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FSAT NEWS

FINANCIAL SERVICES ADVISORY TEAM SPRING/SUMMER 2023

Welcome to our 29th issue of FSAT News, a newsletter published by DJB's Financial Services Advisory Team (FSAT) to better inform and help you manage your business's potential.

If you wish to receive further information regarding the services discussed in this issue, please contact a member of our team:

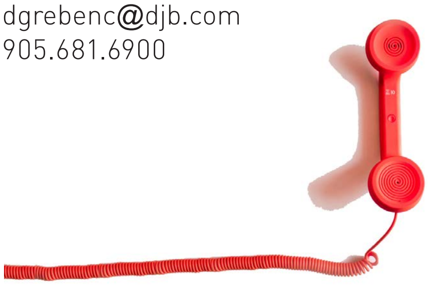
Brent Pyper, CPA, CA, CFF, CFP®
bpyper@djb.com
905.928.1912

Robert Plenderleith, CPA, CA, CBV, CFF
rplenderleith@djb.com
905.525.9520

Colin Cook, CPA, CA, CBV, CFF
ccook@djb.com
905.941.5684

Praveen Perera, CPA, CA, CBV
pperera@djb.com
905.525.9520

David Grebenc, CPA, CA
dgrebenc@djb.com
905.681.6900



Valuing Lost Employment Income – Don't Forget to Include Employer-Sponsored Benefits!

The value of employer-sponsored benefits (health, dental, disability, pension, etc) often form a significant part of a person's 'income' from employment, especially when a pension plan is available. Therefore, the loss of these benefits will often form a significant part of the economic loss quantification for an injured party, especially if the person is unable to return to any gainful employment, and thus no longer has these benefits available to them.

For the purpose of this article, we are concerned mainly with the difficulties in valuing employer-sponsored benefits that are not 'paid' to the employee, such as health, dental, life, and disability. Benefits such as statutory holiday pay and vacation pay are generally paid to the employee and are included in their salary or wage. Bonuses can also often form a significant part of a person's earnings. However, these amounts are also generally

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'paid' to the employee and, thus, are included in their earnings. Lost pension benefits (whether a defined contribution plan, or a defined benefit plan) often form the largest portion of the value of lost employer-sponsored benefits. Although they are not paid to the employee, there is generally sufficient information and documentation available to us, to enable us to value the lost pension benefit amount.

However, employer-sponsored benefits, such as health, dental, life, and disability premiums, are not paid to the employee, and often the employer's cost of providing these benefits is not available to us.

In determining a person's income from employment, either for purposes of calculating a loss due to injury, or for IRB (Income Replacement Benefit) purposes, the value, or the employer's cost, of providing these benefits, should be added to a person's salary or wages that they earned. Unfortunately, as noted above, the actual cost to the employer of providing these benefits (i.e. health, dental, disability, life) is generally not available to us. As such, calculating the loss of these benefits can present some significant challenges. We often need to rely on statistical data in our calculations.

The following are four important questions to consider when valuing the employer's cost of lost benefits:

1. **What benefit coverage was available to the employee?**

   Most full-time employees and some part-time employees are entitled to some employer-sponsored benefit coverage. A copy of the benefit booklet detailing all of the benefits available to the person should be obtained. The booklet may indicate that some benefit coverage may be mandatory and some may be optional. If so, it is important to obtain details of the coverage that the employee elected. This information should be included in the employment file.

2. **What benefits, if any, have been lost?**

   Information should be obtained from the employee, the employer, or the insurance company detailing what, if any, benefits have been terminated as a result of the employee's inability to continue working. Confirmation of the termination date of the benefits is also important. If the insured is receiving disability benefits, they often continue to be covered under the employer's benefit plan and thus no loss of benefits may have been suffered. However, if there is a concern that the disability coverage will be terminated at some point in the future, there may be a future loss of benefits. The short-term disability (STD) and long-term disability (LTD) files should be requested from the insurer as they often contain information regarding the status of the employer-sponsored benefits.

3. **Who was paying for the lost benefits?**

   It is important to determine if the employer, the employee, or some combination of both paid for the cost of the benefits. Only the portion of the benefits that were paid for by the employer should be included in the loss calculation. The benefit booklet should detail who is responsible for paying for the benefits. In addition, a review of the employee's pay stubs, if available, should show if the cost of any benefits are being deducted from their gross pay.

4. **What is the employer's cost of the benefits?**

   Generally, it is often difficult to obtain the employer's cost of providing the benefits to the employee. Occasionally the benefit booklet, or paystubs may include costs. However, confirmation from the employer will usually be required. If this information cannot be obtained, then an alternative would be to use statistical information, such as the KPMG 1998 Survey of Employee Benefit Costs in Canada, which breaks down the cost of various employer-sponsored benefits by employment sector as a percentage of gross annual payroll. In many situations, such as when the injured party was a young child or student, they would not have any work history. Therefore, using statistical data would be appropriate to estimate future lost employer-sponsored benefits in those situations.

Ultimately, calculating the value of lost employer-sponsored benefits for economic loss or IRB purposes is a complicated issue with each case presenting its own set of unique challenges. Our Financial Services Advisory Team (FSAT) has significant experience preparing these calculations. If you have any questions or require assistance with a calculation, please contact a member of our team.

Article written by:

Brent Pyper, CPA, CA, CFF, CFP®
Partner, Financial Services
bpyper@djb.com
905.681.6900

Forms of Payment and Non-Cash Consideration in Business Sale Transactions

Buyers and sellers often concern themselves greatly with the "price" in a sale of a business. However, an equally important factor that has a large impact on the actual "value" exchanged between the two parties in a sale is the form or type of "consideration" exchanged for the business, and the timing of when the consideration is settled or paid out in cash. In this article, we will discuss various forms of "consideration" that are often seen in a business sale transaction, and how they impact the value exchanged.

When a notional business valuation is prepared it is usually under the concept of a "fair market value", which is usually defined as the highest price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, each acting at arm's-length in an open and unrestricted market, when neither is under compulsion to buy or to sell and when both have reasonable knowledge of relevant facts. However, in open market transactions many of the factors are not always so simple and the purchase price may be paid in a number non-cash forms. As a result, the economic value of the purchase price may be different from the face value of those items and should therefore be assessed on an equivalent cash basis.

Cash

The simplest type of consideration seen in business transactions is cash, paid immediately at the time of closing. When a business is sold and the seller receives the entire purchase price upfront in the form of cash from the buyer, the value to the buyer and seller is equal to the amount of cash exchanged. All-cash transactions offer the lowest risk to the seller, as the cash is received immediately and the purchase price is certain. However, all-cash transactions are generally risker for the buyer. If the business does not perform as expected after the sale, the buyer may not realize the full value of the purchase price paid. Additionally, it is often difficult for a buyer and seller to come to an agreement on the price that should be paid for a business.

As a result, business sales are often structured to include multiple types of consideration. Often, a partial up-front cash payment is made, and the remainder of the purchase price is paid in other ways, such as:

- Holdbacks
- Promissory notes or vendor take-backs
- Earn-outs
- Share exchanges, either publicly traded or privately held companies

Holdbacks

Holdbacks are common in transactions for privately held businesses and normally protect the buyer against deficiencies in working capital, debts that were not paid off prior to closing, and undisclosed or unknown liabilities and contingencies such as legal or environmental.

Holdbacks are an effective way to manage risk in a transaction and usually represent only a small portion of the purchase price. Holdbacks tend to be released over an agreed upon time period ranging from six months to two years.

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Promissory Notes or Vendor Take-Backs

Promissory notes or vendor take-backs (VTB) are forms of debt issued by the seller to the buyer. The promissory note or VTB may or may not bear interest, and the interest may be fixed or variable, and may be higher or lower than comparable commercial rates. VTBs arise when a portion of the negotiated purchase price is withheld by the buyer and is paid to the seller over a period of time, or entirely at a later date.

Buyers often favour VTBs as they lower the up-front investment (i.e., cash) required, while still satisfying the purchase price negotiated between the parties. VTBs are also favourable to buyers, as they tend to motivate sellers to ensure a smooth transition after the sale, as the seller retains a portion of the risk related to the business. Further, when using bank debt to finance the purchase of a business, the lender will typically require at least a portion of the purchase price paid through a VTB in order to ensure the interests of the buyer and seller are aligned. VTBs can also be beneficial to sellers in a number of ways. By agreeing to accept a VTB, sellers are able to lower the up-front capital needed by potential buyers, creating a more competitive sale process and attracting multiple potential buyers. Additionally, in a VTB, the negotiated interest rate may lead to higher returns for the seller than if the entire amount was received in cash up-front.

The economic value of a VTB may be different from the dollar amount, or face amount, that is financed. In order to determine the fair market value (i.e., cash equivalent) of a VTB, the payments of future principal and interest should be discounted using a market interest rate. The sum of the present value of these payments is equal to the total fair market value of the VTB loan.

Earn-outs

An earn-out is when a portion of the purchase price is paid over time based on the prospective revenues, earnings, or some other measure related to the post-acquisition results of the acquired business. Earn-outs are commonly used in a business sale to bridge a pricing gap between the buyer and seller, where the parties may disagree on the future prospects of the business. An earn-out effectively shifts the risk from the buyer to the seller because if prospective results are not realized, the purchase price is reduced. Similar to a VTB, in order to determine the fair market value (i.e., cash equivalent) of an earn-out arrangement, the expected earnout payments should be discounted using a discount rate that considers the risk that payment will not be satisfied, as well as the general risk of the business.

Share Exchanges

When a business is sold to another corporation, the corporation may offer its own shares as currency to finance a transaction leaving the seller with an interest in the combined company after the transaction has taken place. Where the seller is a privately held company, and the buyer is a public company, the seller is typically able to assess the value received if the shares received in exchange are freely tradable. However, the valuation exercise becomes more complex where the seller is restricted from selling the shares for a period of time and/or the public company buyer has a relatively small market capitalization, thereby causing the block of shares held by the seller following the transaction to be somewhat illiquid. In these cases, the value of the publicly traded shares that carry restrictions on trading or are illiquid is generally lower than their face value.

Determining the fair market value (i.e., cash-equivalent) of shares received in a share exchange is particularly complicated where the buyer is also a private corporation (i.e., not publicly traded). In effect, it becomes a relative valuation exercise between the buyer and seller. These situations are further complicated when a controlling interest in a privately held company is sold in exchange for a minority interest position in a privately held, and generally larger company. In these situations, a shareholders agreement becomes extremely important as they typically provide a means for the seller, who ultimately holds minority interest of the combined company, to sell their shares to the remaining shareholders for their pro-rata value (i.e., without a minority or liquidity discount). In the absence of a shareholders agreement where shares of two private companies are exchanged, the minority position that the seller receives may be worth less than pro-rata value of their shares in the combined company.

Conclusion

Buyers and sellers typically employ a wide range of transaction structures involving different types of consideration such as contingent and non-cash. When assessing a potential transaction as either a buyer or seller, it is important to consider the types of consideration being offered and the associated risks with each consideration to properly evaluate the merits of the transaction and the economic value being exchanged. Additionally, the tax consequences of a transaction varies depending on the transaction structure, and should be discussed with a designated tax professional.

To receive more information on the topics discussed in this article or assistance in determining the most appropriate structure for your business purchase or sale, please contact our valuation and tax specialists.

Article written by:

Jonathan Corobow
Associate, Financial Services
jcorobow@djb.com
905.525.9520

How Should Redundant Assets be Treated in a Business Valuation?

Three types of assets found in operating companies and their impact on business value

Assets owned by an operating company can be divided into three broad categories in a business valuation:

1. **Tangible assets** (i.e., assets that have a physical substance) required for day-to-day operations of the business;
2. **Goodwill and intangible assets** such as patents, tradenames/ brands, or customer lists which do not appear on the balance sheet unless they has been acquired in a transaction; and
3. **Redundant assets** which are typically physical assets not required by a business for ongoing operations.

In a business valuation, tangible assets, goodwill, and intangible assets usually form part of the going concern value, which is the value of a business enterprise that is expected to continue to operate into the future.

However, redundant assets do not form part of the going concern value as they are not required for operations. A potential buyer considering purchasing a business would only be interested in purchasing the assets that are used by the business to generate operating income. Therefore, redundant assets are not included in the value of the business' operations. Instead, the value of redundant assets are added in addition to the value of the business operations to determine the fair market value of the en bloc share value or equity value of the business.

Examples of typical redundant assets:

- Excess working capital
- Marketable securities
- Due from shareholder/related companies
- Personal assets (i.e., artwork, vehicles, etc.)
- Real estate
- Life insurance policies

Redundant liabilities

Redundant assets increase the en bloc share value of the corporation. Conversely, redundant liabilities are items that reduce the en bloc share value of the corporate and can include non-operating loans such as loan to purchase a personal vehicle or due to shareholders/related parties.

Identifying redundant assets or liabilities

In some situations items that are typically redundant assets may actually be required for operations of the business depending on the nature of the business and its operations. For example, a life insurance policy which is needed as part of a loan covenant/ external lending requirement. As a result, the particular life insurance policy may not be considered redundant.

Real estate as a redundant asset

Generally, when a company does not directly rely on its real estate (i.e., land and building) to generate its revenue, real estate is often considered redundant. However, consideration must be given to the business' industry and availability of rental space for operations, among other factors.

In a notional business valuation situation, businesses with real estate typically engage the services of a professional real estate appraiser to determine the fair market value of the property. In addition, when assessing the value of a business using the income approach, an adjustment to normalized cash flow should be made for the amount that would need to be paid if the operating space was rented at market rates from a third party.

Excess working capital

Working capital, (i.e., accounts receivable, pre-paid expenses, inventory, less accounts payable) is the amount required to keep operations running and meet short-term daily obligations. If a business does not have sufficient working capital, it may require additional funding/investment to operate. Therefore determining the required level of normal working capital is essential and involves a

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review of the business, industry ratios, and banking covenants.

Once a required level of working capital is identified, any excess working capital is deemed redundant and removed from the business. During a sale of a business if there is a deficiency in working capital, a reduction to the transaction price will be made to retain cash in the business. Working capital considerations are discussed in greater depth in our Fall 2022 FSAT Newsletter.

Tax consequences

In a disposal of redundant assets (often during an asset purchase of a business), disposal cost and tax consequences need to be considered such as taxable capital gains/losses, recapture/terminal loss, and income taxes. When a notional business valuation is prepared, the tax consequences are also considered, but may require some discount to account for the fact that the redundant assets will likely be sold at some point in the future, and not at the valuation date.

Conclusion

Proper identification of redundant assets/liabilities and determining an appropriate level of working capital are some important factors in determining an accurate value of a business.

If you would like more information on the topic or assistance in determining the value of your business, please contact our valuation specialists.

Article written by:

Rachel Mak
Associate, Financial Services
rmak@djb.com
905.681.6900

Spotlight - Rachel Mak

Rachel Mak
Associate, Financial Services

Rachel began working at DJB's Burlington office with the Financial Services Advisory Team in September 2020. She has prior experience in the areas of economic loss quantification and business valuations. Since joining DJB, Rachel has continued to provide the following services:

- Business valuations for tax/corporate reorganizations and financial reporting
- Adjusted income reports for matrimonial/family law
- Business interruption insurance
- Economic loss calculations, including motor vehicle accidents, slip and fall claims, income replacement benefits (IRB) and future care cost analysis

Rachel graduated from McMaster University with an Honours Bachelor of Commerce degree. She is a registered student of the CBV Institute/Canadian Institute of Chartered Business Valuators and is working on completing the requirements for the Chartered Business Valuator (CBV) designation.

In her spare time, Rachel enjoys taking landscape photography and travelling.

Financial Services Advisory Team

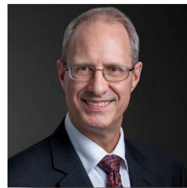
Connect With Us

DJB Burlington
5045 South Service Road
Burlington, ON
L7L 5Y7
Tel: 905.681.6900
Email: burl@djb.com

DJB Hamilton
570 Highland Road West
Hamilton, ON
L8W 0C4
Tel: 905.525.9520
Email: hamilton@djb.com

DJB St. Catharines
20 Corporate Park Drive
St. Catharines, ON
L2S 3W2
Tel: 905.684.9221
Email: stcath@djb.com

DJB Welland
171 Division Street
Welland, ON
L3B 5N9
Tel: 905.735.2140
Email: welland@djb.com



Brent Pyper, CPA, CA, CFF, CFP®
Partner
bpyper@djb.com

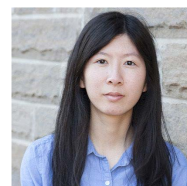
Robert Plenderleith, CPA, CA, CBV, CFF
Partner
rplenderleith@djb.com

Colin Cook, CPA, CA, CBV, CFF
Senior Manager
ccook@djb.com

Praveen Perera, CPA, CA, CBV
Senior Manager
pperera@djb.com

Dave Grebenc, CPA,CA
Manager
dgrebenc@djb.com

Jonathan Corobow
Associate, Financial Services
jcorobow@djb.com



Rachel Mak
Associate, Financial Services
rmak@djb.com

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