VALUATION

What’s it worth to you?

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What’s it worth?

I am often asked by clients, “What’s the business worth?” This question can arise when a client is selling their business or looking at buying a new business. The need to know what a business is worth can also occur for shareholder disputes, matrimonial disputes, business interruption insurance claims and estate planning. I am a Chartered Business Valuator (‘C.B.V.’) in Vancouver and the focus of my practice is business valuations. There are often a variety of interested parties in a given transaction, ranging from buyers and sellers, to the courts and the taxation authorities. Each interested party may have differing opinions on value for the same transaction and therefore professional judgement and experience is critical when determining fair market value.

The Canada Revenue Agency (‘CRA’), also takes a great interest in the value ascribed in corporate reorganizations, estate freezes and rollovers, as well as transfers of shares between family members.

Why did I become a Chartered Business Valuator and why should you choose one?

The Canadian Institute of Chartered Business Valuators is the only recognized professional valuation organization in Canada. With the changing role of the traditional public practitioner, I saw an opportunity to provide an expansion of services to existing and new clients and therefore pursued getting my professional qualifications in this field.

C.B.V.s are fully qualified to serve as independent, expert witnesses when valuation matters arise before courts, security commissions or other regulatory bodies. C.B.V.s are also accepted as experts in valuation disputes by the CRA and are employed in their internal valuation department. When managing risk, whether your firm’s or your client’s, you should consider seeking the appropriate professional assistance when needed. I currently provide consulting services with respect to business valuations to other professional accountants.

Where do you start a valuation engagement?

It may sound obvious, but it is critical to determine at the start of the engagement what is being valued, what is the definition of value, for whom is it being valued, what is the purpose of the valuation and what is the valuation date. For example:

- a local private company is being valued;
- that 'fair market value' is to be used, without the application of a minority discount;
- our client is a 35% shareholder;
- our client wishes to retire and sell to the 65% shareholder; and
- the two shareholders agree to use a value as at the date of the most recent set of financial statements, because in their words, "…not much has changed since then."

Given the number of factors at play in a given assignment, an engagement letter is strongly recommended (and is required by the CPA Code of Conduct) because it will likely flush out any misunderstandings and will also serve to contractually protect the professional.

Valuation approaches

There are two main valuation approaches and the valuator must first determine whether a going concern approach or a liquidation approach would be more appropriate in the circumstances. A going concern approach is used when a business is earning a reasonable or better return on its assets whereas a liquidation approach is used when a business is not earning an acceptable return on its assets and the owner would be better off liquidating the assets and investing elsewhere.

There are numerous valuation methods to work with when valuing a going concern. Accordingly, the valuator must select which valuation method(s) best indicates fair market value. Common valuation methods for businesses that are a going concern are:

<u>Asset Based Method</u>

This method assumes that the underlying assets are often the best indication of value and that goodwill is not likely a factor. For example, real estate holding companies would be valued using this method and the most significant issue would be how to treat the latent tax liability on accrued capital gains.

<u>The Capitalized Earnings Method</u>

This method is used when the value of the earnings exceed the underlying assets, i.e., goodwill exists. Exhibit I is a numerical example of this method. The determination of Adjustable Earnings is basically a mechanical exercise (see line (a) below in Exhibit I). Whereas the determination of Maintainable Earnings (line (b) below) and the Earnings Multiplier (line (c) below), is a function of risk, and requires professional judgement coupled with experience. Maintainable Earnings is the valuator's estimate of likely future annual earnings. The Earnings Multiplier is a function of the expected rate of return, e.g., a 25% expected rate of return would yield a '4 times' multiplier. The

selection of the appropriate multiplier has been the subject of many articles and is often a contentious issue between valuators in court.

Exhibit I

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CAPITALIZED EARNINGS

			20X3		20X2		20X1
	Net income (loss) per financial statements	$	30,000	$	10,000	$	(80,000)
	Adjustments:						
	- spouse's salary		50,000		50,000		40,000
	- bonus to owner		150,000		80,000		-
	- loss from discontinued operations		-		-		150,000
	- income taxes (recovery)		20,000		10,000		(60,000)
(a)	**Adjustable earnings before taxes**	**$**	**250,000**	**$**	**150,000**	**$**	**50,000**
	Maintainable earnings before taxes			$	200,000		
	Capital replacement				-		
	Income taxes				50,000		
(b)	Maintainable earnings			**$**	**150,000**		

			LOW		*HIGH*
(c)	Earnings multiplier		4		5
	Capitalized earnings	$	600,000	$	750,000
	Tax shield on existing assets		50,000		50,000
	Going-concern value of operations		**650,000**		**800,000**
	Redundant assets		-		-
	Leverage adjustment		-		-
	Estimated Fair Market Value	**$**	**650,000**	**$**	**800,000**

Exhibit I also contemplates adjustments for the future tax shield on existing assets, redundant assets not used in the business and a leverage adjustment for a business being under or over financed. Working with Earnings Before Interest and Taxes ('EBIT') is a method of dealing with the leverage issue. These topics, while relevant, are beyond the scope of this article.

The Capitalized Cash Flow Method

This method is similar to the Capitalized Earnings Method but differs in that it measures cash flow instead of earnings. For example, depreciation expense is removed and an estimate of annual capital replacement is considered.

Discounted Cash Flow

This method calculates the net present value of expected cash flows and is used where there are predictable swings in earnings or where there is a finite life to the income stream, e.g. a mine.

Market Comparables

Unlike comparing houses in the real estate market, market comparables are often not available for Canadian small businesses. Data is more readily available in the U.S. market for both private and public companies. Caution must be used when trying to compare to U.S. data or public company data, due to premiums paid for market size, liquidity and other factors.

Rules of Thumb

There are sometimes rules of thumb applicable to a particular industry that the valuator may address in the process of valuing a business, and yet these rules of thumb are rarely used in isolation when determining fair market value. For example, some businesses are valued based on the number of subscribers.

Combining of Methods

Often more than one method is used in the valuation process.

Other key information to consider

In addition to selecting the most appropriate valuation method, there are numerous other issues that may be considered for the unique circumstances of each engagement. Some more common issues are:

Minority discounts

A 25% interest in a company that is worth $1,000,000 is not necessarily worth $250,000. A minority discount is due to the lack of control of the company: a 40% shareholder is unable to elect a majority of the Board of Directors; a 5% shareholder is unable to block a special resolution. It is not uncommon for a minority discount to be 25% to 40%.

Shareholder agreements

Shareholder agreements should be reviewed and often dictate the terms of any sale of shares between shareholders, e.g. whether or not to consider minority discounts.

Special purchasers

Many mergers happen to achieve economies of scale, eliminate costs or reduce the risk of supply. The impact of these savings or the reduction of risk should be quantified as part of the valuation process.

Tangible Asset Backing

Tangible Asset Backing, or TAB, is the fair market value ('FMV') of the net tangible and intangible (e.g. patents) assets, excluding goodwill (see line (d) of Exhibit II below). The greater the TAB, relative to the fair market value of the business, the less risk there is to the purchaser's investment.

Goodwill

Goodwill is defined as the excess of the going concern value of the operations over the tangible asset backing (see line (e) below). The greater the goodwill, the greater the risk to the purchaser's investment. Goodwill is sometimes financed by the vendor. Goodwill can be either personal or commercial and yet it is only commercial goodwill that is transferable. The CRA will not recognize personal goodwill as an asset of a business.

Exhibit II

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TANGIBLE ASSET BACKING AND GOODWILL

	Equity per financial statements			$	400,000
	Adjust: FMV of land used in business	$	700,000		
	Book value of land		600,000		
	Excess				100,000
(d)	Tangible Asset Backing			**$**	**500,000**

			LOW		***HIGH***
	Tangible Asset Backing	$	500,000	$	500,000
(e)	Goodwill		**150,000**		**300,000**
	Going concern value of operations	$	650,000	$	800,000

NOTE:

Goodwill is 1 – 2 times maintainable earnings.

Income taxes

Income taxes are almost always an issue in the valuation process. For example:

- What is the tax shield associated with the assets acquired?
- What taxes are triggered today?
- What is the present value of future taxes?
- Which taxes do the courts recognize in matrimonial disputes?
- Will the CRA recognize future taxes in today's valuation of shares?

Not surprisingly, the tax amount is often a significant item.

Conclusion

What's it worth? As you can see the valuation process is part science and part art. In addition, the courts have ruled on certain issues and the CRA has its own policies as well. Knowing more about business valuations is a good opportunity to provide enhanced services to your clients. Knowing when to seek outside assistance is a key part in managing your firm's and your client's risk.