



The Impact of Internal Control Structures on Business Valuations



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ARTICLE OVERVIEW

The business valuation process tries to objectively quantify current capital and asset levels, and additionally has always considered management structures and capabilities.

Business failures & recent legislation have increased need for process and internal control improvements for public and private entities.

Internal controls focus on:

- > reducing asset loss & preserving entity's value through assets
- > systematic process & understanding of future earnings potential
- > compliance & protection of an organization's intangibles assets such as reputation and intellectual property

Valuators should consider the capabilities of the internal control and governance systems to help the organization achieve its goals, including protection of assets and accomplishment of financial plans. This consideration should include:

- > The organization's culture and reinforcement for ethical behavior
- > Communication channels and information availability
- > Internal and external monitoring processes
- > The appropriateness and application of internal control procedures to guide the actions of individuals
- > Risk assessment procedures to identify potential pitfalls

These considerations should not ultimately result in a conclusion by the valuator as to the effectiveness of the overall control system, however, consideration of the control structure should be an additional tool to help the valuator refine their other analysis.

The valuation process attempts to determine a fair and objective measure of the worth of a venture, including current capital and asset levels, as well as future potential for earned capital and acquired assets. While the determination of the value of current assets can be fairly straightforward using widely recognized methods, the determination of future potential can be subject to greater judgment and estimation. Commonly, the calculation assesses the efficiency of operations, the effectiveness of business processes, and the expertise and competence of management. Additionally, organizations that can remain in compliance with laws and regulations, and avoid penalties, fines, and embarrassing publicity will tend to achieve greater financial results in the future. All these valuation factors are directly implemented within the organization by the structure of internal controls. Understanding the roles and capabilities of these control structures can help refine the valuation decisions made in the valuation process.

Recent business failures have pushed the importance of internal controls for both public and private ventures into the national spotlight. Public companies are required by the Sarbanes-Oxley act to prepare a report on their internal control structures to support their financial statements. This requirement is being expanded to include many private companies as the state accounting boards issue enhanced guidance for the

performance of an audit; some states have contemplated regulations as stringent as Sarbanes-Oxley for the audit of private companies. For both private and public companies, banks and sources of private equity are showing tremendous interest in the availability of this process and control level detail as it offers unprecedented transparency into the operations and management of the organization. The current public visibility of the importance of internal controls is moving the standards for professional analysis as well. As detailed analysis of the internal control structure within an organization becomes more commonplace, failure to perform this analysis becomes a more glaring omission from professional diligence.

Financial auditors are now required by SAS 99 to perform enhanced analysis of

HARRY CENDROWSKI



the internal control structure to support an audit, again reflecting the value of internal controls. This new requirement promises to greatly improve the effectiveness of the financial audit, however, it has also created a degree of confusion in senior management and even practitioners. Erroneously, many believe that SAS 99 requires the creation of a detailed analysis and report on the internal control structure. People also believe that SAS 99 increases the auditor's responsibility for the detection of fraud. It does not. SAS 99 requires the auditor to consider the potential for fraud during the development of audit tests, and requires the auditor maintain fraud awareness and auditor skepticism during audit execution. This additional consideration is for the benefit of the auditor, to improve audit results, not for the benefit of management. This expectation gap, and the need for a comprehensive analysis of the system of internal controls to enhance management's control and operation of the organization is part of the need driving the development of the new Certified Fraud Deterrence Analyst designation recently announced by NACVA.

The auditor's observations on the organization's internal control structure will continue to be conveyed to management according to the standards outlined in SAS 60, "Communication of Internal Control Related Matters Noted in an Audit". The level of detail and scope of SAS 60 and

Certified Fraud Deterrence Reports are contrasted in Exhibit A.

Publicly recognized standards for internal control, such as COSO, note that the system of internal controls is responsible for the accomplishment of 3 vital objectives: safeguarding assets, efficiency and effectiveness of operation, and achieving regulatory compliance. Controls accomplish these objectives by providing uniform, repeatable guidance and instruction to all levels of the organization, an awareness of risks, and appropriate monitoring measures to ensure appropriate completion of actions. Controls replace randomness within an organization with a repeatable process to accomplish and objectively report the results of business activities. An unguided workforce performing a random set of events might be able to attain desired objectives one time, however, it is unlikely such compliance could be sustained. Controls are the linkage to understanding the organizational capabilities to achieve results in a repeatable, sustained manner. Clearly, understanding the organizational capability expressed by the system of internal controls can serve as a valuable tool in refining a valuation analysis.

Asset Existence and Valuation

Prevention of the unauthorized use or removal of assets from an organization is the most commonly understood aspect of internal controls. In very small organizations, this is accomplished by the

JAMES MARTIN



direct involvement of the ownership of the firm in the oversight of assets. The owner, or a trusted designee, ensures the doors are locked, all cash and receipts are deposited, and all purchases are valid; management knows all assets are secure because they are directly responsible for the control activities. As organizations progress in size, and management can no longer possibly perform all actions within the organization, additional definition of required activities is essential to ensure all value is preserved within the organization. As more people are involved with a process, management must still understand that the activities will be performed to management's exact specification, each and every time. A strong set of internal controls are essential to extend the presence and

desires of management throughout the organization to ensure all assets are safeguarded.

Fraud and white collar crime continue to plague organizations of all sizes, in all industries. A recent study by the Association of Certified Fraud Examiners estimated that fraud related losses amounted to \$6 billion annually. In the fraud cases studied in the report, the examiners concluded that in approximately 90% of the fraud cases studied in the report, appropriate and enforced internal controls could have prevented the fraud. Clearly, the controls structure closes the door on the opportunity for fraud, and helps ensure that presumed value is retained by the organization. Asset related fraud directly removes value from an organization through the shedding of assets, but additionally, can distort the financial statements. Fraudulent schemes can only be successful by concealing the fraudulent activity; often, perpetrators will fabricate financial records and transactions to obscure the fraud. Reported financial results are thus less accurate.

Appropriate internal controls also ensure supporting accounting transactions and records accurately portray the financial condition of the organization. For example, in an accounts receivable lapping scheme, the perpetrator will remove cash from the organization, but leave the receivable records intact. Incoming funds are rolled from account to account to conceal the theft. Payments have been made by customers that

are not recorded to the receivable records, thus the accounts receivable balance is overstated. Understanding that the organization maintains a strong process to prevent such theft and misstatement helps verify the integrity of the financial statements and reduce the chance of a missed valuation.

Understanding the capabilities of the internal control system to safeguard assets is particularly important for a valuation as those controls are essential to ensure all the assets allegedly owned by the organization actually exist, and will continue to serve the organization in the future. Inventories and audits can assess the existence of assets at a point in time, however, the control structure defines the process to ensure the assets are continually safeguarded. Such protected assets have a higher value to the organization, as the probability is greater that they will be available for the use of the organization in the future.

Outside investors view these same controls from a different perspective. Many banks and private equity firms have been unpleasantly surprised to learn that their invested capital is no longer present within the firm, and several of the members of management have purchased new cars, boats, and gifts for their spouses. Proactive understanding of the control structure, or lack thereof, would have been beneficial to those particular funding decisions. A private equity firm, considering a funding decision for two similar firms, one with a

strong control structure, the other without, would have substantially lower risk in choosing the former. This reduction in risk represents one aspect of the value of the control structure.

Future Earnings Potential

Operational controls provide the balance between getting things done, and getting things done correctly; they express the desires of management for customer service and satisfaction, quality, and authorized consumption of resources to accomplish those goals. Controls additionally ensure that resources are deployed in an aligned and monitored manner. A defined process for conducting the value creating activities of the organization provides the basis for organizational success in the future.

The estimated level of future earnings is one part of the valuation calculation, the variability of earnings is another. The internal control structure of an organization impacts both factors, and understanding the operational controls is essential to understand the future value potential of an organization.

Future worth is based on an organization's ongoing ability to meet or exceed customer expectations on a continuous basis; this can only be accomplished through a defined business process. In very small organizations, management can directly understand the

customer requirements, and directly ensure all activities are performed to meet those requirements. As the organization grows, or those heroic managers leave, continuing to meet customer expectations becomes a greater challenge. Randomness and volatility is introduced where employees are not supported by clear, consistent direction for performance of duties.

Again, consider a private equity firm considering an investment in one of two companies, both with similar earnings and net income levels. Assume also that one company has a well documented set of control procedures, and a strong control culture. The other company has well meaning employees that know their customers, and generally know what duties to perform and when to perform them, but no supporting procedures. Current results show the companies as very similar, but which one is poised for greater success in the future? The importance of controls grows as environmental factors and expectations change. Growth, employee turnover, new markets, new branch offices, and new management all create change within the organizations that will disrupt an informal procedural structure and lead to volatility in earnings. Frequently, an entity is purchased which is assumed to have a robust business process, however, shortly after the transition, sales and performance suddenly declines. As it turns out, the organizational successes were accomplished by behind the scenes heroics on the part of management or a few key employees who

departed with the completion of the transaction, and unfortunately, the success of the organization was not sustainable independently.

For business carve-outs and mergers, an analysis of the controls and processes which are part and parcel to the transaction will be essential to correctly understand merger integration and entity start up costs. Often, business units receive administrative support which is no longer available after the unit becomes independent. Conversely, for a merger, it is often assumed that two functions with the same function (e.g. accounts payable) are instantaneously compatible and easily combined with a split reduction in cost. In both cases, a more detailed understanding of the underlying business processes and control activities will provide greater insights into the true cost of operation after the transaction is completed.

Compliance and Protection of Intangibles

Every organization is subject to various laws and regulations, and often these regulations carry fines and penalties for non-compliance. Public companies have recently been focused on new provisions of the Sarbanes Oxley act, however, older legislation such as health and safety, environmental, and consumer protection regulations apply on a broader basis. Discovered non-compliance can result in loss of business reputation, negative publicity, and can lead to additional

litigation. The control structure is charged with defining the actions required at each level of the organization to achieve compliance with the regulation requirements, including documentation, recordkeeping, reporting of events, and validation procedures. Consideration of these controls is especially important due to the potential liabilities of past non-compliance, as well as development and implementation costs to bring the company into compliance.

The compliance function is also concerned with protection of intellectual property rights, including patents, copyrights, and trademarks. Often, these rights represent tremendous value to the organization, however, procedural actions are necessary to file, protect, and maintain these rights. The compliance function within the organization should have documented procedures to ensure these rights are protected to serve the organization in the future, and to monitor the environment for unauthorized use.

A comprehensive understanding of the internal control structure within an organization is at the heart of the methodology employed by the new Certified Fraud Deterrence Analyst designation offered by NACVA. This new methodology provides a platform to guide professionals in the evaluation of internal control processes specifically to identify the potential for fraud before fraudulent activity is suspected in an organization.

The CFD report differs from internal controls reports used to support financial audit activities in several major ways (these differences are discussed in Exhibit A) including scope and level of detail considered. The CFD report should contain sufficient detail to support the understanding of the capabilities of the control structure to accomplish important objectives affecting the valuation.

Consideration of the internal control systems of an organization can be a valuable tool in refining a valuation analysis. A company with strong internal controls should have a greater valuation than a similarly sized company without controls due to the additional security of assets and decreased volatility of future earnings. To provide protection and value, the controls to support the business processes must be clear, enforced, and more importantly, continually updated as the organization changes and grows. The amount of value affected by these control features will need to be determined by careful examination and applied professional expertise of the valuation analyst, however, the underlying information will serve as a valuable data point.

Public companies are now required by the Sarbanes Oxley act to develop documentation of their internal control systems to support the filing of their financial statements. These companies are learning that professional service firms will charge a very large fee to develop

documentation of the control structure. The initial documentation of the control structure can then be updated and refreshed for future filings. The initial level of documentation, then, is a valuable asset to the company, and the existence of such documentation should be considered in the valuation analysis as well.

A Premium for Good Governance?

According to a study published in the McKinsey Quarterly, 2002, Number 3, the reward for good governance is large. By moving from worst to best in corporate governance, companies in the study could expect to experience a 10 to 12 percent increase in their market valuation. This result underscores the importance investors attach to the attributes studied. The author's concluded that "investors the world over are looking for high standards of good governance and will pay a premium for shares in companies that meet them".

COMPANY INFORMATION

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EXHIBIT 'A'

	CFD Report	SAS 60 Report
Purpose	Comprehensive document system of internal controls to allow management to conclude on the adequacy of the control structure	Provide summary of internal controls issue noted in course of audit work which could result in material misstatement
Detection	Methodical analysis of key processes and corresponding control objectives and procedures	Control lapses as evidenced by out of compliance transactions reviewed, other audit tests
Scope	Document controls responsible for safeguarding assets, efficient and effective operations, legal compliance	Accurate financial reporting
Timing	Proactive - analysis prior to suspicions of fraud, analysis of controls responsible for reduction of fraud opportunity	Reactive - analysis of historical transactions