Making sense of the dollars– **a closer look at the treatment of assets and income**

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Super Isn't Super- Seminar 2**, The Family Law 'Making Sense Of The Dollars' Seminar Series**

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Consider the following scenario. A Husband and Wife are separating after 13 years of marriage. There are two children of the marriage, aged 9 and 13. The Wife has undertaken the primary home-maker role and has no formal training or work experience. The Husband operates his crane business through a company and has been the primary bread-winner. The net assets and liabilities of the parties total approximately $150,000. This includes the Husband's business which is valued at $129,000. The Husband wishes to retain the assets that would allow him to continue to operate his business.

Having considered all relevant factors, including the Husband's income, the trial judge orders that the Wife is to receive 60% of the assets. In order for the Husband to retain his business and other relevant assets, he is required to pay the Wife $92,000. However, in order for the Husband to be able to pay the Wife this amount of money, he must either sell the cranes and other equipment that he requires to generate income or restructure his business. The latter would result in significantly higher operating costs thereby significantly reducing his earning capacity. Either way, the Husband does not have the capacity to pay the $92,000 to the Wife without this impacting his income earning capacity.

It is reasonable to say that the Court has an obligation to consider the economic consequences which flow from their orders. Section 79(4)(d) of the Family Law Act requires the Court to take into account the effect of any proposed order upon the earning capacity of either party to the marriage. However, this did not occur in the above scenario, which is based on the matter of Elsey & Elsey, refer Appeal No EA 50 of 1996, No. NC1616 of 1995.

It is possible that this matter went to appeal because the trial judge did not have sufficient evidence about the nature, form and characteristics of the assets and the manner in which they were valued, particularly, the Husband's business. However, any effort to put additional evidence before the court does raise some interesting questions, including:

- What information should you put before the Court to explain the nature, form and characteristics of the business valuation?;
- What information is relevant when considering the Husband's income earning capacity that he derives from operating the business?;
- What is the appropriate basis to value the business in the circumstances of the case?;
- Can there be more than one value? If so, why should one value be adopted over another?

This paper aims to help you to ask the relevant questions and gain an understanding of how the answers can assist you and the Court in arriving at an outcome that is just and equitable.

The paper is set out under the following sections:

1. Why is it important to know and understand the basis of valuation used to value an asset?
2. How come the “value to the party” sometimes differs from the “price” a business could be sold for and what do you do when it does?
3. What is the appropriate level of income to adopt for a business owner to avoid double counting or omitting an income stream?
4. Should income producing assets be treated differently to a non-income producing assets?
5. What do you need to consider when dealing with complex assets such as employee share schemes?

1.0 Why Is It Important To Know And Understand The Basis Of Valuation Used To Value An Asset?

1.1. What is commonly referred to as the basis of valuation could also be described as the assumptions on which the valuation is based. Such assumptions could be whether the asset is assumed to be sold over a long period with proper marketing to attract the highest buyer or sold in a short period under a forced or fire sale situation. It is clear that if you change an assumption, the value ascribed to a particular asset could change.

1.2. As one asset can have more than one value, it is important to know the basis of valuation used to value an asset. It is also important to understand what assumptions are adopted by that basis of valuation to ensure that the appropriate value is used in the circumstances of each case.

1.3. I have set out below some common basis of valuation, and a brief description of each:

1.3.1. Market value: is often described as the price that would be negotiated between a knowledgeable, willing but not anxious buyer and a knowledgeable, willing but not anxious seller dealing at arms length. It can also be described as the highest price available in an open and unrestricted market between informed, prudent parties acting at arms length and under no compulsion to act, expressed in terms of money or money’s worth. In more simple terms, market value is the price an asset is likely to be sold for, assuming it is not a forced sale and assuming there is no one willing to pay more than they otherwise would because of the assets particular benefit to them.

1.3.2. Value to the party: attempts to assign a value to the strategic benefits that might be associated with ownership by a particular party. For example, given the personal and professional relationships of an individual, a particular business may be worth more to the current owner than some one else who may not have the same relationships.

1.3.3. Auction value: the estimated amount that one would expect to achieve at a properly promoted, conducted and attended auction sale held on site and at which substantially all of the assets in the inventory listing are offered for sale at one time. Consideration may need to be given to whether the auction value includes the costs associated with selling the asset at an auction and whether it is appropriate to allow for these costs.

1.3.4. Replacement and reinstatement value: the cost of replacing existing assets with identical or substantially similar assets at current new prices together with (where applicable) the cost of transport, installation, commissioning and any other directly attributable costs.

1.3.5. Indemnity value: the cost of replacing an existing asset with an identical or substantially similar asset of comparable age and in comparable condition together with the cost of transport, installation , commission and any other directly attributable costs.

1.3.6. Existing use: is the value of an asset based on the continuation of its existing use, assuming the asset could be sold as part of a business operation regardless of whether that use represents the highest and best use.

1.4. A report setting out the value of an asset should generally include the basis of valuation used and a definition of the basis of valuation that the valuer has adopted. I would encourage you to identify the basis of valuation adopted. If you do not understand the basis of valuation, you should discuss this with the valuer. You should also consider if the method of valuation is appropriate in the circumstances of the matter.

1.5. Understanding the basis of valuation can assist you in achieving a just and equitable outcome for your client. As an example of the importance of understanding the basis of valuation, consider the following which actually occurred (or at least according to an ex-Husband who told me about what he did). The Husband was a little bitter that the Wife remained in the matrimonial home with all the nice furniture etc that they had purchased. He was even more bitter when the furniture was valued at substantially less than what “he” had paid for it. He gained an understanding that the appropriate basis for valuing household contents in Family Law matters was generally not the replacement value. Therefore, he went out and bought a house full on furniture of a similar amount and quality to that which remained in the Wife’s possession. The furniture in his possession would obviously be valued at an amount less than the cash that he used to purchase it with. His theory was that it was reasonable for him to have a furnished residence in which to live and he would need to do this before or after the hearing. By buying the furniture he effectively exchanged the value of the cash with the value of the furniture, which reduced the value of the assets that were in his possession at the time of the hearing. While I do not necessarily condone his actions, I think it is a good example of the importance of understanding the basis of valuation.

2.0 How Come The "Value To The Party" Sometimes Differs From The "Price" A Business Could Be Sold For And What To Do When It Does?

2.1. To assist in understanding the difference between value and price, I would like you to imagine the following: You are on your way to a Conciliation Conference when you walk past a shop and see a shirt that you really like. The ticket says the shirt is $80. You think to yourself “I think I’ll buy that shirt but I had better buy it on the way back to the office rather than risk being late”. The parties tried until 7pm to settle, but couldn’t agree on everything. You are disappointed, because you know that the shop is now closed.

2.2. You go to the shop the next day to buy the shirt, and are happily surprised that the shop is having a sale and the shirt is now $60. After telling this story to a friend who liked your shirt, they go to the shop a few days later only to find the sale is finished and the shirt is back to being $80.

2.3. The value of the shirt can be said to be $80. That is how much you would have paid if the shirt was not on sale. But because the shop wanted to attract more customers on the day you went there, you only paid $60. Therefore, the value of the shirt to you is different to the price that you paid.

2.4. The price at which an asset can be sold, can often be more or less than the value of that asset to a particular party. In considering the value of a business, the Family Court often prefers to consider the value of the business to the party that would continue to operate the business. Just like the example with the shirt, the value to a party of a particular business may be more or less than what the business could be sold for.

2.5. I will explain this using another example. The Wife operates a small financial planning business. She is the only employee other than a part time administrative assistant. From her efforts in the business, she is able to earn herself a profit of about $100,000 per year. This is comparable to the amount she would be able to earn if she was employed in a similar role by an arms length employer. Therefore, as she does not earn any profit over and above a reasonable salary, the value of the business to her lies in the net assets of the business, such as trade debtors and office equipment less liabilities such as trade creditors and lease liabilities. Let’s assume these have a net value of $20,000. This would be the value of her business on a value to the party basis.

2.6. However, the nature of a financial planning business is that it has a certain amount of recurring income, i.e., it receives a trailing commissions from the managed funds in which she has placed her clients’ investments. This recurring commission income can often be sold for three times the annual amount of recurring income. For this example, let’s assume that the annual amount of recurring income of the Wife’s business is $80,000 and that this could be sold for $240,000. You may be wondering why some one would pay this for her business that just makes no more than a reasonable salary. It is because businesses such as the Wife’s can often be valuable to other financial planning businesses looking to consolidate such a business with their existing business and generate reduced overheads from the economies of scale. If the Wife chooses to sell her business, she could realise the $240,000 plus the value of the net assets.

2.7. We now have an example of a business which can be sold for $260,000 (the $240,000 from the recurring income plus $20,000 from the net business assets). This value is significantly different from the $20,000 adopting the value to the party basis. Therefore, the question that arises is which is the appropriate value to adopt for the purpose of the Family Law proceedings?

2.8. In order to determine which value is the appropriate to adopt, the nature, form and characteristics of each value should be understood and applied to the circumstances of the case.

2.9. The “value to the party” value of $20,000 represents the value to the Wife on the assumption she continues to operate the business. Prior to starting the business about eight years ago, she had worked as an employee doing a similar role for a number of different employers. She never enjoyed working as an employee as she found she had different values and principles when it came to customer service. This lead to her decision to start her own business which she would like to continue to run and operate. The wife is currently in her mid forties and expects she will need to keep working until age 65 before retiring. At the time she retires, she would be able to sell the business and receive an amount based on the demand for financial planning businesses and recurring commission income at that time.

2.10. The value of $260,000 assumes that the Wife sells the business. In selling the business, it is likely that she will need to enter into a restrictive covenant such that she may not be able to practice financial planning within a certain area, or provide services to certain clients, for a specified period of time. This would obviously have a significant impact on her income earning ability. She could to start up her business again, possibly in a different location, but this would take time before she could earn a similar amount. Alternatively, she could work for some one else, although her previous experience is that she does not enjoy being in an employed position.

2.11. It should also be noted that there may be costs of realisation and capital gains tax if the Wife sells her business, and therefore the net amount she would receive from selling the business may be less than the $260,000.

2.12. Rather than just provide the value adopting the value to the party basis, the Court can make a more informed decision if it also has evidence of the value on the assumption that the business is sold. While the Court may not adopt the sale based value in the circumstances set out above, it may take into account the possible value the Wife may receive from the sale of the business on retirement as a financial resource or similar.

2.13. To show how important it is to consider the circumstances of each case, let's assume that the Wife is in her early 60's and is hopeful that she will be retiring in a couple of years. In this situation, it would be reasonable to expect the Court to either adopt the sale based value or place a greater weight on this value. This is because it is more probably that this value will be realised by the Wife in the near future and the disadvantages associated with restrictive covenants will not have a significant impact on the Wife as she does not intend to continue working.

2.14. From the above, it can be seen that in some situations it will be important to consider the value adopting different assumptions. Where this is the case, you should ensure that evidence of the nature, form and characteristics of the business (or other asset) is before the Court in order to allow the Court to apply the circumstances of the case and provide a just and equitable outcome.

3.0 What Is The Appropriate Level Of Income To Adopt For A Business Owner To Avoid Double Counting Or Omitting An Income Stream?

3.1. In considering the answer to this question, it is helpful to have a basic understanding of business valuation. In simple terms, a business is often valued by capitalising the profit that can be generated after allowing for a reasonable salary for the owner which can result in a value for the goodwill of the business. This is often referred to as a maintainable earning approach. Where the business does not generate sufficient profit to provide a reasonable salary for the owner there is usually no value for goodwill and the business is usually valued by subtracting the value of the liabilities from the assets of the business. This is often referred as a net asset backing approach.

3.2. For the purpose of assessing 75(2) factors and other considerations, when the profit of the business is less than a reasonable salary for the efforts of the business owner, the average or expected profits could be a reasonable amount to adopt as the income of the business owner.

3.3. However, when the profit is more than a reasonable salary and the business is valued on a capitalised earnings approach, consideration should be given to whether the salary assumed in valuing the business, or the salary plus the profit of the business, should be adopted as the income of the business owner for the purpose of assessing 75(2) factors and other considerations.

3.4. In order to consider how adopting the profit of the business and the salary can have a different impact on the outcome of a matter, we will work through another example.

3.5. The Husband operates a retail store selling bicycles. Due to the location and improvements to bike paths in the area, the shop has been trading well. It generates a profit of $150,000 after allowing a salary of $90,000 for the Husband. The salary is considered reasonable for the hours worked by the Husband and his roles and responsibilities managing the retail shop.

3.6. The single expert has applied a value of $450,000 to the business comprising of $200,000 for goodwill and $250,000 for the other tangible assets and liabilities.

3.7. The question that arises is whether the salary of $90,000 should be seen as the Husband's income, or the addition of his salary and the profit of $150,000, being a total of $240,000. The difference between these amounts will obviously have a significant impact on the 75(2) factors that are applied.

3.8. In determining the value of the business, the single expert capitalised the future profits of the business, i.e. the expert converted the future profit into a lump sum amount. The question that this raises in my mind is whether or not it would be double counting to include as an asset, the value derived by capitalising the profit, and include the profit as part of the Husband's total income. When it is explained like this, it sounds as though the profit in excess of salary is being double counted.

3.9. However, the same situation could also be explained like this. The Husband is employed and receives a salary of $90,000 per annum. He also holds shares in a company valued at $450,000 that provides the Husband with dividend income of $150,000 per annum just like the dividends on a share portfolio. When it is explained like this, it does not appear as though the income is being double counted. Should the business income therefore be treated the same as income from any other income producing asset where the value is included as an asset and the income included as income for the purpose of section 75(2)?

3.10. However, investments of a comparable value may not necessarily have comparable income streams. For example, the rental income from residential investment property may be less than a high interest bank account. However, the investment property may increase in value where as the bank deposit will always have the same face value. In considering the nature of this income, the bank interest is relatively certain, but what happens to the income from the investment property if the tenant moves out and how should the capital gains be treated? How should assets such as bank deposits and investment property and their income be compared to a share portfolio or to the returns from an investment in a business such as the bicycle shop example?

3.11. To generalise, the greater the risk associated with an investment, the greater the return that an investor would hope to achieve. For example, the investment in the bicycle shop carries significant risk. A competitor could easily open up across the road and have a significant impact on the profitability of the business, also significantly reducing the value of the whole business. Due to this risk, an investor will expect a high rate of return on the amount they invest.

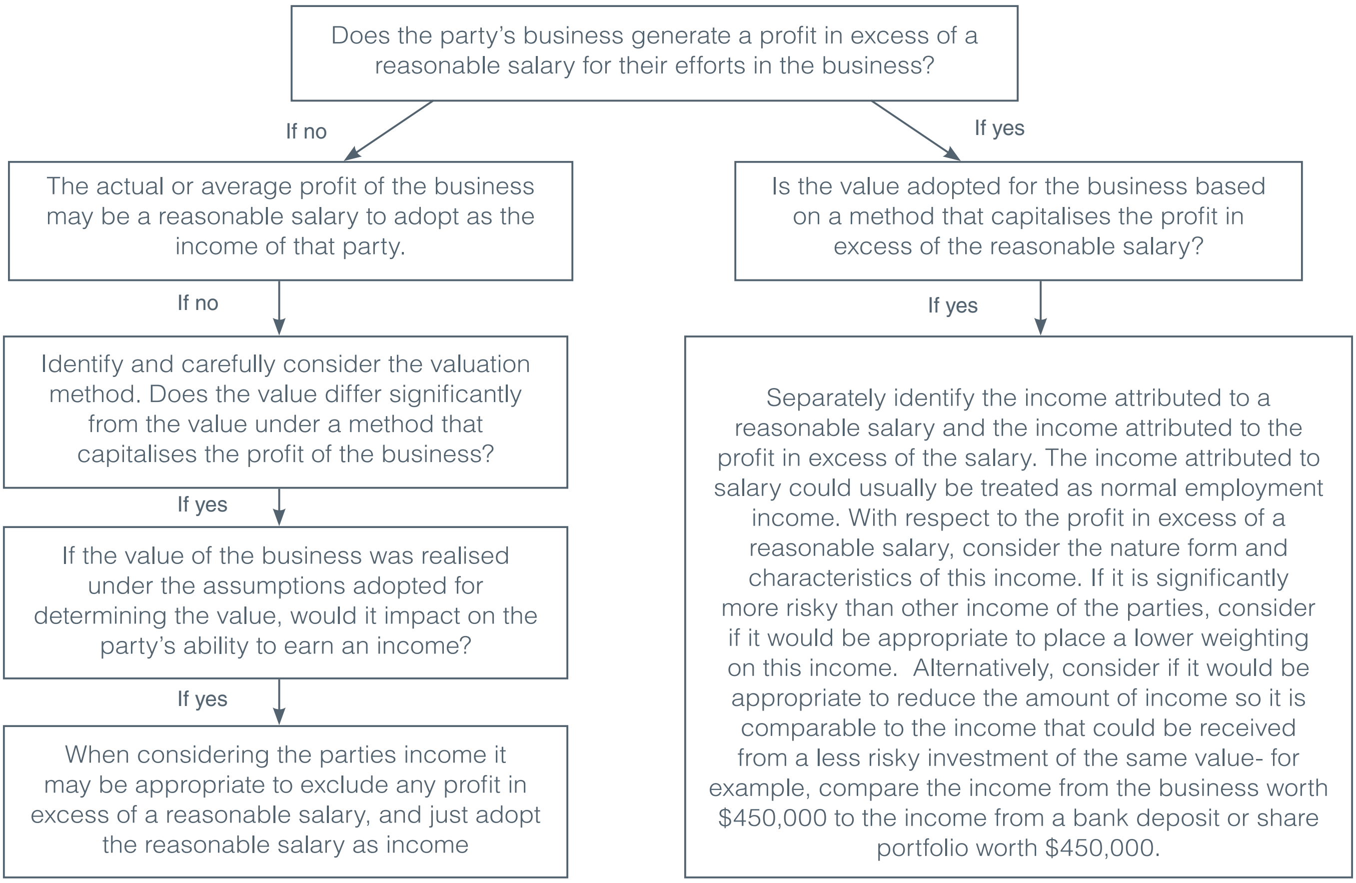
3.12. In comparison, a diversified share portfolio would contain a number of shares in a number of different companies. The income from each of the shares may fluctuate. Should a significant adverse event impact one of the shares, the income and value of that share may decrease significantly. However, this would not have a significant impact on the income and value of the share portfolio as a whole. Therefore, the investor would be prepared to accept a lower rate of return than the bicycle shop because they are not putting all their capital at risk in one investment.

3.13. The question that this raises is the extent to which an individual's choice to accept a higher level of risk in the hope of receiving a higher income should be taken into account when determining the income from the investments that they hold.

3.14. For example, let's continue with the example of our bicycle shop owner. He has an investment with a high level of risk and a high expected return. He could choose to sell the business and invest the money in a share portfolio. This would significantly reduce his risk, but it would also significantly reduce the income that could be generated from his investment. If the total profits of the business were to be included as his income for the purposes of 75(2) adjustments, changing the investment from a small business to a share portfolio may give the Husband a greater share of the assets of the marriage as the income differential would be much less. From a purely financial planning perspective, the above course of action could be justifiable, especially if the investment was to represent a significant portion of the Husband's overall net worth, i.e., it could be foolish to put too many eggs in one basket, especially a risky one.

3.15. While I would hope that a party would not undertake the above course of action merely to increase their share of the assets, I would also hope that the Court would take into account the risks associated with income from different types of investments when considering the amount of income they are attributing to the investment and the weight they are placing on the income for the purpose of section 75(2) adjustments. The Court will only be able to do this if it has the appropriate evidence available on which to make an informed decision.

3.16. The returns from investments in assets such as cash deposit, shares and investment properties are not likely to be materially different. However, an investment in a small to medium sized business generally has significantly higher risk and therefore the returns can also be significantly higher. Where the assets of the marriage include a business and the income from that business will be of importance when considering 75(2) or other adjustments, I would recommend considering the steps outlined below:



3.17. The above flow chart may not be appropriate in all situations. However, it is likely to assist in identifying matters that may be relevant to bring to the Court's attention. Regardless of the process that is adopted, it is important to consider the nature, form and characteristics of the business income and the manner in which the business was valued in order to ensure that any business income is appropriately treated.

4.0 Should Income Producing Assets Be Treated Differently To Non- Income Producing Assets?

4.1. Assume that the assets of the marriage include a $400,000 investment portfolio and a $400,000 luxury boat. The investment portfolio has produced income of approximately $40,000 per year over the last few years. Rather than producing income, the boat actually costs money to maintain. Both of these assets are valued at the same amount. Therefore, if one party was allocated one asset as opposed to the other, from a value perspective there would be no difference.

4.2. Section 79(4)(d) requires the Court to consider the effect of any proposed order upon the earning capacity of either party to the marriage. The allocation of income or non-income producing assets will have an impact on the earning capacity of the parties and therefore should be considered by the Court. To assist the Court do this, it may be appropriate to identify for the Court the amount, nature, form and characteristics of the income that can be generated from each of the assets, and highlight those assets that are not income producing.

4.3. Assume that the assets of the marriage consist of the matrimonial home, an investment property, a sailing boat and a share portfolio, each having a value of approximately $400,000. All of the assets are unencumbered. The contributions to the marriage are approximately equal. The Husband has an income from employment of $80,000. The Wife has been the homemaker and continues to care for the three children. The Husband has moved into the investment property and it is agreed he will keep that property and the Wife will retain the former matrimonial home. The Wife wishes to keep the boat as sailing is more her passion than the Husband's and the Husband wishes to keep the share portfolio as he thinks this would be a sensible decision and assist him to accumulate his wealth.

4.4. The above may seem like an easy matter to settle. You would just need to work out if and how much the Wife might be entitled to for 75(2) factors. In considering this, should you take into account the $40,000 of annual income from the share portfolio? This will form part of the Husband's taxable income and he will be required to pay child support on this income. As the Wife has the capacity to sell the boat and invest the proceeds, she has the ability to decrease the difference between the parties' respective incomes. How should this be taken into account? Should the outcome be any different if the Husband had a passion for sports cars and intended to sell the share portfolio and buy a red convertible?

4.5. In considering situations like these where there are income and non-income producing assets, it may be of assistance to consider the following:

a. What options are available to each party with the assets they will retain? For example, do they have the choice to convert an income producing asset to a non-income producing asset or vice versa (or change the level of risk and income associated with an investment);

b. If they have such a choice, would the likely outcome be different if they made that choice?

c. Would their decision to either keep the asset, or change its nature be a reasonable decision?

d. What is the intention of the parties?

4.6. Let's walk through these steps with the above example in respect of the Husband:

a. *What options are available to each party with the assets they will retain?*

The Husband has the option to retain the share portfolio or to sell it and buy his dream car.

b. *If they have such a choice, would the likely outcome be different if they made that choice?*

If the Husband sold the shares to buy a car, the difference between the income of the parties would be lower, and therefore the 75(2) adjustment may be less. Therefore, there could be a different outcome. Obviously, if the outcome was unlikely to be materially different, there would be no need to continue this approach.

c. *Would their decision to either keep the asset, or change its nature be a reasonable decision?*

The Husband's decision to sell the shares and buy his dream car may in many circumstances appear unreasonable. However, in the present case, it is comparable to the Wife wishing to retain her dream boat. It could therefore be seen as a reasonable choice.

d. *What is the intention of the parties?*

The Husband does wish to buy a nice car. He has not decided if he will wait until the share portfolio further accumulates in value before buying his dream car, or just sell down some of the portfolio to buy a nice car, but not quite his dream car. He intends to discuss some options with his financial planner once he knows the outcome of his Family Law proceedings and make a decision from there.

4.7. From the above, it would appear as though the Husband could have a reasonable argument for lesser weighting to be placed on the income from the share portfolio when considering the amount of any 75(2) adjustment. It would be interesting to know if the Court's view would be different depending on whether or not the Husband's intention was to keep the share portfolio. Would the Court also need to take into account the choice available to the Wife to sell the boat and invest the proceeds thereby assuming that she also has an income producing asset?

4.8. There can be a difference as to how income and non-income producing assets are treated and their impact on the outcome of a matter. By considering the nature, form and characteristics of the income and related assets in comparison to the non-income producing assets, and putting the appropriate evidence before the Court, a just and equitable outcome may be achieved.

5.0 What Do You Need To Consider When Dealing With Complex Assets Such As Employee Share Schemes?

5.1. With simple or complex assets, it is important to consider their nature, form and characteristics. However, as the complexity of an asset increases, there is more to consider and a greater risk of a decision not being just and equitable if the Court does not have all of the appropriate evidence.

5.2. To highlight this, I would like to use the example of an interest in an employee share scheme. I will discuss why it is necessary to understand the nature of the asset, how it is valued, the extent to which the valuation approach includes allowances for the characteristics of the asset, and whether further allowances should be made for these characteristics.

5.3. An employee share option can form part of an employee remuneration package. They are granted or awarded to an employee but do not vest until certain conditions are met, usually continued employment over a number of years. Once vested, the option provides the employee with the right to purchase a share in the company at a fixed price over a defined period, often up to ten years. It is therefore more valuable when the underlying share price is significantly higher than the fixed price at which the employee can buy the share. The employee cannot sell the option to another person – only buy the share at the price set by the option. If they cease employment, they usually lose all entitlements to the options that they have not exercised.

5.4. The first issue that usually arises in a matter with employee share options is whether the employee share options that have not vested should be considered as property or a financial resource. They are obviously contingent on the employee continuing their employment. The holder of the option will obviously argue that they are not presently entitled to the options, and the options should therefore be considered a financial resource. The other side will usually argue that the holder of the options will soon become entitled to the options and they should be treated as property.

5.5. It would be appropriate to engage an expert to value the employee share options. The expert will usually adopt a recognised valuation method and allow a discount for the fact that the employee cannot sell the options to another person. Some experts will also apply a discount for vicissitudes, specifically the risk that the employee may not continue in their employment and therefore that the options may not vest.

5.6. My first concern with this is whether an expert appropriately qualified to value an asset such as an option is also qualified to express an opinion on the probability of a particular individual ceasing their current employment.

5.7. My other concern is that due to the complexity of valuing an asset such as this, it is possible for a user of the expert's report to be unaware that such a discount has been taken into account, and even if they are, to determine the quantum of this discount.

5.8. The decision as to whether or not the options are property or a financial resource is due to the contingent nature of the asset. The discount that a valuer may choose to apply to the value may also take into account the risk that the individual may not continue in their current employment.

5.9. In the event that the Court was to adopt the expert's opinion of the value of the options, and treat the unvested options as a financial resource placing a lesser weighting on the value of the options due to their contingent nature, there is a risk that the contingent nature of the options could be double counted.

5.10. In order to avoid this occurring, it is important to fully read the report of an expert and understand what factors have been taken into account in determining the value.

5.11. When you are dealing with assets with contingencies, it may be appropriate to instruct the expert to value the asset on different alternatives. Using the employee share options as an example, the expert could be instructed to value the options on the assumption that employment is continued for the next one, three, five and ten years.

5.12. This will have the result of providing the parties and the Court with more information. They will be able to consider the impact on the value, if any, that the alternatives will have. The likelihood of the different alternatives occurring can then be considered and the appropriate weight placed on the values under the different alternatives.

5.13. Dealing with complex assets can be less difficult if the nature, form and characteristics of the assets are clearly documented and the manner in which the valuation takes these into account clearly explained.

6.0 Summary

6.1. When dealing with all assets, it is important to consider their nature, form and characteristics as well as if and how the valuation of the asset takes these into account.

6.2. By obtaining the appropriate information and evidence, you will be able to better advise your client, and should the matter end up in Court, the Court will be able to make a more informed decision. This should ensure that the decision is just and equitable.

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