Buried Treasure: Business Valuation in Divorce

Finding true business value takes on a new complexity when the owners are going through a divorce.

By Lynton Kotzin

The typical financial crime is sparked more by the desire for financial gain than by the desire to hurt the victim. That may not be true in a divorce, though, where one party may wish to cheat the other out of his or her fair share of marital property for the sole purpose of inflicting humiliation, emotional distress or financial injury.

Divorce is an emotional event, and because the anxiety, anger and mistrust can be so profound, it is common for one spouse to insist that the other is hiding or undervaluing significant assets.

Suspicion can reach unprecedented heights when the couple's estate includes a closely held company. In such cases, the presumption by the uninvolved spouse that the owner-spouse is suppressing the company's value is almost a given. Determining whether that presumption holds water often requires that a business valuation professional investigate the business's financial records. Once analyzed, the valuator can understand the location of assets, track any significant changes in spending habits of either spouse prior to the date of separation, and look for patterns or breaks in patterns that may point to suspicious activity.

KNOW THE COMPANY

A key reason for understanding the location of assets is to help identify whether any have been removed from the business. The first step in making this determination is to thoroughly understand the company. That makes it easier to identify changes in business patterns that might indicate whether assets have been shifted out of the company. Some of the questions a valuator may ask about the company include:

- What types of products or services does it provide?
- How do trends in other industries affect its income?
- Have there been changes from year to year in key areas of its balance sheet or income statement and the corresponding ratios?
- Has the company or its shareholders recently submitted financial statements to lenders?
- Who are the company's customers?
- Has the level of business from these customers remained steady?
- Have key customers been leaving the company for a single competitor or a new company?

The answers to these questions may reveal some previously unknown facts. For example, a review of sales activity logs may show a sudden decrease in revenues from a major customer. Further investigation may show that several customers have switched their business to the same new competitor. It may turn out that one spouse is a partner in the competing business, which was set up for the express purpose of siphoning off key accounts from the existing business to reduce its value in the divorce settlement.

KNOW THE INDUSTRY

Just as an understanding of the company in question can help a valuator unearth unusual patterns or trends in its business, so can a thorough knowledge of the industry in which the company competes. Trends within the industry as a whole, as well as with the business's competitors in particular, affect the business and provide additional insight to the valuator. Questions a valuator may ask include:

- Is the industry in a growth phase?
- What are common earnings for other members of the industry?
- What are common levels of expenses?
- What other relevant industry trends affect the company?
- Is the competition experiencing similar trends?

If a valuator suspects that a business owner is siphoning off assets from the company by manipulating the accounting records, the valuator should look at statistics from similar companies. As a rule, two companies with similar levels of business should have similar levels of expenditures. If one company is spending twice as much as a comparable competitor on supplies, financial manipulation may be the cause. A detailed analysis of the subject company relative to its peers may highlight areas that require additional investigation or point the valuator in the right direction.

MAKE SENSE OF EMERGING TRENDS

Unearthing hidden assets can be a painstaking process, because the owner-spouse may have started taking steps—perhaps months or years earlier—to cover his or her tracks in anticipation of an increased level of scrutiny.

Careful investigation of the company and the industry (as well as consideration of other factors, such as the individuals involved) can often reveal the trends that will show a valuator how and where assets have been moved.

Finally, a personal lifestyle investigation can be a useful tool to highlight unreported income and can be thought of as a "sanity check" to financial representations made by a dishonest spouse. For example, is the spouse's reported income truly sufficient to support his or her apparently high standard of living? Any shortfall between reported income and lifestyle expenditures should sound a warning and may warrant additional investigation. ■

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