

Forensic Issues in Business Valuation

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Forensic Issues in Business Valuation

- Basic Fraud Triangle

Opportunity

Need / Motive

Rationalization

Forensic Issues in Business Valuation

- Fraud can affect any business valuation engagement because of the direct impact on the financial statements
 - Assets understated or overstated
 - Liabilities understated or overstated
 - Income understated or overstated

Forensic Issues in Business Valuation

- What are some of the direct effects of asset misappropriation?

Forensic Issues in Business Valuation

- Understated income
 - Affects all income methods
 - Can affect asset methods indirectly, but not always
 - Lower cash balances
 - Understated accounts receivable
 - Overstated accounts payable
 - Overstated accrued liabilities

Forensic Issues in Business Valuation

- Understated income
 - Affects many market methods
 - Price to income ratio
 - Price to earnings ratios

Forensic Issues in Business Valuation

- Overstated liabilities
 - Can affect income methods
 - Higher risk adjusted capitalization or discount rates
 - Higher interest expense
 - Understatement of income
 - Directly affects asset methods
 - May affect market methods, but not as likely

Forensic Issues in Business Valuation

- Understated assets
 - Can affect income methods if income is understated
 - Directly affects asset methods
 - May affect market methods, but not as likely

Forensic Issues in Business Valuation

- Common types of business valuation engagements where fraud may occur as a direct result of the business valuation
 - Divorce
 - Litigation between partners / shareholders
 - Business sales

Forensic Issues in Business Valuation

- Divorce and shareholder disputes follow similar patterns of behavior
 - Opportunity:
 - Generally the fraud is committed by an owner with full opportunity to commit the fraud and to CONCEAL the fraud

Forensic Issues in Business Valuation

- Divorce and shareholder disputes follow similar patterns of behavior
 - Need / Motive:
 - To conceal the real value of the business from the marital estate or shareholder / partner

Forensic Issues in Business Valuation

- Divorce and shareholder disputes follow similar patterns of behavior
 - Rationalization:
 - “I hate my spouse, partner, shareholder...”

Forensic Issues in Business Valuation

- Business sales follow different patterns of behavior
 - Opportunity:
 - Generally the fraud is committed by an owner with full opportunity to commit the fraud and to CONCEAL the fraud.
 - However, due diligence process *should* uncover any mysterious activities

Forensic Issues in Business Valuation

- Business sales follow different patterns of behavior
 - Need / Motive:
 - To make the business appear more profitable or more valuable

Forensic Issues in Business Valuation

- Business sales follow different patterns of behavior
 - Rationalization:
 - “This is my life’s work..”
 - Business value to the seller is based on intrinsic value, not fair market value

Forensic Issues in Business Valuation

- Common areas of fraudulent activity
 - Non business related expenses
 - Travel
 - Entertainment
 - Insurance
 - Utilities
 - Cars
 - Supplies
 - Etc.

Forensic Issues in Business Valuation

- Common areas of fraudulent activity
 - Over accrual of taxes
 - Personal property taxes
 - Real estate taxes
 - Payroll taxes
 - Income taxes
 - Deferred Taxes
 - Tax distributions for pass-through entities

Forensic Issues in Business Valuation

- Common areas of fraudulent activity
 - Over accrual
 - Commissions
 - Warranties
 - Customer deposits
 - Interest expense

Forensic Issues in Business Valuation

- Common areas of fraudulent activity
 - Ghost employees
 - Friends
 - Relatives
 - Girlfriends
 - Overpayment of key employees
 - Advances to key employees

Forensic Issues in Business Valuation

- Common areas of fraudulent activity
 - Ghost Vendors
 - Friends
 - Relatives
 - Girlfriends
 - Second company controlled by business owner or friend, relative or girlfriend

Forensic Issues in Business Valuation

- Common areas of fraudulent activity
 - Under reported or unreported sales
 - Deleted invoices
 - Manual invoices
 - Second company with similar name
 - Bad debt write-offs
 - Cash deposits then made in a “separate” undisclosed account
 - Cash not deposited until after the divorce

Forensic Issues in Business Valuation

- Common areas of fraudulent activity
 - Inter-company straddles
 - Expense / payable recorded on company A
 - Receivable / income not recorded on company B

Forensic Issues in Business Valuation

- Common areas of fraudulent activity
 - Partner distributions reported as loans
 - This is done to create a priority of distribution upon liquidation
 - Effective if the company does not have a partnership agreement requiring a full restoration of the capital account upon liquidation

Forensic Issues in Business Valuation

- Common areas of fraudulent activity
 - Stolen or altered check schemes
 - Altered payee schemes
 - Altered endorsee schemes
 - Altered payment schemes
 - Cash skimming

Forensic Issues in Business Valuation

- Common areas of fraudulent activity
 - Shareholder loans receivable
 - Shareholder loans payable

Forensic Issues in Business Valuation

- Common methods to detect
 - Tip from a spouse, partner or shareholder
 - Detailed review of the company books
 - This is often very difficult since the perpetrator of the fraud controls the documents
 - Analytical procedures
 - Financial statement analysis for periods before the “event” and after the “event”

Forensic Issues in Business Valuation

- Common methods to detect
 - Detailed review of customer lists, employee lists, vendor lists before and after the event
 - Inquiry regarding any questionable activity
 - Luck

Forensic Issues in Business Valuation

Thank you for attending

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