

# Business Valuation Notes

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## Not Just For Performance ...

### ANALYSTS USE RATIOS FOR FRAUD

Reviewing financial statements for a company valuation requires more than simply displaying annual statements for several years.

Appraisers use a series of ratios to analyze performance, both for the business over a period of years and also to evaluate the company compared to others in the industry. Professionals also use preliminary testing to ascertain if the company may have “managed” its earnings, manipulated or even fraudulently reported, according to MBVG Senior Business Appraiser Laurel Sorensen.

It’s timely to evaluate if earnings have been managed or if the balance sheet fails to accurately reflect financial condition. KPMG International released the 2008-2009 Integrity Survey last week, the third in a periodic series started in 2000.

Richard Girgenti, National Practice Leader, said in the report, “... managers and employees facing heightened pressure to meet revenue and cost

targets may resort to improper means of doing so – especially if they perceive their jobs to be in jeopardy...

“Nearly three out of four employees report that they have personally observed or have firsthand knowledge of wrongdoing within their organizations during the previous 12 months,” Girgenti wrote.



Girgenti

Sorensen, who is a certified public accountant and is also accredited in business valuation, has worked in both auditing and taxation in addition to valuation. She reflected on the uses of financial statement analysis for preliminary forensic evaluation recently following The 19<sup>th</sup> Annual Business Valuation Conference, Riding Out the Storm in Minneapolis, Minnesota. This annual conference, sponsored jointly by the Minneapolis American Society of



Sorensen

## Auditing Securities May Soon Require Interim Value Reporting

Accountants which audit companies with traded securities holdings may have to get values for year end and quarterly updates soon. However, the methods used remain unclear.

Senior government and accounting officials are sending mixed signals which could have major ramifications for *Fair Value* accounting, first backing continued use of Mark-to-Market (MTM) for valuing securities, and then proposing valuation models which may use other methods for “price discovery”. A series of releases from the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB) display waffling from MTM support to advocacy of other methods for appraisal.

Minnesota Business Valuation Group President Randall Schostag said that although the direction or outcome isn’t clear, he is pleased to see the debate: improved definition and methodology for ascertaining fair value.

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# Securities

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“We’ve been arguing for improved measures and methods for valuing securities in portfolios for several years,” Schostag said. “It took a major melt down, however, before regulators and administrators recognized the failures in the system.”

US Treasury Secretary Timothy Geithner, who was previously president of the New York Federal Reserve Bank, was confirmed by a 60 to 34 vote in the US Senate January 26, 2009.



**Geithner**

Several observers, including Vinny Catalano ([vinnycatalano.blogspot.com](http://vinnycatalano.blogspot.com)) states that first Geithner was comfortable with MTM and then, only a week later, he proposed to have ‘toxic bank assets’ valued by an independent third party.

“Clever guy this Mr. Geithner,” Catalano writes. “Publicly advocate for free market principles (mark-to-market) while working behind the scenes to exploit it (through aggregator bank and price discovery (courtesy the “independent third party”)).”

The issue has remained a topic of focus with the consideration of another version of the Troubled Assets Recovery Program (TARP) for the possible allocation of additional funds to assist an economy in crises. Politicians, tax-

payers, and pundits have complained that a lot of the money distributed last fall went to banks directly and were not used to purchase toxic loans.

Critics have questioned how such loans should be valued for taxpayers to buy them and to prevent the government from overpaying for the troubled loans while bankers, of course, don’t want the loans sold below value.

“At the center of this debate,” Schostag said, “is the definition and recommended ways to measure fair value, according to the Financial Accounting Standards Board.

“FASB and the American Institute of Certified Public Accountants promulgated Standard 157, and that standard is quite rigid. Many also believe the standard fails to conform to reality.”

On January 30 the FASB released FASB Staff Position (FSP) 107-b and APB 28-a, *Interim Disclosures about Fair Value of Financial Instruments*. FSP 107-a had been released on Christmas Eve (2008), but in January, FASB reexposed the comment period.

This FSP would amend SFAS 107 to require disclosures about fair value of financial statements in interim financial statements as well as in annual financial statements.

The FSP’s comment period deadline is March 2, 2009. If adopted, these disclosures would be effective for interim and annual reporting periods ending after March 15, 2009. For initial

reporting, the companies will not be required to show comparative values to prior reporting periods. But such comparisons will have to be reported for periods ending subsequent to initial adoption.

“The SEC study on December 30<sup>th</sup> recommended keeping mark-to-market,” Schostag said. “But important definitions, such as using a hypothetical market participant rather than the value to the holder and considering cash flows are breaking down.

“There is finally acknowledgment that the assumption of a strong form of market efficiency, at least with respect to thinly traded securities, may not be appropriate, and that other measures must be used. Especially since portfolio managers are apparently going to be required to report not only annual values but also on a quarterly basis, FASB and the SEC will refine the discussion about methods to include the income approach and the asset-based approach.

“As business appraisers we recognize that the market approach is a valid tool, but that using only one measure of value is usually not sufficient. That’s also what the courts have determined for appraising privately held securities.”

Typically business appraisers use three approaches to value a business: the market approach, the income approach, and the asset-based approach.

# Fraud

(Continued from page 1)

Appraisers, the Institute of Business Appraisers, and the National Association of Certified Valuation Analysts, featured Darrell Dorrell as a co-keynote speaker. Dorrell spoke about “Forensic Accounting for VALF Practitioners: Tips, Tricks, Tools & Techniques©”.

“We get a lot of clients who don’t understand why MBVG needs several years of financial information or why we want both reported financial statements and tax returns,” Sorensen said. “One year alone isn’t enough to understand what normal is, nor does one year reflect trends.

“Usually the last five years is sufficient to give us an idea of both performance and capital structure. And filings such as tax returns provide another check on reliability.”

Dorrell stresses that using forensic accounting tools and techniques “transcends attest, valuation, economic damages, and tax and fraud” reporting and should be considered for all such engagements, not just for civil or criminal accounting matters.

Sorensen cited an example of using the ratio for total accruals divided by total assets (TA/TA) as one measure which may signal that a company is managing its earnings.

“I expect this ratio to normally be stable, fluctuating in a small range,” Sorensen said. “If there is a spike for a year, I want to determine why. A spike

can arise, in some cases, if someone in the company dresses up a year by altering accruals, a method frequently used to misguide statement users.”

MBVG President Randall Schostag said, “My impression is that most earnings management is based on accruals, the difference between earnings and cash flows.

“Accruals are normal for a firm and tend to reverse out over time (Dechow Sloan & Sweeney and Bartove, Gul and Tsui). If there’s a change, Laurel tries to identify discretionary from non-discretionary accruals (Jones model).

“I tend to view aggressive use of accruals as borrowing from the future while I see the conservative use of accruals as saving up for a rainy day.”

MBVG Secretary and Olsen Thielen Principal Michael Bromelkamp said that



**Bromelkamp**

he wants to know about a company’s key accounting policies and strategy and how the company may vary from others in the industry.

He also wants to understand how much flexibility a firm has exercised in establishing its accounting policies.

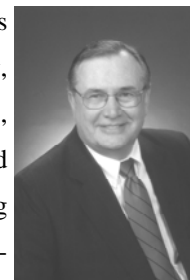
“When companies are audited,” Bromelkamp said, “they don’t have much flexibility in most industries because they must comply with generally accepted accounting and auditing principles. But when MBVG is working with internally

prepared statements or simple compilations, there’s a lot more room to manipulate. The statements for unaudited companies seldom have good footnotes or other explanations of entries; it’s more difficult for our analysts to understand what company management is doing.”

In his presentation Dorrell offered 25, out of what he said are probably 250 to 300, forensic accounting techniques to use to test a business. From a quantitative viewpoint for financial statements, these techniques, besides TATA, include: total accounts receivable to total assets, total inventory to total assets, total depreciation to total assets, total accounts payable to total assets, and an asset quality index.

Except for the asset quality index, Sorensen said, MBVG already has most of the other forensic measures suggested by Dorrell and that MBVG will be adding that measure as another check point. “For most of our valuations, this part of the analysis won’t be significant,” she said. “It’s just another measure to better understand the financial results.”

Schostag remarked that MBVG is fortunate because its holding company, Olsen Thielen & Co., Ltd, is a certified public accounting with internal resources which can be tapped to assist in a forensic analysis.



**Schostag**

# Minnesota Business Valuation Group

## Professional Business Appraisals

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#### **BUSINESS VALUATION**

Goodwill Impairment Analysis (141/142)

Businesses

Intellectual Property

Intangible Assets

Options

Strategic Planning

ESOP

Divorce

Shareholder Oppression / Dissenting Rights

Buy/Sell Agreements

Merger / Acquisitions

Fairness Opinions /Purchase Allocation

Planning

#### **BUSINESS ASSET VALUATION**

Experts or Consultants

Sale / Purchase

Insurance

Fair Rental Rates

Financing

Ad Valorem Taxes

Condemnation

Feasibility

Purchase Price Allocation

Property Records

Fiduciary Review

Sale / Leaseback Structuring

Business Planning

**WE ARE AVAILABLE FOR PRESENTATIONS FOR ESOP IMPLEMENTATION,  
MERGER & ACQUISITION CONSIDERATIONS, EXPERT TESTIMONY PREPARATION,  
GENERAL BUSINESS VALUATION, AND MANY OTHER TOPICS.**

**OUR FORMAT IS POWER POINT - BASED.**

**WE REQUEST THAT YOU SUPPLY THE SOUND SYSTEM AND APPROPRIATE DISPLAY  
INSTRUMENT.**

**WE WILL CONNECT OUR COMPUTER.**

**PLEASE ALLOW AT LEAST 30 DAYS FOR SCHEDULING.**