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BUSINESS VALUATIONS IMPORTANT FOR ALL OWNERS

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There has been a high level of merger & acquisition (M&A) activity in Australia recently and this means it is particularly timely to have a good idea of a business's value. Many organisations are looking for opportunities to expand and, while business owners may have no current plans to sell, an offer that is too good to refuse could be knocking on the door. But how does a business owner know what is too good to be true if they do not understand the value of their business?

The perceived value of a business is likely to vary significantly depending on whether you are the buyer or the seller.

It is not uncommon for a business owner to have an opinion on the value of their business. It is common however for a business owner to not be able to provide commercial validation to support their opinion.

A buyer however is likely to have an anticipated return on investment requirement thus will value the business based on sustainable profit and by applying the rate of return requirement. If the potential buyer is a competitor or in a similar industry the sustainable profit may be significantly higher if the business was merged into the buyer's business due to a broad range of business synergies.

Another trigger for valuing a business is that the owner is getting ready to retire. But it's not always possible to plan ahead, and other unexpected reasons, such as death, illness, divorce or bankruptcy, can also trigger the sale of the business.

It's therefore worthwhile to have a business ready for sale at all times. This includes ensuring sustainable profit from one year to the next is optimised, as that is what prospective buyers would be seeking, as well as having reliable financial accounts, systems and processes, and understanding the business and the trading environment.

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A key element of business valuation is sustainable profit/return on investment into the future. When economic conditions are uncertain, this can make valuations more difficult to assess.

A reasonable estimate of market value requires skill, knowledge and experience. Several valuation and accounting professional bodies and institutes provide certification and standards for valuers.

An experienced business valuer with commercial acumen can navigate all the nuances to ensure that the purpose of the valuation is appropriately considered. An example might be where a significantly higher-than-market price was negotiated for a business, however, the capital gains tax was determined with reference to an appropriate market value.

It can also make good sense to value a business regularly, such as once a year. Once a valuation has been undertaken the first time, the same bases and assumptions can be used each year. This creates a benchmark valuation process so that the factors affecting the performance can be highlighted and evaluated on a regular basis.

Business valuations are often required to support the submissions made to the Australian Taxation Office (ATO) relating to the sale or purchase of business assets. While a valuation is an estimate of an asset's value, the valuation must be based on the most relevant and reliable information that is known or could reasonably be foreseen, at the valuation date. The ATO have some specific requirements for valuations so having an ATO-compliant business valuation is important.

Business owners should always strive to maximise sustainable profits, improve systems and processes and try to ensure they enjoy the fruits of their labour, even though their business may not technically be for sale.

It is common for people selling a house to fix all the little things that didn't work properly and then realise that had they done that along the journey they would have enjoyed the house so much more and may in fact not necessarily want to sell. Business can be the same.

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INTEREST RATES ARRIVING AT A "NEW NORMAL"

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As experienced over the past two years, interest rate movements can be very sudden. The Reserve Bank of Australia (RBA) increased the cash rate 13 times from May 2022 to November 2023, taking it from a record low of 0.10 per cent to the current rate of 4.35 per cent. Now, with inflation falling globally, it looks like interest rates may have peaked and markets are pricing in cuts in official interest rates by the year's end.

Predicting short-term interest rate movements is difficult. What is more important is where interest rates will settle over the longer-term. Most assets are priced against the US 10-year government bond yield, which has risen from 1.7 per cent in early 2022 to now being at around 4 per cent. This indicates that rates are close to peaking and could settle around current levels over the longer-term.

In this environment, many investors are wondering how they should position their portfolios. The last decade was a period of record low interest rates and, as a result, many investors moved up the risk curve and allocated more to growth assets such as shares to achieve greater returns. Many 'balanced' portfolios drifted closer to an 80/20 shares-to-bonds allocation, away from the traditional 60/40 allocation.

Now, with US and Australian share markets having hit record levels, investors may want to reconsider their overall asset allocation and move back toward the traditional 60/40 mix. That rebalancing could involve taking profits on shares and redeploying cash into more defensive fixed interest investments. For example, longer dated secure fixed interest assets are now providing more attractive yields for investors, with some achieving a 5 per cent-plus yield.

Having said that, investors shouldn't make significant changes to their portfolios in response to market movements. A more sensible approach would be to tweak portfolios with a gradual increase in exposure to asset classes that are more attractive in a higher interest rate environment. This could include higher-yielding government and corporate bonds and even cash investments as higher interest rates become the new normal.

But first and foremost, keep in mind your investment goals and financial plan and consider how your portfolio can be best positioned to meet your targets in this new environment of higher interest rates for longer.

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WHAT TO CONSIDER WHEN SELLING A SMALL BUSINESS TO BOOST YOUR SUPERANNUATION

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When selling a business or business asset, small business owners can take advantage of tax concessions and contribute some of or all of the sale proceeds to their superannuation fund without breaching superannuation contribution caps. It can be a great way of boosting superannuation balances.

However, there are a few things to keep in mind to make this work. To ensure the capital realised from a business sale doesn't attract capital gains tax (CGT), there are four CGT concessions for small businesses to consider:

The 15-year exemption

The 15-year exemption allows for contributions to superannuation funds that sit outside the usual caps. This is the most valuable concession, as it allows a contribution of the total sale proceeds of a business up to the CGT cap which is $1.705 million for the 2024 financial year. For example, if an asset is sold for $1.5 million, the full $1.5 million can be contributed to superannuation under this exemption.

To qualify for this concession, a business owner:

- must have owned the business asset for more than 15 years consecutively
- must be over 55 and have the sale happen in connection with retirement, or be permanently incapacitated
- no other small business CGT concessions can be applied

The 50 per cent reduction

Small businesses can reduce the capital gain on the sale of a business or business asset by 50 per cent, in addition to the CGT discount if conditions are met. After applying any current or prior year capital losses and the CGT discount (if applicable), any remaining capital gain is reduced by 50 per cent.

The retirement exemption

This concession allows for a $500,000 reduction in the assessable capital gain of a business. Much like the 15-year exemption, the retirement exemption also allows for contributions to superannuation of up to $500,000 that sit outside the usual caps. However, this is different to the 15-year exemption as it is based on the exempt capital gain, not the total sale proceeds.

Conditions for the concession include:

- the $500,000 exempt capital is a lifetime limit for each individual
- If under 55, the amount must be paid into superannuation
- If over 55, it is optional to pay the amount into superannuation

The small business roll-over

The small business roll-over allows the capital gain to be rolled over into another active business asset. If you choose the roll-over, the capital gain will not be included in your assessable income. If no asset is acquired after two years, then the capital gain arises again at this point. Alternatively, if a replacement asset is acquired and subsequently sold the retirement exemption may be applied without retesting of the CGT concession criteria. This allows a contribution into superannuation on a sale that may not otherwise be available.

Other considerations

CGT and the CGT exemptions only apply to capital gains. CGT concessions do not apply to gains such as those on the sale of plant and equipment or trading stock as they are taxed under a different section of the Income Tax Assessment Act. As a result, there may be a substantial tax bill where plant and equipment has previously been fully deducted under the temporary full expensing concessions and the assets are sold.

It is important to consider the timing of the sale, that is, what is the date that that the funds must be contributed to superannuation under the relevant concession.

Even outside the small business CGT regime, there are ways individuals can boost their superannuation, including:

- *Bringing forward non-concessional contributions* - each member can bring forward their non-concessional contributions for three years to contribute $330,000 each.
- *Carrying back concessional contributions* - members that have balance of less than $500,000 can carry back unused concessional contributions for the previous five years to obtain a larger tax deduction in the contribution year.

The rules can be complex to navigate, so it is prudent to seek professional assistance.

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INTERGENERATION TAX PLANNING AND INSURANCE BONDS

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A trust or investment bond is a tax effective and flexible way for parents and grandparents to save and invest for the future needs for children or grandchildren, such as education, a first home or other life milestones, such as a wedding.

An investment bond, also known as an insurance bond, is an investment solution offered by specific companies where an investor's money is pooled and invested according to the investment option chosen.

A trust, on the other hand, is a legal structure that holds and manages assets for the benefit of the beneficiaries. It can be flexible and tailored to specific family needs.

Trusts offer more control and flexibility, while investment bonds provide certain tax advantages and simplicity in investment management.

Both have their unique features and benefits and whether one is better than the other depends on each family's circumstances. A combination of both may be appropriate depending on the circumstances of the family.

Tax considerations

Both investment vehicles can be tax effective. Insurance bonds are particularly tax effective especially for those on a high personal marginal tax rate. This is because insurance bonds are 'tax paid' investments and their earnings are taxed at the company tax rate of 30 per cent during the lifetime of the bond. This means the parent or grandparent does not need to declare the investment bond income in their personal tax returns.

In addition, insurance bonds can be withdrawn tax-free after ten years. The investor just needs to be careful of the '125 per cent rule', whereby they may add further contributions to the bond without resetting the ten-year period provided this does not exceed 125 per cent of the amount contributed in the prior year.

Trusts on the other hand may offer income-splitting opportunities, potentially lowering the overall tax burden on taxpayers.

How much is needed?

The initial amount to start with depends on individual financial capacity and personal goals. The end-investment goal should align with the intended purpose, whether it's funding education, a home purchase, or other life events. Setting a clear goal and working with a financial advisor can help determine an appropriate target amount and making sure the returns after fees and taxes meets the intended goals.

The age at which the investment matures should be based on the specific financial goals for the child or grandchild. It could coincide with major life events, such as starting university or purchasing a first home. Longer investment horizons provide more growth potential. For investment bonds, in order to achieve the tax-free outcome for withdrawals, this requires a ten-year investment horizon.

Investment maturation age should be carefully chosen to ensure the funds are available when needed. Flexibility is also important, as circumstances can change over time, so it's essential to periodically review and adjust the maturity date as necessary.

Once a decision is made, the investment portfolios of both trusts and investment bonds should be regularly reviewed and assessed as to whether it aligns with the financial goals of a child or grandchild.

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RESILIENCE AND OPTIMISM THE KEY THEMES FROM BUSINESS LEADERS

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Geopolitical upheavals and energy crises to the persistent societal and economic impacts of a global pandemic continue to test the resilience and adaptability of business leaders around the world, but optimism is on the rise, according to the 2024 HLB Survey of Business Leaders.

Our 2024 survey encompasses nearly 1,000 responses from leaders across more than 50 countries from a broad range of industry backgrounds, painting a nuanced picture of today's business environment.

Concerns about geopolitical risks, cyber threats, and environmental challenges have escalated dramatically.

For instance, apprehensions about cyber risks have escalated from 52 per cent in 2020 to 67 per cent today, and environmental concerns have risen from 29 per cent to 52 per cent.

However, amidst these challenges lies a silver lining of resilience and resurgence. We've witnessed a rebound in confidence among business leaders, with many expressing unprecedented optimism about revenue growth in 2024.

This resilience is a testament to the enduring spirit of leadership that adapts, innovates, and thrives even in the face of adversity. The accelerated adoption of new working models, more mobile and cloud-enabled, signifies a radical departure from the past decade's norms. This transformation has been catalysed by the pandemic and facilitated by technological breakthroughs.

Our survey indicates a near doubling in the number of leaders planning to leverage new technologies for growth, with artificial intelligence (AI) taking the lead as the most crucial emerging technology. Which brings us to the theme of this year's report: How are business leaders embracing AI technologies to unlock competitive advantage? We have researched leaders' sentiment towards AI and analysed how different attitudes towards the adoption of AI for business transformation leads to varying actions and strategic tactics leaders are making in the next 12 months.

We have explored barriers to adoption, use cases for AI and AI maturity across a range of stages in one's AI adoption journey. As a result, we've been able to segment leaders into three categories: the Conservatives, the Explorers and the Innovators. The findings of this report explore how each segment is approaching AI and digital transformation in their businesses.

Businesses are on a continuous journey, adapting their businesses to new realities and using technology to remain competitive. It isn't a sprint to adopt multiple plug-and-play AI products, but rather a marathon that demands research, evaluation, and experimentation to determine the role of AI in your operations.

We have identified 10 steps to help plan businesses progress their AI journey, regardless of where they currently sit on the maturity curve. Exploring some essential questions will help business leaders along each step and embrace AI in their organisations.

These steps are summarised as follows:

- **Step 1:** identify objectives & challenges
- **Step 2**: understand AI capabilities
- **Step 3:** data collection & management
- **Step 4:** evaluate & select the right ai solutions
- **Step 5:** integration & implementation
- **Step 6:** compliance & ethics
- **Step 7:** training & change management
- **Step 8:** monitor & evaluate
- **Step 9:** scale and evolve
- **Step 10:** strategic partnerships & collaborations

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MODEST OUTLOOK FOR IPO MARKET IN 2024

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The IPO market experienced a marked deterioration in 2023, with just 32 listings for the whole year, the lowest level yet measured by HLB Mann Judd's IPO Watch Australia Report. The 2023 level was 63 per cent lower than the 87 listings in 2022 and 83 per cent lower than the record-breaking number of 191 IPOs in 2021.

IPO Watch Australia analyses ASX listing activity from the previous 12-month period (excluding property trusts). In 2023, we saw just 32 listings over 12 months, reflecting a much more difficult economic environment.

There were just 14 listings in the first six months to June 2023 and a further 18 in the second half of the year. The total funds raised for the year were $847 million, reflecting a 21 per cent fall compared to 2022 when the total funds raised were $1.07 billion. Last year was the first time since 2012 that the total amounts raised in ASX listings did not exceed $1 billion.

The current pipeline remains very subdued with many businesses waiting until economic conditions improve before considering an IPO. The macroeconomic and geopolitical environment in Australia and globally, including high inflation and capital costs, has presented significant challenges for most companies.

However, there is some hope for improved listings in 2024, including resources listings. Share markets have hit fresh records in the US and Australia this year and

some commodity prices including iron ore are rising. If the gold price remains above the US$2000 level, or lithium climbs, this might trigger greater interest in junior explorers and a higher level of IPO activity overall.

IPO returns in 2023

In terms of price action in 2023, only 18 listings experienced a first-day gain on the ASX, with an average gain of 6 per cent, down from a 16 per cent gain in 2022. Reflecting the tougher conditions, only 11 were able to maintain their listing price or move higher by the year's end. As at 31 December 2023, the average loss across all listings against IPO price was 10 per cent, compared to a year-end loss for IPOs of 2 per cent in 2022.

Of the 32 listings in 2023, there were seven large-cap listings (companies with a market capitalisation over $100 million) representing 22 per cent of total listings.

Large-cap listings contributed 76 per cent of the total funds raised in the year. On average, each large cap raised $92.5 million, with Redox Limited (ASX: RDX) securing the largest amount of $402 million.

In the small-cap market (companies with a market capitalisation of $100 million or less), the $10 million to $25 million band raised the highest amount of funds, reaching $68.39 million. This represented 8 per cent of the total amounts raised during the year.

On a positive note, 29 of the 32 listings in 2023 were able to raise their subscription target amount, 91 per cent of all listings and an increase from 70 per cent in 2022. Listing in the $50 million to $75 million market cap band recorded the best share price performance, with a year-end gain of 29 per cent, delivering a healthy return to investors.

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MANDATORY CLIMATE-RELATED DISCLOSURES – PREPARING FOR THE JOURNEY

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In June, Treasury proposed mandatory climate-related reporting to be phased in from 2024-25 to 2027-28 in Australia. In its climate-related disclosures consultation paper, it indicated that climate-related disclosure requirements will extend to fundraising documents, meaning that organisations preparing for an IPO must consider the steps required as part of their disclosure journey.

In addition, the AASB released Sustainability Reporting Exposure Draft EDSR1 in October 2023. The exposure draft is modelled on IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information* and IFRS S2 *Climate-related Disclosures*, with adaptation for Australian entities preparing general purpose financial statements.

Although the focus of climate-related disclosures will initially focus on larger organisations, boards and management of small organisations must also prepare. Organisations may find themselves unable to meet stakeholder and market expectations should they not commence or consider the following steps:

Governance

Disclose the governance processes, controls and procedures an entity uses to monitor, manage and oversee climate-related risks and opportunities.

- Determine a governance framework and assign responsibilities for managing climate-related risks. The board will oversee the climate-related risk management strategy with support from committees or management.
- Upskill your board and management team on climate-related risks. Directors have an obligation to understand existing and emerging risks that may impact the organisation.

Strategy

Disclosure to provide an understanding of an entity's strategy for managing climate-related risks and opportunities.

- Establish a cross functional working group from various departments and locations. Climate-related risks require collaboration across the whole business.
- Identify key stakeholders and create engagement opportunities to understand stakeholder priorities.
- Gather an understanding of how your organisation is dependent on natural, social and human capital and the impact that climate change can make. Consider and identify climate-related risks in the short, medium and long term.
- Determine opportunities to mitigate climate-related risks including:

- Resource efficiency – efficient production and distribution processes, recycling, reduced energy and water usage.
    - Products and services – development of low carbon products and services, R&D and innovation to develop new products and/or diversify.
    - Resilience – renewable energy and supply chain management.
- Develop a strategy and action plan for mitigating and adapting to climate-related issues.
- Develop scenario analysis to understand the impact and build resilience to potential climate-related risks.

Risk management

Disclose the processes to identify, assess, prioritise and monitor climate-related risks and opportunities and assess the overall risk profile and risk management process.

- Integrate climate-related risks into existing risk management processes. Promote collaboration across departments, locations and management in relation to climate-related risk management.
- Ensure climate-related risk management is consistent with the organisation's current risk management processes.

Metrics and targets

Disclosure to understand an entity's performance in relation to its climate-related risks and opportunities.

- Calculate your greenhouse gas emissions baseline for Scope 1 and Scope 2 emissions and ideally Scope 3.
- Develop reduction targets for Scope 1, 2 and 3 emissions.
- Determine opportunities for reducing emissions such as renewable energy and efficiency strategies.
- Consider industry-based metrics that are relevant to your organisation.

HLB Mann Judd has established a team to help clients with their climate reporting.

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INTERNATIONAL TAX UPDATE

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With international tax there is always something happening and multinational companies need to keep abreast of the latest changes.

The main focus in 2024 is governments seeking to ensure multinationals pay their fair share of tax.

Key changes include:

Thin capitalisation rules

The Australian Federal Government has proposed changes to the thin capitalisation rules, which will impact the amount of interest deductions multinationals can claim and may potentially impact the way Australian multinationals are funded in future.

The changes are part of the 2022-23 Budget and were announced to address risks to Australia's domestic tax base stemming from the use of excessive debt deductions. The proposed changes would strengthen Australia's thin capitalisation rules in line with the Organisation for Economic Cooperation and Development (OECD)'s best practice guidance.

The proposed amendments are currently under consideration in the Senate. The Government proposes that most changes would be backdated to start from 1 July 2023 with the debt creation rules to apply one year later.

Withholding taxes

The ATO has advised that interest withholding tax is on its radar in 2024. When making a payment for interest or royalties to a foreign resident, companies are required to withhold tax at the applicable rate. If they fail to withhold from these offshore payments, they will be denied an income tax deduction for that expense until the withholding tax is paid.

The ATO is targeting arrangements where royalty withholding tax may not have been paid because payments have been inaccurately described, particularly payments for the use of intangible assets such as trademarks. The Federal Court ruled in favour of the ATO in a recent case against Pepsico which was liable for royalty withholding tax in relation to a portion of payments made under service agreements because royalties were embedded in these payments.

The ATO's focus on embedded royalties is likely to continue in 2024. A draft guidance TR 2024/D1 was released in January and discusses when cross-border payments made under a software arrangement will be treated as royalties and therefore subject to royalty withholding tax.

Multinationals with IP-intensive industries such as life sciences, technology, and retail, will need to review their arrangements to determine if an embedded royalty arises from IP use in Australia before the ATO do.

Hybrid mismatch

Another area of focus for the ATO this year is 'hybrid mismatches'. The ATO has designed and implemented hybrid mismatch rules to prevent multinational companies from gaining an unfair competitive advantage by avoiding income tax or obtaining double tax benefits through hybrid mismatch arrangements.

Hybrid mismatches are where the Australian entity cannot demonstrate that tax has been paid by the ultimate recipient of the payment.

The ATO expects multinational companies operating in Australia will have appropriate tax governance and tax policies and procedures in place to minimise hybrid mismatches. A company's related party deductions may be at risk if it has a hybrid mismatch. When preparing an International Dealings Schedule, companies are required to disclose details about hybrid mismatch arrangements.

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"Multinationals with IP-intensive industries such as life sciences, technology, and retail, will need to review their arrangements to determine if an embedded royalty arises from IP use in Australia before the ATO do."

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