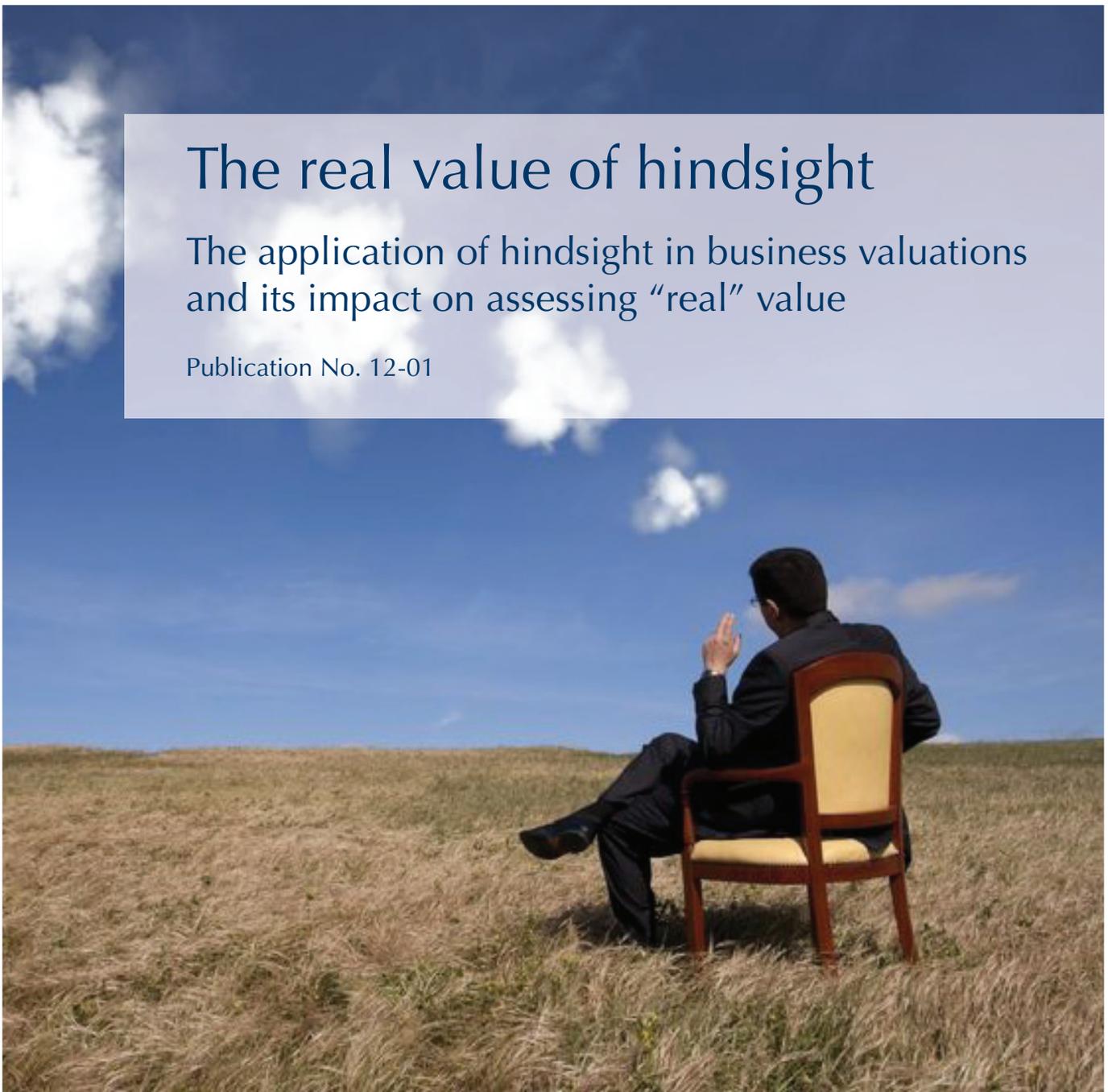


The real value of hindsight

The application of hindsight in business valuations
and its impact on assessing “real” value

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Introduction

When adhering to fundamental valuation principles, valuers should be mindful of events that have not occurred by the valuation date, and had not been anticipated as at that date. Information regarding any subsequent events is often referred to as “hindsight” and is generally not incorporated into business valuations.

However, in this edition of Damages Matters, Jason Cheung discusses multiple court cases that have taken an altered approach to valuations including the use of hindsight. The permissible use of hindsight in these valuations moves away from fundamental valuation principles and is often used as an equitable attempt to derive what is sometimes referred to by courts as “real” value.

Jason Cheung is a Senior Executive Analyst in the Sydney Forensic team at KordaMentha and specialises in disputes and financial investigations.



1 What is “real” value?

Introduction

When valuers are instructed to derive the “real” value of a business or equity, it can entail the use of hindsight in valuations. “Real” value is often used by the courts to mean fair market value adjusted for additional specific facts that have come to light after the valuation date and can be incorporated into the valuation to indicate the “real” worth of the business, asset, or equity being valued.



A deeper look into “real” value

Forensic accountants and valuers are sometimes instructed to value a business or equity as part of assessing loss and damage in the context of misleading or deceptive conduct, breach of contract, or tortious claims. In these circumstances, the courts have sometimes relaxed the principle against the use of hindsight, in order to take into consideration the extended knowledge about the circumstances existing at the valuation date that can only be drawn upon from subsequent events. However, the subsequent events should not be “independent, extrinsic, supervening or accidental”¹ events.

Care must be taken when considering hindsight – in some cases the use of hindsight is an attempt to obtain “real” value, in others it is to take into account intervening events that should not be reflected in “real” value at the earlier date, but is relevant to ensure the correct compensation is provided to the plaintiff.

Various courts have explained the concept of “real value” (see box at right).

“...although the value is assessed as at the date of the acquisition, subsequent events may be looked at in so far as they illuminate the value of the thing as at that date.”²

“[T]he real value of what the plaintiff got must be ascertained in the light of the events which afterwards happened, because those events may show, for instance, that what the shares might have sold for was not their true value or that it was a worthless company.”³

“Finally, although the court is entitled to take into account events after the date of acquisition, it must distinguish among possible causes of the decline in value of what has been bought. “If the cause is inherent in the things itself, then its existence should be taken into account in arriving at the real value of the shares or other things at the time of the purchase. If the cause be ‘independent’, ‘extrinsic’, ‘supervening’ or ‘accidental’, then the additional loss is not the consequence of the inducement.”⁴

“Figures worked out by analysing what willing but not anxious buyers and willing but not anxious sellers would agree on, without taking account of subsequent events, may correspond with market value; but they do not necessarily correspond with true value because the market can operate under some material mistakes...”⁵



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Recent cases

The above comments illustrate the courts' pragmatic approaches to determining "real" value particularly in the interest of equity. For example, in various circumstances, ignoring hindsight could lead to over-compensating the plaintiff thus violating the principle that damages are awarded with the object of restoring the plaintiff to the position they would have been in but for the breach or tort. This is illustrated in *Kizbeau*⁶ and *Willis*⁷.

Recent cases

Further to the cases discussed in Magda Di Vincenzo's (KordaMentha) article "[Why grope in the dark?](#)" released in December 2010, there have been additional cases that have utilised the concepts of hindsight and real value, two of which are discussed below.

Hindsight was used to derive "real" value – *IBEB Pty Limited v Duncan* [2011] NSWCA 368

A newsagent was sold in July 2005 by IBEB to several members of the Duncan family, for \$405,000, including \$350,000 of goodwill.

As part of the sale process, Mrs Duncan, a chartered accountant, had relied upon financial information provided in relation to the level of wages at the newsagency. However, soon after the Duncan family took over the newsagent, Mrs Duncan realised that wage costs were much higher than had been represented. The business made a loss of \$41,341 in the first year, and small profits going forward.

The primary judge found that the information provided by IBEB was misleading and deceptive, and awarded damages in relation to the goodwill paid for the business, and a further award for continuing losses.

The Appeal Judge stated that:

Where a misrepresentation has induced a party to purchase a business, the measure of damages commonly adopted is the difference between the price paid and the real value of the business at the time of purchase (HTW Valuers (Central Qld) Pty Ltd v Astonland Pty Ltd [2004] HCA 54.)

An expert, Mr I, calculated that the goodwill of the business actually purchased was \$46,057, rather than the \$350,000 actually paid. He also calculated that the maintainable profit of the business (after deduction of the proprietor's salary) was actually \$12,794 per year (rather than \$97,100 as initially represented).

The Appeal Judge confirmed Mr I could use the later profit performance of the business to shed light on the value of the business at the date of purchase. However, the Appeal Judge found that simply because there was a shortfall in maintainable profits going forward did not mean that the Duncan family should have been compensated for "continuing losses". He found that this was already included within the calculation of the "real value" of the goodwill of the business and it would result in over compensating the Duncan family.



However, the Appeal Judge found that the first 10½ month loss-making period to 2006, when Mrs Duncan was discovering and attempting to remedy the problem, should have been separately compensated, as this did not relate to “continuing losses”. This damages award required the use of hindsight to estimate the loss incurred in the relevant 10½ month period.

Therefore, the loss due to the Duncan family was:



Main points

The Appeal Judge confirmed that the expert was allowed to use the later profit performance of the business to shed light on the value of the business at the date of purchase. This allowed the calculation of the damages relating to the overpayment of goodwill.

This use of hindsight resulted in the valuer obtaining the “real value” of the business (and therefore calculating the overstatement of goodwill).

It can be seen that in this instance awarding damages to the plaintiff for the continuing loss from the misrepresentation (calculated using hindsight) and the overstatement of goodwill resulted in double counting.

Hindsight ensured plaintiff was not over compensated – Janos v Chama Motors Pty Ltd [2011] NSWCA 238

Premises were leased by the landlord to the tenants for the period 1 August 2007 to 30 June 2010, and the monthly rent was \$12,000 including GST. The tenant suffered financial difficulties and after the rental payments fell into arrears, the tenant paid the rent due up to 1 December 2008. On 2 December 2008, the tenant vacated the premises and returned the keys to the landlord.

Consequently, the landlord attempted (without success) to re-let the premises in December 2008 in order to earn rental income. In January 2009, it was decided the property would be offered for sale. A contract for sale was exchanged on 30 June 2009 and sale of the property completed on 31 July 2009.

Prior to the contract for sale, the landlord had commenced legal proceedings against the tenant and its guarantor for loss of income.

The Court took into consideration the principle demonstrated in *Willis*⁸ where Dixon J said the Court was not limited to the probabilities at the date of death of the plaintiff in that case because “where facts are available they are to be preferred to prophecies”, thus increasing or reducing loss with reference to subsequent events.

This principle was also discussed and applied in *HTW Valuers (Central Qld)*⁹, which cited numerous cases including a number of non-tort cases supporting the application of hindsight.



The property was sold for \$2,145,000 at the end of July 2009, which theoretically represented all future economic benefits. The damages awarded represented eight months loss of rent up to the sale completion date, instead of 19 months rent, which was the remainder of the lease term from December 2008.

Accordingly, the landlord was entitled to the following:

- Accrued rent for the six months from December 2008 to May 2009 of \$42,600 plus interest.
- Enforcement costs of \$7,624 inclusive of pre-judgement interest for its past loss.
- Prospective loss of rent for June and July 2009 amounting to \$14,200 plus interest.

Overcompensation would have occurred if the landlord was to receive 19 months rent in addition to the sale price as there would be double-counting of future economic benefits from the property over the next 11 months.

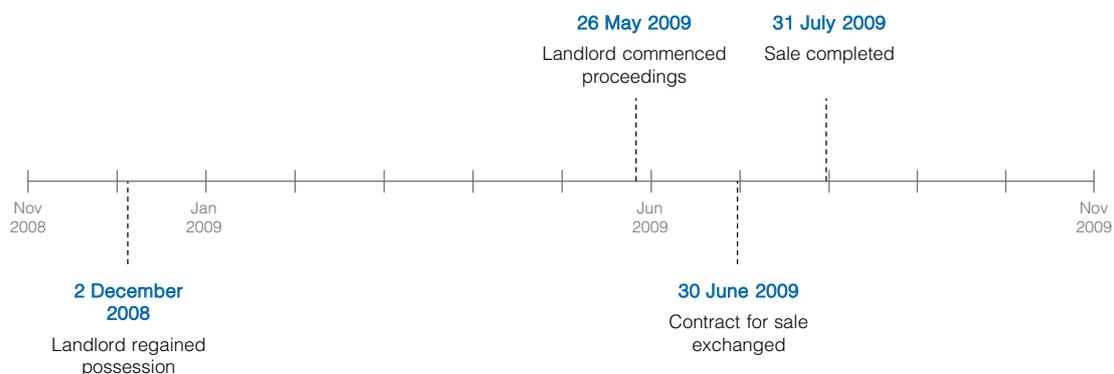
Main points

The landlord had a contractual duty to mitigate its loss, and this was achieved through the sale of the property. The loss mitigation occurred after proceedings had commenced and was an intervening event.

This is an example of how ignoring hindsight could lead to over-compensating the plaintiff, violating the principle that damages are to put the plaintiff in the position they would have been in but for the breach or tort.

In this case, the use of hindsight did not result in the “real value” of the future cash flows from the premises, rather, it ensured that the plaintiff received the appropriate amount of compensation.

Relevant dates in assessment of damages



3 Conclusion

These recent cases further emphasise the difference in treatments of hindsight between fundamental valuation principles used by valuers and the principles applied by the courts when awarding damages.

The difference in treatment reinforces the importance of adopting an appropriate valuation basis, and further, the importance of the instructions provided to valuers by their instructing solicitors in engagements where the courts are, or can potentially be, involved.

For example, instructing solicitors should consider and discuss with their experts:

- Whether damages are to be calculated on the basis of “real” value?
- What subsequent events and additional facts should be taken into consideration for use in the valuation?

The circumstances of each case must be carefully considered and it may be necessary to consider the valuation with and without hindsight to wholly appreciate the impact of subsequent events, and whether such events shed light on the “real value”, or are intervening events.

Where the events are intervening events, the use of hindsight can provide particular insight into the accuracy of crucial assumptions made by an expert. Allowing the use of hindsight may also provide clarity around the reasonableness of assumptions made by the expert, and reduce the need for the reduction of calculated damages often applied by the court to account for vicissitudes and uncertainties (often known as a “top-slice discount”).



- 1 HTW Valuers (Central Qld) Pty Limited v Astonland Pty Limited [2004] HCA 54 [12 November 2004], at [40].
- 2 Kizbeau Pty Ltd v WG & B Pty Ltd [1995] HCA 4, at [16].
- 3 Statement by Dixon J in Potts v Miller (1940) 64 CLR 282, quoted with approval in HTW Valuers (Central Qld) Pty Ltd v Astonland Pty Ltd [2004] HCA 54, at [38].
- 4 Statement by Dixon J in Potts v Miller (1940) 64 CLR 282, quoted with approval in HTW Valuers (Central Qld) Pty Ltd v Astonland Pty Ltd [2004] HCA 54, at [40].
- 5 HTW Valuers (Central Qld) Pty Ltd v Astonland Pty Ltd [2004] HCA 54, at [46].
- 6 Kizbeau Pty Ltd v WG & B Pty Ltd & McLean [1995] HCA 4.
- 7 Willis v Commonwealth [1946] HCA 22; (1946) 73 CLR 105.
- 8 Willis v The Commonwealth [1946] HCA 22; (1946) 73 CLR 105, at [116].
- 9 HTW Valuers (Central Qld) Pty Ltd v Astonland Pty Ltd [2004] HCA 54, 217 CLR 640, 658-9, at [39].

About the author



Jason Cheung is a Senior Executive Analyst and joined the Forensic team at KordaMentha in March 2011, having previously worked in audit with KPMG, Sydney and in corporate insolvency. At KordaMentha, Jason's work includes disputes, forensic accounting and fraud and financial investigations.

Jason Cheung
Senior Executive Analyst

Sydney

Tel: +61 2 8257 3041
jcheung@kordamentha.com

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Contacts

Melbourne

Owain Stone
Partner
+61 3 8623 3410
ostone@kordamentha.com

Robert Cockerell
Executive Director
+ 61 3 8623 3355
rcockerell@kordamentha.com

Perth

Jarrod Baker
Director
+61 8 9220 9330
jbaker@kordamentha.com

Sydney

Andrew Ross
Partner
+61 2 8257 3051
aross@kordamentha.com

Nigel Carson
Partner
+61 2 8257 3080
ncarson@kordamentha.com

Brisbane

Brian Wood
Partner
+61 7 3225 4993
bwood@kordamentha.com

David Van Homrigh
Partner
+61 7 3225 4992
dvanhomrigh@kordamentha.com

John Temple-Cole
Partner
+61 2 8257 3077
jtemplecole@kordamentha.com

Andre Menezes
Executive Director
+61 2 8257 3023
amenezes@kordamentha.com

Singapore

Matthew Fleming
Partner
+65 6593 9363
mfleming@kordamentha.com

Lily Yap
Director
+65 6593 9329
lyap@kordamentha.com

