



## BETWEEN THE LINES

# Private pitfalls

Asking the right questions could help you avoid what might be the worst investment of your life

by **Al Rosen**



**O**wning a piece of the company that employs you sounds great on the surface. It's an investment in the organization you know best, and a way to be compensated directly for all your hard work. On the downside, it's also likely to be a minority interest in a private company. And just like with some public entities, management avarice and legerdemain can leave minority owners with less than their fair share.

Problems can arise during three main phases of investment in a pri-

vate company: at the time of purchase, during ownership and when selling the shares. The best time to examine contractual protections for minority shareholders is before any money changes hands. Significant issues to tackle upfront include who you are buying the shares from (the company or another shareholder) and how the share price will be determined.

When you buy from or sell to another shareholder, your purchase cost or sale proceeds are clearly known. A capital gain or loss is calculated in the same way as with a

public company. However, serious income tax implications can arise when share purchases or sales occur between you and the company. Extra tax might be levied against your shares because you automatically participate in certain of the company's past tax decisions.

In terms of share price, values can be determined in many different ways. If purchase prices are based on accounting figures, you should know that the books can be cooked in myriad ways, as outlined in several previous columns. The additional caveat here is that financial manipulation can be even easier in private companies, where fewer people are usually needed to commit a financial statement fraud.

You might purchase your shares based on a factor of earnings that have been temporarily boosted with accounting games. But, don't count on those earnings being equally as inflated when it comes time to sell your shares. The measuring stick can be moved quickly to shortchange minority owners.

Clearly defined accounting methods should be specified in share purchase contracts. Simply agreeing to follow generally accepted accounting principles can leave investors wide open to abuse. The choices available to management under these rules are simply too broad for comfort.

The accounting can also become a problem while holding the investment. Management bonus schemes based on accounting profits are a golden opportunity for executives to divert more money their way.

Aside from accounting rules, shareholders also need to ask for upfront agreements on the financial operating procedures of the business. A serious problem for minority shareholders is the self-deal-

ing that can exist between executives and the companies they control. Abuse of expense accounts, nepotism and other executive perks can all decrease investment return for minority owners. One of the easiest ways to scoop profits out of their hands is to overcharge the company for goods or services supplied by a firm owned wholly by an executive or group of executives.

If minority shareholders get fed up and decide to sell their shares, it should go without saying that they need to scrutinize the sale price calculation and at least the last few years of profits. It might even be worth going as far as hiring an expert investigator if serious wrongdoing is suspected.

Some shareholders don't even have a say in divesting their shares if management decides it is time to

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sell the company. Minority owners might not receive fair compensation if executives negotiate for excessive non-compete payments or similar golden parachutes. The costs of those perks will simply come off the top before the remainder is disbursed to shareholders.

The overriding axiom here is that an ounce of prevention is worth a pound of cure. You might not be in a position to bargain for changes or better terms upfront, but at least by asking the right questions, you can avoid what might be the worst investment of your life.

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