MW Forensic

Prepared by Munday Wilkinson, Chartered & Forensic Accountants Issue 30 June 2017

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

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Valuation of SMEs in Australia

Munday Wilkinson, Chartered & Forensic Accountants, values many small and medium-sized enterprises (SMEs) each year for purposes such as family law, shareholder disputes, mergers and acquisition, and taxation. Since July 2000 Munday Wilkinson has valued approximately 2,000 SMEs.

The SME market in Australia is very diverse.

Actively trading businesses are businesses that have an ABN and are actively remitting in respect of a GST role. According to the Australian Bureau of Statistics (ABS) as at 30 June 2016, the number of actively trading businesses in the market sector was 2,171,544:

- Construction (Divisions E) had the highest number of businesses operating in Australia with a count of 346,499 units.
- Electricity, Gas, Water and Waste Services (Division D) had the fewest businesses operating in Australia with a count of 6,113 units
- Accommodation and Food Services (Division H) had the highest entry rate at 19.2%.
- Agriculture, Forestry and Fishing (Division A) had the lowest entry rate at 7.0%.
- Public Administration and Safety (Division O) had the highest exit rate at 16.5%.
- Health Care and Social Assistance (Division Q) had the lowest exit rate at 8.4%.
- Health Care and Social Assistance businesses were the most likely to survive from June 2012 to June 2016, with a survival rate of 74.2% across these years.
- Accommodation and Food Services were the least likely to survive from June 2012 to June 2016, with a survival rate of 53.3% across these years.

In June 2016, 60.7% of actively trading businesses in Australia had no employees, 27.6% had 1–4 employees, 9.2% had 5–19 employees and 2.3% had 20–199 employees. Only 0.2% of businesses had 200 or more employees.

The ABS defines:

- a small business as an actively trading business with 0–19 employees. Micro businesses are small businesses with 0–4 employees.
- a medium business as an actively trading business with 20–199 employees, and a large business as an actively trading business with 200 or more employees.

In June 2016, 59.3% of actively trading businesses had annual turnover of less than $200K. These are micro businesses per the ABS definition.

SMEs make a significant contribution to the Australian economy. Australia's 2 million SMEs employ almost 70% of the workforce, which is large by international standards.

SMEs account for over half of the output of the private sector and tend to be a major source of innovation in the economy.

Small business entrepreneurs will often use their families' finances to fund their business. Some seek external funding, which can include extra equity or debt from family and friends, debt from financial institutions, or equity from venture capital funds. Banks' business models and expertise are more suited to providing debt finance to established businesses, whereas venture capital is more suited to start-up firms in nascent industries.

Small businesses are less likely to have debt than larger businesses. According to the Australian Taxation Office, 40% of small businesses had debt in 2010 while 60% of larger companies did.

Interest rates on SME loans are generally higher than those for large business loans and mortgages.This largely reflects the higher costs and risks associated with bank lending to SMEs. Smaller businesses typically have less documentation and shorter financial histories, so it is generally harder and more costly for banks to get the required information to make accurate credit assessments. In addition, SMEs typically have more volatile revenue streams and are more likely to default. As such, lenders generally make higher provisions for loan losses than for larger corporates. However, lenders do differentiate on price and some businesses can pay below standard rates, depending on their credit history and quality of collateral.

Since the GFC, interest rate spreads on small business loans have increased relative to other loan types, which reflects the generally higher price of risk. This is similar to developments in some other advanced economies.

About 300,000 small businesses begin operation each year, while a similar number cease to operate. Many small businesses exit the market because they cannot compete effectively with established firms.

Challenges facing SMEs

As a trusted advisor with over 400,000 members, the Chamber for Commerce and Industry Queensland (CCIQ) regularly conducts surveys on the inhibitors of business. CCIQ's most recent survey found the top challenges facing small business were:

1. Cash flow	A healthy cash flow is a vital part of running a business.
2. Profitability	Beyond just a stable operating budget, the real reason business owners create and progress their ventures is because they want to create lasting wealth, driven by profit.
3. Productivity	Productivity is getting the most from your efforts.
4. Connections	How can we connect more business owners to each other, new opportunities and markets, and new customers?

5. Customers	Someone nailed the importance of attracting and retaining customers: "A customer is the most important visitor on our premises. He is not dependent on us. We are dependent on him. He is not an interruption in our work. He is the purpose of it. He is not an outsider in our business. He is part of it. We are not doing him a favour by serving him. He is doing us a favour by giving us an opportunity to do so." (*This quote is often attributed to Mohandas Gandhi, more likely it was Kenneth B. Elliott from The Studebaker Corporation.*)
6. Regulation	Deloitte published a report *Building the Lucky Country #4 — Unleashing productivity* outlining that rules, regulations and red tape cost Australians $249 billion a year in compliance and loss of productivity. That's the equivalent of everyone working 8 weeks a year just to cover the cost of following the rules.
7. Processes	From hiring, HR, running finances, doing marketing, paying bills, and then actually doing their real work — SME owners are stretched across many business functions themselves.
8. Marketing	Marketing comes in all shapes and colours. According to LinkedIn data, social media marketing was the single highest in-demand skill in Australia in 2015, closely followed by digital media marketing.
9. Time	While time is infinite, the hours in a day are not. Of course owners are stretched for time. Having more time boils down to two steps: 1. Identify the essential. 2. Eliminate the rest.
10. R&D	Given the range of tasks above, it's no wonder that innovation — tomorrow's problem — is often shifted to the backburner.

Valuing SMEs

Key factors to consider in the valuation of SMEs include:

- The majority of SMEs are heavily dependent on the owner. Management structures are typically not in place.
- Financial statements of SMEs are generally unaudited and optimised for tax. There may be a degree of "private expenses" charged through the business entity such as motor vehicles, travel, telephones, etc. Some items such as work-in-progress and employee entitlements may not be included in the accounts.
- Business information systems of SMEs are typically not well developed.

Does a valuation of an SME include due diligence?

The definition of "valuation" in the professional standard APES 225 Valuation Services states:

> ***Valuation*** means the act or process of determining an estimate of value of a business, business ownership interest, security or intangible asset by applying Valuation Approaches, Valuation Methods and Valuation Procedures. <u>A Valuation does not involve the verification of information in respect of the business, business ownership interest, security or intangible asset being valued</u>.

So unless, specifically part of the engagement terms, a valuation does not include a due diligence.

Nevertheless, a valuer has an underlying duty of care and should identify obvious errors, such as the gross margin percentage to revenue not being within industry benchmarks, and therefore note that the integrity of the financial statements should be questioned.

Benchmark information regarding types of businesses (including gross profit %, wage/sales percentages and net profit margins can be obtained from the ATO's small business benchmarks and benchmarking.com.au.

Key methods to value a SME include:

- **Capitalisation of earnings**

  An earnings-based approach estimates a sustainable level of future earnings for a business (maintainable earnings) and applies an appropriate multiple to those earnings, capitalising them into a value for the business.

  Earnings are typically on an earnings before interest and tax (EBIT) or earnings before interest, tax, depreciation and amortisation (EBITDA) basis to value the business (or enterprise). Sometimes on an earnings before interest, tax, depreciation and amortisation and owner salary basis (EBITDOS) (to value micro businesses where buyers are buying a job as much as buying an investment).

  Then adjust for non-business items such as surplus cash, investments, property, related party loans, bank loans, to value the entity (company, trust, partnership as the case may be).

  The assessed maintainable EBIT, EBITDOS is determined by reference to recent years trading (adjusted for commercial salaries for owners, non-recurring, private expenses, etc.), budgets and forecasts.

  The assessed EBIT/EBITDA is then capitalised/multiplied for an appropriate rate to allow for required rate of return for comparable investments of the same risk. Data on this is not generally publicly available. ValueMyBusiness publishes a quarterly “benchmark” of private business value multiples (which it provides by broad industry type for business with revenue less than $500,000 (micro), $500,000 to $1m (small), $1m to $5m (medium) and $5m to $15m (middle)). Another source is Business Values’ quarterly newsletter.

  An earnings-based valuation is suitable for established profitable businesses with no changes expected in the medium term.

- **Discounted cash flow**

  Under a discounted cash flow (DCF) methodology, forecast cash flows are discounted back to the valuation date, generating a net present value for the cash flow stream of the business. A terminal value at the end of the explicit forecast period is then determined and that value is also discounted back to the valuation date to give an overall value for the business.

  In a discounted cash flow analysis, the forecast period should be of such a length to enable the business to achieve a stabilised level of earnings, or to be reflective of an entire operation cycle for more cyclical industries. Typically a forecast period of at least five years is required, although this can vary by industry and by sector within a given industry.

  The rate at which the future cash flows are discounted (the discount rate) should reflect not only the time value of money, but also the risk associated with the business’ future operations. This means that in order for a discounted cash flow to produce a sensible valuation figure, the importance of the quality of the underlying cash flow forecasts is fundamental.

  In calculating the terminal value, regard must be had to the business’ potential for further growth beyond the explicit forecast period. This can be calculated using either a capitalisation of earnings methodology or the “constant growth model”, which applies an expected constant level of growth to the cash flow forecast in the last year of the forecast period and assumes such growth is achieved in perpetuity.

  Theoretically, an asset is worth its future cash flows. Therefore, the DCF valuation is in theory the soundest methodology. However, it is often difficult to apply in practice due to the lack of reliable information about future events.

  A discounted cash flow valuation is suitable for valuations of start-ups and limited life businesses.

  Where the cash flows of a business are predicted to grow more or less uniformly in the foreseeable future, there is little point in doing anything other than a capitalisation of the future cash flow stream/ earnings because the derived result will be much the same.

- **Net assets backing**

  Assets-based methods, including the net tangible assets basis of valuation, is usually used to determine the value of an investment entity or an entity where it is considered that it does not generate a reasonable return on its assets for the associated risk.

  This method of valuation requires a determination of the current market value of the net tangible assets of the business.

  Where the business is financially viable, the valuation is based on the going concern value of the assets. If it is not financially viable, then the value of the assets should be on an orderly realisation approach.

  However, if the return is considered insufficient for the risk involved, the assets may require discounting towards a notional liquidation value.

  A net asset approach is also useful as a crosscheck to assess the relative riskiness of the business (e.g. through measures such as levels of tangible asset backing).

- **Industry rule of thumb**

  Market-based valuations are a general way of determining a value indication of a business, business ownership interest, or security, that compare the subject to similar businesses, business ownership interests, securities, or intangible assets that have been sold. It can include the Guideline Public Company Method (whereby market multiples are derived from market prices of stocks of companies that are engaged in the same or similar businesses and that are actively traded on a free and open market) or the Guideline Transaction Method (whereby pricing multiples are derived from observations of transactions within a specific industry), also known as rules of thumb.

  Rule of thumb (ROT) valuations often apply to small accounting firms (cents per dollar of fees for goodwill), financial planning (multiple of trailing commission/recurring income), real estate agency rent rolls (multiple of property management fees), nursing homes, etc.

  ROTs apply when there are many players in the industry, lots of buying and selling of businesses in that industry, and the businesses in that industry have similar business models.

  Whether the particular business being valued is at the lower end or upper of the ROT range applicable is influenced by that business' years in business, profitability (EBIT margin), profit history, growth history and growth prospects, etc.

Value drivers

Value drivers either reduce risks associated with owning the business or enhance the prospects of the business growing. Examples of key value drivers include:

- Stable, predictable cash flow — a solid, diversified client base.
- Recurring revenue — because of its reliability, this type of revenue has inherently higher value (higher earnings multiple) than one-time revenues.
- Reliable financial information — accounts prepared regularly and reconciled to subsidiary records.
- Quality staff employed.
- Good management team in place.
- Good systems and procedures in place.
- Strong market presence, strong brand name.
- Patent protected products.
- Access to efficient technology.
- Growth opportunities — through introduction of new products and services or entering new markets.

Assumptions in Quantification of Loss of Profits

In a commercial dispute, the two main factors are liability and the quantum of loss of profits.

Many expert accountants limit their report to simply respond to the instructed scenarios and assumptions to form the basis of an opinion. In doing so there is a risk that their report will be thrown out by the court if those scenarios and assumptions include disputed facts.

To quantify the loss of profits incurred as a result of an event, it is necessary to make a series of assumptions as to what would have occurred but for the event. The methodology generally adopted involves comparing actual earnings achieved to the "but for" earnings to determine the loss of profits incurred.

We were recently instructed to review and comment on a loss of profits claim that included a variety of scenarios as to what would have occurred but for the incident. The quantification of loss under each scenario varied materially. However, in our opinion, the instructed scenarios were at the extremes of possibilities or were based on unsupportable assumptions as to the level of future earnings, such as the business would have doubled in size and a lucrative contract would have been won.

As a result, the range of claimed loss of profit was unsupportable and significantly exceeded the historical profit of the business.

APES 215 Forensic Accounting Services, the forensic accounting standard issued by the Accounting Professional & Ethical Standards Board Limited, requires:

- where an accounting expert's opinion is based on assumptions that he/she believes are likely to mislead the court, they then must include a statement in their report to that effect and an explanation why, (para. 5.6 (j)); and
- where an accounting expert becomes aware that an opinion expressed in a report, or in oral evidence, was based on false, misleading or material that contained omissions he/she is required to promptly inform the parties and the court and consider whether or not a supplementary report should be issued.

When assessing the loss of profits, the quantification should be based on facts, and where assumptions have been relied upon they should be supported by appropriate verifiable financial information including financial statements, sales summaries, BAS returns, actual contracts, etc.

Veronica Griesel qualifies as a Certified Fraud Examiner

Veronica Griesel of this office has qualified as a Certified Fraud Examiner. Veronica completed the Association of Certified Fraud Examiners pre-course and passed her exams in March 2017.

This training and qualification covers areas such as:

- financial statements fraud
- asset misappropriation
  - cash receipts
  - fraudulent disbursements
  - inventory and other assets
- bribery and corruption
- theft of intellectual property
- financial institutions fraud
- cheque and credit card fraud
- insurance fraud
- healthcare fraud
- consumer fraud
- computer and internet fraud
- contract and procurement fraud.

Cyber crime and data security presentation

> We believe that data is the phenomenon of our time. It is the world's new natural resource. It is the new basis of competitive advantage, and it is transforming every profession and industry. If all of this is true – even inevitable – then cyber-crime, by definition, is the greatest threat to every profession, every industry, and every company in the world.
>
> *Ginni Rometty, IBM Chairman, President & CEO*

Daunting as it might seem, everyone can protect themselves through data security. Veronica Griesel recently attended a presentation (organised by DFKANZ Accountants) by Dr Stephen Hill, a leading UK expert in cyber crime and data security.

Key points from Dr Hill's presentation were:

- **Methods of data security protection** include:
  - install firewalls
  - keep anti-virus and anti-spyware software up to date
  - use encryptions
  - destroy old computers, back-up tapes, etc.
  - clean out temporary internet files, cache and history files regularly.
- **Methods of hiding your identity online** include: through Proxy and VPN services, and by using Orbot – Tor software.
- **Cyber dependent crimes** include: malware/spyware, hacking, viruses and distributed denial of service attacks. The five tops reasons why attacks are possible are:
  - the end user didn't think before clicking
  - weak password or default password in use
  - insecure configuration
  - use of legacy or unpatched hardware or software
  - lack of basic network security protection/segmentation.
- Other points to consider about data security:
  - User education and awareness for cyber risks (i.e. policy).
  - Manage user privileges and monitor user activity.
  - Develop a mobile working policy and train staff to adhere to it (build to all devices).
  - If an email looks suspicious or unknown recipient attachments, "Think before you click…".
  - Update your browser whenever a new version is available.
  - Do you install third party software from unknown download pages, without paying attention to the Download Agreement?

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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.

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 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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