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FSAT NEWS

FINANCIAL SERVICES ADVISORY TEAM FALL/WINTER 2024

Welcome to our 32nd 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.

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Valuing Economic Loss for Realtors in the Current Realty Market

In calculating the economic loss for an employed, or self-employed individual, we typically compare the person's pre-accident potential earnings (being what they would likely have earned had the accident not occurred) to their expected post-accident actual earnings (being what they will likely now be able to earn, if anything, given the injuries they suffered in the accident).

Under relatively normal and stable economic conditions, the potential earnings are often estimated based on what the person was earning at the time of the accident, or perhaps based on an inflation-adjusted average of their pre-accident earnings. However, given the large fluctuations in real estate markets over the last few years, determining the potential and expected actual earnings for real estate agents/brokers, has become more complex and difficult to determine.

Earnings of real estate agents are typically based on commissions on the sale price of the residential and commercial units sold. Over the past few years, the sales prices of real estate have increased dramatically. The resulting commissions on those property sales have also increased dramatically. Therefore, real estate agents are typically earning much more per home/unit sold now, than they did before these increases.

A real estate agent injured in an accident likely can't work to the same extent as they could before their accident. Therefore, they have likely suffered a loss due to the accident because they are selling fewer homes than they were before the accident. However, because their commission income per home/unit sale is now much higher, their income may not have actually decreased, even though they are selling fewer homes. That is, had they not been injured in the accident, they likely would have sold more homes/units than they did in their injured state, and thus, they have suffered a loss, even though they may have earned as much, or

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more, income than they did prior to their accident.

To add to the complexity, real estate agents have also experienced somewhat inconsistent sales volumes with the interest rate increases that began in March 2022, and remained at higher levels until the recent decreases in the middle of 2024. Other external factors may also apply, with the number of homes sold throughout the Golden Horseshoe area fluctuating significantly over the last few years. For example, the annual number of residential sales in the Hamilton area increased by about 8% in 2020, and almost 14% in 2021, before decreasing sharply by about 33% in 2022, and a further 15% in 2023. Based on this, it would likely not be reasonable to assume that any specific real estate agent's sales would have remained constant throughout this period. Rather, it is likely that their number of sales would have fluctuated somewhat consistent with the market. We need to consider these fluctuations in estimating the person's potential earnings.

Based on the above, when estimating a real estate agent's potential earnings during this period, we would want to consider both the change in real estate prices (and thus commission income) and the fluctuations in the market. We can then compare this to the actual number of units sold, and income earned, by the real estate agent to estimate the loss suffered due to their injuries.

Ultimately, calculating the value of lost employment or self-employment income for economic loss 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

Discount Rate Increases to 1.1% for Trials in 2025

Each year the Ministry of the Attorney General of Ontario publishes the discount rates to be used for the calculation of awards for future pecuniary damages in Ontario under rule 53.09 of the Rules of Civil Procedure. The rates for the first 15 years are based on calculations set out in the Rules of Civil Procedure, with the annual rate thereafter fixed at 2.5%. The discount rate is intended to reflect the difference between estimated investment and price inflation rates.

For 2024, the discount rates were set at 1.0% for the first 15 years, and 2.5% thereafter.

For trials scheduled to commence on, or after January 1, 2025, the rates have been increased to 1.1% for the first 15 years, and 2.5% thereafter.

Although not a significant change, the effect will be to reduce our present value calculations for trials beginning in 2025, as a higher discount rate results in a lower present value.

The above-noted rates are to be used for amounts expected to increase with inflation (e.g. salary). For amounts that are static (that don't increase with inflation), such as Income Replacement Benefits (IRBs) or many Long-Term Disability benefits, a higher discount rate would be warranted. Based on the Attorney General published inflation rates, the discount rates for such amounts will be 3.4% for the first 15 years, and 3.4% thereafter, for trials beginning in 2025. These are up from 3.2% and 3.2% (respectively) for 2024.

Our Financial Services Advisory Team (FSAT) has significant experience preparing these present value calculations. If you have any questions or require assistance with a calculation, please contact a member of our team.

Rule 53.09 Rates

	2025	2024
First 15 years	1.1%	1.0%
Thereafter	2.5%	2.5%

Approaches to Value Customer-Related Intangibles

This is the third article in a series on intangible assets and the various valuation methodologies and considerations. Please see our Spring 2024 FSAT newsletter for the first and second articles in our series, 'Unlocking the Value: Understanding Intangible Assets in Business Valuation' and 'Determining the Economic Benefits of Customer-related Intangible Assets.'

In the previous article, we discussed the economic benefits of cultivating customer-related assets. In this article, we will explore the various approaches to value these benefits. The most common approach is the Multi-Period Excess Earnings Method (MEEM), which is often used to value customer-related, technology-related intangible assets, or other intangible assets that could be considered essential to the business. Ideally, the MEEM is selected when the company only has one key intangible asset. The MEEM employs market-participant assumptions and Contributory Asset Charges (CAC) to identify the cash flows directly associated with the intangible asset. CAC are essentially notional charges that are unique to the business and represent the reliance on other assets to support the intangible asset to generate earnings. The assets relied on include working capital, fixed assets, brand/trade name, assembled workforce, non-compete agreements, and more.

As the MEEM is based on the identification of the cash flows directly associated with the intangible asset, such as customer relationships, it is important to consider historical and projected information to develop reliable cash flows. This analysis should consider how long future cash flows from these customer relationships are expected to last. Factors such as the length of the historical customer relationships, renewals, cancellations, and customer switching costs, help us estimate the annual customer attrition rate, which reflects the expected decline in purchases over time. For technology-related assets, this may be referred to as a technological decline that reflects replacement of existing technology or migration to other products.

A disadvantage of the MEEM arises in situations where there are potentially multiple key intangible assets. For example, a business that has built a strong customer base and as a result has a valuable customer relationship intangible asset. This business may also have an exclusive distribution agreement which generates significant revenue. Thus, both the customer relationship and distribution agreement could be key intangible assets of the business. In this case, it can be challenging to isolate and allocate cash flows among the intangible assets, making it difficult to assess the value of the intangible assets separately. Furthermore, proper consideration of the CAC should be analyzed to avoid double counting charges.

An alternative option to the MEEM is the Disaggregated Distributor Method or Distributor Method (DM) which is similar to the MEEM but uses market-based distributor data for the CAC charges and discount rate. This is commonly used in manufacturing industries where sales are transactional in nature and the cost of switching to a competitor is not significant. The DM is only intended to value customer relationships; however, this allows the MEEM approach to be used to value another intangible asset. In addition, it reduces the risk of double counting the CAC which arises when using the MEEM to value two assets. The disadvantage of the DM is the lack of available distributor-related market information.

A third and least common option to value customer relationships is the With-or-Without method which calculates the value of the business with the intangible asset (scenario 1) and without the intangible asset (scenario 2). The difference in value between the two scenarios would be attributed to the customer relationship. This method requires careful consideration of the discount rate for each scenario to ensure risk is not double counted in the cash flows, particularly in the without scenario. Similar to the DM, this allows the MEEM approach to be used to value another intangible asset.

In conclusion, customer-related intangible assets are often valued using the MEEM but occasionally the DM or the With-or-Without method are applied. Properly assessing the unique traits of the intangible asset is essential to facilitate the identification of the approach that would most accurately reflect the value of the customer-related asset.

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

Article written by: Rachel Mak, Registered Student of CBV Institute

Quality of Earnings Reports – What They Are and Why They Matter

What is a Quality of Earnings Report?

A Quality of Earnings (QoE) report is a type of financial due diligence report often prepared as part of a Mergers and Acquisitions (M&A) transaction. The depth, period covered, and nature of the analysis included in a QoE report can vary depending on the complexity and nature of subject company and its financial reporting, and the perceived areas of risk by the user.

Due to differences in financial reporting practices that vary from company to company, and different accounting standards, the reported net income in a company's financial statements may not necessarily be a reliable representation of the company's ability to generate ongoing cash flows. Quality of Earnings does not have a standardized or regulated definition, but generally considers the amount of cash or non-cash earnings, recurring or non-recurring items, the precision of amounts recorded, or those involving estimates that are subject to judgment or change.

A QoE report analyzes the consistency of accounting policies, the degree of subjectivity or estimation, trends in reserves (i.e., warranty, bad debts, inventory, etc.), financial disclosures, and the impact of related party transactions in relation to reported accounting earnings/net income to provide a better understanding of the potential future ongoing cash flows that the business can generate. Since cash flow is often a key consideration, working capital balances and trends are often analyzed to identify operational requirements and the time required to convert sales to cash.

In a QoE report, the reported earnings are typically normalized to account for items such as non-recurring transactions, non-market transactions, discontinued operations, changes in subjective estimates, and other irregular or non-continuing items. The result is the normalized earnings, which is often measured in earnings before interest, taxes, depreciation, and amortization (EBITDA).

Additional analysis of the company's financial processes may also be conducted to provide a better understanding of how a company accrues or recognizes revenue and expenses, and the related cash inflows and outflows associated with these transactions.

Sources of information used in a QoE analysis may include financial statements, trial balance reports, general ledgers, company bank statements, and other detailed company financial information.

Why are Quality of Earnings Reports Needed?

A QoE report can be prepared for both the purchaser and the vendor in M&A transactions.

It is common for a purchaser to have a QoE report prepared during the due diligence phase of the transaction to assess potential risks of the transaction and for negotiating purposes. The lender that is financing the transaction or an insurer that is providing representations and warranties coverage may also require the purchaser to have a QoE report prepared to assist with financing or insuring the transaction.

A vendor may also want to have a QoE report prepared in advance of a transaction to gain a better understanding of areas of the business that can be improved before taking the company to market or to alert them of any potential issues that could negatively impact a sale.

Our Expertise in Quality of Earnings and Mergers and Acquisitions Transactions

At DJB, our team of specialists have the professional experience to assist prospective buyers and business owners throughout the transaction process. Our trusted professionals can assist in many aspects of M&A transactions, including assisting in the financial and tax due diligence process and preparing QoE reports.

Article written by: Jonathan Corobow, CBV

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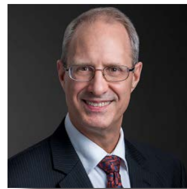

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FSAT Services

- Assistance with Business, Acquisitions & Divestitures, including Due Diligence & Quality of Earnings Reports
- Business Interruption Insurance
- Business Valuation
- Collaboratively Trained Professionals
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- Matrimonial Disputes
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- Value of Future Care Cost Analysis
- Wrongful Dismissal Claims

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