Making Everything Easier!™

Business Valuation For Dummies

Learn to:

- Accurately determine the value of a business
- Understand financial statements
- Estimate the cost of capital
- Evaluate assets and income

Lisa Holton
Former business editor and reporter,
Chicago Sun-Times

Jim Bates, MBA

The forensic accountant who caught Capone

Frank J. Wilson, a U.S. Treasury Department accountant, was the guy who put Al Capone away for evading taxes on income. The true story isn't quite like the movie *The Untouchables,* but it's close enough. Capone got away with dozens or perhaps hundreds of murders, but an aggressive bean counter brought him to heel through Capone's own financial records.

Wilson and his team worked 18-hour days, reviewing more than 2 million documents and other key evidence seized in various raids on Capone's operations over a 6-year period starting in 1929. They analyzed phone records and investigated banks and credit agencies. They developed a network of snitches, tapped phones, and seized various sets of financial documents related to Capone. Eventually, they found evidence linking Capone to gambling proceeds through a dog-track operation in Florida.

Capone unsuccessfully ordered a hit on Wilson and his wife, who moved from hotel to hotel while the investigation went on. Undeterred, Wilson gathered evidence to prove that Capone had a total of $116,000 in nondeductible expenses after claiming no income. Capone was found guilty and sent to prison in 1931.

WARNING!

Forensic accountants may work in concert with investigators and other covert players in the investigative process, but they need to know the legal restrictions on certain investigative tactics. Therefore, you need to confirm that your forensic accounting professional understands the laws that are likely to apply. If you're hiring a forensic accountant, ask what her investigative limits would be for your situation, and ask what things she would and wouldn't do. If she indicates that she operates without limits or is unable to answer your question specifically, go with a candidate who can.

What training is involved

Forensic accountants begin as trained Certified Public Accountants (CPAs), but most have something extra: a taste for the discovery and presentation of evidence to fill in the blanks in valuations, divorce proceedings, corporate investigations, and dozens of other kinds of cases and projects. They may spend plenty of time in court testifying on their findings, so they have to think faster than the lawyers who are peppering them with questions. (Forensic accountants may never have to defend their results in court, but their responsibility is to prepare their results as if they will.)

Forensic accountants are often asked to investigate cases that involve fraud, shareholder lawsuits, insurance claims, personal injury, business valuations, and other proceedings involving money transactions. Since 2001, counterterrorism has also been a fast-growing segment of most skilled practices.

Combat CPAs

Darrell Dorrell is a CPA, CVA, and ASA (American Society of Appraisers business analyst) with financial forensics in Lake Oswego, Oregon. He has trained employees of the Justice Department and the Federal Bureau of Investigation in forensic accounting. Dorrell, who grew up in a military family, only half-jokingly calls accountants like himself "combat CPAs" because they have to work fast, quietly, and thoroughly to get results — sometimes before the object of the investigation knows that forensic accountants are onto him.

Dorrell says the "combat" part applies only partially to the process of investigation. The other part has to do with the tough courtroom grilling many accountants get over valuation assignments and other financial data they uncover. He maintains that typical CPAs trained in valuation alone are not always prepared for tough, detailed questioning on the stand in a particularly nasty divorce proceeding or corporate fraud case.

"Our job is to look behind and beyond the numbers," Dorrell explains. "Classic ratio analysis used in business valuation is predicated on comparing one set of numbers to another and reaching conclusions based solely on those figures. The observations really don't tell you about the veracity of the numbers.

"Our job is to drill down into the composition of the numbers and tell you whether something's wrong or purely structural. Forensic tests such as indices can assess whether financial statements have been manipulated and where the manipulation has likely occurred."

Most forensic accountants may have experience in auditing: reviewing the accuracy of a company's or person's figures along accounting guidelines. Beyond basic accounting training that leads to CPA certification, the forensic accounting field (like most industries) is exploding with certifications in a variety of forensic accounting–related skills. Here are a few:

- **Certified Fraud Examiner (CFE):** This designation comes from the Association of Certified Fraud Examiners, a 25,000-member organization in Austin, Texas. Though many CPAs have this designation, you don't have to be a CPA to earn it; indeed, the CFE was designed for members of the law enforcement and security communities who lacked CPA certificates.
- **Certified Forensic Financial Analyst (CFFA):** This designation is provided by the National Association of Certified Valuation Analysts (`nacva.com`).
- **American College of Forensic Examiners:** This organization (`www.acfei.com`) offers a cornucopia of certification courses in a variety of areas, including consulting, accounting, nursing, medical investigation, homeland security, information security, and disaster preparation.

Expect forensic training to grow in the future.

Where forensic accountants work

Many accounting firms are dedicated to the practice of forensic accounting or have forensic accounting divisions. Some of the biggest employers of forensic accountants are the U.S. government and corporate America.

The Internal Revenue Service, Federal Bureau of Investigation, and many state and local police departments have forensic accountants on staff to address local law enforcement needs, whereas corporations may have forensic accountants on their own payrolls to stem internal fraud.

TIP

Some major accounting firms may say that they have forensic departments, but you still need to check an accountant's experience. Checking a forensic accountant's qualifications and training is critical.

Recognizing situations that link forensic accounting and valuation

The chief job of many forensic accountants in valuation assignments is to reconstruct income and/or identify the ownership of various assets — most often, its illegal path into the wrong hands inside or outside an organization. In some cases, forensic accountants, such as Darrell Dorrell, CPA, CVA, and ASA, use existing information, such as public-company data or industry benchmarks, but often, they need a subpoena to access needed information.

Following are some typical situations that unite forensic accountants with valuation assignments:

- **Mergers and acquisitions:** Forensic accountants may make appearances on due diligence teams in a host of deals. Forensic accountant Darrell Dorrell says involving a forensic accountant is a good thing to consider in most due diligence situations. Investment banks and other lenders also bring in forensic accountants to safeguard their interests.

  Besides scrutinizing numbers, forensic accountants question human beings in the process and do onsite inspections of the facilities being sold to verify the pricing in the deal. Fake or inadequate assets listed as being a major part of a deal may be found by any valuation professional, but forensic accountants specifically look for them.

- **Purchase of troubled assets:** In a tough economy, the last guy standing with cash in his pocket is in a position to make some great deals on business assets or whole businesses. But troubled companies — ones that are barely keeping the lights on, that have idled property and machinery, or that have padlocks on the door — got that way for a reason. Forensic accountants can check to see whether mistakes or malfeasance devalued those assets.

- **Investigation of company theft:** Some of the worst financial crimes happen right under the nose of the boss. *Ghost payrollers* — fake employees getting real checks — are common in companies and governments alike. Crooked employees can create such scams very easily, based on resources close to them. They can funnel cashable paychecks through currency exchanges that are in on the scam, for example. Forensic accountants are trained to spot irregularities in accounts that can reveal such mischief.
- **Divorce investigations:** Never underestimate the loss potential of love gone wrong. We talk about valuation issues in divorce in Chapter 19, and forensic accountants may play a big part in that process. In family law, a lot of the friction occurs over the lack of information sharing and suspicions that shared numbers are far below — or sometimes far above — where they should be.
- **Global terrorism:** Increasingly, companies have to meet legal standards to make sure that employees in the United States and abroad are not involved in illegal activities that could affect local, state, or national security. Terrorists gather their funding through many disparate sources, delivering small amounts that largely go undetected, says Dorrell.

  The USA Patriot Act, signed after the terrorist attacks of September 11, 2001, requires financial institutions to establish and maintain anti-money-laundering programs. In addition, all U.S. companies are required to comply with the Foreign Corrupt Practices Act, which establishes acceptable business practices. Many states have laws governing private investigation practices that apply to CPAs.

From a valuation professional's perspective

Most of the time, a valuation professional does "amateur" forensic accounting work on her own, but her work doesn't replace the formal procedures and tests done by a trained and certified forensic accountant. Valuation professionals get close to the forensic process when they begin to normalize the financials of the business. Most of the time, they're just adding back the owner's perks or making adjustments for fair market rent, fair market wages, and various other financial activities inside the company. If a valuation professional sees something that doesn't look quite right, she simply notes it in the valuation report.

Here's an example that should raise the eyebrows of a valuation professional but could be found more easily by a forensic accountant doing some closer snooping: A medical-device company takes an order, delivers the equipment to the patient's home, and charges the customer (or his insurance company) for the items. So far, things seem perfectly normal. But suppose that the

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The transaction was originally structured to declare the patient the owner of that equipment. Here's the problem: When the material is returned, the company illegally takes the equipment back into its inventory without recording it and then uses the returned equipment to fulfill new orders as they come in. This process works to understate the company's actual inventory and its overall cost of goods, making the company appear to be more profitable than it actually is. Higher profit means higher valuation — which may be based on fraud.

Because this operation is likely being done off the books (with no formal records being kept), a valuation professional may not catch the fraud. But if she were to smell something funny — such as margins wildly higher than those of competitors in the industry — she'd either try to investigate it herself or recommend an audit. The forensic exercise would take place as part of the audit.

In essence, the forensic accountant would perform an investigation to uncover the truth behind the numbers; then the valuation professional would use the results of the forensic exercise to renormalize the numbers. The two professionals would combine their efforts to establish and reinsert the true normal inventory costs, thus realigning gross margins to what they should've been.

Many appraisers working on small-company deals don't catch this sort of operation unless they're very talented and experienced. They simply don't have records to tip them off and have to rely on other signals, such as erratic margins or other swings in financial performance that can't be explained through traditional business evidence. But if a forensic accountant is brought in during due diligence, this situation is exactly what he should be looking for.

TIP

An audit can be the very thing that keeps a new owner from overpaying for a business, so if you're a potential buyer, budget for audits that include the services of a forensic accountant.

From a forensic accountant's perspective

The relationship between a valuation professional and a forensic accountant should be close. A valuation professional is something like an emergency medical technician, whereas a forensic accountant is like a pathologist. Both parties need to be talking. The same relationship rules go for attorneys and other professionals brought into the process.

Like valuation professionals who are CPAs, however, forensic accountants have only one allegiance: to their certificate, meaning the set of professional standards to which they're required to adhere. "We have to honor those to testify to those findings under oath," says forensic accountant and CPA Darrell Dorrell. "We are the only credential holders in the United States with the word *public* in our title. The public expects us to be independent and objective above all else."

Comparing Basic and Forensic Accounting

Most people think that forensic accounting is part of the basic accounting process. In most cases, the processes are very separate and distinct. According to Darrell Dorrell, the following holds true:

- An *audit* is a CPA's commentary on the representation of financial statements produced by management. Typically, virtually no forensic accounting is applied.
- Basic accounting, such as the day-to-day assembly and reporting of a company's financial transactions, requires virtually no forensic accounting.
- Forensic accounting typically assesses basic accounting reports and compares them with reality, identifying departures, undisclosed items, and related matters.

"Traditional accounting is scorekeeping according to a set of rules such professionals must follow. Forensic accounting is about investigation," Dorrell explains. Yet he points out that forensic accounting isn't just about fraud; it's also an essential component of accurate business valuation based on facts and circumstances.

"It's not just people outside the accounting profession; people inside the accounting profession often confuse forensic accounting with fraud. The two are related, but fraud is a subset of the forensic accounting discipline," says Dorrell, whose company provides valuation services in addition to the more common activities associated with forensic accounting. Dorrell continues:

> "Business valuation must consist of forensic tests because by exercising forensic tests, you resolve valuation-related questions. For example, with forensic tests, you can determine the actual pattern of cash flows — the ultimate measure of value, what kind of normalization (adjustment of financial statements) needs to occur, the optimal capital structure of the business — measure the similarity of guideline transactions, assess the fit of a discount rate, and so on."

Can small companies afford forensic accounting?

For many companies, professional bookkeeping and accounting services can be a significant expense. Here are some appropriate questions to ask yourself about affordability:

- Do you have a concern about the financials of a target company or a company you already own and think that an investigation is necessary? Assess the reasons you think a forensic investor would be appropriate in this situation.
- If the first point is relevant, what are the potential costs of *not* doing an investigation? The company may face possible civil or criminal charges, or cash may be disappearing at a rate that threatens the viability of the business.
- What are the costs in your area for forensic accountants with the correct training and certification, and do they work for companies of your size?

The more complicated the investigation — and whatever chores are tied to the investigation, such as valuation — the more the investigation will cost. Professionals typically don't charge fixed fees in such complex matters, but fees are worth asking about.

An effective way to manage fees is to instruct the forensic accountant to conduct the work in phases. In other words, consider writing into the work agreement a statement like this: "When you have reached $5,000, let me know your findings and where else it might be beneficial to investigate." A legitimate specialist will advise you to stop when there appears to be no reason to continue.

Recognizing Business Situations That Trigger Forensic Accounting

Forensic accounting is not all about illegal activity, though questionable financial behavior certainly is a major catalyst for many such investigations. Here are some of the kinds of situations that forensic accountants may be hired to investigate in organizations:

- **Ownership:** Evidence of improper or illegal manipulation of ownership within a company or hidden assets relevant to heirs, shareholders, or soon-to-be ex-spouses
- **Succession planning:** When there's doubt that a new management team was formed with proper diligence and planning
- **Bankruptcy:** When there's suspicion of illegal or incompetent financial manipulations that led to companies' going into bankruptcy or liquidation

- **A need for added oversight:** When an owner or shareholder needs someone to assess a business valuation done at the request of the controlling shareholder
- **Skimming and embezzlement:** Anything from petty theft to scams that create massive financial losses within an organization
- **Top-level corporate fraud:** Companies such as Enron and WorldCom — two major firms that failed in the early 2000s — owed much of their demise to illegal and questionable acts by top management
- **Mergers and acquisitions:** Errors, either intentional or unintentional, may surface in the valuation of assets when companies are getting together
- **Tax evasion:** Evidence of hidden tax liability and possible illegal tax avoidance that can become a major liability for future management
- **Money laundering:** Suspicion that a company may be filtering ill-gotten money through a series of financial transactions so that the money looks as though it came from legitimate sources
- **Contradictory financial reporting:** When a company has reporting inconsistencies in its financial data, it may not be illegal, but it's exceptionally important for a prospective buyer or seller to determine what the inconsistencies are and see that they're fixed before a purchase or a sale

Doing a Forensic Accounting Test

This book can't give you in-depth knowledge about forensic accounting processes, but here's the basic definition of a *forensic test:* a financial formula or process that puts a company's numbers through different paces to test or determine the accuracy and completeness of its figures. "By doing forensic tests, you can determine what kind of normalization needs to occur on a balance sheet," Darrell Dorrell says.

Valuation involves few specific formulas, specific tests that apply within forensic evaluation. A well-known test, TATA (total accruals to total assets), looks something like this:

$$\text{Total Accruals to Total Assets} = (\text{Working Capital} - \text{Cash} - \text{Current Taxes Payable} - \text{Depreciation/Amortization}) \div \text{Total Assets}$$

A TATA test compares the consistency of results period to period. You'd do a

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Looking at Forensic Accounting Case Studies

Forensic accountant Darrell Dorrell won't cite actual situations, to ensure the privacy of clients, but he tells a few stories about small companies that could've used outside forensic accounting and valuation help:

- **Case 1:** "Two companies were competitors within a geographic region," he says. "One was large and had been operating more than 70 years; the other, much smaller and had been operating about 5 years. The two companies agreed to merge, and each company had its own very high-profile accountants and attorneys conducting due diligence over an 18-month period. After closing the transaction the following May, the combined operation was out of business within 90 days."

  Dorrell's firm was called in to diagnose what had happened. They found that the firms' due diligence had failed to identify the extreme seasonality of the businesses, and both firms went ahead with a leveraged buyout that happened at the precise time when each business historically began losing cash due to the seasonality. "They simply ran out of money. This is an example of how traditional tools and techniques are simply inadequate," Dorrell says.

- **Case 2:** "A company hired a national business valuation firm to determine the value of its shareholdings in anticipation of a sale. One of the shareholders believed that the results made no sense in comparison to his understanding of the company," Dorrell says.

  Dorrell's firm was called in to assess the results and found that that the national firm had used an earnings before interest, taxes, depreciation, and amortization (EBITDA) multiple but failed to account for the post-transaction capital structure. Consequently, the private financing firm backed out of the transaction because it was doomed to fail. (For more on EBITDA, go to Chapter 4.)

- **Case 3:** The founder of a company that was more than 40 years old wanted to retire. "The longtime CFO, a supposed friend of the family (he had completed the entire family's tax returns for many years), structured a deal that was portrayed as beneficial to owners, employees, customers, and lenders," Dorrell explains.

  The trusted chief financial officer had two national valuation firms determine value, and based on that result, he secured additional debt and equity financing to buy most of the owner's stock. The nature of the accounting treatment enabled the CFO to redeem all the old stock and issue new stock with a private benefit to himself. He gave himself an ownership position of nearly one-third without paying even a penny for his stock.

> Within two years, the company was struggling under the new capitalization plan, and it became clear to the remaining family members that the deal had been made for the CFO's benefit.
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> Dorrell's firm was called in to assess the problem, diagnose a remedy, and implement changes. It found that the valuation firms had overvalued the company to trigger the CFO's accounting treatment. The overvalued company resulted in a debt load that nearly strangled the company. The firm was revalued at its correct value, and the capital was restructured, and the CFO no longer works for the company.
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> Says Dorrell, "This was to have been a simple sale of a company where the owner had been around for 40 years. He relied on his CFO to arrange the buyout and wasn't as closely involved in the process as he should have been, but indeed, the CFO structured a deal that ended up giving two-thirds of the company's stock to the owner's son and the other third to himself."

Dorrell has seen many situations in which attorneys, valuation professionals, and corporate accountants and CFOs didn't make a thorough evaluation of what the deal would cost the company post-closing. He maintains that the preceding examples are only a few of the reasons it's important to bring in a forensic accountant before any major financial transaction takes place at a company to make sure that its numbers are in order.