

Figure 6.2 Juxtaposition of Data and Hidden Earnings

ACME WIDGET CORPORATION  
THREE-YEAR SUMMARY OF INCOME AND EXPENSES (000 omitted)

	1998	1999	2000	<i>Hidden Earnings</i>
<b>Sales</b>	\$405	\$412	\$415	
<b>Expenses</b>				
Advertising	3	3	8	5
Automotive	7	8	9	6
Depreciation	18	16	15	6
Insurance	16	13	14	5
Legal & accounting	5	5	6	1
Maintenance & repair	4	5	5	
Miscellaneous	0	0	0	
Office supplies	8	8	9	
Raw materials	45	45	46	6
Rent	27	27	27	
Taxes & licenses	20	21	21	1
Telephone	3	3	3	
Utilities	8	8	8	
Wages				
Owner	31	34	32	
Other employees	206	211	209	16
Total expenses	\$401	\$407	\$412	
Pre-tax net profit	\$4	\$5	\$3	\$46

**Owner's Revelations.** After the buyer has studied the income statements and any other data supplied by the owner and assuming that the buyer and owner are establishing rapport with each other, a point will be reached where the buyer needs to sit down with the owner in private and determine the necessary facts to make these data truly meaningful. The meeting described below between a business owner and a prospective buyer, though fictional, is a kind of compilation of some actual cases, but not the general case.

A buyer is looking at Acme Widget Corporation. The buyer thinks to himself that a \$300,000 asking price for a business showing pre-tax operational earnings of only \$3,000 seems absurd. The buyer also notes, however, that the company has an aura of prosperity about it and that except for the seemingly low earnings, it appears to be attractive. The buyer therefore decides that the owner should be given a chance to explain why the company is worth \$300,000. Thus, a meeting after hours is arranged.

The buyer, though never having owned a business, knows the widget industry (which is the main reason the owner is willing to meet with the buyer) and expects that the owner will pull some earnings out of hiding. The buyer brings along a sheet like the one in Figure 6.2 with a special column to itemize any earnings which have been hidden to minimize taxes. (Italics are used to simulate the buyer's handwritten figures in the Hidden Earnings column.) The buyer, sensitive to the emotional needs of the owner, knows how to ask questions or, as the occasion demands, how to gently probe.

The advertising expense shows an increase from \$3,000 in 1998 and 1999 to \$8,000 in 2000. Did that increase help to boost sales? The owner answers that the increased advertising had nothing to do with sales. Acme Widget relies solely on *Yellow Pages* advertising since other media have proved ineffective in the widget industry. The \$5,000 increase went entirely into radio advertising but was bought through a public relations firm just started by the owner's brother-in-law. The expenditure was made under pressure from the owner's spouse. The buyer, now realizing that the \$5,000 is not a true expense but discretionary income, enters that amount as hidden earnings as shown in Figure 6.2. The buyer also thinks to himself that this is a strange and costly way to keep peace in the household but that since the radio advertising was actually delivered, it is a legitimate expense in the eyes of the IRS. (Such seemingly wasteful expenditures as this one are occasionally found in the world of small business. They are a part of the game.)

The buyer asks whether automotive expense is in line considering that some wholesale customers pick up their widgets at the company facilities and that raw materials are usually delivered by the suppliers. The owner allows that there is a company credit card for the sole purpose of servicing the pickup truck but that there are three cars in the family (owner's, spouse's, and one teenager's) and that the company credit card sees a lot of use to pay for gas, oil changes, and repairs. The justification is that any one of the three cars may be used on occasion to run a business-related errand. The owner estimates personal and family automotive expenses at \$3,000 or \$4,000 annually, then reconsiders and ups it to \$6,000. The buyer enters that amount under hidden earnings as shown in Figure 6.2. The buyer also makes a mental note that these expenses seem to represent an exaggerated interpretation of the tax code that would not survive an audit but that probably would not be considered fraudulent. The buyer further notes mentally that since there appears to be no fraud, the owner would probably suffer no more than minor penalties if caught by the IRS despite the obvious misinterpretation of the code.

The buyer notes that depreciation expense for the last three years totals \$49,000. Comparing it to the cost when new of \$90,000, he wonders if the equipment must have a short life to be more than half depreciated in only three years. The owner replies that the actual expected life is ten years, but that their CPA is taking full advantage of accelerated depreciation as allowed by IRS rules. The buyer then divides the \$90,000 cost-when-new by the ten-year life expectancy to get an actual depreciation of \$9,000 per year, then enters \$6,000 (\$15,000 – \$9,000) into the column for hidden earnings.

The owner explains the variations in insurance expense from one year to the next as nothing more than the result of changing insurance companies and interrupted payment schedules. The \$14,000 shown for 2000 is accurate and reflects the ongoing needs of the company. The owner also states that about \$5,000 is for personal and family insurance. The buyer enters that amount under hidden earnings.

No questions are raised regarding office supplies but the owner volunteers that the amount shown is about right since any pens, pencils, stationery, and postage stamps taken by the family for personal use probably do not amount to more than \$40 or \$50 per year. Well, maybe \$75 or \$100.

The buyer wonders if the legal and accounting expenses don't seem a bit high for this size of operation. The owner says that normally the accountant's charge of about \$3,000 per year is Acme's only professional expense. Three years ago, however, they hired a lawyer to explore obtaining a license to manufacture a unique widget which was invented and patented by another company. Some ongoing legal problems have arisen costing about \$2,000 per year. In year 2000, the owner continues, the same lawyer took care of some family problems which cost about \$1,000 but which were included in the lawyer's bill to Acme. The buyer asks if there is a written company policy

regarding employee benefits and whether legal services are included. The owner responds that no written policy exists but notes that no auditor would ever catch the admittedly questionable charge because the lawyer made no mention of it in his statement to the company. The buyer enters the \$1,000 figure under hidden earnings while making a mental note not only that charging the company for personal expenses is probably illegal but that, if so, the lawyer is a party to the fraud.

The buyer, having written several cost proposals for his employer, observes that raw material seems about 10% high for the level of sales experienced at Acme. The owner replies that they have found a way to store wealth without being taxed on it and describes the following scheme: Acme is on a job-order system whereby each batch of widgets made is assigned a separate job order, and all direct expenses for each batch including materials and labor are charged to the job. By estimating generous scrap allowances (translation: by purposely charging more materials than are needed), each job is completed with raw materials left over. The leftover materials go into the storage bin but since they already have been charged as an expense, there is no record (no official record, anyway) that these leftover materials exist.

Several advantages are realized. Since these excess materials are charged as an expense, they reduce earnings and taxes. While they sit in the storage bin, they gain in value due to inflation but obviously no tax has to be paid on the gain. Though no material shortages have occurred recently, if any ever do, Acme Widget will be prepared. If, for the record, earnings ever need to be improved—say, for the purpose of looking good when borrowing money from a bank—the materials in the bin can be used on upcoming job orders, reducing the expenses charged and boosting earnings. Finally, if ever a little quick cash might come in handy, selling those materials to other users will provide it and nobody will ever know the difference. Moreover, if those other users happen to be smaller companies not eligible for the wholesale price breaks that Acme gets, some nice profits can be made. The owner volunteers that about \$6,000 worth of raw materials at cost went into the storage bin this year. The owner adds that the \$6,000 does not include any profits made by selling the materials to smaller companies. The buyer notes to himself that the overbuy of materials, conceptually speaking, is skimming in the same way that a retailer placing cash into his pocket without ringing it up on the cash register is skimming. The buyer also notes that profits made by selling the overbought materials constitute profits on the skim, imbuing the scheme with a wry elegance seldom found with humble merchants dealing in cash. The buyer, however, regardless of what his feelings toward such illicit schemes may or may not be, reasons that silence is the wisest course and offers no comment other than nodding to acknowledge that the scheme is understood.

Moving quickly to the next items on the income statement, the buyer notes that the rent, maintenance and repair, taxes and licenses, telephone, and utilities expenses all seem to be reasonable and orderly. The owner affirms that they are.

The buyer asks if wages might be improved a bit. The owner replies that their three teenage children draw a total of about \$16,000 per year ostensibly for cleaning the office and running errands but for actually very little that's useful. The buyer makes no mention that useless employment of family members for tax avoidance is probably illegal but enters the \$16,000 figure into the column for hidden earnings and notes that those earnings now total \$45,000. The buyer reviews his figures and notices that if the payroll decreases by \$16,000, the payroll taxes (mostly for social security) should also decrease. He enters \$1,000 in the hidden earnings column for taxes and licenses and changes the total to \$46,000.

A moment of silence ensues. Then the buyer, with halting voice, says that he would like to ask a question and that he asks this question only in the spirit of thoroughness with no personal implications intended. The buyer realizes that business owners and their accountants strive to put down all the expenses they can think of in order to minimize taxes. The \$46,000 in hidden earnings, however, raises the question in his mind of whether there are any hidden expenses. The owner compliments the buyer on his insight and replies that no, there are no hidden expenses in his business but that he knows exactly what the buyer means. The owner's accountant, for example, is very active in his political party and he doubts, therefore, that it is any coincidence that his accountant receives a piece of the municipal auditing assignments each year. Although his accountant has never said anything, the owner speculates that his accountant probably pays for those auditing jobs in one way or another, such as cash contributions to the party or below-scale accounting services either to the party or to the political bosses in power. The owner adds that one of his colleagues—who, he has to admit, produces a fine widget—pays off the purchasing agents for two of his best customers. Some of these costs probably would be accounted for as entertainment expenses but most of it, he speculates, would, for obvious reasons, never show on the books. Then the owner repeats that he does not engage in any of these sorts of activities. He abhors the thought of having to pay a purchasing agent to get business. It is against his principles.

The buyer has no more questions to ask and so the buyer and owner chat about the widget industry, where it is going, and how bright the future is for a young person contemplating ownership. The owner is impressed with the buyer's knowledge of the industry, his preparation for their meeting, and his tact at asking questions. They chat for a while longer. The conversation is warm and friendly. The owner feels comfortable with the buyer. At an opportune moment, the owner refers to the extra money to be made in the business. The buyer feels comfortable too but, still in the role of a supplicant, merely raises his eyebrows at the mention of extra money. The owner continues by noting that many retail customers wander into the store on Saturday afternoons even though the store officially closes at noon. The purchases made after hours are not always rung on the cash register and even if they are, the tapes are discarded. The buyer is emboldened by the owner's directness and asks whether an IRS audit would reveal lack of accountability for the widgets sold after hours. The owner replies that holiday sales, special discounts, clearance sales, and markdowns for shopworn and damaged widgets are not just for purposes of inventory clearance, meeting the competition, or building a customer base although, to be sure, those are important benefits. Equally important is to obviate reliable audits, the idea being that whatever cannot be otherwise accounted for is explained by the various and frequent price reductions that nobody can realistically keep track of.

The buyer thinks for a moment, then remarks that the owner has just provided a new perspective on price-cutting and that now the buyer understands why, when customers at the local tavern are high at happy hour on two drinks for the price of one, the tavern owner is even higher on loss of accountability. The owner nods in agreement and observes a generality that the fuzz on a pricing system almost always creates an opportunity for making some extra money.

The buyer and owner agree that there is nothing more to discuss at this time and the meeting is adjourned. On his way home, it begins to sink in on the buyer that now he has become an accessory to the fact. He will have to think about that.

Note that the meeting and owner's revelations described above are not typical but nevertheless approximately represent the exchange of information which may occur at a private meeting between buyer and owner. What is fairly typical is that cheating on taxes in the world of business is occurring in one form or another, including, in addition to the devices shown in the above example, such schemes as a manufacturer using shop labor to build his home (even on defense contracts subject to government audit); paying workers in cash, either partly or wholly, to avoid social security and unemployment taxes, but also to offset any revenues that are being skimmed so as not to arouse suspicion of the IRS; paying suppliers partly in cash while the suppliers in turn omit the cash-paid supplies from their invoices, destroying accountability for both the business owner and the supplier (a cooperative system aptly described as two-tiered or vertical cheating); tavern owners purchasing their liquor at retail stores; retailers cheating customers by making "mistakes" at the checkout counter; and so on.

The cheating itself is usually not described so starkly or so honestly as to refer to it explicitly as cheating. Instead, a host of pet names and innocent-sounding phrases is employed such as "my golf money," "household funds for the spouse," "pocket change," "spending money," "special bonus," and so forth. The cuteness or triteness of the term can belie the amount. One manufacturer, when asked how much his pocket change might amount to in a year, replied around \$60,000. Interestingly, some owners are too boastful to hide behind euphemisms. One restaurateur with a high-profit-margin menu enjoyed telling the first buyer brought to him by the broker that he skims \$350,000 a year. (The broker's cost analysis roughly corroborated the owner's boast.)

Some owners defer to secrecy and silence rather than mention any untoward activities. Such secrecy may be absolute and accompanied by such words as "what you see is what you get," a non-informative disclosure referring to the financial data and tangible assets, or it may be suggestive when expressed by such words as "whether there are any other profits to be made in this business or not I would rather not comment on." If the buyer is brought by a broker, the owner may disclose his schemes only to the buyer during which meeting the broker may be told to wait in another room, or the owner may level with the broker but refuse to divulge anything to the buyer, the idea presumably being that information from the broker to the buyer is hearsay for which the owner could not reasonably be held accountable.

Some company accountants may be a party to or may even have initiated such schemes. Other accountants are so clean that they will refuse to work for a company in which cheating occurs if they discover it. If they do not explicitly discover it, they will probably continue to work for the company though they may suspect it.

A kind of irony or double standard may accompany the cheating. Some business owners will cheat on taxes in every way possible if they think they can get away with it, but these same owners would never

cheat a customer, a supplier, an employee, or any individual out of a penny. For other owners, cheating is a way of life. **Illustration 6.1**



“The fuzz on a pricing system. That’s where you make your golf money.”

Since cheating for some owners is a way of life, a buyer must be alert to the possibility of being misled to pay a higher price through exaggerations of the money being made. A buyer’s best safeguard is to be well qualified to own and manage the business being bought. Strong qualifications provide two lines of defense. First is the thorough understanding of the business which helps to see through misinformation. Second is the ability, once the business is owned and the deceit discovered, to overcome the resultant cash-flow problem by smart application of hard work and long hours. The buyers of the coin-operated laundry in Example 6.4 below were misled into paying too high a price (the seller had lied about the sales) but still managed to make a salary and a capital gain through smart management and hard work.

Another line of defense against being lied to or misled is found in the maxim that human beings tend to see others in their own image. Happy people, for example, tend to see others as happy while the bitter tend to see others as bitter. The same holds true for the honest and the dishonest. Thus a business owner who seems trusting is probably trustable while one who seems guarded probably needs to be guarded against. But the clues themselves can mislead. The cheat may trust a person on minor matters to set that person up for a kill. Or the person who seems extravagant in protecting himself may have been a cheat’s victim. In any case, unless the person being dealt with is known for his or her probity, the plan is always to use sound business procedures. Tried and true business procedures include putting everything important into writing; obtaining bank financing as opposed to seller financing even though it means a lot more work and a higher rate of interest; hiring both a lawyer and an accountant even when they don’t seem to be needed and even when they seem to cost too much; refusing to take short cuts during fact-finding such as not bothering to check on a person’s references and not taking the time to check the zoning laws or the environmental implications; and so on.

It should be clear that some business owners are strictly and totally honest and proud of it, and that some of them who are doing well even make conscious efforts to disburse some of their earnings once they

have attained financial stability. They do so out of genuine altruism or deep appreciation of how good the business and the community have been to them. Such disbursements may be to charitable organizations but they may also take the form of larger-than-needed purchases from community businesses and organizations such as neighborhood newspapers for advertising, local gardeners for landscaping, service companies for maintenance, and so on. These owners also may reward employees with above-scale year-end bonuses, with benefits above the industry standard, and/or with continuous pay the employees can count on even when work is slow (the latter being fairly common in businesses which need to hold onto their skilled employees). These disbursements are not always easy to identify as expenses which are unnecessary—like the year 2000 advertising expense in Figure 6.2—and must be sought out to form an accurate picture of the earnings. Thus, owners who bury such disbursements in their expenses pose the same problems for buyers needing to discover the hidden earnings as do owners who cheat on taxes.

It is apparent from the above descriptions that business owners as a group are extremely variable in the management of their affairs. A buyer therefore should be prepared for anything.