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FSAT NEWS

FINANCIAL SERVICES ADVISORY TEAM SPRING/SUMMER 2024

Welcome to our 31st 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:

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Normalizing Earnings or Cash Flow

Businesses with active operations are commonly valued based on their ability to generate earnings or cash flow. For mature businesses that demonstrate consistent earnings or cash flow, a Chartered Business Valuator (CBV) or other valuation practitioner may employ a capitalized earnings or cash flow methodology to assess the value of the business operations if future results are expected to be stable. Under this type of methodology, historical business results are analyzed to estimate a sustainable level of earnings or cash flow. A capitalization rate or multiple is then applied to determine the hypothetical amount an investor would pay for the business operations.

In order to determine the sustainable level of earnings or cash flow a business can generate, historical results are reviewed. Adjustments are made to the reported results to arrive at "normalized" earnings or cash flow, which are then considered when selecting the sustainable level or range. Below are some examples of common normalizing adjustments made to determine a business's normalized earnings or cash flow:

Related Party Transactions

Businesses often have transactions with related individuals (such as shareholders or their family members) and companies controlled by these individuals. These transactions may involve discretionary payments or do not always reflect the economic value transferred. When normalizing earnings or cash flow, these transactions are typically adjusted to market rates that would be paid or received from an arm's-length (unrelated) party. Examples include compensation paid to owners or their family members working in the business, rent for real estate or equipment owned by a related individual or corporation, sales or purchases with related entities, and consulting or management fees. These can be in the normal course of business, but they may sometimes be for other purposes such as tax planning.

Redundant Asset Adjustments

Businesses may own redundant assets — assets not used in active operations. Under an income approach, the value of redundant assets is considered separately from the value of business operations to avoid double counting. Income or expenses related to these redundant assets are removed from normalized earnings. Examples include dividend or interest income from marketable securities and loans, investment management fees, and life insurance premiums. If a business owns real estate not essential for operations, treating it as a redundant asset involves adjusting earnings by adding back ownership costs and deducting a "market" rental rate.

Non-Recurring and Non-Operating Adjustments

Non-recurring items are amounts that are not expected to occur in the future on a predictable basis. Examples of non-recurring items include lawsuit settlements, moving costs, discontinued operations, and revenue from one-time projects. These non-recurring revenues and expenses are removed from normalized earnings/ cash flow. Non-operating expenses are also removed and include personal expenses paid by a business on behalf of a shareholder.

Selecting a Maintainable Level:

There is no precise method or formula to determine the maintainable earnings of a business. Normalized historical results are one factor among others considered when estimating the maintainable future earnings for valuing business operations. Other factors include short-term budgets/forecasts, industry and economic data, management input on the future business outlook, and the professional judgment of the valuation practitioner.

If you have any questions regarding your business's earnings or cash flow, please contact a member of our Financial Services Advisory Team (FSAT) team.

Article written by: Jonathan Corobow, CBV

FSAT Services

- Assistance with Business, Acquisitions & Divestitures, including Due Diligence & Quality of Earnings Reports
- Business Interruption Insurance
- Business Valuation
- Collaboratively Trained Professionals
- Child & Spousal Support Income Calculations
- Economic Loss Calculations regarding Motor Vehicle Accidents, Slip and Fall, Medical Malpractice and Dependency Claims
- Experienced Expert Testimony
- Forensic Accounting
- Income Replacement Benefit (IRB) & Other Accident Benefit (AB) Calculations
- Long-Term Disability Calculations
- Matrimonial Disputes
- Shareholder Agreements & Dispute Resolution
- Value of Future Care Cost Analysis
- Wrongful Dismissal Claims

Unlocking the Value: Understanding Intangible Assets in Business Valuation

Introduction:

When an acquiror obtains control of a business, both the International Financial Reporting Standards (IFRS) 3 Business Combination and Accounting Standards for Private Enterprises (ASPE) Section 1582 require a fair value measurement for assets acquired and liabilities assumed. Unraveling the layers of intangible assets becomes pivotal, and the purchaser's motivation sheds light on identifying and determining the significance of the intangible assets acquired.

This is the first of a series of articles on intangible assets and the various valuation methodologies and considerations.

The focus of this article is an overview and discussion of the five categories of identified intangible assets and the difference between fair value and fair market value, exploring the characteristics and considerations that play a key role in a valuation.

Five Categories of Identifiable Intangible Assets:

There are five distinctive categories of identifiable intangible assets, encompassing a range of elements vital to business operations. These include, but are not limited to the following:

1. **Marketing-related:** Trademarks, trade names, and non-compete agreements.
2. **Customer-related:** Customer lists, customer relationships, and customer contracts.
3. **Contract-based:** Licensing, supply agreements, royalty agreements, and lease agreements.
4. **Technology-based:** Computer software, databases, and trade secrets/formulations.
5. **Artistic-related:** Books, scripts, music, and movies.

Fair Value vs. Fair Market Value

IFRS 3 requires intangible assets to be valued using IFRS 13's definition of fair value: "as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

ASPE 1582 requires intangibles assets valued in a business combination to use the following definition of fair value: "the amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act."

In Canada, the definition of fair market value in business valuations is generally 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, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell when both have reasonable knowledge of the relevant facts."

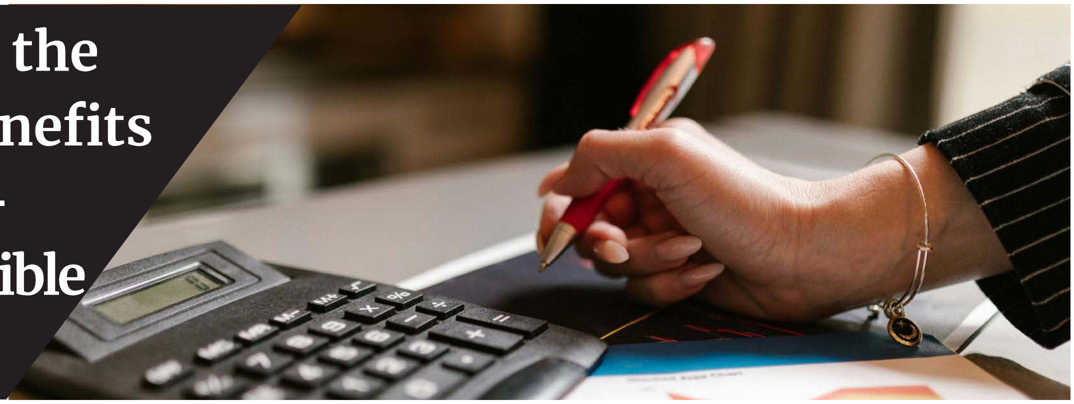
While the definitions are similar, they are not identical and may lead to a difference in assumptions and have an overall impact to the valuation conclusion.

Conclusion:

Navigating the intricacies of business combinations and the valuation of intangible assets requires expertise and precision. For inquiries or assistance in this domain, our Financial Services Advisory Team (FSAT) is ready to guide you through the valuation process and provide assistance. Your understanding of these intangible assets is the key to unlocking the true value embedded in your business.

Article written by: Robert Plenderleith, CPA, CA, CBV, CFF & Rachel Mak, Registered Student of CBV Institute

Determining the Economic Benefits of Customer-related Intangible Assets



This is the second article in a series on intangible assets and the various valuation methodologies and considerations. Please see page 3 to read the first article.

Customer-related intangible assets present insight on customers and their buying patterns. This can be analyzed to execute the development of new products or services, align a company's strategic initiatives, or expand to new markets and geographic locations. Examples of customer-related intangible assets include customer lists, customer relationships, and customer contracts.

Organic growth vs. Inorganic growth

A business can grow through two categories: organic growth and inorganic growth. Organic growth is natural growth from existing operations, such as selling more products, reducing costs, or improving efficiency.

In contrast, inorganic growth is rapid growth of a business through acquisition or expansion resulting in an immediate increase in market share. Through a business acquisition, a competitor's customer-related intangible assets can also be obtained to gain a competitive advantage. Accordingly, customer-related intangible assets are a commonly identified intangible asset in a business acquisition.

In this article, we address some of the nuances in valuing a customer-related intangible because of a business acquisition.

Customer lists vs. customer relationships

A customer list contains customer information, such as personal, behavioural, or demographic data and can even potentially be re-sold. A purchaser can use this information to determine a target demographic when marketing new products and services or expanding existing product offerings.

A customer relationship is based on a history of sales transactions. The value of a customer relationship depends on how often purchases are made, the friction or costs to find and replace customers, and how dependent those customers are on the business. The benefits of a strong customer relationship include customer retention, loyalty, referrals, and satisfaction. A contract does not need to exist for a customer relationship to have value, as long as there is an expectation of the relationship to continue.

Customer contracts

Customer contracts not only provide an estimate of future profits, they can also provide economic reassurance to the purchaser during a business acquisition. A contract can exist in various forms such as verbal, written, express, or implied. An intangible asset can exist as long as the contract is legally enforceable. The specific contract terms are reviewed when determining the value of a customer contract.

In addition, customer's purchasing patterns, length of the relationship, and potential of renewal also need to be reviewed to meet specific financial reporting and accounting standard requirements when valuing intangible assets in relation to the definition of fair value.

Customer attrition rate

Customer attrition is the expected future loss of customers or decline in future customer purchases and is based on historical revenue or customer count to provide an indication of future expectations. The selection of the customer attrition rate is based on historical data, future forecasts, and the following factors:

Customer segmentation: Separating customers based on their as personal, behavioural, or demographic data will improve accuracy of the customer attrition rate.

Loss occurring at a variable or constant rate: The rate of customer loss can occur early in the relationship, later in the relationship, or be constant regardless of the age of the relationship. The telecommunication industry has a high rate of customer loss early in the relationship because of competition and relative ease for customers to switch providers.

When a customer is considered "lost" can vary depending on the product or service offered. For a music or video streaming service, a customer may be considered lost after cancellation as the relationship can end very easily. However, for a home appliance or home furnishings store, a customer may not be considered lost until five years have passed with no sales due to the periodic and large nature of purchases from those stores.

Conclusion

If you have any questions or require assistance regarding business combinations and valuing customer-related intangible assets, please contact a member of our Financial Services Advisory Team (FSAT) team.

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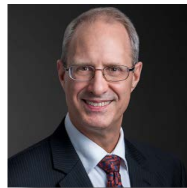

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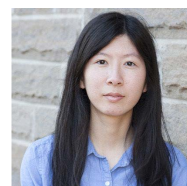

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