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Business valuations – do you really **understand them?**

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1.0 Introduction

1.1 You have probably been in the situation where a business valuation has been prepared for a matter and you have provided the valuation report to the client.

Having read the report, the client (and perhaps you as well) will say "I don't understand why the value is so high/low?" (delete as applicable for your client!).

1.2 The first step to answering that question is to understand how the valuer has arrived at their opinion of value. But that is not the only reason why you should understand how the valuer has arrived at their opinion.

If you don't understand how the valuer has arrived at the value set out in their report:

- You will not understand why the value is more or less than what was expected.
- You will not know if the valuer has made an assumption that is in complete contrast to the facts or assertions of the parties.
- When completing the parties personal balance sheet, you will not know if double counting or omitting assets and liabilities as you will not be aware of how the valuer has accounted for them in their valuation, if at all.

1.3 The objective of this paper is to provide you with a basic understanding of business valuations and how to get a better understanding of the conclusions reached in a business valuation report. After discussing the basics of business valuations, the paper will provide a series of questions that you can ask yourself when reviewing business valuations to help you understand how the valuer has reached their conclusions. You will then know how to better incorporate the valuation in the context of each matter.

Each valuation report must be read in the context of its individual circumstances in order to be properly taken into account in the matter for which it was prepared.

1.4 Whilst not normally covered in a business valuation paper, I'll also discuss the Shakespeare quotes "A rose by any other name would smell as sweet" and a twist on "To be, or not to be, that is the question". But you'll have to read on to find out how I manage to make that relevant to our topic of understanding business valuations.

1.5 It is sometimes said that business valuation is not just a science, but an art – and I would generally agree with that statement. From my experience, it can be relatively simple to teach a well trained accountant about the science of valuations, being the valuation approaches and methodologies to be used. However, it often takes that well trained accountant some years before they start to perform the art of valuation, being those parts of the valuation process where professional judgement must be exercisedin order to arrive at a robust and supportable opinion.

1.6 You may well be asking yourself, if it can take a well trained accountant some years to be able to perform the art of valuation, what hope does a lawyer have?

1.7 As a lawyer and a user of valuation reports, it is not your role to be able to exercise the art of business valuation. However, I believe it is your role to be able to understand the valuation reports that you read. If you blindly accept and adopt the value set

out at the front of a report because you don't understand how the value was arrived at, then you could be putting your client at a disadvantage. Perhaps the valuation relies on a fact or assumption that contradicts your client's case. Perhaps the treatment of assets or liabilities within the company being valued is inconsistent with the treatment of assets or liabilities outside of the company and that could lead to an omission or double count. Perhaps there could be other issues but if you do not understand how the value has been arrived at, then you will never know if simply accepting the value in the report is putting your client at a disadvantage.

2.0 A Little Bit Of The Art Of Business Valuations

2.1 For the most part, it is not necessary for a solicitor to understand the art of business valuations. However, there is one concept that I consider to be part of the art of business valuations that is so fundamental that I think it must be understood in order to have any understanding of how a value has been arrived at. That concept is the relationship between risk and return.

2.2 The concept of risk versus return can be most easily seen by comparing different types of investments.

2.3 One of the lower risk investments that we can make is to put our money in a bank. There is very little risk of our money not being returned to us. Therefore, we can only expect a small return in the form of interest on the money we have invested. Low risk means a low return.

2.4 An example of an intermediate level of investment risk would be an investment in the share market. An investment in the share market carries a certain level of risk as the price of shares can go up and down. Therefore, if there is a risk that we could lose some of our money if we invest in the share market, why do many people invest in the share market as opposed to leaving it in the bank to earn interest? Some might say the answer is greed. We hear stories of people making 10, 20 sometimes 30 per cent and think "I want some of what they're getting".

2.5 Whether consciously or not, by investing in the share market we accept a higher level of risk in the hope and anticipation of higher returns. There is the potential for the money we invest to grow as share prices increase. The dividends we receive on the shares can sometimes be more than the interest we would have received had we invested our money in the bank. Whilst the returns can be higher from our investment in the share market, we must also accept a higher level of risk if we choose to invest in the share market because there is the potential for the value of our investment to decrease.

2.6 An investment in a small business will usually carry more risk than an investment in the share market. An investment in a small business will usually mean buying a business that operates in one location and generates its income from a relatively narrow group of goods or services. Therefore, if a competitor opens up next door, the goods or services sold go out of fashion or are superseded by new technology, then the profits earned by the business can quickly reduce or disappear. In comparison, an investment in the share market usually means an investment in several companies operating different businesses in different areas, therefore spreading and reducing the risk. If there is greater risk by investing in a small business why do many people invest in small businesses as opposed to the share market? The answer again is because there is the potential for the returns on our investment to be even greater. Again, whilst the returns are higher, we must also accept a higher level of risk if we choose to invest in a small business.

2.7 When buying a business, you are not just buying the tangible assets such as plant & equipment, stock etc that you need to operate the business. What you are really buying is the right to receive the profits that can be earned from operating that business. In the same way that you put your money in the bank to earn interest or buy shares to receive dividends, you buy a business to be able to receive the profits from that business.

2.8 Like many things in life, running a business is not certain and the uncertainty of those future profits must be considered. You might be willing to pay something close to $100 for the right to receive $100 at a point in the future if it is certain that you will receive that $100. However, what if there is some uncertainty about where you will receive the $100? If there is some risk, you probably wouldn't be willing to pay as much. And it's the same when buying a business. It is logical that we would pay less per dollar of future profits where the risk associated with those profits is higher. Therefore, higher risk means a lower value per dollar of future expected profits.

2.9 The art of business valuations is about considering the potential future returns and assessing the level of risk associated with those future returns in order to determine their value, i.e., how much might someone pay for the right to receive those future profits, given the risks and uncertainties involved.

3.0 The Science Of Business Valuations

3.1 The science of performing a business valuation is the valuation approaches and processes that a valuer uses in order to arrive at a business valuation. Knowing these approaches and processes is the basics of business valuations and being familiar with them is essential to understanding the value set out in a report.

3.2 What is actually being valued?

3.3 Before we can consider the valuation approach to be adopted, it is important for both the valuer and the person instructing the valuer to know what is being valued. Is the valuation just the value of the business or is it the company that owns and operates that business, including any other assets and liabilities of the company? Similarly, is the value for 100% of the business or company, or is it for a share in that business or company?

3.4 Let's consider a company called Davis Wholesalers Pty Limited. The company operates a wholesaling business.

3.5 The instructions about what is to be valued will have a significant impact of the value that is set out in the valuer's report. Let's assume that the business called Davis Wholesalers has a value of $1,000,000. Let's also assume that the company, Davis Wholesalers Pty Limited owns all of the assets associated with the business and the company also has a bank loan of $300,000.

3.6 If the valuer was instructed to value the business of Davis Wholesalers, then the valuer's report would set out a value of $1,000,000. However, if the valuer was instructed to value Davis Wholesalers Pty Limited, then the report would set out a value of $700,000, being the value of the business less the debt held by the company.

3.7 This is because the value of the company includes all of the assets and liabilities held by the company, which includes but is not limited to the business. Whereas the value of the business will exclude those assets and liabilities that are held by the company and are not part of the business.

3.8 Whilst the above is a simple example, from my experience what is to be valued is not always clearly set out in the letter of instructions to a valuer. As can be seen from the above example, it is important to define what is to be valued to ensure that it is appropriate for the circumstances of a matter.

3.9 It is also very important to read the valuation report to understand what has been valued. From my experience a report prepared by a business broker will generally set out the value of the business and not the value of the company. A report prepared by an accountant is more likely to set out the value of the company, but will sometimes set out the value of the business only.

3.10 The valuation premise

3.11 The valuation premise or basis of valuation forms part of the circumstances or assumptions on which the valuation is based. The most common basis of valuation is the premise of "market value". The definition of market value is often described as the price at which an asset would be exchanged between a willing but not anxious buyer and a willing but not anxious seller.

3.12 The premise of a valuation can have a significant impact on the value. For example, the value arrived at by adopting the premise of going concern could be very different compared to the premise of liquidation.

3.13 It is important to understand the premise of valuation and ensure that it is appropriate given the purpose of the valuation. For example, in Family Law matters, it is common for the appropriate premise of valuation to be "value to the party/owner". To show how the valuation premise can have an impact on a valuation, I will compare how the premise of value to the party differs to market value in the value of a business for Family Law purposes.

3.14 Let's again adopt Davis Wholesalers Pty Limited which operates a wholesaling business. If we were to determine the value of the business adopting the premise of market value, then in determining the risks associated with buying the business it would be appropriate to consider whether the sellers were restrained in any way from opening up new business in competition. If there was no restraint in place and the business relied heavily on the relationships between the owners and suppliers or owners and customers, then the lack of restraint would have a significant impact on the value of the business as a purchaser is likely to pay significantly less if the sellers could easily open up a business in competition.

3.15 However, if the valuer was to determine the value adopting the premise of value to the party, then the issues of restraints do not need to be considered. This is because the existing relationships are held by the current owners and there is no risk to them that they will open up in competition against themselves. Therefore, adopting the premise of value to the party eliminates one of the risks that would be associated with adopting a market value premise.

3.16 If the market value premise was to be determined assuming no restraints in place, then there is likely to be a reasonable difference in value between the market value and value to the party premises. This is because the risks between the two valuation assumptions are significant. However, if it was assumed that reasonable restraints were in place and there would be a handover period where the seller continued in the business for a period of time, this would reduce the risks between the two valuation premises and therefore the values adopting each premise would be more comparable.

3.17 As can be seen above, the valuation premise and assumptions can have a significant impact on value, although the amount of any difference will depend on the circumstances of each matter. Therefore, it is important to ensure that the valuation premise is appropriate for the circumstances of the matter.

3.18 Common valuation approaches and methodologies

3.19 The most common valuation methods for valuing businesses are set out below:

i) The net present value of the projected cash flows (discounted cash flow method);

ii) The capitalisation of future maintainable earnings method; and,

iii) An asset based method such as the adjusted book value method (other asset based methods may be appropriate where the business is not intended to continue as a going concern).

3.20 The discounted cash flow method is normally considered a superior technical approach because it allows for fluctuations in future performance of the business to be recognised. It also values the business on the basis of the future free cash flows generated. However, to utilise this methodology requires reliable long term cash flow forecasts. The nature of many small to medium sized businesses does not lend itself to preparing cash flow projections over a five or ten year period with the necessary reliability. Therefore, this method is not often applied to value small to medium sized businesses.

3.21 Where there is a lack of reasonably reliable cash flow forecasts, the capitalisation of future maintainable earnings is the most common method applied to value an actively trading business. This method requires the determination of the future maintainable earnings of the business and the assessment of an appropriate capitalisation rate. The capitalisation rate is applied to the maintainable earnings of the business in order to determine the value of the business. The amount by which the value of the business exceeds the value of the net business assets (the assets and liabilities required to operate the business) is the value of goodwill. The surplus assets and liabilities of the company are then added to determine the value of the company. Should the value of the net business assets be greater than the capitalised earnings or business value, then an asset based method is normally the appropriate method to adopt.

3.22 The asset based methods assume that the value of the business is determined by the aggregated value of its assets less its liabilities. The adjusted book value method involves reviewing the recorded values of the assets and liabilities of the company as disclosed in the financial statements. The recorded values are adjusted where they are not a reasonable reflection of the value of assets and liabilities as at the valuation date. An asset based method is usually performed adopting the assumption of going concern, an orderly realisation of assets or a liquidation basis. The values adopted for the assets and liabilities will reflect the assumptions adopted. On occasion, it may be appropriate to adopt different assumptions for different assets in the one company. The asset based methods are often appropriate for an entity with passive investments, i.e., a company without an actively trading business, or for an actively trading business where the capitalised earnings are less than the net tangible business assets.

3.23 The most common valuation method adopted to value small to medium businesses is the capitalisation of future maintainable earnings. I will therefore discuss this method in more detail. This method can be broken down into three steps:

i) Determine the future maintainable earnings, i.e., what level of profits can be expected in the future;

ii) Determine the multiple or capitalisation rate to apply to the earnings of the business. The future maintainable earnings times the valuation multiple is often referred to as the capitalised earnings or enterprise value and represents the value of the business;

iii) A comparison of the business value to the value of the tangible assets utilised in generating the earnings is then made to determine if the business has any goodwill.

3.24 *Determining the future maintainable earnings*

3.25 The first step in valuing a business is to determine the future maintainable earnings of the business. This means determining the estimated profits that are most likely to be received by the owner of the business in the future and on a maintainable basis.

3.26 The future maintainable earnings are normally determined by reference to the trading results of past years. Whilst past performance is no guarantee for future performance, if the business has demonstrated if has been able to achieve certain results in the past, then all things being equal there would often be reasonable prospects of the business achieving similar results in the future.

3.27 However, the past results as reported in the financial statements need to be considered and adjusted where appropriate for:

i) Non arms length transactions - these are the transactions between the business and entities or persons related to the owner. Common non arms length transactions include wages, superannuation and rent (if the business owner also owns the premises from which the business is conducted);

ii) Abnormal or one off transactions – these are items of income or expense that are greater than normally incurred due to a one off event and are not likely to be incurred on a regular basis;

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iii) Non-business income and expenses – these could be expenses of a personal nature claimed as business expenses or other income and expenses of the company conducting the business but not related to the business, such as property rental income and expenses.

3.28 The adjusted historical results are then often averaged to determine the future maintainable earnings of the business. The result of averaging recent earnings is then reviewed to ensure that they represent the likely future earnings and alternatives such as placing a higher weighting on more recent years may be adopted.

3.29 *Determining the earnings multiple*

3.30 The business valuer considers the risks associated with the future earnings of the business in order to determine the earnings multiple.

3.31 The earnings multiple can also be described as a capitalisation rate and can be expressed as a whole number or a percentage. For example, a multiple of 4 can be described as a capitalisation rate of 25% (100% divided by 4) and a multiple of three would be a capitalisation rate of 33.3% (100% divided by 3).

3.32 The capitalisation rate is effectively the rate of return on the amount invested in the business. For example, a capitalisation rate of 25% means that if we purchased that business we would hope to achieve a return of 25% on the funds that we invested in the business. This could be compared to a return of say 10% for investing in the share market or 5% for investing our money in a bank. The higher return reflects the higher risks associated with the investment in a small business.

3.33 *Calculating the value of goodwill, if any*

3.34 In order to determine the value of goodwill, if any, the future maintainable earnings are multiplied by the earnings multiple and then compared to the value of the net assets required to operate the business. If the capitalised earnings are greater than the assets required to operate the business, then the difference is goodwill. However, if the capitalised earnings are less than the assets required to operate the business, then there is no value attributed to goodwill. This can be seen in the example below:

	Company A		**Company B**	
Future earnings		250,000		250,000
Earnings multiple		3.0		3.0
Capitalised earnings		750,000		750,000
Net business assets				
- Cash	50,000		50,000	
- Inventory	150,000		500,000	
- Debtors	100,000		350,000	
- Plant & equipment	250,000		200,000	
- Creditors	(100,000)		(100,000)	
		450,000		1,000,000
Difference		300,000		(250,000)
Goodwill		300,000		Nil

3.35 In both scenarios, I have assumed estimated future maintainable earnings of $250,000 and a multiple of 3. The capitalised earnings is effectively how much someone might pay for the business to be able to receive its future profits. In the above example, Company A's business has a value of $300,000 for goodwill because the capitalised earnings have a value higher than the net business assets required to operate that business.

3.36 However, Company B's business has no value attributed to goodwill. Whilst both businesses are expected to generate similar profits and have similar risks associated with the future earnings, Company B's business requires a much higher investment in the net business assets, particularly inventory and debtors, to be able to operate the business.

3.37 The valuation approach that would be adopted for Company B would therefore be the net asset backing approach. This value is represented by the value of the assets less the liabilities, being $1,000,000. This is because the underlying assets could realise $1,000,000 if sold and this value would be adopted where it is greater than the capitalised earnings.

3.38 Where the solicitor's instructions to the valuer are to value the company that operates the business and not just the underlying business, the value of the goodwill is included in the balance sheet of the company. The value of the company is equal to all of its assets, including any goodwill of the business, less its liabilities.

4.0 How To Understand Business Valuation Reports

4.1 One of the sayings that I like is "You don't know what you don't know". The concept behind this saying is that all knowledge can fit into one of three categories, what we know we know, what we know we don't know and what we don't know we don't know. The message is important as it highlights how dangerous it is when we think we know everything about something when there is actually something that we do not know.

4.2 It would be dangerous in a matter if you adopted the value set out in a valuation report thinking you knew all about how the value was derived, when there was an assumption or fact which you did not know was relied on by the valuer. In order to find out if there is something that we don't know we don't know, we must ask questions. I have therefore set out a list of questions to assist you in turning what you don't know into what you do know. However, this list should only be used as a starting point and not a comprehensive list as every valuation will be different.

4.3 If you are reviewing the valuation in more detail because you or your client is trying to address the "I don't understand why the value is so high/low?" question, then when addressing the questions below ask yourself if the facts and assumptions on which the valuer has based their opinion are the same as mine/my client's understanding and if not, does that explain why the value is higher/lower than expected.

4.4 What has been valued?

4.5 Whilst this may sound simple, the simplest things are often the easiest to over look. Consider what has been valued. Does the valuation report set out the value of a company including all of the assets and liabilities owned by it? Or does it just set out the value of the business operated by the company.

4.6 Is what has been valued appropriate in the circumstances of the matter? Does adopting the value set out in the report result in double counting or omitting assets or liabilities?

4.7 What valuation premise has been adopted?

4.8 Once again, this is a relatively simple concept, but one that can have a significant impact on the outcome of a valuation.

4.9 The valuation report should set out the premise of the valuation, such as market value or value to the party. This should be considered in the circumstances of the matter to ensure the premise is appropriate.

4.10 A different valuation premise can make a significant difference to the outcome of a valuation, but that is not always the case. Recall the example of Davis Wholesalers above where the valuation premise would have an impact on the value depending on the existence of restraints due to the relationships held by the existing owner. Rather than the owners being the key to the success of the business, let's assume that the key to the success of the business of Davis Wholesales was its large warehouse in a unique position close to its customers. If it would be very difficult and costly to construct a similar building in the same area, then much of the goodwill would be associated with the right to occupy the building and restraints from the existing owners would be less important. In such circumstances, the difference between adopting the premise of value to the party and market value would be less.

4.11 What if the business being valued was Company B from the example above which had no goodwill? If there is no value attached to goodwill, then there is little value which would be protected by a restraint and once again the difference in valuation between value to the party and market value may not be great.

4.12 Therefore, whilst you might have concerns as to whether or not the appropriate valuation premise has been adopted in the circumstances of a matter, before incurring time and cost building legal arguments and strategy based on these concerns, it would be worthwhile asking the valuer to advise if the value would be different if an alternative valuation premise was adopted and if so, would the difference be material in the circumstances of the matter.

4.13 Is there any value attributed to goodwill?

4.14 Review the report to identify the valuation method and whether there is any value attributed to goodwill. Consider the approach used to determine goodwill, usually future maintainable earnings. As discussed above, determining the value of goodwill involves determining the future maintainable earnings, determining a multiple to apply to the earnings and comparing the capitalised earnings to the net business assets required to operate the business. Therefore, an error or inappropriate assumption in any one of those steps can lead to a different result in the value of goodwill.

4.15 Therefore, it is appropriate to review each step to see if there are any errors or inappropriate assumptions.

4.16 Are the adjustments to the reported earnings reasonable when determining the future maintainable earnings?

4.17 As noted above, the future maintainable earnings are normally determined by considering and adjusting the past earnings for non arms length transactions, abnormal and non-business income and expenses.

4.18 Identify that part of the report that adjusts the past earnings. Review what adjustments have been made and ask yourself if each of the adjustments are reasonable and appropriate in the circumstances of the matter?

4.19 Most valuation reports will include a summary of the profit and loss statements for recent years. Review that summary to consider if there are any abnormal, non-recurring or non business income or expenses and check to see if they have been adjusted for appropriately.

4.20 When considering what expenses might be abnormal or non-recurring, consider the size and nature of the income or expense and the extent to which similar income or expenses may occur in the future. For example, in reviewing and adjusting three years of past results, there might be one year that was negatively impacted by an event such as high staff turnover. Whilst high staff turnover is not expected every year, it is not unreasonable that is will occur in some future years. Therefore, the impact of such an event may not be adjusted in the earnings.

4.21 In contrast, let's say that the profit of a business in one of the recent years was greater than normal due to a one off event, such as a World Cup sporting event being held near the location of the business that is not likely to return for many years to come. Such an event should be adjusted from the past earnings in order to determine the future earnings.

4.22 In virtually all valuations it will be necessary to consider adjustments for non arms length transactions. The two most common and most likely to have an impact on valuations are the owners' remuneration and rent (where the property from which the business is conducted is owned by the business owner or a person/entity related to them).

4.23 Identify if the owner of the property from which the business is conducted is related to the owner of the business. Where this is the case, the rent expense should be reviewed and if an arms length rent is not being expensed, then an adjustment should be made. Check to see if any adjustment is reasonable and preferably based on an independent assessment by a real estate expert.

4.24 With respect to owners remuneration, it is common for the valuer to make an estimate of the arms length remuneration for the business owner and adjust the earnings accordingly. Whilst the estimate of an arms length remuneration is often based on salary surveys or similar, business valuers are rarely remuneration experts as well. Therefore, this is one element of the adjustments that should be carefully considered.

4.25 Consider if the assumptions on which the expert has relied on with respect to roles, responsibilities and hours worked are reasonable. If it is suspected that the assumptions are not reasonable, consider what impact different assumptions would have.

4.26 For example, let's assume that the valuer has relied on information provided that the owner worked 30 hours per week in the business. If your client asserted that the owner worked significantly more, then it might be appropriate to adopt a higher salary. This would have the impact of lowering the future maintainable earnings which in turn would lower the value of goodwill. Consider if the proposed adjustment would be favourable to your client and if so, what is the amount of any such impact and whether the costs associated with obtaining that change in value would be warranted. For example, would the potential benefit to your client warrant the costs of engaging a remuneration expert?

4.27 It is also worth reviewing the expenses to consider the extent to which, if any, items are not related to the business. It may be useful to do this with your client as their knowledge of the business may be of assistance. For example, the nature of the business could mean that it is normal to expect it to have travel expenses which have not varied significantly each year and therefore travel expenses was not queried by the valuer. However, your client may be aware that the annual family holiday was claimed as a business expense or that the sponsorship expense relates more to the business owner's personal hobbies than promoting the business.

4.28 What assumptions and facts has the valuer considered when determining the earnings multiple?

4.29 Determining the earnings multiple is one of those areas of valuation that is more art than science. However, if you remember that higher risks means a lower value and lower risks means a higher value, as a lawyer you can still review the matters considered by the expert to determine the multiple and consider if the assumptions are reasonable and appropriate for the matter.

4.30 For example, let's say that your client believes the value determined by the valuer is too high. The valuer notes the low level of competition as one of the factors considered when determining the multiple. However, your client is aware of a direct competitor about to open near the subject business. A new competitor would normally increase the risks associated with future earnings and therefore, a lower multiple may be appropriate.

4.31 Having reviewed the assumptions and facts considered by the valuer to determine the multiple, if any are inappropriate or significant matters omitted, it would be appropriate to ask the valuer if such assumptions were changed, would it impact their assessment of the multiple and resulting value.

4.32 Have all assets and liabilities of a company been appropriately valued?

4.33 The valuation of a company will usually be based on the annual financial statements prepared by the accountant. When determining the financial statements, the accounting standards and principle adopted do not always reflect the underlying value of the assets. This is particularly important where businesses are not considered reporting entities and do not need to adopt all accounting standards required of much larger organisations.

4.34 Let's say that in addition to the business, the company also holds a portfolio of publicly listed shares. The shares might be recorded in the financial statements at their historical cost of $100,000. However, the underlying value of the shares may actually be more or less than that value.

4.35 The financial statements of the company may be prepared on the same basis as the tax returns and therefore the accrued liability for employees' annual and long service leave may not be recognised on the balance sheet as a liability. Even though the leave liabilities are not recognised in the financial statements, they do represent an actual liability of the company and should be taken into account in the valuation.

4.36 The valuation report will normally include a summary of the assets and liabilities of the company being valued. This should be reviewed to determine if the values stated reflect the underlying assets and liabilities, as well as whether there are any assets or liabilities that are not disclosed in the financial statements that should be accounted for in the valuation.

4.37 Where the matter is a Family Law matter, if the financial statements include a liability for annual and long service leave, consideration should be given to whether any of the annual and long service leave liabilities are attributable to the Husband or the Wife. If the liability has been included when determining the value of the company, consideration should be given as to whether the amount of the leave entitlements of the Husband or the Wife should be taken into account as a personal asset or financial resource to them.

4.38 What is the basis of the plant & equipment value?

4.39 Whilst this question is one part of reviewing the assets and liabilities of the company as reported in the financial statements, the value attributed to plant & equipment deserves special consideration where the business is a small business. Over recent years, the Australian Tax Office has been changing the rules regarding depreciation for small businesses. A business with less than $2,000,000 of annual sales will generally be considered a small business. There are two parts to these changes.

4.40 The first increases the threshold for writing off assets in the year in which they are purchased. From 15 May 2015 a small business can claim an outright deduction for most depreciating assets that cost less than $20,000. For example Annette buys a $5,900 camera and a $4,500 high resolution printer for her photography business. Both the camera and the printer are depreciating assets used entirely for business. As each cost less than $20,000, she can claim as a deduction $5,900 for the camera and $4,500 for the printer in the 2015-16 income year.

4.41 The second change further amends the rules relating to the pooling of depreciating assets. Prior to any of the asset pooling options which were first introduced in 2001 , assets were depreciated individually based on a depreciation rate for that class of asset. Small businesses were then given the option to pool assets into a general pool and a long life pool with the long life pool having a lower depreciation rate. The changes combine both pools and most depreciating assets that cost more than $20,000 (regardless of their effective life) can be pooled under the simplified depreciation rules. The depreciation that can be claimed is 30% of the balance of the pooled assets held at the start of the year and 15% for the first year in which any new assets are purchased (and thereafter they form part of the opening balance of pooled assets and depreciated at 30% in the year after purchase).

4.42 So what do all of these changes mean for the valuation of small businesses?

4.43 As noted above, prior to all of the pooling options, assets of a small business were depreciated individually based on a depreciation rate for that class of asset. This meant that the book value of the assets were often a reasonable reflection of the actual value of the plant & equipment held by the business. Therefore, the value set out in the financial statements for plant & equipment and other depreciable assets was often adopted as the value of those assets for the purposes of the valuation.

4.44 However, it must be considered for many small businesses, the financial statements are prepared on the same basis as the tax rules allow. This would mean that if an asset for less than $20,000 is purchased, this would be expensed and would not be included as an asset on the balance sheet. Therefore, there may be many assets which will no longer be recorded on depreciation schedules.

The rules relating to the pooling of assets for depreciation were optional and with the changes over the years have generally become more favourable.

4.45 The pooling of assets and depreciating all assets at 30% per annum can also lead to assets being depreciated much faster than their useful life. This can result in the book value of the pool of assets being lower than the actual value of the plant & equipment. The book value can even be further reduced by the way in which the sales of assets in the pool are accounted for.

4.46 The following is an actual example in a valuation that I completed (I only rounded the numbers for simplicity, the size of the impact was real). My analysis of plant & equipment identified that the written down book value of the plant & equipment decreased from $335,000 as at 30 June 2011 to $61,500 as at 30 June 2012, a reduction of $273,500. Further analysis of this decrease identified that the Company adopted a "Pooled Approach" to its accounting for the depreciation of its plant & equipment. As noted above, this means that all assets are grouped together in a pool ("the Asset Pool") and are depreciated at the same rate, being 30% (with the exception that the rate of 15% is applied to individual assets in the financial year in which they are purchased). When an asset is sold, the proceeds of the sale are deducted from the written down book value of the Asset Pool. No profit or loss on sale of an individual asset is realised.

4.47 During the year ended 30 June 2012, a grinder was sold for $173,000. The grinder had been purchased in the year ended 30 June 2009. If it had been separately depreciated, it would have had a written down book value of approximately $73,000 when sold, resulting in a profit on sale of approximately $100,000 (being $173,000 less $73,000).

4.48 A non-pooled approach to accounting for depreciation would have resulted in the profit of $100,000 being recognised as income in the Company's profit and loss account. The written down value of the plant & equipment disclosed in the Company's balance sheet would have been reduced by the grinder's written down value on sale (being $73,000).

4.49 Given the Pooled Approach adopted by the Company, the proceeds from the sale of an asset are deducted from the carrying value of the pool of assets. The sale of the grinder had the effect of reducing the written down book value of plant & equipment by the proceeds of sale, being $173,000 as all of the proceeds from the sale of an asset reduces the "pooled value" of the assets. Therefore, the decrease of $273,500 in the written down book value of plant & equipment during the year ended 30 June 2012 is made up of:

- depreciation for the year being 30% of the pooled written down book value of plant & equipment as at 30 June 2011 ($335,000 multiplied by 30%, or $100,500); plus
- the proceeds on sale of the grinder, being $173,000.

4.50 Adoption of the Pooled Approach resulted in an additional decrease in written down book value of plant & equipment of $100,000 (being $173,000 less $73,000) in comparison to a non-pooled approach.

4.51 In the above example it was highly likely that the actual value of the plant & equipment held by the company was more than the book value as at 30 June 2012 of $61,500 and reliance on the balance reported in the financial statements could result in the valuation being understated.

4.52 In addition to considering the impact of these tax changes on the value of assets disclosed in the financial statements, care also needs to be given to the reported profits in the early years of these changes. This is because a business may currently be claiming a depreciation expense for assets purchased before these changes as well as claiming immediate deductions for assets purchased for less than $6,500. This could result in the reported profits being lower than what could be generated on a maintainable basis and such an adjustment should be considered when determining the future maintainable earnings.

4.53 Is there any double counting of assets or liabilities?

4.54 In certain matters, such as Family Law matters, in order to achieve an equitable outcome for the parties, it is necessary to consider the treatment of assets and liabilities held within a company in comparison to those assets and liabilities treated as personal assets.

4.55 As a simple example, let's say that the parties' motor vehicles are owned by the company and have been included as assets on the balance sheet of the company by the company's accountant. It is therefore likely that the valuer has included the value of the motor vehicles as assets of the company when determining the value of the company. Therefore, if these assets are also included as personal assets of the parties, then the value of the motor vehicles will be double counted.

4.56 A less obvious example could be bank liabilities. Let's say that to assist with funding for the business, the parties increased their personal borrowings secured against the matrimonial home and lent $200,000 to their company. Let's assume that to keep things simple and include the interest as a tax deduction the company's accountant reported this loan as a bank loan in the financial statements of the company. However, when the parties applied for the additional $200,000 from the bank, they borrowed the money in their personal names to keep the paper work simpler. For their Family Law proceedings, the parties have obtained details of their various overdrafts and loans from the bank which included this $200,000 amongst other liabilities.

4.57 The valuer is likely to include the bank loan as a liability of the company as that is how the loan is reported in the financial statements. However, if the parties also include that loan as a personal loan, then that would double count the liability.

4.58 Therefore, consideration should be given to treatment of corporate assets and liabilities relative to those disclosed as being held personally to ensure there is no double counting or omitting of assets.

4.59 How are loans between the company and its shareholders treated?

4.60 Amounts owed by a company to a shareholder or by a shareholder to a company will have an impact on the value of the company. That is because they should be treated as assets or liabilities in the same way as though they were loans between the company and unrelated third parties. However, it is appropriate to consider how such loans should be treated in the circumstances of the matter. In Family Law matters, the loans should be accounted for as personal assets or liabilities of the parties to ensure there is no double counting or omitting of assets or liabilities.

4.61 I have set out below an example of two companies which have the same value. If only the company value was adopted, then the outcome would not be just and equitable.

	Company A		Company B	
Assets:				
- Cash	50,000		50,000	
- Inventory	150,000		500,000	
- Debtors	100,000		350,000	
- Plant & equipment	250,000		200,000	
- Goodwill	(100,000)		-	
- Loan to Husband	**250,000**		-	
		1,100,000		1,100,000
Liabilities:				
- Creditors	100,000		100,000	
- Tax	50,000		50,000	
- Bank loan	250,000		-	
- Loan from Husband	-		**250,000**	
		400,000		400,000
Value of Company		**700,000**		**700,000**
Loan with Husband		250,000)		250,000
Net interest in Company		**450,000**		**950,000**

4.62 As can be seen in the above example, both companies A and B have a value of $700,000. One of the assets of Company A is the loan owed to it by the Husband of $250,000. As the Husband owes this money to the company, it should be treated as a liability of the Husband. Therefore, his net interest in Company A is $450,000. However, in Company B, the Husband has lent the company $250,000. As the company owes the Husband $250,000, it should be treated as an asset of the Husband. Therefore, his net interest in Company B is $950,000.

4.63 From the above example, it is easy to see how not correctly treating the loans between the entities and the parties to proceedings can have a significant impact on their net interest in the entities and care should be taken to ensure there is no double counting or omitting of such loans.

5.0 A Rose By Any Other Name Would Smell As Sweet

5.1 I said in the introduction that I would link a couple of Shakespeare quotes to the understanding of business valuation reports. Whilst a rose by any other name would smell as sweet, is the value of a business the same, regardless of the type of entity in which it is held? The short answer to this is yes, if the same business, assets and liabilities are held in a Company, Trust, Partnership or Sole Trader, the value of the "business" will be the same.

5.2 However, when considering the possibility of double counting or omitting assets or liabilities, greater care should be taken where the business is held as a Sole Trader. This is because all assets and liabilities will be held in the individual's personal name and there is less likely to be a distinction between what is a business asset/liability and a personal liability.

5.3 Where a spouse owns an interest or share in an entity as opposed to owning the whole entity, the type of entity can have an impact on the value of that interest in the entity and therefore the rose may not smell as sweet. This is because rights of a shareholder in a company, unitholder/beneficiary of a trust or partner of a partnership differ and those different rights need to be taken into account when considering the risks and benefits associated with holding a share in a business via that structure. The value of the entity could also be different as a result of taxation implications.

6.0 To Be Or Not To Be, That Is The Question

6.1 We could begin to discuss the life changing significance of the question "To be, or not to be". However, in the circumstances, it would be much more practical to discuss "To value or not to value, that is the question" that often presents itself in many Family Law matters.

6.2 It would be common in many Family Law matters for the business owning spouse to say that their business is not worth anything and to have it valued will only incur more fees in what is often considered a very costly process. But are they right? In some matters their statement will be true, and in others it will not. Unfortunately there is no rule that can be applied to get the right answer every time. But I have set out below a couple of questions that may help guide you and your clients in deciding whether or not to get a business valuation report and what to do if the parties decide not to obtain a business valuation report.

6.3 Does the spouse have a business or job?

6.4 In order to make it worthwhile obtaining a business valuation, it will be of benefit to consider whether the person actually has a business, or just a job.

6.5 The difference between a business and a job may be best explained with examples. Let's compare Davo, Johnno and Robbo. Davo, Johnno and Robbo are all brickies. They might often describe themselves as having their own business. They each have a business name and they are their own boss. Davo and Johnno have no employees whereas Robbo has two brickies and an apprentice that work for him.

6.6 Where there are other employees, such as Robbo, it will usually be considered a business and getting a valuation should be further considered or at least proceeding to the question at 6.9 below.

6.7 Davo works for a number of building companies. The building companies have all of the building materials delivered to site and Davo goes to each building site as requested and gets paid based on the number of bricks he lays. What Davo does is more like having a job than a business. The amount Davo earns depends on how hard and how long he works. Therefore, it may not be worth obtaining a business valuation for Davo's "business".

6.8 Johnno provides quotes to home owners and builders for the cost of building different brick structures. Johnno does some brickwork himself, but also engages other subcontractors such as Davo to help lay bricks. Of the three, Johnno's circumstances are probably the hardest to identify as a business or a job. If Johnno regularly has two or three subcontractors working for him each day, then what he does would probably be considered as a business. The fact that Johnno is providing fixed quotes direct to customers, buys the bricks and other materials himself and charges the customers for both his time and the materials also lends itself to being a little more like a business than a job. In circumstances like Johnno where it is not clear if the person has a job or a business, then it is worth considering the next question.

6.9 Does the business provide any profit in excess of a reasonable wage?

6.10 Where a business is unable to provide any profit in excess of a reasonable wage, then the appropriate question is "why would anyone pay good money for a business where all they will be able to earn is the same wage as they would being an employee, but with the risks of running a small business?" In circumstances where the business cannot provide any profit in excess of a wage the business will often have no value for goodwill and the value of the business will be the value of its tangible assets less its liabilities.

6.11 For example, let's assume that the average brickie who has a job like Davo or those working for Robbo earns around $60,000 per annum. If Johnno's business allows Johnno to earn around $60,000 per annum and there is no profit in excess of a reasonable wage for the roles and responsibilities he performs, then there may be little benefit in having a valuation performed. However, if Johnno's business means that he has consistently earned over $120,000 per annum, being a substantial amount in excess of a reasonable wage, then it would be worthwhile considering the business being valued.

6.12 In some circumstances, it will be easy to see that the profitability of the business is in excess of a wage. However, in other situations, say if Johnno's company paid him a small wage, as well as paying a wage to his Wife and paid rent for use of the shed next to the house, then considering if there is a profit in excess of a wage will not be as easy and you may require some assistance from an accountant.

6.13 What to consider where no valuation is being obtained?

6.14 If no formal valuation is being obtained because the spouse just has a job or the business only makes a wage, that doesn't mean that the business has no value.

6.15 Let's continue with Johnno. Whilst he may only make a reasonable wage, he does have a shed full of cement mixers, laser levels and other equipment. If he operates as a company, does the company have a bank account separate to his personal account? Are there amounts that are owed by customers for work that has been performed, i.e., does he have any trade debtors. Are there amounts that are owed to suppliers?

6.16 Where possible, if financial statements have been prepared for the business or it uses an accounting package like MYOB, then obtain a copy of the balance sheet. Review the assets and liabilities disclosed on the balance sheet and consider if the value stated is reasonable and if all assets and liabilities have been included, such as the trade debtors and creditors.

6.17 The value of the net business assets should be included on the parties' personal balance sheet and as noted above, care should be taken to ensure that there is no double counting or omitting of assets and liabilities.

7.0 Summary

7.1 Whilst business valuations can be complex and confusing, it is important to understand how the value in the valuation report was derived to ensure the value adopted is appropriate in the circumstances of the matter. If you blindly accept and adopt the value set out in a report because you do not understand how the value was arrived at, then you could be putting your client at a disadvantage because you don't know what you don't know.

7.2 It makes common sense to avoid situations where the valuation relies on a fact or assumption that contradicts your client's case. It makes common sense to avoid situations where the value set out in the report is used in the proceedings in such a way that it results in double counting or omission of assets or liabilities. Therefore, if you don't understand how the value set out in the report has been derived then it makes common sense to develop a greater understanding of the value set out in the report.

7.3 Hopefully addressing as many of the above questions as possible will reduce the risks of the pitfalls it makes common sense to avoid. The above process should also assist in addressing the times when you or your client is thinking "I don't understand why the value is so high/low?" or should we incur the costs of getting a business valuation. However, where the concern remains, you should consider addressing such questions to the valuer or engaging a shadow expert to assist you and your client to ensure the valuation is appropriate in the circumstances of the matter.

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