MW Forensic

Prepared by Munday Wilkinson, Chartered & Forensic Accountants Issue 20 September 2011

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

Dealing with Cross- Examination

Many Experts have unpleasant experiences during cross-examination in Court.

At the ICAA's National Forensic Accounting Special Interest conference held in Sydney in March this year there was a very interesting session facilitated by Hugh Selby (and with Michael Porter of Axiom Forensics and Tony Samuel of Sapere Forensic) on how to prepare for and cope when being cross examined as an expert witness. It referred to how the cross-examining counsel will try to:

- attack your independence
- attack your expertise
- attack the facts and assumptions you have relied upon
- attack your analysis and opinions.

The panel mentioned:

- the pitfalls of poor instructions that can compromise independence.
- how there is an increasing tendency to have the expert's file subpoenaed.
- there can be a tension between an expert's duty to the court and a Solicitor's instructions which attempt to adopt a set of assumptions.
- it is up to the expert to consider the reasonableness of instructions (refer Orrong Strategies Pty Ltd v Village Roadshow [2007] VSC).
- there is a risk of being in breach of Code of Conduct (APES 215) if material assumptions are not identified in the expert's report.
- on occasions it is worth an expect discussing with the lawyer in a meeting the scope of the report prior to drafting the letter of instruction.
- to get your counsel to play "devils advocate" prior to going into Court. It is important to know your detail.
- the importance of knowing what to concede to and what to stand firm on.
- that a joint conference and report of experts before the hearing should be viewed as a way to minimise the risk that cross-examination in court goes badly.
- the expert should only answer the question asked, but do not limit yourself to yes or no answers.
- to not be too concerned if there is more of a story to give. Answer questions in a manner that gives counsel a "tag" to re-examine in chief.

The panel stated that if you are well prepared you can turn the tables on the cross-examiner by:

- Having a well researched, well written report coupled with an open, clear and succinct presentation as a properly briefed witness.
- Explain and confine any shortfall in your report during examination in chief by your counsel.
- Focus attention on the judge to demonstrate your expertise, neutrality, etc.
- Offer straightforward examples to make an exertion seem self-evident.
- Have a verbal sign that you include in answers to cross-examination that tells your counsel to "ask me about this in re-examination".
- The Judge only needs to know that you and your methods are trustworthy. He or she can then confidently apply your opinions.

Inside this Issue • Dealing with Cross-Examination
• Discounted Cash Flow Valuations • Capitalisation of Earnings Valuations

Discounted Cash Flow ("DCF")

The value of an asset today is equal to the present value of the cash flow it will generate.

DCF Valuation is a 5 step process:

- ☐ 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 include:

- ☐ Sales and growth
- ☐ Profit margins
- ☐ Effective tax paid
- ☐ Working capital required
- ☐ Fixed assets required
- ☐ Real or Nominal Cash Flows
- ☐ Note in DCF it is most difficult to assess expected cash flows.

- ➢ **Discount rate determination**
  - ☐ Weighted Average Cost of Capital method
  - ☐ If real dollar cash flows, use real discount rate.
- ➢ **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. Indeed most of our valuations of Small Medium Enterprises are based adopting a capitalisation of un-geared earnings approach.

Capitalisation of Maintainable Earnings ("CME")

A CME valuation of an entity involves:

- ☐ **Assessing the maintainable earnings before interest and tax of the business.**
- ☐ **Consider historical results, budgets**
- ☐ **Adjust for:**
  - Interest expense
  - Interest and other income on surplus assets
  - Commercial remuneration for working owners
  - Commercial rent if owned by entity / related party
  - Abnormal events – large legal dispute, one-off project, etc
- ➢ **Capitalise the maintainable earnings by an appropriate earnings multiple (for SMEs, this could be anywhere between 1.5 and 8 times EBIT). Consider:**
  - Spread of customers
  - Reliance on owner
  - Sources of Supply
  - Level of market share / degree of completion
  - Growth history / prospects
  - General economic conditions
  - Degree of regulation by government
  - Net tangible operating assets supporting the business
- ➢ **The above will determine the value of the business. To value the entity, surplus assets and liabilities need to added / deducted. These include cash surplus to needs of the business, investments, properties, related party loans and external borrowings. It is important to:**
  - Adjust surplus assets such as property / listed shares to market value
  - Allow for applicable unrealised capital gains tax.

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Our Aim

Munday Wilkinson is a boutique business valuation and forensic accounting firm established in June 2000.

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

All our professional staff are subscribed members of the Business Valuation and Forensic Accounting Special Interest Groups of the Institute of Chartered Accountants in Australia.

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.

Further Information

If you would like further information regarding this newsletter or our services, please contact us:

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