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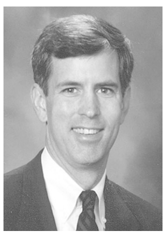
*Guest Article:*

# Business appraisers and allegations of accounting fraud

***by George B. Hawkins and Michael A. Paschall****



George Hawkins

In many dispute situations (particularly those that are noticeably acrimonious), there may be allegations of financial misrepresentation by one or both parties. One example of this may be a wife's allegation that she and her husband have been underreporting income for years and the value of the company is actually much higher than would otherwise appear.

However, what is often referred to as fraud is not really fraud at all—it actually may be the expensing of non-business-related costs through the business, which has the effect of lowering the company's reported profitability.

This article will clarify the business appraiser's role as it pertains to this issue and the ramifications of dealing with issues of fraud if clients believe it to be present. It will examine the various categories of income statement distortions for which the business appraiser might consider necessary adjustments.

### Business appraiser's role

Allegations of fraud raise several issues for the business appraiser. First, business appraisers must rely on the financial information provided by the parties under the assumption that, if an auditor has organized this information or this is the information reported by the company to the federal government, it is good enough information to use in a valuation report. In other words, the business appraiser accepts the financial results as accurate and complete.

Second, business appraisers are not forensic accountants or fraud examiners and are neither trained nor experienced to investigate claims of this nature. Such an individual can be expensive to hire, and the time required to undertake an inquiry and reach a conclusion may be substantial, with an unknown outcome.

Finally, the party making this allegation should be aware that, although this information may help him or her win the battle, it may also cause them to lose the war. In the example above, if a wife's allegation of underreporting of income were proven by hard evidence to be true, the value of the company may well rise, increasing the value of the marital estate. However, the wife may have opened up a Pandora's box should this information of underreporting come into the public record and to the attention of state and federal taxing authorities. If this is the case, the wife and her ex-husband could be subject to back taxes, penalties, and fines that could dwarf any moderate gains the wife achieved as a result of blowing the whistle (not to mention the risk of a felony charge for tax fraud).

### Income statement distortions

This does not mean that some of these factors aren't often considered in business appraisals. The business appraiser normally attempts to determine if adjustments to the income stream used for valuation purposes are warranted. There is an almost unlimited variety of potential revenue and expense items that may be encountered in actual valuation engagements that might warrant adjustment for valuation purposes. This article provides only illustrative examples.

Michael Paschall

Broadly speaking, most of the potential distortions that are typically encountered fall into one of four categories. Shown below is a listing of these four categories, along with a few of the many examples of items that might warrant adjustment under each.

### Possible income statement adjustments

1. **Officer and shareholder compensation and benefits:**

- Officer compensation that is above or below a market rate for the services provided
- Unusual or unnecessary perquisites, such as country club dues, lavish autos, or non-business travel
- Excessive meals and entertainment
- Personal accounting and legal advice paid by the company (e.g., divorce-related fees)
- Payment of management fees to companies affiliated through similar ownership at rates that are above market

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## INSIDE...



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# Business appraisers and allegations of accounting fraud

*Continued from front page ...*

- Rent paid on real estate owned by related parties which is above or below a market rate that would be available from an unrelated third party

**2. Accounting policy issues:**

- Use of cash basis accounting, slowing down the receipt of receivables at year-end and accelerating the payment of expenses
- The recognition of revenues and expenses in project-oriented companies (e.g., percentage of completion versus completed cost methods for general contractors)
- Expensing of assets fully in the year purchased (IRC section 179 depreciation expense) for tax purposes even though their economic useful life may be many years
- Actual cash taxes versus deferred taxes
- The use of accelerated or tax basis depreciation methods that overstate economic levels of depreciation in earlier years
- Amortization or deferral of revenues or expenses over the life of an asset, project, etc., that may not reflect the actual economic reality

**3. Unusual or non-recurring income or expenses:**

- Legal fees or lawsuit settlement costs associated with unusual litigation
- Environmental cleanup costs
- Restructuring charges
- Gains or losses on the sale of assets
- Unusual storm or fire damage (expense) or income from hazardous insurance policies to cover the impact
- Unusually high or low revenues or expenses in a given year due to an unusual or one-time event (e.g., cleanup costs associated with a natural disaster)

**4. Non-operating asset revenues and expenses:**

- Cost of owning, renting, or maintaining beach and mountain homes
- Yachts or personal airplanes not central to the business
- Investment real estate not used by the business, or excess real estate that is owned by the company but not needed to operate (e.g., the 500 acres adjacent to the plant not needed for future expansion)
- Dividend and interest income from marketable securities or loans to shareholders
- Investments in art
- Interest income on excess cash that is at levels not needed by a buyer to operate the business

The above are but a few examples of the more common items under each category for which income statement adjustments might be needed. The variety of possible distortions to company revenues, expenses, or earnings is virtually limitless. Whether the income statement should be adjusted for these and other similar items requires careful judgment on the part of the appraiser.

Also, sometimes distortions may be present but it may be impractical or impossible to make a supported adjustment. Ultimately, the central issue is whether the elimination of an individual item would provide a more accurate picture of the long-term earnings capacity of the business and the economic returns available to a buyer.

This is why it is incumbent upon the business appraiser to carefully examine a company's financial results to determine if distortions that warrant adjustment are present. As with the issue of true fraud, however, the business appraiser can only rely on the completeness and reliability of what he or she is told, but must know how to ask the right questions to gain the information necessary to determine if adjustments are warranted. This does not mean, however, that the appraiser must accept the business owner's view of what is a personal expense versus what is a business expense.

## Conclusion

Business appraisers are not auditors and therefore cannot audit a company's past results when there are allegations of fraud. However, when fraud is believed to be present, the parties face the difficult decision of whether to hire an outside forensic auditor. Factors to consider include the substantial costs, time required, and potential legal ramifications of doing so.

Realistically, much of what is referred to as "fraud" in valuation disputes isn't necessarily fraud at all, because the numbers may be entirely accurate. Instead, such "fraud" is often merely the use of corporate resources for the owners' personal needs, distorting profitability downward. The business appraiser can play a valuable role in attempting to make reasonable adjustments in these situations.