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Valuation looks to the future, not the past

The last three to five years of financial statements are often on the list of documents appraisers use to value a business. But historical results are only relevant to the extent that similar results are expected in the coming years. If so, historical trends may be used to help forecast future performance.

How do business valuation professionals handle major changes, such as new government regulations, increasing direct costs or the purchase of a major piece of automation equipment? For many retailers, restaurants and manufacturers, these are more than just hypothetical scenarios. They're real-world changes that are likely to unfold under the U.S. Department of Labor's (DOL's) new overtime regulations, scheduled to go into effect on December 1, 2016.

Understanding the new regs

In every business valuation assignment, the expert considers internal and external factors that may impact value, including any changes in government regulations. To illustrate, the DOL recently increased the income threshold for nonexempt workers to $47,476 a year. That's more than *double* the existing income threshold of $23,660 a year.

On the flip side, *exempt* employees aren't required to be paid overtime for working more than 40 hours a week. The DOL has also updated the income threshold for "highly compensated" employees who are automatically exempt from overtime pay to $134,004 a year. (Prior to December 1, the threshold for highly compensated employees is $100,000 a year.) Both income thresholds are scheduled to be adjusted every three years, starting in January 2020.

What about employees who fall in the middle of these two categories? For workers earning more than $47,476 but less than $134,004 after December 1, employers must perform a duties test to determine whether they should receive overtime pay.

The DOL estimates that more than 4 million workers will be reclassified under the new overtime rules. To avoid paying overtime, some companies may opt to use more part-timers or independent contractors during seasonal peaks. Others may reduce benefits to offset the incremental overtime costs. But it's likely that the changes will significantly lower earnings for certain businesses, no matter how hard they try to minimize overtime hours.

Measuring the impact

When valuing a business that's affected by the updated DOL regs, experts usually ask 1) how

Watch out for shortcuts in forecasted future cash flow

Before valuing a business based on estimates of future cash flow, valuation professionals ask: "What changes are on the horizon?" While business appraisers aren't fortunetellers, some changes may be known (or knowable) on the valuation date.

With some companies, it's possible to simply take historic financial statements and apply an assumed growth rate into perpetuity. But experienced valuation pros know that future performance can't always be expected to mirror the past. One key reason future performance may vary is capacity constraints.

To achieve an expected growth rate, a larger facility or additional equipment may be needed over the long run. Alternatively, if a decline is expected, a smaller facility, salary cuts and layoffs can help preserve cash flow over the long run.

Often, management creates budgets for internal planning purposes. These documents can provide insight into the company's expected cash flow by highlighting emerging opportunities and threats, but they need to account for major changes in operations. If not, a valuation that's based on the budget won't be accurate.

Experts generally rely on management's representations, including any internally prepared forecasts, when estimating the value of the business, as long as the representations appear accurate and unbiased. But company insiders need to view them with scrutiny, too.

the updated rules will affect future earnings, and 2) how management plans to minimize the adverse effects. There are several possible ways that the new law could impact expected cash flow:

- Direct labor costs and salaries paid to administrative personnel and middle managers could increase.
- Professional fees paid to external payroll and accounting firms to help implement changes to accounting systems and meet additional recordkeeping requirements could increase.
- Over the long run, some companies may purchase automated equipment, such as robots or self-checkout kiosks, if labor rates become cost-prohibitive.

If a company decides to replace people with machines, the decision could fundamentally change its product costing. That is, direct labor would be replaced by an overhead allocation for equipment usage. The company's balance of debt and equity would also change if the automation equipment were financed with debt. In theory, this could affect the company's cost of capital in future periods.

Taking a holistic approach

The updated overtime rules are just one example of how a company's operating environment could change. The company's expected performance may be affected by countless internal and external factors, such as the loss of a key person or customer, a significant reduction in the corporate tax rate, a major cyberbreach, or the emergence of new technology.

Experienced valuation professionals take no shortcuts when valuing a business. It's a time-consuming process that requires research, finesse and expertise. ■

PECO Logistics v. Walnut Investment Partners

Beware of valuation provisions

A recent Delaware Court of Chancery case demonstrates how courts give substantial weight to valuation provisions in owners' agreements, especially when the experts maintain their independence and follow the terms of these agreements. Here are the details of how some minority investors were forced to sell their units after exercising a put option, even though the investors objected to the purchase price determined under an owners' agreement.

Valuation provisions of LLC agreement

In 2011, two minority investors acquired preferred equity units in PECO Logistics, a limited liability company (LLC). The company's sole asset was an interest in a pallet rental company. The investors became parties to an LLC agreement, granting them a voluntary "put option" to sell their preferred units back to PECO Logistics over a three-year period.

If the investors exercised the put option, the LLC agreement required the company to "retain a nationally recognized valuation firm to determine the fair market value of the preferred units in accordance with a specified formula." Under the LLC agreement, the value of the investors' units would be based on the pro rata value of the entire company, expressly excluding discounts for lack of control or marketability.

Within 45 days of the completion of the valuation, the agreement required the company to repurchase the preferred units at the appraised value. The LLC agreement also stated that both the company and the investors "shall be bound by the determination" of the valuation firm. A potential shortcoming was that the LLC agreement included no mechanism that allowed the owners to review the determination of value.

Lawsuits over appraised value

In 2014, the investors exercised the put option and the board hired a nationally recognized valuation firm to value their interests. When the company attempted to repurchase their interests at the appraised value, the investors objected, and the company sued the investors for the right to purchase their units.

The investors subsequently filed counterclaims that PECO Logistics had breached the implied covenant of good faith and fair dealing. The

investors also claimed that the letter of intent unilaterally "reserved their rights" to participate in the valuation process and review the determination of value.

Independence and reasonableness

The valuation expert determined a total enterprise value of approximately $275 million, using the discounted cash flow and merger and acquisition methods. Because this value exceeded the prescribed cap under the EBITDA collar, as defined by the LLC agreement, the total enterprise value was reduced to approximately $209 million. The total equity available for distribution to owners — after adjusting for debt, cash and cash equivalents, and hypothetical transaction, legal and accounting fees — was approximately $93 million.

The court abstained from questioning this methodology, because:

1. The appraisal firm maintained its independence from both the company and its investors, and

2. The assumptions underlying the valuation were reasonable.

The court concluded, "When parties to a contract agree to be bound by a contractually established valuation methodology, this Court will respect their right to order their affairs as they wish and refrain from second-guessing the substantive determination of value." Accordingly, the court ordered the investors to sell their units to PECO Logistics at the appraised value.

Lessons learned

This case shows that courts typically defer to agreements that owners enter into before disputes arise. So, when drafting valuation provisions for owners' agreements, it's important to be detailed and comprehensive. For instance, if the parties expect to participate in the selection of a valuation firm or in the valuation process — or if they want to retain the right to review the appraised value before initiating a buyout — the agreement should specifically provide for those rights.

To help cover all the appraisal-related bases, contact a valuation professional when you're writing or reviewing an owners' agreement. If you wait until a dispute arises to define or test the valuation provisions, it may be too late. ■

Assessing fraud risks

Valuation professionals factor fraud into the valuation equation

When fraud strikes, it can have a major impact on a company's value. The Association of Certified Fraud Examiners (ACFE) estimates that companies lose approximately 5% of revenues to internal theft and financial misstatement each year, according to the *2016 Report to the Nations on Occupational Fraud and Abuse*. Here's how this statistic relates to the value of a business and how valuation professionals factor fraud into their analyses.

Understand the impact on value

Suppose a company reported $5 million in revenues in 2015. This equates to an estimated annual fraud loss of $250,000 ($5 million × 5%). Assuming a pricing multiple of 1.2 times revenues, fraud implicitly would impair the company's value by $300,000 ($250,000 × 1.2) based on its estimated fraud losses.

The company's actual losses could be higher or lower than this estimate, however.

And this analysis doesn't include indirect fraud costs — such as lost productivity, accounting and legal fees, reputational damage, and reduced goodwill — that can also affect business value.

Identify fraud risks

Fraud takes a significant toll on companies. So an important part of the business valuation process is identifying potential fraud risks and gauging whether management has taken appropriate action to mitigate those risks.

Not only does fraud drain company resources, but it also lowers morale, distracts management, results in regulatory actions — and can eventually lead to bankruptcy. All else being equal, companies with higher fraud risks warrant higher discount rates or lower pricing multiples, or both.

Evaluate controls

A strong system of internal controls is one of a company's most powerful fraud deterrents. In addition, a vigilant corporate culture can make a big difference in deterring fraudulent acts. But neither provides an absolute guarantee against fraud, because the internal control system can be intentionally circumvented.

Valuation professionals evaluate internal controls and corporate culture by looking for formal codes of conduct, reporting hotlines, antifraud training, and clear channels of communication between frontline workers and their supervisors. They also interview management to observe subtler clues.

For example, appraisers might inquire about the extent to which managers pressure subordinates at month- or year-end to meet goals. Or they might ask about previous fraud occurrences and how they were resolved. Careful, consistent handling of fraud cases speaks volumes about management's attitude toward fraud risk.

Customize the assessment

Company size can affect its overall risk profile. That is, small companies are generally perceived to be riskier (and warrant higher returns from investors) than larger companies. One reason is that smaller businesses tend to be more vulnerable to fraud because they often lack adequate fiscal and human resources. They also tend to have fewer internal controls in place to deter and detect scams. So, fraud strikes small, private businesses more frequently. In addition, their losses tend to be more costly and devastating over the long run.

The 2016 ACFE study revealed that corruption was more prevalent in larger organizations, while check tampering, skimming, payroll and cash larceny schemes were twice as common in small organizations as in larger ones. Industry also affects the fraud risk assessment. In the cases reported in the 2016 ACFE report, the most represented sectors include:

- Banking and financial services,
- Government and public administration, and
- Manufacturing.

These findings underscore the need for valuation professionals to customize their fraud risk assessments, depending on the size and industry of the subject company.

When fraud risks materialize

Business appraisers consider fraud risks in every valuation assignment — and many experts are cross-trained in both valuation and forensic accounting. But detecting and investigating fraud is outside the scope of traditional valuation assignments. If fraud suspicions arise, it might be time to call in reinforcements and expand the scope of the engagement. ■

How to estimate reasonable owners' compensation

The issue of reasonable owners' compensation often comes up in federal tax inquiries. But it may also be an issue in shareholder disputes and divorce cases.

For instance, minority shareholders or the spouses of a controlling shareholder may claim that an owner is taking an excessive amount of salary, thereby impairing the value of the business. Alternatively, a nonowner-spouse may claim that a salary is too low, because the owner-spouse is trying to minimize the base on which alimony and child support payments will be calculated. Here's how a valuation expert can help you support — or defend against — these types of claims.

Factors to consider

What's considered reasonable in shareholder disputes or divorces may vary based on state law or legal precedent. A reasonable compensation assessment generally starts by looking *outside* the company at external market conditions and geographic location. Then, the analysis turns to internal factors, such as the company's size, financial performance and compensation programs. Finally, the individual's contributions to the company, including his or her responsibilities, skills, reputation and experience, are factored into the analysis, along with any personal guarantees from the owner.

An owner may sometimes warrant a salary that's higher or lower than what nonowner-employees receive for similar positions. For example, the Tax Court recently upheld a combined annual salary of more than $7.3 million for two owners of a large Arizona concrete contractor. That may seem like a lot of money, but the court ruled that the company's investors still received a reasonable return on investment after owners' salaries were paid. This type of analysis is known as the independent investor test.

Compensation resources

Another type of analysis hinges on comparable salaries paid in arm's length compensation arrangements. You can find reliable compensation data for a particular industry or geographic market in several public and private salary surveys, such as:

- Willis Towers Watson's executive salary surveys,
- The Risk Management Association's Annual Statement Studies®,
- MicroBilt's Integra industry reports,
- Economic Research Institute's quarterly salary surveys,
- The Conference Board's annual executive compensation reports, and
- Dun & Bradstreet's Key Business Ratios on the Web.

Additional industry- or location-specific data can be obtained from salary surveys that break down the data by industry, market or size; industry trade associations and publications; and executive headhunters.

Outside expertise

Deciding what's reasonable can be subjective and sensitive. Valuation professionals provide objective insight by researching comparable market data and using it to estimate how much a nonowner-employee would receive for performing similar services, based on the characteristics of the company, market and individual. ■

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