How much is your business worth?

Management issue paper

At some point most business owners require an independent valuation of either the shares or assets of their businesses. The reasons for needing a valuation are varied:

- purchase, sale, or merger of a business;
- reorganization or amalgamation done for tax purposes;
- bringing key employees into ownership;
- buy/sell agreements, resolution of shareholder disputes;
- equitable division of matrimonial property;
- corporate finance, e.g., lender security, raising equity funds; and expropriation.

A business valuation can be attempted by anyone; the law does not designate who is qualified to perform valuations. However, a number of court cases have recognized the distinction between evidence provided by a qualified business valuator and that provided by someone without the same degree of competence and education. The Canadian Institute of Chartered Business Valuators is an example of an organization dedicated to the performance of business valuations in an independent and competent manner (conferring the title CBV).

There is no organized market, e.g., listed companies trading on a stock exchange, for private corporations. Often a valuation is needed, despite the fact that the subject business will not be exposed to the marketplace for sale. Business valuators called on to estimate a fair transaction price in these circumstances call their opinion a "notional market valuation. "

In some industries, there are so-called "rules of thumb " or guidelines that are generally accepted as value determinations. For example, insurance agencies are sometimes sold for a multiple of annual commissions. Business valuators tend to use these rules only as a secondary indicator of value, since each business (even within industries) is different, with often distinctive revenue and expense characteristics.

Qualified business valuators tend to use future cash flow approaches to measure value. Fundamentally, the value of a business lies in its ability to generate profits in the future. Using a company's track record of earnings, valuators derive an expected level of cash flow for the company, "normalized" for unusual revenue or expense items. Normalizing adjustments include unusual items such as excessive owner-manager salaries or non-recurring revenues or expenses.

The valuator then multiplies the expected normalized cash flows (adjusted for tax effects) by a capitalization factor. The capitalization factor is a reflection of what rate of return a reasonable purchaser would expect on the investment, as well as a measure of the risk that the expected earnings will not be achieved. Market transactions involving similar businesses often provide meaningful information on expected rates of return, and, more importantly, what post-transaction additional earnings (i.e., synergy, economies of scale) that purchasers will pay for.

Where no transaction data is available, valuators often use a "build-up " method to determine an appropriate capitalization rate. Build-up methods tend to start with a "risk-free " rate, such as long-term Government of Canada bonds, and add on risk points related to the industry, the investment cycle and the specific business. Well established businesses with a history of strong earnings and good market share might often trade with a capitalization rate of, say 12% to 20%. Unproven businesses in a fluctuating and volatile market tend to trade at much higher capitalization rates, say 25% to 50%.

In some cases, valuators will use asset-based approaches as their best estimate of value because the business has not been able to generate sufficient profits for an investor to earn the expected rate of return. Asset-based approaches can be done on a going concern basis, or on a liquidation basis.

The issue of business valuations has increased in complexity just as the complexity of modern business has increased. Judgment calls with respect to expected earnings and rates of return are not done in isolation. The valuator must review the operations (financial, production, and marketing) of the business and consider the industry and the general economy when determining the value of a business.

On a final note, valuations for tax purposes are the most common type of notional market valuation. When deciding that a valuation is needed, you should keep in mind that Revenue Canada has experienced valuators on staff who will probably review the assumptions and calculations behind your value. Making sure that your valuation report is prepared by a qualified business valuator will help in answering their queries.

About Grant Thornton in Canada

Grant Thornton LLP is a leading Canadian accounting and advisory firm providing audit, tax and advisory services to private and public organizations. Together with the Quebec firm Raymond Chabot Grant Thornton, Grant Thornton has more than 3,100 people in offices across Canada. Grant Thornton LLP is a Canadian member of Grant Thornton International Ltd. We're next door, we're nationwide, and we're worldwide.

About Grant Thornton International Ltd

Grant Thornton International Ltd is one of the world's leading organizations of independently owned and managed accounting and consulting firms providing assurance, tax and specialist advisory services to privately held businesses and public interest entities. Grant Thornton International Ltd and the member firms are not a worldwide partnership. Services are delivered by the member and correspondent firms within Grant Thornton International Ltd. Member and correspondent firms operate in over 100 countries worldwide. Grant Thornton International Ltd is a non-practicing international umbrella organization. Any and all references to Grant Thornton International are to Grant Thornton International Ltd.

A listing of Grant Thornton offices and contact information can be found on our website at: www.GrantThornton.ca