FORENSIC ACCOUNTING
for commercial disputes

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Published June 2011

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First published June 2002
Second edition July 2006

Also published by the same authors:

Forensic Accounting for Family Law Matters (October 2001 and April 2004)

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CONTENTS

PREFACE v

1 INTRODUCTION 1

2 COURT REQUIREMENTS OF AN EXPERT 4
   Cases 4
   Legislation 5
   Court Rules 6

3 FORENSIC ACCOUNTING SERVICES – APPLICABLE STANDARD 7
   Report of an Expert Witness 8
   Engagement Letter 9

4 EXPERT EVIDENCE 10

5 DAMAGES 11

6 FORECASTING THE EARNINGS CAPACITY OF SELF-EMPLOYED INDIVIDUALS 14
   Asbestos-related Matters – Past & Future Loss of Earnings 16

7 ESTIMATING ECONOMIC LOSS 18

8 VALUATIONS OF BUSINESSES, ENTITIES AND SHARES 21
   Purpose of a Business Valuation 21
   Definition of Business Valuation 21
   Applicable Standards 22
   Concept of Value 23
   Relevant Time of Valuation 24
   Main Methods of Valuing a Business 24
   Capitilisation of Future Maintainable Earnings 25
   Discounted Cash Flow 29
   Asset-based Valuations 30
CONTENTS

8  VALUATIONS OF BUSINESSES, ENTITIES AND SHARES (continued)
  Rules of Thumb Valuations 31
  Comparative Sales 32
  Selection of Appropriate Valuation Method 32
  Minority Interest Holdings 33
  Small Business Valuations 35
  Valuation of Professional Practices 36
  Sources of Information 38

9  FRAUD INVESTIGATION AND PREVENTION 39

10 PROFESSIONAL INDEMNITY MATTERS 44

11 BUSINESS INTERRUPTION CLAIMS 45

12 TAXATION IMPLICATIONS OF COURT ORDERS & SETTLEMENTS 46
  Income Tax Issues 46
  Capital Gains Tax Issues 46
  Goods & Services Tax Issues 48

APPENDIX I
  Form 44A Expert Witness Code of Conduct 49

APPENDIX II
  Practice Note CM7 51

APPENDIX III
  Forensic Accounting Sample Engagement Letter 53

THE AUTHORS 56
  MUNDAY WILKINSON 58
PREFACE

Since the release of our second edition of this booklet in 2006, professional standards, legislative changes and the development of court rules and practice notes have further reinforced the paramount duty of the forensic accountant to the court, a duty which overrides any duty to the client.

We have prepared this booklet to provide solicitors, and others involved in commercial disputes, with a general understanding of forensic accounting services, and the role of a forensic accountant in the investigation and quantification of commercial disputes.

In particular, we comment on:

• legislative and court requirements of experts;
• professional standards issued by the various accounting bodies that sets the standard for the provision of forensic accounting services;
• the basis of appointment of an expert;
• the work undertaken by a forensic accountant; and
• the structure of a forensic accountants’ expert report.

In addition, we discuss:

• the role of the forensic accountant in the assessment of damages;
• calculating loss of earning capacity for the self-employed; estimating economic loss;
• preparation of valuations of businesses, entities and shares; fraud investigation and prevention;
• the provision of expert opinion in professional indemnity matters, business interruption claims; and
• comment on other matters that a forensic accountant can assist.

This booklet is based on our extensive personal professional experience, knowledge and dedication to the specialist role as forensic accountants.

We trust this booklet is of interest and will be of assistance in your work with forensic accountants.

Russell J Munday                                       P Bruce Wilkinson
INTRODUCTION

This booklet has been prepared to provide solicitors with a general understanding of Forensic Accounting Services and the role of a forensic accountant in the investigation and quantification of commercial disputes.

Forensic Accounting Services\(^1\) include:

**Expert Witness** – a professional service provided in the context of proceedings to give expert evidence in a report or, in certain circumstances, orally in court.

An Expert Witness may express opinions based upon his or her specialised training, study or experience on matters such as whether technical or professional standards have been breached, the amount of damages, the amount of the account of profits, or the amount of a claim under an insurance policy.

**Consulting Expert** – a professional service provided in the context of proceedings including acting as an advisor, arbitrator, mediator, member of a professional tribunal, expert in an expert determination, referee or similar role.

**Investigation** – a professional service to perform, advise on, or assist with an investigation, whether or not in the context of proceedings, in connection with allegations of, or concerns regarding conduct that may be illegal, unethical or otherwise improper.

**Lay Witness** – a professional service provided in the context of proceedings to provide evidence other than expert evidence, whether orally or in the form of a report or both. This service involves giving evidence on matters within the lay witness' professional knowledge that are directly observed or perceived.

Forensic accountants generally have the skills required to undertake and perform the quantitative analysis necessary to develop evidence required in complex commercial disputes.

The forensic accountant should:

- be conversant in court procedures and guidelines for expert evidence;
- be aware of the law of assessment of damages;
- have experience in, and understand, the law pertaining to evidence and conducting investigations;
- have good communication skills;
- have good report writing skills;
- be experienced in giving evidence in court; and
- be knowledgeable in the areas of quantification of damages, business valuations, auditing, taxation, etc.

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\(^1\) APES 215 Forensic Accounting Services
INTRODUCTION

Forensic accounting services can involve:

- **Accounting, financial and commercial analysis** – based on available or reconstructed information.
- **Preliminary advice** – assessment of the case from a financial viewpoint and assessment of the options available to the client.
- **Discovery** – review of discovered financial documents and identification of missing documents.
- **Expert advice** – liaison with legal team regarding strategies.
- **Expert reports** – analysis of relevant information and presentation of expert opinion (including business valuations, quantification of damages).
- **Expert evidence** – preparation for and delivery of expert opinion in court.

Examples of the types of matters that may require a forensic accountant include:

- **Preparation or review of valuation** of businesses, shares, other equity and intangible assets.
- **Quantification of damages** for loss of profits and future economic loss for commercial litigation matters such as trade practices disputes, product liability, etc.
- **Personal injury** – evaluation of past and future loss of earnings arising from motor vehicle and industrial accidents.
- **Fraud investigations** including reconstruction of financial data.
- **Professional indemnity/negligence** – review of working papers, reports and circumstances to form a professional expert opinion as to whether there has been a failure to comply with appropriate standards, and the assessment of damages resulting from negligent conduct.
- **Financial and corporate investigations**, including asset betterment tests.
- **Matrimonial valuations and investigations**, including determination of the pool of family assets in a matrimonial matter.
- Assistance in claims for **business relocation or compulsory acquisition**.
- Directors’ liability for **insolvent trading**.
- **Determining tax consequences** (income, capital gains, GST) of proposed settlements.
A forensic accountant’s role may also include the following:

• **Expert witness** – where the forensic accountant is engaged by one party to render an expert opinion in court.

• **Single expert** – where the forensic accountant is engaged by both parties, or court or tribunal, to render an independent expert opinion.

• **Consultant** – where a forensic accountant is employed by one party to advise about the facts, issues and strategy of a case. In such a role, the forensic accountant acts as an advocate. Therefore he or she could not give expert evidence and his or her work papers would, generally, not be subject to discovery.

• **Expert determination** – whereby the accountant is appointed by both parties or nominated by a body to provide a binding opinion on an issue, such as the value of a parcel of shares. Such appointments being usually as a result of a specific clause in an agreement, such as a shareholders’ agreement etc, where an independent accountant is appointed to resolve a dispute.
2 | COURT REQUIREMENTS OF AN EXPERT

The key role of an expert witness is the overriding duty to the court. Further, the expert’s opinion is to be at all times confined to the expert’s area of knowledge, skill or experience and is to include all relevant matters presented on an impartial and dispassionate basis.

Cases

The role of the expert as set out in Heydon JA’s judgment in *Makita (Australia) Pty Ltd v. Sprowles* (2001) 52 NSWLR 705 is that the court must be able to arrive at an independent assessment of an expert’s opinion and its value and this can only be done if the basis of the opinion is clearly explained by the expert.

The following key points were raised by Heydon JA:

• An expert gives an opinion based upon certain facts, thus the facts giving rise to the expert’s opinion must be clearly set out.

• The judge must then determine whether the facts accepted or assumed by the expert have been proved. Facts “observed” by the expert must be identified and admissibly proved by the expert. Facts which are assumed by the expert must be identified and proved in some other way. If other admissible evidence establishes that the matters assumed are “sufficiently like” the matters established “to render the opinion of the expert of any value”, even though they may not correspond “with complete precision”, the opinion will be admissible and material.

• It must be agreed or demonstrated that there is an area of specialised knowledge in which the witness has become an expert by reason of training, study or experience.

• The opinion must be wholly or substantially based on the witness’s expert knowledge applied to the relevant facts.

• The expert must explain the intellectual basis of the conclusions reached. That is, how the field of specialised knowledge in which the witness is expert applies to the facts assumed or observed so as to produce the opinion propounded. It is possible for an expert to adopt statements made in scientific works as part of his or her testimony, but bare references to particular propositions carry no weight unless their basis is explained. The expert’s duty is to furnish the judge with the necessary “scientific” criteria for independently testing the accuracy of the expert’s conclusions.
COURT REQUIREMENTS OF AN EXPERT

Legislation

Since 2008 there have been significant legislative changes in Victoria which impact on the evidence given by expert witnesses in Victorian courts.

The key changes being as a result of:

- the Evidence Act 2008 (Vic) (“the Evidence Act”) which brought the law of evidence in Victoria into conformity with the Evidence Act (1995) (Cth) and the Evidence Act 1995 (NSW); and
- the Civil Procedure Act 2010 (Vic) (“CP Act”) which includes placing overarching obligations on expert witnesses.

The CP Act defines an expert witness as follows:

“Expert witness, in relation to a civil proceeding, means a person who has specialised knowledge based on the person’s training, study or experience.”

This definition uses similar wording to that in s. 79 of the Evidence Act.

The CP Act imposes the following overarching obligations on an expert witness in a civil proceeding:

- the paramount duty in s. 16;
- the duty to act honestly in s. 17;
- the duty to cooperate in s. 20;
- the duty not to mislead or deceive in s. 21;
- the duty to narrow the issues in s. 23;
- the duty to ensure that costs are reasonable and proportionate in s. 24; and
- the duty to minimise delay in s. 25.

The CP Act also provides that the above obligations are in addition to, and not in derogation of, any existing duties applying to expert witnesses. This suggests that the obligations under the rules of court continue to apply to experts.

Section 29 of the CP Act provides that a court may, if it is satisfied that the expert witness has contravened any overarching obligation, make:

“an order that the person pay some or all of the legal costs or other costs or expenses of any person arising from the contravention of the overarching obligation.”

and also make an order that the expert witness:

“...compensate any person for any financial loss or other loss which was materially contributed to by the contravention of the overarching obligation...”
COURT REQUIREMENTS OF AN EXPERT

Court Rules

Court rules and practice notes pertaining to expert evidence differ from court to court. However, each court’s rules are fundamentally the same.

Courts generally require the following to be included in an expert report:

• the name and address of the expert;
• the expert’s qualifications and experience;
• a statement detailing the expert’s area of expertise;
• instructions defining the scope of the report;
• facts and material relied upon in the preparation of the report;
• any assumptions made by the expert; and
• a summary of the opinion.

Further the expert is generally required, where appropriate, to:

• identify any provisional opinions not fully researched for any reason;
• any instruction covering an area falling outside the expert’s area of expertise; and
• any part of the report considered incomplete or inaccurate.

An expert witness is not an advocate for a party to a proceeding.

The relevant expert witness Practice Notes and Rules for courts in Victoria are:

Supreme Court of Victoria

Supreme Court (General Civil Procedure) Rules 2005 – Rule 44.01 Expert Witness Code of Conduct (refer Appendix I)

County Court of Victoria

County Court Civil Procedure Rule 2008 Order 44 – Expert Evidence

Federal Court of Australia

Practice Note CM 7 – Expert Witnesses in Proceedings in the Federal Court of Australia (refer Appendix II)

Family Court of Australia

Family Law Rules 2004 – Part 15.5-Expert Evidence

Victorian Civil and Administrative Tribunal

Practice Note PNVCAT2 – Expert Evidence
The Accounting Professional & Ethical Standards Board (APESB) was established as an independent body in February 2006, as an initiative of CPA Australia and the Institute of Chartered Accountants in Australia (the Institute). CPA Australia, the Institute and the National Institute of Accountants are all members of APESB. Accountants who are members of these professional bodies must comply with all professional standards issued by APESB.

APES 215 Forensic Accounting Services sets the standard for the provision of quality and ethical forensic accounting services by members.

The fundamental responsibilities of members when engaged to perform a forensic accounting service are to comply with the following fundamental principles:

❖ **Integrity**

Not to be associated with reports, communications or other information where they believe that the information:

- contains a materially false or misleading statement;
- contains statements or information furnished recklessly; or
- omits or obscures information required to be included where such omission or obscurity would be misleading.

❖ **Objectivity**

Not to compromise their professional or business judgment because of bias, conflict of interest or the undue influence of others.

❖ **Professional Competence and Due Care**

Before accepting an engagement or assignment to provide a forensic accounting service, a Member should exercise professional judgment to determine if the member is competent to provide the requested forensic accounting service having regard to the member’s training, study or experience.

❖ **Confidentiality and Ethical Behaviour**

Confidential information acquired in the course of professional work for a client or employer, shall not be used for any purpose other than the proper performance of that professional work.
FORENSIC ACCOUNTING SERVICES – APPLICABLE STANDARD

APES 215 requires a member who is acting as an expert witness must comply with the following:

• the paramount duty to the court which overrides any duty to the client;
• a duty to assist the court on matters relevant to the Member’s area of expertise in an objective and unbiased manner;
• a duty not to be an advocate for a party;
• a duty to make it clear to the court when a particular question or issue falls outside the Member’s expertise.

APES 215 also requires a member who is acting as an expert should comply with evidentiary and procedural requirements relating to expert witnesses.

Report of an Expert Witness

APES 215 requires, subject to any legal requirements or restrictions, a Member providing an expert witness service shall clearly communicate in a report:

• the instructions received, whether oral or written;
• any limitations on the scope of work performed;
• details of the Member’s training, study and experience that are relevant to the matters on which the Member is providing evidence;
• the relationship, if any, the Member or the Members firm or the Member’s employer has with any of the parties to the proceedings that may create a threat or a perceived threat to the member’s obligation to comply with the fundamental principles of the Code or the Member’s paramount duty to the court, and any appropriate safeguards implemented;
• the extent, if any, of reliance by the Members on the work of others;
• the opinions formed by the Member;
• whether an opinion is provisional rather than concluded, and, if so, the reasons why a concluded opinion has not been formed;
• the significant facts upon which the opinion is based;
• the significant assumptions upon which the opinions are based and the following matters in respect to each significant assumption:
  (i) whether the Member was instructed to make the assumption or whether the Member chose to make the assumption;
  (ii) if the Member chose to make the assumption, then the reason why the Member made that choice;
FORENSIC ACCOUNTING SERVICES – APPLICABLE STANDARD

• if the member considers that an opinion of the member may be misleading, because a significant assumption is likely to mislead, then a statement to that effect and an explanation of why the assumption is likely to mislead;
• where applicable, that the Member’s opinion is subject to the veracity of another person’s report upon which the member’s report is based;
• the reasoning by which the member formed the opinions, including an explanation of any method employed and the reasons why that method was chosen;
• a list of all documents and sources of information relied upon in the preparation of the report;
• any restrictions on the use of the report; and
• a statement that the expert witness service was conducted in accordance with the Standard.

APES 215 requires a member shall not enter into a contingent fee arrangement or receive a contingent fee for forensic accounting service, that requires independence or where the member purports to be independent.

Most forensic accounting services are billed based on hours incurred at professional hourly rates plus out-of-pocket expenses incurred. Alternatively, a forensic accountant may conduct the assignment for a fixed fee.

Engagement letter

APES 215 requires a Member in Public Practice to document and communicate the terms of engagement when providing forensic accounting services.

An example engagement letter used by the Forensic Accounting Special Interest Group of the Institute of Chartered Accountants in Australia is set out in Appendix III to this booklet.
4 | EXPERT EVIDENCE

One of the most important stages of the litigation process is the provision of expert testimony in court.

It is important to prepare and present expert opinions on complex matters in a clear and concise manner that is easily understood.

Key attributes of a good expert witness include:

- independence;
- objectivity;
- truthfulness;
- experience;
- competence;
- qualifications;
- reputation;
- resources;
- communication skills; and
- good preparation.

An expert’s report may be in various forms including:

- verbal advice to instructing party;
- explanatory report to legal counsel;
- an affidavit; and
- a report to court (which must stand alone).

Content and form of a written report depends upon the type of engagement and circumstances surrounding the engagement. Typically the format would include:

- details of instructions;
- summary of professional experience and qualifications;
- purpose of the report;
- overview of the conclusions;
- information relied upon / list of information not available;
- the assumed facts which the report is based;
- approaches and reason for adopting a specific approach;
- detailed workings and analysis;
- detailed opinion with explanations; and
- schedules / appendices (including copies of essential documents).
5 | DAMAGES

To access damages it is necessary to consider the various legal decisions affecting the quantification of damages and the way in which the claim has been pleaded.

Claims can be pleaded as a negligence (negligence claim), a breach of statute such as sections 51A and 52 of the *Trade Practices Act 1974* (Cth) (statutory claim) or as a breach of contract (contractual claim). The quantum of damages is therefore dependent upon which claim is being examined and quantified.

A forensic accountant’s work is often concerned with the quantification of such damages.

The forensic accountant is generally only concerned with economic or pecuniary damages and not general damages such as pain and suffering or loss of reputation, etc.

The general principle governing an award for damages was defined by Lord Blackburn in *Livingstone v. Raywards Coal Co.* [1880] App. Case 25:

“that sum of money which will put the party who has been injured, or who has suffered, in the same position as he would have been if he had not sustained the wrong for which he is now getting compensation…”

To this general principle there are certain qualifications pertaining to remoteness and mitigation. A plaintiff is not entitled to compensation from the defendant for damage, which is held to be too remote in law, though it may undoubtedly be a consequence of the defendant’s wrong. Also, a plaintiff has a duty to take all reasonable steps to mitigate the loss as a consequence of the wrong and thereby cannot claim damage for any part of the damage resulting from neglecting to take such mitigating steps.

Traditionally, under tort, damages have been calculated under the “reliance” principle that compensation should place the plaintiff in a position he or she would have been in if the tort had not been committed [e.g. *Radferry Pty Ltd and Anor v. Starborne Holding Pty Ltd and Anor* (1998) 1689 FCA].

However, under breach of contract, damages are generally calculated under the “expectation” principle, where compensation is intended to place the plaintiff in the same position as if the representations (or terms of contract) were true; or to compensate the plaintiff for the loss of bargain.

Under the *Trade Practices Act*, the loss is measured by a comparison “between the position of fact of the party which alleges loss and the position that would have been obtained had there been no contravention” of the legislation [refer *Marks v. GIO Australia Holdings* (1998) 196 CLR at 494]. This often equates to the measure of damages in tort.
The High Court of Australia in Hungerfords [*Hungerfords v. Walker* [1989] HCA 8; (1989) 171 CLR 125 F.C. 89/008] held that if the loss suffered could only be accurately estimated by reference to compound interest rates, the plaintiff was entitled to compound interest, and that both “opportunity costs” and “incurred expense” were foreseeable they were claimable as general damages.

This decision enabled a claim of interest as damages, rather than interest upon damages. The distinction being drawn between an order for interest to be awarded upon damages and an award of damages to compensate a plaintiff for the loss of the use of money. In the decision Brennan and Deane JJ stated “…a loss assessed by reference to the interest which would have been earned by safe investment of the money or which was in fact paid upon borrowing money”.

This booklet does not offer assistance in this area, but only alerts the reader to ensure clear instructions are given to the forensic accountant concerning whether the claim is for damages under contract, tort or both.

Examples of the types of disputes that require a quantification of damages include:

- breach of contract.
- product liability.
- business interruption.
- franchise disputes.
- intellectual property infringements.
- professional or director negligence.
- compulsory acquisitions or relocation of business.
- other commercial disputes.

The process to assess the past losses is then:

- Identify past income trends after adjusting for unusual items.
- Project results (gross profits less variable costs) as if the event did not occur.
- Deduct actual results (gross profits less variable costs) from projected results.
- Loss of profit then emerges.
- Address taxation issues.
- Consider additional expenses (such as temporary premises, overtime, professional fees, relocation, plant hire, etc.).
- Apply interest to past losses.
The process to calculate future losses includes:

- Consider if there is a future loss.
- Determine the realistic future period during which losses will accrue.
- Consider most recent annual loss of gross profit (less variable expenses saved) as per past loss calculations.
- Consider if a growth factor should apply.
- Calculate Net Present Value based on estimated loss of profit, growth rate, future periods and discount rate.
6 | FORECASTING THE EARNINGS CAPACITY OF SELF-EMPLOYED INDIVIDUALS

For a variety of reasons the calculation of loss of income for self-employed individuals (e.g. farmers, professionals, and owners of small businesses) is more complex than the comparable calculation for a typical employee.

There are two major problems when forecasting the earnings of self-employed individuals.

Firstly, although income tax returns and financial statements are generally available, they do not necessarily show an accurate picture of the self-employed individual’s earnings potential due to:

- Claiming some personal expenses as business expenses. Several items listed as business expenses may have benefited the owner directly.
- Not receiving payment for services or products sold in the year he or she earned the income (cash basis rather than accrual basis of accounting).
- Receiving cash or payment in kind for services or products sold that may not be reported as income.
- Entering into an income splitting arrangement where earnings are shared with a spouse who is a co-owner.

Resolution of these issues usually requires assistance from the plaintiff’s accountant.

Secondly, even if one can determine that the net income reported by the owner or operator represents his or her actual income in any particular year, it may still be difficult to project the self-employed individual’s future earnings potential, had the accident (or incident) not occurred.

Factors affecting future income include:

- the cyclical or seasonal nature of the industry the business is in;
- whether the industry is growing, mature or declining;
- whether the business results were consistent with overall trends in the industry as a whole.

Many of these issues can be dealt with through the use of business and industry profiles and statistics, such as those published by the Australian Taxation Office and private organisations such as Benchmarking.com.au Pty Ltd, which detail gross margins, operating ratios, etc. for groups of businesses in the same industry.

The basic approach to forecasting business income is to restate the income and expenses for each year from available information, review it for trends prior to the accident (incident), consider the state of the industry and make projections for the post-accident period.
FORECASTING THE EARNINGS CAPACITY OF SELF-EMPLOYED INDIVIDUALS

An alternative approach is to estimate the cost of hiring an employee to replace the individual’s involvement in the business. This approach may be appropriate where the individual has no special knowledge or skill or where the injuries are such that they only limit the ability to undertake the physical aspects of their previous role. If neither of these conditions apply, use of this “replacement approach” may not be appropriate.

From a forensic accountant’s viewpoint, obtaining the appropriate financial documents is the first step in carrying out economic loss calculations. These generally include the income tax returns, detailed profit and loss statements, and balance sheets for the three years before the accident/event and for the period from the date of the accident/event to the date of the report.

Other relevant documents depend on the circumstances of each matter and may include:

- past/current award rates;
- position held and period held;
- analysis of revenue items;
- cash books and general ledgers;
- depreciation schedules.

The earnings are based on an after-tax basis and are generally calculated to the individual’s expected retirement date.

Future losses (for permanent injuries) are generally based on the likely remaining working life based on Australian Life Tables, which convert the value of a regular income of $1 a week to a female or male aged x, to the value at retirement assuming various discount rates.

For example, the value of a net income of $500 per week to a man aged 45 ceasing at 65, based on 5% discount, is $323,150 (per Australian Life Tables 2005–2007 – 5%).

In some cases the amount of the loss of earnings, including superannuation, may be capped to three times average weekly earnings. However, in each jurisdiction the definition of “average weekly wages” varies.
FORECASTING THE EARNINGS CAPACITY OF SELF-EMPLOYED INDIVIDUALS

Asbestos-related Matters – Past & Future Loss of Earnings

Every year hundreds of Australians are discovering that they are victims of asbestosis, a fatal lung disease related to the historical exposure to asbestos. Sadly, in most cases the victim will die within 12–18 months after diagnosis of the disease.

Depending upon the victim’s age at the time of diagnosis, many are still active participants in the workforce with an expectation that they would have continued to work and earn an income for many years to come.

After consultation with their lawyers many people diagnosed with asbestosis find that they are able to make a claim for damages including compensation for their loss of earnings and other employment-related benefits.

The employment situation of each victim is unique and variables that need to be considered include the nature and extent of income received and the number of years the victim had expected to work until retirement.

In many cases the calculation of the lost future earnings can be relatively straightforward. For example, a 62-year-old male earning an after-tax income of $1,000 per week who had an expectation that he would have retired at age 65. In such cases actuarial life tables can be utilised to calculate the present value of the expected stream of income.

Difficulties in calculating the past and future losses can arise in circumstances where the plaintiff:

• is self-employed;
• owns and operates a business or professional practice;
• is relatively young with expectations of future salary increase;
• is an employee remunerated on a commission basis and/or paid regular and variable bonuses;
• is an employee receiving non-cash benefits.

Other difficulties arise where the plaintiff had intended to alter his or her current working structure some time in the future and move to part-time employment prior to retirement.

Every situation requires careful individual examination to ensure that all variations and contingencies are considered.

In difficult cases our analytical skills as forensic accountants are often sought. The following cases illustrate some of the variables we have encountered in the preparation of expert reports in asbestos-related matters:

• a motel owner operator who, due to illness, was forced to sell the business earlier than expected, incurring a loss on sale;
FORECASTING THE EARNINGS CAPACITY OF SELF-EMPLOYED INDIVIDUALS

- an engineer who had received regular annual salary increases and had an expectation of future real increases;

- a self-employed plumber with historically low earnings not indicative of future earning potential;

- a senior computer industry executive remunerated based upon large but fluctuating sales commission and detailed industry formulas;

- an owner of a medium-sized business who was unable to sell his business on the same basis as it was operated by him due to the loss of non-transferable agency agreements;

- a real estate agent with large but variable commission income based upon commercial real estate developments;

- a full-time employee with “after hours” use of his employer’s plant and equipment to manufacture products for sale on his own account;

- a full-time employee on minimum award rates receiving variable production and attendance bonuses.

When briefing a forensic accountant in asbestos-related matters, lawyers for the plaintiff need to provide the following instructions:

- if the plaintiff is still working, the expected date the plaintiff will cease working and whether or not they are receiving sick pay from their employer;

- if the plaintiff has already stopped working, the date employment ceased and whether there were any periods of sick leave taken without pay or any social security payments or other benefits received since ceasing work;

- the age which the plaintiff had expected to retire prior to diagnosis and any particular plans the plaintiff had regarding the transition from full-time work to retirement.
7 | ESTIMATING ECONOMIC LOSS

Generally, in any claim for economic loss, it is alleged that the defendant is responsible for a harmful event that occurred sometime in the past. The plaintiff seeks to recover monetary damages for losses occurring in the past and possibly in the future. This harmful event may be an act that is itself wrongful, as in tort, or it may be a failure to fulfil a promise, as in a breach of contract.

In the first case, damages are calculated generally under the principle that compensation places the plaintiff in a position economically equivalent to the plaintiff’s position absent the harmful event or tort.

In the case of a breach of contract, damages are calculated generally under the principle, in which the compensation is intended to replace what the plaintiff would have received if the contract had been performed.

While there is a difference between damages sought in tort and damages for breach of contract, both generally result in a damages analysis as described for past and future losses. Compensation is the difference between the value of earnings that were actually received or receivable and earnings that would have been received or receivable.

As set out in Chapter 5, the standard procedure to assess damages, or economic loss, is:

• Past losses relate to earnings until trial had the harmful event not occurred, less actual earnings before trial, plus interest.
• Future losses relate to projected earnings after trial had the harmful event not occurred, less projected earnings after trial less discounting.

Earnings are net of associated costs.

The key features of estimating economic loss are:

• quantification of the reduction in earnings;
• calculation of interest on past losses;
• quantification of future losses;
• application of financial discounting to future losses.

For personal injury cases the retirement age is usually 65 years and the discount rate is 5%. In other cases (such as business interruption, public liability) the determination of the future period that losses will continue and the discount rate to apply will depend on the circumstances, the nature of the claim and the jurisdiction in which the claim is made.

Some issues common to most economic loss matters include:

How was the plaintiff harmed and what legal principles govern compensation for the harm?

• The characterisation of the harmful event begins with a clear statement of the event and its effect on the plaintiff. Changes in economic conditions (including the cyclical nature of the industry, whether the industry is growing, mature or declining, etc.) need to be considered.
Is there disagreement about the costs that the plaintiff would have incurred but for the harmful event?

- If the effect of the harmful event is lost sales, then lost profit is lost revenue less the variable costs avoided by selling a lower volume (these include cost of manufacturing, marketing, selling costs). Fixed costs cannot generally be avoided (rent, administration costs, etc.). This can be a common area of dispute.

Is there dispute about mitigation?

- The plaintiff has a duty to mitigate its loss.
- The defendant may propose to subtract the earnings the plaintiff should have achieved, under proper mitigation, rather than actual earnings. Alternatively, for example, a defendant may presume that the plaintiff could mitigate by locating another source of supply in the event of a breach of a supply agreement. Damages may be limited to the difference between the contract price and the current market price in such a situation.

Are losses measured before or after the plaintiff’s income taxes?

- For personal injury loss assessments, the calculations should be on an after-tax basis. For commercial matters the calculation is generally on a before-tax basis as the settlement proceeds would be taxable to the plaintiff.

What interest rate should apply on past losses, should interest be on a simple or compound basis and should interest be calculated on a before or after tax basis?

- This may depend on what the law prescribes. If the law does not prescribe the form of interest for past losses, an expert will normally apply a reasonable rate of interest to bring those losses forward. The before-tax rate is the normal quoted rate. Courts are commonly given the discretion to decide whether or not to award interest, at what rate and what period to apply it.

Is there disagreement about the projection of profitability but for the harmful event?

- A common source of disagreement about likely profitability of a business is the absence of a track record of earlier profitability. Whenever the plaintiff is a start-up business, the issue of reconstructing the value of a business with no historical benchmark will arise. We were recently involved in a case involving a start-up manufacturer of health food targeted to supermarkets. This business had established its productive capacity and was in the process of marketing its products to supermarkets, airlines, etc. We had to assess the earnings (had the harmful event not occurred) based on projecting likely revenues, applying appropriate costs, and discounting for the high level of risk pertaining to start-up businesses.

The above issues illustrate some areas of dispute that frequently arise when economic losses are claimed.
ESTIMATING ECONOMIC LOSS

Case Study

The purchaser of a business alleged that the vendor had overstated the sales of the business in the three years prior to the sale. The allegation was made primarily based upon the significant deterioration of the sales being achieved by the purchaser.

We were engaged to review the last three years financial statements and tax returns which had been provided to the purchaser.

To facilitate our investigation we requested a soft copy of the sales ledger and identified a mismatch between the recorded dates of many sales and the computer generated "docket i.d." sequence number.

The above graph reveals docket i.d.'s in the range 4,560 to 4,630 had been processed in early 2007 but had been backdated to as early as July 2004, indicative of sales being randomly added into the historical sales records.

Further investigation revealed that both the tax returns and BAS returns which had been provided to the plaintiff had not been lodged with the tax department and that the financial statements provided had been manipulated to increase monthly sales in the three-year period July 2004 to March 2007.

Based upon our analysis of the financial records of the defendant's legal team were able to negotiate a resolution to the matter.
8 | VALUATIONS OF BUSINESSES, ENTITIES AND SHARES

Purpose of a Business Valuation
Business valuations are required for a wide variety of purposes including:

- **Compliance** – such as capital gains tax, stamp duty, probate, restructures, accounting standards, etc.
- **Merger and Acquisitions** – such as business sales and acquisitions, partnership admissions and retirements, mergers, etc.
- **Disputes** – such as family law disputes, shareholder disputes, vendor/purchaser disputes, economic loss assessments, compulsory acquisitions, etc.

The purpose for which the valuation is intended can impact on the value and the appropriate methodologies to be applied.

Definition of Business Valuation
It is important to understand what is meant by business valuation.

A business valuation refers to the value of the net operating assets, which are involved in the operations of the business in question, and could include:

- debtors
- stock
- plant and equipment
- goodwill
- other intangible assets such as patents, brands, customer lists, business name, etc.
- creditors
- employee entitlements.

A business is funded by a mixture of equity and debt. Debt could be from an interest-bearing financier such as a bank or from the owners of the business in the form of loans rather than equity capital. Businesses are generally sold without their associated funding, be it equity or debt.

It follows then that an entity such as a company is worth:

- the value of the business it operates (net operating assets); and
- the value of non-operating assets and liabilities such as investments, loans, debts to financiers, etc.
VALUATIONS OF BUSINESSES, ENTITIES & SHARES

Applicable Standards

APES 225 Valuation Services issued by APESB in July 2008 sets professional standards for the provision of quality and ethical valuation services by members.

It is a mandatory requirement of APES 225 that in circumstances where a member prepares a written valuation report in respect of a valuation service, the valuation report clearly communicates:

• the name of the party engaging the Member;
• a description of the business, business ownership interest, security or intangible asset being valued;
• the date at which the value has been determined;
• the date on which the valuation report has been issued;
• the purpose for which the valuation report has been prepared;
• the name and qualifications of the Member(s) responsible for the valuation;
• the scope of the valuation, including any limitations or restrictions;
• the basis of the valuation;
• a statement whether the valuation was undertaken by the Member acting independently or not;
• the valuation approaches adopted in determining the estimate of value and a description of how they were applied;
• the specific information on which the Member has relied and the extent to which it has been reviewed;
• a description of the material assumptions applied in the valuation and the basis for those assumptions;
• a conclusion of value for a valuation engagement or a limited scope valuation engagement, or a calculated value for a calculated value engagement;
• all qualifications that materially affect the conclusion of value or calculated value;
• for a limited scope valuation engagement, a statement that if a valuation engagement had been performed the results may have been different;
• for a calculation engagement, a statement that if a valuation engagement had been performed the results may have been different;
• where a Member has prepared a valuation report that requires independence or purports to be independent, a statement that the compensation to be paid to the member is not contingent on the conclusion, content or future use of the valuation report; and
• a statement that the valuation service was conducted in accordance with this Standard.
VALUATIONS OF BUSINESSES, ENTITIES & SHARES

Concept of Value

Given the lack of legislative guidelines concerning value, the courts have developed their own definitions. Most of these definitions evolved from interpretation of state and federal taxation statutes. The courts in both Australia and England have discussed whether valuation is a theoretical discipline or whether it is merely guesswork. For instance, in *Myer v. Commission of Taxes* [1937] VLR 106, the Victorian Supreme Court determined that the process of valuation is essentially an art which involves an element of guesswork. In *Gold Coast Selection Trust v. Humphrey* [1948] AC 459, the Court stated that valuation is an art, not a science.

The concept of “fair market value” which was developed by the High Court, has become a widely accepted definition of “value”.

In *Spencer v. Commonwealth* [1907] 5 CLR 418, Griffith CJ stated the definition of value as:

“In my judgement the test of value of land is to be determined not by inquiring what price a man desiring to sell could actually have obtained for it on a given day, that is, whether there was in fact on that day a willing buyer, but by inquiring: “What would a man desiring to buy the land have had to pay for it on that day to a vendor willing to sell it for a fair price but not anxious to sell?” ...to ascertain what, according to the then current opinion of land values, a purchaser would have had to offer for the land to induce such a willing vendor to sell it, or, in other words, to inquire at what point a desirous purchaser and not a unwilling vendor would come together.’

This definition, by implication, involves the notion of the hypothetical willing but not anxious purchaser and the willing but not anxious vendor. This concept has been further developed as:

“The price that would be negotiated in an open and unrestricted market between a knowledgeable, willing but not anxious buyer and a knowledgeable, willing but not anxious seller acting at arm's length.”

There are particular assets and circumstances where a “special” or “intrinsic” value is utilised instead of “market value”.

Adamson makes the following observations in relation to the definition of “value”:

“The word “value” cannot be defined in a decisive sense which will meet all purposes. Although property must at any given time have the same value for the same purpose, it is evident that it could have differing values on the same day according to the reason for which it is necessary to establish a value. Market value established by actual sales does not necessarily represent the value to a holder who does not wish to sell; neither is the value to a holder necessarily coincident with the value to a prospective purchaser. Then we speak of intrinsic value, market value, holding value, fair value, tangible assets value, value as a going concern, and realisation value.”

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VALUATIONS OF BUSINESSES, ENTITIES & SHARES

This statement recognises the differing concepts of value: that of market value and value to the owner. It is this distinction which becomes crucial in many family law property cases where assets that belong to the parties of the marriage may not necessarily be of significant value to the hypothetical purchaser but will be of significant value in the hands of the owner of that asset.

In these circumstances the Family Court may exercise its discretion under s. 79 of the Family Law Act 1975 (Cth) and value the asset according to some other basis, which in the circumstances would be more appropriate. A “special” or “intrinsic” value may be used which reflects the worth of that particular asset to the party or parties to the proceedings.

Relevant Time of Valuation

The relevant valuation date varies from matter to matter.

In a commercial dispute involving the ownership or interest in a business the date of the valuation is dependent upon the nature of the dispute and the claim being made or defended.

In a claim for breach of contract it is not unusual for valuations to be obtained as at various dates. For example, at the date of acquisition, the date of disruption or disturbance, the date when an assertion or promise was made or broken, the date of sale of the interest or the date of the hearing.

Main Methods of Valuing a Business

The main method utilised to value an interest in a business will depend on whether the business is operated by a listed public company, or whether it is a private business owned under a sole tradership, partnership, trust or company structure.

Where shareholdings are in listed entities the valuation of those shares is relatively straightforward. In the majority of cases, the share price is determined by consulting the quoted prices for those companies listed on the Stock Exchange. However, the position with interests in unlisted businesses is more complicated. When valuing an interest in a private company, the shareholding in that company must be valued and not the assets of the company.

With respect to businesses, there are three basic types of valuation methods. The first is based on the earnings of the business, the second is based on the assets of the business and the third is based on market expectations.
VALUATIONS OF BUSINESSES, ENTITIES & SHARES

In summary these methods may be broken down into these categories of valuation methods as follows:

**Income Based**
- discounted cash flows
- capitalisation of maintainable earnings

**Assets Based**
- going concern
- realisation of assets or liquidation value

**Market Based**
- rules of thumb
- comparative sales

Differing valuations will result from using the capitalisation of income basis, the asset-backing basis or the market-based methodologies.

The valuer has to decide which is the most appropriate methodology.

The capitalisation of future maintainable earnings is widely used to value an entity that is a going concern. A going concern is an entity which is able to generate sustainable investment return after deducting all reasonable expenses associated with running the entity.

Where the entity is underperforming, the net asset approach is the most appropriate valuation method. An underperforming entity is one which is not making an economic return (loss-making, marginal profit).

**Capitalisation of Future Maintainable Earnings**

Capitalisation of earnings is the most commonly used method for the valuation of businesses with a consistent earnings trend that is indicative of ongoing earnings potential.

It is not suitable for start-up businesses, businesses with erratic earning patterns or those which have large capital expenditure requirements in the near future.

A capitalisation of earnings requires consideration of:

- the estimated future maintainable earnings of the business;
- the appropriate capitalisation rate (or price earnings multiple) which will reflect the purchasers required rate of return, risk inherent in the business, future growth opportunities and alternative opportunities; and
- a separate assessment of surplus or unrelated assets and liabilities, being those not essential to producing the estimated future earnings which are then added or deducted from the capitalised earnings.
VALUATIONS OF BUSINESSES, ENTITIES & SHARES

The Capitalisation of Future Maintainable Earnings method of valuation requires an estimate of the maintainable level of earnings of a business.

This estimate is based on available information. In practice, a review of historical results will provide a guide to the entity’s future performance. The result is adjusted to remove any extraneous or abnormal items that are not recurrent to the typical operations of the company. Once the future maintainable earnings is determined, it is then multiplied by an appropriate price earnings multiple (or the inverse where it is divided by the capitalisation rate) to arrive at the value of the business. This rate will allow for elements such as risk, time value of money and future growth prospects. The use of an earnings based method of valuing an interest in a company for the purpose of s. 79 of the Family Law Act 1975 was discussed by Mason J in Mallet v. Mallet 156 CLR 605:

“It has been said that a valuation based on earning capacity is generally most appropriate because the hypothetical purchaser of shares in a company which is a going concern is looking, not to a winding up, but to the profits which will ensure from the company continuing to trade: McCathie v. FC of T (1944) 69 CLR 1; Abrahams v. FC of T (1944) 70 CLR 23; Commissioner of Succession Duties (SA) v. Executor Trustee and Agency Co of SA Ltd (1947) 74 CLR 358.”

In contrast, the Family Court in Ramsey v. Ramsey (1997) FLC 92-742 followed the decision in Turnbull v. Turnbull (1991) FLC 92-258 where it was held that the purpose of the valuation is to ascertain the value to the individual shareholder, not the commercial or market value of the shares to the hypothetical purchaser. The value to be assigned must be realistic. Warnick J in Ramsey’s case pointed out that there is a need to recognise the point at which the difference between value to the shareholder and the market value becomes relevant.

The level of future maintainable earnings will not necessarily be the same as present or past earnings, although these figures may serve as a guide.

In considering the relevance of past results as a guide to expected future maintainable earnings, several factors have to be critically examined. For instance, changes that have or are likely to occur in regard to the type of business activity conducted (such as product lines) and the structure of the industry and marketplace (level of protection, competition and growth), should be considered. The financial results for a number of years should be reviewed to determine the frequency of trade or season cycles and the pattern or trend in profitability.

Past accounting policies must be evaluated as they may have been inconsistent or may be inappropriate for the purpose of valuation.

There are several areas where accounting methods that have been utilised by a business may have been inappropriate. It will be necessary to select the most appropriate accounting policies to adopt. Where this differs from the method used, the effect of this difference should be calculated and the prior results recast on the new basis.
In particular, the following should be reviewed:

- criterion for determining the timing of income recognition;
- basis of depreciation;
- method and consistency of stock and work-in-progress valuations;
- the timing of expenditure and period-end accruals;
- uses of provisions for losses and expenditure;
- income tax accounting (tax effect or not);
- accounting for unearned income (e.g. Construction contracts);
- extraordinary items included in past earnings;
- discontinued business;
- commercial rentals; and
- new businesses.

The recasting of current and past results must also have regard to the potential impact of a change in ownership or management of the business as well as changes in legislation.

The current management and its level of remuneration (in particular, the sufficiency or excessiveness of owner’s remuneration packages) has to be critically examined. The change of management may impact on the clientele of the business, the relationship with suppliers or the costs of finance (if low interest loan funds of present owners are withdrawn). The impact of changes in income tax and other laws such as superannuation, payroll tax, sales tax, GST and trade practices, may affect future earnings. It is ultimately a question of degree as to whether or not past results can be recast to reflect these types of changes in order that they are representative of a trend in expected future maintainable earnings.

The “Price Earnings Multiple” or its inverse, the “Capitalisation Rate” must be determined.

Once this figure is determined and applied to the future earnings, it will reflect the expected rate of return from the business.

Factors to be taken into consideration in determining such a rate include:

- **Degree of risk associated with this type of activity** owing to:
  - external factors, economic indicators
  - the industry or business sector
  - the level of competition
  - risk of obsolescence
  - degree of control and regulation
  - degree of protection or assistance by governments
  - seasonal and trade cycle variability
  - changes in tax rate, allowances for tax losses or changes in the status of the entity.
VALUATIONS OF BUSINESSES, ENTITIES & SHARES

- **Growth expectations of investment**
  - changes in the product cycle
  - expected life of the product
  - industry outlook for future growth.

- **Degree of negotiability**
  The degree of negotiability of an investment affects the required rate of return. The readily negotiable nature of publicly listed shares is one of the contributing reasons as to why the expected rate of return on such shares would be much lower than a parcel of shares in a proprietary company which, pursuant to its Constitution, places restriction on transfers.

  The relevant constituent documents must be examined carefully by the valuer. This procedure is not only important in the area of negotiability, but more importantly in regard to the rights or entitlements of the interest being valued (e.g. preference versus ordinary shares).

- **Control**
  The lesser degree of control over one’s investment the higher the required return (e.g. non-voting shares as against voting shares or minority interest not enabling a directorship).

- **Multiples achieved for other investments**
  Reference to the multiples achieved for other investments may assist in determining an appropriate level of return for the risk involved.

**Surplus assets which do not contribute to the operations of a business should be separately valued and then added to the business valuation which has been obtained from the capitalisation of future maintainable earnings.**

Surplus assets would include excess cash, non-core investments or property not used in the operations of the business. Such non-core assets should be isolated from the core assets of the business as these non-core assets will generate a different return and represent a different risk profile than those core assets that are central to the business.

Property that is used in the business can be considered a “surplus asset” by adjusting the estimated maintainable earnings to reflect a fair commercial property charge. Property has a different risk profile to that of a business and therefore should be assessed separately.

**In the determination of future maintainable earnings, the valuer needs to consider whether to use profit after interest and tax (NPAT) or profit before interest and tax (EBIT).**

The capitalisation rate or multiple must, of course, be based on what is being capitalised. Clearly a higher multiple is applied to NPAT than EBIT.

Current trends in valuation indicate that there is more emphasis on valuing businesses on an ungeared basis (that is, on a multiple of estimated maintainable EBIT), and then deducting the debt and adding any surplus assets, to determine the value of the entity.
VALUATIONS OF BUSINESSES, ENTITIES & SHARES

Discounted Cash Flow

The discounted cash flow (DCF) method of valuation of a business is a measure of the expected future value of the flow of cash both in absolute terms and the time period over which it is derived.

Discounting of future cash flows has a strong theoretical foundation. It involves assessing the present value of future cash inflows and outflows which are then discounted to determine what they are worth in “today’s” dollars. The discount rate chosen should reflect the required rate of return, given the risk associated with generating those cash flows.

Considerable judgement is required in estimating future cash flows. Usually the net present value is extremely sensitive to small changes in underlying assumptions, few of which are capable of being predicted with accuracy especially after the first 2 – 3 years. It also requires calculation of a terminal value at the end of the forecast period. These factors impose their own difficulties and this is why the capitalisation of earnings is the most commonly used method to value established industrial businesses.

Adopting the discounted cash flow approach to a valuation of a business or interest in a business requires:

- an assessment of the cash flows to the business for a period of say five years;
- an assessment of the termination value at the end of the period;
- an assessment of an appropriate discount rate to apply the projected cash flows to reflect the time value of money and the risks associated with actually achieving the potential future earnings of the company.

The basic principles behind a DCF are that a dollar today is worth more than a dollar received in the future (due to the effects of inflation), and that the availability of cash is limited, as it has an opportunity cost (i.e. a cost of other opportunities foregone).

The value of a business is determined by assessing the present value of the cash flows which are expected to occur in the future. This process involves determining the likely future receipts and expenditure of cash, expected to be received/incurred over a number of years, these are then discounted to determine what they are worth in today’s dollars, or their “present value”. The discount rate chosen to determine the present value should reflect the required rate of return given the risk associated with generating those cash flows. The discount rate used should reflect the opportunity cost of capital.

The DCF method will not be suitable for valuing all businesses and there are some risks associated with its application.

Because the method is dependent on future cash flows which a project or business is expected to generate, an estimate of both the amount and timing of these cash flows must be made.

A further issue is to determine an appropriate discount rate to use. It needs to accurately reflect the risk and expected return of the project or business.
VALUATIONS OF BUSINESSES, ENTITIES & SHARES

For instance, substantially differing valuations can be achieved when discounting an amount of $10,000 to be received in 10 years time by using differing discount rates. $10,000 in 10 years time is worth $6,139 if discounted by 5%, $3,855 if discounted by 10% and $1,073 if discounted by 25%.

Typically the types of businesses or investments to which DCF valuations are most applicable are those with:
• finite lives;
• new investments with high growth until maturity;
• existing investments requiring high levels of additional capital expenditure or entering growth stages; and
• long-term lease arrangements where a residual value is anticipated.

There are a number of potential advantages to using a DCF basis for valuing as compared to a capitalisation of maintainable earnings. The potential benefits are:
• the DCF basis is focused on cash, which is how investors and bankers evaluate an investment;
• by being focused on cash the DCF basis eliminates any distortions that may arise due to the use of creative accounting or differing accounting procedures; and
• the DCF basis places emphasis on the time value of money which is important in evaluating investments over a number of years.

For the above reasons it could be said that the DCF basis is more objective when compared to the capitalisation of maintainable earnings which is more open to manipulation by the use of differing accounting policies. In determining which is the preferable earnings-based method of valuing, the circumstances of that particular valuation will be crucial in determining which method is the most suitable.

Generally where the cash flows are predictable and not expected to vary, the DCF basis will be applicable. However it may be difficult to accurately predict cash flows due to factors such as the variable nature of interest rates and other economic conditions. Thus in circumstances where the cash flows are predictable and the investment life is finite the DCF model would be appropriate. However in reality there may not be many circumstances where these conditions will be met.

Asset-based Valuations

An asset-based valuation, on both a “going concern” and “realisation of assets” basis may be an appropriate method of valuing a business.

A valuation based on the asset-backing of a business is normally used as a secondary method of valuation as a crosscheck on the reasonableness of the capitalisation of maintainable earnings method. That is, after valuing the business on an earnings basis, does the “Price to Asset Ratio” appear reasonable in the circumstances? The Price to Asset Ratio measures the value of the business as derived divided by the Net Tangible Operating Assets of the business. Generally, this would derive a value of between 1 and 2 for most businesses, perhaps higher for service/professional businesses.
However, it is a primary method of valuation for businesses that are underperforming or not making a sufficient economic return to derive a value on a capitalisation of earnings basis greater than an asset-backed valuation.

Where a business is profitable it is not open for the court to adopt an asset-based method unless the maintainable earnings provide an inadequate as a return on the net tangible operating assets utilised in the business.

There are two asset-backed valuation approaches:

• going concern basis; and
• realisation of assets basis.

In both instances it is necessary to critically examine and adjust, where necessary, the recorded book value of assets. Therefore, in many instances this would require the assistance of independent experts for items such as real estate and plant valuations.

**A valuation on a going concern basis would have regard to the value of assets on the assumption that they would be realised in the normal course of business.**

The realisation of assets or liquidation basis of valuation assumes that the business will cease operations and as a result may give rise to certain adjustments to those values compiled on the going concern method referred to above, namely:

• the reduction in certain asset values e.g. machinery, stock, work-in-progress owing to the need to discount prices for discontinuance of trading;
• the incurring of additional liabilities e.g. lease payouts, income tax, capital gains tax liability, redundancy, retrenchment and liquidation costs; and
• the loss of non-transferable industrial rights, franchises, leases etc.
• The realisation basis in most instances is more a measure of security of an investment rather than valuation unless liquidation is contemplated in the near future.

**Rules of Thumb Valuations**

A “rule of thumb” method of valuing a business is widely used in certain industries such as childcare centres (value per child), nursing homes (value per bed), professional practices (value per $ of gross fees), small retail outlets, etc.

Rule of thumb valuations are not a primary valuation method and have, over a period of time, developed as a result of market transactions. They are mainly prevalent in the valuation of small businesses or readily comparable businesses.

This method is often criticised as being too simplistic and ignoring the financial results of the business. Care should be taken when using the rule of thumb method, as a value may be difficult to substantiate in court. The method often leads to over-valuation and therefore inadequate returns on investment.
VALUATIONS OF BUSINESSES, ENTITIES & SHARES

However the method is widely used to value a number of small (or comparable) businesses such as:

- professional practices such as accounting firms, medical practices
- newsagencies
- real estate rent rolls
- childcare centres
- nursing homes
- hotels
- restaurants/cafes
- small retail businesses.

This method is often seen as a useful and quick benchmark to compare with other values and determine whether they are reasonable. However care should be taken when using this method as an inaccurate value may prove difficult to substantiate in court.

Comparative Sales

This method of valuation, as the name implies, is based on a comparison of sales achieved in the market place for similar businesses.

Although a comparison may be made, it is necessary to consider the various factors that can and do affect individual businesses.

Factors such as years of operation, systems adopted, staffing, location, demographics, competition, position in the market place, quality of the business equipment, security of tenure, reputation, relationship with customers, etc., may affect the expected future profitability and hence the value of the business.

Selection of Appropriate Valuation Method

Differing valuations will result from using the capitalisation of earnings, the asset-backing or market-based methods.

The valuer has to decide which is the most appropriate methodology. If the business has high earnings and low net assets, an earnings-based method may be appropriate, whereas an asset-based method may be appropriate where the business has significant assets but relatively poor earnings.

At the end of the day, the value must reflect what a rational person would be willing to pay or to receive in light of the circumstances surrounding the business or entity under consideration. Valuers must presume a market and place themselves in the position of a rational purchaser and seller.
VALUATIONS OF BUSINESSES, ENTITIES & SHARES

Typically:

• A capitalisation of earnings approach is adopted for performing, mature businesses with no major changes envisaged in the medium term.

• A DCF approach is appropriate for finite life projects, businesses with predictable cash flows, start-up businesses (which may incur losses initially and then turn to profit), existing businesses entering an expansion phase, resource companies.

• Asset-based methods are normally a secondary method (check the “Price Asset Ratio” for reasonableness), but are suitable for non-performing businesses or entities which have passive investments in equities and property.

• Market-based methods, are also normally a secondary method but have relevance to small business and comparable businesses.

Minority Interest Holdings

A minority interest holder in an entity cannot exert control over:

• dividends paid by the company; or

• management.

There are two alternative approaches to assessing the value of a minority interest:

❖ Pro rata Value of Minority Interest Holding

Where the interest to be valued is a minority shareholding, a discount will be applied to that interest to compensate for the restriction on the transfer of the shares and for the lack of control over the business.

This method requires the entity to be valued as a whole, then the pro rata value for minority holding is calculated. To this value a discount is then applied for the minority interest.

The discount reduces the pro rata value of the entire business to reflect the absence of control and lack of negotiability. This discount generally varies between 10% and 30% depending on the circumstances.

This principle has been judicially accepted in revenue cases such as Gregory v. Commissioner of Taxation (1971) 123 CLR 547 and Commissioner of Taxation v. Sagar (1946) 71 CLR 421.
VALUATIONS OF BUSINESSES, ENTITIES & SHARES

❖ Capitalisation of Future Maintainable Dividends

– Estimate future maintainable earnings of company.
– Estimate likely dividends on such earnings.
– Apply appropriate capitalisation rate.

To illustrate which method to adopt we set out two extreme cases:

Case 1

Mrs A owns 30% of a company, does not work in the business and does not receive a dividend.

Mr B owns 70%, draws $1.5 million in salary/benefits (i.e. above a commercial level).

A capitalisation of dividend approach values Mrs A’s interest at nil. However this doesn’t consider:

• any oppression remedies available;
• that a 30% interest is valued the same as a smaller interest; and
• it being highly unlikely the owner would sell 30% holding for nothing.

A discounted pro rata approach would:

• give a tangible base from which minority interest could be considered; and
• give a more realistic value.

Case 2

Mrs C owns 30% in the company and does not work in the business.

Mr D owns 70% and draws a commercial salary of $110,000 p.a.

All net profit is included in the accounts and Mrs C gets 30% of it.

In this case a capitalisation of future maintainable dividends probably could be used to assess Mrs C’s interest. However, it would be appropriate to also consider the discounted prorata approach.

There are cases where shareholders are quasi-partners. In this case it may be appropriate to value their interest on a full prorata basis without any discounting. Reference should be made to any shareholder agreements in place.

The spread of shareholders and the lack of a controlling shareholder will also impact on the appropriate discount to apply to a minority holding. Having 10 shareholders each with a 10% holding is different from having 10 shareholders with 2% each and another shareholder with an 80% holding.
Small Business Valuations

Business valuation theory tends to insist that an allowance be made for the owner/operator to receive a fair wage before estimating maintainable earnings of the business.

Business brokers, on the other hand, generally do not allow for a commercial wage to the owner/operator. Small businesses are generally sold in the market place on the basis of a multiple of earnings before an allowance for the owner/operator’s wage.

For example:

- A takeaway food shop was sold for $42,000.
- The business was making $40,000 profit before owner wages.
- The price consisted of $10,000 for plant and equipment, $9,000 for stock and $23,000 for goodwill.
- A fair annual wage for the owner would be $36,000 ($15/hour @ 48 hours/week)

If a fair wage was included, the real profit of the business would be $4,000. On this basis the price of $42,000 appears high. Yet the purchaser was prepared to pay this price.

Reasons for this include:

- The purchaser was buying an income.
- The purchase can subsidise living expenses from the business (e.g. if food business).
- The purchaser is his own boss.
- “Cash” aspect of the business.
- The purchaser can split his income with his spouse.
- Purchasers of small businesses do not differentiate between profit and wage.

Other factors making small business valuations difficult include:

- availability of reliable records;
- profits can fluctuate;
- private expenses (such as motor vehicle, telephone, etc.) may be included in the accounts.

The above factors are reasons why more than one method should be considered in valuing small businesses (capitalisation of earnings, rule of thumb).
VALUATIONS OF BUSINESSES, ENTITIES & SHARES

Valuation of Professional Practices

The same methods apply in valuing an interest in a professional practice as those applied in valuing any other type of business.

Some partnerships have formulae for ingoing and outgoing individual partners. Indeed, many of the larger legal and accountancy practices now operate on a “no goodwill” basis. That is incoming partners pay no goodwill when they are admitted to the partnership and receive no goodwill payout when they leave. The individual partners cannot sell their interest.

These formulae rarely reflect all considerations that should be factored into either valuing the practice in total or one partner’s interest in the practice.

Professional goodwill is the difference between the value of the practice as a whole and its net tangible operating assets. It relates to the recognition of the firm’s name, its established clientele and connections, its services, databases, systems, etc.

The key is to differentiate between goodwill pertaining to the practice and that pertaining to the individual. Personal goodwill relates to the person’s own contacts, experience, and reputation.

A derivative of the capitalisation of earnings, that is, the capitalisation of super profits is often applied to the valuation of a partner’s interest in large professional practices.

Super profits are the profits in excess of those required to provide an economic rate of remuneration for all labour and capital used in the practice.

To assess profitability of a practice the previous year’s results are reviewed. These should be adjusted for:

• non-recurring items (abnormal bad debts, client losses, etc.)
• accrual accounting (many small practices are on a cash basis and exclude work-in-progress, debtors, creditors, etc.)
• a commercial salary for the partners.

The assessed maintainable profit is then capitalised at an appropriate rate to reflect associated risks.

Example 1: Two partner practice – Capitalisation of earnings approach

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Fees</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>Assessed Maintainable Profit</td>
<td>500,000</td>
</tr>
<tr>
<td>Less Assessed Commercial Salaries</td>
<td>300,000</td>
</tr>
<tr>
<td>Partnership Profit Before Tax</td>
<td>200,000</td>
</tr>
<tr>
<td>Less Tax at say 50%</td>
<td>100,000</td>
</tr>
<tr>
<td>Earnings after Tax</td>
<td>$100,000</td>
</tr>
<tr>
<td>Capitalisation Rate, say</td>
<td>20%</td>
</tr>
<tr>
<td>Value of Practice</td>
<td>$500,000</td>
</tr>
<tr>
<td>Less Net Tangible Operating Assets</td>
<td>200,000</td>
</tr>
<tr>
<td>Derived Goodwill</td>
<td>$300,000</td>
</tr>
</tbody>
</table>

One partner’s interest in the practice may therefore be assessed at $250,000 ($500,000 / 2).
Example 2: One partner’s interest (aged 50) in a no goodwill practice – Super profits approach

Assessed Maintainable Profit $500,000
Less Assessed Commercial Salary 300,000
200,000
Less Interest on Capital & Current Accounts ($350,000 at say 8%) 28,000
Super Profits 172,000
Less Tax at say 50% 86,000
Super Profits after Tax $86,000

These may be earned until the partner retires (say, age 60). However, the possibility of death should also be factored in. Based on this the Net Present Value of the Super Profits may be calculated as:

<table>
<thead>
<tr>
<th>Age</th>
<th>Super Profits After Tax</th>
<th>Mortality Factor⁴</th>
<th>Discount Rate⁵</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>50</td>
<td>$86,000</td>
<td>0.99697</td>
<td>0.86957</td>
<td>$74,556</td>
</tr>
<tr>
<td>51</td>
<td>86,000</td>
<td>0.99671</td>
<td>0.75614</td>
<td>64,814</td>
</tr>
<tr>
<td>52</td>
<td>86,000</td>
<td>0.99643</td>
<td>0.65752</td>
<td>56,345</td>
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<tr>
<td>53</td>
<td>86,000</td>
<td>0.99614</td>
<td>0.57175</td>
<td>48,981</td>
</tr>
<tr>
<td>54</td>
<td>86,000</td>
<td>0.99581</td>
<td>0.49718</td>
<td>42,578</td>
</tr>
<tr>
<td>55</td>
<td>86,000</td>
<td>0.99546</td>
<td>0.43233</td>
<td>37,012</td>
</tr>
<tr>
<td>56</td>
<td>86,000</td>
<td>0.99507</td>
<td>0.37594</td>
<td>32,171</td>
</tr>
<tr>
<td>57</td>
<td>86,000</td>
<td>0.99462</td>
<td>0.32690</td>
<td>27,962</td>
</tr>
<tr>
<td>58</td>
<td>86,000</td>
<td>0.99409</td>
<td>0.28426</td>
<td>24,302</td>
</tr>
<tr>
<td>59</td>
<td>86,000</td>
<td>0.99348</td>
<td>0.24718</td>
<td>21,119</td>
</tr>
</tbody>
</table>

Net Present Value of Super Profits $429,840

Each practice is different and careful analysis of each situation is required to assess whether the valuation should be based on value to the owner or fair market value. It is important to be familiar with what is actually happening in the commercial world concerning payment of goodwill on the admission/retirement of partners/sale of practices, how specialised the practice is, the availability of staff, etc.

⁴ From Australian Life Tables 2005–2007, probability of reaching the age at year end a start of age 50.
⁵ Discount rate of 15% per annum real. Higher rates might apply.
VALUATIONS OF BUSINESSES, ENTITIES & SHARES

Sources of Information

Typically, the forensic accountant has a checklist of information required in a business valuation, such a list would generally include:

- legal structure of family group of businesses (if more than one business)
- historical financial statements for the last 3 to 5 years
- income tax returns of business and owners for the last 3 to 5 years
- management reports (if available)
- budgets (if available)
- Business Activity Statements and working papers (current year)
- business plan (if available)
- details of investments (as shown on balance sheet)
- details of properties (as shown on balance sheet)
- depreciation schedule for plant and equipment
- aged debtors and creditors listing 30 June or most current
- staffing details – role, hours, wages
- details of lease on business premises
- key events in business’ history
- details of major competition
- details of main products/services sold
- partnership, shareholder and other agreements.

If the accounts of the business appear unreliable (compared to industry statistical information, etc.) then further examination of source records may be required including:

- general ledger
- bank statements
- sales journals
- cash payments/cash receipts journal
- purchases journal
- stock records
- wages records
- general journal
- register rolls
- recent finance applications
- credit cards of owner.

Sundry research into the industry the business is part of is also required. It is best if the forensic accountant is given the opportunity to visit the business and interview the owner/operator.
FRAUD INVESTIGATION AND PREVENTION

Financial investigations relate to accounting analysis, which provides evidence that is suitable to the court for the basis of discussion, debate and ultimately dispute resolution.

It can be associated with criminal matters such as employee theft and fraud, or relating to misrepresentations made in respect of business sales, franchise agreements, etc.

Financial investigations utilise accounting, auditing and investigative skills. It is important to be able to respond quickly and to communicate financial information clearly and concisely.

The experience of the Major Fraud Squad in Victoria is that 80% of corporate frauds come from within the organisation.

The key ingredients of any fraud are opportunity and motivation. While most employees are honest, there is always an element that is not if the opportunity arises. Thus the saying, “Trust is good, control is better”.

The main motivations for fraud are greed, lifestyle, high debts, gambling, poor salaries and poor company morale.

Frauds can take three main forms:

- asset misappropriation particularly in regard to cash, cheque accounts, inventory, supplies, equipment and information;
- corruption including bribery, illegal gratuities and conflicts of interest;
- fraudulent statements.

Specific examples include:

- payment for work not performed;
- overcharging;
- unauthorised transactions;
- altering stock records;
- cheques made out to false persons;
- equipment/supplies stolen;
- collusion with customers/suppliers (kickbacks, supplier overcharging, unauthorised discounts);
- theft of funds under management or held in trust;
- overclaiming employee expenses;
- false insurance claims;
- incorrect information in selling memorandums / vendor of business statements.
FRAUD INVESTIGATION & PREVENTION

The biggest opportunities for frauds are:
- small business where there is generally a lack of segregation of duties;
- where large companies have undertaken cost cutting exercises and audit trails are unclear;
- specialised work areas where there is an acknowledged expert;
- managed investment schemes (e.g. fraudulent investment schemes).

Warning signals indicating conditions conducive to fraud include:
- absence of audit committees;
- substantial contracts awarded without tendering;
- purchasing decisions involving one person;
- key staff accumulating annual leave;
- discrepancies between physical inventory and computer records;
- high bad debt write-offs;
- unexplained analytical review variances (e.g. unexplained fall in gross profit percentage);
- a domineering CEO/MD;
- employees with lifestyles inconsistent with earnings;
- frequent changes in advisors (e.g. accountants);
- work backlogs, especially in financial reconciliations.

To prevent fraud, companies should regularly assess their susceptibility to fraud. This relates to the opportunities and motivation that employees, customers and suppliers have to access cash and stock from the organisation without paying for them.

A control plan could form part of the overall risk management strategy of the company.

Most fraud is uncovered as a result of tips and complaints from other employees, rather than routine audits.

While some frauds are well hidden, most are not. Fraud can be prevented and detected with common sense and inexpensive solutions. The US Association of Certified Fraud Examiners’ Report to the Nation on Occupational Fraud Abuse listed simple points, including:
- Setting the tone at the top. Employees who view their leaders as honest people are more inclined to emulate that behaviour and vice versa.
- Have a written code of ethics. This sets out what the organisation expects from its employees.
- Check employee references.
FRAUD INVESTIGATION & PREVENTION

- Check accounts regularly for unusual suppliers, unusual trends, etc.
- Have a hotline which allows whistleblowers an opportunity to complain and report suspected frauds without fear of retribution.
- Create a positive work environment. This helps reduce the motivation factor behind frauds.

The points above focus on the preferred scenario — “shutting the door before the horse has bolted” by implementation of various controls and other solutions to prevent or reduce the incidence of fraud.

Unfortunately, not all frauds can be prevented.

Once a fraud is committed the focus is on identifying offenders, and identifying and recovering losses and misappropriated assets. It is therefore important that appropriate lawyers and accountants are engaged.

A fraud investigation involves an objective inquiry and assessment of a suspected fraud with a view to quantifying the fraud, assigning responsibility and gathering admissible evidence.

A lawyer can provide advice on areas such as employment law (including interviewing suspects) and privacy law issues, reviewing the evidence obtained by the forensic accountant, liaising with police and assessing whether civil action should be taken to identify, locate and recover misappropriated assets.

It is important that the forensic accountant understands the rules of evidence. Evidence consists of facts, documents, testimony and physical exhibits which may be legally admitted in order to prove the facts in issue.

It is also important to ensure that the process of investigating an individual suspected of fraud is conducted in a just and reasonable way. If not, the company may breach unfair dismissal laws and could be exposed to civil action for defamation.

It is important to:

- Determine the company’s key objectives: punishment, loss recovery, future prevention, keep from the public, etc.
- Quantify and evaluate the source of the allegations of the fraud.
- Determine the period over which the alleged fraud is believed to have occurred.
- Determine the availability of documentation.
- Interview witnesses in private as soon as possible after the alleged fraud.
- Keep detailed records of the investigation.
- Set out a clear and concise chronology of significant events.
- Develop a profile on the suspect that may provide insight into the fraud and whereabouts of any assets taken.
FRAUD INVESTIGATION & PREVENTION

- Determine if collusion is applicable.
- Discuss with the lawyer as to whether the employee should be suspended pending results of a thorough investigation.
- Always have a third person present.
- Obtain a signed, dated written statement if possible.
- Identify what assets are missing.
- Secure assets that may be at further risk by changing passwords, bank account signatories, etc.

As computers play a major role in frauds, the forensic accountant generally needs the assistance of an IT expert to review computer workstation files and telephone logs. Record checks are normally conducted after hours.

Collection of information in the course of an investigation must be lawful and fair. Statutory searches with ASIC, Land Titles Office and motor vehicle registration bodies can identify relationships between the suspect and the payee and assets of the payee or their family.

Investigation methods include:
- interviewing suspects and witnesses;
- analysing relevant documents, accounts and transactions;
- conducting searches with ASIC to identify relationships;
- background checks on suspects;
- computer file/telephone log review by IT expert;
- surveillance by expert.

Once all evidence is collected it should be collated in an organised and readable report setting out:
- a covering report detailing instructions, approach adopted, evidence obtained, detailed workings and analysis and conclusions;
- a brief statement of facts;
- a list of witnesses;
- a list of exhibits;
- witness statements;
- investigator’s statements;
- personal history of the accused.

It is important to implement appropriate controls to prevent the fraud reoccurring.
Case Study

An employee of a real estate agency was accused of misappropriating in excess of $200,000 over a three-year period by tampering with tenants' rental payments and bond payments and covering up the alleged misappropriations by manipulating the associated trust accounting records.

On review of the documents, affidavits and other evidence, we quickly established that the accusations made were not clearly articulated or quantified and that while a lot of accounting documents had been discovered there was no detailed analysis and reconciliation undertaken that established the involvement of the defendant in any misappropriation to the exclusion of all other employees.

We further identified that the plaintiff had relied on only a small number of suspect transactions but had claimed that there was a much larger fraud by extrapolating across the whole client base.

The identified suspect transactions involved circumstances where tenants had produced original signed receipts for rental payments but the transaction had been processed to the tenant's ledger for a lesser amount and in some cases the tenant's log also recorded changes to the tenants' "paid to dates" and or "credit amounts".

The signed receipts did not bear the normal signature of any of the defendant or any other staff members; nevertheless it was alleged without evidence that the defendant had disguised her signature to prevent identification.

Significantly, the plaintiff's computer system was accessed by all staff member without entering an identifying password. Consequently, it was not possible without further investigation to determine who had processed any particular receipt or entered changes. But again without evidence it was alleged that the defendant had processed all the suspect transactions.

Based upon our analysis and critique of the plaintiff's evidence, the defendant's legal team were able to quickly understand the deficiencies in the plaintiff's case and ultimately the proceedings were dismissed.
10 | PROFESSIONAL INDEMNITY MATTERS

Matters involving professional indemnity are approached by the forensic accountant from two perspectives:

❖ Technical – has a breach of generally accepted accounting principles or generally accepted auditing standards or other standards of practice occurred? Professional negligence claims may also require expert evidence as to the commercial reality of advice given.

❖ Loss Quantification – what loss was incurred.

If the professional in question is an accountant, tax adviser, investment adviser, business valuer, auditor, director or management consultant, the forensic accountant is often involved with both perspectives. If the matter involves other professions, for example a medical practitioner, the forensic accountant may only be retained to perform a quantification of the loss.

We have been requested to provide our professional opinion on the conduct of numerous professional advisers including advising on:

• whether a firm of accountants acted in a reasonably prudent manner when introducing clients to a fraudulent infrastructure scheme;

• what a reasonably prudent accountant would have advised in respect of issues concerning carry forward tax losses, FBT and thin capitalisation;

• whether an audit committee of a professional association acted in a reasonably prudent manner in respect of a fraud committed by an employee;

• the appropriateness of an audit of a travel fund;

• what information could reasonably be included by an accountant in a business plan (subsequently used as a business selling memorandum);

• the appropriateness of both the value of a shareholder’s interest and the structure of the buyout.
11 | BUSINESS INTERRUPTION CLAIMS

A disruption to a business or section of it caused by an unforeseen event such as a fire or flood can have serious consequences. There is inevitably a loss of sales or production and ultimately profit.

To offset the financial consequences of a disruption most business today take out Business Interruption Insurance also referred to as Loss of Profit Insurance or Consequential Loss Insurance.

Business Interruption Insurance covers:

• profits that would have been earned had the interruption not occurred; and
• operating expenses that may continue to occur even if the activities of the business are interrupted.

Important elements of a Business Interruption Policy that requires regular review includes:

• adequacy of the sum insured;
• gross profit definition;
• uninsured working expenses; and
• indemnity period.

In the case of a business interruption claim being made, the lost profit is calculated based upon the business’ historical financial records adjusted for trends.

Disputes often arise between the insured and the insurer concerning the historical financial results of the business and the likely performance of the business had the interruption not occurred.

Forensic accountants are often called upon to assist in the identification and analysis of key financial records of the business and to undertake detailed trend analysis.
12 | TAXATION IMPLICATIONS OF COURT ORDERS & SETTLEMENTS

Income Tax Issues

There are numerous cases and pronouncements of the Commissioner of Taxation with respect to compensation receipts.

In general terms, compensation receipts take the character of the item they replace.

It is generally accepted that if the compensation is for loss of wages or income only, the amount will be assessable income. This will be the case whether it is paid on a periodic basis or lump sum basis (e.g. wrongful dismissal).

If the compensation is for loss of earning capacity for loss of limbs that is viewed as a capital item and amounts will be received in a capital nature. However, it is not always easy to differentiate between loss of income and loss of earnings capacity.

Typical compensation receipts, together with comments pertaining to assessability are as follows:

<table>
<thead>
<tr>
<th>Compensation Receipt</th>
<th>Character</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss of trading stock</td>
<td>Intrinsic of an income character</td>
</tr>
<tr>
<td>Termination of agency</td>
<td>Capital nature</td>
</tr>
<tr>
<td>Termination of management agreement</td>
<td>Capital nature</td>
</tr>
<tr>
<td>Cancellation of business contract</td>
<td>Cancellation of ordinary contracts will be of an income nature</td>
</tr>
<tr>
<td>Compensation for loss of fixed asset</td>
<td>Capital nature</td>
</tr>
</tbody>
</table>

Capital Gains Tax Issues

On 20 September 1985, capital gains tax legislation was introduced. Prior to this date, there was a clear advantage in having a compensation receipt determined as capital in nature and therefore tax-free.

Tax Ruling TR 95/35 deals with “Capital Gains Tax: treatment of compensation receipts” and was released on 6 December 1995. It describes the CGT consequences of compensations received for non-personal injuries and wrongs.

According to the ruling, a compensation receipt received by a taxpayer is any amount in respect of a right to seek compensation or a cause of action or any proceedings instituted by the taxpayer in respect of that right or cause of action, whether or not:

- in relation to any underlying asset;
- arising out of court proceedings; or
- made up of dissected amounts.
TAXATION IMPLICATIONS OF COURT ORDERS & SETTLEMENTS

The “underlying asset” is the asset that is disposed of or has suffered permanent damage or has been permanently reduced in value because of some act, which has ultimately resulted in a right to seek compensation.

Example

If a taxpayer receives compensation for the destruction of the taxpayer’s truck, the truck is the underlying asset. If the underlying asset (the truck) was a pre-CGT (pre-20 September 1985) the compensation will be tax-free.

Permanent damage refers to damage or reduction in value which will have a permanent effect unless some action is taken by the taxpayer to put it right.

TR 95/35 states that if no “underlying asset” can be identified, the compensation will be taken to relate to the “disposal of the right to seek compensation”, which in itself is an asset for CGT purposes [refer High Court Case Georgiadis v. Australian and Overseas Telecommunications Corporation (1994) 179 CLR 297]. Accordingly, where no underlying asset can be identified and where the right to sue was acquired post 20 September 1985, the full compensation receipt will be taxable as a capital gain.

Accordingly, it is important, wherever possible, to identify an underlying asset.

Total acquisition costs of post-CGT assets should be reduced by the amount of the compensation. No capital gains or loss arises in respect of that asset until the taxpayer disposes of it. If the compensation exceeds the total indexed acquisition cost of the underlying asset, there is no CGT consequences in respect of the excess compensation amount.

An individual taxpayer is exempt from CGT in relation to compensation or damages awarded for any wrong, injury or illness suffered personally [refer old section 160ZB(1) of the Income Tax Assessment Act 1936 (Cth) or subsection 118-15(b) of the 1997 Act].

A capital gain or capital loss is exempt from liability under section 118-37(1) of the 1997 Act if it directly relates to:

• compensation or damages for any wrong or injury suffered by a taxpayer in his or her occupation; or
• compensation or damages for any wrong, injury or illness the taxpayer or a relative suffers personally (e.g. damages for personal injury, defamation or negligence of a solicitor failing to instigate a personal injury action).
TAXATION IMPLICATIONS OF COURT ORDERS & SETTLEMENTS

Goods & Services Tax Issues

On 20 June 2001, the Commissioner released ruling GSTR 2001/4 – “GST Consequences of Court Orders and Out of Court Settlements” which was amended on 12 November 2008 by GSTR 2001/4A.

In summary these rulings mean that litigation will not take an ordinarily taxable transaction outside the GST net and litigation does not of itself, attract GST consequences.

In general, there is no GST payable if—

• a payment of damages is made;
• a payment of party/party costs is made;
• a payment to a plaintiff/claimant by an insurer through and/or on behalf of an defendant/insured is made; or
• an undertaking to discontinue proceedings as part of a settlement is made—
given that payment or undertaking stands alone, there are no GST consequences.

In general, GST is payable if—

• the underlying transaction giving rise to the litigation (earlier supply) or a component of a settlement or judgement (a current supply) is a taxable supply (that is, not GST-free or input taxed); and
• the party receiving the payment is required to be registered for GST; and
• the payment relates to a supply made in the course of carrying on an enterprise—
then the GST consequences of the underlying transaction, or the new component, carry through to the settlement or judgment.

Examples

1. Plaintiff claims damages for breach of copyright. Damages are paid by way of settlement.

   No GST is payable as the damages claim is not regarded as constituting a supply.

2. Plaintiff claims damages for breach of patent. Terms of settlement are that the defendant pays $70,000 for damages and $30,000 for an agreement to use the intellectual property contained in the copyright.

   GST is not payable on the damages but is payable on the use of the copyright.

3. Bloggs Pty Ltd sells services to Jones Pty Ltd for $5,000 plus $500 GST. Jones Pty Ltd does not pay. Bloggs Pty Ltd sues and obtains judgment for $5,500 plus costs.

There will always be a question of fact to be determined as to whether a settlement payment will be purely for breach or whether part of it reduces the original agreed consideration.

Taxation of compensation receipts has many issues to be considered. Specific advice should be obtained in respect of each particular case.
Appendix I

Supreme Court (General Civil Procedure) Rules 2005
S.R. No. 148/2005

FORM 44A

Rule 44.01

EXPERT WITNESS CODE OF CONDUCT

1. A person engaged as an expert witness has an overriding duty to assist the Court impartially on matters relevant to the area of expertise of the witness.

2. An expert witness is not an advocate for a party.

3. Every report prepared by an expert witness for the use of the Court shall state the opinion or opinions of the expert and shall state, specify or provide—

   (a) the name and address of the expert;
   (b) an acknowledgement that the expert has read this code and agrees to be bound by it;
   (c) the qualifications of the expert to prepare the report;
   (d) the facts, matters and assumptions on which each opinion expressed in the report is based (a letter of instructions may be annexed);
   (e) (i) the reasons for,
       (ii) any literature or other materials utilised in support of,
       (iii) a summary of—
       each such opinion;
   (f) (if applicable) that a particular question, issue or matter falls outside the expert's field of expertise;
   (g) any examinations, tests or other investigations on which the expert has relied, identifying the person who carried them out and that person's qualifications;
   (h) a declaration that the expert has made all the inquiries which the expert believes are desirable and appropriate, and that no matters of significance which the expert regards as relevant have, to the knowledge of the expert, been withheld from the Court;
   (i) any qualification of an opinion expressed in the report without which the report is or may be incomplete or inaccurate; and
   (j) whether any opinion expressed in the report is not a concluded opinion because of insufficient research or insufficient data or for any other reason.
APPENDIX I

4. Where an expert witness has provided to a party (or that party’s legal representative) a report for the use of the Court, and the expert thereafter changes his or her opinion on a material matter, the expert shall forthwith provide to the party (or that party’s legal representative) a supplementary report which shall state, specify or provide the information referred to in paragraphs (a), (d), (e), (g), (h), (i) and (j) of clause 3 of this code and, if applicable, paragraph (f) of that clause.

5. If directed to do so by the Court, an expert witness shall—
   (a) confer with any other expert witness; and
   (b) provide the Court with a joint report specifying (as the case requires) matters agreed and matters not agreed and the reasons for the experts not agreeing.

6. Each expert witness shall exercise his or her independent judgment in relation to every conference in which the expert participates pursuant to a direction of the Court and in relation to each report thereafter provided, and shall not act on any instruction or request to withhold or avoid agreement.
Appendix II

FEDERAL COURT OF AUSTRALIA

Practice Note CM 7

EXPERT WITNESSES IN PROCEEDINGS IN THE FEDERAL COURT OF AUSTRALIA

1. Practitioners should give a copy of the following guidelines to any witness they propose to retain for the purpose of preparing a report or giving evidence in a proceeding as to an opinion held by the witness that is wholly or substantially based on the specialised knowledge of the witness (see Part 3.3 - Opinion of the Evidence Act 1995 (Cth)).

2. The guidelines are not intended to address all aspects of an expert witness’s duties, but are intended to facilitate the admission of opinion evidence, and to assist experts to understand in general terms what the Court expects of them. Additionally, it is hoped that the guidelines will assist individual expert witnesses to avoid the criticism that is sometimes made (whether rightly or wrongly) that expert witnesses lack objectivity, or have coloured their evidence in favour of the party calling them.

Guidelines

1. General Duty to the Court

1.1 An expert witness has an overriding duty to assist the Court on matters relevant to the expert’s area of expertise.

1.2 An expert witness is not an advocate for a party even when giving testimony that is necessarily evaluative rather than inferential.

1.3 An expert witness’s paramount duty is to the Court and not to the person retaining the expert.

2. The Form of the Expert Evidence

2.1 An expert’s written report must give details of the expert’s qualifications and of the literature or other material used in making the report.

2.2 All assumptions of fact made by the expert should be clearly and fully stated.

2.3 The report should identify and state the qualifications of each person who carried out any tests or experiments upon which the expert relied in compiling the report.

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1 As to the distinction between expert opinion evidence and expert assistance see Evans Deakin Pty Ltd v. Sebel Furniture Ltd [2003] FCA 171 per Allsop J at [676].

2 See rule 35.3 Civil Procedure Rules (UK); see also Lord Woolf Medics, Lawyers and the Courts [1997] 16 CJQ 302 at 313.


4 See rule 35.10 Civil Procedure Rules (UK) and Practice Direction 35 – Experts and Assessors (UK); HG v. the Queen (1999) 197 CLR 414 per Gleeson CJ at [39]-[43]; Ocean Marine Mutual Insurance Association (Europe) OV v Jetopay Pty Ltd [2000] FCA 1463 (FC) at [17]-[23]
APPENDIX II

2.4 Where several opinions are provided in the report, the expert should summarise them.

2.5 The expert should give the reasons for each opinion.

2.6 At the end of the report the expert should declare that “[the expert] has made all the inquiries that [the expert] believes are desirable and appropriate and that no matters of significance that [the expert] regards as relevant have, to [the expert’s] knowledge, been withheld from the Court”.

2.7 There should be included in or attached to the report:
   (i) a statement of the questions or issues that the expert was asked to address;
   (ii) the factual premises upon which the report proceeds; and
   (iii) the documents and other materials that the expert has been instructed to consider.

2.8 If, after exchange of reports or at any other stage, an expert witness changes a material opinion, having read another expert’s report or for any other reason, the change should be communicated in a timely manner (through legal representatives) to each party to whom the expert witness’s report has been provided and, when appropriate, to the Court.

2.9 If an expert’s opinion is not fully researched because the expert considers that insufficient data are available, or for any other reason, this must be stated with an indication that the opinion is no more than a provisional one. Where an expert witness who has prepared a report believes that it may be incomplete or inaccurate without some qualification, that qualification must be stated in the report.5

2.10 The expert should make it clear when a particular question or issue falls outside the relevant field of expertise.

2.11 Where an expert’s report refers to photographs, plans, calculations, analyses, measurements, survey reports or other extrinsic matter, these must be provided to the opposite party at the same time as the exchange of reports.6

3. Experts’ Conference

3.1 If experts retained by the parties meet at the direction of the Court, it would be improper for an expert to be given, or to accept, instructions not to reach agreement. If, at a meeting directed by the Court, the experts cannot reach agreement about matters of expert opinion, they should specify their reasons for being unable to do so.

M E J BLACK
Chief Justice
25 September 2009

5 The Ikarian Reefer [1993] 20 FSR 563 at 565
   See also Ormrod Scientific Evidence in Court [1968] Crim LR 240
Appendix III

FORENSIC ACCOUNTING
SAMPLE ENGAGEMENT LETTER

Addressed to Solicitor and / or Client

Dear Client / Solicitor

Litigation Proceedings

We understand that you / your client wish/es to retain our firm in relation to your / their .......... proceedings.

Prior to undertaking any substantial work on your client’s / your behalf, we wish to clarify for you / your client the basis upon which this firm is prepared to act for you / your client, the way in which we would, if retained, charge for work done on your behalf and your obligations in relation to the payment of our costs.

1. PURPOSE AND SCOPE

1.1 We have been advised that you / your client would like us to:


1.2 To the extent you / your client ask us to reach conclusions or form opinions, we are obliged to do so without regard to the impact that our conclusions may have on the litigation.

1.3 We have also found that we are often required to perform additional work to that originally agreed resulting from either the findings of our initial engagement or our discussions with Counsel.

1.4 We note that it is impractical to obtain instructions on every aspect of our involvement in this litigation matter and there will often be instances where we will have to use our discretion in determining the work to be performed.

2. TIMING

2.1 You / your client has indicated to us that you / your client require this engagement to be completed by [Date of Completion]. We anticipate that we will be able to meet this timetable, provided we receive the necessary information in a timely manner.

Important notice

The engagement letter contained here is provided as an example only. An engagement letter should be tailored to the specific requirements and circumstances of the engagement being undertaken. Neither The Institute of Chartered Accountants in Australia or any of its members (a) warrants that the sample engagement letter is complete, accurate and reliable (b) accepts any responsibility for any loss resulting from reliance on this engagement letter. You should seek legal advice as to the contents of an engagement letter.
APPENDIX III

3. CONFLICT OF INTEREST

3.1 We have performed an internal search for potential client conflicts based upon the names of the parties that you / your client have provided. We are not aware of any circumstances that, in our view, would constitute a conflict of interest or would impair our ability to provide objective assistance in this matter. Should any unforeseen conflicts arise that would impair our ability to perform objectively, we would advise you / your client immediately and determine our continued involvement in the engagement.

4. LEGAL PROFESSIONAL PRIVILEGE AND CONFIDENTIALITY

4.1 We understand that all communications between ourselves and you [only applicable to solicitors] as legal advisors, as well as any materials or information developed or received by us, whether oral or written, may be protected by legal professional privilege and they will of course be treated by us as confidential.

4.2 Any written reports or other documents which we prepare are to be used only for the purpose of this litigation and may not be published or used for any other purpose without our written consent.

5. STAFFING AND BILLINGS

5.1 The professional staff assigned to your litigation matter will perform work under the ultimate supervision of a partner or principal.

5.2 Each litigation report is unique in its preparation and presentation. It is therefore not possible for us to furnish a precise estimate of our final costs as they will be subject to many factors.

5.3 Our fees are based upon the time necessarily spent on the assignment by professional and secretarial staff with the appropriate level of skill and experience. Costs relating to the work performed by the people assigned to the engagement are charged on the basis of time units of [insert method of charging]. This method of time costing applies to all attendances, such as conferences, telephone calls, attendances at court and travelling and waiting time.

5.4 The current average hourly rate (or detailed breakdown per level of staff) for all professional and secretarial staff is $XXX. Our charge out rates are reviewed on [insert review dates] each year.

5.5 Disbursements such as photocopying, courier, facsimile, telephone, search fees and travelling expenses will be itemised separately and charged as incurred.

5.6 Based on our understanding of the work that we have been asked to undertake at this time, we estimate that our fees may be in the vicinity of $....... to $........ [Optional]- A retainer of $....... will be payable prior to the commencement of our work and is included in our estimate of fees. This estimate of our fees excludes the cost of disbursements and any additional work undertaken by us at your request (or your Counsel’s request) in the future.

5.7 As we have stated above, this is an estimate only and could vary for any number of reasons. This estimate does not amend or replace our basis of charging as set out above but is indicative only and subject to additional work being undertaken during the course of our investigation, as deemed necessary by ourselves, yourself, or your client.
5.8 We will notify you / your client in the event that our costs will exceed the above preliminary estimate prior to additional costs being incurred. At that time we will provide you / your client with a further estimate of the overall fee.

5.9 As you / your client have engaged our services in this matter, our billings will be directed to you / your client. We understand that you / your client accept responsibility for their payment. Our fees will be billed on a (weekly, monthly, periodic) basis, detailing the work undertaken on your behalf during that period. Our terms require payment within …… days from the date of invoice. Any unpaid amounts will attract interest at our overdraft rate (presently ……%).

5.10 Our fee is not contingent upon the final results and we do not warrant or predict results or final developments in this matter.

5.11 If you / your client wish to retain our services, please complete the confirmation and return a signed copy of this letter to our office. Please note that we will not be able to commence any substantial work on your behalf until we have received the signed agreement [optional and a cheque for the retainer of $………]. We will send you an invoice to acknowledge the payment of the retainer once it has been received by us.

5.12 In addition, to our fees you agree to pay any tax or other charge imposed on us (now or in the future) in relation to any transactions arising in connection with or as an outcome of, this agreement including (but not limited to) a goods and services tax.

6. LIMITATION OF LIABILITY

6.1 We shall use reasonable skill and care in the provision of the services set out in this letter.

6.2 We shall accept liability to pay damages for losses arising as a direct result of breach of contract or negligence on our part in respect of services provided in connection with, or arising out of, the engagement set out in this letter (or any variation or addition thereto). However, such liability of [insert firm name], its partners and staff (whether in contract, negligence or otherwise) shall in no circumstances exceed [five] times the fees paid in the aggregate in respect of all such services.

6.3 You / your client agree to hold our firm, its partners, and employees harmless from any liabilities, costs and expenses relating to, or arising from this engagement (including, without limitation, legal fees and the time of our personnel involved) incurred by reason of any action we take in good faith (unless we are negligent).

6.4 You / your client agree that if you / your client make any claim against us for loss as a result of a breach of our contract, and that loss is contributed to by your / your client’s own actions, then liability for your / your client’s loss will be apportioned as is appropriate having regard to the respective responsibility for the loss, and the amount you / your client may recover from us will be reduced by the extent of your / your client’s contribution to that loss.

If you / your client have any questions regarding the scope of our engagement, or else if any of the terms of this agreement are unclear, please contact either myself or ...................... of this office and we will discuss the matter at no cost to you / your client.

We look forward to hearing from you / your client.

Yours faithfully,
Russell John Munday

Russell is a chartered accountant and holds a Bachelor of Commerce degree obtained from the University of Melbourne and a Graduate Diploma in Finance & Investment from the Securities Institute of Australia.

He is a Fellow of the Institute of Chartered Accountants in Australia and a Fellow of the Financial Services Institute of Australasia, an Associate of the Australian Institute of Management and an Associate of the Australian Institute of Company Directors.

He has over 30 years experience in Chartered Accounting being employed in many areas of accounting including auditing, business and taxation services and corporate finance.

As a Forensic Accountant he undertakes investigations, assessment of loss of earnings, expert determinations, professional opinions (of the actions of accountants, auditors and advisers) and the valuation of businesses for compliance (CGT, stamp duty, probate, etc.), mergers and acquisition (business acquisitions, sales, mergers, partnership admissions/retirements, etc.) and dispute (matrimonial disputes, shareholder disputes, etc.) reasons.

Russell has appeared as an expert witness in a variety of matters in the Supreme Court, Federal Court, County Court and Family Court.

He was the founding chair of the Melbourne branch of the Forensic Accounting Special Interest Group of the Institute of Chartered Accountants in Australia and is a member of the Business Valuation Special Interest Group.

He has presented on the subject of “Business Valuations” on numerous occasions such as at the CPA Australia’s Congress, for Legal & Accounting Management Seminars Pty Ltd and at the Leo Cussen Institute.
P Bruce Wilkinson

Since 1989, Bruce has specialised in Forensic Accounting, undertaking investigations, assessment of loss of profits, expert determinations, professional opinions (concerning actions of accountants, auditors and advisers) and valuation of businesses for a variety of purposes.

Bruce is a Fellow of the Institute of Chartered Accountants in Australia and holds a Bachelor of Business (Accounting) obtained from the Royal Melbourne Institute of Technology in 1979.

He is a Fellow of the Taxation Institute of Australia, a Registered Company Auditor, and a Registered Tax Agent.

Bruce is a member of the Institute of Chartered Accountants in Australia’s Forensic Accounting Special Interest Group and the Business Valuation Special Interest Group and has lectured on Dispute Analysis in a postgraduate course at the University of Melbourne.

Having over 35 years experience in both commercial and professional accounting services, Bruce has been employed in many areas of accounting including auditing, business services and taxation services and in commerce.

Bruce has prepared expert witness reports for matters before most major jurisdictions in Australia and has provided a deposition for a matter before the Eastern District Court of New York. In support of reports prepared Bruce has appeared as an expert witness in Supreme Court of Victoria, Federal Court of Australia, Family Court of Australia, County Court of Victoria, Magistrates’ Court of Victoria, Victorian Civil and Administrative Tribunal and in various Arbitrations.

With extensive experience as a specialist forensic accountant, Bruce is able to readily advise on the commercial reality underlying a dispute and provide invaluable guidance on the accounting evidence.

Bruce also provides more traditional corporate service consulting work including consulting to State Government authorities, and claimants, on the financial impact on businesses affected by the compulsory acquisition of property from which they operate and the level of compensation payable on the destruction or relocation of the business.
Munday Wilkinson is a boutique forensic accounting firm established in July 2000 by Russell Munday and Bruce Wilkinson.

We offer the legal profession and others quality service and technical proficiency commensurate with the larger accounting firms. At the same time, we are able to provide a more personalised service as we operate in a framework that enables us to be very responsive to our clients in a cost effective manner.

The directors, Russell Munday, Bruce Wilkinson and Paul Spence, jointly have over 65 years accounting experience including over 45 years specialising in forensic accounting. We have extensive experience in:

- Business and Company Valuations
- Family Law investigations, valuations and tax advice on settlements
- Quantification of Economic Losses
- Fraud Audits and Reviews
- Loss of Earnings Assessments for personal injury matters
- Business relocation or compulsory acquisition – claims assistance
- Due Diligence Reviews
- Professional Negligence matters concerning professional advisors
- Solvency Reviews
- Expert Determinations
- Expert Witness
Published matters in which Munday Wilkinson has provided expert evidence include:

- **Balanced Securities Limited v. Bianco & Ors (No. 2) [2010] VSC 201**
- **First east Auctions Holdings Pty Ltd v. Ange [2010] VSC 72**
- **Cibalevski v. Ristevski (No. 2) [2010] VCC 503**
- **Bacchus Gift Pty Ltd v. Martrak (Vic) Pty Ltd & Reardon [2010] VCC 541**
- **Khuu and Lee Pty Ltd v. Micropos Pty Ltd and Others [2010] SADC**
- **Sali & Anor v. Metzke & Allen [2009] VSC 48**
- **Kaleni v. Apostolidis & Ors [2009] VSC 208**
- **Lowe v. Mack Trucks Australia Pty Ltd [2008] FCA 439**
- **Saltonspruse Pty Ltd v. Bencorp Investments No. 3 Pty Ltd (formerly Vac-Tech Group Pty Ltd) & Anor [2005] VSC 65**
- **Reiterer & Ors v. Csenar & Anor; Csenar & Anor v. Reiterer & Ors [2005] VSC 12**
- **Plain v. Howard & Ors [2004] VSC 240**
- **Vand Pty Ltd v. Highpoint Shopping Centres (Leasing) Pty Ltd [2004] VCAT 2016**
- **Saint-Gobain RF Pty Ltd v. Maax Spa Corporation Pty Ltd [2004] VSC 335**
- **WGB & CEM [2004] FMCAfam 17**
- **Kemp v. CBT Refrigerated Transport Pty Ltd [2002] VSC 540**
- **National Office Products Ltd v. The Commonwealth of Australia [2001] VSC 162**
- **Macdav Pty Ltd v. Alliswell Pty Ltd [2001] VCAT 2436**
- **Nemur Variaty Pty Ltd v. National Australia Bank Limited & Anor [1999] VSC 342**
- **ACN 006 530 132 (in liq.) v. Freedman [1999] VSC 441**

The firm produces a regular newsletter **MW Forensic** an information bulletin on topical forensic accounting or expert witness matters pertinent to the legal profession.