's reputation, lowers morale, distracts management, results in regulatory actions — and can eventually lead to bankruptcy. All else being

equal, companies with higher fraud risks warrant higher discount rates or lower pricing multiples, or both.

## The right questions

A strong system of internal controls is one of a company's most powerful fraud deterrents. In addition, a vigilant corporate culture can make a big difference in deterring fraudulent acts. But neither provides an absolute guarantee against fraud.

## Careful, consistent handling of fraud cases speaks volumes about management's attitude toward fraud risk.

Valuation professionals evaluate internal controls and corporate culture by looking for formal codes of conduct, reporting hotlines, antifraud training, and clear channels of communication between frontline workers and their supervisors.

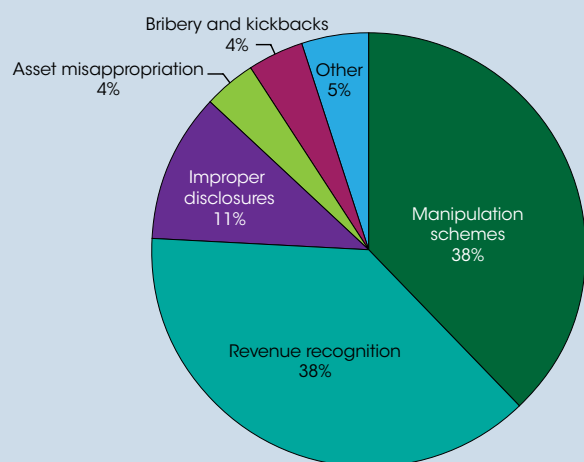
Appraisers also interview management to observe subtler clues. For example, they might inquire about the extent to which managers pressure subordinates at month- or year-end to meet goals. Or they might ask about previous fraud occurrences and how they were resolved. Careful, consistent handling of fraud cases speaks volumes about management's attitude toward fraud risk.

## Risky business

Every organization faces fraud risks, but some businesses are statistically more vulnerable. For example, companies with fewer than 100 employees tend to lack adequate fiscal and human resources. So, fraud strikes small, private businesses more frequently. In addition, their losses tend to be more costly and devastating over the long run, according to the Association of Certified Fraud Examiners' (ACFE) *2008 Report to the Nation on Occupational Fraud and Abuse*. The ACFE study also revealed that check tampering

## Fraud scheme prevalence

January 2000 through December 2007  
SEC enforcement releases



**Data source:** Ten Things About Financial Statement Fraud, 2nd edition, published by Deloitte Forensic Center, December 2008.

and fraudulent billing were the most common small business fraud schemes.

The ACFE study reports that financial statement fraud generally tends to be costlier than asset misappropriation or corruption. “Fraud scheme prevalence” on page 2 illustrates which fraud schemes are the most common, according to a recent review of Securities and Exchange Commission (SEC) enforcement releases by Deloitte Forensic Center.

### Kinds of fraud

Approximately 38% of SEC fraud enforcement releases from January 2000 through December 2007 involved expense, asset, liability, reserve or accounts receivable manipulation. Also common were revenue recognition schemes, including fictitious revenue, bill-and-hold and falsified return scams.

The Deloitte study revealed that two-thirds of the fraud schemes occurred in two industries: 1) technology, media and telecommunications

(37%) and 2) consumer business (29%). Appraisers are therefore more alert to fraud risks when valuing companies engaged in these sectors, including publishers, retailers and distributors.

Appraisers tailor their analyses of fraud risks based on the subject company’s size, complexity, industry and goals. Such risk assessments predict where fraud may occur and who the perpetrators might be, as well as the schemes fraudsters may engage in and how they might conceal their activities.

### Extra expertise

Rather than wait for fraud to strike, proactive companies take preventive measures, especially in today’s high-risk environment. Few experts cross-specialize in both valuation and fraud. And even if an expert is qualified to conduct both types of engagements, detecting and investigating fraud is outside the scope of traditional valuation assignments. If you suspect fraud has occurred, consider calling in reinforcements and expanding the scope of the engagement. ●

## Avoid M&A pitfalls with targeted due diligence

Whether you’re buying, selling or merging, it’s important to “kick the tires” before signing on the dotted line. A financial professional can conduct due diligence procedures that target high-risk areas for any industry.

### Seller concerns

Although merger-and-acquisition (M&A) due diligence is typically the buyer’s responsibility, sellers also have concerns. In addition to helping establish a reasonable asking price, financial professionals can help sellers compile prospectus packets, discuss deal structure options and screen potential buyers.

Qualified buyers must sign confidentiality agreements before obtaining access to the seller’s confidential information, such as financial data, in-process research and development, and customer lists. This



protects sellers from opportunistic competitors or, in a more likely scenario, a deal that falls apart before it reaches the finish line.

## Buyer concerns

Many business combinations ultimately fail to increase shareholder value. But thorough due diligence can help buyers beat the odds. Due diligence findings educate the buyer about the target company's financials and operations and reveal stumbling blocks.

Practitioners Publishing Company's *Guide to Buying and Selling a Business* provides a list of the most common due diligence problem areas. Here are some of the most significant, along with some examples:

- Tax issues — for example, liabilities, evasive practices, and audits related to income, sales, payroll and property taxes,
- Internal control weaknesses such as a lack of segregation of duties,
- Unreliable inventory balances — for example, inadequate reserves or the existence of old, obsolete or damaged goods,
- Assignability of key contracts such as franchise agreements, insurance policies, or equipment and property leases,
- The existence of off-balance-sheet items, including undisclosed property liens or judgments, ongoing litigation, golden parachute clauses, or environmental violations,
- Inaccurate or unrealistic management representations and estimates such as overly optimistic projections of operating results and cash flows, and
- Valuation of financial instruments, such as stock options, repurchase agreements, and hedge instruments.

Problems or material misrepresentations may warrant a lower offer price or renegotiated terms. Sometimes, it may be in the buyer's best interest to walk away from the deal. A financial expert can keep the buyer focused on the numbers instead of on an emotional attachment to the deal.

## What sellers want to know

Sellers also need to know something about the financial health of their potential buyers to prevent fraud and deal-ending financing shortfalls. Some buyers may be

willing, but not financially able, to acquire a business. In the current market, many business buyers find it extremely difficult to qualify for bank loans and often rely on the seller to finance at least part of the deal. Because seller-financed loans or deal structures that involve installment payments depend on how well the buyer runs the acquired business, sellers must ensure that the buyer is a good risk.

## Problems or material misrepresentations may warrant a lower offer price or renegotiated terms.

A seller's financial expert, therefore, should analyze the buyer's financial statements, business plans, credit history and public records (including performing background checks on all of the company's principals) to help evaluate whether the company will make good on the loan or installment plan.

## M&A today

Increasingly, baby boomers are considering retirement — and the rough financial climate has many owners of distressed companies eager to sell. While bargains abound for buyers with cash or access to adequate financing, caution is key. The last thing a buyer needs is to inherit another owner's headaches.

The extent of due diligence a buyer performs will be determined, in part, by the type of sale. Asset sales may be advantageous, because buyers inherit less baggage. Asset purchasers generally are responsible for only the liabilities expressly assumed and those secured by the purchased assets. Conversely, a buyer in a stock sale assumes all liabilities, including undisclosed and contingent obligations, and must be vigilant in reviewing not only financial statements, but also hard assets, facilities, real estate and legal agreements.

## Money well spent

Under no circumstances should a company or business owner attempt to conduct due diligence on its own. Do-it-yourself M&As can lead to disastrous outcomes and unexpected surprises. Enlisting the help of M&A, financial and legal professionals early in the process saves buyers and sellers money and stress over the long run. ●

# Shortcuts can be embarrassing — and costly

Valuation requires time, patience and experience. Business owners and attorneys who retain unqualified or novice valuers who sidestep valuation procedures may be in for a rude awakening.

## Covering all the bases

Qualified and experienced valuers perform a standard checklist of procedures based on accepted valuation methodology when valuing a business. For starters, they request a list of documents that may include tax returns, financial statements, business plans, equipment lists, lease agreements and marketing materials.

Appraisers also tour company facilities and interview management, and some require managers to provide written responses about how the business operates. After conducting whatever independent research they deem necessary, these experts synthesize the data they've collected to reach a determination of the company's value.

## Diligence pays off

Courts are becoming increasingly sophisticated in appraisal matters. When a valuator skips steps or fails to understand a company's operations, the court is likely to discount — or even reject — the expert's opinion.

That's just what happened in the Massachusetts appellate court case *Burr v. Burr*. In this divorce action, the husband owned a real estate consulting



## Garbage in, garbage out

A valuation is only as reliable as the information upon which it's based. Most valuation reports presume that the information management provides is accurate. In fact, valuers might not independently verify financial data unless specifically hired to do so — though they may inquire about any external information that contradicts management's representations, such as press releases, loan applications and Web sites.

Unfortunately, some companies submit inaccurate financial information or withhold information to skew valuation results. For example, a divorcing spouse might hide equipment or overstate expenses.

Such omissions often come back to bite management. If a valuator suspects misrepresentations, he or she might pull off the engagement and leave the business owner without an expert opinion. Moreover, a strong opposing expert is likely to present contradictory evidence, which will help the court see through the smoke and mirrors.

and development company, which his appraiser valued at \$159,000, including a 25% key person discount. After perusing electronic bookkeeping records and tax returns, the wife's expert valued the business at \$794,000.

The trial court found the testimony of the husband's expert more thorough and convincing, because he'd interviewed management, reviewed contracts and conducted in-depth industry research. The wife's expert had overlooked significant risk factors — including the company's reliance on three key

contracts and one key person. The appellate court upheld the decision.

### Haste makes waste

Valuing a business takes time and diligence. Shortcuts can be costly for business owners and related parties, as the *Burr* case demonstrates. That's why it's important to retain a qualified and experienced appraiser — and give him or her all the time, financial information, and access to company personnel and facilities he or she needs to generate a well-thought-out conclusion. ●

## Finding the appropriate valuation standard

Value isn't static and can change depending on the purpose of the valuation. The three most common standards of value are: fair market, investment and fair.

Fair market value is the price for which the universe of buyers and sellers agree to exchange a business

interest. Investment value, sometimes called strategic value, is the value unique to a particular buyer and seller, while fair value is defined by law. Usually, valuers will arrive at a different value for each.

### Considering fair market value

Treasury department regulations define fair market value as:

The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.

When estimating the fair market value of a business, it's important to remember that there are two sides to the coin: a willing buyer and a willing seller. Too many well-documented valuation reports focus exclusively on what the buyer would pay for a business.

When a valuator doesn't consider what a seller, under no compulsion to sell, would accept for his or her business interest, he or she invariably undervalues the business interest. After all, a third-party buyer is hoping to find a bargain and will negotiate the lowest price possible. The seller, on the other hand, wants to get the most from his or her investment.



It's the compromise between the bid price (the buyer's position) and the ask price (the seller's position) that establishes a company's fair market value. Determining a fair market value to which both buyer and seller will agree involves finding a starting point that reflects future earnings, considers existing conditions not yet reflected in the financial results, and eliminates unusual events and transactions. Without it, consensus and a signed contract will be hard to accomplish. In fact, few businesses sell for fair market value.

### Determining investment value

Investment value — the value unique to one party — is the preferred standard in business combinations. Investment value considers a specific investor's expectations, risks, tax situation and synergies.

When quantifying investment value, appraisers frequently focus on the discounted cash flow method over other valuation techniques. Key inputs include management's projected cash flows, expected growth rates and the combined entity's expected cost of capital.

### Valuing synergy

In successful business combinations, the value of the combined entity exceeds the sum of the parts operating independently. This incremental value commonly is referred to as "synergy."

Fair market value is a logical starting point for valuing synergy, but rarely an ending point. Instead, sellers hold out for strategic buyers, who often are willing to pay a premium for control attributes and synergy. (See "The synergy trap" at right.)

Put simply, synergy is the difference between 1) the sum of the companies' fair market values without pursuing the business combination, and 2) the investment, or strategic, value of the combined entity.

### Finding fair value

In many ways, fair value for reporting purposes is similar to fair market value as defined in IRS Revenue Ruling 59-60. Both standards of value assume an exchange price that involves hypothetical buyers and sellers with both parties knowledgeable, unrelated, and able and willing to transact. In addition, buyer-specific synergies are excluded from the company's fair value.

## The synergy trap

Quantifying synergy is no easy task. It requires complex, subjective financial analysis. One key reason for failed business combinations is overvalued synergy. Management's previous budgeting track record, past merger-and-acquisition experience, and familiarity with the target's market and industry (if different from the acquirer's business) can affect the reliability of management's forecasts for the combined entity.

In these cases appraisers often play devil's advocate, questioning whether management considered factors that might diminish potential synergies. For example, does management allow for a reasonable assimilation period before synergies begin to affect projected cash flows? Does management consider postdeal assimilation costs — such as incongruent corporate cultures or incompatible information technology systems — that offset potential synergies?

There are some subtle differences between the two terms. Fair value may contain some elements of investment value. For instance, in September 2006 Financial Accounting Standards Board (FASB) Statement No. 157, *Fair Value Measurements* (FASB 157), introduced the concept of "market participants," which refers to buyers and sellers in the principal (or most advantageous) market for the asset or liability.

Thus, the pool of market participants in a hypothetical fair value transaction may be smaller than the entire "universe of potential buyers and sellers" considered when estimating fair market value. The principal market is also entity-specific and may vary from company to company.

### Minimizing confusion

Identifying the appropriate valuation standard up front can minimize confusion down the road. Buy-sell agreements and buy-back provisions, for example, should directly state the desired valuation standard. The goal, of course, is to arrive at a reasonable and supportable value conclusion in light of all the surrounding facts and circumstances. ●