The Price of Everything and the Value of Nothing

Business Valuation in the Context of Fraud or Misrepresentation

A cynic, Oscar Wilde once observed, is a man who knows the price of everything and the value of nothing. Buyers of companies in M&A transactions are sometimes left empathising with this sentiment, amid claims that the value of their acquisition is far lower than the price they paid for it.

“HP Alleges Fraud In Autonomy Deal; Takes $8.8B Charge” proclaimed a newspaper headline in November 2012.1 A similar news story referring to the acquisition of a company in Asia by Caterpillar Inc. a year later read: “Cat Scammed: How A U.S. Company Blew Half A Billion Dollars In China.”2 In the post-financial crisis world, disputes arising from large corporate M&A deals appear to be on the rise. Such disputes are particularly common in Asia, where foreign investors acquiring local companies operate in an unfamiliar business environment, and where standards of corporate governance and regulatory scrutiny are often not as mature as in more developed markets.

International arbitration is increasingly the dispute resolution mechanism of choice for cross-border investors. As cross-border investment continues to flow into (and increasingly out of) Asia (see Figure 1), it is likely that some cross-border acquisitions will result in disputes, and that many of these disputes will be resolved through arbitration.

Post-acquisition disputes, which often relate to allegations of misrepresentation or fraud by the vendor, can require various, interrelated, questions of value to be addressed. Questions such as, ‘What is the true market value of the company acquired?’ or ‘What would the acquirer have paid had it been

![Figure 1: Foreign Direct Investment into Asia Pacific, net inflows](image)

Notes: (1) Excludes Central Asia (2) Source: World Bank.

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1 Savitz, E. (2012, November 20), Forbes.
aware of the true financial performance of the target company?3 are commonly raised in the dispute resolution process. This article considers the common issues that arise in valuing a business following the discovery of fraud or financial misrepresentation.3 We begin by describing certain relevant principles of business valuation.

The Fundamental Drivers of Business Value

Fundamentally, the value of a business (like any other asset) arises from its ability to confer economic benefits upon its owner. In the case of an operating business (as opposed to an investment holding company) that is a going concern, its value arises principally from the future operating profits it is expected to generate.4 Two other factors are also relevant: (i) the risk, or uncertainty, associated with the expected future profits, and (ii) any non-operating assets owned by the business.

Risk is significant because investors are risk-averse (i.e. they will not accept additional risk without being compensated for it in the form of greater returns). All else being equal, a rational investor will place a lower value on an asset that has greater uncertainty concerning its future economic benefits.

Non-operating assets are assets that are not employed in generating the operating profits of the core business, such as investments in surplus real estate or financial assets. Non-operating assets can include cash, where it is surplus to the operating requirements of the business — a well-known example of this being that of Apple Inc., which amassed a cash surplus approaching US$100 billion prior to initiating a distribution to its shareholders in 2012. Such assets represent a source of value additional to the operating business, since they can be disposed of or put to other uses without the operating business being affected. Similarly, if a business does not possess all of the assets required to continue its operations (for example, if it has a deficit of working capital) this will also impact business value. This is because additional investment will be required to continue operations.

The drivers of business value can therefore be summarised as shown in Figure 2.

It is important to note that while various valuation methods can be applied to value a business, the fundamental drivers of business value remain the same. The above framework can either be applied explicitly — for example, in a Discounted Cash Flow (“DCF”) valuation — or implicitly, through the use of valuation multiples (such as the price/earnings ratio) derived from comparable companies. The aim of a comparable companies analysis is to identify companies which are similar to the target in respect of the parameters described above, and to adjust for any differences that remain. A valuation based on comparable company multiples is therefore a ‘shortcut’ to considering the above fundamentals explicitly, based on the assumption that the market operates efficiently in valuing the comparable companies.

Non-operating assets/deficit in operating assets

Risk associated with expected future operating profits

Expected future operating profits

FIGURE 2: Drivers of Business Value

Nature of Overstated Assets

Disputes in arbitration or litigation in Asia often arise from allegations that assets have been overstated, or that assets have been misappropriated, such that the balance sheet of the acquired company is inflated. In considering the impact such allegations can have on value, it is important to identify the nature of the relevant assets — for instance operating fixed assets, working capital, surplus assets (e.g. investments), etc. Overstatement in different types of assets impacts value in different ways, for the reasons discussed further below.

Expected Future Operating Profits

Expectations of the future performance of a business at any time are informed by many factors, such as its historical performance, the strength of its customer proposition at the relevant time, and market and competitive trends. In projecting future profits, analysts typically consider (i) the current and historical profits generated by the business, and (ii) the expected growth in these profits given company and market dynamics.5

This reduction in projected future profits can be a combination of (i) a lower starting base of ‘current’ profits and (ii) a potential reduction in the rate at which these profits are expected to grow in the future.6

In post-acquisition disputes in arbitration or litigation, the question being debated is sometimes what price the specific buyer and seller might have agreed in alternative circumstances, or based on alternative information. In this article, we focus on the more general question of how to value a business where there has been misrepresentation or fraud.

4 In fact, it is the future cash flows that are relevant, and these can differ from future profits. For simplicity, we use the terms ‘profits’ and ‘cash flows’ interchangeably in this article.

5 In some cases there may be discontinuities in growth due to factors such as company restructuring, the launch of a revolutionary new product or the loss of a major customer.

6 In practice, growth expectations will be influenced by many factors, of which historical growth will only be one.
A simplified version of this effect is illustrated in Figure 3. In quantifying the impact of misrepresented historical profits, it is important first to consider whether the misrepresentation has any impact on the expected future performance of the business. Where a future impact on the business is expected, it is necessary to consider whether this will be ongoing, or one-off, in nature. For example, if the profits from a one-off sale of an asset in the past have been misstated, this may have no impact on expected future operating profits.

In some cases, actual financial results for the post-acquisition period may be available at the time the valuation is undertaken (depending on the timing of the arbitration or litigation proceedings in comparison with the timing of the deal). These results can provide one possible reference point for determining what expectations of future business performance would have been at the acquisition date, based on the true historical performance of the business. Care must be taken, however, to distinguish between the effect on performance of fraud and financial misstatement, and that of other factors, such as changes in market conditions or the competitive environment, which may not have been foreseeable at the time of the acquisition. This is particularly relevant for deals concluded around the time of the global financial crisis, or during other periods of market disturbance, where acquired companies may have suffered a downturn in their fortunes for macroeconomic reasons. (Many of the post-acquisition disputes in arbitration or litigation in recent years related to deals done around the time of the global financial crisis. Six years on from the major events of the crisis, this trend is unlikely to continue.)

**Non-Operating Assets (or Deficit in Operating Assets)**

In addition to the inflation of profits, another common allegation in post-acquisition disputes is that the represented assets of the target company have been overstated. This can be as a result of the misappropriation of assets of the company, or through the deliberate recording of fictitious assets (or inflating the recorded value of real assets). The assets owned by a business can be categorised as:

- operating assets (or ‘core’ assets), which are used to generate the operating profits of the business; and
- non-operating assets (or ‘surplus’ assets), such as investments. These are assets that are not deployed in the core operations of the business, and can potentially be put to alternative use, or disposed of, to realise value.

If a post-acquisition review of a business reveals that its true asset position was overstated, this will typically impact business value through one of the above categories. If the overstated assets were non-operating in nature, then these sources of value no longer exist or are reduced. If core operating assets are found not to exist or to be impaired, this may mean that greater investment is required to continue operations and generate the expected future profits, again reducing the value of the business.

An exception to this may be where the recorded ‘book value’ of operating assets that do exist, and are able to service the requirements of the business, has been overstated. In such cases, a write down of the book value of such assets may have no impact on the ability of the business to generate future profits, and hence no impact on business value.

As a liability is an obligation that is expected to result in a future outflow of economic benefits, the discovery of additional liabilities also has a negative effect on the value of the business.7

It is also worth noting that misstatements in assets or liabilities will typically have a “one-off” impact on business value, rather than a recurrent impact on financial performance as described for factors affecting operating profits above.

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7 The impact of additional liabilities on value is relatively straightforward to assess (once the liabilities have been quantified). Allegations of the existence of additional liabilities are, however, a common cause of post-acquisition disputes in arbitration and litigation.
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TABLE 1: Illustrative company valuation based on represented and true financial performance

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<tbody>
<tr>
<td>Base year profits</td>
<td>$10</td>
<td>$8</td>
<td>Base year profits reduced as found to be overstated</td>
</tr>
<tr>
<td>Multiple applied</td>
<td>12x</td>
<td>10x</td>
<td>Multiple reduced to reflect reduced growth expectations and potentially increased risk</td>
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Risk Associated With Expected Future Operating Profits

The discovery of fraud or financial misstatement can also affect perceptions of the risks associated with ownership of a business. Uncertainty about true historical performance may lead to greater uncertainty about expected future performance. Investors may also question the quality of management and corporate governance, and the reliability of systems and controls, and be concerned that more issues may be discovered in the future. In certain circumstances, there may be a risk of fines or penalties being imposed on the business as a result of past misdemeanours (such as the substantial fines faced by J.P. Morgan over the ‘London Whale’ incident in 2012). All such factors could increase the risk associated with the business, and reduce its value.

As the discovery of fraud may cast doubt over the reliability of historical information as a basis for a valuation, this could also mean that a buyer would likely perform more comprehensive due diligence, incurring greater costs as a result. An increase in transaction costs could also reduce value.

Further, the subject business might suffer reputational damage, which could impact its ability to retain and attract customers, suppliers and business partners, ultimately negatively impacting the future prospects of the business.

Conclusion

A simplified illustration of how the factors described above may be taken into account is set out in Table 1. This shows illustrative multiples-based valuations of a hypothetical acquisition target, based both on its represented financial performance, and on its true financial performance.

In this example, the target company’s annual profits were represented to be $10, and a multiple of 12x was applied to value the operating business. Non-operating assets of $80 were added to determine the total value of the business.

Adjusting for certain financial misstatements, the target’s true annual profits were found to be $8, and its true historical growth profile less impressive than represented. Given a reduction in growth expectations (and potentially an increase in risk), a lower multiple of 10x profits is now considered appropriate. The non-operating assets of the business were also found to be overstated by $30, so reduced non-operating assets of $50 are added to the revised value of the operating business. In the example provided, the value of the target company is reduced from $200, based on its represented financial position, to $130, based on its true financial position.

In Figure 4, we summarise the ways in which financial misstatements can, in general, affect business value. This framework provides a useful guide when considering issues of value in the context of post-acquisition disputes in arbitration and litigation.

FIGURE 4: How financial misstatements can impact business value

- Expected future operating profits
- Risk associated with expected future operating profits
- Non-operating assets/deficit in operating assets

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8 Whether this is relevant in assessing the value of a business in arbitration or litigation depends on the specific scenarios in which the business is to be valued.

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