

## Valuation conditions, assumptions, and terms

This appendix sets out the typical conditions, assumptions, and terms of a calculation valuation report. The assumed facts of each specific case govern their application to that case.

I understand that the report to which this is appended may be used in resolving the interests of the parties cited in the report, and this confirms my consent for such use. This report should not be otherwise circulated or used for any other purpose without my consent, and I assume no responsibility for any loss incurred by anyone using or misusing this report.

### A.1 Basis of the estimate

There are three types or levels of valuation reports or opinions as to the fair market value of assets, shares, or an interest in a business, namely comprehensive, estimate, and calculation reports:

*Comprehensive* — In a *comprehensive* valuation report, the opinion as to the value is based on a comprehensive review and analysis of the business, its industry, and all other relevant factors, adequately corroborated, and it is generally set out in a detailed valuation report.

*Estimate* — In an *estimate* valuation report, the opinion as to the value is based upon a limited review, analysis, and corroboration of relevant information, and it is generally set out in a less-detailed valuation report.

*Calculation* — In a *calculation* valuation report, the opinion as to the value is based upon a limited review and analysis with little or no corroboration of relevant information, and it is generally set out in a brief valuation report,

As noted, this is a calculation valuation report, which inherently limits the scope of review and analysis. Thus the value opinion expressed herein may have differed had a comprehensive valuation been conducted.

*Fair market value* denotes the highest price available in an open and unrestricted market between informed, prudent parties acting at arms' length and under no compulsion to act, expressed in Canadian dollars. It is the greater of

- (i) the fair market value of the assets as if carefully liquidated, selling costs and taxes paid, and the proceeds applied against the liabilities, and
- (ii) the capitalized earning capacity of the firm as a going concern, where the discount rate reflects the time value of money, financial-market conditions, and the risks and opportunities of the firm and its markets.

If the second method shows a greater value, the increment is *goodwill*.

The personal and economic forces influencing an actual market differ from those in the notional market. Readers should be advised that the value arrived at may not apply to these interests or assets at other times or under other conditions, nor to interests or assets of apparently similar firms, and that an actual sale would likely occur at a somewhat different price than estimated here, depending upon the circumstances of the sale, of the interest sold, and of the buyer and seller.

The valuation is also subject to the following assumptions and conditions:

- (i) Information, estimates, and opinions used in this report are obtained from sources considered to be reliable, though I assume no liability for such sources. The financial statements of the company, in particular, present its financial statements fairly, and neither the company nor its principals has any assets or contingent or other liabilities except as are presented in its financial statements.
- (ii) Possession of this report or a copy of it carries no right to release or publish it in whole or in part, nor may anyone but the client use it for any purpose without the my prior written consent and that of the client, and, in any event, it may be used, released, or published only with proper attribution.
- (iii) The various assumptions and estimates presented in this report apply only to this valuation in this context and may not be used out of the context presented herein. This valuation is valid only for the purpose and in the circumstances specified herein.
- (iv) This valuation reflects facts and conditions believed to have obtained at the valuation date. Events subsequent to the date of this report cannot have been considered, and I have no obligation to update this report for such events or conditions.
- (v) This valuation is prepared as though the company is or could remain a *going concern*, so that either the value of its assets can be realized in orderly liquidation or its operations will tend to continue as they have in recent years, except as otherwise noted, and the value of its assets will tend to be realized in the course of such operations. If this assumption does not hold, then these estimates would need to be revised.
- (vi) This valuation is based upon and reflects the cited documents and other information. Further or different information might lead or have led to a different result.

This report was prepared by Howard Teasley, MA(Econ), CGA. He has no interest in or relationship with the company or any of its owners, and he contemplates none in future.

## A.2 Valuation approaches, terms, and parameters

The previous section noted the two general approaches to estimating fair market value, namely that it is the greater of (i) the fair market value of the assets if carefully liquidated and applied against the liabilities [“the *asset-liquidation value*”] and (ii) the capitalized earning capacity of the firm as a going concern with continuing operations [“the *going-concern value*”], where the discount or capitalization rate reflects the time value of money, financial-market conditions, and the risks and opportunities of the firm and its markets. If the second method shows a greater value, the increment is *goodwill*. When income that might give rise to goodwill appears as above-average earnings of the principals, that increment might be identified, capitalized, and added to net asset value.

For a firm with a record of operations and diverse activities and customers that will likely persist, its own financial results afford the best indication of continuing operations. Thus the financial statements of typical prior years indicate the likely future revenues, earnings, working capital, and other parameters critical to the estimation of its value. The figures for any years that are not typical — in the sense that they are influenced by factors that will not persist or recur — are not likely to be representative of future years.

The figures for all representative years should be considered, with appropriate weighting. A simple average gives equal weight to all prior years, while a typical weighted average (1 for the earliest year, 2 for the second-earliest, etc.) emphasizes more recent conditions. Considering only the latest year or later years would weight the perhaps-transient conditions of those years too heavily and exclude the information in representative earlier years' records. A range may be appropriate.

This analysis will employ some or all of the following terms and parameters in pursuing those approaches:<sup>i</sup>

*Barriers to entry* — Obstacles that make the emergence of a competitor difficult or unlikely. Examples include a high minimum investment in plant or equipment, specialized knowledge, an isolated and limited market area, or restricted government licences. Such barriers are consistent with and can give rise to *goodwill*.

*Capitalization rate* — The required rate of return (usually expressed as an annual percentage) that is used to translate annual income or cash flow into present value; usually the discount rate. It represents the risk-free rate of return, typically the Canada long-bond rate, plus premiums for the risks of the industry, firm, market, or any other factors. The reciprocal is the *Multiplier*.

*Discretionary cash flow* — Net after-tax earnings, plus any nonbusiness expenses, plus the actual compensation for management or other services not provided at arm's length, plus such noncash charges as depreciation and amortization, less the economic cost of management or other services not provided at arm's length, and less *Sustaining capital reinvestment*.

*Economic profit* — Economic profit, sometimes called economic rents or excess profits, equals the firm's income less the economic costs of capital and management. It might be indicated by the ability of the firm to command better margins on sales, or better returns on capital employed or on equity, than the top quartile of comparable firms as to industry and sales bracket; the comparable figures might come from Statistics Canada's *Financial Performance Indicators*. Economic profit might be indicated by the ability of owners or managers to command materially higher incomes than the average, comparably qualified person in that occupation — the cost of management — in the context of sustained profitable operation, as indicated by an industry salary survey or special tabulation by Statistics Canada of the Census in British Columbia.

*En-bloc value* — The value of the assets or ownership interests of a business, viewed as a whole before allocation to individual shareholdings.

*Going concern* — A business that both is conducting operations at a certain date and has every reasonable expectation of continuing to do so for the foreseeable future after that date.

*Goodwill* — Goodwill, as noted, equals the excess, if any, of the value of an operating firm over the value that its assets could realize by orderly sale, less its liabilities. It represents the capitalized ability of the firm to earn an *economic profit*. It can arise from such factors as reputation, location (the tendency of customers to return to the prominent or convenient place), the product or service or process, some critical input, or some other *barrier to entry*. To affect the value of the firm, it must be *saleable* (a buyer can realize it) rather than *personal* (the connections, knowledge, skill, or reputation departs with the vendor). It can arise, as noted, from the firm's sustained ability to pay supernormal management compensation.

*Latent taxes* — When the market value of an asset exceeds its carrying value, the increment is potentially taxable, and the taxable gain equals half the increment. When the sale of the asset, distribution of net assets by way dividends, or redemption of shares as a deemed dividend is not foreseen, however, the taxes arising upon sale, distribution, or redemption are *latent*. They are conventionally estimated at current tax rates, discounted by half. That discount represents, eg, a delay of seven years discounted at some 10% per year, or 10 years at 7%, or five years at 15%.

*Minority discount* — The reduction from the pro-rate portion of the *en-bloc* value of the assets or ownership interests of a business as a whole to reflect the disadvantages of owning a noncontrolling interest. A minority interest may suffer a discount for reasons of:

*Internal* — the absence of the power of control and the resultant inability to effect such matters as the election of directors, the payment of dividends, the future financing or direction of the corporation, and generally the performance of the investment, as well as to control the sale of the shareholding where there are legal or contractual restrictions with respect to such a sale or the sale of all the shares of the corporation; and/or

*External* — the inherent lack of liquidity or marketability of the investment.

In remedies for oppression of a minority owner by the majority, however, no such discount applies, as the shares were not offered in the open market and a notional purchaser would not have become a minority shareholder.<sup>ii</sup>

*Multiplier* — The reciprocal of the *Capitalization rate*. It can sometimes be considered as approximating the number of years that the favourable conditions will persist.

*Redundant assets* — Assets of a business that are beyond what the business needs or would prudently hold for continuing operation. Because they are redundant, they can be severed from the business and liquidated, so that their value (net of any taxes or other costs of disposal) is added to the value of the operating business. Comparison with typical ratios for the industry can indicate redundant or deficient assets — not only redundant or deficient current assets or fixed investment but also a debt-equity structure with less or more debt than is typical. For a company that owns real property from which it operates, unless its business is the renting or leasing of such property, such property is typically redundant in that it could be sold and leased back and any related debts settled.

*Special-interest purchasers* — Purchasers who could, or believe they could, realize economies of scale or strategic advantages by combining the acquired business interest with their own. The presence or possibility of two or more such special purchasers would tend to increase the value.

*Sustaining capital reinvestment* — The capital outlay required each year to maintain operations at existing levels, net of the present value of the *Tax shield* from tax-deductible depreciation of such outlays.

*Tangible-asset backing* — An amount equal to the aggregate value of all tangible and identifiable intangible assets (other than goodwill), where the latter have values that can be separately determined and where the values of all tangible and identifiable intangible assets have been determined under a going-concern assumption (noncurrent assets will be realized in use), minus all liabilities. This is one element of the going-concern approach, and it differs from the asset-liquidation approach, in which

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all assets would presumably be disposed of rather than realized in use, perhaps incurring taxes on disposition. Higher tangible-asset backing tends to lower the risks and thus the required discount rate.

*Tax shield* — The present value of the expected tax savings that will accrue in future as the result of the owner of depreciable or capital assets claiming depreciation expense or capital-cost allowance against otherwise-taxable income.

*Working capital* — The amount by which current assets exceed current liabilities. A material excess above the normal level constitutes a *redundant asset*, added to the value of the operating business, while a material shortfall below the normal level (which must be made good for the business to operate) constitutes a negative redundancy that is deducted from the value of the operating business.

### A.3 Notes to this appendix

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- <sup>i</sup> **Definitions** — Most of the definitions in §I(c) are taken or paraphrased from I. R. Campbell, R. B. Low, and N. V. Murrant, *The Valuation and Pricing of Privately-Held Business Interests*, pp xxv ~ xlvi [Toronto: Canadian Institute of Chartered Accountants, 1990]. The exceptions are *Barriers to entry*, indicators of *Economic profits* and *Redundant assets*, the nonbusiness expenses and the non-arm's-length services in *Discretionary cash flow*, and *Latent taxes*.
- <sup>ii</sup> **Minority discount** — This follows the Supreme Court of British Columbia in *Diligenti v RWMD Operations Prince George Ltd, McConachie, Radcliffe, and Welters*. (1977) 4 BCLR 134.