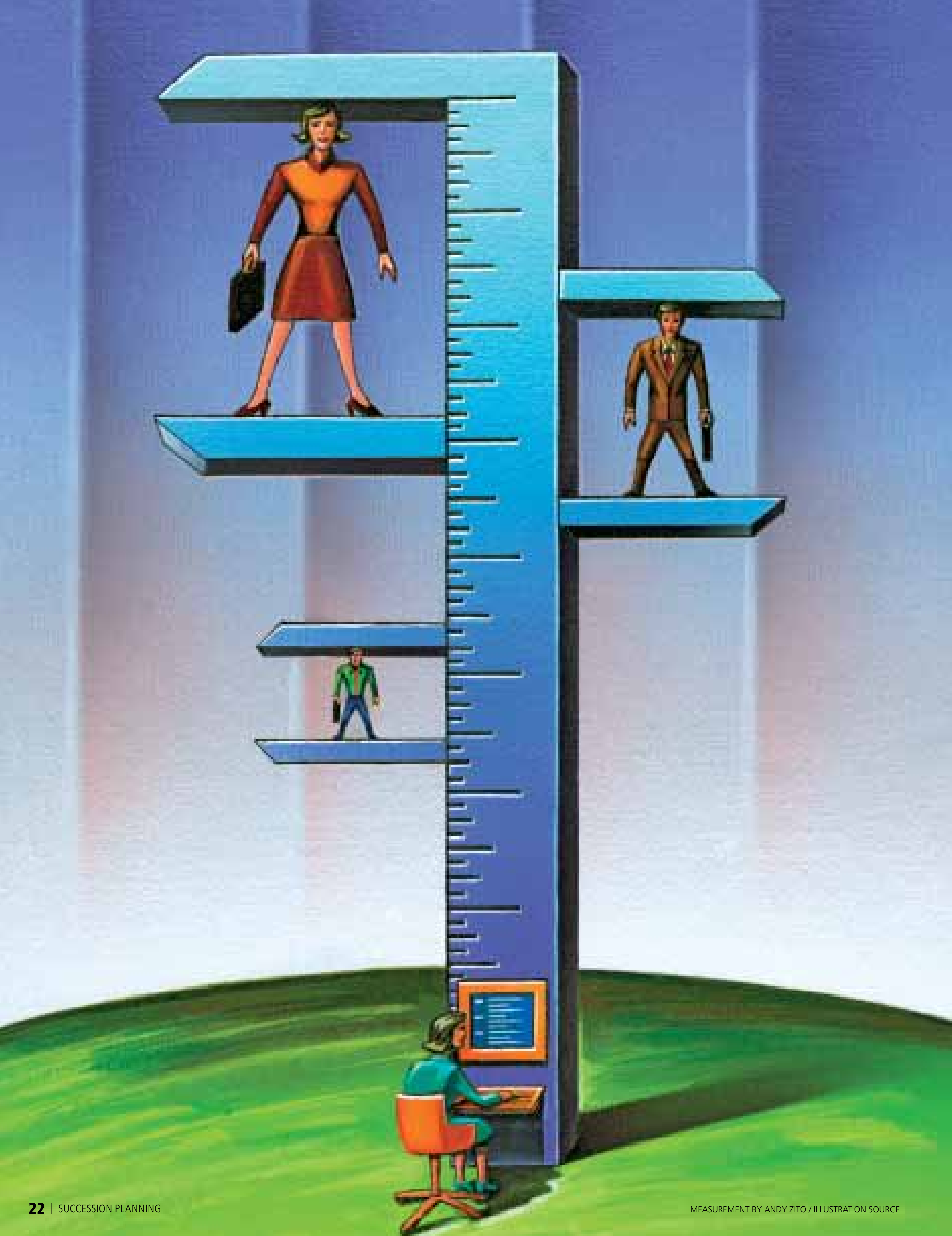

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One goal, different approaches

A business sale is fraught with complex legal and accounting considerations, including valuation

By Jeff Buckstein

BUYERS AND SELLERS of businesses, beware: A cadre of professionals, including lawyers, accountants, business valuators and real estate appraisers, all need to play a key role in helping structure a sound deal where parties to an arm's-length transaction are involved. The complexity involved can be immense.

"Selling a business is quite a substantial process to go through. You can't just decide November 1 you want to sell it, and it's sold within 60 days. It may be a year," says Tom McCallum, a Whitby, Ont.-based certified general accountant and chartered business valuator.

"The valuator is going to perform an exercise to arrive at what rate of return a hypothetical buyer will want on this particular business, considering all of its strengths, weaknesses, opportunities and threats. We call that a SWOT analysis," says Richard Wise, a valuation and litigation support partner with MNP in Montreal.

There are three major ways to value a business: via an income or cash flow approach (although each involves a different calculation), an asset approach, or a market approach.

Income approach

The income approach takes into account past performance numbers, including earnings and cash flow, but is also forward-looking in the sense that a business valuator will attempt to normalize those numbers or calculate a future stream of benefits, says Wise, a chartered accountant and chartered business valuator.

For example, "in a private company, the owner may have the mother-in-law or kids on the payroll who have never been to daddy's plant. So what the evaluator will typically do is normalize those earnings to the extent there are excess salaries, or management fees [or other] non-recurring items that have to be adjusted. [Or] there may have been a one-time charge against the profits, which you would have to add back to the income to get rid of the adverse effects," he says.

WILL IT BE SHARE SALES OR AN ASSET PURCHASE?

Various legal considerations may be given to a business that is being sold in an arm's length transaction.

One is whether the deal is to involve assets or shares. Often, it's a preference of the buyer to be coming in and buying only assets, explains Paul Amirault, a partner with the law firm Norton Rose in Ottawa.

There are two reasons. One is by just purchasing assets the buyer can limit the value of the liabilities they take on. Second, from a tax perspective, they are able to depreciate the value of those assets over a period of several years.

However, "the classic preference from a vendor's perspective is to sell the shares. It's typically thought that might give the vendor certain tax advantages, including an ability to use up their lifetime capital gains exemption. What goes along with a share sale is the idea that the buyer is buying all of the business, and all of its disclosed and undisclosed liabilities," Amirault adds.

Ultimately, the due diligence necessary in either a share deal or an asset deal is going to involve running a number of publicly available searches against the company or its assets, and having professionals like lawyers and accountants review documentation, including financial statements and tax returns.

"It's also going to include negotiating the appropriate paperwork for the transaction that will provide for representations and warranties about the business, along with certain negotiated indemnification provisions concerning the purchase and sale of that business," Amirault says.

McCallum illustrated how the cash flow approach can provide a very different valuation than the income approach. If a firm's annual depreciation was $40,000, but management was only replacing its assets as they wore out at the rate of $10,000 a year, the cash flow would show $30,000 more than net income. In that instance, "the cash flow approach for valuing the business would probably be more appropriate than a net income approach, because the net income approach overstates the replacement of your assets," he says.

"If you use the earnings or cash flow approach, the assumption is there's an intangible value to the business," McCallum says. "That approach determines the overall value of the business inclusive of what we'll call goodwill. That's applicable where the business is providing a sustainable amount of earnings into the reasonably foreseeable future."

Says Trevor Hood, a chartered accountant and chartered business valuator with SB Partners, a CA firm in Burlington, Ont.: "Either the cash flow or income approach [are] the predominant methods that we find when we're doing valuations for a company. We advise clients to really focus [on] the earnings the business is generating. What is the multiple that's going to be applied to those? The multiple is a function of the risk associated with the business. So it's trying to present the strengths of the business and minimize the weaknesses or risks," he says.

Asset approach

The next generally accepted valuation method is the asset approach. "That's generally only applied in situations where there is no goodwill value associated with the business," says Hood.

This method is applicable in instances where the buyer is really after the assets, rather than a stream of profits being generated by a manufacturing or distributing company, or a retail or professional practice, Wise explained.

Take the example of an investment holding company where there are no profits to multiply or capitalize, and the buyer is interested in the company's underlying assets, such as a portfolio of real estate assets or a portfolio of investments or securities. A real estate appraiser would appraise those values; a business valuator could then rely on those figures and use them in arriving at an overall valuation on the balance sheet.

"If you have a company that owns a property in downtown Toronto, it may have had an original cost of $1-million 15 years ago. Today, let's say it's worth $7-million. The balance sheet is going to show it at $1-million. But a valuator is going to say: 'I'm going to adjust it for valuation purposes and bring it up to $7-million, and then take into account any tax issues.' There could be accrued capital gains that will be taxable, depreciation recaptured; things like that," Wise says.

Market approach

The third approach is market-based.

"That looks to transactions in the marketplace where you have meaningful data saying 'here's a company just like the one I'm valuing — [it's] roughly the same size, same markets, same risk profile that operates in a substantially similar manner. I see that this company sold for X times net profit. I assume that if this company I'm valuing right now were to be put on the market it would sell for a similar price,' " Wise says.

But a valuator would have to dig deeper than that, he added, drawing an analogy to a house sale where homes in one neighbourhood might look the same on the outside, but inside there may be big differences in terms of workmanship, amenities, etc.; therefore, despite what appears on the surface, they are really

MONEY BY WAHOOO / ISTOCKPHOTO.COM , TAX BY AMPHOTORA / ISTOCKPHOTO.COM worth different amounts.

"Market transactions don't tend to be used that often, at least for private enterprise and succession planning, because not only is there lack of information, not a lot of people openly communicate about the sale of their business," Hood says.

Experts also note that in terms of the payment structure for acquiring an arm's-length business, there are two major ways to structure a sale. The first is via an earn-out, whereby an initial down payment is made to the vendor, followed by an agreed-upon contingency amount provided certain conditions are met. The second is a one-time payment to the vendor.

With an earn-out, the seller may be telling the buyer that they're more than happy to meet a certain price that's being asked, but are only willing to pay a certain percentage of that up front. The rest goes into an escrow account and a trustee, or escrow agent will only release the money provided what you say is going to happen will happen, Wise says.

A number of factors go into working out an escrow amount, including what the buyer views as risks in the transaction and what the vendor is willing to agree to set aside in order to cover that risk.

"Typically, an earn-out is put in place as a structure that favours the buyer. Essentially what it does is makes the business owner approve the value that [they] bargained for in connection with the purchase price until that value is proven," explains Paul Amirault, a partner with the law firm Norton Rose in Ottawa.

"Until certain post-closing targets are met, the valuation or purchase price that's been bargained for hasn't been proven. Vendors need to be careful about how earn-outs are structured and what control over the business they have to prove the value of that business post-closing," he adds.

"The earn-out has some advantages for both the buyer and the seller that a single payout doesn't," says Mark Redinger, a partner with the law firm Dickinson & Wright in Toronto. "In an earn-out scenario, the buyer gets the comfort of knowing the valuation they placed on the business will be at least as good on the day of close as it is whenever the earn-out expires. The seller gets some comfort in knowing in some cases that they still have a piece of the business going forward."

But there could also be a downside to the earn-out to the purchaser, McCallum says. He pointed to a hypothetical situation in which a business is being purchased for $2-million, with $1.2-million up front, and another $800,000 contingent on certain earning conditions over the next few years.

"It really makes life difficult for everybody. After a while, [the purchaser] has got to say to [themselves], 'OK, I bought a base of business. Now I'm going to pay a premium if there's more. Am I paying the seller for what I generated — what my own abilities and skills brought to the table?' You start to resent those payments," he says.

In contrast to the earn-out, the one-time purchase price is generally analogous to a no-returns retail policy. "To the seller, the advantage is that he gets a one-time payment [although] typically the valuation on a [one-time price] sale is less than on an earn-out," Redinger says.

The single payment method is "the classic vendor preference. I think the single payment method would typically be preferred over instalment or earn-out payments, as most would see benefits in the certainty of having all the money up front," Amirault contends.

However, that might not universally be the case. In some instances, "sellers need to realize that, even if there is a single payment, the buyer may require an escrow or holdback of a percentage of the payment — such as 10 per cent — of the payment over a period of time post closing — such as one year, as a method of satisfying any indemnification obligations of the seller that may arise after closing. Therefore, the seller may not get all the money in one payment up front," he adds. **END**

TAX IMPLICATIONS OF AN EARN-OUT

It is essential for vendors in a business transaction to ensure they get proper taxation advice involving an earn-out structure, to ensure the entire amount gets established on the books as a capital gain, according to Trevor Hood, a chartered accountant and chartered business valuator.

"There are some challenges in terms of structuring the earn-out because depending on how it's structured, the earn-out may be taxed as income versus capital gains. If it's taxed as income, generally higher tax rates are associated with that as opposed to the capital gain," says Hood, a partner with chartered accountancy SB Partners in Burlington, Ont.

Technically, earn-outs are commonly structured as reverse earn-outs in order to provide more favourable tax implications, explains Richard Wise, a valuation and litigation support partner with MNP in Montreal. "A reverse earn-out protects the seller from being taxed as full income on any portion of the sale. A reverse earn-out treats everything as capital gains."

Wise offers an example of a deal structured with a $1.5-million payment, with a $300,000 holdback to be held in escrow, so the purchaser only needs to pay $1.2-million up front. On a pure earn-out, the vendor will treat the $1.2-million as a capital gain, and be taxed on the $300,000 escrow amount as regular income when it is subsequently received.

But if the deal is structured as a reverse earn-out, with $300,000 of that amount held back as a balance of sale, then the entire $1.5-million payment can be treated as a capital gain – including the $300,000 held back, he explains.

There are different tax implications for the purchaser, which is why professional tax and legal advice is always advised, experts stress.