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Factors of Management Valuation

Introduction about the Role and Use of Management Valuation

The valuer fraternity is usually facing the problem of validating the assessed valuation. Normally in the Plant and Machinery Valuation, we usually make the assumption that the plant and machinery valuation is subject to the potential profitability using the discounted cash flows. Doing the Enterprise Valuation, the assumptions taken mostly depend upon the management capabilities to achieve the projected targets. At times when valuing the assets of the particular sector which is down, and revival chances are mute, it becomes important to analyse the management. We have analysed certain areas which differentiate good management from bad management.

Enterprise Valuation and Factors Affecting it-

The Enterprise Valuation (EV) is based on Sales Growth Rate, margins, discounting factor & external factors etc. While doing the EV, the management factoring in the valuation is also important & it is to be seen whether the management is:

1. Capable to accelerate the growth in sales over and above the average growth rate,
2. Capable of handling the scalable sales of the company smoothly,
3. The team handling different verticals is sufficient & intelligent enough for serving the long-term growth for the company.
4. The management is fair

The point no 1 to 3 are well managed if the management is fair, honest and diligent. A good management is who has clear goals in the mind, create wealth / takes care of the stakeholder/ investors, employees, vendors. But there is very thin line in good management vs bad management. We are valuing the traits of good management by defining the loopholes within the systems which are used by some management which defeats the long-term goals.

We have addressed the point no 4 for the Management valuation. At the same time, for assessing the management, we have taken the parameters such as financial parameters, Corporate Governance, Data reporting, Legal issues pending in the courts/contingent liabilities, Social media reports etc. We will discuss these parameters one by one.

A. Financial Parameters-

Management tries to increase the sales growth, the profit margins/profit. But there are some unfair means by which company do it within the law or beyond law. Some of the methods to escalate sales and the profit are

Managing the Sale-

There are instances where the management has increased the sale by related party transactions i.e., making the circular trading i.e., 2-3 or more associated companies doing the sale to one another and increase it. There may be the value addition by associated companies in the circular trading, which is correct but by increasing the sale by circular trading is to be seen alarmingly.

Second is the channel stuffing i.e., pushing the products to the channel partners more than the selling capacity. Third is the premature revenue i.e., recognition of revenue by the management before it has fully met the conditions required under accounting standards. Fourth is recording the revenue where the payment may be uncertain. There may be certain positives such as flexible payment terms, seller financing. All the above activities inflate the top line with uncertainty or loss of the payments The overall effect may be increase in the inventory, bogus or inflated receivables, increase in the cash/Bank Balance.

Managing the Profits-

Crisil Research came across these loopholes by studying the notes to account and footnotes in the annual reports of companies. While most of them would probably not amount to a violation of the law, at least some are breaches of the law in spirit. The companies are just exploiting the loopholes that exist in the law such as -

Write-off Expenses from Reserves: Expenses towards research and development or money paid to employees or provision for taxes as part of a voluntary retirement scheme must reflect in the profit and loss (P&L) statement.

Revalue assets to write off losses/expenses, show loan waiver as income, Transfer loans to associates, Transfer fixed assets to current assets-Yet another way of revaluing assets. A corporate balance sheet typically has fixed assets (such as land, machinery) and current assets (cash, bank balances, receivables). Under the pretext of selling a piece of machinery, a company might transfer a portion of its fixed assets to current assets.

Fixed assets are often valued at book value or the price at which they were bought. When they are transferred to current assets, they can be done at market price. If market prices are more than the book value, the difference could be shown as income, which again boosts profit.

Inventory Valuation: Often, the closing stock of goods for a manufacturing firm is valued at higher than the selling price by using different techniques.

B. Corporate Governance- It encompasses a range of challenges within organizations, involving inadequate oversight, lack of transparency, ineffective leadership, and ethical lapses. These issues often result in mismanagement, financial irregularities, conflicts of interest, and decision-making problems. Corruption and bribery, conflict of interest, poor risk management, inadequate regulatory control etc are the areas where the management fails in the corporate governance. Other area where the watchful management seals the company is from cyber security threats.

All the above information can be gathered from the different notices/clarification sought by the financial watchdogs/ Internal Audit report. Some of the companies reports false information to the investors in the mandatory reporting and gets clarification notices from the watchdogs, this should be seen as the red flag.

Good governance fosters trust among stakeholders, including customers, investors, employees, and the public, enhancing an entity /management's reputation. There are two tools to tackle it - Transparency and Accountability. Transparent governance mechanisms ensure that actions and decisions are open to scrutiny, while accountability ensures responsible conduct, reducing corruption and unethical practices. All the above information can be got from different notices/clarification sought by the financial watchdogs. The companies adhering to these principles should be given advantage in the valuation.

C. Data Reporting.

If we analyse the data given in the balance sheet, there might be few red flags which are to be looked upon-

1. Auditor's Report to Management

The auditor tracks all errors and includes the list under the section 'Summary of Misstatements' in the Auditor's Report to Management & sometimes, the management can have a different opinion compared to auditors. We must ensure / compare the reports and identify if there is any red flag.

2. Unusual Accounting Policies

Sometimes, companies can adopt unusual accounting practices and/or methods, making it difficult to understand. Some practices may relate to over/ under-estimation of assets, valuation of the inventory, reserves creation, expenses relating to the development of the business, profit management through non-profit activities.

3. Changes in Financial

Some large adjustments made late in the year to make amends for the errors and/or inaccurate data which may cause significant change in the senior management of the company.

4. Anomalies in the Financials

In the financial statements of a company, if there are anomalies – numbers that are higher or lower than expected, then it should serve as a red flag. Some of the anomalies may be - 'Other Expenses' category which turns out to be very high or a sudden jump in legal fees or an attempt to hide exorbitant expenses, while the sales figures are good, the majority of them are in the last few days of the month or the quarter consistently, a sudden surge in the value of fixed assets or intangibles – way above expectations indicating that costs are being capitalized, there may be some complex Transactions-that seem highly complex – with internal or external parties. These may be seen as red flags.

5. Performance-linked Bonuses-

In some companies, the compensation of the management team is tied to the performance of the company. Hence, senior management has a huge incentive to manipulate the results. Sometimes, the management team is awarded bonuses for the short-term performance of the company. This could lead to decisions that are not beneficial for the company in the long term.

6. Gross Profit Margin is Increasing, but Sales are Declining

If we see that the company has a trend of increasing profit margins, then it might be inclined to give it a pass. However, it is important to remember that the gross profit margin should never be looked at in isolation. Ensure that there may be red flags in the sales figures and overheads.

7. Rising Debtors or Inventory

See the debt and inventory to assess the reasons behind an increase in them. Usually, an increase in inventory or debt is a sign of possible bad debt.

D. Legal issues pending in the courts & Contingent Liabilities- When a company faces a legal dispute, the impact can be multifaceted, affecting various aspects of the business. Regardless of their nature or origin, legal disputes can significantly affect a company's operations, finances and reputation. Contingent liabilities are a common feature of modern business. They are potential liabilities that may arise from past events or from existing conditions, whose existence will only be confirmed by the occurrence of one or more uncertain future events. liabilities are not recorded in the financial statements of a company, but they are disclosed in the notes to the financial statements. Contingent liabilities are essential to know by the stake-holders who rely on financial statements to make informed decisions. If contingent liabilities can be qualified, then the same can be considered by the Valuer

E. Social Media Reports-

The good or the bad information is made available about the company, by the users, critics on the social media & the information can be gathered about the management. Good management reacts to the information and provides suitable solutions. Some managements do not take any cognizance. After the IPO, the companies float the hype about the company in the market on regular basis through the social media /media reports to offload the shares of big investors /give a passage to big investors of the company. These factors should be given negative or the positive values.

Summary.

While assessing the financial projections for EV, the unreasonable figures may be adjusted from the sale / expenses to smoothen the EBITA, which is the easier part. The difficult part is to give negative or positive weightage to the management on the subjective matters and making it objective. The points mentioned about the traits of management defined above, can be converted in the rating form from some of the areas mentioned in the article. The positive or negative effect may be adjusted to the EV calculated to get the adjusted EV or effective EV.The management analysis may be used as effective tool for different kind of the valuations.