



BUSINESS VALUATION

Presented to the Halifax Estate Planning Council



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Business Valuation in Canada

- Valuation is not a restricted activity in Canada
 - No required qualifications
 - Auditors/accounting advisors often perform valuations
 - May be held to CICBV standards – at least to some extent
 - CBV profession dominates the litigation market
- Chartered Business Valuators (“CBV”)
 - Only business valuation professional organization in Canada
 - Approximately 1,700 CBV professionals across Canada
 - CICBV is governing body (cicbv.ca)
 - Professional code of conduct and practice standards

Fair Market Value

- *“The highest price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm’s length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts”*
- Required by the Income Tax Act
- Recognized by CRA

Fair Market Value (Continued)

- The highest price
- Expressed in terms of cash
- Willing and able buyer & seller
- Acting at arm's length
- Open and unrestricted market
- Neither is compelled to buy or sell
- Both have reasonable knowledge of the relevant facts

Principles of Valuation

1. Value is prospective = Future
2. Value is determined at a point in time
3. Commercial vs. Personal goodwill
4. Market drives the required rate of return
5. Value is usually driven by earnings / cash flows
6. Higher the Asset values, the lower the risk
7. Minority interests are usually worth less than their prorated value

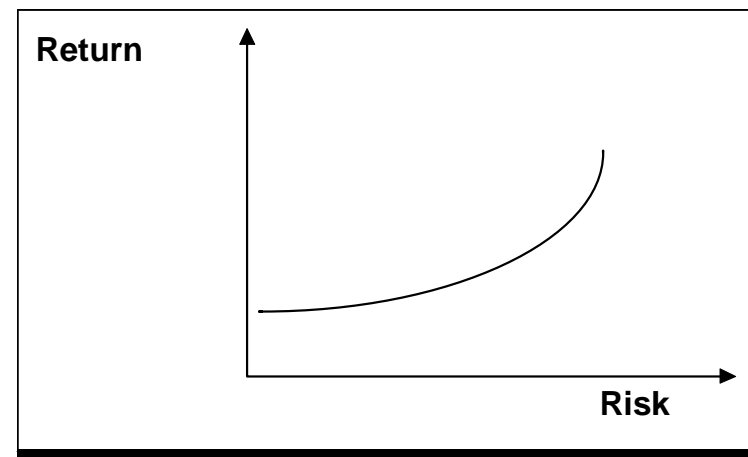


Value Drivers

Value drivers:

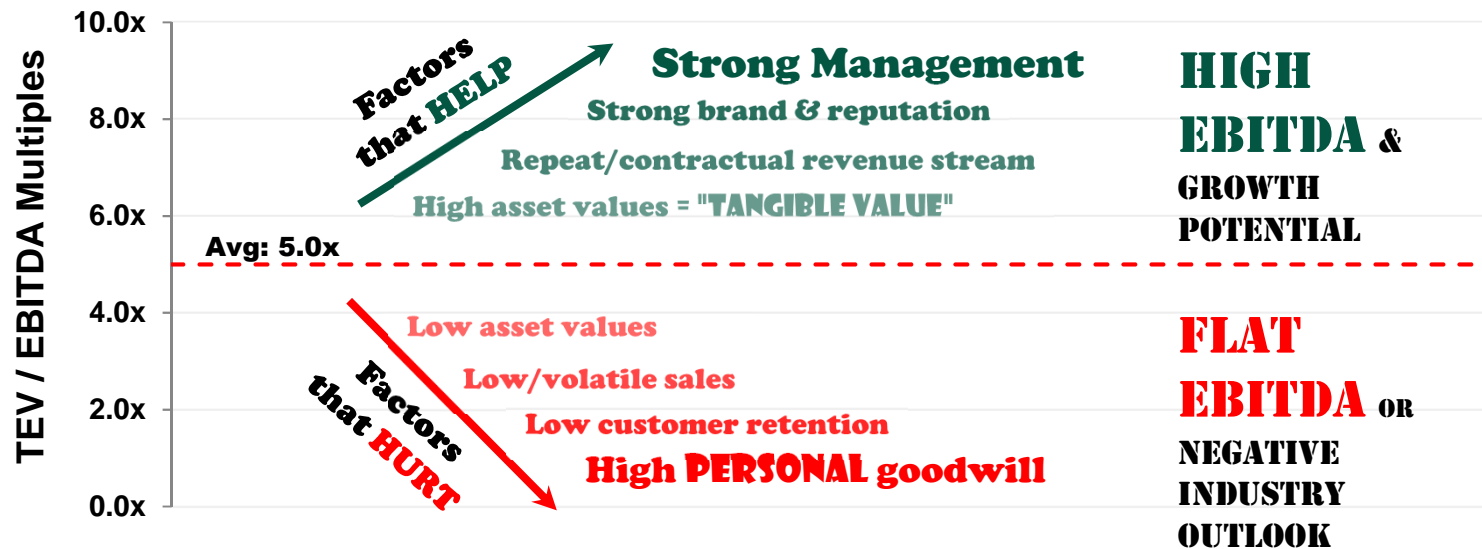
- **Risk → Growth → Leverage**
 - Cash flow (cash is King!)
 - A strong Balance Sheet = High Asset values = lower Risk
 - Overall Reputation
 - Relationships with customers, suppliers and employees – with multiple ‘touch points’
 - Management team experience
 - Corporate structure
 - Internal “housekeeping”
 - controls, processes, etc.

Value is about Risk vs. Return

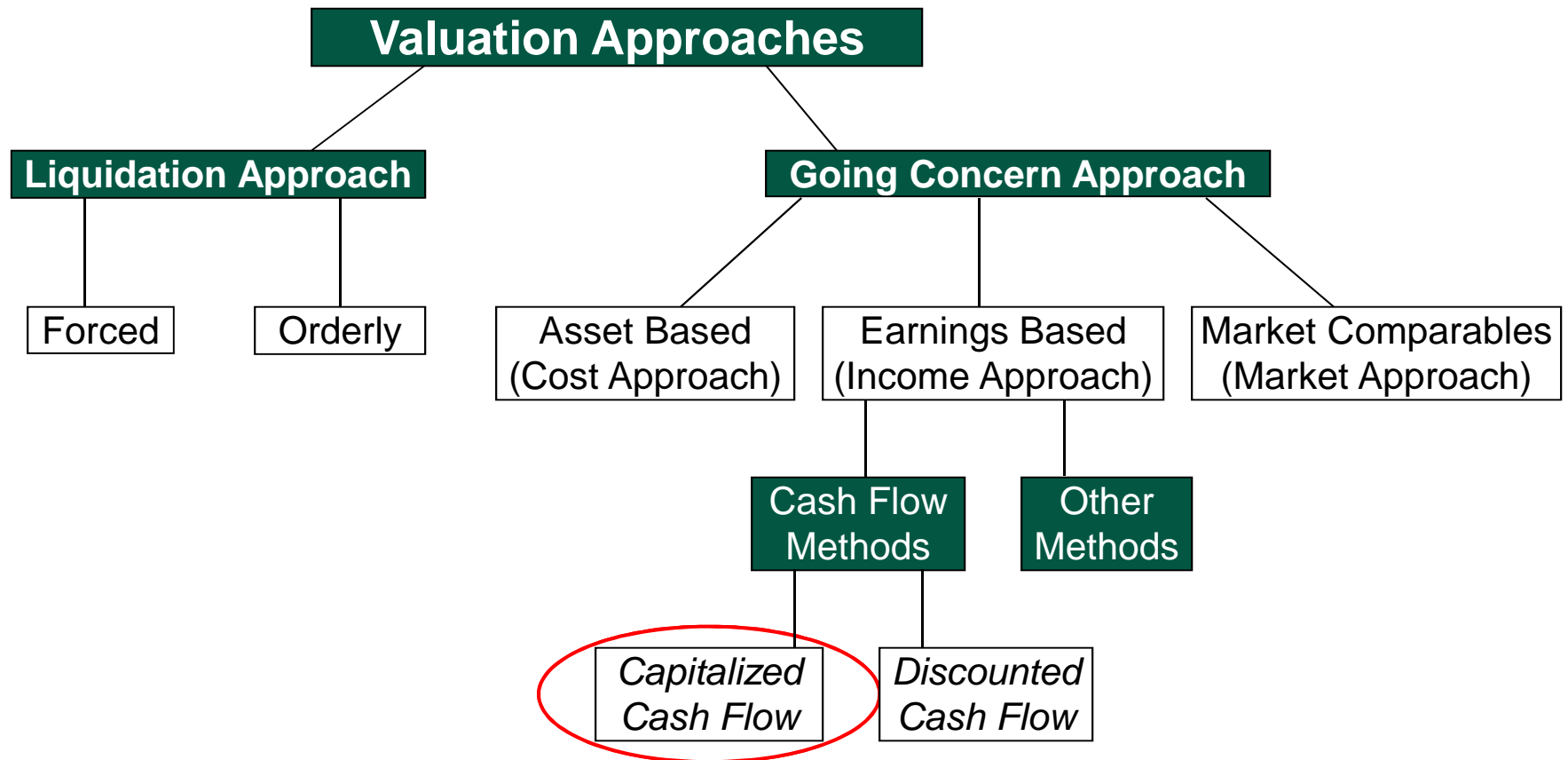


“The Multiple”

Enterprise Value / EBITDA



Valuation Approaches & Methods



Capitalized EBITDA

Example

Maintainable EBITDA \$ 800,000

Enterprise Value to EBITDA Multiple 5.0x

Enterprise Value \$ 4,000,000

Average operating line of credit balance (250,000)

Long-term debt outstanding at Valuation Date (400,000)

Shareholder loan (100,000)

Equity Value \$ 3,250,000

Valuation Reports

- A valuation report is defined as “any written communication containing a conclusion as to the value of shares, assets or an interest in a business, prepared by a valuator acting independently.”
 - The types and contents of valuation reports are defined in CICBV Practice Standard No. 110
- Other relevant standards:
 - Standard 210 Advisory Reports
 - Standard 410 Limited Critique Reports

Types of Valuation Reports

- **Comprehensive valuation report**
 - Contains a conclusion based on a comprehensive review and analysis of the business, its industry and all other relevant factors, adequately corroborated
 - Usually required when providing expert evidence to a court, for stock exchange and other securities regulation purposes
- **Estimate valuation report**
 - Contains a conclusion based on limited review, analysis and corroboration of relevant information
- **Calculation valuation report**
 - Contains a conclusion based on minimal review and analysis and little or no corroboration of relevant information

Distinguishing Between the Reports

- Level of assurance provided differs
- Report detail and scope differs
- Each type results in an 'opinion'
- Distinction between the 3 types is somewhat grey
 - Left to professional judgment
 - The CICBV in September 2012 issued a practice bulletin to provide more guidance on report distinctions
- Value usually stated as a range rather than a specific amount

Report Contents

1. Summary opinion
2. Purpose of the valuation
3. Premise of value and principles used
4. Scope of review
5. Key assumptions made
6. Background of the business
7. Industry background
8. Economic background
9. Valuation approach and methodology
10. Value conclusion
11. Restrictions on use
12. Supporting schedules and appendices

Common Errors and Pitfalls

- Not future-oriented
- Loss of objectivity
- No research or independent verification
- Just “number crunch”
- Using hindsight
- Incorrectly calculating cash flows
- Ignoring market information and comparable transactions
- Ignoring previous transactions in securities of the equity
- No file documentation
- Insufficient support for discount/cap rate
- Inadequate consideration of key man/personal goodwill issue
- “Smell” test

Issues to Watch For

- Shareholder mix
 - Percentage holdings
 - Family/group control
 - Historical dividend policy
 - Shareholders' agreement
- Prior transactions
 - Same company
 - Comparable companies (as available)
- Key person discount
- Minority, Liquidity and Marketability discounts
- Valuation date and use of hindsight
- Capitalization rate (multiple) selection
- Information Circular 89-3
- Other discounts

Zeller Estate v. The Queen

2008 TCC 426 (CanLII)

- Provides a good overview of court interpretation of several critical valuation issues
- In short:
 - death of a taxpayer that was a shareholder of a business
 - Estate filed tax return claiming business value of ~\$1 million
 - CRA reassessed with a business value of ~\$5.5 million based on an internal CRA valuation report
 - Estate appealed, this time having engaged an independent valuator submitting an expert valuation report concluding on \$2.2 million in business value
 - CRA submitted a second expert report prepared by an internal CBV concluding on an even higher business value of ~\$6.4 million
- The Judge concluded on a business value of ~\$3.4 million

Zeller Estate v. The Queen (continued)

2008 TCC 426 (CanLII)

- In arriving at her conclusion of ~\$3.4 million in business value, the Judge scrutinized in detail:
 - Capitalization rates and support provided by the experts for specific inputs used in their analyses
 - Minority discounts and their specific relevance to 50% shareholdings and less-than-50% shareholdings
 - Marketability discounts over-and-above the minority discounts already considered
 - The applicability of trapped-in capital gains taxes
 - The applicability of distribution taxes

Third-party Civil Penalties

- Third-party civil penalties under section 163.2 of the Act also apply to business valuers
- If the valuation was **not** considered to have been arrived at in good faith and/or with **reasonable cause**, the penalty provisions will apply because the valuation opinion will be deemed to be a “**false statement**”.
- If the fair market value **was** determined in good faith and there was **reasonable cause** for the over- or understatement of value (“false statement”), the CRA would **not** apply the penalty.

Third-party Civil Penalties

- The penalty against business valuers can be severe
 - Could be greater than \$100,000
- The CRA will **not** invoke the penalty provisions if the valuator’s fair market value opinion falls outside of the “prescribed range” provided that it was:
 1. reasonable in the circumstances;
 2. made in good faith; and
 3. not based on unreasonable or misleading assumptions.
- **“Unreasonable or misleading assumptions”**: the assumptions used (or accepted) by the valuator must be:
 - supported;
 - reasonable; and
 - not purely hypothetical

CRA “Policy”

- Can be regional → Atlantic
- Reluctant to set national policy on some issues (ie. Latent taxes, costs)
- Move to be more in line with CBV Standards (ie. reports and methodologies)

Final Comments

- “It’s just for tax purposes...”
- Many benefits to taking a more thoughtful and detailed approach to valuing the business your client has spent a lifetime building
- Tune-up reviews – really beneficial (→ **ExitSmart Planning**)
- Living in a sellers’ market
- December 2017 Federal Tax changes – focus on value question of meeting “excluded shares” defined as 10% of Votes and Value
- **THANK YOU!**

Questions?



"I've still got 37 more slides to go!"

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