Dealing with businesses and accounts in ancillary relief cases

<u>Aim</u>

To consider obtaining and use of business valuations in ancillary relief cases and handling business accounts.

NB within this paper B is the party with an interest in the business, and A is the party applying for a share of the business.

<u>Business valuations</u>

Introduction

1. A variety of business models which may arise in ancillary relief cases : sole trader; partnership; limited company (including companies which are in reality the alter ego of the husband or wife; family companies involving husband and wife and/or members of their families; and companies involving husband and/or wife and other non-family members). Issues of value may arise in each of these different situations.
2. We may ask : "If a house can be valued by an estate agent, why can we not ask an agent specialising in business sales to value a business?" but :
   - There is not a ready market for many of the businesses we will encounter; and
   - If there were, the negotiations leading to a price being agreed would focus on the valuation methods used by accountants in a business valuation report ie looking at the value of the assets, likely future income etc.

   Of course, this assumes that the accountant carrying out the valuation has some practical experience of advising clients on buying or selling businesses. It may be worth whether the proposed valuer has any such experience, particularly in the locality.
3. A and B may want to achieve different results : on the assumption B will continue to run the business :

   B may want to argue that :

   - the business has no substantial value over and above the net assets;
   - the asset value is unrealisable whilst the business is a going concern;

- the business should be viewed as an income stream rather than a capital asset;
- the income is under pressure due to the recession, loss of contracts, bad debts etc and is very uncertain; and
- there is insufficient liquidity to enable A to receive a share of the capital value of the business.

A may want to argue that :

- there is a substantial goodwill element in addition to the value of the assets;
- as B will retain the capital value, it should be fully taken into account in any division of the assets;
- the future prospects of the business are better than the past accounts appear to show due to new products/ new markets/ new contracts; and in consequence the business has been undervalued; and
- B can pay a lump sum by a variety of means including sale of assets, cash in the business bank account and/ or further borrowing.

<u>Should the business be valued?</u>

1. In valuing a business there are two main bases of valuation :
   - The net asset basis (which involves valuing the assets and deducting the liabilities); and
   - Capitalisation of the future income of the business (although this can be undertaken in a variety of ways).

   The latter method will require expert accountancy advice; the former may not although it may require other expert evidence. The real question is whether one needs expert evidence from an accountant or other expert.
2. This is a question which should be asked at the very earliest opportunity :
   - B is required to address it in the Form E : section 2.11 requires "Your estimate of the current value of your business interest. Explain briefly the basis upon which you have reached that figure."

     This is often addressed either by attaching a letter from the firm's accountant or by using the net asset value from the latest accounts.

     B should not use a figure he is not willing to stand by.

It is usually unwise for B to spend substantial sums on obtaining a valuation (except by prior agreement with A) as the Court may subsequently order a report of a SJE jointly funded by A and B.

- A's advisers should consider it before the First Appointment and be in a position to argue for an appropriate report at the First Appointment.

3. In V – v – V [2005] 2 FLR 697 Coleridge J upheld the decision of a DJ who refused to attribute a capital value to H's interest in an optician's business. His Lordship upheld this conclusion in circumstances in which it was conceded that the business was unsaleable, the asset illiquid and in which the order for periodical payments in the case was dependent on the income stream from the business.

   NB Before seeking to draw too much of a principle from this case it should be borne in mind that in that case no proper valuation evidence was put before the DJ. At para 28 his Lordship said :

   > "There can, of course, be no hard-and-fast rule in relation to the extent to which the capital value of businesses are or are not brought into account but where (as here) there is no real value except as an income stream, to include it in circumstances where there is no suggestion that there should be a clean break, runs the serious risk, in my judgment, of double-counting. I consider that the proper approach in a case of this kind is for the court to treat such business assets as primarily a secure income of the parties, from which there has to be a substantive and unlimited order for periodical payments."

   The particular principles appear to be :

   (i) Where there is to be a joint lives maintenance order payable out of the business income, obtaining a business valuation may involve double counting;

   (ii) Where the business is unsaleable, a business valuation seeking to capitalise the income stream is inappropriate.

4. The sort of factors which will justify a capitalisation approach requiring a business valuation by an accountant are :

   - The business is a profitable solvent going concern; and
   - The business is capable of being sold as a going concern

   (However, as an exception to this, certain asset-rich businesses such as farms, hotels and care homes are valued on a net asset basis.)

5. Other businesses valued on a net asset basis include new businesses with uncertain prospects and insolvent businesses.

6. The answer is often fairly obvious : the difficulty usually arises where B is a small self-employed tradesman who is a one-man band. At what point is it worth seeking a valuation of his business? Questions which may be worth answering are :
    - Is the business likely to be saleable?
    - When B retires, what is likely to happen?
    - If B were to employ someone to carry out his/her functions within the business, would s/he still be left with a profit?
7. What if that same tradesman sets up a limited company?
8. If in doubt, seek initial advice from an accountant as to which method of valuation is likely to be appropriate, whether expert evidence is required, whether evidence is required from a specialist valuer.
9. In all cases have regard to proportionality in relation to the cost of the report.

<u>Methods of valuation</u>

The two main methods are the net asset basis and the capitalisation basis.

Net asset basis

1. When is this used?
    - Asset-rich businesses producing a low rate of return
    - Investment businesses
    - New businesses
    - Insolvent businesses
    - Businesses where another basis is not appropriate
2. How is it calculated?

    Obviously : value of assets less total liabilities

    BUT consider the following :

    - A farm
        - Value the farm
        - Value live and deadstock
        - Deduct liabilities

    - A sole trader whose business is not saleable

- The assets are often very limited. In this case, is the Court likely to attach any value to tools etc?
    - Is it likely to be proportionate to re-value assets to which a value has been attributed in the balance sheet on a depreciated historic cost basis?
    - What if there is no balance sheet?
- A larger-scale business with a more complex balance sheet
    - May require disclosure of management accounts to obtain the up-to date value of the business.
    - May require accountancy advice as to (a) whether the bottom line fairly represents the value of the business, for example if there is substantial provision for contingent liabilities; should the value of old assets appearing in the balance sheet be written off; (b) how to treat a figure appearing in the balance sheet for goodwill; and (c) in the case of a partnership, what is B's share of the net value.
- A business which owns property
    - The property is likely to appear in the balance sheet on a historic cost basis and, consideration should be given to revaluing it
- In all cases avoid double counting of liabilities :
    - A liability may appear in the balance sheet and also appear separately in the Form E in section 2.3 (overdrawn bank account) or 2.9 (liability)

Capitalisation basis

1. Variations on the capitalisation basis
    - Most commonly, earnings valuation : net or gross earnings and multiplier
    - Rarely, dividend yield
2. When is this used?
   In the vast majority of cases where an accountant's valuation is appropriate.

3. How is an earnings valuation calculated?

- There are two elements : earnings and a multiple.
- It is unlikely to be helpful to adopt a rule of thumb such as "Value = 3 x net profits" because in assessing value (a) an accountant is unlikely simply to accept the net profit figure in the accounts; and (b) multiples vary from industry to industry and selecting the appropriate multiple is a matter of skill and judgment.
- **Earnings**
  - The accountant is seeking to assess future, sustainable recurring net profits
  - It is likely that net profits will be adjusted to reflect the commercial cost of employing a manager to run the business
  - There may be further adjustments to remove expenses not properly attributable to the business (eg personal expenditure)
  - The figure for future net profits is then an average of the adjusted net profits over the last three years weighted in favour of the most recent year's profits eg

	2009	2008	2007
Adjusted net profit	23230	21383	16418
Weighting	3	2	1

    Weighted average : (23230 x 3) + (21383 x 2) + (16418 x 1) = 128874 / 6 = 21479
  - If following the accountant's report latest figures show a substantial change in the net profits, it may be worth updating the calculations : eg

    Net profits in 2010 £26650

    The weighted average of the last three years will exclude the much lower figure in 2007 and produce the following calculation :

    (26650 x 3) + (23230 x 2) + (21383 x 1) = 147793 / 6 = 24632

- **Multiples**

Accountants derive the multiple from a variety of sources including comparators in sales of similar companies; published price/ earnings ratios and the PCPI (Private Companies Prices Index); the return on capital likely to be sought by an investor.

Past transactions

- In some cases the value of a shareholding in a private limited company may be determined or informed by prior transactions
- If in the relatively recent past a shareholder in the company has retired and sold the shareholding to another shareholder or a stranger, the sale price may inform a consideration of the value of B's shareholding.
- If there has been a past sale, or if there have been recent negotiations to sell the business as a whole or in part, it may be important to seek the fullest disclosure about such sales or negotiations.

Discounting for minority shareholdings

In the case of a minority shareholding in a private company, it may be argued that in determining the value there should be a discount because the shareholding is a minority interest, but :

- Where W and H together hold a majority interest this will not be appropriate (see G – v – G [2002] 2 FLR 1143).
- Nor will it be appropriate if a sale of B's interest alone as a minority interest is unlikely because the business is a quasi-partnership.

<u>Viability of the business</u>

In a variety of situations it may be reasonable to ask : "Is this business viable?"

- In the case of a sole trader who has no business assets and a very small annual profit it may be entirely reasonable to ask "Why carry on? Why not go and get a job?"
    - Under section 25(2)(a) the Court is required to consider any increase in earning capacity which it would be reasonable to expect a part to take steps to acquire.

- There may be reasons why the apparently low profit does not accurately reflect the state of the business including :
  - Unrecorded cash takings
  - Personal expenses shown as business outgoings

- In the case of an asset-rich business such as a farm, where the profits are low, it may be better for the assets to be realised and distributed and for B to seek employment :
  - If the assets are worth, say, £1 million and the net profit is, say, £10000, the rate of return at 1% is very low.
  - If the balance sheets for the last two or three years show increasing debt with no apparent explanation it may be worth arguing that the farm is not viable and should be sold.
  - It may be appropriate to obtain expert evidence on this issue.
  - Where the farm is jointly owned and A is entitled to a half share, this line of argument may be irrelevant as A is a sale may be inevitable to enable A to receive a fair share of the assets.

<u>Procedure</u>

1. It is important for this issue to be addressed as early as possible within the framework of the ancillary relief rules :
   - At the First Appointment the issue is "What evidence is required?"
   - By the time of the FDR the evidence should be available in its final form. Thus, the timetable should provide for questions to be asked and answered, if so advised, before the FDR.
2. **First appointment**
   - Is expert evidence required, if so what?
   - Joint instruction or separately instructed experts?
   - Is it appropriate to instruct the business accountant?
   - Is further disclosure required before instructing the expert?
   - Provision in the timetable, before the FDR, for the expert(s) to answer questions if so advised, and if more than one expert, for an experts' meeting.

3. **Further information**

   If once instructed the expert requires further information :

   - Will B disclose it voluntarily?
   - If not is an application needed for further directions?
   - In either case will it affect the timetable for the FDR?

4. **Questions**

   - Questions to clarify ambiguities in the report
   - If you have obtained some separate accountancy advice which conflicts with the SJE, questions may arise as to methodology, the multiple selected etc. These questions may be asked as part of the process set out in DANIELS – v – WALKER [2000] EWCA Civ 508.
   - Where the report is based on the last set of accounts (which may be as much as 12 months old) and there have changes or alleged changes of circumstance since those last accounts (eg management accounts showing a significantly better or worse position; loss of major contracts; other factors which may affect turnover or profit etc) how do these changes affect the value.

5. **The FDR hearing**

   - Does either party wish to instruct their own expert for reasons which are not fanciful (see DANIELS)
   - Is permission needed for the expert to give oral evidence?

<u>How should the value be viewed?</u>

1. Beware of the element of double counting in which the business is both treated as capital in H's hands and as an income stream : see V – v – V.

   However, this argument only applies where B is expected to pay substantial ongoing maintenance from the business income.

2. In any event, even if B is paying maintenance from the income, if the business will be sold on retirement, B will have a sum of capital from the sale of the business at that stage; and it is possible that the maintenance obligation will cease at that stage.

3. In any event, like a pension, the business capital is unlikely to be realisable in the immediate future and may not be realisable until retirement (although unlike a pension it will be realised at that stage as capital not income).
4. It is arguable therefore that a discount should be applied to the capital value of the business to reflect the delay in realisation.

   Example : Assume B is 37 and expects to retire at 65. The business is valued at £67000.

   If the value is discounted at 2 to 3% per annum over a 28 year period, the value for the purpose of the Schedule of Assets would be £28500 to £37300.

   The Ogden tables provide the appropriate discounting factors.

<u>How is A to be provided with a fair share of the value of the business?</u>

There are the following possibilities :

1. The capital value of the business is modest : A can receive a fair share from the other assets of the parties.
2. The capital value is very substantial and the return relatively modest : the only fair solution is a sale of the business (eg a jointly owned farm).
3. Money can be taken out of the business to enable an immediate payment to A (a) from cash in the business; (b) by selling surplus assets (often argued in farming cases); or (c) by additional borrowing (often requiring security against business property).

   The accountant will often be asked to address the question of how money can be extracted from the business, what assets could be sold without affecting the profitability of the business and whether additional borrowing can be supported. If the accountant advises that additional borrowing can be supported, B may need to obtain evidence from lenders as to the availability of borrowing.
4. Where the capital is not realisable because the business will continue to be run as a source of income it may be impossible for A to receive a fair share of the capital immediately. Consideration should be given to the following :
5. The Court may order B to buy out A’s interest over a period of years : in R – v – R [2005] 2 FLR 365 Coleridge J ordered H to pay W £1 million over a 5 year period with substantial discounts for early payment as follows :

	30/1/05	1/1/06	1/1/07	1/1/08	1/1/09	1/1/10
1	200000					
2	92000	100000				
3	126000	138000	150000			
4	152000	168000	184000	200000		
5	136000	152000	168000	184000	200000	
6	90000	102000	114000	126000	138000	150000
	796000	**860000**	**916000**	**960000**	**988000**	**£1m**

Interest was payable on any sum not paid by the due date.

6. Other cases demonstrate the importance of achieving practical solutions which are fair to both parties rather than mathematical equality : in G – v – G [2002] 2 FLR 1143 Coleridge J said :

> "…fairness dictated that the parties leave the marriage on terms of broad financial equality. That did not mean precisely 50% of the value of a given assets schedule on a given date, but leaving each side in a position of broadly similar financial muscle."

See also the comments of Charles J in A – v – A [2006] 2 FLR 115.

7. Other possible solutions include the following :
   - Permitting A to become or remain a shareholder or partner in the business.
   - Permitting A to take over a discrete part of the business.
   - Purchase of A's shares by the company or an outside investor.
8. The accountant may be able to advise on these or other solutions and on safeguards if A is to remain a shareholder or partner.

Matters to check for when considering business accounts

1. Has B attached the last two years' accounts to the Form E as required by section 2.11? (NB This will enable a comparison of three years' figures). It may well be necessary to have three years of accounts for the expert.
2. When will the next accounts be due? Should management accounts be sought?
3. In the case of a company, have the full accounts been disclosed or only the abbreviated accounts? Copies of the full; accounts should be disclosed.
4. Compare turnover/ profit/ drawings for the three years and consider :
   - Is there a reason for a difference in turnover?

- Is there a substantial difference in the ratio of profit to turnover? If so is there an obvious reason?
- How do drawings compare with profits : is B living beyond means, or saving excess profits? If so is there evidence of what has happened to the surplus?

5. Directors' current accounts/ partners' capital accounts : is B's account in credit or overdrawn? If so is there a hidden asset/ liability which should be factored into the Schedule of Assets? It may be appropriate to seek a full breakdown of transactions on the account.
6. Compare the items of expenditure in the profit and loss account with the Form E outgoings. Is there any overlap eg loan interest, motoring expenses, use of home as office etc?
7. Compare the liabilities in the balance sheet with the liabilities in the Form E. Is there any overlap?

<u>Taxation</u>

Remember that whilst instructing an accountant it may be useful to ask for advice on issues of CGT and/ or other taxation issues.

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