

Dear All,

Back in November, I wrote an article on how “damages based agreements” might impact client engagements post 1 April 2013. The Jackson Reforms also included guidance on managing and monitoring experts’ costs – an issue dear to my heart. I summarise some of the key issues later in this newsletter.

Also featured is an article on the importance of cash and liquidity, and how that might impact both the value of a business and the capacity to extract funds from that business; this is often a critical factor in matrimonial disputes. Additionally, we take a look at the concept of “hidden assets” in confiscation cases, and how that can be used to justify a disproportionately high benefit figure.

Best wishes,

Greg Lacey, Managing Director

The Angel of the North?

Mike Ashley, billionaire founder of the Sports Direct retail empire and owner of Newcastle United football club, recently made a seemingly magnanimous offer; should the Magpies beat Arsenal at home in their last league game of the season, a bonus of £1 million would be shared by the club’s backroom staff.

However, this gesture might not have been quite as generous as appears at first blush. Premier League prize money is determined based on a club’s finishing league position. A Newcastle win would have catapulted them up four places in the final league table – earning a tidy additional £3 million in the process. It seems likely that the “bonus” would have been self-funded, with a nice sum left over. Of course, it is also feasible that the payment would have been made from Mr Ashley’s own pocket – however, in my experience, entrepreneurs don’t often graduate into billionaires through acts of such beneficence.

I don’t know whether Arsenal’s backroom staff had been promised a similar windfall. Victory for the Gunners would have been considerably more



lucrative. As well as the £0.75 million prize money differential between 4th and 5th positions, participation in Champions League football is estimated to generate incremental revenues of around £25 million over and above that earned from entry into the Europa League, its poorer cousin.

Just in case you didn’t hear the scoreline from St James’ Park (or, to give it its full name, “sportsdirect.com @ St James’ Park Stadium”), Newcastle lost. No doubt, the Toon tea lady will be holidaying in Whitley Bay, rather than the Seychelles, for yet another year.

Free cash!

Phil Southall considers some of the issues relevant when assessing “liquid” resources in a business, increasingly an important factor in matrimonial and shareholder disputes

When instructed to undertake a business valuation in the context of matrimonial proceedings we are often also instructed to assess the available, or free, cash in a family-owned business with the objective of understanding whether scope exists for the owners/shareholders to pay out drawings or a dividend in order to fund a one off payment to the other spouse.

Whilst this is of particular importance in the context of matrimonial proceedings, the issue of free cash (which is sometimes referred to as liquidity) is pertinent and therefore needs to be assessed for all business valuations where the valuation approach adopted is anything other than one based on net assets. In other words, if a business is valued on the basis of its future expected cash-flows, there may be an additional value reflected in any free cash retained within the business over and above that required to fund day-to-day working capital. It being only right that in any sale of the business the existing owners are compensated for not only future earnings potential but also for historic earnings which just happen to have been retained in the business. In these circumstances an enterprise's value will be the present value of its future cash-flows plus free cash. Conversely, if a business carries net debts, its value will often be diminished.

So far, so good. However, the tricky part often comes in assessing what the level of free cash actually is.

Typically we will be presented with sets of historic accounts, and these will typically be significantly out of date (a private company does not need to file its accounts at Companies House until 9 months after the end of the accounting reference date, and many directors take maximum advantage of this time limit). Whilst a historic balance sheet might reflect the cash position at a particular point in time, and you will have the benefit of knowing what the cash position was at the end of the previous trading period too, the cash figure in the balance sheet is of very limited assistance in helping assess the current value of free cash. There are numerous factors that will have a bearing on free cash going forward, not all of which will necessarily be obvious from the historic accounts alone.

Most of these relate to factors that have impacted the company since the balance sheet date, including:

- the underlying trading performance of the business since the date of the accounts;
- post balance sheet and future planned refinancing/repayment of loans/HP etc, including introduction of capital and re-organisation of the terms of bank debt and loans;
- post balance sheet and future planned capital expenditure;
- timing of future tax liabilities (VAT is generally paid quarterly, corporation tax once or twice in any year) etc

Indeed there are so many possible factors that can affect a business' working capital/free cash position that realistically the only means of accurately establishing the level of free cash is to rely on an up to date balance sheet (for example, based on a recent set of management accounts) and to look at the projected future cash-flows of the business over (say) at least the coming twelve months.

In a shareholder dispute case we were recently involved in we were surprised by the approach adopted by a mid tier firm in looking to assess free cash. In that instance, they looked at historic cash levels held by the business over the previous 12 months and concluded cash held had swung up and down by £500k and that therefore, whilst the current cash held was £1.6 million, £500k would be needed to cover movements in cash over the next 12 months and a further £500k would be needed for an expected corporation tax liability due to be paid 9 months after the end of that trading year (they were at this point at the start of month 11). They concluded that the value of free cash available for distribution as a dividend was £600k.

There were some fundamental errors in this approach.

In assessing the movement in cash over the past 12 months of £500k and assuming £500k should be withheld from the current £1.6 million, this approach completely failed to appreciate where the business was in its cash-flow cycle. In fact by the start of month 11 the business

had just paid out its month 9 VAT quarter liability and was at the lowest point in its cash-flow cycle.

Whilst current year profits were forecast to be £2.4 million, seeking to withhold £500k for an anticipated future corporation tax liability completely failed to take account of the fact that at that point in time and going forward, the company was actually generating net cash inflows each month of £200,000 (i.e. its profits were translating directly into cash). In other words, by the time the £500k corporation tax liability would fall due in 11 months' time, in addition to the £1.6 million currently sat in the bank, the company expected to generate a further £2.2 million, so the company would then have held cash in the bank of £3.8 million, albeit with a liability pending for the month 9 VAT quarter.

Clearly the approach adopted by this mid tier firm failed completely to consider the future projected cash-flows of the company. Had they done so, they would have concluded there was considerably more free cash in the business than they were advising their client.

Conclusion

We would recommend therefore that, wherever possible, when looking to establish the value of free cash in a business you should look to the business owners to provide a forecast of future trading and cash-flows over the coming year, as well as providing an up to date, even if draft, balance sheet.



POCA's hidden agenda

Simon Paley highlights how the concept of “hidden assets” can be used to justify disproportionate confiscation orders

In any confiscation matter, establishing the following two concepts is key:

- (1) the value the defendant received from his criminal conduct (the “benefit”); and
- (2) the amount of his realisable assets from which any confiscation order might be paid (the “available amount”).

Where the defendant is deemed to have a “criminal lifestyle”, by virtue of the nature of the offence he has committed (such as, money laundering and drugs dealing offences) or due to recurrent offending, then the assessment of benefit under the Proceeds of Crime Act 2002 (“POCA”) can be quite severe; effectively creating a presumption that all his unexplained income, expenditure and assets derived from nefarious activities. The application of these POCA assumptions and the term “draconian” go hand in hand.

Let us take the hypothetical example of Mr Snip, the owner of a barbershop. Mr Snip has been leaned on by the local drugs baron, and has agreed to pass cash derived from drugs transactions through his business bank account. He is arrested and convicted of money laundering offences.

The Crown establishes that, over a three-year period, £1 million of dirty money passed through the barbershop bank account, although it is Mr Snip’s evidence that he received payment of only £10,000 for this service. Applying the POCA assumptions, Mr Snip’s benefit might well be assessed by the court as £1 million (the value of funds legitimised through the banking system). Often, the Crown will request the highest justifiable sum under the POCA assumptions – a natural (albeit perhaps unplanned) consequence of allowing prosecuting bodies to retain a proportion of the funds they are able to recover under POCA.

However, the aggregate realisable value of Mr Snip’s house (after deducting the outstanding mortgage) and business is deemed to be only £100,000. There is a



significant disparity between the benefit figure (£1 million) and Mr Snip’s identifiable assets; a deficit of £900,000.

The consequences of this are twofold:

Firstly, we can see that the value of Mr Snip’s barbershop business (a business he has taken many years to build up) will become subject to confiscation. Given that he received payment of only £10,000 for his criminal act, this might seem unfair. Tough luck, we might respond, he shouldn’t have assisted the drug dealing activities.

Secondly, the Crown might argue that the deficit of £900,000 reflects “hidden assets” accumulated by Mr Snip – monies squirreled away for him to enjoy once he has served his sentence. Perhaps he has acquired a secret holiday home in Majorca? You might expect that the court can only take into account property which the Crown can prove to exist. Not so. The burden is placed squarely on the shoulders of the defendant.

As you can imagine, this can present significant difficulties; how do you prove the non-existence of something? Failure by Mr Snip to rebut the assertion regarding hidden assets could lead to him suffering an additional default prison sentence (and the unsatisfied confiscation amount will remain with him even after his release). Clearly, this is not in the public interest, never mind the interests of Mr Snip.

Whilst the above might sound like an

extreme example of the possible inequities that might strictly arise under POCA, it is not necessarily exceptional. The Commons Public Accounts Committee reported that during 2011/2012 the level of outstanding confiscation orders was in excess of £1.3 billion. No data is available, however, to indicate how much of this outstanding amount relates to alleged “hidden assets”.

Recent confiscation cases have perhaps suggested that the courts are looking to apply a more considered approach. In the case of *Waya* (who had been charged with mortgage fraud), the Supreme Court reduced his confiscation amount and emphasised the need to observe the provisions of the European Convention on Human Rights to ensure a proportionate result was achieved without the risk of injustice.

In the more recent case of *R –v- Ahmad & Ahmad*, Lord Justice Hooper, who reduced a confiscation order on appeal, stated: “it seems to us that a confiscation order which, due to its magnitude, exceeds by far the likely assets of the defendant may operate as a disincentive to co-operate.” Admittedly, the *Ahmad* case featured some astronomical figures (the original confiscation order, relating to VAT fraud, was for £92 million).

Whilst these developments are encouraging, it has yet to be seen whether the focus on “fairness” proposed by the appellate courts will filter down to the Crown Courts. Whilst, as forensic accountants, our traditional role has been to make a reasoned assessment of the “benefit” figure, increasingly we are asked to consider the application of the defendant’s funds over the relevant period. If the income received by way of benefit can be shown to have been spent; for example, on day-to-day living expenses (or perhaps a more lavish lifestyle in some of the more high-value cases), then it may be possible to convince a court that assets are not hidden, but instead that they simply don’t exist.

Instructing experts under Jackson

Greg Lacey considers how the Jackson reforms might impact the instruction of experts in commercial litigation



What has changed?

From 1 April 2013 parties seeking permission for expert evidence must:

- identify the issues to be addressed by the evidence; and
- provide an estimate of the costs of that evidence.

Why has this change been introduced?

Regarding the costs estimate, the aim is to make it easier for the court to exercise its pre-existing power to limit the amount recovered from an opponent in respect of experts' fees and expenses. This ties in with the new procedures for judicial costs management and the court's greater focus on managing costs in advance rather than just retrospectively. It can be taken as read going forward that this will entail that expert's costs will need to be proportional to the value in dispute.

What are the implications for commercial parties?

In seeking permission to adduce expert evidence, and in order to keep a limit on costs, parties will need to consider and identify the specific issues that need to be addressed by evidence, rather than just identifying the field of expertise. This means that parties will need to be clear from an early stage what issues need to be addressed by expert evidence, and that their chosen expert(s) are able to support the party's case on the relevant issues. It should also reduce the risk of wasting time and costs with experts addressing peripheral or unnecessary issues.

How can we help?

We consider that in light of the requirement to now specify the issues and to provide certainty, but also proportionality, in expected experts' costs, we are well placed to ensure the Court approves our appointment as experts.

Over the past decade we have worked closely with a number of law firms in an in-house capacity with the remit to provide ad hoc expert accounting advice – the rationale for this being to enable accounting input on lower value claims or where affordability was an issue for clients. As a result we have developed an approach that focuses on limiting our scope to dealing with the key issues.

It seems likely that any increase in experts' costs over and above the original estimate supplied in any budget may not be recoverable from the other party. Acknowledging that often the decision to proceed with litigation entails a financial decision factoring in costs, time and likely recovery, as well as the need for many finance directors to have certainty over their expected future costs for budgeting and cash-flow purposes, we are often instructed to work to a fixed fee. Indeed, this has always been the case in all the work we have undertaken funded by the public purse.

We consider that Jackson will help cement our reputation as being proportionate, cost effective and reliable experts.



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FAR Consulting - Key contacts



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Greg, a Chartered Accountant, has specialised in forensic accounting for over 15 years. Greg has represented many of his clients at mediations and as an expert witness. He has prepared reports as an expert, a single joint expert and court-appointed expert. He has experience of high profile cases involving contract and pricing disputes, completion accounts disputes, product recalls and royalty disputes, gained whilst acting for a number of high profile clients across a broad spectrum of industry sectors.

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Phil is a Chartered Accountant with over 13 years' post qualification forensic experience during which he spent over two years working as an in-house forensic accountant at a national law firm. His almost unique experience in this role and extensive forensic background make him ideally placed to advise on settlement strategies, using "decision analysis" techniques which analyse a client's potential costs, and the risks and rewards of being involved in litigation.

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Simon Paley
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Before joining FAR Consulting, Simon worked in Ernst & Young's forensic accounting team and has over 16 years' forensic experience, principally in commercial and contractual disputes, with a particular interest in insurance claims. He also has a broad experience advising clients on purchase price adjustments, completion accounts, breach of warranty claims and other transaction-related disputes. He has acted as both expert and single joint expert, and has given evidence in court on a number of occasions.

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