

Valuation & Litigation Briefing

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Site visits and management interviews

Why experts insist on touring a company's facilities

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Big picture considerations prevail over complex methodology

Know the perils of financial testimony by owners and employees



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Site visits and management interviews

Why experts insist on touring a company's facilities

Without site visits and management interviews, it can be difficult for a valuation professional to gather all of the information needed to fully understand a business's operations. So, if a controlling owner refuses to give an expert access to its facilities and employees, the valuation report will likely list that fact as a limiting condition. Here's a closer look at how these steps facilitate the valuation process.

What are experts looking for?

When valuation experts tour facilities, they're looking for conditions that may affect the company's earnings or increase its risks. Questions they may ask include:

- ◆ Are the company's property, plant and equipment in good condition?
- ◆ Do any fixed assets or inventory appear to be nonoperating, idle, obsolete or damaged?



- ◆ Do the company's operations appear to be organized and efficient?
- ◆ How are working conditions? Is the facility clean and uncluttered? Do workers seem productive, or overworked and under unusual stress to perform?
- ◆ Are there any capacity constraints that might hamper the company's ability to handle future growth?
- ◆ What's the skill level of the company's employees and managers?
- ◆ How is staff morale? Do any employees or managers appear to be disgruntled or adversarial?
- ◆ Are there any obvious environmental issues, such as pollution or questionable storage or disposal of toxic waste?
- ◆ Does the company have adequate physical controls over assets, such as inventory, cash and equipment?
- ◆ Are there any discrepancies between the interview with management and site visit observations?

If the business is a retailer or otherwise open to the public, management's permission might not be needed to conduct a site visit. This may be helpful in adversarial situations in which the client doesn't control the business.

The expert can simply show up like a mock customer to evaluate the typical customer experience and consider whether there's adequate signage, parking and access. However, a formal tour must be scheduled if the expert needs a behind-the-scenes tour or wants to interview management.

What questions are asked?

Interviews with executives and other employees allow an expert to look beyond a company's historical financial statements to factors that affect its future earning potential. Interviews allow the valuation professional to assess the quality of a company's management team and other key employees, providing insights that formal titles and organizational charts don't reveal.

For example, is management "thin"? That is, does the company rely heavily on the owner, the CEO or a small group of key employees, increasing its risk? If so, the expert will consider whether the company has taken steps to mitigate this risk, such as initiating employment contracts, noncompete agreements and well-designed succession plans.

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Another key area of inquiry involves the strength of the company's customer and supplier relationships. An expert will inquire about customer retention rates, formal long-term contracts and customer concentration risks. Relationships that depend on personal relationships with the owner or outside referrals may warrant an adjustment to the company's value.

Experts will also inquire about the company's competition, intellectual property rights, technology, brand-name strength, product development and strategies for reducing competitive risk.

Indispensable tools

Site visits and management interviews can provide information — both positive and negative — that a company's books and records will never reveal. Investing the necessary time and effort almost always pays dividends in the form of a more accurate valuation report that carries more weight with courts and other users. ■

A courts-eye view of site visits

In a litigation context, valuation experts who fail to conduct site visits and management interviews — or who don't receive the access they need — may damage their credibility in court. Courts today are more knowledgeable about valuation concepts and want to see experts back up their assumptions.

Cases highlighting the importance of site visits and management interviews include:

Zeefe v. Zeefe. An Ohio appellate court relied on an expert's valuation of a car parts business because, unlike the opposing expert, he personally viewed all three locations of the business. It was reasonable, the appellate court said, for the trial court to conclude that the chosen expert's testimony was "more accurate and more reasonable."

Kohler v. Commissioner. The U.S. Tax Court rejected the testimony of one of three experts engaged to value stock for estate and gift tax purposes. Among other things, the expert who was rejected met with the company's management for less than three hours, insufficient time to understand the company's business. The second expert was more familiar with the company because he had valued its stock in the past. And the third expert spent three and a half days at the company and interviewed 12 employees.

Anzalone v. Anzalone. In this divorce case, the court found that the wife's valuation expert was more credible because he considered the company's financial statements and recent performance. He also "interviewed management to learn what has happened behind the numbers and to obtain other key data and information that are not contained in the financial statements."

Boo! Solving the mystery of the phantom employee

Do your clients have ghosts on the payroll? If so, they might be losing thousands of dollars to bogus salary and bonus expense each year. Here's how phantom employee frauds work, including the warning signs and tips to help clients "exorcise" these scams from their payroll records.

Real life example

Phantom employees can be make-believe people or, more likely, real people who are in cahoots with an individual who's in charge of payroll records. For example, a senior director for a health insurance company recently pleaded guilty to setting up his wife and another person as phantom employees. The director's wife, who supposedly worked from home, performed no services for the company but earned wages and bonuses totaling more than \$785,000.

The other phantom employee, a friend of the director, was paid \$61,000. The director entered false documents, such as performance reviews and other reports, into the company database and altered emails to justify the payments.

Opportunity for fraud

It may seem easier to hide phantom employees in large businesses, especially those with multiple locations and offsite payroll departments. But small firms can be victims, too. All it takes is a dishonest employee who's in charge of authorizing transactions or has other access to the payroll system. These scams require three simple steps:

1. Put the phantom on the payroll. This can be as simple as adding a fictitious name to the payroll system or using the name of an employee who's retired or otherwise left the company. If the criminal doesn't have access to the system, he or she might have to forge documents to create a fictitious account.



2. Create wage records. If the phantom employee is paid a regular salary, it may not be necessary to fabricate time sheets or other records. Routine payments at regular intervals work to the criminal's advantage. However, the perpetrator may have to falsify time sheets and other documents for hourly phantom employees.

3. Take the money. Converting paychecks or direct deposits to cash may require more subterfuge than direct cash payments. For example, an employee may set up a falsified bank account for direct deposits. Check cashing is riskier and may lead to apprehension. But once the crook pockets the cash, the fraud trail goes cold.

Red flags

There are certain warning signs that a phantom employee is haunting your payroll system, such as:

- ◆ Missing employee files,
- ◆ Employees with overly vague (or no) job titles or descriptions,
- ◆ Multiple employees with the same mailing address or bank accounts for payroll deposits,

- ◆ Employees who list a post office box as their mailing address, and
- ◆ High, unexplained employee turnover rate.

These warning signs can be cause for concern. However, your clients may discourage the creation of phantom employees by imposing stronger internal controls.

Ghostbusters

Your clients can take various measures to strengthen internal controls. For example, a business could simply stop paying employees in cash. Direct deposits aren't foolproof, but they can cut down on fraud by eliminating paper paychecks and the possibility of alteration, forgery and most theft.

Managerial review can also reduce a business's risk. For example, different supervisors might be assigned to approve payments to employees on

a random basis. This makes it more difficult to hide a phantom employee. Supervisors should also be trained on how to scan the payroll records for red flags, such as suspicious names and multiple employees with the same mailing address.

Finally, the payroll system should be equipped with checks and balances. For instance, the head of a department should be required to verify any employees that are added or removed from the payroll system. Moreover, payroll records can be coordinated with personnel reviews. If an employee doesn't show up for a review, it warrants further investigation.

Forensic accounting expertise

Phantom employees allow fraudsters to hide in plain sight. Over time, false wage payments can add up and become harder to detect. Contact a forensic accounting expert to help your clients reveal these scams. ■

The case of the disappearing discount

Big picture considerations prevail over complex methodology

In *Estate of Koons v. Commissioner*, the Eleventh U.S. Circuit Court of Appeals affirmed the U.S. Tax Court's valuation of a revocable trust's interest in a limited liability company (LLC). The primary issue in the case was the size of the discount for lack of marketability: The Tax Court rejected the 31.7% discount proffered by the estate's valuation expert and accepted the IRS expert's 7.5% discount.

The Eleventh Circuit agreed with the Tax Court. Although the estate's expert backed up his computations with a detailed regression analysis, the court's conclusion was based more on "big picture" considerations.

A liquid business

A businessman operated Central Investment Corp. (CIC), which owned a Pepsi bottling and distribution business, a vending machine business and some other operating businesses. In 2004, the businessman owned 46.9% of CIC's voting stock and 50.5% of its nonvoting stock. His children and other family members owned the remaining stock.

In late 2004, after a dispute with Pepsi over exclusivity rights, CIC sold its bottling and vending machine businesses to Pepsi for around \$352 million and received an additional \$50 million settlement payment. The proceeds, settlement and



remaining operating businesses were placed in a new LLC. The LLC's operating agreement limited annual discretionary distributions to 30% of the excess of "distributable cash" over income tax distributions.

The businessman's children conditioned their sale of CIC shares on receiving offers from the LLC to redeem their interests. These offers were made and accepted before the businessman's death, but the sales weren't finalized until approximately two months after his death in March 2005.

Redemptions "almost certain" to occur

When the businessman died, his revocable trust owned a 46.94% voting interest in the LLC. However, that interest increased to 70.42% once the redemption offers closed, giving the trust the power to lift the restriction on distributions.

In valuing the LLC, the estate's expert applied a 31.7% discount for lack of marketability. That figure was derived from a regression analysis of 88 public companies designed to quantify the difference between the price of publicly traded stock and the price of restricted shares of the same stock. The expert opined that there was a significant risk that the redemption offers wouldn't close and, even if they did, a majority interest holder wouldn't be able to force a distribution of most of the LLC's assets.

The IRS expert found several flaws in the estate expert's regression analysis. More important, he concluded that the risk the redemption offers wouldn't close was a small one and, once they closed, the trust would have the ability to force a distribution. He valued the trust's interest based on its pro rata share of the LLC's net assets, less a 7.5% discount for lack of marketability.

Both the Tax Court and the Eleventh Circuit agreed with the IRS expert: The redemptions were "almost certain" to occur and a hypothetical seller of the trust's interest wouldn't accept less than the amount it could receive in a distribution — in this case, approximately \$140 million. The Tax Court valued the interest at \$148 million, based on the valuation prepared by the IRS's expert, because it was just slightly above that minimum.

Common sense wins out

Koons is noteworthy because it illustrates the need for valuers to step back and consider the big picture: Does this valuation make sense from the perspective of hypothetical buyers and sellers? In this case, the valuation prepared by the IRS's experts was appropriate because it was aligned with a hypothetical investor's expectations. ■

Know the perils of financial testimony by owners and employees

Owners, executives and other key employees sometimes testify in litigation involving lost profits or valuation issues. But beware: Layperson testimony that crosses over into expert witness territory is at risk of being excluded from evidence.

Lay vs. expert testimony

Rule 701 of the Federal Rules of Evidence (FRE) governs opinion testimony by lay witnesses. A nonexpert's opinion is limited to one that is:

- ◆ Rationally based on the perception of the witness,
- ◆ Helpful to a clear understanding of the witness's testimony or the determination of a fact at issue, and
- ◆ Not based on scientific, technical or other specialized knowledge within the scope of Rule 702, which governs expert testimony.

A witness's testimony may be excluded if he or she qualifies as an expert — for example, the witness is a CPA or credentialed valuation analyst — but was not disclosed as such. Or a layperson may be disqualified because he or she doesn't possess the required scientific, technical or other specialized knowledge to testify on a particular subject.

Lay testimony on financial matters

The opinions of lay witnesses on lost profits and other financial matters may be allowed in certain situations, however. According to the FRE Advisory Committee's notes, "Most courts have permitted the owner or officer of a business to testify to the value or projected profits of the business, without the necessity of qualifying the witness as an accountant, appraiser, or similar expert. . . . Such opinion testimony is admitted not because

of experience, training or specialized knowledge within the realm of an expert, but because of the particularized knowledge that the witness has by virtue of his or her position in the business."

For example, in a lawsuit for unpaid equipment rentals (*United States ex rel. Technica, LLC v. Carolina Cas. Ins. Co.*), the company's CEO was permitted to testify as a lay witness regarding the reasonableness of re-rental charges because of his "particularized knowledge gained from years of experience within his field."



But when testimony requires more complex financial or valuation knowledge, courts are likely to require an expert. For example, in *Ruhr v. Immtech International, Inc.*, the court rejected testimony from the plaintiff's president regarding lost profits because it involved a new product in a complex market — financial matters outside of his personal knowledge or perception.

Handle with care

In commercial litigation, exclusion of damages testimony can be devastating. If you're contemplating the use of an owner or employee to provide financial testimony, carefully consider whether the subject of the testimony requires more specialized knowledge or perception. ■



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