INFORMATION ASYMMETRY IN PRIVATE COMPANY TRANSACTIONS

What is Information Asymmetry?

In 1978, George Akerlof, an economist who is currently a professor at the McCourt School of Public Policy at Georgetown University, released what is now a famous paper, "The Market for Lemons: Quality Uncertainty and the Market Mechanism."[1] The paper examines the market for used cars, and the impact that information asymmetry has on the pricing of cars. The results of the paper have wide-ranging implications. Information asymmetry occurs when one party in a transaction (i.e., the buyer or the seller) possesses greater material information regarding the subject of the transaction (i.e., the asset or security being sold in the transaction).

When purchasing a used car, the car could either be a "good car" or a "lemon" (i.e., a "bad car"). At the time of purchase, due to the limited time spent driving the car, an incomplete history of the car's maintenance, a lack of knowledge regarding the prior owner's driving habits, and the lack of a thorough mechanical evaluation of the car, the buyer cannot be certain whether the car is a good car or a lemon. The seller, who we assume in this case is the prior owner, possesses all of this information. Following the purchase and after spending additional time with the car, the buyer will develop a greater ability to predict whether or not the car is a lemon; however, this is too late, as the buyer has already purchased the car.

Thus, the market for used cars is an imperfect one, where the buyer possesses less information regarding the quality of the product than the seller does. Akerlof points out that in a used car market with asymmetric information, buyers are willing to pay less for a car, due to their inability to distinguish between a good car and a lemon, resulting in sellers of good cars exiting the market. This trend results in buyers overpaying for inferior products.

This phenomenon is seen in the health insurance market as well. As insurance companies raise the price of insurance, it begins to attract unhealthy individuals, who are more certain of their need for insurance. Thus, the average medical condition of insurance applicants deteriorates as the price rises.

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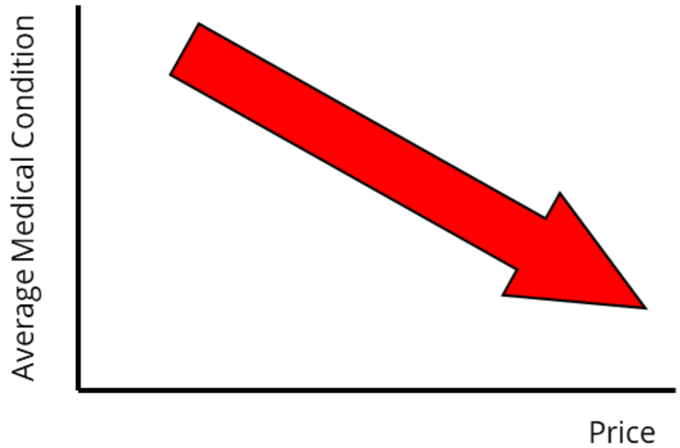
1 Akerlof, George A., "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism." *The Quarterly Journal of Economics*, vol. 84, no. 3, 1970, pp. 488–500. *JSTOR*, www.jstor.org/stable/1879431.



Implications for Buying/Selling a Company

When purchasing a company, naturally the seller possesses greater information about the company than the buyer. This results in long, drawn out due diligence processes. One often overlooked component of due diligence is a Quality of Earnings (QoE) analysis. The intent of this analysis is to reveal any abnormalities in the financial reporting process and control for one-time events and accounting policies. The financial statements can be manipulated, intentionally or not, by the seller which results in unreliable figures, such as overstated profitability. This can lead to a dramatically exaggerated valuation of the company, resulting in lower returns to the buyer.

QoE analysis is particularly important when purchasing a private business, as those companies are not required to follow generally accepted accounting principles (GAAP). Often these companies have non business-related expenditures buried in the financial statements, which can be revealed in a QoE analysis. The following table illustrates this example and the potential impact.

TTM Income Statement	**Company A**	**Company B**
Revenue	$1,000,000	$1,000,000
COGS	500,000	500,000
Gross Profit	$500,000	$500,000
Payroll	150,000	150,000
Owner's Compensation	-	250,000
Rent	50,000	50,000
Other Expenses	25,000	25,000
EBITDA	$275,000	$25,000
Multiple	5.00	5.00
Enterprise Value	**$1,375,000**	**$125,000**

Each company in the table is identical, but for the owner's compensation line. Company A's owner is compensated via a distribution, which will not appear in the income statement, while Company B's owner takes a salary. If a thorough analysis on these income statements is not performed, the value of Company A appears to vastly exceed Company B but, in reality, they are worth the same. The buyer of Company A would be thoroughly disappointed upon realizing that they need to now factor in compensating a new CEO.

The same can be true in reverse; take a look at the following example.

TTM Income Statement	Company A	Company B
Revenue	$2,000,000	$2,000,000
COGS	500,000	500,000
Gross Profit	$1,500,000	$1,500,000
Payroll	350,000	350,000
Owner's Compensation	200,000	200,000
Rent	75,000	75,000
Other Expenses	25,000	25,000
One-Time Expenses	200,000	-
EBITDA	$650,000	$850,000
Multiple	5.00	5.00
Enterprise Value	**$3,250,000**	**$4,250,000**

Again, we have two identical financial statements, with the exception of one-time expenses. Company A relocated offices and faced $200,000 of additional expenses. While this could have other impacts on the business, for the purposes of this example we will assume it does not. If the $200,000 remains in the income statement as an expense, this lowers EBITDA, thus lowering the value. The seller is being penalized for a non-recurring expense that has no impact on the future of the business.

Conclusion

Information asymmetry can be detrimental to both the buyer and seller. The buyer is purchasing a product for which the information possessed is insufficient to determine its true value. The seller can be penalized due to the assumption of a lower quality product (i.e. the buyer assumes that the car might have unforeseen problems). All of this culminates into an inefficient market, and when dealing with the purchase of a company, can have massive implications.

A QoE analysis is imperative when engaging in transactions, and ValueScope provides top of the line service at a fraction of the cost of larger firms. Our team of PhDs, CFA Charterholders, and CPAs possesses expertise in valuation that is unmatched in the industry.

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