BUSINESS VALUATIONS: PART II

Hendry Warren Chronicle - Tax and Accounting Simplified June 2017

In our May newsletter we outlined the key reasons, from an income tax perspective, why a business valuation is required. In essence, it is to support the provisions of Income Tax Folio S4-F3-C1 – Price Adjustment Clauses whereby a taxpayer must determine fair market value using a fair and reasonable method. This helps to ensure that the provisions of the price adjustment clause remain valid should a significant difference arise between the fair value determined by the taxpayer and that of the Canada Revenue Agency. The detail shared in our May newsletter was supported by the plenary session on this very subject given by the Canada Revenue Agency at the recent national conference held on June 15th and 16th by the Canadian Institute of Chartered Business Valuators (CICBV) in Quebec City.

The benefit of using a Chartered Business Valuator (CBV) to determine fair market value is their ability to apply the standards developed and codified by the CICBV, Canada's preeminent professional business valuation association.

Our goal is to provide updates on topical accounting and tax issues. Information contained in this newsletter is not meant to be a comprehensive summary of the issues raised. Rather, we wish to bring what we believe to be important issues to the attention of our valued clients and readers. We would be pleased to discuss any questions that you, the reader, might have in greater detail.

What's It Worth?

This is the age old question put forward by entrepreneurs, investors and tax professionals in the context of assessing the value of a privately held enterprise. However, unless parties are acting at arm's length where value is determined through their negotiations and ultimately defined within their agreement, determining fair market value is not easy. It is also generally biased towards the perspective of the party interested in defining value and the myriad of purposes for which it is required. Prior to the development of common professional practice standards for business valuations, the determination of value largely fell to either the party requiring the value or to their team of professional advisors where both were not independent of the process and possibly had a bias in how they calculated fair market value. This lack of practice standards coupled with the implied bias and lack of independence ultimately led to the creation of an association dedicated to establishing the practice standards, educational guidelines and ethical standards required to ensure that the quantification of fair market value is carried out in an unbiased and professional manner.

The first question, "What is it Worth?" implies that value is quantifiable. However, a definition of value is required for the context of any discussion. In Canada, fair market value is defined as "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 arms-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". This definition implies a determination that is free from bias and forms the cornerstone of how value is determined by a CBV.

Valuation Methodologies

The definition of fair market value only provides the cornerstone whereas the calculation itself is determined by one of three distinct approaches:

- Market based;
- Income based; and
- Asset based.

The market based approach uses

comparison with a similar business, business interest or similar assets to determine value.

The income based approach determines value through methods which associate the value of a business, business interest or asset to its quantifiable economic benefit. In particular, value is determined through the calculation of capitalized earnings or cash flows or the calculation of the discounted cash flow. The use of any of these methods requires the normalization of the earning or cash flow streams to ensure that discretionary amounts are adjusted for. The selection of whether to use a capitalized approach or a discounted approach depends entirely on the business, business interest or asset being valued.

The asset based approach determines value via methods based on the value of assets net of related liabilities. The adjusted net book value approach adjusts tangible and intangible assets and the associated liabilities to their fair market values.

In many cases the ability to employ the market based approach is limited especially when determining the value of a privately held business as this approach requires that comparable businesses, business interests or assets are easily identifiable. Never the less, as any entrepreneur would assert, their business is anything but easily comparable and the use of a market based approach could prove difficult. As such, the use of the income based approach and the asset based approach are predominantly used in determining the value of privately held enterprises.

The mechanics of each approach are beyond the scope of this newsletter. However, a Chartered Business Valuator can determine which approach is appropriate as well as the consideration of which specific valuation method under each approach is most appropriate to ensure that the valuation itself meets the standard of “a fair and reasonable method” as set out by CRA in Income Tax Folio S4-F3-C1 – Price Adjustment Clauses.

Type of Reports

The CICBV has not only established practice standards related to how valuators determine value but also on how they report the value conclusion to their clients. Valuation reports, when used to report on the determination of value, are governed by Practice Standard no. 110 ‘Valuation Report Standards and Recommendations”. Practice Standard no. 100 outlines the availability of three distinct reports each providing their own level of assurance as well as identifying the valuator’s scope of review and the amount of disclosure required:

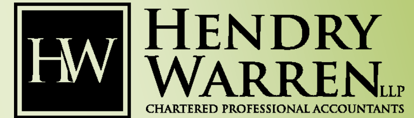
- Comprehensive Valuation Report which contains a value conclusion based on a comprehensive review and analysis of the business, its industry and all other relevant information and factors which are adequately corroborated;
- Estimation Valuation Report which contains a value conclusion based on limited review, analysis and corroboration of all relevant information and factors; and
- Calculation Valuation Report which contains a value conclusion based on minimal review with little or no corroboration of relevant information or factors.

The type of valuation report required to meet the standard set out by CRA in Income Tax Folio S4-F3-C1 – Price Adjustment Clauses is a matter to be discussed and agreed upon between the taxpayer, the tax professional and the valuator. This determination would take into account the purpose for which the report is being prepared, the information available to determine value and the taxpayer’s need for assurance as well as the valuator’s requirement to ensure that the report is credible and is not misleading to the reader.

It has been my experience, as well as the extensive experience of the partners and managers in our Income Tax Group, that a Calculation Valuation Report is sufficient to meet CRA’s standards. Perhaps in certain cases, an Estimate Valuation Report should be considered.

Conclusion

In consideration of CRA’s requirements relating to Price Adjustment Clauses, I am confident that by engaging a Chartered Business Valuator to prepare a valuation under the practice standards established by the CICBV, the taxpayer meets and exceeds CRA’s requirements. If you wish to further discuss either the income tax considerations noted in our May newsletter or the related business valuation considerations noted in this newsletter, please contact either Jacob Milosek or David Ienzi.



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