

ADVOCATE'S EDGE



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Magarik v. Kraus USA, Inc.

Bad assumptions sink expert's plumbing business valuation

Courts expect valuation experts to base their analyses on sound data and realistic assumptions. If experts fail to do so, courts may disregard all or part of their conclusions. Here's a recent statutory appraisal case from New York that highlights the importance of using reliable inputs when valuing a business.

Lead-up to litigation

Kraus USA is an S corporation that sells fine faucets, sinks and related plumbing fixtures online, primarily through retailers. All its products are manufactured in China. The petitioner joined the company in 2009. He "contributed substantially to the value of the business ... and to its success," according to the Nassau County Supreme Court. The company experienced rapid growth. In 2012, it had \$21 million in sales; in 2015, that figure had jumped to \$36 million. But the company failed to generate positive cash flow.

In 2015, the company applied for a revolving credit line. The loan application included monthly cash flow projections prepared by the company's CFO, who forecast a sales increase of more than 40% over the coming year. The shareholders also

submitted personal net worth statements that valued the company at around \$30 million.

Appraisal action

Shortly after securing the credit line, the petitioner sought a judicial dissolution of the company under New York corporation law. The petition alleged illegal, fraudulent and oppressive actions by the other shareholders. At the time of the action, the petitioner owned 24% of the company's shares. The remaining shares were split 25% and 51% between two defendants.

In lieu of dissolving the company, the defendants elected, as allowed under state law, to purchase the petitioner's shares for fair value. The petitioner eventually voluntarily dismissed his lawsuit, leaving one issue for the court to decide: the fair value of his 24% interest on the day before he filed the dissolution petition.

Dueling valuations

At trial, the petitioner's expert applied the market and income approaches. His income approach valued the entire business at \$21.9 million, while his market approach arrived at a value of about \$38.8 million. He proposed that these two values, which the court called "incredibly disparate," should be averaged. Under this methodology, the value of the entire business was around \$30 million, the same figure submitted with the loan application, and the value of the petitioner's 24% interest was \$7.2 million.

The defendant's expert also applied the market approach, which generated a value range of \$5.26 million to \$6.1 million for the entire business. And he applied the income approach,



Exercise caution when using management's projections

The petitioner's expert in *Magarik* (see main article) isn't the first to make the mistake of basing the value of a business on internal projections that were originally compiled for a loan application. Loan applicants tend to present optimistic estimates of expected future performance, particularly their projected growth models. This is especially likely for start-up ventures and entrepreneurs and other businesses without a stable earnings history.

When inflated projections are mistakenly used to calculate value for litigation purposes, it can severely undermine an expert's credibility. Valuation experts should consider industry trends and market conditions before relying on information provided by company insiders. Reliable projections are supported by objective, market-based evidence that's relevant to the subject company.



which produced a value range of \$5.9 million to \$6.1 million. Placing greater weight on the income approach, the expert valued the company at \$6.05 million on a controlling basis. After applying a 25% discount for lack of marketability, he concluded the petitioner's 24% interest had a fair value of approximately \$1.1 million.

Court findings

The court found numerous flaws with the conclusions set forth by the petitioner's expert. His application of the market approach was based on public companies that weren't reasonably related to the subject company in terms of size, ownership or marketability. Likewise, the income approach was based on "unrealistic and optimistic" projections from the loan application that never materialized.

The court pointed out that the petitioner's expert didn't sufficiently account for the competitive nature of the online marketplace or the company's lack of cash flow. In addition, his estimates included the

value of the company's so-called "brand" — which the company didn't own. Instead, the brand was owned by another entity over which the company had no direct control.

In contrast, the court found that the defense expert's conclusions were supported by credible evidence. The expert showed that Kraus USA was a successful, growing business that wasn't particularly liquid. So, the court accepted his value for the entire business (\$6.05 million), but it lowered the discount for lack of marketability to 5%. As a result, the petitioner's interest was valued at approximately \$1.379 million.

Garbage in, garbage out

Value conclusions are only as reliable as their underlying assumptions. Experts' analyses are likely to fall apart in court if the inputs are unreliable. Ingredients for a defensible valuation include 1) the use of experienced, credentialed experts, and 2) the application of professional skepticism when relying on financial projections and comparables. ■

Estimating impairment in the COVID-19 era

The COVID-19 pandemic may have triggered an impairment test for some companies and nonprofits — even those that have opted to amortize goodwill under U.S. Generally Accepted Accounting Principles (GAAP). Impairment charges reduce the carrying value of acquired goodwill and lower profits for accounting purposes — a possible red flag for investors and lenders. So, it's important to get it right.

GAAP basics

Under GAAP, the term “goodwill” refers to the value of certain nonphysical assets that are acquired in mergers and acquisitions. Initially, the carrying value of goodwill is determined by deducting the value of tangible assets, identifiable intangible assets and liabilities obtained in the purchase, from the cost to buy the business or nonprofit entity.

Subsequently, management is required to monitor and evaluate goodwill “impairment.” Impairment write-downs reduce the carrying value of goodwill on the balance sheet and lower profits reported on the income statement.

Fair value of goodwill

Under GAAP, fair value is, “the price that would be received to sell an asset or paid to transfer a liability in an orderly market transaction, as opposed to a fire sale or other unusual circumstance.” When determining fair value for financial reporting purposes, information based on publicly quoted prices (if available) is typically weighted more heavily than nonpublic information and management estimates. This subtly makes fair value estimates different from fair *market* value estimates.

Goodwill impairment equals the amount by which the carrying value of a reporting unit exceeds its fair value. No impairment is reported if the reporting unit's fair value is greater than its carrying value.

Annual testing vs. amortization

Under current GAAP, companies are generally required to evaluate goodwill impairment annually. In lieu of annual impairment testing, *private* companies and nonprofit entities may choose to amortize goodwill over a period not to exceed 10 years. (Note: In recent years, the Financial Accounting Standards Board has discussed extending this alternative to *public* companies, but no decisions have been made as of this writing.)

Additionally, all companies must test goodwill for impairment when a triggering event happens. Examples of triggering events include:

- Loss of a key customer,
- Loss of a key owner or executive,
- Unanticipated competition,
- Negative cash flows from operations, or
- A disaster that causes an extended business interruption.



Once goodwill has been written down, it can't be recovered in a subsequent accounting period. Unfortunately, interim balance sheet and cash flow projections used to measure impairment may have lost relevance by the time annual financial statements are issued.

For example, a goodwill impairment test may have been triggered in the spring of 2020 when fears about COVID-19 peaked. Though market conditions may not seem as dire in hindsight, management should have evaluated impairment through the lens of what was known at the time of the triggering event, not what's known at year end.

Possible relief

The Financial Accounting Standards Board recently approved an accounting alternative for evaluating triggering events. It would allow private companies

and nonprofits to assess events that may trigger a goodwill impairment test at the reporting date, rather than throughout the reporting period as triggering events happen.

This simplified alternative is applicable to annual and interim reporting periods after December 15, 2019. However, the alternative is available only for goodwill. It doesn't apply to other intangibles or long-lived assets.

Outside input

Few companies employ internal accounting staff with the requisite training and time to handle impairment testing. And most auditors won't perform valuation services for their audit clients for fear of violating their independence standards. Business valuation specialists are often called in to handle these complex assignments. Contact us for more information. ■

Close-up on kickbacks and corruption

White collar crime is typically associated with asset theft and financial statement fraud. But more than 40% of fraud cases involve corruption, such as kickbacks, bid rigging, conflicts of interest and extortion, according to *Report to the Nations: 2020 Global Study on Occupational Fraud and Abuse* by the Association of Certified Fraud Examiners. Many people think corruption only happens to businesses in foreign countries, but it can also happen at domestic companies, large and small.

Distinguishing gifts from kickbacks

There's a fine line between modest, acceptable gifts and illegal kickbacks. In a kickback scheme, a crooked employee might give a vendor preferential treatment (such as awarding a long-term contract

to provide supplies) in exchange for a cut of the money the vendor receives. Kickbacks may be disguised as:

- Cash payments,
- Travel,
- Entertainment,
- Hidden business interests,
- Loans, and
- Property transfers above or below fair market value.

The key consideration to differentiating between gifts and kickbacks is the *intention* of the giver. It's illegal for an employee to accept any gift offered with the intent to improperly influence business



decisions — or that would give the impression of compromising the employee's ability to act in the best interests of the company. Companies should apply the same integrity test in deciding whether to offer a gift to a customer or any other third party.

Defining what's proper or improper with a specific dollar amount can be extremely difficult. Common sense must determine if a gift is extravagant or excessive. Most companies address guidelines for offering or accepting gifts in their employee handbooks. Likewise, professional organizations may provide their members with standards for gift giving and receiving.

Unearthing corrupt workers

Detection of a corruption scheme usually begins with a tip from an honest coworker or vendor who notices suspicious behavior. That's why it's important for companies to implement antifraud education programs and create designated reporting mechanisms (usually anonymous hotlines) that are communicated to internal staff and external stakeholders.

It's also critical to watch for red flags of corruption schemes. For example, irregular habits in purchasing behavior may be a sign of trouble. Forensic accounting experts look closely for employees who order materials at a time other than the usual reorder point or who consistently place orders with the same vendor. Kickbacks in general purchasing

may be revealed by comparing costs of materials to revenue and shipping expenses over time. Another potential giveaway is a pattern of lavish business entertainment.

Monitoring the bidding process

Sometimes corruption schemes infiltrate bidding processes. For instance, a bidder might offer an employee money in return for advance information about

competitors' bids. Owners should look out for irregularities in the bid solicitation and submission process — for example, an employee who tailors solicitation requirements to fit the products or capabilities of a single contractor.

Detection of a corruption scheme usually begins with a tip from an honest coworker or vendor who notices suspicious behavior.

Other signals of possible trouble include prequalification procedures restricting competition and bypassing necessary review procedures. Also be wary of foreshortened bid submission schedules that allow only those with advance information time to prepare proposals.

Need help?

Corruption schemes can quickly drain business resources. Contact a forensic accounting specialist in cases where employees appear to cross the line between gift and kickback or to engage in other suspicious behaviors. In addition to helping businesses adopt targeted detection efforts, an outside expert can help evaluate risks and implement preventive measures to safeguard against these scams. ■

Warning: Ambiguous support provisions can prolong divorce cases

Ideally, a separation agreement brings divorce litigation to a definitive resolution. But poorly drafted agreements can lead to multiple rounds of litigation. In a recent Connecticut divorce case, *Marshall v. Marshall*, the parties just wrapped up their court battles — 13 years after the court originally approved the couple’s separation agreement.

Defining key terms

The husband held a 40% interest in an S corporation. A provision in the couple’s 2007 separation agreement specifically excluded Subchapter S distributions from the definition of “pretax income from employment” for purposes of spousal and child support.

However, a conflicting provision didn’t limit pretax income from employment to W-2 income; it defined the term as “base salary plus additional benefits.” The same provision used the fair market value of the husband’s business interest to compute “reasonable and appropriate compensation levels” for base salary. The agreement allowed either party to seek modification based on a substantial change in the husband’s compensation, his employment or his ownership in the company.

Circling back to income

In 2009, the husband’s support payment dropped significantly. He paid nothing in 2010 and filed a request to modify support based on substantial change the next year. To determine the husband’s arrears, the trial court calculated his income based solely on his W-2. After the court granted the motion to modify, the wife appealed, arguing it should consider *all* the business funds available for distribution to shareholders, in addition to salaries paid.

The Connecticut Court of Appeals found that the agreement was unclear about whether pretax income from employment should include the



husband’s distributions and, if so, to what extent. It remanded the case to the trial court to determine the parties’ intent.

Leaving matters open to interpretation

The trial court concluded that the parties intended to include some distributions from the business in the husband’s income. Then it applied his expert’s methodology for computing pretax income — multiplying the business’s gross revenue by a certain percentage to determine reasonable compensation. Ultimately, the court granted the motion to modify.

The wife appealed. She asserted that the plaintiff’s pretax income should have equaled the amount the husband would have earned if the S corporation had distributed 100% of its earnings. But the appellate court affirmed the lower court’s use of the reasonable compensation methodology.

Seeking financial expertise

No one wants to endure unnecessary, protracted litigation over a painful chapter in life. Consult with an experienced financial expert when drafting critical agreements that involve compensation and other financial matters to ensure agreements are clear and comprehensive. ■



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