

# Cautionary Tales of Valuation Adjustments and Potential Forensic Implications in Litigation

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NACVA AND THE CTI'S

2020 Business Valuation and Financial Litigation

**VIRTUAL SUPER CONFERENCE**



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# NACVA AND THE CTI'S 2020 Business Valuation and Financial Litigation VIRTUAL SUPER CONFERENCE

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Karolina Calhoun, Vice President at Mercer Capital, has been involved with hundreds of valuation and litigation support engagements in a diverse range of industries on local, national and international levels. Prior to joining Mercer Capital, Karolina was a Senior Auditor at EY Memphis in their Audit and Assurance Services practice. As a member of Mercer Capital's Litigation Group, she provides valuation and forensics services for family law, gift & estate planning, commercial litigation, transactions (M&A), and further matters related to privately held businesses, dissenting shareholders, intellectual property, personal goodwill, etc. With her forensics accreditation, she provides economic and financial damages studies, asset tracing, lost profits, and lifestyle analysis.

Karolina also provides financial reporting and valuation analyses related to mergers & acquisitions, intangible assets, private equity portfolio companies, contractual agreements, and complex capital structures. She has experience in valuing a wide variety of intangible assets such as patents, customer lists, trademarks, and contracts. These engagements have been conducted for the purposes of mergers & acquisitions, buyouts, financial reporting, estate and gift taxes, allocation of purchase price, litigation support, shareholder dissent, buy-sell agreements, dissolutions, financing, and business planning.

Karolina is the Valuation Chair of the AICPA's Forensic and Valuation Services Conference Committee and a member of the AICPA's CFF Task Force. In 2018, she received the Forensic and Valuation Services (FVS) Standing Ovation award, presented by the AICPA to professionals for significant contributions in their specialty areas and in their communities. Karolina is the President of the Memphis Chapter of TSCPAs. Karolina is also a presenter of various valuation and forensic topics to attorneys, accountants, and business professionals for the purpose of educating the public.



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# Session Overview

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Valuations of a closely held business in the context of litigation such as in a contentious divorce, shareholder dispute, damages matter or other litigated corporate matter can be multifaceted and may require additional forensic investigative scrutiny. As such, it is important to consider the potential forensic implications of valuation adjustments as they may lead to other analyses. For example, in a divorce business appraisal, a valuation adjustment for discretionary (personal) expenses may, in turn, provide an implied “true income” and pay ability of a spouse. This is but one example - this session will address other examples you will likely face.

## Learning Objectives:

1. Evaluate financial statement adjustments and corresponding implications; and,
2. Interpret the need for forensic services as a result of valuation adjustments, such as tracing services, income determination, and other analyses.



## SECTION 1

# Adjustments in Business Valuations

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# Valuation Adjustments – What’s the Point?

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Develop a “public equivalent” for comparability purposes

Identify significant non-recurring or unusual expenses  
(or potentially sources of income)

Determine a reasonable earning power of the Company



# Types of Earnings Adjustments

	Description	Examples
<b>Type 1: Non-recurring, unusual items</b>	One-time gains or losses, unusual or non-recurring items, discontinued operations, run-rate adjustments, etc...	<ul style="list-style-type: none"> <li>• Sell a building; remove gain on sale</li> <li>• Settle a lawsuit; remove settlement expense</li> <li>• Adjust ongoing revenue and expenses for a mid-year acquisition</li> </ul>
<b>Type 2: Discretionary items</b>	Normalizing officer/owner compensation and discretionary expenses that would not exist in a well-run, publicly traded company	<ul style="list-style-type: none"> <li>• Owner takes distributions in lieu of comp or takes all profit in form of salary; normalize comp</li> <li>• Treat owner's condo as non-operating asset; remove related expenses</li> </ul>



# Where Do We Find Potential Adjustments

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## Reviewing trends in the financial statements

- Assess financial information
  - Historical trends
    - Changes from prior year(s)
    - Ratio analysis
    - Margin analysis
    - Unit sales trends, if applicable
    - Historical common-sized statements
    - Compare/contrast with industry peers & the general econ



## Assess qualitative, non-numeric data

- SWOT analysis

## Reviewing notes to the financial statements



# Where Do We Find Potential Adjustments

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## Management interviews and site visits

- It's interesting what may come up during a conversation

## Asking the questions:

- Any non-recurring, extraordinary, unusual expense(s)?
- Any personal expenses or additional benefits paid by the business?
- What is captured in this account?
- Why did this account increase X%?
- Walk me through what is captured in this balance



## SECTION 2

# Importance & Relevance

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# Valuation Adjustments

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Develop a “public equivalent” for comparability purposes

Identify significant non-recurring or unusual expenses  
(or potentially sources of income)

Determine *a reasonable earning power* of the Company



# Why Do We Care?

**Adjustments can  
have material  
impact on value**



## SECTION 3

# Business Valuation for Marital Dissolution

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# Valuations in Family Law

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Valuations of a closely held business in the context of a (contentious) divorce can be especially multifaceted

Analysis may require additional forensic investigation for any irregularities in the financial statements (current and/or observed period leading up to current):

- Potential dissipation of business/marital property
- Excessive prepayments
- Expense deferrals
- Other financial alterations



# Valuations in Family Law

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It is important to consider these types of situations especially if only one spouse is involved with the operations and management of the company, otherwise referred to as the “in-spouse.”

Potential for altering the financial position of the business

Potential for altering salary/income in anticipation of divorce (i.e. basis for potential alimony)



## SECTION 4

# Valuation Adjustments... Income Determination

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# Adjustments in Family Law Valuations: Example for Income Determination

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During a business appraisal:

- A valuation adjustment, or multiple adjustments, for discretionary expenses may, in turn, provide an implied “true income”
- Tennessee Code Ann. §36-5-121(i) (Decree for support of Spouse). Although each of these factors must be considered when relevant to the parties’ circumstances, ***“the two that are considered the most important are the disadvantaged spouse’s need and the obligor spouse’s ability to pay”***



# Adjustments in Family Law Valuations

*What are possible adjustments that may impact income determination?*

## Normalization of compensation

- How is the owner/officer paid?
  - Salary/wages
  - Year-end bonus
  - Commissions
  - Owner distribution
  - Flow-through of year-end business income
  - Deferred compensation
  - Or a combination of the above



# Adjustments in Family Law Valuations

*What are possible adjustments that may impact income determination?*

## Normalization of compensation

- Pay-out arrangements
  - Review historical trends to investigate potential deferral of bonus or payroll disguised as work by other employee
    - Review salary trends for other owners
    - Review salary trends for other employees
  - Review distributions taken from business and charged to a loan account



# Adjustments in Family Law Valuations

*What are possible adjustments that may impact income determination?*

- Expenses on non-business asset: farm/ hunting lodge
- Lavish automobile, boats, planes, vacations
- Excessive meals & entertainment
- Personal life insurance (i.e. not key man life insurance)
- Other perquisites
  - Personal telephone, wireless, cable
  - Dry-cleaning
  - Private school tuition
  - Country club dues
  - Automobile expenses
  - Non-business related fees: tax preparation fees; financial planning fees, divorce attorney



# Illustration #1

ABV/CFF Inc.

Valuation Analysis as of March 1, 2020

Derivation of Adjusted Income Statements

Income Statements	Fiscal Years Ended December 31				References and Comments
	2019	2018	2017	2016	
Sales	\$9,750,000	\$9,000,000	\$11,000,000	\$10,500,000	<i>No Adjustments</i>
COGS	5,600,000	5,000,000	6,000,000	5,700,000	
Gross Profit	4,150,000	4,000,000	5,000,000	4,800,000	
Reported Operating Expenses	3,900,000	3,750,000	4,100,000	3,950,000	
Adjustment (1): Litigation Settlement	(5,000)	0	0	0	<i>Non-recurring litigation settlement</i>
Adjustment (2a): Normalization of Owner Compensation	(100,000)	(100,000)	(100,000)	(100,000)	<i>Owner salary per historical financials</i>
Adjustment (2b): Normalization of Owner Compensation	200,000	200,000	200,000	200,000	<i>Reasonable compensation estimate based on Source XYZ</i>
Adjustment (3): Discretionary Expenses: Farm/Hunting Lodge	(50,000)	(50,000)	(50,000)	(50,000)	<i>Non-business related expense on historical financials</i>
Adjustment (4): Discretionary Expenses: Personal Vacations	(25,000)	(60,000)	(85,000)	(75,000)	<i>" "</i>
Adjustment (5): Discretionary Expenses: NFL Season Tickets	(25,000)	(25,000)	(25,000)	(25,000)	<i>" "</i>
Adjustment (6): Personal Life Insurance Expense	(40,000)	(40,000)	(40,000)	(40,000)	<i>Not key-man life insurance; non-business related expense</i>
Adjustment (7): Other Perquisites	(111,280)	(114,100)	(128,600)	(142,100)	<i>See Exhibit 2a</i>
Adjusted Operating Expenses	3,743,720	3,560,900	3,871,400	3,717,900	
<b>Adjusted Operating Profit</b>	<b>\$406,280</b>	<b>\$439,100</b>	<b>\$1,128,600</b>	<b>\$1,082,100</b>	
<i>Adjusted Operating Margin</i>	4.17%	4.88%	10.26%	10.31%	
<i>Reported Operating Margin</i>	2.56%	2.78%	8.18%	8.10%	



# Illustration #1

ABV/CFF Inc.

Valuation Analysis as of March 1, 2020

Derivation of Other Perquisites Adjustment

Income Statements	Fiscal Years Ended December 31				References and Comments
	2019	2018	2017	2016	
Private School Tuition (3 Children)	\$60,000	\$60,000	\$60,000	\$60,000	<i>Non-business related expense on historical financials</i>
Donation to Giving Organization	25,000	25,000	35,000	50,000	" "
Dry Cleaning for Entire Family	2,680	5,500	7,500	8,500	" "
Reimbursement for Cellular Phone for Entire Family	3,600	3,600	3,600	3,600	" "
Country Club Dues	10,000	10,000	10,000	10,000	" "
Personal Tax Preparation Reimbursement	5,000	5,000	7,500	5,000	" "
Personal Financial Planning Reimbursement	5,000	5,000	5,000	5,000	" "
<b>Total Perquisites Expenses</b>	<b>\$111,280</b>	<b>\$114,100</b>	<b>\$128,600</b>	<b>\$142,100</b>	



# Illustration #1

Income Statements	Fiscal Years Ended December 31				References and Comments
	2019	2018	2017	2016	
Sales	\$9,750,000	\$9,000,000	\$11,000,000	\$10,500,000	
COGS	5,600,000	5,000,000	6,000,000	5,700,000	<i>No Adjustments</i>
Gross Profit	4,150,000	4,000,000	5,000,000	4,800,000	
Reported Operating Expenses	3,900,000	3,750,000	4,100,000	3,950,000	
Adjustment (1): Litigation Settlement	(5,000)	0	0	0	<i>Non-recurring litigation settlement</i>
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Adjusted Operating Expenses	3,743,720	3,560,900	3,871,400	3,717,900	
<b>Adjusted Operating Profit</b>	<b>\$406,280</b>	<b>\$439,100</b>	<b>\$1,128,600</b>	<b>\$1,082,100</b>	
<i>Adjusted Operating Margin</i>	4.17%	4.88%	10.26%	10.31%	
<i>Reported Operating Margin</i>	2.56%	2.78%	8.18%	8.10%	



**Note:**

<b>Total Adjustment for Discretionary Expenses</b>	<b>\$251,280</b>	<b>\$289,100</b>	<b>\$328,600</b>	<b>\$332,100</b>
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*Note: Does not include Normalization of Owner Compensation*



# Illustration #1 – Other Considerations

Income Statements	Fiscal Years Ended December 31			
	2019	2018	2017	2016
<i>Adjusted Operating Margin</i>	4.17%	4.88%	10.26%	10.31%
<i>Reported Operating Margin</i>	2.56%	2.78%	8.18%	8.10%

## Qualitative Analysis:

- Trends from peers/comparisons
- Trends from industry
- Trends from the general economy
- Trends year-over-year (5-6 years if possible)
- Lifestyle
- Other qualitative



# Illustration #1 – Concluding Thoughts and Challenges

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Are you working on behalf of the “in-spouse” or “out-spouse?”

- Does this impact the ability to collect information (qualitative and quantitative) to support the adjustments?
- The importance/ability to conduct management interviews and/or site visits
- Information limitations: one spouse does not possess as much knowledge of the business

“Noise”

- Inherited business?
- Family business?
- Other

Beware of “Double Dip”



## SECTION 5

# Business Valuation for Business Litigation

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# Adjustments in Business Litigation

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In a shareholder dispute matter, a valuation adjustment may:

- Normalize operations to reflect only those that are business-related
- True-up margins for variations in expenses not consistent with the industry/peers or Company's previous historical performance (for various reasons)
- Insinuate dissipation of business assets and require further forensic investigations



# Adjustments in Business Litigation

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## Normalization of compensation

- Just as in previous example, review historical trends to investigate potential deferral of bonus or payroll disguised as work by other employee
  - Review salary trends for all owners
  - Review salary trends for other employees

## Discretionary, non-business expenses

## Accelerated depreciation



# Adjustments in Business Litigation

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Intercompany & Related party items, both payables and receivables

- Ex: Loan to shareholder
  - Review distributions of cash balance that may be charged to a loan account
- Ex: Related party payable (to related entity)

Other non-operating in nature business assets and corresponding expenses

Customer discounts & coupons (contra-revenue)



# Adjustments in Business Litigation

## Don't forget to investigate rental arrangements and associated expenses

- Is the property owner (lessor) is a related party?
  - Shareholder or possible relationship to the shareholder
- Is the rent FMV?
- Have you checked for rent prepayments?  
Are they historically common?
- Any other excessive expenses?  
Or lack-there-of?



# Illustration #2

ABV/CFF^2 Inc.

Valuation Analysis as of December 31, 2018

Historical Balance Sheets

Assets	For the Fiscal Years Ended December 31				
	2018	2017	2016	2015	2014
Cash & Equivalents	\$40,000	\$100,000	\$300,000	\$350,000	\$350,000
Accounts Receivable	4,500	5,500	0	1,000	100,000
Inventories	55,000	65,000	65,000	70,000	55,000
Prepaid Expenses & Other	365,000	139,000	41,000	67,900	15,000
Total Current Assets	464,500	309,500	406,000	488,900	520,000
Property and Equipment	11,000,000	10,000,000	10,000,000	9,500,000	9,500,000
Accumulated Depreciation	(6,000,000)	(5,900,000)	(5,800,000)	(5,700,000)	(5,600,000)
Net Fixed Assets	5,000,000	4,100,000	4,200,000	3,800,000	3,900,000
Goodwill & Intangibles	0	0	0	0	0
Other Assets	0	0	0	0	0
Total Assets	\$5,464,500	\$4,409,500	\$4,606,000	\$4,288,900	\$4,420,000

## Detail of Prepaid Expenses & Other

Prepaid Expenses	55,000	12,000	25,000	60,000	10,000
Employee Advance	10,000	2,000	1,000	400	0
Loan to Shareholder	300,000	125,000	15,000	7,500	5,000
Total Prepaid Expenses & Other	\$365,000	\$139,000	\$41,000	\$67,900	\$15,000



# Illustration #2

ABV/CFF^2 Inc.

Valuation Analysis as of December 31, 2018

Supplemental Notes to Income Statements

Notes to Income Statements	For the Fiscal Years Ended December 31				
	2018	2017	2016	2015	2014
<b>(1): Net Sales detail:</b>					
Net Royalty Sales:					
Food Sales	\$10,000,000	\$10,400,000	\$10,750,000	\$9,900,000	\$9,000,000
Sales Tax	(750,000)	(780,000)	(806,250)	(742,500)	(675,000)
Net Royalty Sales:	9,250,000	9,620,000	9,943,750	9,157,500	8,325,000
Discounts & Coupons	(975,000)	(800,000)	(750,000)	(620,000)	(500,000)
Total Net Sales	\$8,275,000	\$8,820,000	\$9,193,750	\$8,537,500	\$7,825,000
<b>Percentage of Net Sales:</b>					
Net Royalty Sales:					
Food Sales	120.8%	117.9%	116.9%	116.0%	115.0%
Sales Tax	-9.1%	-8.8%	-8.8%	-8.7%	-8.6%
Net Royalty Sales:	111.8%	109.1%	108.2%	107.3%	106.4%
Discounts & Coupons	-11.8%	-9.1%	-8.2%	-7.3%	-6.4%
Total Net Sales	100.0%	100.0%	100.0%	100.0%	100.0%



# Illustration #3

ABV/CFF^3 Inc.  
Valuation Analysis as of September 30, 2019  
Derivation of Adjusted Income Statements

Income Statements	For the Fiscal Years Ended December 31					References and Comments
	2018	2017	2016	2015	2014	
Reported Net Sales	\$45,000,000	\$40,000,000	\$35,000,000	\$35,000,000	\$27,500,000	Reported Financial Statements
Adjustment: None	0	0	0	0	0	
Adjusted Net Sales	45,000,000	40,000,000	35,000,000	35,000,000	27,500,000	
Reported Cost of Sales	37,000,000	33,000,000	29,000,000	29,000,000	23,000,000	Reported Financial Statements
Adjustment: None	0	0	0	0	0	
Adjusted Cost of Sales	37,000,000	33,000,000	29,000,000	29,000,000	23,000,000	
Adjusted Gross Profit	8,000,000	7,000,000	6,000,000	6,000,000	4,500,000	
Reported Operating Expense	5,500,000	4,750,000	4,000,000	3,250,000	1,750,000	Reported Financial Statements
<b>Adjustment (1): Normalization of earnings to 10% profitability</b>	<b>(2,000,000)</b>	<b>(1,750,000)</b>	<b>(1,500,000)</b>	<b>(750,000)</b>	<b>0</b>	Per Industry Data, Historical Performance & Expectations
Adjusted Operating Expense	3,500,000	3,000,000	2,500,000	2,500,000	1,750,000	
Adjusted Operating Income	4,500,000	4,000,000	3,500,000	3,500,000	2,750,000	
<b>Reported Margins</b>						
Reported Net Sales	100.0%	100.0%	100.0%	100.0%	100.0%	
Reported Cost of Sales	82.2%	82.5%	82.9%	82.9%	83.6%	
Reported Gross Profit	17.8%	17.5%	17.1%	17.1%	16.4%	
Reported Operating Expense	12.2%	11.9%	11.4%	9.3%	6.4%	
<b>Reported Operating Income</b>	<b>5.6%</b>	<b>5.6%</b>	<b>5.7%</b>	<b>7.9%</b>	<b>10.0%</b>	
<b>Adjusted Margins</b>						
Adjusted Net Sales	100.0%	100.0%	100.0%	100.0%	100.0%	
Adjusted Cost of Sales	82.2%	82.5%	82.9%	82.9%	83.6%	
Adjusted Gross Profit	17.8%	17.5%	17.1%	17.1%	16.4%	
Adjusted Operating Expense	7.8%	7.5%	7.1%	7.1%	6.4%	
<b>Adjusted Operating Income</b>	<b>10.0%</b>	<b>10.0%</b>	<b>10.0%</b>	<b>10.0%</b>	<b>10.0%</b>	Imputed using Goal Seek



# Illustrations #2 & #3

## Concluding Thoughts and Challenges

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Are you working on behalf of the oppressed shareholder or the oppressor?

- Strategy: Nit-picky or big picture?

How much historical financial data can you get?

Were you able to obtain detailed backup to the financials?

- If so, does any support or possibly not support the profitability assumption

What peers & databases did you use and have you properly documented?



## SECTION 6

# Other Examples & Possible Triggering Events

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# Un(der)reported Cash Sales

How does one discover and deal with these scenarios?

- Assess trends in margins
- Assess inventory levels and turnover ratios
- Review non-operating assets and loans
- Further investigations

What are possible adjustments? How are they supported?



# Kickbacks

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How do we learn about potential kickbacks?

Where are kickbacks captured?

- Business financial statements?
- Personal bank accounts?
- Pricing concessions?
- Other?



# Post M&A Disputes

Financial statement misrepresentations

Projections

- Erroneous
- Misrepresented
- Most commonly due to earn-out provisions and adjusted working capital provisions



# Possible Triggering Events

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Involuntary dissolution of business

Forced squeeze-out of shareholder

Non-payment or reduced payment of historical distributions

Partnership replacement issues



# Possible Triggering Events

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Diversion of opportunity

Theft of customers

- Valuation of intangible assets
  - Forensic tracing
  - Revenue analysis

Breach of contract

Discovering hidden assets

- Forensic tracing



# Concluding Thoughts

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No case is just like the previous.  
There is no one size fits all approach.

We must always be independent,  
skeptical, prudent & wise when  
applying our analytical and  
investigative toolkits.



# Mercer Capital's Core Services

## Valuation & Financial Opinions

- Litigation Related Expert Witness Opinions
- Succession & Shareholder Planning
- Valuations for Corporate Tax Planning
- Valuations for Gift & Estate Tax Planning
- Fairness Opinions
- ESOP & ERISA Advisory Services
- Valuations for Buy-Sell Agreements

## Transaction Advisory & Restructuring Services

- Bankruptcy & Restructuring Services
- M&A and Investment Banking Services
- Fairness & Solvency Opinions
- Quality of Earnings

## Litigation Support Services

- Statutory Fair Value
- Business Damages & Lost Profits
- Family Law & Divorce
- Tax-Related Controversies
- Corporate Restructuring & Dissolution
- Valuation, Labor & Contract Disputes
- Initial Consultation & Analysis
- Testimony & Trial Support

## Financial Reporting Valuation Services

- Purchase Price Allocation Services
- Impairment Testing Services
- Portfolio Valuation Services
- Equity-Based Compensation Valuation

## Family Business Advisory Services

- Customized Board Advisory Services
- Management Consulting
- Independent Valuation Opinions
- Transaction Advisory Services
- Confidential Shareholder Surveys
- Benchmarking/Business Intelligence
- Shareholder Engagement
- Shareholder Communication Support



# Questions?

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