

## Business Valuation & Forensic Accounting Special Interest Group Joint Conference

On 14 and 15 September 2006, the Institute of Chartered Accountants held a joint National Conference of its Business Valuation (BVSIG) and Forensic Accounting (FASIG) special interest groups at the Westin Hotel in Sydney.

It was the inaugural conference of the BVSIG and the 6th conference for FASIG.

Russell Munday and Paul Spence of Munday Wilkinson attended the conference.

### BVSIG Topics Covered:

- Capital Asset Pricing Model
- Purchase Price Allocation in Australia under AIFRS
- Impact of size on Market Risk
- Issues in Valuations and Impairment Testing
- Discounts and premiums in the context of the valuation of unlisted SMEs and interests
- Current Issues in Independent Expert Reports
- Discounted Cash Flow Valuations (DCF)
- Tax Consolidations: the Issues
- Valuation of Professional Practices
- Concepts of Value in the Legal Environment

### Discounted Cash Flow

Issues discussed in the DCF Valuations included:

- The value of an asset today is equal to the present value of the cash flow it will generate.
- 5 Steps to a DCF Valuation
  - Forecast expected cash flows
  - Estimate the discount rate
  - Calculate the terminal value
  - Convert cash flow and terminal value to Net Present Value
  - Derive equity value by adjusting for non-operating assets/liabilities and interest bearing debt

- What is the appropriate length of forecast period (at least 5 years)
- Use of free cash flows or equity cash flows (usually free cash flow)
- Calculation of free cash flow
  - Revenue*
  - Operating expenses*
  - = Earnings Before Interest & Tax*
  - Taxes*
  - + Depreciation/Amortisation*
  - +/- Movement in Working Capital*
  - Capital Expenditure*
  - = Free Cash Flow*
- Key drivers of forecast cash flow
  - Sales and growth
  - Profit margins
  - Effective tax paid
  - Working capital required
  - Fixed assets required
  - Real or Nominal cash flows
- Discount Rate Determination
  - Weighted Average Cost of Capital Method
  - If real dollar cash flows, use real discount rate.

### Inside this Issue

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  - Business Valuation Topics
  - Discounted Cash Flow
  - Concept of Value
  - Valuation of Professional Practices
  - Forensic Accounting Topics
- Recent Matters

# Business Valuation & Forensic Accounting Special Interest Group Joint Conference (continued)

- Calculation of Terminal Value
  - Gordon growth model
  - Multi-stage calculations
  - Market multiples
- Common Errors in DCF Analysis
  - Projections too rosy in regard to growth, margins, synergies
  - Mismatch between cash flows and discount rates (one real, the other nominal)
  - Enterprise or Equity Value not distinguished

The advantages of DCF include:

- The value driver assumptions are explicit
- The growth duration period is explicitly modelled
- It can include lumpy cash flows and major capital investment
- It is useful in assessing value of underperforming businesses.

The disadvantages include:

- It is difficult to accurately assess value driver projections
- The period of growth difficult to reliably assess
- A significant proportion of total value usually attributable to terminal value which is usually very sensitive to assumptions.

We also find in practice that where the business is in a mature phase of its life cycle and no major capital investment is envisaged in the medium term, that the capitalisation of earnings approach is a very good surrogate method of valuation rather than adopting DCF.

## Valuation Concepts

This presentation focused on the definition of value including:

- **Fair Market Value** - “the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical, willing and able seller at arms length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts” - AICPA & Ors, “International Glossary of Business Valuation Terms”.

- **Value to the Owner** - a term relating to an extraordinary element of value over and above fair market value to the existing owner. An example might be the personal goodwill (rather than *commercial* goodwill) pertaining to the owner or a specialist legal practice or a specialist accountancy practice (such as a forensic accounting firm).
- **Special Value** - it is the increment of value over fair market value that could be applicable to a particular owner or user of an asset/business rather than to the market at large. However, if there are a number of potential purchasers to whom the asset has value then this will be reflected in fair market value. An example of this could be a rent roll of a real estate agency having a special value even where there is only one person/entity to which the special value applies.

## Valuation of Professional Practices

The Valuation of Professional Practices was of particular interest to us as we are frequently engaged to value such practices. The presentation considered:

- The definition of practice value:
  - Fair market value, or
  - Special value to a party
- The importance of distinguishing between personal and commercial goodwill and the need to acknowledge that personal goodwill is inalienable and non-transferable. Whilst it has no commercial value it may have special value to the owner.
- There are numerous “No-goodwill” legal and accounting practices whereby goodwill is excluded by agreement. Nevertheless, goodwill may still exist.
- Some of the factors to consider in the approach to value “no-goodwill” accounting practices were:
  - Entitlement to income only whilst a partner
  - Partnership interest is not transferable nor realisable

- It is a minority interest holding with little voting power
- Adopt a “Bottom-Up” approach valuation of goodwill is preferred:
- Capitalised super profit (after fair notional and current accounts) plus balance of capital and current accounts) plus balance of capital account and current account of partner.
- Capitalise at between 25% and 50% of after tax super profit.
- For “Goodwill” Accounting Practices:
  - Adopt a “Top-Down” approach
  - Establish EBIT or EBITDA
  - Deduct fair notional salary of partners
  - Capitalise at 3 to 5 times, depending on risk factors
  - Deduct debt including current accounts to determine equity value
  - Partner’s percentage of total practice value
  - Adjust of unequal capital accounts
  - Convert goodwill value to cents in dollar of gross fees and deduct cents in dollar from existing partner for any fees taken (if going into competition).
- For unprofitable (after factoring in notional principal salary) accounting practices. the value may simply be goodwill (based on x cents / dollar of gross fees) plus net tangible assets. From our experience this cents / \$ can vary between 30 cents to 80 cents, depending on the type of work, spread of clients, charge out rates of the practice, profitability of the practice.

#### **FASIG topics covered included:**

- Anti-money laundering - presentation by The Hon Chris Ellison, Minister of Justice & Customs and Neil Jensen of ATRAC
- Experts points of view
- Understanding Insurance Fraud risk assessments: a new opportunity for forensic accountants
- Transnational Crime: fraud and corruption
- Cross Examination - be prepared as you enter the witness box
- Recent issues in Family Law

An interesting discussion was held about discounting for minority interests / lack of negotiability in an unlisted SME and family law context. It was argued that often these companies are “quasi partnerships” and therefore minimal discounting should apply.

Also, an interesting discussion was held about the roll of “rules of thumb” in assessing the value of small businesses ensured. We are of the view that rules of thumb certainly have a significant role in the valuation of some businesses including accounting practices, real estate rent rolls, financial planning businesses, nursing homes, kindergartens, etc.

### **Recent Matters**

Munday Wilkinson has been retained in a wide variety of forensic matters. Recent examples include:

#### **Business Valuations of:**

- Finance Company group
- Legal Practices
- Accounting Practices
- Real Estate Agents
- Larger Printer
- Restaurants
- Surveyors and Consulting Engineers
- Mobile Phone Retail Franchisor
- Earth Moving and Cartage business
- Electrical Contractor
- Legal Costing business
- Consulting Practice
- Medical practices
- Physiotherapy Practice
- Quarry
- Freight Forwarding business
- Importer / Distributor of Homeware products
- Importer / Distributor of Retail merchandise
- Gift Paper / Greetings Card Importer and Manufacturer
- Computer Software for Financial Planning Industry
- Chain of Retail Clothing Stores

## Recent Matters

### Expert Determinations in relation to:

- Assessing the value of an exiting shareholder's interest in an unlisted company which imports and distributes power transmissions
- Assessing the loss of earnings in relation to numerous personal injury matters, particularly in regard to asbestos victims including:
  - dentist;
  - cleaning franchise owner;
  - real estate agent and property developer;
  - plumber; and
  - electricians
- Assessing loss of profits incurred by:
  - numerous parties in relation to the Corio Bridge Collapse
  - a sock manufacturer as a result of a bank failing to correctly process a telegraphic transfer
  - a mortgage company as a result of a loan default
  - A burger franchise that did not achieve claimed sales levels
- Investigation in relation to dispute between Trustees and Beneficiaries of Tattersalls
- Forensic audit of a golf resort body corporate manager - re allocation of expenses between residents, the golf club and general area.
- Review of various experts reports pertaining to major insurance claim involving a listed company
- Acting for the Australian Government Solicitor (ATO) in relation to valuation of Intellectual Property in regard to two matters before the Administration Appeals Tribunal
- A Christmas tree farm that lost 45% of its trees as a result of a compulsory acquisition of land.

## Professional Indemnity

- Opinion as to the appropriateness of the valuation advice provided by a Big 4 firm concerning several bakery franchises
- An accountant's work in relation to a Section 52 statement
- Review and financial analysis in relation to posthumous financial transactions in a deceased estate
- Determination of the historical and current net value of a salary package including various fringe benefits
- Dispute between Partners regarding financial contribution to and projected performance of Information Technology business.

## Professional Income Protection Insurance

- Review and financial analysis on behalf of a medical practitioner

## Family Law

- Preparation of numerous Single Expert Reports
- Review of other Single Expert Reports

### Further information

For further information please contact either Russell Munday, Bruce Wilkinson, Paul Spence or Gerard Lim at:

**Munday Wilkinson**  
**Chartered & Forensic Accountants**  
**Level 10, 470 Collins Street**  
**Melbourne, Victoria, 3000**

**Telephone:** 9621 1622  
**Facsimile:** 9621 1522  
**Email:** [advice@mwforensic.com.au](mailto:advice@mwforensic.com.au)  
**Website:** [www.mwforensic.com.au](http://www.mwforensic.com.au)

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