

MW Forensic is a newsletter prepared on an ad hoc basis covering topical issues in the areas of business valuations and forensic accounting.

ASIC Regulatory Guides – 111 Content of Experts Reports and 112 Independence of Experts

Following the “Better Experts Report” initiative, ASIC Regulatory Guides 111 & 112 were issued on 30 October 2007 and replace RG 112 (Valuation Reports and Profit Forecasts), RG 42 (Independence of Expert’s Reports), RG 75 (Independent Expert Reports to Shareholders) and part of RG 74 (Acquisitions agreed to by Shareholders).

Whilst RG111 and RG 112 relate to expert report’s prepared to satisfy requirements of the Corporations Act 2001 (Cth) its views on valuation methodologies and independence can be adopted more broadly.

RG 111 states (in regard to valuation methodology):

“An expert should use its skill and judgement to select the most appropriate methodology or methodologies in its report. The expert must have a reasonable (or tenable) basis for choosing its valuation methodologies...” (111.49)

“We consider that an expert should, when possible, use more than one valuation methodology...” (111.50)

“It is generally appropriate for an expert to consider using the following methodologies:

- a) *the discounted cash flow method and the estimated realisable value of any surplus assets;*
- b) *the application of earnings multiples (appropriate to the business or industry in which the entity operates) to the estimated future maintainable earnings or cash flows of the entity, added to the estimated realisable value of surplus assets;*
- c) *the amount that would be available for distribution to security holders on an orderly realisation of assets;*
- d) *the quoted price for listed securities, when there is a liquid and active market and allowing for the fact that the quoted price may not reflect their value, should 100% of the securities be available for sale; and*
- e) *any recent genuine offers received by the target for any business units or assets as a basis for valuation for those business units or assets. (111.53)*

“An expert should usually give a range of values . The value of securities is typically subject to uncertainty and volatility...” (111.62)

“Nevertheless, the range of values should be as narrow as possible....” (111.63)

At 111.64 to 111.67 it states that other specialists may need to be retained to value surplus individual assets (such as real estate).

RG 112 states in regard to relationships:

“Previous and existing relationships may threaten, or appear to threaten, the independence of the expert. The objectivity of an expert may also be compromised, or called into question, if the expert has an interest in the outcome of the transaction that is the subject of the report”. (112.21)

“The closer the relationship between the expert and the commissioning party or any other interested party, the greater the onus on the expert to demonstrate the absence of bias”. (112.22)

We as forensic accountants are already obliged to ensure we are independent of the parties - The Institute of Chartered Accountants in Australia’s APS 11 Statement of Forensic Accounting Standards states that:

“A member must not accept or continue to carry out an engagement to undertake forensic accounting services where the engagement would give rise to a conflict of interest for the member or the member’s firm”.

Inside this Issue

- ASIC Releases new Regulatory Guidelines 111 & 112
- Small Business Capital Gains Tax Exemptions (effective 1 July 2007)
- Role of a Valuer
- Quantifying and Valuing Loss of Profits
- Our Services



Munday Wilkinson

Our Aim

Munday Wilkinson is a boutique forensic accounting firm.

We offer the legal profession, and others, a quality, personalised, time efficient and cost effective service.

Our Services

We are well experienced in:

- Business, share and other equity valuations
- Quantification of economic loss
- Loss of earnings assessments /reviews
- Family Law – Single Expert Reports, review of Single Expert Reports, investigations, advising on tax and refinancing issues for proposed settlements
- Fraud Reviews and Financial Investigations
- Due Diligence Reviews
- Professional Negligence matters concerning accountants, tax advisors, auditors and directors
- Compulsory Acquisitions – claims assistance
- Due Diligence services
- Expert Determinations
- Expert Witness

We can provide forensic accounting services for a wide variety of dispute related matters from the small to the large.

Small Business Capital Gains Tax Exemptions (effective 1 July 2007)

New Capital Gains Tax concessions for small business became effective from 1 July 2007.

Capital Gains Tax (“CGT”) is the tax paid on any capital gain made in your year of income. They can relate to sale of goodwill or property, for example.

The concessions apply to “active” assets used in the business including business premises and goodwill. The asset has to have been active for the lesser of 7.5 years or half the ownership period.

It applies if you have net assets (excluding family home and superannuation) worth up to \$6 million or if the business (and related trading entities) has turnover less than \$2 million and you own at least 20% (directly or indirectly).

Once the various tests have been passed, there are four capital gains tax small business concessions available.

The first is the 15-year asset exemption which provides a total exemption for a capital gain on a CGT asset if it is continuously owned for at least 15 years. In addition, this exemption can only be used if the owner is retiring (over 55) or is permanently disabled.

Apart from the \$6 million net assets limit there is no limit on the amount of capital gain that will qualify for this concession.

When claiming the other three concessions a systematic approach must be taken in calculating how much capital gain will receive the exemption. Once the capital gain on the sale of the business has been calculated:

- *It must be first reduced by any capital losses made during that tax year.*
- *The remaining capital gain is then further reduced by any capital losses carried forward from previous years.*



- The general 50% discount can be claimed by individuals, partnerships or trusts.

Finally, any capital gain remaining after the losses and the general discount can be further reduced by the 50% small business active asset exemption. [Companies and fixed trusts do not get the same benefit from this exemption as it can lead to untaxed dividends and distributions, which results in tax being paid then].

The next concession that can be claimed is the small business retirement exemption. It provides a maximum lifetime benefit limit of \$500,000. If a person has reached preservation age, the capital gain can be taken in cash up to the limit. If under 55, the gain must be rolled over into a superannuation fund.

The last available concession is the small business asset rollover which provides a deferral of capital gain if a replacement asset is acquired.

The above Small Business CGT concessions will reduce the “latent” CGT liabilities to apply to the family pool of assets when negotiating family law property settlements.

Role of a Valuer

We are appointed as a Valuer for a variety of reasons including:

- Independent Values - when nominated by The Institute of Chartered Accountants of Australia (pursuant to shareholders’ agreement) to make an expert determination of the value of an interest in a company. A recent example was where Russell Munday was appointed as an Expert to assess the value of one party’s interest in Carpet Call (Holdings) Pty Ltd.
- Single Expert Valuations – appointed by both sides in the context of litigation. We are constantly preparing single expert valuation reports, generally for family law purposes, but also for commercial disputes.

- Expert Witness – appointed by one party in the context of litigation both commercial and family law.
- Advisor – appointed by one side in the presentation of a client’s case on valuation usually to the independent valuer or reviewing the work of a single expert.
- Other examples are valuations for prospective vendors and purchasers of businesses, valuation for capital gains tax, stamp duty purposes.

The valuation of shares or businesses is often at the heart of a dispute and consequently is of substantial importance to the parties involved. Accordingly, the appointment of an independent valuer or expert witness should be taken with great care. It is important to engage a competent, experienced and objective valuation expert.

Quantifying and Valuing Loss of Profits

At the heart of many commercial disputes lies the issue of quantum.

Assuming that breach of contract has been proven and has led to a loss of profits for the plaintiff the issue then is:

- To quantify the annual loss of profits
- To value the annual stream of lost profits over the contract period into a single damages settlement.

If company A has a 10 year contract with company B to act as its sole distributor in a given market and B reneges on that contract, A can claim compensation for loss of profits for the remainder of the 10 year period, say 7 years. Whilst profits today are a fact, predicting profits over the next 7 years will depend on how sales and costs move over the next 7 years. If there is steady history, then future revenues and costs are reasonably capable of forecasting.

For earlier staged businesses, sales forecasts can be made based on a model that makes assumptions concerning industry growth, market share, etc. A separate forensic economist may be required to quantify the lost future annual sales.

A forensic accountant can then translate the revenue forecast into a profit forecast with reference to industry gross margins, labour costs, etc. Once the loss of profit has been quantified into a year by year profit stream, it needs to be valued in today's dollars. This requires adopting a discount rate to apply to the stream of profits.

Assuming the remaining 7 year stream of profits average \$3 million per annum, the net present value (of this stream) discounted at 6% (typical government bond rate) is \$16.7 million.

However, such a settlement would be too generous as it ignores the fact that the stream of future profits is uncertain (businesses can fail) and is variable in amount (due to economic cycles, etc), compared to investment in government bonds which provide a steady, predictable income and are completely risk free.

This is why expected returns on government bonds are around 6% and expected returns for listed equities are +/-12%.

Those who hold equities require and receive an extra return for taking on the extra risk associated with fluctuations in profits, share prices. Under the "Capital Asset Pricing Model" this is called equity risk premium.

The stream of lost profits to be valued is an equity like income stream.

If the equity risk premium in the industry where the breach of contract has occurred is say 8%, then total returns in that industry are 14%, then \$14.8 million would deliver an expected return of \$3 million per annum, with the same risk profile as the lost profits that are the subject of the dispute.

Further discounting for unlisted, small and early stage business may apply.

These considerations can have significant effect on the level of damages awarded. Discounting \$3 million per annum at various discount rates over 7 years gives the following results:

Discount Rate	NPV \$m
6%	16.7
12%	13.7
18%	11.4
20%	10.8
25%	9.5
30%	8.4
35%	7.5
40%	6.8

Further Information

If you would like further information regarding this newsletter or our services, please contact Russell Munday, Bruce Wilkinson, Paul Spence or Gerard Lim at:

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