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## **Reconstructing a Complete Picture of Value**

Professional valuers tackle each assignment with a blend of art and science ... and sometimes solid detective work.

The need to recreate or restructure financial information often occurs in litigation situations such as a divorce settlement, particularly if one or both spouses own a business. It may also be necessary in an acquisition or merger of businesses, where one party stands to gain by providing incomplete information that misrepresents the company's true financial health.

In these instances, where does the valuator begin the search? What are the best places to look in order to spot clues? While performing a valuation always requires strong analytical skills, these cases make it even more imperative to have a solid methodology to guide the process.

Starting with the big picture, valuers examine several important areas, hunting for clues that will help narrow the scope of the investigation. Such an approach requires discipline, but also provides residual benefits in that it ensures that time is spent examining only those areas that will yield the greatest benefit to the engagement.

### **Determining the Approach**

The circumstances of the assignment always dictate the valuator's analytical approach. In other words, the investigative process hinges first and foremost on the type of value that is being sought.

There are, after all, significant differences between fair market value, liquidation value, investment value, equity value and a host of other measurements. And the analytical process used to hunt for clues differs, depending on which type of value is being determined.

Depending on the nature of the assignment, and the type of value that is sought, the valuator may begin narrowing the scope of the search with a closer examination of historical financial information. Looking over the past five years, he or she may notice some aberration in the pattern of the data that triggers a red flag and invites closer investigation.

In a similar fashion, clues may emerge by comparing the company in question to other similar companies in that industry, or in the same geographic area.

### **Guidelines for Divorce Cases**

In a divorce situation, tax returns sometimes point the way to more complete information regarding areas of income. For example, salaries reported on Forms W-2 and 1099 can be matched with bank deposits to determine if all paychecks have been deposited for the benefit of the marital estate.

It may be possible that a spouse has been depositing part of his or her paycheck into a separate, undisclosed account. If this continued for many months, a significant amount of assets could be hidden from the other spouse.

The reporting of rental income indicates the existence of property that should also appear on the list of marital assets and liabilities. Even though rental property often produces losses for tax purposes, it still provides income that has been available during the marriage and should be included in the valuation report.

Tax payments and refunds should also be closely examined. For example, one spouse may be intentionally over-withholding to reduce his or her net income for purposes of alimony and child support, or to defer a large refund until after the divorce. On the other hand, a spouse may under-withhold to shift the resulting increase in pay into a hidden account.

### **Hunting for Clues**

In a corporate situation, rates of growth, financial performance, executive compensation and valuation all depend heavily on revenues. Sitting at the top of the income statement, revenue provides an initial indication of a company's success.

That being the case, it isn't too surprising that professional valuers need to carefully scrutinize any number of areas related to revenue, hunting for clues for false or misleading reporting, including premature or fictitious revenue recognition.

Premature revenue results from inappropriate timing — when a legitimate sale has occurred but is recognized too soon. For example, recognizing revenue for goods that have been ordered, but not yet shipped, would be considered premature revenue recognition. Fictitious revenue, on the other hand, involves recording revenue for sales that never did exist.

To detect such problems, professional valuers must first carefully examine and understand the company's policy for revenue recognition. Armed with this understanding, they would then inspect activities recorded under accounts receivable. A significant buildup in accounts receivable may indicate overly aggressive revenue recognition practices.

Beyond revenue, valuers will examine numerous other areas of a company's financial reporting, including depreciation, inventory valuation methods and other variables that can affect the bottom line.

Even if the company is complying with generally accepted accounting principles, preparers have several accounting alternatives that can affect the company's earnings picture and misrepresent overall performance and value. For example, a company may be overly aggressive in recognizing obsolete or slow-moving inventory.

### **Outside Sources of Information**

Sometimes valuers need to search beyond the financial information that is provided by the initial source. Bank statements can be requested and compared to tax returns to reveal potentially hidden accounts. Previous offers to buy a company or significant stock transactions may provide clues in a business valuation.

Evidence may even emerge by interviewing individuals relevant to the situation. And in today's technology age, a wealth of personal and business information is also readily available from government and private sources through numerous Internet sites.

**The Value of a Solid Valuation**

The benefits of a solid analytical approach — and thus a thorough and accurate determination of value — are particularly apparent in situations where the initial presentation of information is incomplete or misleading. By working with a valuation specialist, you'll be armed with a complete interpretation of the financial picture ... and be in a much better position to deliver a winning outcome for your client.