NIIFA NEWS 28

Approved Expert Financial Witnesses

The Newsletter from The Network of Independent Forensic Accountants

# THE VALUATION OF BUSINESSES - BE CAREFUL WHAT YOU ASK FOR...

**Those instructing forensic accountants to value businesses should take particular care how to define the scope of their instructions in order to avoid situations where what is delivered is what was requested, but not what was wanted.**


Much confusion surrounds the difference between Open Market Value and Fair Value but the position is further complicated as different principles of valuation apply in different contexts. For example so called 'Fiscal' valuations for tax purposes follow different rules to those that apply to say a valuation for the purposes of a divorce or a dispute.

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## THE VALUATION OF BUSINESSES part 2

In an attempt to bring a degree of consistency to the definitions of terms associated with business valuations, the International Valuation Standards Council has introduced an International Valuation Standard Framework, which includes the following useful definitions:


Significantly, Fair Value will take into account any **Special Value** which arises where an asset has attributes that make it more attractive to a particular buyer than to any other buyers in the market. For example, the buyer may be a shareholder in a company who wishes to buy the shares of a minority shareholder in order to gain control of the company. The shareholding will be worth far more than the value of a minority shareholding in normal circumstances.

According to the IVSC Framework, Market Value specifically excludes any element of Special Value because Special Value reflects an additional element of value that makes it more attractive to a particular buyer or owner. Interestingly this exclusion must be seen in the context of the provisions of HM Revenue and Customs' Valuation Manual that states that, for Fiscal Valuations,

> *"The open market excludes no-one. The open market must be assumed to include all possible purchasers who both wish to buy the shares and have the necessary funds to do so. This includes not only hypothetical purchasers but also, possibly, the institutions or pension funds if the value of the holding is exceptionally large, and actual members of the company, including directors.*
>
> *The directors and actual members may be special purchasers because they may have some special reason for paying more than market value to acquire a particular holding (because it may provide them with control for instance). Whether or not the statutory open market is influenced by such purchasers is a question of fact acknowledging as we must that all likely purchasers are present".*

## THE VALUATION OF BUSINESSES part 3

In the context of the valuation of a family business or private company, instructing solicitors need to give careful consideration as to whether they or those they instruct need to take account of any Special Value that may arise by virtue of the existence of Special Purchasers. The identification of Special Purchasers is, itself, not straightforward.

A recent unreported case in which the author was involved concerned a private company in which a shareholder had retired and sold his shares to the remaining shareholders. It was argued that the remaining shareholders were Special Purchasers who paid Special Value that ought to be left out of account for the purposes of valuing the shares in the litigation. In effect, it was suggested that the real world transaction should be ignored.

**In such cases three questions need to be addressed:**

**Firstly,**
Were those taking part in the transaction in question Special Purchasers because they were a category of persons likely to pay a premium or Special Value for the shares;

**Secondly,**
if they were Special Purchasers, did they as a matter of fact pay a premium and, if so, how much of the price paid related to the Special Value; and

**Thirdly,**
does the context of the valuation (and the instructions to the valuer) require Special Value to be left out of account or has a Fair Valuation been commissioned, which would take account of any Special Value.

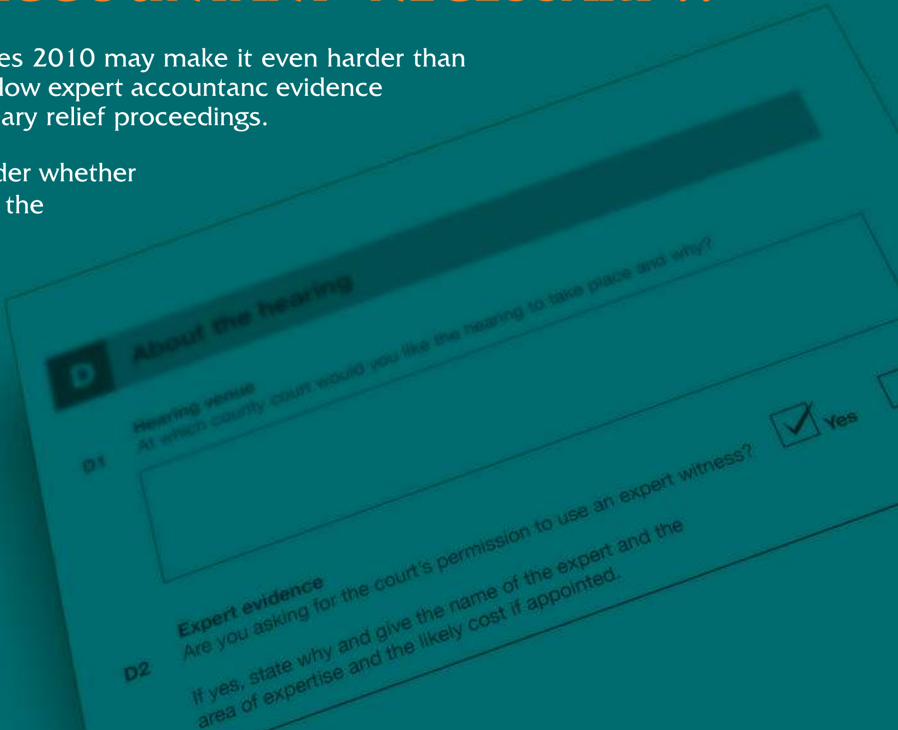
It is the third of these points that will be of most importance to instructing solicitors and which ought to be borne in mind when instructions are drafted.

# IS YOUR FORENSIC ACCOUNTANT 'NECESSARY'?!

Recent changes to the Family Procedure Rules 2010 may make it even harder than it was previously to persuade the court to allow expert accountanc evidence to be adduced in matrimonial financial ancillary relief proceedings.

Previously the courts were required to consider whether expert evidence would be of assistance but the bar has been raised and the test now is whether or not the expert evidence is necessary.

NIFA members are never afraid to justify their existence and so instructing solicitors should feel free to ask for assistance with court applications that explain why, in particular circumstances, **a forensic accountant is not just useful but absolutely vital!**



# THE VALUATION OF A COMMERCIAL AGENCY

**Litigation arising from the termination of commercial agencies is becoming increasingly common and a recent case in which the author was involved, which settled at mediation for a seven figure sum, demonstrates that compensation claims can sometimes be substantial.**

While politicians continue to debate whether the UK should remain within Europe, our laws continue to be influenced widely by the adoption of European Regulations that can often be an anathema to long lines of juris prudence. A stark example is the application of the Commercial Agents (Council Directive) Regulations 1993 that govern the relations between commercial agents and their principals.

The relevance of the Regulations to forensic accountancy arises in circumstances in which the termination of a commercial agency triggers statutory compensation. The concept of statutory compensation is not unusual in other jurisdictions but in England and Wales, whilst employees and consumers have long enjoyed statutory protection, it is relatively unusual for a statutory regime to interfere in commercial relationships.

The theory behind the Regulations is that a commercial agent should be protected in the event that his efforts to build up a customer base for his principal also build goodwill for the principal from which, without statutory protection, he would not be able to benefit. One might counter such a line of thinking by suggesting that there would be nothing to prevent a commercial agent from negotiating terms with his principal to provide for compensation on the termination of the agency and for such compensation to be governed by contract, as are most relations between contracting commercial parties. However, the fact is that the Regulations have been in force for nearly ten years and as their provisions are becoming better understood, more and more lawyers are recognising situations in which it may be arguable that a commercial agency existed and has been terminated so as to trigger compensation.

*'compensation payable should be the amount the agent could reasonably expect to receive for the right to stand in his shoes...'*

In most other European countries compensation is paid on the basis of a formula, such as a number of years' turnover. However, following the case of Lonsdale[1], the House of Lords determined that the compensation payable to a commercial agent by a hypothetical purchaser should be the "amount the agent could reasonably expect to receive for the right to stand in his shoes, continue to properly perform the duties of the agency and receive the commission which he would have received". In other words the agency has to be valued to ascertain what a hypothetical third party would pay for it. Lonsdale says that, even if, as a matter of contract, the agency was not assignable, a hypothetical purchaser must still be assumed to be able to take over the agency.

**The following factors need to be considered:**

**1. The prospects for the agency as they existed at the date of termination**

**2. The likely future annual earnings of the agency taking into account the costs that the agent would have to incur to earn the commissions from that agency**

**3. The expected performance of the principal's business after the termination of the agency**

**4. The agent's ability to take his customers elsewhere**

In essence, the compensation should be based on what the business is worth to the agent, i.e. on the basis of the annual net profit that the agent is forgoing by giving up the agency.

As one is placing a value upon future net income, one must discount the number of years purchase of future net earnings by an appropriate discount rate. Perhaps the most subjective element of the valuation will be the choice of an appropriate discount rate. In the writer's experience such rates can vary widely from as low as 5% to as much as 33% depending on the circumstances.

Another key issue is likely to be the costs that are attributable to the agency, especially if the agent has several agencies and costs need to be apportioned between them.

Finally, any valuation will have to include a deduction for the notional market salary of the agent that reflects the role that he undertakes. The larger and more complex the agency, the higher is likely to be the level of notional remuneration.

In some cases the agency agreement may provide for the agent to be paid an indemnity as opposed to compensation. The calculation of an indemnity is defined by the Regulations and is significantly different from the calculation of compensation.

1 *Lonsdale v Howard & Hallam Ltd* [2007] UKHL 32

2 *Moore v Piretta PTA Ltd* [1999] 1 All ER 174

3 Regulation 17(4)

It is a three stage process[2], as follows:

**First one must assess the value of additional and continuing new business the agent has brought the principal.**

**Then one must assess what is 'equitable' having regard to all factors including the commission 'lost' by the agent; and**

**Finally one must apply a statutory cap equal to average annual remuneration calculated over the last five years.**[3]

The key to a successful claim for compensation or an indemnity on the one hand and the successful defence against such a claim on the other, is often to build a team whose members, being solicitor, barrister and forensic accountant, all have the relevant experience and expertise and can work together effectively to ensure the optimum outcome for the client.

Beyond All Question

NIFA, THE NETWORK OF INDEPENDENT FORENSIC ACCOUNTANTS, SETS AND APPLIES HIGH STANDARDS TO BE DELIVERED BY OUR APPROVED EXPERT FINANCIAL WITNESSES

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# A FAIR DAY'S PAY FOR A FAIR DAY'S WORK

**It is becoming increasingly common in litigation in areas from commercial litigation to clinical negligence to form a view as to the appropriate rate of remuneration that would be paid to owner-managers if they were simply employed without an equity stake in their businesses.**

The use of remuneration experts tends to be frowned upon by the courts in their attempt to keep the number of expert witnesses to a minimum.

Obtaining data on directors' remuneration can be difficult in relation to all but the largest companies because smaller entities are not required to disclose details of directors' remuneration within their accounts. In any event, even if they were to do so, many pay remuneration at off-market rates for tax-planning reasons, e.g. preferring to pay themselves dividends and save employer's national insurance contributions.

*'many pay remuneration at off-market rates for tax-planning reasons'*

One of the few and very useful sources of information on directors' remuneration is the annual survey published by Croner Reward. It analyses remuneration on a geographic basis but also by industry sector and size of company.

**NIFA members have access to the survey.**