The best bits by FAR

February 2012

Dear All

We hope you all enjoyed a fantastic Christmas, and you have entered the New Year in fine fettle. For some light reading to keep you entertained during the freezing winter nights, we are pleased to present our latest newsletter.

In this issue, we consider the following:

- the importance of the much-maligned and undervalued cashflow forecast;
- the treatment of a "notional salary cost" in business valuations, and commercial agency valuations in particular; and
- the impact of the economy on valuations more generally.

But first, we set out some quick thoughts on banker's bonuses – a topic that has hit the headlines this week.

As ever, if you would like to have an informal chat on any financial implications of a case you are working on, please don't hesitate to give us a call. I would also urge you to take a look at our website, www.farconsulting.co.uk, which has been spruced up over recent weeks. Any feedback you have will be well received!

Best wishes,

Greg Lacey, Managing Director

Numbers in the news... banker's bonuses!

This week saw the news that RBS' chief executive Stephen Hester has turned down a bonus offered to him of £1 million. This was to be in addition to his reported salary of £1.2 million. The public outcry was perhaps understandable given the huge financial support provided to RBS by the UK government following the credit crunch and near financial Armageddon in the final quarter of 2008. HM Government's initial investment of £37 billion in October 2008 secured a 58% stake in RBS, and after further capital injections that stake has now increased to 83%.

Now whilst the politics behind putting pressure on Mr Hester to forego his bonus may be sound and clear cut, we thought it might be helpful to illustrate the impact on HM Treasury of UK based bankers forgoing their bonuses.

By foregoing his bonus, the bank potentially gets to report an improved profit (or a reduced loss, depending on the out-turn position) of £1 million. Actually this is nearer £1.14 million if employer's national insurance contributions (NIC) are taken into account. This would mean the Treasury could hope to recover 26% corporation tax (at 2011 rates) on those improved profits, equating to £296,400, leaving additional reserves of £844,000 in RBS. HM Government through its 83% stake would then stand to get a share of those reserves, assuming profits are distributable, by way of dividend. This would amount to 83% of £844,000, which would be a further £700,000, giving an overall potential gross saving to the government of £996,400.

However, had Mr Hester taken the bonus, HM Treasury would in any event have received employer's NIC of £140,000 and Mr Hester himself would have been assessed to statutory deductions at a rate of 52% (50% tax and 2% employee's NIC), generating a further £520,000 for the Treasury.

Therefore, as the Treasury would have got £660,000 in any event, the net gain to the Treasury in Mr Hester forgoing his bonus is likely to be around £336,400 (£996,400 - £660,000).

However, if you look at bankers working for banks not partially owned by the UK Government (Barclays for instance), for every £1 million bonus foregone (ignoring non-doms) the Treasury loses £640,000 in income tax and national insurance, and gains only 26% (£296,000) in corporation tax. Therefore, **if** the UK government is not later down the line required to offer further bail outs, then for each £1 million bonus paid the Treasury is actually £344,000 better off. This, of course, is a big "if".

It's all about cashflow!

Greg Lacey takes a look at the importance of this often overlooked financial statement

Traditionally, the key financial statements that we are more often than not asked to comment upon are the profit and loss account and the balance sheet included within a set of accounts.

The profit and loss account serves to record profitability over a specific accounting period, which is generally a year but can occasionally be longer or shorter. The balance sheet records the assets and liabilities of a business at a specific point in time, being the end of a particular accounting period. In effect, the former shows past performance, whilst the latter reflects the available resources and financial position of a business at a specific point of time.

The profit and loss account is useful for instance in enabling us to assess whether a claim for, say, loss of profits is consistent with past actual performance. The balance sheet provides an indication as to whether a business has the financial wherewithal to continue trading in the future.

In recent months however we have become aware of an increasing number of cases where our attention has been focused on reviewing cashflow forecasts for businesses and for reasons described later we expect that we will be receiving further instructions on a similar basis going forward.

So what is a cashflow forecast? It is literally a summary of anticipated cash inflows and outflws over a prospective trading period showing the overall net effect on a business' cash position. Cashflow is all important in assessing whether a business can continue to trade, and indeed a business will only become insolvent once it is no longer able to meet its debts as they fall due – in other words it has insufficient access to cash to be able to meet its day to day running costs.

Our focus on cashflow issues in recent months has been for various reasons and in a different number of contexts. For instance, we have been asked to consider the appropriateness or otherwise of cashflow forecasts in the following circumstances:

- In a claim brought against the auditors of a company acquiring out of administration a music retailer, we were asked to assess whether the Whitewash Procedure required under Section 155 of the 1985 Companies Act had been complied with. Under the Whitewash Procedure, directors are asked to certify that the business can afford to pay its debts "*as and when they fall due over the next 12 months*" and the auditors then confirm whether this certification is reasonable. Failure to comply is a criminal offence under Section 151 of the Act. In this case the cashflow forecast, which was extremely sensitive to even small changes in assumptions, was prepared on the basis that VAT would be paid in the month after it was actually due and that trade creditors would all be paid 30 days later than under agreed terms, it was patently self evident that going forward the business would experience cashflow difficulties, and debts would not be paid when due;
- In director's disqualification proceedings we were instructed to review the cashflow forecasts that were prepared for and relied upon by management of a company which it was later alleged was involved in unlawful trading. Our role here was to assess whether management had considered, on a timely basis, the ongoing financial performance of the business and given that likely performance, whether it was reasonable to continue trading. Whether a business can (and should) continue to trade will be determined by its future expected cashflows;
- We also had to consider the reasonableness or otherwise of a cashflow forecast that directors' had relied on when declaring a dividend which was later challenged as being illegal;
- We have been instructed to review cashflows and subsequent spending patterns in a number of Proceeds of Crime Act confiscation matters. Here our focus has a slight twist to it as we are essentially reviewing past actual cashflows which often prove integral in establishing where cash has come from and to where it has subsequently been applied. This can be crucial particularly where allegations have been made that there are hidden assets;
- Cashflows also play an essential part in most valuations. The value of a business to a potential purchaser might readily be equated to the present value of expected future cashflows, discounted back to a present value at the business' internal rate of return.

We expect there to be an increased focus on cashflows as due to the current economic climate sales revenues drop and margins shrink so that those running businesses find that they have less access to cash within the business and this is exacerbated by a current squeeze in bank lending which prevents them obtaining access to cash externally.

We expect that the following will drive further focus on cashflows going forward:

- Given the economic climate, regardless of the nature of a dispute whether it is a commercial dispute or an insurance claim, where a business is interrupted and a claim is made for future losses it will be vital to give some thought as to whether the business was likely in any event to be able to continue trading, which will come down to an assessment of future expected cashflows and resources available to the business. If a business would have been unlikely to continue trading anyway then there should be a cap on any future loss claim;
- Many businesses have availed themselves of HMRC's "Time to Pay" scheme whereby HMRC agreed to defer payment of taxes such as VAT and PAYE to enable businesses to use the "government's credit" to meet short term cashflow problems, which required amongst other things a cashflow forecast to be supplied with the application. We expect issues to arise going forward where businesses fail and HMRC is left with a massively increased unpaid debt and the focus will then be on whether the cashflow forecasts supplied by the business to HMRC were justified – we expect many will not be. This may result in negligence claims against directors and their professional advisers;
- We also expect there to be an increase in unlawful and wrongful trading cases, partly as a consequence of the downturn since 2008 but also as a result of directors failing to take appropriate account of deferred tax liabilities agreed under the "Time to Pay" scheme. This in turn will lead to an increase in directors' disqualification cases;
- Finally, due to inherent uncertainties in the economy there will be increased scope for challenging cashflow projections. When an economy is benign as the UK economy was between 1997 and 2007 you can assume underlying trends would have held good going forward. This is now not the case, and therefore there is scope to challenge underlying assumptions whether in the context of profit projections or indeed cashflow forecasts.

Many retailers will have hoped to repair holes in their cashflows through the pre-Christmas trading period; the fact that several have already announced plans to enter administration in early 2012 suggests performance was insufficient. After a year of huge increases in raw material prices, with consumers' cutting back their spending, VAT at 20%, discounting already evident and banks reining back their lending this may just be the conditions for a perfect storm for retailers as the squeeze on sales, margins and access to cash takes its toll.

All change please!

Simon Paley considers the issue of notional salary costs – and whether a bus conductor might be interested in acquiring a commercial agency business

In a number of recent commercial agency disputes in which we have been instructed to act, one of the most contentious issues is that of the "notional salary deduction" and its impact on the valuation of the agency business.

As you may be aware, the Commercial Agents (Council Directive) Regulations 1993 ("the Regulations") codified the rights of agents to compensation upon the termination of their agency relationship. The basis on which that compensation should be determined was clarified in the landmark case of *Lonsdale -v- Howard & Hallam Limited*, in which Lord Hoffman established that it should be assessed by reference to the value of the agency relationship, on the assumption that the agency would have continued and a hypothetical purchaser would have been able to take over the agency contract and properly perform it. However, not all relevant valuation issues were definitively resolved in Lord Hoffman's ruling.

Under an earnings-based approach, the valuation of a business is often determined by applying a multiplier to the profits generated by that business. It is not the reported profits that is relevant here – but instead the "maintainable" or underlying profits.

Often, when we scrutinise corporate acquisitions, we see instances where the vendors (the director-shareholders of the target company) have "overpaid" themselves above the normal market rate for their services and, for example, received a premium salary or luxurious benefits such as a high-spec company car. On other occasions, perhaps where the business has faced financial difficulties, the owners might take a reduced salary, which does not fully reflect the extent of their contribution to the business.

When adopting an earnings-based valuation approach, a competent purchaser would ordinarily adjust his assessment of maintainable profits to reflect the true contribution of the owner – at a market rate of salary. The rationale for this adjustment is in recognition of the fact that the owner will most likely leave the business following the sale, and it will then become necessary to replace the owner with an employee or employees. Clearly, it is the cost of those employees that is of relevance to our hypothetical purchaser when making his buying and valuation decision, and not the arbitrary remuneration paid to the former owner.

If a commercial agency business was operated under an incorporated business structure, we might expect a similar adjustment to be made. However, commercial agents most commonly operate as sole traders. We would not expect a sole trader to pay himself a conventional "salary" – instead, he will receive (and be taxed upon) the retained earnings of the business. Following the principles set out above, it seems appropriate, when assessing the value of a

commercial agent's business, to make a deduction to reflect the market rate of the services provided by that agent. However, the practical consideration of that assessment is not always simple, as illustrated below.

Our first example considers the position of Mr Cannon, who acts as an agent for the manufacturer of packaging machines. Mr Cannon spends all week travelling to different production facilities in the UK and Europe, demonstrating the capabilities of the machines to potential customers.

This is a full-time role for Mr Cannon. He generates average annual commissions of £50,000 and, after deducting his direct costs (principally, subsistence, telephone and travelling expenses), Mr Cannon's agency business generates a net profit of around £25,000 per annum. As a sole trader, this net profit represents Mr Cannon's earnings, and is the sum on which he will ordinarily be expected to pay tax.

Let us now suppose that Mr Cannon's agency is terminated. Under the Regulations, he will become entitled to compensation equivalent to the sum a "hypothetical purchaser" would have paid for that business. Our hypothetical purchaser might, quite reasonably, consider that it is appropriate to evaluate Mr Cannon's agency business based on a multiple of earnings, and following a review of comparator businesses believes that a pre-tax multiplier of (say) 4 is suitable.

However, it would not be appropriate to value Mr Cannon's business at £100,000 (£25,000 x 4). Our hypothetical purchaser should factor into the valuation the cost of replacing Mr Cannon's labour input. The hypothetical purchaser could do this in one of two ways:

1. Hire a replacement for Mr Cannon (at a market-led rate); or
2. Our hypothetical purchaser could forego his own (existing) job and perform the work himself.

In either case, this comes at a cost (the cost of giving up your own job is termed an "opportunity cost"), and it is necessary to adjust pre-tax profits to reflect this cost accordingly.

For the sake of simplicity, let us assume that the cost of replacing Mr Cannon would be £15,000 per annum. Adjusting for this notional cost reduces pre-tax profit profits to only £10,000 per annum. For the purposes of our valuation, this represents the "maintainable earnings" of the business, and based on a multiplier of 4 would suggest an overall valuation of £40,000.

Alternatively, if the notional cost of replacing Mr Cannon was (say) £30,000 per annum, then adjusting for this cost would extinguish the profits of the business. It might then be argued that the agency business is worthless. Lord Hoffman referred to this issue in passing in his *Lonsdale* judgment:

"... it is hard to see why anyone should have paid for the privilege of a full time job which earned him less than he would have been paid as a bus conductor."

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All change please! (continued)

Nevertheless, assessing this "notional salary" deduction might not always be so simple.

Let us consider a second example, where Mr Ball acts as an agent for the sale of cat food to the major supermarket chains. Like Mr Cannon, he generates net commission (after deducting his direct costs) of £25,000 per annum.

However, the nature of Mr Ball's agency work is rather different to that of Mr Cannon. Mr Ball visits a representative of each of the supermarket chains once every quarter, following which they place their orders. He then is available at the end of the phone to deal with any supply queries they may have in a general trouble-shooting role.

Should a "notional salary" deduction be made here?

On average, Mr Ball spends around 10% of his working week dealing with the business of the cat-food agency. It might therefore be reasonable, when valuing that agency, to make a notional deduction of 10% of the cost of a full-time replacement (say, 10% of £30,000 = £3,000 per annum). This would reduce maintainable earnings to £22,000 per annum, and suggest a value of the agency business (again, assuming a pre-tax multiplier of 4) of £88,000.

You will appreciate that the Regulations consider the position of a "hypothetical purchaser", and this represents a hypothetical deduction. No one is really suggesting that the purchaser should pay someone to work around 4 hours each week. In practical terms, there are two other more realistic scenarios:

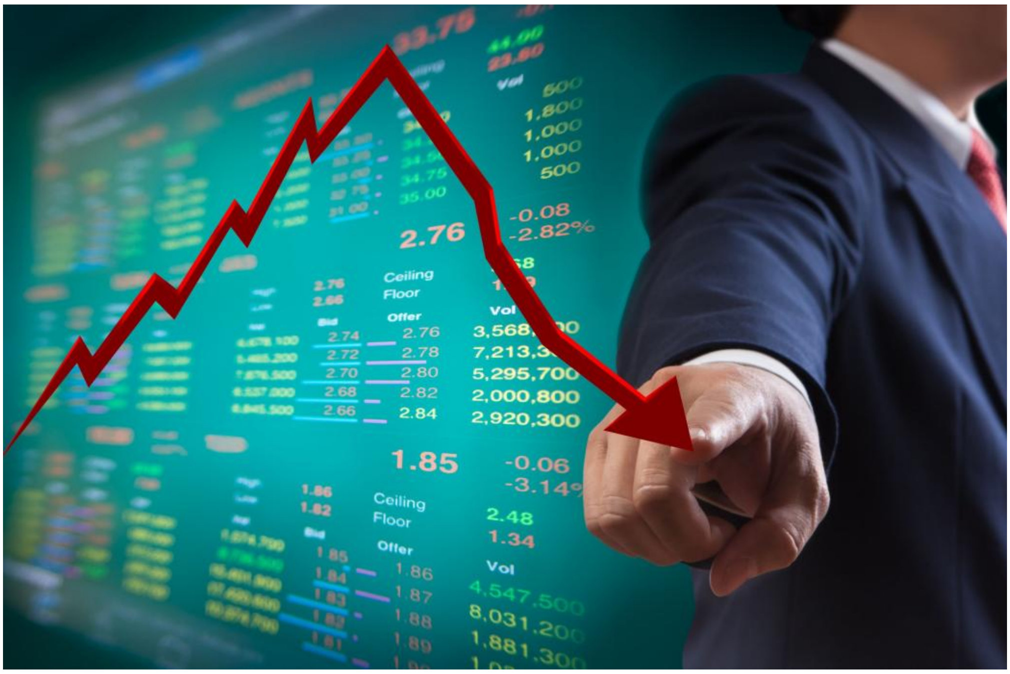
1. The purchaser <u>would</u> have given up his job (maybe he was a bus conductor and was looking for a change in career), to take on this agency arrangement; or (and perhaps more likely)
2. The purchaser is an existing agent, already supplying pet food products to the supermarkets.

Clearly, the notional cost under each of the above scenarios is widely different. Under the latter scenario, it is possible that the purchaser would expend no significant additional time in performing the duties of the cat food agency previously undertaken by Mr Cannon – after all, he would be holding regular meetings with the pet food purchasers of the supermarkets in any event. Mr Cannon's business is a direct "bolt on" to the purchaser's existing business, and will not result in any noteworthy additional cost or effort. Under these circumstances, it is arguable that no notional salary deduction at all should be applied when assessing the value of the agency business.

However, it would seem rather untidy if the agency valuation was to depend on the specific circumstances of a purchaser, who is any event imaginary! It might therefore be most equitable to make the modest, 10%, deduction described above, even though that does not represent the most realistic pretend scenario. This illustrates that, whilst a notional salary deduction may be correct in principle, each case must be assessed based on its own specific facts.

Time gentlemen please!

In the third of a series of articles, Phil Southall considers how the current economic climate can affect the value of unquoted businesses during uncertain times.



As described in previous articles, theoretical business valuations are often required in, amongst others, the following litigious situations:

- shareholder disputes;
- acquisition disputes;
- matrimonial breakdowns;
- the termination of a Commercial Agency; and
- Compulsory Purchase Orders.

Business valuation is as much as an art as it is a science, and there is no one size fits all approach. Each business must be valued specifically by reference to its own asset base and its potential to generate ongoing maintainable earnings from them.

The importance of the valuation date

For certain types of dispute, the date of any theoretical valuation required may be self evident. For example, in acquisition disputes, it is the date of the acquisition that is critical, and similarly if a principal terminates a commercial agency, then it is the date of termination that is relevant.

However, for other scenarios, the appropriate date may be more opaque. Exactly when did a shareholder agreement breakdown? In matrimonial disputes, the date of the valuation again may be unclear, depending on the specific circumstances leading up to, or following, any separation. Inevitably, assessing the appropriate valuation dates could be significantly complicated by common real life factors, such as attempted reconciliations etc.

Indeed, I have previously been required to undertake valuations on two different dates, as the parties were unable to agree which was the relevant date for the purposes of litigation.

Is timing so critical?

As many of you will no doubt know, a common technique for valuing a business is the "capitalised earnings" or "price earnings" methodology, whereby a "P/E ratio" is applied to projected future (maintainable post-taxation) earnings. An appropriate P/E ratio being assessed by reference to comparable companies, which are typically:

- recently acquired comparable companies; or
- quoted companies operating in the same sector.

In 2008, and also more recently, banks were reluctant to lend, and actual or potential breaches of bank lending covenants caused an increased number of distressed sales. Both factors served to drive down values that purchasers were willing to pay for businesses. Consequently, between 2007 and December 2008, with the exception of the Health Care and Financial sectors, all industry sectors P/E ratios reduced year on year (highlighted red) (see table on the next page).

Since then, however, performance has been significantly varied in differing sectors of the UK economy over different time periods.

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Between 2008 and 2010, most sectors recovered, or at least partially recovered. Sectors which recovered but which did not reach 2007 levels are shown in amber, and those which recovered to exceed 2007 levels are shown in green.

However, with the exception of Oil & Gas, *all* of the sectors that showed recovery between 2008 and 2010 have since declined, some quite significantly. Is this indicative that there wasn't a real recovery, but was merely the market's perception at that time?

My original December 2008 article regarding the economic downturn on business valuations concluded that:

"...the current state of the economy, as is regularly reported, is having a widespread negative impact across many sectors; decreasing the market value of the companies that operate therein.

Unless there are specific, supportable reasons as to why a company operating within such sectors rebuts the general trend, it is likely too, that the value of that company has fallen compared with this time last year..."

This conclusion rings true today; and indeed is evidenced by the distinct lack of green in the final columns, showing that none of the current sector P/E multiples are as high as they were in 2007.

However, within each sector, there can be a significant contrast in the individual fortunes of the component companies. This makes it possible to rebut general sector trends, by seeking to benchmark the subject company not against whole sectors, but specifically against individual companies operating within that sector.

For example, despite the relative stability of the Health Care sector throughout this period, the P/E ratio of GlaxoSmithKline almost doubled between December 2008 and December 2010, to 23. The main reason for this was because its profits more than halved during this period, and as a result of the relatively unchanged share price, its P/E ratio doubled. Indeed, to the extent that depressed profits are not reflected in the proportionate decrease in share price, then this can lead to more volatility in P/E ratios throughout a recession.

Other issues created by economic uncertainty

A period of prolonged economic uncertainty also raises other issues that will need to be considered when preparing a valuation:

Firstly, years of acquisition activity has led to a conventional "rule of thumb" being developed for many business types, e.g. professional services firms are typically valued by reference to turnover. With limited deal activity over the past three years, any pre-existing "rules of thumb" are unlikely to have changed; however, are they now out of date and thus less, or not, relevant?

Secondly, the theoretical market value of any business is the price that a *willing* seller would accept and a hypothetical purchaser would be willing to pay. If a number of reported transactions represent distressed sales, how can these sales be identified? Are these transactions then relevant when seeking to ascertain the value that a ***willing*** seller would be willing to accept, or would using them understate the market value?

When unprofitable businesses are acquired, a P/E ratio cannot be assessed. It is possible that throughout the last three years, when many companies were loss making, there fewer P/E ratios reported in deals than had historically been the case. Therefore, with fewer transactions, and even fewer reporting a P/E multiple, this is a further reason why average P/E ratios are likely to have been more volatile, as they are being calculated by reference to fewer transactions, with each one therefore having a greater bearing on the average.

Finally, in addition to all of the uncertainty and potential volatility with P/E ratios, let us not forget that making robust reliable assumptions regarding the future profitability of a company is also inherently more difficult when the future is uncertain. This is particularly so in light of recent developments regarding the Eurozone, which may impact on UK exporters in particular.

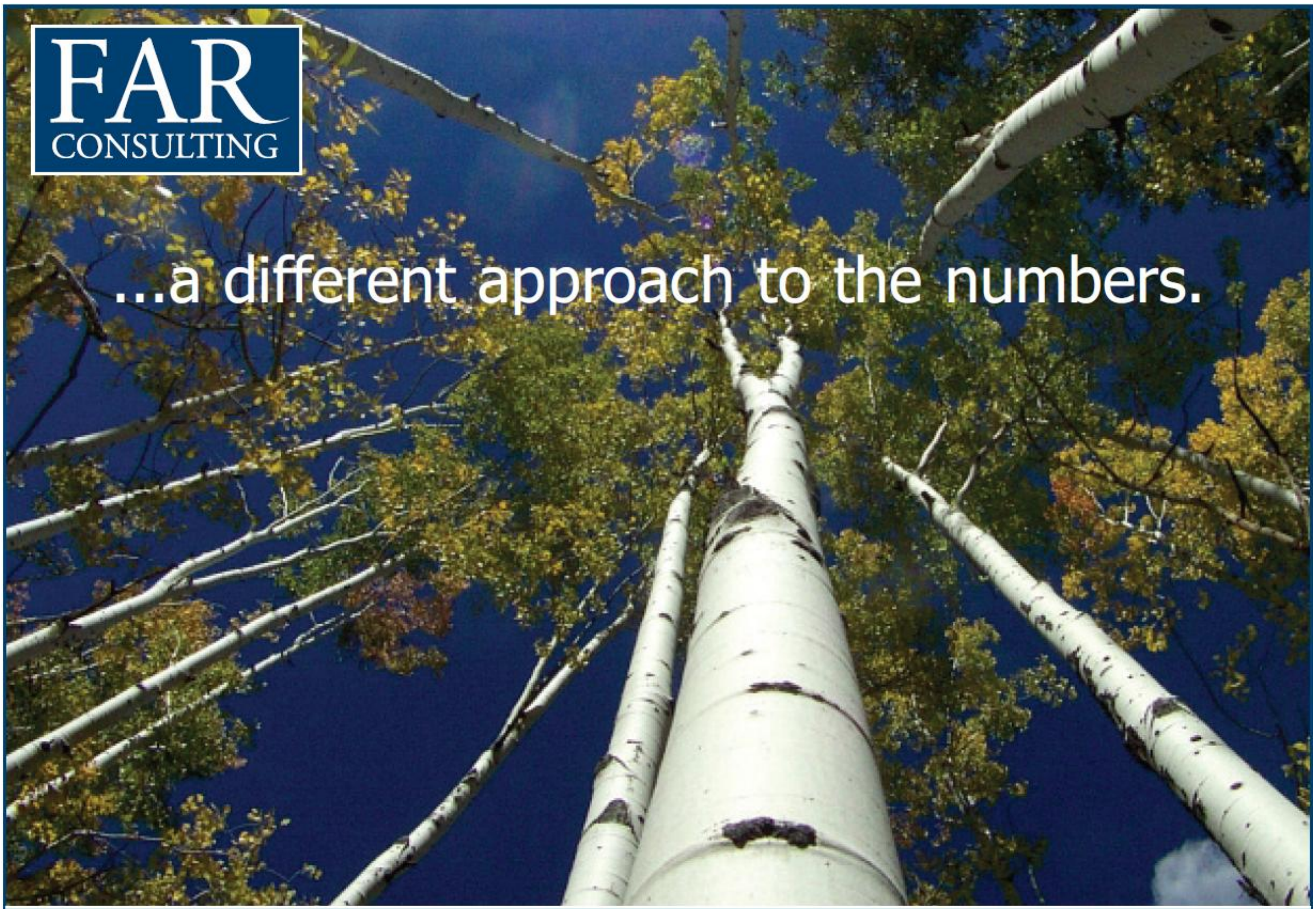
Summary

We are now seeing an increasing number of shareholder disputes requiring current valuations, across a broad range of industry sectors. Perhaps this is indicative of majority shareholders seeking to acquire greater control of businesses at a time when they perceive the market is at its lowest, and that the longer term future is likely to be rosier. Whether this is borne out in practice will remain to be seen.

Overall sector trends indicate varying performances of different sectors over different periods throughout the last three years. Moreover, and more importantly, there has potentially been more volatility, and increased fragmentation within individual sectors throughout this period. There is also the ongoing added complexity of making reliable assessments regarding future profitability.

As a result of this, it is even more important that careful consideration is given to ascertaining the relevant date of valuation, and in choosing the appropriate comparable companies or transactions when seeking to value any unquoted company.

FTSE Sector P/E Multiple:	Dec-07	1-year movement	Dec-08	2-year movement	Dec-10	1-year movement	Dec-11
Oil & Gas	12.57	(47%)	6.66	+34%	8.94	+11%	9.96
Basic Materials	11.08	(62%)	4.23	+192%	12.36	(55%)	5.61
Industrials	16.24	(34%)	10.67	+84%	19.61	(36%)	12.59
Consumer Goods	16.63	(2%)	16.24	(5%)	15.43	(6%)	14.56
Health Care	14.74	+2%	15.05	(12%)	13.27	+5%	13.89
Consumer Services	14.79	(37%)	9.37	+50%	14.05	(16%)	11.86
Telecommunications	13.28	(30%)	9.31	(11%)	8.28	(8%)	7.64
Utilities	13.42	(4%)	12.91	(19%)	10.49	+6%	11.11
Financials	8.92	+5%	9.34	+104%	19.05	(55%)	8.55
Non-financials	13.75	(37%)	8.72	+37%	11.94	(17%)	9.94
Technology	26.46	(51%)	13.02	+80%	23.40	(9%)	21.20



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Simon Paley is notionally based in Birmingham. Before joining FAR Consulting, he worked in Ernst & Young's forensic accounting team. Simon has over ten 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 adjustment mechanisms, completion accounts, breach of warranty claims and other transaction-related disputes. He has provided advisory and expert witness services to clients involved in disputes across a wide range of industries and has experience of most forms of dispute resolution.

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