

The ABCs of valuation

Although each business valuation assignment may vary somewhat depending on facts and circumstances, most follow an established set of steps.

This article explains some of the basic steps of the valuation process, including defining the engagement, gathering relevant information and analyzing data. In addition, the article notes the importance of good verbal communication skills, breadth of experience and uncompromising objectivity—whether the appraiser is valuing a business for merger or acquisition purposes, gift tax planning, or in connection with a legal matter.

Understanding the process

Most valuations follow an established set of steps. Knowing these steps reduces the risk of unwanted surprises.

Defining the engagement

Detailed directives are imperative to accomplish the engagement's objectives. Most business appraisers use engagement letters to spell out the terms and scope of the valuation assignment. The following are some key elements of a business valuation engagement letter:

- **Name of the business to be valued** (ABC Company);
- **Client name** (the person or firm that will actually be retaining the valuation expert);
- **Interest to be appraised** (i.e. 100 shares or 10% of the common stock);
- **Valuation "as of" date** (as of Dec. 31, 20XX);
- **Standard of value** (fair market value, fair value, or investment value);
- **Premise of value** (going concern or orderly liquidation);
- **Purpose** (marital dissolution, merger, gift tax, planning); and
- **Report type** (full comprehensive or summary).

The engagement letter should also address issues such as timelines, deliverables, responsibilities of each party, and fees, including payment

terms. Most business appraisers will not start working on the assignment until receiving the signed engagement letter.

Gathering relevant information

Following the engagement letter, the appraiser will typically send the client an initial information request. Initial information requests often include financial statements and tax returns, fixed asset listings, budgets and projections, shareholder or partnership agreements, and previous business or asset appraisals.

Along with the initial document request, some appraisers will also ask management to complete a questionnaire. Management interviews may supplement (or supplant) that questionnaire. Questionnaires and interviews often cover a broad range of topics, such as product or service offerings, company history, technology, and industry trends. In addition, a site visit provides the appraiser with another opportunity to assess business operations and ask questions.

In adversarial situations—such as a shareholder dispute or divorce—business owners sometimes deny the opposing experts access to records, management or facilities. In these situations, it will generally be necessary to request specific documents and information through court filings early in the discovery process.

Analyzing data

Next, the appraiser analyzes the data. His or her analyses may include adjusting the historical financial statements for purposes of projecting future cash flows. Business appraisers often use databases and research studies to estimate various appraisal metrics, such as pricing multiples (for use in the market approach), the Company's cost of capital (for use in the income approach), and discounts for lack of control or marketability. After analyzing all the data, the appraiser utilizes various valuation methodologies to form his or her ultimate conclusion of value.

Writing the report

Business appraisers generally communicate the results of their analysis in a written report. A well written valuation report should be both comprehensive and understandable. At a minimum, the report should include an overview of the business' operations, the appraisal processes utilized, economic and industry conditions, critical assumptions and a reconciliation of the various indications of value.

Providing expert testimony

Business appraisers are often called upon to provide expert testimony to explain their work and conclusions of value. In addition to explaining and defending their own opinions, valuation experts may be asked to prepare

A question of relevance

Calculating lost prospective profits

Establishing lost profits for businesses that were never actually operational can prove difficult. In *Parlour Enterprises Inc. v. The Kirin Group*, a California appellate court weighed in on the key factors to consider when calculating prospective profits in such cases.

As this article explains, the court's decision emphasizes the need to hire qualified business appraisers who can build a case with reasonable certainty by using, for example, expert testimony, financial data and market surveys.

Establishing lost profits for businesses that were never actually operational can prove difficult. In *Parlour Enterprises Inc. v. The Kirin Group*, a California appellate court weighed in on the key factors to consider when calculating prospective profits in such cases. Among other points, the court's decision emphasizes the need to hire qualified business appraisers.

The big chill

From 1963 to the mid-1980s, at various times, 55 to 140 Farrell's Ice Cream Parlours were in operation across the United States. Operations shut down in the mid-1980s, except for one location in San Diego. Then, in 1996, Herman Chan formed a corporation, Kirin, and purchased trademarks and trade names from Farrell's.

Kirin opened a Farrell's in Temecula, Calif., in January 1999, but closed the restaurant in early 2002 because it wasn't profitable. Before the closing, Kirin entered a series of agreements with Parlour Enterprises to develop Farrell's subfranchises in California. Under the agreements, Parlour would receive an upfront fee, as well as royalties based on a percentage of net sales.

The agreements also required Parlour to open a minimum number of restaurants within a certain time period. It opened only one restaurant—in Santa Clarita—in that time, but obtained an extension from December 2002 to December 2003. In October 2003, Kirin terminated the agreements for failure to pay certain attorneys' fees. Parlour sued for, inter alia, breach of contract.

Building reasonable certainty

The California Court of Appeal evaluated the defendants' contention that the plaintiffs' expert testimony was too speculative to support the award of lost profits. The court began by noting that, when an established business's operation is interrupted, lost profits damages are generally recoverable. The occurrence and extent of such damages can be ascertained with reasonable certainty from the past volume of business and other provable data relevant to probable future sales.

Lost profits damages for unestablished businesses generally aren't recoverable because their occurrence is uncertain, contingent and

speculative. But they may be recovered, the court noted, "where the evidence makes reasonably certain their occurrence and extent.... Certainty as to the amount is not required."

The court explained that reasonable certainty as to damages can be built with:

- **Expert testimony,**
- **Economic and financial data,**
- **Market surveys and analyses,**
- **Business records from similar businesses, and**
- **Prelitigation projections, particularly those prepared by the defendant.**

The court added that whether the market is established is also relevant. The underlying requirement for each type of evidence cited is "a substantial similarity between the facts forming the basis of the profit projections and the business opportunity that was destroyed."

Notably, the court observed that expert testimony alone can provide sufficient basis for a lost profits award in a new business context—but only if the expert opinion is supported by tangible evidence with a substantial and sufficient factual basis. Mere speculation and hypothetical situations won't suffice. With these precepts in mind, the court turned to the evidence in question.

Everybody does it...

*Expense padding is an easy—
and popular—form of fraud*

One of the easiest ways to defraud a company is by padding expense reimbursement reports—which is why it has always been a popular scheme.

This article talks about ways businesses can prevent such fraud by implementing strict controls and punishing perpetrators. Stopping expense reimbursement fraud before it starts isn't complicated. But it does require management to lead by example and be vigilant in investigating and acting on suspicions.

In its 2007 report on corporate fraud, Oversight Systems, the leading provider of automated continuous monitoring solutions, said that 75% of respondents feel there's more institutional fraud today than five years ago. They should know: More than half (56%) claim they've personally witnessed financial misconduct in the last year.

One of the easiest ways to defraud a company is by padding expense reimbursement reports—which is why it has always been a popular scheme. The good news is that you can generally prevent such fraud by implementing strict controls and punishing the perpetrators. Stopping

Shaky projections

The plaintiffs' expert based his opinion in part on projections taken from an offering circular Parlour had prepared for potential investors. The circular figures weren't based on those from actual operations, but from Parlour's assumptions over five years. In fact, each of the figures included disclaimers that income and expense estimates might not reflect actual results.

The court acknowledged evidence that Parlour's COO had prepared the projections with the assistance of another officer of the company, and that both of them had extensive experience in the restaurant industry. Neither, however, testified about particular qualifications that permitted him to predict income, expenses or profits specifically for a Farrell's restaurant.

The COO did testify that he had consulted with defendant Chan when preparing the circular projections. Chan conceded this but added that he, the COO and a Parlour shareholder had "backed into [their] numbers" to appear economically viable.

Ultimately, the court rejected Parlour's expert's use of the offering projections. And it reiterated that projections must be based on facts substantially similar to the lost business opportunity to be relevant and admissible.

Questionable use of market data

The plaintiffs' expert also considered market data on Friendly's Ice Cream Corp., which he asserted was relatively similar to Farrell's because its restaurants offer both ice cream and food. The court countered that "many

restaurants serve both ice cream and food; that alone does not make them sufficiently similar to Farrell's for purposes of proving lost prospective profits."

The court found that the expert's "cursory" description of Friendly's business model failed to establish that its profit and loss experience was sufficiently similar to Farrell's to be relevant. It reached the same conclusion regarding the market data for the dozen or so smaller ice cream parlors, which served only ice cream, considered by the expert.

Finally, the court assessed the expert's use of market data from existing Farrell's restaurants and other businesses. The expert didn't use actual numbers from the Santa Clarita location as a starting point for his estimates of lost profits for other locations. And, as to the data from the San Diego location, he presented no evidence on what those figures were or how they affected his calculations. Again, the expert didn't show the required substantial similarity with the locations at issue.

Expert selection matters

After applying the factors it outlined, the court reduced the plaintiff's original award from about \$6.6 million to \$203,000. Don't make the same mistakes made here: Work with qualified valuation experts who can back up their analysis with solid, relevant and admissible data and credible testimony. ■

expense reimbursement fraud before it starts isn't complicated. But it does require management to lead by example and be vigilant in investigating and acting on suspicions.

Plenty of ways to cheat

Employees may cheat on their reimbursement reports by inventing expenses or by inflating actual ones. They might, for example, charge your company for personal expenses such as gas or lodging accrued while extending a business trip for leisure. Or they might claim larger service tips on their expense reports than they actually paid.

Other common reimbursement fraud schemes include submitting:

- **Bills for trips that were never taken, such as canceled airline tickets or hotel registration refunds,**
- **Claims for items the employee didn't purchase, such as office supplies,**
- **Separate auto mileage bills from employees who actually traveled together,**

- **Inflated mileage totals,**
- **Bills that include non-reimbursable expenses, such as alcohol or leisure activity tickets, or meals with friends and family members, and**
- **Tips added to tabs that already included gratuities in the total.**

Some employees are habitual cheaters and may, for example, stock up on blank receipts from cab companies and restaurants to submit phony expense reports.

Get fraud under control

This type of recurring fraud can surface quickly if you use basic fraud control procedures. For starters, make it a habit to match employees' travel logs to their claimed expenses because it can reveal mileage discrepancies. Also, always require original receipts rather than accept photocopies, which an employee can forge or alter.

Your reimbursement procedures, too, can prevent fraud. Don't, for example, put your administrative assistant in charge of authorizing expenses. Instead, make supervisors responsible for verifying and approving expenses. And if you

don't already have a fraud hotline, consider establishing one. Employees are likely to be your single best source of fraud detection—as long as you give them a confidential and convenient means for reporting suspicious activity.

Most important, remember that fraud prevention begins at the top. Establish a culture of honesty and accountability, and clearly communicate your expectations to all employees. Develop policies and procedures for expense reimbursement, and require every employee to read and sign it.

Then enforce it. If, for example, your policy states that employees must submit original receipts for single expenditures of more than \$25, you can't routinely make exceptions for executives. Everyone in the company—including you—should expect to have to follow the rules.

Holding costs down

Individual incidents of expense reimbursement fraud don't typically involve significant sums, but left unchecked they can add up. In the case of senior management, they can add up quickly. Don't let expense reimbursement fraud make the cost of doing business even higher than it already is. ■

UPCOMING EVENTS & PUBLICATIONS

JUNE 28 – JULY 1, 2009: PYA will be exhibiting at the American Health Lawyers Association annual meeting in Washington, DC.

AUGUST 27TH, 2009: Jim Lloyd will be presenting “*Building Long Term Value (in privately held companies)*” at the Georgia Society of CPAs 2009 Southeastern Accounting Show in Atlanta, GA

SEPTEMBER 25, 2009: Carol Carden and Mark Browne, M.D. of PYA will be presenting “*Collaborating through Turmoil*” at the AICPA Healthcare Conference in Phoenix, AZ.

SEPTEMBER 28TH AND 29TH, 2009: Jim Lloyd and Doug Arnold of PYA, will be presenting “*Fraudulent Financial Statements—Managing and Assessing the Risk*” at the 39th Virginia Accounting and Auditing Conference in Roanoke, VA.

OCTOBER 12 – 13, 2009: PYA will be exhibiting at the American Health Lawyers Association’s Tax Issues for Healthcare Organizations Conference in Arlington, VA.

NOVEMBER 15 – 17, 2009: Jim Lloyd will be presenting “*Mixing Forensic Accounting and Valuation in the Litigation Engagement*” at the AICPA National Business Valuation Conference in San Francisco, CA.

NOVEMBER 15, 2009: Carol Carden will present “*Healthcare Valuation Case Study*” as a pre-conference workshop at the AICPA National Business Valuation Conference in San Francisco, CA.

NOVEMBER 19TH AND 20TH, 2009: Jim Lloyd and Doug Arnold of PYA, will be presenting “*Fraudulent Financial Statements—Managing and Assessing the Risk*” at the 39th Virginia Accounting and Auditing Conference in Virginia Beach, VA..

NOVEMBER 30, 2009: Carol Carden and Mark Browne, M.D. of PYA will present “*Quality-based Hospital/Physician Collaboration*” at the Tennessee Society of CPAs Healthcare Conference in Franklin, TN.

ABCs continued from page 1

rebuttal reports or verbally critique the opposing expert’s opinions

The valuation expert’s testimony is generally a critical factor in many litigation matters. Therefore, successful testifying experts will need excellent communication skills, a solid understanding of the facts, industry experience and uncompromising integrity.

Familiarity breeds respect

A general understanding of the valuation process by all parties will help reduce the risk of misunderstandings and false starts. When choosing a valuation expert in connection with litigation, make sure he or she has the necessary communication skills, experience, and integrity to provide credible testimony in court. ■

RECENT EVENTS

MARCH 26, 2009: Carol Carden participated as a panelist in the “*Tools for Predicting and Driving Value for Healthcare Organizations*” webinar sponsored by the American Institute of CPAs.



(800) 270-9629 | www.pyapc.com
Atlanta | Austin | Knoxville | Tampa Bay

Contact Information:

For additional information please contact
Jim Lloyd or Carol Carden at (800) 270-9629.

