II. VALUING A BUSINESS

1.0 INTRODUCTION

In today's world, the requirement for business valuations is steadily increasing. Although it may not be necessary to be an expert in the area of business valuations, many individuals in various professions and positions are finding it beneficial to understand the basics in this area of study.

The Valuing a Business section of the course is intended to provide lawyers, whether in public practice or industry, with a general understanding of the following:

- When a business valuation is required;
- Differences in value terms and definitions;
- Fundamental valuation principles;
- General approaches and methods for determining business values;
- Minority discounts;
- Analyzing valuation reports; and
- Potential causes for differing business valuation conclusions.

Once again, bear in mind that this course is of an introductory nature. Therefore, the Valuing a Business section of the course is not intended to provide a thorough understanding of business valuation.

1.1 TYPES OF BUSINESSES ADDRESSED

The Valuing a Business section of the course primarily deals with the valuation of the shares of private corporations and not those of public corporations. However, most of the materials and concepts are applicable to many other entities, which include public companies, partnerships, and unincorporated businesses.

1.2 NOTIONAL MARKET VERSUS OPEN MARKET

Further, this section of the course addresses notional market valuations as opposed to open market transactions. In a notional market, value is determined in the absence of an actual open market transaction. In other words, the shares of the company are not actually sold in a notional market. Rather, value is determined in a hypothetical context - that is, what price would the shares transact at in an actual open market deal. Obviously, in an open market transaction the price of the shares is readily available and not subject to debate.

Determining value in a notional market is not so much a science as it is an art. There are no strictly defined procedures or mathematical equations. Rather, notional market valuations rely on broad principles, subjectivity, experience, and professional judgment. As a result, different individuals may reach valuation conclusions for the same entity that are significantly divergent and often a business valuation expert is required.
2.0 CIRCUMSTANCES REQUIRING A BUSINESS VALUATION

There are various circumstances that require a business valuation. Further, lawyers are often involved to some extent in these situations. Some of these are as follows:

• **Dissent actions.** Both the *Canada Business Corporations Act* (s. 190) and the *Alberta Business Corporations Act* (s. 184) provide for shareholder dissent rights, which are invoked by a variety of significant corporate changes. These changes include the following:

  i.) Amendment to the company's articles of incorporation. These amendments may impact provisions restricting the issue or transfer of shares or other rights attaching to a company’s authorized share capital. They may also change the restrictions on the nature of the business that may be carried on by the corporation;

  ii.) Amalgamation;

  iii.) Continuation of a company to another jurisdiction; and

  iv.) Sale, lease, or exchange of all or substantially all of the corporation's assets.

Dissent remedies allow a minority shareholder of a corporation to demand that the corporation buy back his/her shares at their "fair value."

• **Oppression actions.** Both the *Canada Business Corporations Act* (s. 242) and the *Alberta Business Corporations Act* (s. 234) provide for the protection of individuals in situations where the individual is impacted by corporate conduct, which is "oppressive or unfairly prejudicial to or unfairly disregards the interests of any security holder, creditor, director, or officer." Concerning minority shareholders and aside from other remedies, the Courts may order the company to purchase the oppressed person's shares at their "fair value."

• **Compulsory acquisitions ("squeeze-outs").** Pursuant to both the *Canada Business Corporations Act* (s. 199) and the *Alberta Business Corporations Act* (s. 187-198) minority shareholders who collectively own 10 per cent or less of the issued shares of a particular corporation are subject to "squeeze-out" provisions. These provisions allow a purchaser of a corporation who acquires in a takeover bid at least 90 per cent of the shares of which it did not previously own to force the remaining shareholder to sell their shares at "fair value."

• **Fairness opinions.** Various provincial Securities Acts require fairness opinions, which necessitate a business valuation. For example, the Ontario Securities Commission's Rule 61-501 and Companion Policy 61-501 CP regulates insider bids, issuer bids, going private transactions, and related party transactions.

• **Marital breakdown.** Subject to various provincial laws, it often is necessary to determine the value of matrimonial property to effect an equalization payment to be made by one spouse to the other. Frequently, marital property includes the shares of a private corporation, which need to be valued.
• **Commercial litigation.** Due to various causes, such as a breach of contract, an entire business may be permanently impacted, which may lead to litigation. In such cases, it may be necessary to determine the value of the business both prior and subsequent to the event in order to quantify monetary damages.

• **Taxation purposes.** The value of a business may be required to determine the quantum of capital gains, to effect the reorganization of a corporation, to conduct effective taxation planning, and to undertake estate planning.

• **Shareholder relationships.** A business valuation may be required to structure shareholder agreements and to provide updated value information to the parties of the agreement. Shareholder agreements may contain buy/sell provisions. Further, due to shareholder disputes, the value of a business may be required to be determined in conjunction with [mediation](#) or [arbitration](#). Due to the high costs of litigation, arbitration is increasingly becoming a more popular dispute resolution mechanism.

• **Financing.** Banks and/or venture capital entities often require an independent business valuation prior to advancing funds.

• **Mergers and acquisitions.** Business valuations are often undertaken when evaluating a potential business acquisition or divestiture.

• **Employee plans and/or transactions.** In order to compensate, invoke loyalty, and motivate employees, private companies are increasingly selling equity to their employees and/or establishing stock option plans. Sales of shares to employees requires a current business valuation while stock option plans require periodic and ongoing business valuations.

• **Expropriation issues.** Often businesses experience a loss of income in conjunction with expropriation. In these cases, the value of the entire business prior to the expropriation sets a maximum amount for damages. Further, in some cases the business cannot continue after expropriation. In these situations, damages are represented by the value of the business's goodwill.

• **Business interruption claims.** Like expropriation situations, the value of the entire business prior to the business interruption sets a maximum amount for the claim.
3.0 VALUATION PROFESSIONALS

As mentioned previously, valuing businesses properly is often a complex undertaking that requires specialized expertise. In order to provide excellent client service and obtain desirable and fair results it is advisable to hire an expert practitioner in the area of business valuation.

Currently, the business and security valuation field in Canada is essentially unregulated. The Canadian Institute of Chartered Business Valuators ("CICBV") is a self-regulating body. The CICBV is Canada's largest valuation organization. For over 25 years the CICBV has been dedicated to ensuring excellence in business valuation, through the training and education of its members, and to protecting the, public by developing and enforcing Practice Standards and a Code of Ethics. Persons qualified as members of the CICBV are entitled to use the professional designation Chartered Business Valuator ("CBV"). The CBV designation has come to be recognized as the premier credential for professional business valuators in Canada, with members providing a broad range of business valuation services to Canada's business, legal, investment, banking, and government communities. The courts recognize CBV's as expert witnesses in valuation and damage quantification matters.

The CICBV's objectives are as follows:

- Foster, promote, and develop the profession of business valuation;
- Establish and encourage adherence to a high standard of ethics;
- Provide mutual assistance within the profession and facilitate the exchange of ideas and concepts of valuation, through conferences, meetings, exhibitions, and other means;
- Foster research and education;
- Establish programs for examining and testing members; and
- Establish a library and publish papers and journals in the field of valuation.

For more information on the CICBV, please see www.businessvaluators.com.
4.0 VALUE DEFINITIONS

Depending upon the circumstances demanding a business valuation, which were discussed previously, it is necessary and imperative that the correct definition of value be used. According to various legal statutes, case laws, and situations, different definitions of value may be appropriate. The most common definitions of value are "fair market value," "fair value," and "price, which are discussed below.

4.1 FAIR MARKET VALUE

The most common value term encountered in Canada is "fair market value." The definition of fair market value has evolved throughout the years from various Canadian Court cases (Minister of Finance v Mann Estate (1972),5 WWR 23 at 27; affd. (1973) CTC 561 (CA); affd. (1974) CTC 222 (SCC) and Re Domglas, supra). The definition is as follows:

"The highest price available in an open and unrestricted market between informed and prudent parties, acting at arm's length and under no compulsion to act, expressed in terms of cash."

Not only is the above definition accepted by the Canadian Courts, the Canadian Customs and Revenue Agency (formally know as Revenue Canada) officially adopted this definition in Information Circular 89-3.

The definition of fair market value assumes a perfect market. However, in reality, such a market does not exist either in an open market context or in a notional market context. In any event, fair market values are determined in an notional context as best as possible, which necessitates a certain amount of subjectivity and judgment.

Each of the phrases in the definition of fair market value has specific meaning to a valuator.

- **Highest price available.** One must bear in mind that both the vendor and the purchaser would transact only at a price deemed fair by each. There is always uncertainty as to whether fair market value represents the highest price available, as the company is not actually sold in an open market transaction (i.e., fair market value is determined in a notional market). Should the company be offered for sale on the open market "special interest purchasers" may pay more for the company than other potential purchasers in order to realize economies of scale and/or synergies and/or a strategic advantage. It is difficult to identify such special interest purchasers in a notional market context let alone quantify the additional amounts that they would pay above other potential purchasers.

- **Open and unrestricted market.** The term "open" means that no potential purchasers are to be excluded from the notional market place. The term "unrestricted" means that any statutory, contractual, or other restrictions that may impact the marketability of a business interest are momentarily lifted so that a sale may take place in the notional market. This does not mean that one ignores the existence of any factual or legally enforceable restrictions. Rather, the notional purchaser is deemed to acquire the business interest subject to those conditions. This may have an impact on the estimate of fair market value.
Between informed parties. In notional market valuations, there is often debate on how much information should be assumed to be available. Since open market transactions are conducted without the use of hindsight information, it is inappropriate to use hindsight information in notional market valuations. However, in open market transactions it is often the case that both the vendor and purchaser have different information available to them. In any event, in Canada, valuators tend to assume that fairly full and open disclosure of information relevant to a purchase and sale should be assumed in fair market value determinations.

Between prudent parties. This assumes that both the vendor and purchaser exercise due diligence and act reasonably.

Acting at arm’s length. This assumes that both the vendor and purchaser have opposing interests and, therefore, value is not impacted by non-economic considerations such as sentiment. In other words, the vendor wants as much as possible and the purchaser wants to pay as little as possible.

Under no compulsion to act. This assumes that neither the vendor nor the purchaser is forced to transact. Rather, they are willing to buy/sell at a fair price. Should there be some type of compulsion on the vendor, a lower price than possible may result. The converse is true for the purchaser.

Expressed in terms of cash. Fair market value is stated as a cash amount and does not consider factors as to how the price would be paid. Fair market value reflects the price at which an absolute transfer of the risks and rights associated with the property would take place.

4.2 FAIR VALUE

"Fair value" is the value term accepted by Canadian Courts to be used in dissent actions, oppression actions, and compulsory acquisitions. In all of these cases, minority shareholders are impacted.

Canadian Courts have generally accepted that fair value be determined by using fair market value as a base. Fair value is a portion of the en bloc fair market value of a class of shares. For example, say that the fair market value of all of the issued and outstanding common shares, considered together, of XYZ Corporation, as at June 30, 2000, is $1.20 million. Further, assume that a minority shareholder holds 15 per cent of these common shares and has initiated an appraisal remedy. Since fair value is to be used under an appraisal remedy, the fair value of this 15 per cent holding is $0.18 million (i.e., $1.20 million, which is the en bloc value, multiplied by the applicable portion percentage, which in this case is 15 per cent).

In short, fair value does not incorporate a minority discount. However, in certain cases fair value may include a premium for forcible taking.
4.3 PRICE

Price is the amount that is determined in an actual open market transaction. This is opposed to fair market value, which is determined in a notional market context, since the business being valued is not actually sold. Price may differ from fair market value due to a variety of reasons. In general, one should look at each term of the definition of fair market value, which was done previously, and compare this to the environment in actual open market transactions. For example, open market transactions are often not conducted in an "open and unrestricted market," as not all potential purchasers may be considered in all cases. In open market transactions often the purchaser or vendor has more information than the other, which impacts price. In open market transactions often the vendor or purchaser has better negotiating skills and either or both parties may not be rational. In open market transactions there may be a compulsion to act. For instance, a vendor may want to sell her/his business because he/she has just been diagnosed with an incurable disease.
5.0  VALUATION PRINCIPLES

There are a number of fundamental valuation principles that must always be considered in all valuations, whether they are done in a notional market or in an open market transaction. In other words, these valuation principles are always applicable in determining value. These principles guide valuators through various circumstances and situations.

When analyzing a valuation report, always consider whether the fundamental valuation principles have been adhered to. If they have not, one may question the valuation conclusion.

The following are the fundamental valuation principles.

5.1  POINT IN TIME

Value is determined at a specific point in time. It is a function of facts known, and forecasts made, only at that point in time.

Note that the notional market is intended to mimic a fair open market. As future events are unknown when determining the price in an open market transaction, it follows then that future unanticipated events as at the valuation date should not be incorporated into a notional valuation of the same entity.

The value of a business is fluid and can change for numerous reasons. Accordingly, a value calculated at one point in time may not be applicable at another point in time. For example, the trading price per share of a public company is constantly changing.

5.2  VALUE IS PROSPECTIVE

Value is prospective. It is equivalent to the present value (or economic worth) of all future benefits anticipated to accrue from ownership.

This is a very important concept in business valuations. A purchaser is interested in the future earnings or cash flows of the business - not the past earnings or cash flows of the business. Analysis of historical results is a useful and necessary step in assessing value. However, valuators should not rely only on history while ignoring future prospects and trends.

5.3  COMMERCIAL VERSUS NON-COMMERCIAL GOODWILL

Where value is defined as "the present value (or economic worth) of all future benefits anticipated to accrue from ownership," and where that definition is applied to privately held business interests, it may have two distinct components, commercial (or transferable) value and non-commercial (or value-to-owner) value.

In the context of notional fair market value it is only commercial goodwill that is transferable. For example, say that there are two shareholders, each owning 50 per cent, of a small company that constructs small buildings to house tools on oil and gas properties. Further, assume that this company has historically made a lot of money and is anticipated to continue to do so in the future. Also, assume that all of the contracts awarded to this company are the result of one of the shareholders. This shareholder has a key relationship with a key vice-president in a large oil and gas company. In this case, most of the value of this company is in non-commercial goodwill. That is, although the company is expected to make a lot of money in the future, a reasonable and prudent
purchaser would not pay much for the company. The reason for this is if the key shareholder suddenly quit or died, the company would cease to earn significant profits.

5.4 HINDSIGHT

Except in limited circumstances, hindsight (or retrospective) evidence is inadmissible.

In the context of notional fair market value, only information available at the valuation date is permissible (Wallace R. Brunelle v MNR, (1977) CTC 2506; 77 DTC 326, and National System of Baking of Alberta Ltd. v MNR, (1978) CTC 30; 78 DTC 6018; afld (1980) CTC 237; 80 DTC .6178). The reason for this is that when negotiating an actual open market transaction, neither the vendor nor the purchaser has the benefit of knowledge of events that will take place at a future date.

In limited circumstances the courts have allowed the use of hindsight evidence to test the validity of forecasts and other assumptions made at the valuation date (Diligenti v RWMD Operations Kelowna Ltd. (No 2), 4 BCLR 134, and Re Domglas: Domglas Inc. v. Jarislowsky, (1983) 138 DLR 521, affd. (1980) 13 BLR 135).

5.5 OTHER PRINCIPLES

Other fundamental valuation principles are as follows:

• The market determines the required rate of return;

• Value relates to future earnings or cash flow generating ability, except in limited cases where net liquidation value would yield a higher value;

• The higher the underlying net tangible assets of a business, the lower the risk and therefore the higher the value;

• One "special purchaser" will only pay nominally more than other purchasers. Two or more "special purchasers" create a "special purchaser" market; and

• In the absence of agreements to the contrary, a minority interest is generally valued at a discount.
6.0 VALUATION APPROACHES

In general, there are two general valuation approaches.

1. The liquidation approach; and

2. The going concern approach.

When valuing businesses that are providing an "adequate return on invested capital," the going concern approach should be used. On the other hand, if a business is not providing an "adequate return on invested capital," the liquidation approach should be used.

For businesses not operating as a going concern, a higher value is obtained from liquidating the assets of the company and extinguishing its liabilities than if the company continued to operate. In other words, the equity holders of the company would obtain more cash on the date of liquidation than they would from the present value of cash generated by the company in the future. In these cases the company is "better off dead than alive."

When deciding upon whether a company is a going concern, one must not only analyze past operating results and the current financial position of the business, but the future prospects of the company should also be assessed. As discussed previously, one of the fundamental valuation principles is that value is prospective. For example, assume that a mining company generated sufficient cash from operations prior to the valuation date. However, due to changing government legislation, which requires equipment to be installed to reduce emissions for environmental purposes, the company in question will have to spend a significant amount of money in the next year on capital improvements. In this case, the mining company may no longer be a going concern.

Various valuation methods can be employed under each of the general valuation approaches (i.e., the liquidation and going concern approaches). The selection of the appropriate method is dependent upon each specific situation. The valuation methods are as follows:

<table>
<thead>
<tr>
<th>General Valuation Approach</th>
<th>Liquidation Approach</th>
<th>Going Concern Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>For liquidation</td>
<td>Capitalization of earnings</td>
</tr>
<tr>
<td></td>
<td>Orderly liquidation</td>
<td>Capitalization of cash flow</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Discounted cash flow</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Adjusted net asset value</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Rules of thumb</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Capitalization of earnings before interest and taxes (&quot;EBIT&quot;)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Capitalization of earnings before interest, taxes, depreciation, and amortization (&quot;EBITDA&quot;)</td>
</tr>
</tbody>
</table>

Of the going concern approach methods, the capitalization of earnings, capitalization of cash flow, and discounted cash flow methods are the most frequently used.
7.0 LIQUIDATION APPROACH

As mentioned previously, if a business is not providing an "adequate return on invested capital," the liquidation approach should be used.

Liquidation value represents the amount realizable on net assets in the event of the liquidation or bankruptcy of a business.

When computing liquidation value, it is first necessary to determine whether a forced liquidation or an orderly liquidation is warranted.

- Under a forced liquidation, the assets of the company are assumed to be sold as soon as possible. Often, the assumption is that the assets are sold by means of an auction process. Since the assets are assumed to be sold quickly, not all potential purchasers are considered, which generally results in lower selling prices than if the assets were exposed on the market for a longer period of time. For instance, when liquidating a company that sells perishable goods, a forced liquidation would be used.

A forced liquidation assumption is generally not used because it often does not result in the "highest price available," which is a component of the fair market value definition, as discussed previously. However, in some cases it is very costly to continue operating a business while exposing its assets to the open market for a period of time. In these cases, the greatest proceeds upon liquidation are obtained when assets are sold as quickly as possible.

- Under an orderly liquidation, the assets of the company are assumed to be sold over a reasonable period of time. In this situation many potential purchasers are considered, which generally results in the proceeds of liquidation being maximized. For example, when liquidating a company that sells specialized heavy construction equipment, the highest proceeds from selling the equipment would likely be obtained if the equipment was exposed for sale over a long period of time.

An orderly liquidation assumption is generally used because it often results in the "highest price available."

In short, the decision between using a forced liquidation and an orderly liquidation assumption depends upon which method results in the maximum amount of proceeds obtainable when considering the time value of money. In most cases, an orderly liquidation approach produces the greatest amount of proceeds although this is not always the case.

The assumption of a forced liquidation or an orderly liquidation impacts the value of the company's assets. However, the general steps under the liquidation approach are the same, which are as follows:

1. Determine the liquidation value of the company's assets either under a forced liquidation or an orderly liquidation assumption. Note that the liabilities of a company rarely need to be restated;

2. Determine the estimated selling and other disposal costs that would be required to liquidate the assets and cease business operations. Such costs may include legal fees, auction fees, and employee severance costs. Further, one must not forget about the net operating after-tax costs that would be incurred during the liquidation period such as employee wages and salaries and rental costs; and
3. Quantify the income taxes that would be incurred upon the sale of various company assets. Income taxes may be triggered on capital gains and/or recaptured depreciation.

The following provides a numerical example of computing value under a liquidation approach:

**Example of Liquidation Approach**

<table>
<thead>
<tr>
<th></th>
<th>Book Value per Financial Statements</th>
<th>Liquidation Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>200,000</td>
<td>210,000</td>
</tr>
<tr>
<td>Other assets</td>
<td>15,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>(65,000)</td>
<td>(65,000)</td>
</tr>
<tr>
<td>Deferred income taxes</td>
<td>(50,000)</td>
<td></td>
</tr>
<tr>
<td>Legal fees for liquidation</td>
<td>N/A</td>
<td>(5,000)</td>
</tr>
<tr>
<td>Employee severance costs</td>
<td>N/A</td>
<td>(30,000)</td>
</tr>
<tr>
<td>After-tax operating costs during liquidation period (warehouse rental and employee wages)</td>
<td>N/A</td>
<td>(7,000)</td>
</tr>
<tr>
<td>Income taxes on sale of assets</td>
<td>N/A</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Totals</td>
<td>$200,000</td>
<td>$188,000</td>
</tr>
<tr>
<td>Value under liquidation approach (per above)</td>
<td>$188,000</td>
<td></td>
</tr>
</tbody>
</table>
8.0 GOING CONCERN APPROACH - CAPITALIZATION OF EARNINGS METHOD

As mentioned previously, there are various valuation methods that may be employed under the going concern approach. These are as follows:

- Capitalization of earnings method;
- Capitalization of cash flow method;
- Discounted cash flow method;
- Adjusted net asset value method;
- Rules of thumb method;
- Capitalization of earnings before interest and taxes ("EBIT") method; and
- Capitalization of earnings before interest, taxes, depreciation, and amortization ("EBITDA") method.

As the objective of this course is not to provide a thorough understanding of business valuation and not to teach individuals to become business valuators, only the capitalization of earnings method will be addressed. The general steps and theory for this method are similar to those of the capitalization of cash flow, capitalization of EBIT, and capitalization of EBITDA methods. In short, although the other capitalization methods involve more complexities and considerations, the capitalization of earnings method provides a general understanding of the going concern approach.

8.1 CAPITALIZATION OF EARNINGS GENERAL EQUATION

The general equation for determining the fair market value of shares under the capitalization of earning method is as follows:

\[
\text{Selected after-tax earnings from operations} \times \frac{1}{\text{capitalization rate}} \\
\text{Going concern value of operations} + \text{Redundant assets} \\
\text{Fair market value of shares}
\]
Each of the components of the general valuation equation will be discussed below.

### 8.2 DETERMINING SELECTED EARNINGS

Selected earnings imply a level of earnings that can reasonably be expected in the future (i.e., subsequent to the valuation date), an average level and not one that will necessarily be achieved in each and every year by the company being valued. To the extent that growth in earnings can be anticipated, it is generally considered in the selection of the price/earnings multiple or its inverse, the capitalization rate.

In choosing an appropriate level of selected earnings for a company, one must consider not only the company's actual performance to the valuation date but also the potential revenue and profits of the entity based on the general market and legislative environment at that date.

Selected earnings are usually determined by summarizing the historical earnings results (i.e., results prior to the valuation date) for the company. These historical earnings results often have to be "normalized" to eliminate the impact of unusual or non-recurring items, as well as non-arm's-length income and expenses of a discretionary nature. Normalization adjustments are required to determine the historical operating income generated by the company being valued. The reason for this is the potential purchaser of the company is interested in the earnings/cash flow that can be generated from operations by the company.

Some common normalization adjustments are as follows:

- **Shareholders' and related parties compensation and expenses.** This is a common adjustment in private company valuations. For tax planning purposes, private companies often declare significant bonuses both to shareholders and individuals who work for the company and are related to the shareholders. The amount of these bonuses often does not reflect a fair market value compensation amount (i.e., an amount commensurate with the level of work undertaken by these individuals for the company).

- **Non-arms'-length transactions.** The owners of private companies often own other companies and business is often conducted between these entities. Further, the owners of private companies may conduct transactions on behalf of a company with non-arms'-length individuals, such as relatives. These transactions may not be conducted at fair market value rates, often because of income tax planning considerations.

  For example, say Company A rents its premises from Company B for $100 per month. Assume that the same shareholder owns each of these companies. Also, assume that if a non-related company wanted to rent the premises, the Company B would charge rent of $1,000 per month. Obviously, the $100 per month rate is not a fair market value rate. A potential purchaser of Company A would have to take this into consideration when valuing Company A, as his/her rent charge would likely be $1,000 per month.

- **Re-capitalization to "normalize" debt and equity.** Some companies have a capital structure that is either under or over-levered (i.e., too little or too much debt compared to equity). Should such a company be acquired, the purchaser of the company would in theory re-capitalize (i.e., incur more debt or reduce debt by injecting equity) this company and any additional leverage (shortfall) would be divested out (funded) by the shareholding group. This would either increase or decrease the interest expenses incurred by the acquired company.
• Income (expenses) related to redundant assets (liabilities). Redundant assets are assets that are not required for the normal ongoing operations of the business. These assets do not impact the going concern value of the operating assets of a business. Rather, redundant assets have a different risk profile than the operating assets and are therefore valued separately.

For example, say a company that manufactures widgets has some portfolio investments, such as an investment in Bell Canada. Further, assume that these portfolio investments generate annual dividends. The manufacturing company does not need these portfolio investments to manufacture and sell widgets, which is its operations. Therefore, the dividend income from these portfolio investments must be eliminated in determining an amount of selected earnings.

• Accounting depreciation versus sustaining capital expenditures. Accounting depreciation is the result of an accounting convention whereas sustaining capital expenditures contemplate the actual cash, net of income tax considerations, that must be expended by a company to maintain (not expand) a current level of operations. These two annual amounts may differ.

When considering that value is based on the future cash flows of a business, one should use sustaining capital expenditures rather than accounting depreciation when the two differ significantly.

Once the historical results of the company have been normalized, the valuator may then select a level of earnings that can reasonably be expected in the future. Always remember the fundamental valuation principle of value is prospective when selecting a level of earnings. Historical results often are a proxy for future results but in some cases bear no resemblance to expected future results.

The following provides a numerical example of determining selected earnings:

**Going Concern Approach**
Selected Earnings Calculation
Example Co.

<table>
<thead>
<tr>
<th></th>
<th>1999</th>
<th>1998</th>
<th>1997</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income (before taxes)</td>
<td>$596,856</td>
<td>$190,632</td>
<td>$198,000</td>
</tr>
<tr>
<td>Adjustments</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Management salaries</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Actual</td>
<td>132,765</td>
<td>58,000</td>
<td>163,231</td>
</tr>
<tr>
<td>Economic</td>
<td>(150,000)</td>
<td>(145,350)</td>
<td>(139,350)</td>
</tr>
<tr>
<td>Non-recurring expense</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Computer software</td>
<td>30,441</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales of Capital Asset</td>
<td>(240,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Adjusted Income</td>
<td>$368,062</td>
<td>$103,282</td>
<td>$221,881</td>
</tr>
<tr>
<td>Est. selected (before tax) earnings from operation</td>
<td>$240,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
8.3 CAPITALIZATION RATE

The capitalization rate is the required rate of return, which is usually expressed as a percentage, that is used to convert income/cash flow into value. The inverse of the capitalization rate is referred to as the multiple or multiplier. For example, say that an appropriate capitalization rate is 20 per cent. In this case, the multiplier would be 5.0 times (i.e., 1 divided by 20 per cent).

The capitalization rate indicates the rate of return that an investor would require based on returns available from alternative investments with similar risks. Obviously, if an investor could invest in Investment A, which has a higher rate of return and lower risks than Investment B, Investment A would be chosen.

In essence, the capitalization rate reflects the risks of the purchaser not being able to generate an anticipated future level of economic benefits (i.e., cash flow) after the acquisition of a company. Once again, always bear in mind the fundamental valuation principle that value is prospective. The greater the uncertainty and risks of being able to generate future anticipated economic benefits, the greater the capitalization rate, which translates into a lower multiple and a lower value for the company being valued.

The selection of a capitalization rate is often quite subjective and requires a lot of research and professional judgment. In short, there is no "one appropriate multiple." Rather, the facts in each case situation must be analyzed carefully. It is because of this subjectivity that two different valuators valuing the same company may have selected widely divergent capitalization rates, which may translate into significantly different valuation conclusions.

The factors to be considered in selecting a capitalization rate are as follows:

- External factors;
- Internal factors;
- Comparable transactions;
- Differences between public and private companies; and
- Growth potential

8.5.1 EXTERNAL FACTORS

Factors external to the company that may/should impact the selection of the capitalization rate include the following. This is a short list that is by no means all-inclusive. As mentioned previously, all risk factors that may impact the future earning capacity of the company being valued must be considered.

- Money market and stock market. Obviously, if the money market and the stock market are providing high returns in relation to a certain level of risk, the capitalization rates for private companies must be quite high to attract capital. The reason for this is private company investments are often more risky than money market and stock market investments.
• General economic conditions. A consideration in this area is expected future inflation rates. The higher the expected future inflation, the greater returns required by an investor simply to mitigate the erosion on income caused by inflation. Another consideration is the future anticipated state of the economy in general. If the economy is expected to be strong, there may be less risk in the company’s ability to generate the future expected economic benefits.

• Political environment. For example, some governments are business friendly and their policies may assist companies’ ability to generate future expected economic benefits (i.e., lower risk).

• Social environment. Social values may impact future earnings. For example, fur coats are not as acceptable in today’s society as they were a number of years ago. Obviously, this impacted the earnings for fur coat manufacturers.

• Competition. If competition is strong and/or is anticipated to be strong and increase after the valuation date, there is pressure on the company being valued to generate economic benefits after the valuation date (i.e., greater risk).

• Raw material supply. If raw material supplies are limited, there is a greater risk that supply costs will increase in the future, which may have a negative impact on the future economic benefits generated by the company being valued.

• Growth rate of existing market areas. The higher the growth rate, the greater the potential to generate future economic benefits, and the lower the risk of generating these benefits.

• Government regulation.

8.5.2 INTERNAL FACTORS

Factors internal to the company that may/should impact the selection of the capitalization rate include the following. This is a short list that is by no means all-inclusive. As mentioned previously, all risk factors that may impact the future earning capacity of the company being valued must be considered.

• Size. The larger a company in terms of employees and revenues, generally the lower the risk, as larger companies have more diversified revenue sources and access to financing than that of smaller companies.

• Management dependence and experience. Some private companies have only one key manager and if this person were to leave the company and/or worse yet, die, the company would have difficulty in generating a comparable level of future economic benefits (i.e., high risk).

• Products or services offered. Companies that are diversified in the products or services offered often have a lower risk of generating future economic benefits than companies that rely solely on one product or service.
• Plant facilities / capital intensive or not. Companies that are capital intensive may have a benefit in that it would require a large investment for a competitor to enter the market. With less anticipated future competition, the risks of generating future economic benefits may be lower.

• Marketing ability, experience, and depth.

• Location.

• Market share.

• Labour force. Companies that have a unionized workforce may be prone to labour unrest, which may negatively impact the future economic benefits generated by the company being valued.

• Significant contracts and leases. A company may currently have a favourable lease rate. However, this lease contract may expire soon after the valuation date and if not renegotiated successfully, lease rates may increase in the future. This increases the risks of generating future economic benefits.

• Customer and supplier dependence. Some companies rely exclusively on a few customers to generate a significant portion of their earnings. Should these customers switch allegiances, the company may have difficulty in generating future economic benefits.

• Net tangible asset value. As mentioned previously, one of the fundamental valuation principles is the higher the underlying net tangible assets of a business, the lower the risk and therefore the higher the value. The reason for this is if a business had to liquidate for some reason after the valuation date, it would receive more proceeds than a company with lower net tangible assets.

8.5.3 COMPARABLE TRANSACTIONS

When selecting a capitalization rate, one should attempt to identify comparable open market transactions. That is, transactions in which companies that are very similar to the company being valued in the notional market are actually bought/sold. These transactions provide evidence as to how the market is currently assessing risk factors.

The difficulty that is often experienced is identifying companies that are involved in open market transactions that are comparable to the company being valued. Often, companies that are sold in the open market do not have the same risk profile as the company being valued. Further, even if a comparable transaction is identified, it is usually difficult to find detailed information on the capitalization rate used.

Comparable transactions are used quite extensively in the United States because in that country there are many more companies that are bought and sold than in Canada. This has allowed valuators in the United States to develop extensive and detailed databases that contain transaction information. In any event, valuators in Canada must always attempt to find comparable transactions, as databases in Canada are steadily growing.
8.5.4 DIFFERENCES BETWEEN PUBLIC AND PRIVATE COMPANIES

When valuing a private company, comparable transactions involving public companies may be found. This may be the case since information on public companies is more readily available than on private companies that are associated with open market transactions. Should this be the case, the capitalization rate used in the actual public company open market transaction must be adjusted for fundamental differences between public and private companies.

In general, public companies have a higher capitalization rate, and hence, value, than private companies. The reasons for this are varied but include the fact that public companies are often more diversified geographically, they have better access to capital, they usually have greater management depth, and their stock is usually more liquid.

8.5.5 GROWTH POTENTIAL

Examining both internal and external factors, which were addressed above, may assess the growth potential of the company being valued. The higher the expected future growth rate in economic benefits anticipated to be generated by the company being valued, the lower the capitalization rate, which translates into a higher multiple and company value. This makes inherent sense in that companies that are expected to grow their cash flows in the future are more valuable than companies that are not expected to grow their cash flows.

8.4 REDUNDANT ASSETS

As mentioned previously, redundant assets are assets that are not required for the normal ongoing operations of the business. These assets do not impact the going concern value of the operating assets of a business. However, their value is included in the overall fair market value of the company.

Some examples of redundant assets are as follows:

• Excess cash. In theory, if a company has cash balances over and above what it requires for operations, it could pay this cash in the form of a bonus or dividends to its shareholders.

• Securities portfolios. Portfolio securities are items such as investments in public companies or money market instruments.

• Excess land and buildings.

• Underlevered business. Companies that are underlevered (i.e., do not have a sufficient amount of debt when compared to the equity in the company) may in theory borrow funds from a bank. These borrowed funds may then be paid out the shareholders in the form of a bonus or dividend.
8.5 NUMERICAL EXAMPLE OF CAPITALIZATION OF EARNINGS METHOD

The following provides a numerical example of the capitalization of earnings method, which builds on the previous example of the computation of selected earnings. This example employs the capitalization of earning general equation:

\[
\text{Selected after-tax earnings from operations} \times \left( \frac{1}{\text{capitalization rate}} \right) = \text{Going concern value of operations} + \text{Redundant assets}
\]

Fair market value of shares

Fair Market Value Calculation
Capitalization of Earnings
Example Co.

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selected Operating Earnings</td>
<td>$240,000</td>
</tr>
<tr>
<td>Tax @ 44.62%</td>
<td>(107,000)</td>
</tr>
<tr>
<td>Selected After-Tax Earnings from Operations</td>
<td>133,000</td>
</tr>
<tr>
<td>Price/Earnings Multiple</td>
<td>5x</td>
</tr>
<tr>
<td>Going Concern Value of Operations</td>
<td>665,000</td>
</tr>
<tr>
<td>Redundant Assets</td>
<td></td>
</tr>
<tr>
<td>Excess Cash</td>
<td>200,000</td>
</tr>
<tr>
<td>Land</td>
<td>400,000</td>
</tr>
<tr>
<td>Fair Market Value</td>
<td>$1,265,000</td>
</tr>
</tbody>
</table>
8.6 COMPUTATION OF NET TANGIBLE ASSET VALUE, GOODWILL, AND REASONABLENESS CHECK

8.6.1 NET TANGIBLE ASSET VALUE

Net tangible asset value represents the aggregate fair market value of all tangible and intangible assets (except for goodwill) determined on a going-concern basis, less all liabilities. The computation of net tangible asset value is similar to that of computing value under a liquidation approach with the following exceptions:

- Rather than determining the liquidation value of the company's assets either under a forced liquidation or an orderly liquidation assumption, the company's asset value is determined under a going concern basis.

- Since net tangible asset value is determined under a going concern basis, it is not necessary to recognize the full amount of estimated selling and other disposal costs that would be required to liquidate the assets and cease business operations. As these estimated selling and disposal costs would be incurred some time in the future after the valuation date, unlike as at the valuation date or shortly thereafter under a liquidation scenario, only a portion of these costs are recognized.

- Further, since a net tangible asset value computation does not contemplate the sale of the company's assets in the near term, it is not necessary to recognize the full amount of income taxes that would be incurred upon the sale of various company assets like under the liquidation approach. Once again, as these income taxes would be incurred some time in the future after the valuation date, unlike as at the valuation date or shortly thereafter under a liquidation scenario, only a portion of these taxes are recognized.

The following provides a numerical example of computing net tangible asset value.
Example of Net Tangible Asset Computation

<table>
<thead>
<tr>
<th></th>
<th>Book Value per Financial Statements</th>
<th>Liquidation Value</th>
<th>Net Tangible Asset Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>200,000</td>
<td>210,000</td>
<td>280,000</td>
</tr>
<tr>
<td>Other assets</td>
<td>15,000</td>
<td>5,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>(65,000)</td>
<td>(65,000)</td>
<td>(65,000)</td>
</tr>
<tr>
<td>Deferred income taxes</td>
<td>(50,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Legal fees for liquidation</td>
<td>N/A</td>
<td>(5,000)</td>
<td>N/A</td>
</tr>
<tr>
<td>Employee severance costs</td>
<td>N/A</td>
<td>(30,000)</td>
<td>N/A</td>
</tr>
<tr>
<td>Costs to rent warehouse</td>
<td>N/A</td>
<td>(7,000)</td>
<td>N/A</td>
</tr>
<tr>
<td>during liquidation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income taxes on sale of assets</td>
<td>N/A</td>
<td>(20,000)</td>
<td>N/A</td>
</tr>
<tr>
<td>Totals</td>
<td>$200,000</td>
<td>$188,000</td>
<td>$320,000</td>
</tr>
<tr>
<td>Value under liquidation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>approach (per above)</td>
<td>$188,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net tangible asset value (per above)</td>
<td></td>
<td></td>
<td>$320,000</td>
</tr>
</tbody>
</table>

One of the reasons for computing net tangible asset value is to determine the amount of goodwill that is present in the company’s fair market value, which is discussed below. Also, as discussed under the capitalization rate section, the higher a company’s net tangible asset value, the lower its risk, the lower its capitalization rate, the greater the multiple, and, hence, the greater the company’s fair market value.

8.6.2 GOODWILL COMPUTATION AND REASONABLENESS CHECK

Goodwill is defined as the difference between the going concern value of operations and the sum of the net tangible and identifiable intangible assets. As a reasonableness check, the number of years of earnings that goodwill represents may be computed. The equations for these computations are as follows:
Going concern value of operations

\[
\text{Minus} \\
\text{Net tangible asset value} \\
\text{Equals} \\
\text{Goodwill} \\
\text{Divided by} \\
\text{Selected after-tax earnings from operations} \\
\text{Equals} \\
\text{The number of years of earnings that goodwill represents}
\]

The following provides a numerical example of computing goodwill and the number of years of earnings that goodwill represents.

**Goodwill Calculation and Reasonable Check**

**Example Co.**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Going Concern Value</td>
<td>$665,000</td>
</tr>
<tr>
<td>Less: Net Tangible Asset Value</td>
<td>$320,000</td>
</tr>
<tr>
<td>Value of Goodwill</td>
<td>$345,000</td>
</tr>
<tr>
<td>After-Tax Selected Earnings</td>
<td>$240,000</td>
</tr>
<tr>
<td>. Goodwill expressed a number of years of selected after-tax earnings</td>
<td>1.44</td>
</tr>
</tbody>
</table>

Goodwill is fundamental to the going concern value of a company. By examining the number of years of earning that goodwill represents, one may be able to assess the reasonableness of the fair market value conclusion. If the number of years is quite high, this either means that the company is very valuable or the company has been overvalued. In any event, one must step back and look at all of the factors impacting the company. One must also assess whether a reasonable, prudent, and fully informed purchaser would be willing to pay an additional amount over the value of the “hard” assets of the business being valued to avoid having to start up a similar operation elsewhere. This assessment is often left to expert valuators who use professional judgment and experience.
8.7 RULES OF THUMB

You may have heard the following expression:

"Determining the value of that company is easy. In the industry that that company operates in, companies sell for two times last year's revenues."

The above is an example of a rule of thumb. The question is, should the results of rules of thumb be relied upon? The answer is generally no.

A rule of thumb is a secondary method of valuing a business. In other words, one should value a company under one of the liquidation or going concern approaches and compare the result to the rule of thumb result. If there is a significant difference between the two value conclusions, the valuator should reconcile the two.

Rules of thumb often have many problems that contravene the fundamental valuation principles.

- Rules of thumb are often revenue based and ignore the company's profits. As mentioned previously, value is entirely dependent upon a company's future earnings or cash flow generating ability. Revenues are not necessarily indicative of earnings or cash flow.

- Rules of thumb often ignore past trends that are expected to continue into the future. As mentioned previously, value is prospective.

- Rules of thumb ignore the special features and risks associated with a particular business. All companies have, different risks and characteristics and a simple rule of thumb does not consider this.

- A further problem with rules of thumb is that it is often unclear as to what the result relates to. For example, does two times revenues value equity, goodwill, hard assets and goodwill, etc.
9.0 MINORITY DISCOUNTS

The concept of minority discounts may be illustrated in the following example:

Assume that an investor has $300,000 to invest in one of the following:

a.) 100 per cent of Private Company, valued at $300,000; or

b.) 15 per cent of Private Company, valued en bloc at $2.0 million.

Further, assume that the investor's return on his investment is identical in both instances.

Which investment is more attractive?

Should the investor pay $300,000 (i.e., 15 per cent multiplied by the en bloc value of $2.0 million) for the second investment option?

One could argue that the first investment option is more attractive and that the investor should pay something less than $300,000 for a 15 per cent equity interest in the second investment option. These assertions are based on the concept of minority discounts.

For definitional purposes, a minority shareholding is one that does not afford the minority shareholder control of the company. A minority shareholder's per share value is less than the per share value of a controlling shareholder due to the following:

1. Lack of control. The minority shareholder cannot control various aspects of the corporation. For instance, such a shareholder cannot dictate the future direction of the corporation, the election of directors, or manipulate the timing of economic returns from the company through the form of dividends.

   Although the minority shareholder is often "at the mercy" of the controlling shareholder, although he/she may be protected through law by both appraisal and oppression remedies, which were discussed previously.

2. Lack of liquidity of investment. In private companies, there is a very limited market for the shares held by a minority shareholder. Hence, in order for a minority shareholder to sell her/his shares, she/he may have to incur some quantum of discount.

To illustrate the determination of the value of shares held by a minority shareholder, the above example will be employed. First, the minority shareholder percentage is applied to the en bloc fair market value of the company. Next, a minority discount is applied to the resulting amount.

<table>
<thead>
<tr>
<th>En bloc fair market value</th>
<th>$2.0 million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Multiplied by: Minority shareholder interest</td>
<td>15 per cent</td>
</tr>
<tr>
<td>Subtotal</td>
<td>$300,000</td>
</tr>
<tr>
<td>Less: Minority discount (say, 20 per cent)</td>
<td>(60,000)</td>
</tr>
<tr>
<td>Fair market value of minority shareholding</td>
<td>$240,000</td>
</tr>
</tbody>
</table>
The selection of a minority discount percentage is often subject to debate and requires both professional judgment and application of the facts in each particular situation. Some factors impacting the quantum of the minority discount are as follows:

- **Dividend yield.** If the minority shareholder has, prior to the valuation date, obtained a significant dividend yield, this would lower the quantum of the minority discount.

- **Capital appreciation.**

- **Size of the minority holding compared to other shareholders.** If the minority shareholder owns a certain percentage (in Alberta, over 33.3 per cent), he/she may be able to block unanimous shareholder resolutions. This lowers the quantum of the minority discount.

Further, assume that a corporation has three shareholders - Shareholders A and B each own 45 per cent of the company, while Shareholder C owns 10 per cent of the company. Either Shareholder A or B may wish to acquire Shareholder C's shares to afford them control of the company. In this case, the quantum of the minority discount would be lowered.

- **Shareholder agreements.** These agreements may provide a market (i.e., liquidity) for the minority shareholder's share. For example, there may be a buy/sell provision in which one party can offer to sell her/his shares to the other party. If the other party chooses to do so, he/she can buy the shares at this amount. On the other hand, the other party may refuse the offer and in this case the offering party has to buy the other party's shares at the offer amount per share. Such agreements lower the quantum of the minority discount.

- **Restrictions on the transfer of shares may increase the quantum of the minority discount, since liquidity is reduced.** For instance, there may be a restriction that states a shareholder cannot sell her/his shares to an outside party unless all other shareholders agree to the sale. Obviously, if all the other shareholders do not agree with the sale, the shares cannot be liquidated (i.e., sold).

- **Shareholder relationships.** The Canada Customs and Revenue Agency has denied minority discounts when the minority shareholder is related (i.e., part of the family) to the controlling shareholder. This is true unless there is evidence that the relationship between the minority and controlling shareholder is acrimonious.

- **Nuisance value.** At times a minority shareholder may present an obstacle to the controlling shareholder's efforts to run the company. In these cases, the minority shareholder's shares may be more valuable than if this nuisance was not present.

- **Existence of an organized market.**

As discussed earlier, minority discounts are relevant in determining fair market values. However, they are not relevant in determining fair value. Fair value may be required in legal matters such as oppression remedies, appraisal remedies, and "squeeze out" situations.
10.0 ANALYZING VALUATION REPORTS

There may be situations in which a non-valuation practitioner must analyze a valuation report prepared by another party. For example, a commercial litigator may be assisting his client through an oppression remedy, and has to assess a determination of fair value. A taxation lawyer may be restructuring a group of companies and may have to rely on a fair market value conclusion.

Obviously, if the value amount is significant and has significant repercussions, it is highly advisable to engage a valuation expert. In any event, a non-valuation practitioner may wish to consider the following areas when analyzing a valuation report prepared by another party. Be aware that this listing is by no means all-inclusive, as the subject of business valuation is extensive and complex.

- **Type of valuation report provided.** In general, a valuation report may provide one of the following three types of conclusions. These conclusions differ by the level of assurance they provide and the amount of analysis, investigation, and corroboration undertaken by the valuator.
  
  1. Opinion report. This type of report provides the highest level of assurance. The analysis undertaken by the valuator preparing this type of report should be extensive. Opinion reports are appropriate for important matters such as court.
  
  2. Estimate report. This type of report provides a medium level of assurance. The analysis undertaken by the valuator preparing this type of report should be at an average level. Estimate reports are appropriate for matters that are quite important but not as important as those for opinion reports. These reports may be used for pre-trial negotiations.
  
  3. Pricing calculation report. This type of report provides no assurance. The analysis undertaken by the valuator preparing this type of report is minimal, and the information relied upon has been, for the most part, provided by management.

- **Preparer of the report.** Is the person who prepared the valuation report experienced in valuing businesses and is the preparer trained in the area of business valuation? A Chartered Business Valuator is trained specifically in the area of business valuation, as discussed previously.

- **Purpose of the valuation report.** Valuation reports are usually prepared for a specific purpose. For example, they may be prepared for obtaining financing, for litigation purposes, for taxation planning purposes, or for contemplated buy/sell transactions. A valuation report prepared for one purpose may not be relevant for another purpose. This has been the subject of recent litigation actions.

- **Valuation date.** As discussed previously, one of the fundamental valuation principles is value is determined at a specific point in time. Therefore, it is necessary to evaluate the appropriateness of the valuation date used. For example, various provincial family law statutes stipulate the valuation date to be used, which may be the date of triggering events or date of application, or some other date.
• **Parties interviewed.** Often, notional valuations are conducted in an environment in which two parties involved with the company have diametrically opposed opinions of value. In these cases, the valuator valuing the company should attempt to speak to both of the parties in order to get each viewpoint. If a valuator has not or was prevented from holding discussions with one of the parties, this should be noted as a scope restriction in the valuation report.

• **Major assumptions.** Consider the reasonableness and supportability of all major assumptions relied upon in forming a valuation conclusion.

• **Reasonableness of goodwill amount.** This was discussed previously.

• **Information relied upon.** Ensure that the information used to form a valuation conclusion is appropriate and reliable.

• **Fundamental valuation principles.** When reviewing a valuation report, always ensure that the fundamental valuation principles were adhered to. These principles were discussed previously. A common example of this is hindsight, as some valuators will use hindsight to obtain a biased valuation conclusion.

• **Market information.** As discussed previously, when valuing a company a valuator should always attempt to find comparable open market transactions. Therefore, when reviewing a valuation report see whether such an attempt was undertaken.
11.0 REASONS FOR DIFFERING VALUATION CONCLUSIONS

As mentioned previously, determining value in a notional market is not so much a science as it is an art. There are no strictly defined procedures or mathematical equations. Rather, notional market valuations rely on broad principles, subjectivity, experience, and professional judgment. As a result, different individuals may reach valuation conclusions for the same entity that are significantly divergent and often a business valuation expert is required.

Please see Appendix 10 for an example of two differing business valuation conclusions for the same entity.