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Forensic Accounting: At Crossroads Of Business Valuation, Forensic Accounting

Business valuation methods are commonly used by practitioners to assess damages in litigation, prepare for mergers and acquisitions, and properly anticipate estate planning. Valuation, however, is not just a "back of the envelope" exercise. Often times, the financial data on the books and records may not tell the entire picture. A deeper analysis is often necessary to find the explanations behind the numbers.

It is within this context that the roads of business valuation and forensic accounting intersect.

Definitions of forensic accounting commonly refer to fraud-related activity. However, forensic accounting is often applied within a number of contexts to conduct business valuations, litigation and non-litigation alike. Forensic accounting has been commonly defined as the application of investigative and analytical skills for the purpose of resolving financial issues in a manner that meets standards required by courts of law.

It is not just the calculation of numbers, but the details behind the numbers that count. Forensic accounting allows for the process to identify, explain, contradict and verify the financial data presented when valuing a business.

Valuation 101

Business Valuation 101 states, in a simplistic manner, that the value of a business is equal to the present value of the company's future cash flows and that there are three acceptable valuation approaches: Asset, Income and Market.

The Asset Approach adjusts the recorded book values of a company's assets and liabilities to their market values. The excess of the market value of the assets over the market value of the liabilities is the value of the business. This approach often serves as a valuation floor since many companies have greater value as an ongoing business than if liquidated, i.e., the present value of future cash flows generated by the assets exceeds the liquidation value of those assets.

Under the Income Approach, the value of a business is derived from expectations of future earnings or cash flow. The future benefits of ownership can be evaluated in the capitalization of a single-period level of earnings or cash flow which are expected to recur in the future.

The Market Approach estimates value based on the prices at which sales of similar businesses or ownership interests are transacted. In selecting these companies and transactions, consideration is given to financial condition, operating performance, business description and other factors. Pricing multiples are then calculated using financial metrics such as earnings, cash flows and revenues. These multiples are then applied to the financial metrics of the subject business to estimate the value.

Regardless of the approach or approaches used, the financial records of the business are significant. But what happens when those numbers are incorrect or misleading? Or more importantly, how can you verify whether the numbers are reliable?

Normalization Adjustments

A company being valued may require financial statement normalization and/or discretionary adjustments that impact the valuation. Normalizing adjustments eliminate the effects of nonrecurring events and determine a normal level of business activities (e.g., one-time gain on sales of assets, severance payments, legal settlements). Discretionary expenses may be more difficult to determine and may involve more complicated techniques to unearth. Common adjustments include:

• Excess owner's compensation

• Wages for family members who do not actually work for the company

• Marketing expenses that include personal expenses such as travel and vacations

While these may appear obvious, often however, these adjustments are not that easy to find. This is where forensic accounting techniques come into play. Using specialized skills that may include auditing, finance, accounting, research and investigative and interviewing techniques, information can be identified that provide clarity to the numbers in the books.

For example, in performing a valuation in a shareholder litigation matter, we performed our standard financial analysis, due diligence and research which led us to question the accounts payable and cash levels of the business relative to typical industry ratios. Through a combination of targeted questioning and investigation, we discovered that approximately 50 percent of all payables to one supplier were actually going to pay off the shareholder's gambling debts. Clearly, this is a non-business expense.

In another assignment, we were engaged in connection with a divorce proceeding to value the marital assets, which included a cash-based, family-owned restaurant. The scope of our initial valuation work was limited to a review of the historical books and records that had been maintained by our client's spouse, the proprietor of the restaurant. Suspicious that sales were lower than anticipated given the size and location of the business, we asked to compare the sales with those from a subsequent future period. Prior to our analysis of the books, we covertly placed the restaurant under surveillance during the examination period to establish the revenue threshold: customers entering and leaving the business were counted.

A subsequent examination of the books identified that not all transactions were accounted for in the paper documents The business actually had three cash registers: one for cash, one for credit, one for take-out, which was a euphemism for cash into the pocket. The end result was an increased valuation of the business.

The end question is how do these adjustments impact the value of a business? Under a market approach, assume similar companies are sold at an average price of eight times annual earnings. If expenses are overstated by $400,000 due to discretionary expenses, the value of the business would be $3.2 million lower. If, under the income approach, the assuming a capitalization rate of 20 percent and a tax rate of 40 percent, $400,000 of discretionary expenses lowers the value by $1.2 million.

The valuation methods discussed above consider the financial performance of the business being valued. Blindly relying on financial records when the reliability of those records is in question may result in significant valuation errors It is in these instances, where the crossroads of business valuation and forensic accounting meet and can lead to accurate and meaningful results. •

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