# SMALLER, NOT SIMPLER: CHALLENGES WITH LITIGATION ENGAGEMENTS FOR SMALLER BUSINESSES

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# SMALLER, NOT SIMPLER — CHALLENGES WITH LITIGATION ENGAGEMENTS FOR SMALLER BUSINESSES

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If you've been retained on litigation engagements for small businesses, chances are you've encountered clients who are new to litigation and have issues with the reliability of financial information such as unreported cash sales and questionable business expenses—for example, a home office at the cottage or vet bills for a "guard dog". Put simply, a small business does not automatically mean a less complicated engagement.

This article identifies six common challenges in litigation engagements for smaller businesses, what you should consider during the initial assessment, and how you may be able to resolve each challenge.

## I. Quantifying Cash Sales and Unreported Revenue

Small businesses in general have a higher risk of unreported or underreported cash sales. In instances where a small business is known to have cash sales, it's common that all expenses but not all sales are reported for the purpose of minimizing taxable income. Depending on the nature of the business and the industry that it operates in, cash sales may comprise a substantial portion of total sales, and records to substantiate the amount may be non-existent or irreconcilable.

Cash sales and unreported revenue in a litigation context are often a significant issue and highly contested between the parties, however, a CBV can use a range of techniques in their investigation to assist in quantifying cash sales.

### Initial Assessment

Understanding the nature of the business is a critical first step in assessing the opportunity for cash sales and unreported revenue in the business. Further, reviewing the goods and services offered by the company can assist in identifying which may be easily transacted for cash, unreported due to low traceability (i.e. cover charges at a bar) or the ability to simply manipulate records (i.e. time spent on a service).

In addition, reviewing the accounting system, internal controls and any related company policies or operating procedures will build a solid understanding of the overall operations of the business and the risk and opportunity for cash sales and unreported revenue.

Lastly, if cash sales are identified, look at the specifics of the cash transaction and how it may flow through the financial reporting system. Further, if possible, analyze if cash sales are comingled in the business or tracked separately.

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**Possible Solutions**

The best approach will depend on the amount of supporting information available:

- Bank statement analysis — where some cash sales are known to be deposited into a corporate bank account, or more frequently, into the personal bank accounts of the business owner or their spouse or children, identify cash deposits based on preplanned criteria (e.g., specific period, specific accounts, materiality level of amounts), then verify these transactions to supporting documentation. If they're income, verify if they have been reported. An important note is that this technique generally requires significant supporting documentation, and you often need complete information to substantiate the amounts, making it potentially time-consuming and costly.
- Comparable benchmark ratio analysis – where good source documentation is not available, or as a secondary check to test the reasonability of the amount of cash sales, various resources can be considered such as:
    - Industry level: Statistics Canada's SME Benchmarking Tool, RMA's Annual Statements Guide, IBISWorld.
    - Company level: DealStats (formerly Pratt's Stats), S&P Capital IQ, Bloomberg.
- Comparing a company's reported operating results to benchmarks can help you explain or estimate the amount of unreported cash sales (see Exhibit 1). However, use this technique with caution as there may be specific factors that make your client's company different from the industry data being used in the analysis.
- Overall reasonability analysis of cash component of sales—where customer accounts, booking logs, and purchase records are available they can assist with tracing cash or unreported transactions. For example, based on a company's booking logs this analysis could compare the value of services of the bookings to the total reported sales to identify if any significant variances exist.

Finally, while there is no silver bullet for identifying unreported cash sales, creative approaches can also deliver results:

- Searching historic public matrimonial records of business owners for any indication of cash sales in the past.
- Comparing reported sales from financial statements to other internally or externally provided records (e.g., "actual sales" used for forecasts/projections, company website, presentations for shareholder meetings, bank loan applications).
- Reviewing historic marketing and promotional materials (e.g., a restaurant sign stating "save 10% if you pay in cash" would imply cash sales that may be unreported).

*Exhibit 1:* **Example industry comparable analysis used to reveal and estimate unreported cash sales**

| **Subject Company** | | | **Comparable Benchmark Industry Data** | | |
|---|---|---|---|---|---|
| | **Amount** $ | **% of sales** | | **Amount** $ | **% of sales** |
| Reported Operating Results: | | | | | |
| Total Revenue | 1,000 | *100%* | Total Revenue | 1,250 | *100%* |
| Less: COGS | 700 | *70%* | Less: COGS | 500 | ***40%*** |
| Gross Income | 300 | *30%* | Gross Income | 750 | *60%* |
| Less: Expenses | 100 | *10%* | Less: Expenses | 125 | *10%* |
| Reported Net Income before taxes | 200 | *20%* | Net Income before Taxes | 625 | ***50%*** |
| Adjustment: | | | | | |
| Estimated Unreported Cash Sales | 300 | *30%* | | | |
| Adjusted Net Income before Taxes | 500 | ***50%*** | | | |

* Notional amounts used for illustrative purposes.

## II. Quality and Availability of Financial Documentation

It's more common than not that documentation that has been requested is incomplete or unavailable for a myriad of reasons such as the passage of time, destruction (e.g. a fire) or the documentation was never prepared by the company.

In addition, financial records provided to you may also contain inconsistencies, such as tax returns that don't reconcile to the financial statements or internally prepared profit and loss statements.

### Initial Assessment

As previously mentioned, having a solid understanding of the nature of the business is key, particularly for determining what financial, economic and industry documentation might be available to assist in the analysis.

You should also review the accounting system and inventory system (if applicable) and any related policies, procedures, and internal controls.

It's important to keep track of any discrepancies in the financial records, and their estimated impact (if any) on your analysis. Using sensitivity analysis based on the variances discovered can help you estimate the impact of certain discrepancies on your financial model or analysis. For example, if certain expenses are reported differently between two sets of financial records, how would your analysis differ if you used one set versus the other?

Lastly, determine what financial information has not been provided and more importantly, why wasn't it provided. While an incident such as a fire loss may be good rationale for lost information, a client who doesn't seem to have possession of very specific key documentation that should exist, or is always "looking for it", may raise a red flag regarding management's credibility and whether information is being purposely concealed.

### Possible Solutions

Prior to receiving information, where possible, take the time to review the requested items with the client to ensure they understand:

- What you're asking for and why.
- Which specific supporting documentation—or types of documentation—would best satisfy each request.
- Why this information is important and why it needs to be provided in complete, accurate form.

Consider speaking directly with the company employees responsible for preparing any unavailable or inconsistent information, to clarify the flow of transactions, how it's reported, and other information that may be available to help substantiate where there are gaps in the information.

On the more creative side, options include:

- Investigate if information can be economically obtained from third parties. These can include customer records of sale; vendor records for certain purchases; filed tax returns, HST returns or source deductions available from CRA; or external accountants' working papers.
- Is it possible or economical to rebuild the data, using bank statements, sales invoices and receipts? If yes, proceed with caution as preparing financial statements for use in your analysis can lead to self-review risks.
- Analyze if missing information could be reasonably estimated:
    - From existing supporting documentation?
    - Using comparable ratio analysis or other industry statistics?

If the answer is no to either question or the amounts being reviewed are highly material to the analysis don't try to force the outcome. Opinions based on significantly weak information will ultimately be unsupportable.

## III. Identifying Personal and Discretionary Expenses

In general, small businesses have a higher risk of non-business related expenses being integrated into their financial records. In closely held businesses, owners generally have full discretion over operations and financial records, often with few checks and balances and little segregation of duties. Non-business-related expenses may comprise a substantial portion of the business's expenses (e.g., related party remuneration) with the intention of minimizing income tax expense.

Small businesses also have greater potential for co-mingling of business and personal expenses. For example, vehicle-related and cellphone expenses reported in the corporation at 100% of the expenses amount despite 80% being used for personal use.

### Initial Assessment

In addition to having a firm understanding of the nature of the business, interviewing the client to discuss how business expenses are being reported and the method they use to determine business vs. personal use can assist with understanding what expenses are legitimately related to the business operations.

Include in this discussion the business roles and duties of family members, as well as any internal controls for preventing personal and discretionary expenses from creeping into the financial statements.

After gathering preliminary details and support concerning known or suspected non-business activities, consider any unusual or one-time events, such as the purchase of a cottage, construction of a new home, or personal travel, where associated personal expenses could potentially slide into the corporation.

### Possible Solutions

First, you should maintain an active dialogue with the client to fully understand the nature and reporting of expenses.

Second, review the general ledgers of the business. This could be a full or ad hoc review. For efficiency, using keyword searches may assist with identifying targeted expenses. If searches generate many results, review vendor names and descriptions, and further analyze names that may be questionably unconnected with the business or personal in nature.

Third, analyze vendor spending. Inquire about one-time vendors for large amounts and/or vendors with significant fluctuations in annual purchasing levels.

Lastly, if you need to go into deeper detail, conduct a targeted forensic analysis on high-risk expense accounts or transactions:

- Request details (and support where warranted) for unexplained year-over-year fluctuations in expenses.
- Perform a transactional level review of:
  - Activities that often contain a personal element (e.g., meals and entertainment, advertising, promotions, travel, etc.).
  - Related party expenses (e.g., remunerations, expense reports, corporate credit cards, shareholder loans, etc.).
- Request supporting details (and documentation where warranted) for either identified or unexplained expense accounts.

## IV. Identifying Personal Goodwill

Small owner-managed businesses may be reliant on the business owner's expertise or long-term personal relationships to generate profits. Often, business owners (or their spouses) will assume that a business has a high valuation due to a history of strong profits, however a history of profitability does not necessarily translate to transferable commercial goodwill.

Assessing the extent to which personal goodwill exists is often an important step in the valuation of smaller business interests, and should be discussed early in the valuation process, both to manage expectations and to focus the disclosure request.

An example of a common business where value is tied to personal goodwill is an incorporated consultant who carries out ad hoc project work though a corporation. In such a case, all profits are earned based on that individual's specialized skills and relationships rather than the company's location or reputation.

### Initial Assessment

Understanding how a business generates revenue is key to properly assess the risk of personal goodwill. Ensure that you have a thorough understanding of both the business owner's role in generating revenue, as well as the likelihood that someone else can step or be transitioned into the current owner's shoes and continue to generate the same revenue level.

### Possible Solutions

Questions to consider include:

- Does the business have a base of skilled employees or does it rely on subcontractors?
- Is there a management team or succession plan in place?
- Is management under contract or can they easily leave the company?

Consider, too, the nature of revenue:

- Is there a base of recurring revenue, or does revenue arise from one-off projects generated by the business owner?
- Is there a diversified customer base or dependence on a few key customers who may leave if the current owner is no longer involved?

In some cases, it may be possible to transfer the business to another individual with the same or similar skill set using a non-competition agreement or transitional employment period, thereby mitigating the risk of personal goodwill. Whether this is a feasible approach will depend on the industry and specific fact pattern.

Ultimately, you need to identify what precisely is being sold or transferred to the purchaser under a notional sale and whether it is reasonable to conclude that such a sale would include commercial goodwill.

Lastly, industry research will help corroborate your conclusions about the nature of the business' goodwill. For example:

- Review relevant industry or trade associations for articles on selling or transitioning businesses in the subject company's industry. You may find tips for marketing a business for sale, including how to transfer goodwill to a new purchaser.
- Search online for similar types of businesses for sale. Note the numbers of listings, and attributes and key selling features of businesses for sale, for comparison with your client's business.
- Review transaction databases for past transactions — a large number of transactions and purchase prices in excess of net asset value increase the likelihood of commercial goodwill.

## V. Communicating Directly with a Business Owner (and their Spouse)

In larger litigation engagements, we are typically working with in-house Counsel or the accounting department of a larger company. These individuals will be knowledgeable about the documentation being requested, and providing this documentation is part of their job. This is very different than communicating directly with a business owner or their spouse.

When dealing directly with an owner-manager, always remember that your client is personally invested in the litigation outcome as it will directly impact their finances. Emotions may cloud their judgement, causing them to fixate on aspects of the financials that are not relevant to your analysis. Consequently, they will have certain biases which you need to anticipate and mitigate.

Clients in smaller litigation engagements are often not financially sophisticated. You may be working with an entrepreneur who understands their business but is not a "numbers" person, or with a non-owner spouse in a matrimonial engagement. Communicate clearly and avoid jargon.

In many cases, clients will not be familiar with the litigation process and your role as an expert. You can expect such clients to ask you legal questions (e.g., how long the process will take, what happens at the next stage, what kind of outcome to expect), or want to discuss legal strategies with you – even responding to your questions with "What answer will give me the best outcome?"

### Initial Assessment

The main goal is to understand the client's familiarity with the business's financial records:

- Do they have a financial or accounting background?
- Do they play any role in preparing the financial records?
- If not involved in preparing the records, to what extent do they review the records?

Once you have this background, you can decide where to direct your questions, how in-depth to discuss the financial records with the client, and what should be addressed with their trusted financial professionals (e.g., external accountant or in-house controller).

Here too you will need to be cognizant of potential biases and to understand the client's emotional state and potential triggers.

### Possible Solutions

Start by listening to the client's pain points and trigger issues. You need to understand what the client is communicating to you, just as the client needs to understand what you are asking of them.

If the client's sensitivities are material to your analysis, explain how you are addressing them and the range of possible outcomes. If the items are outside the scope of analysis, or not practical to pursue (e.g., transactions from 15 years ago, while the analysis is focused on the last three to five years), clarify why these are not part of your analysis. If not fully addressed, these out-of-scope topics tend to resurface, and can be a point of frustration for the client. Managing the client's expectations clearly will avoid misunderstandings later on.

As is the case for disclosure requests, ensure the client understands why you're requesting certain information and what specific forms of documentation would satisfy the request. In cases where a client's staff or professional advisors will be providing the support, communicate directly with these team members to avoid communication breakdown and minimize follow-up requests.

In explaining your analysis, avoid jargon, provide analogies, and repeat key concepts and findings. Don't assume that the client will understand the analysis first time.

Finally, be very clear with the client about your role as a financial expert in contrast to the role of Counsel. Alert Counsel to the client's legal questions and concerns. In some cases it may be beneficial to include Counsel in client meetings or calls, to ensure everyone is on the same page.

## VI. Striking the Right Balance between the Analysis Performed/Fees Charged and the Quantum of the Potential Claim

One of the biggest challenges faced by CBVs working with smaller claims is the relationship between professional fees the client will need to incur for a fulsome analysis, relative to the size of the claim. Such fee pressures increase the need for completing your work in the most efficient, focused manner possible.

However, as we've discussed throughout this article, smaller does not equal simpler. You must still address many of the same issues and follow a similar process as in a larger engagement, as certain "fixed costs" are unavoidable. For example, an initial meeting with the client to understand the business and your mandate tends to take an hour, no matter how big (or small) the claim size.

Clients in smaller engagements will often be sensitive to these cost challenges and look for ways to short-cut the analysis; however, beware of requests for "pared-down" deliverables! Common requests include the following:

- "My accountant will prepare the analysis and you can review." This request often happens when the client expects to settle quickly or go to mediation. While the accountant may be intimately familiar with the business, they will typically have a superficial understanding of valuation or loss quantification theory. Often their analysis will be incorrect and/or difficult to follow, and therefore time consuming for you to review and ensure that calculation errors are resolved. Under this approach, the final cost to the client will often exceed that of a traditional, straightforward deliverable. Furthermore, if the case does proceed to trial, an independent expert report will ultimately be required.
- "I don't need a full report; can you just write a letter explaining [particular topic]?" Such a bespoke deliverable carries risk, as it may not be possible to craft a letter that's both useful for the litigation and also within the CBV practice standards. Where it can be done, such a letter would likely need to be carefully worded by a senior practitioner, charging at a higher rate than more junior staff who could complete the analysis required for a standard CBV deliverable efficiently and at a reasonable cost.

### Initial Assessment

Upfront planning is essential to managing fees. Start by estimating a range for the valuation or loss conclusion, based on readily available information, such as the business's annual revenue and historical EBITDA.

Once you have this range, you can then establish what type of analysis to conduct to reach the final conclusion, and where to focus the analysis. Identify the big-dollar issues that will have the most impact on conclusions — a sensitivity analysis can help you prioritize your efforts.

Other issues to consider:

- The client's areas of concern, along with the extent to which you can incorporate them into your analysis, where appropriate.
- Availability and quality of financial information, as these will have a big impact on time spent and fees charged.
- Whether the opposing party to the litigation also has hired an expert, and if so, where they are in their analysis.

### Possible Solutions

Consider a staged approach to the engagement; you might start with a limited or highly focused Phase 1. For example, in undertaking a forensic analysis, you may start with certain accounts or statements. Based on the findings of this initial analysis, you may then expand your scope to a broader mandate.

Regular communication throughout the course of the engagement is key. Bill monthly with detailed invoices so the client understands where the fees are being spent and what type of analysis is being performed. Ensure you keep Counsel updated on your progress and any issues you encounter — this is especially important if your analysis takes longer or becomes more complex than anticipated.

Coordinate efforts if the opposing party has also engaged an expert. Clarify if one party will issue a report that the other party will then review, and thereby minimize duplication of efforts. For example, if the opposing party's expert has already issued a disclosure request list, use their list as a starting point.

Always keep in mind the appropriate level of analysis for the ultimate deliverable: What will the report look like? What can you streamline? Can you do a calculation instead of an estimate? As you write the report, stick to short wording and short sentences. Emphasize key items rather than provide excessive background information. Staff according to needs, including assigning tasks to junior team members where reasonable.

Above all, ensure your final deliverable meets the CBV Standards and provides good value for the client.

### Concluding Thoughts

Litigation engagements for small business clients are often challenging due to: incomplete or unreliable financial records required for the analysis; client-specific communication challenges or sensitivities; and additional fee pressures inherent to quantifying a smaller claim/value conclusion. The strategies outlined in this article should provide a helpful roadmap to practitioners navigating these engagements.