When We (Think We) Know Better

Every once in a while, you run into a valuation expert who really believes that he/she knows better how to run the business being valued than the current owner/operator – even when that owner/operator has been running the business for say 20 years or more. The purpose of this article is to deal with that type of situation under one set of financial facts that we believe raise interesting issues.

As part of our routine forensic investigation and related financial analysis, we will often review various expenses of a business in order to give us a comfort level as to whether any adjustments need to be made (for instance for the typical owner benefits/perquisites often run through a business, or perhaps for a more benign non-recurring situation). We also often look to compare various operating expenses (as a percentage) to a benchmark, if available. The benchmarking typically comes from proprietary databases to which we subscribe where those databases cull information from a variety of sources on a variety of businesses.

For purposes of this article, our underlying premise is that the expert has determined, using benchmarking and/or personal knowledge (the latter can be rather dangerous) that the payroll expense for this business is out of sync with what the expert would have expected based on industry/profession norms. Further, the expert, through the forensic process, has satisfied him/herself that there is no issue with family or special friends on the books, or anything of that ilk. Rather, the expert has determined that the payroll is too high – and that there must be a reason, one which entitles that expert to make certain adjustments. In other words, at least as to this issue, the expert knows better than the business owner how to operate the business.

As compared to the benchmarking norms, there are certainly a number of reasons why payroll can be out of whack with the norm. Perhaps a critical issue that arises is whether that by itself suggests anything warrants an adjustment to what are perfectly legitimate operating expenses. Let us consider a few possibilities:

- The owner is underworking, and thus calls upon employees to do more. This in a sense would impact our normalization adjustment as to reasonable compensation. If we were strong as to support for this position (that is for instance that the owner was only working 20 hours a week when he/she should be working 50 hours), then there would be the need for an adjustment through the reasonable compensation process. The result would be to leave the non owner payroll as is – legitimately, it would be a greater percentage than is

normal. However, no adjustment to that payroll would be necessary – or would it? See the next paragraph

- Using the preceding, the expert might decide that what he/she needs to do is to allow for the normal working effort of an owner, allow the appropriate reasonable compensation, and then disallow some of the otherwise legitimate payroll – under the theory that had the owner been working at the appropriate (normal) level, that extra payroll would not have been incurred. One "benefit" of this type of approach is that it puts more of the income in the hands of the owner – which, if this is a divorce matter, might indeed be appropriate and beneficial to the spouse of that business owner. In contrast the above paragraph approach leaves the non owner payroll as such and "simply" reduces the appropriate compensation for the owner/spouse.

- Another approach or consideration might be along the lines of the expert (with the support from the benchmarking data) arguing that the subject business is not operated as efficiently as it should be (as efficiently as its peer group), and thus some of the payroll expense should be "disallowed", added back in the process of determining normalized income. Or, perhaps the expert has determined that some employees are overpaid (not suggesting here any special relationship between the owner and any employees), perhaps because of longevity, and thus maybe there is inertia in the payroll; maybe because the owner is not good at confrontation and overpays his/her employees rather than risk losing them. On that basis, the expert decides that some of the payroll is unnecessary – that a hypothetical buyer, that the business environment in general, would not incur that extent of payroll expense.

In probably any of the above illustrations, but perhaps most pointedly as to the last one, the expert might be overstepping what is traditionally the expert's role, and perhaps in this case arguing a managerial issue. The expert here is suggesting that he/she knows better in terms of what this business needs to run than the person running the business; that if only the current business owner did a better job, the business would be more profitable – and by simple extension, thus more valuable. On that basis, the expert is arguing that some part of the expenses should not be allowed, resulting in higher income and thus the expert is going to conclude with a greater value than would be the case based on the company's actual numbers. We experts make adjustments all the time resulting in increased income (and sometimes in reduced income) compared to that as reported. However, those are typically because personal expenses were run through, or there was something nonrecurring or the like. Here the argument is that there is nothing improper, nothing nonrecurring, etc. – just that the

business is not operating as efficiently as it should be, and thus is worth more than would appear to be the case.

Certainly, an interesting hypothesis, and one which perhaps can be supported with the appropriate amount of analysis. However, in such a case, the "appropriate amount of analysis" would require some extraordinary efforts, which therefore means fees – above and beyond what might normally be the case for whatever else is involved in this matter. Also, depending on how well presented the hypothesis, it would seem that the expert would also be exposed to a challenge that he/she is over extending him/herself, going outside of the parameters of an expert, and now becoming perhaps the equivalent of a management consultant. Further, to do this properly, would the expert need to be an expert in that business/field rather than "simply" an expert in valuation? That is not to say that this is not the proper province of an expert doing a business valuation or that it is any way improper for a valuation expert to consider this type of analysis and approach. Only that if it is to be done, it must be done with care and an extra layer of attention.