UNDERSTANDING THE VALUE OF BUSINESS VALUATIONS

April 4, 2022

Last Updated on

May 6th, 2022 12:09 pm

Imagine, for a moment, an alternative reality in which only 2% of all homeowners know how much their homes are worth. For the other 98%, it’s all guesswork, from whether their insurance rates are appropriate to how much equity they have and how much their houses would fetch on the market.

It sounds bizarre, not to say unworkable. Yet swap out the word “homeowners” for “business owners”, and this is actually the case. According to industry estimates, 98% of business owners have never had an independent business valuation done[i] and have no real idea how much their businesses are worth.

To some extent, their reluctance is easy to understand. Business valuations are an expensive, intrusive hassle, usually costing thousands of dollars and taking more than a month to complete. For business owners who aren’t planning to sell anytime soon, the question becomes, “Why should I?”

The answer is that an independent, expert assessment of their business’s value is one of the most vital pieces of data a business owner can have. With it, they can assess whether their financial strategies are working, check whether their insurance rates are appropriate, and plan for the future with confidence.

Without it, the entire enterprise is on shaky ground and any planning is really just theorizing. Estate and retirement planners have no reliable figures to go on. Tax and insurance specialists have to resort to guesswork. The succession team can’t put together a proper buy-sell agreement. Heirs or purchasers can’t make confident decisions, including about how to finance the sale.

In short, getting a valuation done is non-optional for any owner who cares about the best interests of their business and their family.

In Canada, business valuations are carried out by members of the Canadian Institute of Chartered Business Valuators. The valuation is usually based on Earnings Before Interest, Taxes, Depreciation or Amortization (EBTIDA), and can be carried out using a number of methods[ii]. Among them are

* **Asset valuation.** This method counts all of a firm’s tangible assets, such as cash, stocks, and patents, as well as its intangible assets, such as customer relationships.
* **Historical earnings valuation.**With this method, the valuator will look at factors in a family business’s history, such as its ability to pay off debt and rebound after downturns. It sets a value on the goodwill that the family firm has earned.
* **Relative Valuation.** A relative valuation looks at how much a similar business might bring, akin to a real-estate agent coming up with a list price for a property based on “comparables”.
* **Future maintainable earnings valuation.**Using the past three years of sales, expenses, and profits, this method predicts future performance to calculate present-day value.

It is best to compare the results of two or more methods, as each has its limitations. For instance, a relative valuation will be working with far less information about comparable businesses than a realtor would with real estate, since the finances of private companies are rarely disclosed.

In many cases, one valuation is not enough: the valuation needs to be updated intermittently or even annually. The ideal frequency for renewing the valuation depends on various factors, including how volatile the sector is. When a sale is imminent, however, only a valuation done within about a year will generally be accepted.[iii]

Business owners who stall on their valuation should know that one way or another, it *will* be done. When they die or sell the business, the CRA will carry out an evaluation of its own to assess fair-market value and will levy the appropriate capital-gains tax.[iv] If the business has filed a “guesstimate” valuation with the Canada Revenue Agency at any point, stiff penalties can apply if the CRA finds a significant gap between that valuation and their own assessment of the company’s fair market value[v]. It’s one more factor making a business valuation good value for the money.

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[ii] Fagundes, Laura. “5 Common Business Valuation Methods.” Securedocs.com. https://www.securedocs.com/blog/5-common-business-valuation-methods

[iii] “When to conduct a business valuation.” DCA. https://donohoocpa.com/when-to-conduct-a-business-valuation/

[iv] Madan, Allan. “Transferring Business to Family Member [sic] in Canada.” Madan Chartered Accountant. https://madanca.com/blog/transferring-business-to-family-member-in-canada/

[v] “Valuations for Income Tax Purposes: What Does the CRA Think?” DMCL. https://www.dmcl.ca/valuations-income-tax-purposes-cra/