<u>**Business Valuations: Practical Considerations in Business Valuations**</u>

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Business Valuations

Given that I am certainly not an expert in valuing businesses and do not profess to have the expertise to go through all of the considerations involved with valuing a business, the focus of this paper is to review of some of the most common issues that I see arise when a business valuation is required and summarize some applicable case law.

Through this paper and presentation it is hoped that you will gain a better understanding of some of the issues that you should be alert to when a business is being valued.

Purpose Behind a Business Valuation

Generally speaking, if you are seeking a business valuation, you are trying to determine the "fair market value" of a business as of a specific date. My co-presenter, Mr. Weber, will be outlining the definition of fair market value in his presentation.

In the family law context (where a number of the business valuation issues arise), the definition of "value" is prescribed to be the "fair market value" of an asset or, if the fair market value cannot be determined, a "reasonable" value[2].

Where I Start When Involved with a Case Involving a Business

The first documents that I seek when involved with a potential business valuation are the corporate financial statements and income tax returns for the business for the past number of years (generally the last three years). In the corporate financial statements, I often first turn my attention to the balance sheet of the business.

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[2] *The Family Property Act,* Section 2(1)

It is important to understand that the balance sheet of a business gives you the net book value of a business as of the date of the financial statement. The net book value of the business is not the fair market value of the business.

Thus, a balance sheet should not be considered an accurate representation of the value of a business. However, it does provide you with important information such as the cash on hand and the debts of the business as of the date of the financial statement[3].

Considerations When Looking at a Balance Sheet

A balance sheet would often look similar to the one below.

Your Company Name		**Balance Sheet**
Assets		
Current assets:	**2014**	**2013**
Cash and cash equivalents	20,000	8,000
Inventories	10,000	8,000
Accounts receivable	5,000	4,000
Pre-paid expenses	0	0
Other	0	0
Total current assets	**35,000**	**20,000**
Property, Plant and Equipment	**2014**	**2013**
Property, plant and equipment	50,000	50,000
Total property, plant and equipment	**50,000**	**50,000**
Total assets	**85,000**	**70,000**
Liabilities		
Current liabilities:	**2014**	**2013**

[3] It must be kept in mind, of course, that many financial statements rely heavily on the information provided by the business owner to the accountants. To be assured of the information in the financial statement, background documents might need to be obtained.

Accounts payable and accrued liabilities	5,000	3,000
Income taxes payable	1,000	1,000
Other	-	-
Total current liabilities	**6,000**	**4,000**

Long-term liabilities:	**2014**	**2013**
Mortgage payable	12,000	15,000
Total long-term liabilities	**12,000**	**15,000**

Shareholder's Equity

Owner's equity:	**2014**	**2013**
100 Class "A" Shares	100	100
Accumulated retained earnings	66,900	50,900
Total owner's equity	**67,000**	**51,000**

Total liabilities and shareholder's equity	**85,000**	**70,000**

Looking at the balance sheet above, there are a few issues to consider:

1. Property, plant and equipment – A value of $50,000 has been given to property, plant and equipment. Again, the value on the balance sheet is the net book value of the asset. In other words, the $50,000 value tells you the acquisition cost of the property, plant and equipment minus accumulated depreciation. The property, plant and equipment line item does not tell you what the property, plant and equipment is worth today. I would want to consider, with input from a business valuator, whether we should be obtaining an appraisal of the property, plant and equipment, particularly if the asset is likely to have increased or decreased in value since acquisition;

2. Goodwill – The balance sheet obviously does not have a line item for goodwill. I will want to discuss with my expert whether this business might have goodwill and work with him or her to obtain the information necessary to assess the potential goodwill of the business.

There are potentially other adjustments that would need to be made such as assessing whether the accounts receivable are realistically recoverable, whether there has been too much of a write down for bad debt, whether the "cash equivalents" represent the current fair market value of those assets, etc. You should discuss the adjustments that might be of relevance and what documents should be obtained in your particular circumstance with your business valuator.

Goodwill

Valuing goodwill of a business is one of the true arts of business valuation. There may be significant or no goodwill in a business. There are numerous ways to try to calculate the potential goodwill of a business and many different factors that need to be considered.

Goodwill is an intangible asset and, thus, reasonable business valuators can have very different assessments of the value of goodwill.

Trying to consider all of the different factors that might go into establishing goodwill goes well beyond my knowledge and the scope of this paper. However, there are a number of decisions where the matter of goodwill has been at issue. A small sampling includes:

1. *Dun-Rite Plumbing & Heating Ltd. v. Walbaum*, 2009 SKQB 174 – In a rather lengthy decision with competing experts, the Court found that the plumbing business in question did not have any marketable goodwill. The goodwill in the business was "personal goodwill" in the sense that the customers had personal relationships with one particular business owner, as opposed to any connection to the business itself. The Court also commented about ensuring the neutrality of the experts and took issue with one of the experts;

2. *Cey v. Teske*, 2006 SKQB 315 – The Court again considered conflicting expert reports on whether there was any goodwill associated with a plumbing business (involved primarily with commercial plumbing enterprises). There were conflicting expert opinions tendered. The husband's valuator suggested that the business had no marketable goodwill; the wife suggested goodwill of $100,000. Justice Ryan-Froslie determined that the business had goodwill of $50,000. She indicated that there were differences between "personal goodwill", "individual goodwill" and "commercial goodwill". In this case, Justice Ryan-Froslie determined that there was "individual goodwill" in the business, which would be of value to a potential purchaser should the husband remain with the company and allow for a transition of the business. Justice Ryan-Froslie also commented on the value of the existing customer base with the long-standing business and found that there would be value to a prospective purchaser beyond the liquidation value of the business;

3. *Lepage v. Lepage* (1999), 179 Sask. R. 34 (Q.B.) – The Court determined that the husband's interest in the Deloitte & Touche accounting partnership did not have a goodwill value, as there was no evidence that the husband would be able to realize upon any goodwill if he attempted to transfer or sell his interest in the business;

4. *Hildebrandt v. Hildebrandt* (1990), 26 R.F.L. (3d) 137 (Q.B.) – The Court determined that the husband's one-man business operation did not have any marketable "goodwill". The business relied on a personal relationship between the husband and the company's main customer, which would not be of value to a potential purchaser;

5. *Stelter v. Stelter* (2012), 405 Sask. R. 63 (C.A.) – The majority at the Court of Appeal dismissed an appeal of the trial judge's determination of the goodwill of a business. There were two competing business valuations,

one in which the business was determined to have goodwill value and the other where it was determined that the business had no goodwill. Justice Richards wrote a strong dissent outlining why the husband's expert's opinion should have been preferred which determined that the business had no goodwill value. One of the primary issues at play was accounting for the fair market value of the services provided by the husband to the corporation.

There are frequently also issues in terms of assessing capitalization rates, multipliers and adjustments for the fair market value of wages.

When dealing with goodwill, it is important to get good advice from a professional, as there are many factors to consider in assessing whether and how much should be attributed to goodwill.

Tax Ramifications

Of course, if one is seeking the value of the interest in a business, one must consider the costs associated with obtaining that value. In particular, there can be tax ramifications on the sale of the shares of a business.

One of the frequent questions is how contingent tax liabilities should be considered. Namely, should the Court assess the potential tax ramifications as if the business were being sold today, or should there be a discount for potential tax planning and deferrals that might occur in the future?

Justice Ryan-Froslie, in *James v. Belosowsky*, 2012 SKQB 316, 403 Sask. R. 12 (Sask. Q.B.), does an excellent job in summarizing these concepts. She states:

> **70** Since *Carlson*, *supra*, the Saskatchewan Court of Appeal has considered the application of s. 21(3)(j) of *The Family Property Act* in a number of cases, including: *Dembiczak v. Dembiczak* (1985), 48 R.F.L.

(2d) 113, 42 Sask. R. 314 (C.A.); *Deyell v. Deyell* (1991), 90 Sask. R. 81, [1991] S.J. No. 49 (C.A.) (QL); *Seaberly v. Seaberly* (1985), 44 R.F.L. (2d) 1, 37 Sask. R. 219 (C.A.); *Vilcu v. Vilcu* (1999), 43 R.F.L. (4th) 385, 172 Sask. R. 201 (C.A.); *Russell*, supra; and *Mehlsen v. Mehlsen*, 2012 SKCA 55, [2012] S.J. No. 314 (QL). From a review of these authorities the following principles emerge:

> (1) Section 21(3)(j) of *The Family Property Act* allows a court to take into consideration a tax liability that may be incurred by a spouse as a result of the transfer or sale of family property or any order made by the court (see: *Carlson*, *supra*, and *Deyell*, *supra*).
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> (2) The court should only consider a tax liability where it would be "unfair or inequitable" to make an equal distribution of the family property without having regard to the tax consequences (see: *Dembiczak*, *supra*).
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> (3) There must be an evidentiary basis to support the tax consequences. That evidence need not be provided by experts but should address such matters as the intention or need to dispose of the asset, the applicable marginal tax rate and the potential for tax planning to avoid the payment of tax (see: *Vilcu*, *supra*, at para. 50, and *Mehlsen*, *supra*, at para. 38).
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> (4) Where assets are divided *in specie* no tax liability should be considered (see: *Vilcu*, *supra*, at para. 53, *Deyell*, *supra*, at page 12, and *Seaberly*, *supra*, at para. 29).
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> (5) Where the order for distribution of family property does not force a sale and where there is no evidence that a spouse intends to sell or otherwise dispose of the assets in the near future then the tax liability must be discounted for contingencies (see: *Carlson*, *supra*, at para. 9, and *Deyell*, *supra*).
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> (6) The contingencies referred to in the case law that may result in a discounting of the income tax liability include but are not limited to the following:
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>> (i) no intention to sell the asset in question in the near future (see: *Carlson*, *supra*, at para. 9, and *Seaberly*, *supra*, at para. 26);
>>
>> (ii) that there are mechanisms by which the spouse can minimize or defer tax (see: *Carlson*, *supra*, at para. 9);
>>
>> (iii) the age of the parties (see: *Vilcu*, *supra*, at para. 52);

(iv) the reasonable likelihood of some tax liability (see: *Deyell*, *supra*, page 13).

(7) The courts generally apply a discount of 50% to the marginal tax rate where the tax liability is contingent (see: *Carlson*, *supra*, at para. 9; *Deyell*, *supra*, at pages 12 and 13; *Seaberly*, *supra*, at para. 26; *Vilcu*, *supra*, at para. 47; and *Russell*, *supra*, at para. 75).

As can be seen from the above, there are factual issues that should be addressed in evidence to properly assess contingent tax liabilities.

Minority Discount

If you are dealing with a situation where the shares being valued constitute less than 50% of the voting shares of the corporation, it may be appropriate to discount the value of those shares for a "minority discount". A minority discount is applied to account for the fact that a purchaser of the shares would not be able to control the operations or governance of the corporation, being in a minority shareholding situation. Thus, the purchaser is unlikely to purchase the shares in the business for their appraised value.

There are a number of decisions discussing minority discounts and whether and how much of a discount should be applied. Some of those decisions are:

1. *Guckert v. Koncrete Construction Ltd.,* 2009 SKQB 484 (Q.B.) – There were a number of valuation issues raised in this particular case and competing expert opinions. One of the issues was to what extent there should be a minority discount on the shares in the business. One business valuator suggested a minority discount of 15%; the other suggested 30%. After looking through the various arguments supporting one discount rate or the other, Justice Sandomirsky accepted a minority discount of 25% on the husband's shares;

2. *Frank v. Linn*, 2014 SKCA 87 – The husband in this case argued at trial for a minority discount of 10% and the wife argued for no minority discount. The Court discussed a few decisions where no minority discount was applied and distinguished those cases. The Court of Appeal ultimately employed a 10% minority discount;

3. *Waller v. Waller* (1998), 164 Sask. R. 161 (Q.B.) – The Court determined that it was not appropriate to factor in a minority discount, in part because the business owners tended to make their decisions by consensus, notwithstanding the fact that each might have different financial interests in the business;

4. *Rosenau v. Rosenau*, 2004 SKQB 275 – Each party differed on the appropriate minority discount (50% and 20%, respectively). The trial judge ordered that the shares in the business be discounted by 20% after considering the expert evidence.

It is worth noting that the cases set out above assess a minority discount to try to assess the fair market value of the shares of a business. This is distinguished from the "minority discount" that is discussed in cases involving the oppression remedy under *The Business Corporations Act.*

In cases involving the oppression remedy, the term "minority discount" is used to establish a fair amount to deduct from the value of the oppressed shareholders' shares to account for his or her conduct in relation to the company. For instance, in *Derdall v. Derdall Irrigation Farms Ltd.*, 2010 SKCA 104, the Court of Appeal overturned the trial judge's assessment of a minority discount of 20% and applied a 60% minority discount. The Court of Appeal determined that the conduct of an oppressed shareholder is a factor in assessing an appropriate minority discount. Given that the son voluntarily left the farm and waited some 30 years to seek a buy out of his shares, it was appropriate to discount the value of his shares by 60%.

Again, the minority discount terminology used in an oppression action, in my respectful view, is not relevant in other contexts where one is seeking the fair market value of the interests of a business.

As can be seen from the cases outlined above, there is no “hard and fast” rule as to an appropriate minority discount in the case law. Each case must be considered on its own facts.

Conclusion

The four issues raised above (evaluating the fair market value of the assets of the business, assessing goodwill, contingent tax ramifications on disposition and minority discounts) are common issues that arise when business interests are being valued. These should all be discussed and considered with whichever expert may be assisting you.