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ADVOCATE'S EDGE

990 Stewart Avenue
Garden City, New York 11530

t: 516.288.7400
f: 516.288.7410
e: info@garibaldicpas.com

GARIBALDI GROUP
Certified Public Accountants
Financial and Management Consultants

www.garibaldicpas.com

Valuation takes center stage when business owners divorce

Splitting up a marital estate can be a long, complicated process, particularly if it includes a private business interest. Fortunately, a valuation professional can provide answers to these critical financial questions:

How much is my business interest worth?

There are three ways to value a business: the cost, market and income approaches. All of these techniques start with the company's financial statements. But discovery shouldn't stop there, especially for spouses who aren't involved in day-to-day business operations. Valuation experts should be given equal access to financial records and opportunities to tour the company's facilities and interview management. Inadequate discovery can cause an expert to miss critical information and possibly lead to inaccurate value opinions.

Another related question is: How much of the value should be included in the marital estate? If the business interest was owned before the marriage, it might be appropriate to include in the marital estate only the *appreciation* in value over the course of the marriage, depending on the facts of the case and relevant state law. Estimating appreciation in value requires a comparison of the current value of the business interest vs. its value on the couple's wedding day.

> In states that find double dipping unfair, the value of the business's goodwill (or a portion of it) may be specifically excluded from the marital estate.

Does the asset allocation overlap with maintenance payments?

Another reason to exclude a part of the business's value from the marital estate relates to the concept of "double dipping." This may occur when a spouse receives double recovery for a single asset. For example, courts in some states have decided that it's inequitable for a spouse to receive maintenance payments based on his or her spouse's future income, along with half of the value of a business that's based on its ability to generate future income.

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Why an appeals court requested an *expert* valuation

At trial, the parties in a divorce case might not be *required* to present expert valuations of marital assets. But *Lacoste v. Lacoste*, a Mississippi appellate court ruling, shows why it's a good idea to hire an expert from the start.

Here, the husband owned and operated a fitness training company. Although the business was the couple's main asset and source of income, neither spouse presented valuation evidence.

Left to her own devices, the chancellor hearing the case decided that the income approach was most appropriate for valuing the business. She noted that a valuation professional would review the company's historical earnings, adjust the income to reflect normalized earnings and divide the normalized earnings by a capitalization rate. Lacking such testimony, the chancellor valued the business using the only information she had: one year's income statement.

The husband appealed, arguing that the chancellor had erroneously valued the business. The appellate court found the chancellor had done the best she could with the evidence presented, but it reversed and remanded the case for an adequate valuation. The court determined that a valuation was so important here that it was essential to obtain further testimony by the parties, their experts or an independent expert appointed by the chancellor.

be specifically excluded from the marital estate. Before goodwill can be excluded, however, it must be valued. Often, this requires goodwill to be split between personal and business goodwill. The former is linked to the individual owners and their abilities to generate future income. Usually personal goodwill is based on the individual owner's ability to generate income and can't be transferred to a third party.

Is the controlling shareholder hiding anything?

A controlling shareholder spouse may try to hide income or assets to achieve a more favorable divorce settlement. Downplaying assets and income (or, conversely, exaggerating liabilities and expenses) can lead to 1) lower business valuations, and 2) reduced payments for child support and alimony — unless the valuation expert identifies the anomaly and makes an adjustment to record the value of the missing or inaccurate item(s).

Reasonable "replacement" compensation — based on the market value of the owner's contribution to the business — is a common adjustment that's made in divorce cases. Additionally, some business owners try to deduct their personal attorney's fees or expert witness fees as business expenses. Running personal expenses through the business not only reduces the value of the business interest, but it could also expose the noncontrolling spouse to IRS inquiry.

Other adjustments may be needed to normalize the income stream to benchmark the subject company against comparable companies. Examples include adjustments for nonstandard accounting practices (such as cash-to-accrual basis of accounting changes) and for nonrecurring income or expenses (from, say, a discontinued product line or the sale of a nonoperating asset).

Need help?

If your marital estate includes a business interest, it's probably one of the biggest line items on your personal balance sheet. A fair settlement hinges on an accurate valuation. That can be achieved by hiring an experienced valuation expert who understands how courts handle challenging divorce issues in your jurisdiction. ■

It's all about value

Fortify shareholders' agreements with these 4 valuation details

Shareholders with the forethought to sign buy-sell agreements help facilitate voluntary and involuntary transfers between shareholders. But when it's time for a buyout, many shareholders discover that their agreements don't cover all of the necessary details. Here are four key terms to consider when drafting or reviewing a buy-sell.

1. Definitions

One of the leading causes of disputes in shareholder buyouts is failure to provide valuation guidelines and define key terms. For example, buy-sell agreements often state that the buyout price is the value of an interest in the business. But "value" can mean different things in different contexts, so the agreement needs to spell out whether the price should be based on fair market value, fair value, investment value or some other standard of value.

> Independent professional valuation services increasingly are favored in buy-sell agreements because shareholders must agree on a valuation firm's qualifications and independence.

Moreover, every valuation is effective "as of" a certain point in time, and the valuation date can have a big impact on the result. The agreement should specify whether the date used is the date of the triggering event, the last day of the company's most recent fiscal year or some other date. Using a specific date rather than the date of the triggering event discourages owners from timing their departures to maximize the buyout price.

2. Discounts and premiums

Even if a buy-sell agreement specifies a standard of value, the *level* of value — which can range from a controlling interest to a nonmarketable, minority interest — can have an enormous impact on the outcome.

Parties to buy-sell agreements often assume that value is based on their pro-rata share of the value of the business as a whole. Without further direction, a valuation specialist might adjust this value to reflect control premiums, minority interests or marketability discounts.

To avoid unintended consequences, the agreement should clearly specify which discounts or premiums, if any, apply. The parties might feel, for example, that a fair price is the fair market value of an owner's interest, without regard to discounts or premiums. Beware: Sometimes discounts and premiums are imbedded in the valuation expert's methodology. So consider addressing in the buy-sell agreement which types of adjustments can be made when projecting the company's income stream.

3. Use of valuation experts

Other issues to consider include time limits for completing various valuation steps, appraiser qualifications and alternative dispute resolution (such as arbitration or mediation). The preferred method of resolving valuation problems inherent in buy-sell agreements is an agreement requiring shareholders to abide by independent findings if the agreement's terms trigger a valuation.

Independent professional valuation services increasingly are favored in buy-sell agreements because shareholders must agree on a valuation firm's qualifications and independence. The resulting valuation under the agreement will be objective and independent of any individual shareholder's interests, making it fair to all shareholders.

4. Timeline

A final consideration, especially if using a single appraiser, is when the appraiser will be selected. Many buy-sell agreements provide that the parties will select an appraiser after a triggering event occurs. But there are two significant drawbacks to this approach. First, it may be difficult for the parties — who now have conflicting interests — to agree on someone. Second, even if both parties are comfortable with the appraiser, the outcome will be uncertain.

A more effective strategy is to select an appraiser at the time the agreement is signed. Ideally, the appraiser will perform a valuation at that time to set the initial buyout price and then revalue the business annually (or every two or three years). This allows the parties to become comfortable with the appraiser's methods and conclusions and to get a handle on what the buyout price will be.

If a triggering event occurs, the buyout price is based on the most recent appraisal. But many agreements provide for a new appraisal if the most recent one is out of date (more than a year old, for example). In addition, a buy-sell agreement must be kept current to have any validity, so it's critical to review the agreement regularly and amend it, including any valuation provisions, as necessary. ■

Fight fraud with these common managerial accounting tools

When thinking about the ways financial experts can uncover fraud, data analysis and other forensic accounting techniques may come to mind. But qualified experts also know how to use everyday managerial accounting practices to ferret out fraud.

Budgets

Budgets can provide insight into how management expects a company to perform in the near future. As such, budgets might highlight unusual transactions and other developments that fall outside of management's expectations and warrant further investigation.

Budgets can also play a role in fraud deterrence. Creating budgets typically requires input from people across the organization. Such interdepartmental communication and information sharing provides an informal fraud "screen" that makes it harder for perpetrators to manipulate the financial results.

Conversely, the absence of variances when they would be expected can be cause for concern. For example, an organization may have run into an unanticipated price jump for a critical component, which would understandably lead to a purchase price variance. If no such variance is found, it could be a sign of financial reporting fraud.

Would-be thieves may be deterred by the idea that managers and co-workers in other departments are paying attention to what they're doing.

Variance analysis

After a budget has been finalized, management may review it and investigate differences between actual and budgeted performance to find the causes. For example, if actual wages significantly exceeded budgeted wages, the difference could be due to wage increases, productivity declines, greater downtime, unexpected demand for the company's goods or services, or a combination of these possibilities. It could also signal phantom employees on the payroll, however.

When it comes to fraud detection, experts pay particular attention to variances related to inventory and purchase pricing. For example, variances between the actual and budgeted pricing for supplies could suggest the existence of:

- Kickbacks, where the perpetrator takes a cut from a vendor that inflates its prices, or
- Fictitious vendors, where the payments go to the perpetrator and no inventory is received in exchange, requiring the organization to spend more money to restock inventory.

If a scheme involves the purchase of subpar materials or fewer units than ordered, it could show up in spoilage or other inventory-related variances.

Contribution margin

The term "contribution margin" generally refers to the difference between a unit's sale price and its variable costs. It's often used to make pricing decisions, calculate breakeven point, and evaluate profitability. But contribution margin analysis also can be used to detect fraud schemes, such as skimming or inventory theft.

The key lies in the contribution income statement. The traditional financial accounting income statement (also known as a profit and loss statement) initially computes a gross margin (revenues less variable and fixed manufacturing costs). But the contribution income statement first calculates the contribution margin (revenues less variable manufacturing and nonmanufacturing costs). Contribution margin as a percentage of revenue should remain fairly consistent over time.

If the contribution margin is dramatically lower than usual, fraud could be to blame. Perhaps an employee is understating revenue to hide skimming — but the margin would fall because the variable costs relate to the actual sales, not the falsely lower sales that are reported.

Important caveat

While the techniques explored here can raise red flags that fraud is occurring, it's important to remember that red flags aren't solid evidence. When fraud is suspected, a forensic accounting specialist can help you make a defensible determination. ■

How FRCP amendments affected e-discovery rulings in 2016

The amended Federal Rules of Civil Procedure (FRCP) took effect in December 2015. What effect did the amendments have on cases involving the discovery of electronically stored information (ESI)? The answer may be found in a recent study published by Kroll Ontrack, a data recovery and e-discovery consulting firm. The conclusions drawn can help you anticipate pretrial challenges and how courts might handle them.

Unearthing the main issues

Kroll's study reviewed 57 significant state and federal cases and revealed four common ESI-related issues:

1. Disputes over production, including methods of production, proportionality and scope of discovery (56% of the cases studied),
2. Preservation, spoliation and options for sanctions (32%),
3. Procedural concerns, such as search or predictive coding — also known as technology assisted review (TAR) — protocols (8%), and
4. Cost considerations, including cost shifting and taxation of costs (4%).

The FRCP amendments emphasize both relevance and proportionality — and the study found that the 2016 court opinions focused on the same issues.

Digging deeper into the cases

The study came to some important conclusions. For example, it found that the opinions addressing proportionality demonstrate that the amendments haven't changed the discovery burden. In other words, both the requesting and responding parties must explain why a discovery request should or shouldn't be granted.

The opinions also reflect the greater attention paid to preservation practices under the amended FRCP 37. The cases considered 1) reasonable steps to preserve, 2) intent to deprive another party of relevant ESI, and 3) the inherent power of the court to impose sanctions. One case noted that the court had the power to grant sanctions even if FRCP 37 hadn't applied.

Cases involving procedural issues largely dealt with search protocols and predictive coding. Although courts acknowledged that predictive coding is frequently the most effective and efficient search option, they refrained from requiring parties to use it. Instead, courts found that the responsible party is usually best positioned to determine how to search for and produce responsive ESI.

When courts addressed cost-centered issues, they seemed willing to require parties to pay for their own discovery in some circumstances. For example, the plaintiff in one case was given access to emails (at the plaintiff's expense) where the defendant didn't have its own archiving system.

Lessons learned

Research shows that courts expect parties to collaborate early in a case to establish the scope of discovery, production formats and similar matters. Such collaboration could preempt many pretrial disputes over e-discovery. ■

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