How to Value a Business When Data and Cooperation Are Not Forthcoming from Management: An In-Depth Explanation of Forensic Business Valuations

by Chris Hamilton

Introduction

A "normal" valuation requires a tremendous amount of time, concentration, and objectivity by the appraiser. Under the best of circumstances, having a business appraised is a highly invasive process that is time consuming and involves providing a total stranger (the appraiser) all of the intimate financial, management, and competitive information for the firm.

However, if the owner and/or senior management of the business chooses not to participate in the process or, worse, chooses to impede or disrupt the process, it becomes unpleasant for everyone involved. An appraisal usually depends on the assistance of management and the supply of accurate and reliable information. Where that assistance and/or information is not available, the appraiser is forced to take a forensic approach. The forensic approach to business valuation will not only require more time and creativity, both in the analysis and in supporting the conclusion of value, but must be accomplished without compromising the objectivity of the analysis. This article will discuss how to accomplish the appraisal engagement in spite of the lack of readily available information and assistance on behalf of the business being appraised.

When Is a Forensic Approach to Business Valuation Needed?

There are three situations that generally describe most "forensic" valuations. The first, and most prevalent, is a contentious marital dissolution. In a marital dissolution one spouse usually has all the information or access to the needed information, while the other spouse is on the outside looking in. If the "insider" spouse chooses to play "hide the ball," the process of valuing the business can completely stall. Depending on the laws in the appraiser's state, and/or the willingness of the judge to force cooperation, these can be the most difficult engagements.

The second example of a situation requiring forensic valuation is the aftermath of a disaster of some kind. For example, if fire has destroyed a premises including all the financial records, then whatever assistance management can willingly provide will be insufficient to accomplish the appraisal. The raw data simply no longer exists in the form most readily usable by an appraiser. This circumstance provides an example of the classic definition of forensic valuation which is to determine the value of a business immediately before a disastrous event and comparing it with the value immediately after the disastrous event.

The third example of a situation requiring forensic valuation involves a litigated matter where all the data is available but management refuses to assist, or is barred from assisting, in the interpretation of the data or providing anything beyond the bare necessities.

These three examples of forensic situations provide all the possible combinations of obstacles:

- The relevant data exists but there is no assistance or cooperation from management
- Complete cooperation of management but no reliable financial data
- No data and no cooperation from management

Adding to the difficult obstacles just described is the factor of time. Often the appraiser labors under severe time constraints and acquiring the necessary documentation takes a long time. This time constraint adds to the pressure of the forensic engagement and will test the ability of the appraiser. The appraiser must bring together the skills of a financial analyst, accountant, economist and, in the context of situations described above, a detective.

What Are the Forensic Methodologies for Valuing a Business?

There are several methods available to arrive at the value of a business, but most appraisers use as their derivative formula the following foundation formula: *Value = Income ÷ Capitalization Rate*. The methodologies and guidance provided in this article will focus on the two variables in the formula: Income and Capitalization Rate.

Income

Income is by far the more difficult of the two variables to calculate when there is a lack of cooperation, a lack of information, or both. Determining the amount of income to be capitalized is, obviously, a critical exercise and must be based on some rational method of estimation.

The first source of data to look for is recent transactions that involve ownership interests in the subject company. Depending on the time horizon this source may not provide enough data to rely upon but it can start the process of building a defensible conclusion. An historical transaction provides three critical pieces of information: the income that was capitalized, the capitalization rate, and the value. However, the practitioner knows that if circumstances place the engagement in the "forensic" category, all those factors may not be disclosed or available. Typically, only the transaction price is available. If income upon which the recent transaction was based is unavailable, the basic valuation formula (*Value = Income ÷ Capitalization Rate*) can be highly useful, if modified. Using algebra, the basic valuation formula can be restated as follows: *Income = Capitalization Rate x Value.*

The appraiser must determine as best she can an appropriate capitalization rate or an informed guess at the rate that was used in the transaction. If the appraiser can get a sense from the participants in the transaction the actual capitalization rate they used, the analysis is reduced to simple mathematics. If that actual rate cannot be obtained, the forensic appraiser must determine an appropriate capitalization rate. In theory, anyone can determine the appropriate capitalization rate since the appropriate rate is based on the investment not the investor. The capitalization rate times the deal price ("Value") will result in the amount of income upon which the transaction was based. Depending on the delay from the time of the transaction to the time of the forensic valuation date, this information can range from highly useful to marginally helpful or just "interesting."

The forensic appraiser's next step is to obtain current information about historical income. This data can be used to support the analysis of previous sale transactions or supersede it if the information about the previous transactions is unreliable or unavailable. In the context of litigation, several documents should be requested and, depending on the appraiser's jurisdiction, will be compelled by the court if necessary. The following list of suggested documents is not comprehensive. Often in a forensic engagement comprehensive lists are useless as opposing counsel objects to the requests as "burdensome" and their client often responds that the data does not exist.

The following is a list of essential, and sometimes forgotten, documents that can be obtained from a third party who is either required to retain copies or most likely will have retained copies:

- ***Tax returns*** which are usually prepared by an outside firm that retains copies of the tax returns and related workpapers. If not, copies should be obtained directly from the IRS. This may be difficult to do in a litigation setting, but where management is cooperating this source should not be overlooked.
- ***Financial statements*** prepared by an outside accounting firm. The outside firm certainly retains copies in their files and, even if client records are unavailable or were destroyed, the outside firm should be able to provide copies of the statements as well as supporting workpapers.
- ***Bank statements*** for at least three years which are available directly from the bank.
- ***Loan applications*** which are also available directly from the lending institution.
- ***Corporate minutes*** which are usually maintained at attorney's office.
- ***Valuation reports*** previously prepared for the subject company. If the appraiser can determine who prepared the previous reports, a copy can likely be obtained directly from the issuer of the report.
- ***Contracts and related correspondence for all prior sales of company stock.*** If a business broker, attorney, and/or escrow company was used in the sale, an independent trail of documentation will exist.
- ***Copies of all stockholder and employment agreements with amendments*** which are also maintained in law firm's files in most cases.

In some cases, bank statements are all that can be obtained in a timely manner. This is especially true in cases where there has been a disaster of some kind or there is a claim that all financial records have been destroyed. While bank statements do not include everything an appraiser would like to see, the opportunity to obtain them should never be overlooked. A bank statement analysis should be performed by simply preparing a schedule summarizing the information on the monthly statements. If there are multiple bank accounts, all of them should be summarized and a combined summary prepared. To the extent transfers between the accounts can be identified, their effect should be eliminated on the combined summary. The result is a schedule which shows total cash flow and, if applicable, any seasonal patterns.

Bank statements can also be helpful in other ways. For example, if the owner indicates there are no other accounts than those for which the statements were provided the appraiser should review the account statements very carefully. All transfers should be traced. It is common to come across a transfer from a known account to an unknown account or from an unknown account to a known account. Most bank statements will actually provide the account number of the destination account. Attorneys love it when the forensic appraiser shows definitively that the "other side" is playing dirty. More importantly, it allows the engagement to move forward once more complete information is obtained based on the bank statement analysis.

If financial statements are obtained *via* discovery, it is unlikely that the appraiser will have the ability to determine if they are complete or accurate. Forensic analysis methods will, however, enable the appraiser to gain some confidence in the data. A profoundly easy way to obtain this information when all else has been destroyed or otherwise made unavailable is to obtain copies of recent loan applications. Most businesses have debt of some kind and many have a line of credit with a bank or other lending institution. Most lines of credit require annual financial updates (re-applications) to the lending institution. The forensic appraiser should obtain the file either voluntarily or through a subpoena depending on the circumstances. The file is invaluable and should be considered reliable; loan applications are usually signed under penalty of perjury. Further, the representations on the application are reviewed carefully and verified by the lending institution. Therefore, all workpapers and notes prepared by the bank in connection with the application should also be obtained. In a litigation context, conclusions based on this type of evidence are assailable only if the owner/management is willing to say they filed a false, incorrect, and misleading application. This is, obviously, not highly likely and is certainly not advisable.

Stockholder agreements can be useful since most have buy-out provisions and some even state the "value" of the firm as of the time the agreement was executed. Buy-out provisions also generally state valuation methodology and criteria that can provide guidance for the appraiser. If the agreement was recently signed and does state the value of the firm, the appraisers job can be greatly simplified to a process of verifying the value and adjusting for subsequent events, if applicable.

In the course of litigation questions can be put to the owners/managers in written (interrogatories) or oral (deposition) form. While both processes are contentious and somewhat tedious, there is often no better method to obtain relevant facts. The forensic appraiser should be prepared to participate by proposing good questions and evaluating the answers. Many attorneys do not think to request such assistance in which case the appraiser should offer to participate. The appraiser's participation often results in less wasted time.

The following are just some of the questions which should be asked, either through interrogatories propounded to, or at a deposition of, the owners and/or senior management of the firm being appraised. These questions highlight the areas that should not be missed by the forensic appraiser since the answers may provide significant direction and evidence:

• ***What is your company worth? How do you calculate it?*** These questions force the responding party to "go on the record" with information that they might think is useless but which actually may be quite valuable in piecing together an opinion of value. These are obvious questions that often go unasked!

• ***What is your total compensation including salary, benefits, and personal expenses paid by the business?*** This is critical to valuing a stockholder-managed company since many business owners effectively pay dividends through some form of deductible disbursement. An obvious follow-up series of questions should establish the management role and function of the owner.

• ***Have you sold, gifted, or otherwise disposed of any interests in the business?*** This question lays the foundation for questions regarding dates, values, and valuation methodologies for prior transactions. It is also a question that should follow a series of questions about the responding party's acquisition of the ownership interest.

• ***List dates and amounts of any capital contributions made to the business in the last "x" years.*** While this question will not elicit direct evidence of the value of a business, it can provide trails to significant time periods, circumstances surrounding a "capital call," and comparison with other stockholder records.

• ***Have there been unusual transactions or events in the past "x" years that would affect the relevance or comparability of the financial statements?*** The number of years to ask about is determined by the number of years of financial data available to the appraiser. For example, financial statements for a travel agency would be expected to show significant changes in operating results after September 11, 2001.

Capitalization Rate

A capitalization rate is any divisor used to convert anticipated benefits into value. A capitalization rate is used to value historical income as a basis for expectations of future results. A discount rate adds on a component of expected growth and is used to place a value on income projections. As previously mentioned, these income methods use the basic valuation formula or a derivative of the formula. Often, the only measure of income available to the forensic appraiser is projections since reliable historic data is not available. In other cases the appraiser may only feel comfortable valuing historic income because reliable projections are not available or the future of the business has been significantly altered due to disaster. In either case, a capitalization rate must be developed.

The capitalization rate is effectively a measure of risk associated with the business being valued and is constructed based on the risks inherent in the general marketplace and the risk associated with the company being valued. Variables considered in the development of a capitalization/discount rate include depth of management, competition, stability of financial performance, and the general and local economic conditions. In a forensic valuation this is perhaps the easier of the two variables to determine. The capitalization rate is a "forward-looking" measurement of the cost of capital that is based on historical data. Most aspects of the development of the capitalization rate can be obtained independent of the business owner and independent of any knowledge of business operations. These include the study of general, local, and industry economic conditions, and the competitive standing of the subject firm in its industry.

However, a critical element to building the capitalization rate is the company-specific risks. This is typically developed by interviewing management, reviewing management's assessment of risk, and comparing the financial results of the subject firm with the industry. In a forensic valuation none of these may be accomplished and the appraiser may be left either to prepare a range of values based on a range of capitalization rates or to build the rate in another way.

To determine a company-specific measure of risk the forensic engagement may require unique approaches to obtaining information about the depth of management, financial performance, and competition. If stockholders and senior management are not able, or willing, to provide the information, the appraiser must either withdraw from the engagement or find another way find to the answer. For those who specialize in appraisals in the litigation setting, withdrawal is rarely acceptable.

Searching several sources, available to the public, usually yields a surprising amount of information:

• ***Dun & Bradstreet*** (D&B). Obtaining a report from D&B (www.dnb.com) costs money, but it is often well worth the investment. It is surprising how much information some people will provide to total strangers through a service such as D&B. The reports from D&B can provide historical financial information, history of management, credit history and rating, and other background information.

• ***The subject company web site.*** Again, it is astonishing how much proprietary and sensitive information some firms make available on the World Wide Web. Some firms will post financial data when you would not otherwise expect to see it. A good understanding of the services and products offered by the business, as well as the markets in which it operates, can usually be obtained from the web site. Posted employment opportunities can provide clues about the firm's stability, comparative compensation rates for employees, growth, expansion or contraction, and employee turnover.

• ***Public data base searches.*** Subscription or pay-as-you-go services such as www.knowx.com will provide a public record search for liens, lawsuits, UCC filings, judgments, officers, office locations, and the like. The state agency overseeing corporations usually maintains a web site with information available for every corporation authorized to do business.

• ***Industry association web sites and publications.*** A firm that is active or predominate in an industry association will leave a trail that can be followed. This trail is useful to see how the subject firm is viewed in the industry, whether they actively advertise and market their firm, what their ads and marketing say about the business, and to identify key people in the company. Such publications may also identify unrelated individuals who, if contacted, might be willing to discuss the company, its reputation, and its position in the industry.

• ***Public job postings and executive search firms.*** As with a review of the firm's web site, access to public information regarding the types of job openings, number of job openings, and general salary ranges (when compared to industry) could yield very valuable information.

• ***Competitors.*** Sometimes a competitor is very willing to tell what they know. Of course, information from a competitor should be carefully calibrated with information obtained from other sources. An entire conclusion of value cannot be based on interviews with competitors, but significant leads can be obtained through such conversations.

• ***Business brokers.*** Brokers in the specific industry of the subject firm can be a great source of "reputation" information as well as the identities of individuals (*e.g.,* competitors) who might be willing to talk about the subject firm.

• ***Google and other internet searches.*** When performing a forensic valuation the appraiser should never skip this step. Using the incredibly powerful searching capabilities available *via* the internet is amazingly simple and provides detailed useful information almost every time.

In a forensic valuation all available information should be considered, weighed for its value and relevance, and incorporated into the basis for capitalization rate. The objectives of the analysis are fairly simple and should be kept in mind: What is the relative risk of an investment in the subject company compared to alternative uses for the money? The answer should be an appropriate capitalization rate.

Conclusion

A "normal" valuation requires a tremendous amount of time, concentration, and objectivity by the appraiser. In cases where there is little or no readily available information the engagement requires a forensic approach that must be accomplished without compromising the objectivity of the analysis. A forensic approach will also require a great deal of time both in the analysis and in supporting the conclusion of value. When all is said and done, the goal of the appraiser in a forensic environment is to deliver a reasonable estimate of value based on relevant evidence and reliable information. The outcome, then, is the same as a normal appraisal engagement. It will simply take more creativity, drive, and effort to get there.

Chris Hamilton, CPA, is President and a Principal of Arxis Financial, Inc., a CPA firm headquartered in Simi Valley, CA. He is a Certified Public Accountant, a Certified Fraud Examiner, a Certified Valuation Analyst, and a Diplomate of the American Board of Forensic Accounting and has extensive experience in tax and accounting issues in the context of litigation consulting, fraud examinations, and business valuations. Chris can be reached at. 805-306-7890 or chamilton@arxisgroup.com.