CBV Institute

CBV INSIGHTS

FEBRUARY 2023

SUPPORTING SUCCESS

THE IMPORTANCE OF CBVs IN SUCCESSION PLANNING

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About Chartered Business Valuators Institute (CBV Institute)

CBV Institute leads the Chartered Business Valuator (CBV) profession – Canada's only designation dedicated to business valuation since 1971. With CBVs and Students across Canada and around the world, we uphold the highest standards of business valuation practice through education, accreditation and governance of the CBV, for the benefit of the public interest. The integrity of the CBV accreditation is grounded in the rigour CBV Program of Studies and upheld by the Membership Qualification Examination and Code of Ethics.

CBV Insights

CBV Insights is a thought leadership periodical published throughout the year, sharing relevant insights on emerging topics of interest to our network and the general public. The opinions expressed by contributing authors in *CBV Insights* periodicals do not necessarily carry the endorsement of CBV Institute.

INTRODUCTION

The Canadian Federation of Independent Business (CFIB) recently released a highly-anticipated research report, *Succession Tsunami: Preparing for a decade of small business transitions in Canada* (the "CFIB Report"). To put it mildly, the results of the report were staggering. Of note:

- 76%[1] of owners plan to leave their business within the next 10 years (15% within 1 year, 41% within 1 to 5 years, and 20% within 6 to 10 years), *and*
- The value of assets changing hands over the next 10 years is potentially over $2 TRILLION, *yet*
- Only 1 in 10 owners have a formal business succession plan in place!

In other words, a massive transfer of wealth is imminent, but the vast majority of business owners do not have a formal succession plan in place.

From a valuation perspective, the CFIB Report also noted that *43% of business owners cite valuing their business to be an obstacle, and 84% noted it was very or somewhat difficult to determine the value of their business.* This paper outlines why the valuation of a business is a perplexity to so many business owners, and how Chartered Business Valuators (CBVs) can play a key role on any business owner's multi-disciplinary succession planning team.

WHO ARE CBVs?

CBVs are accounting, finance and business professionals who have received extensive formal education and accreditation in business valuation from CBV Institute, and must comply with ongoing professional obligations, including professional development, a Code of Ethics and Practice Standards, and a mandatory practice inspection program[2].

The CBV education program provides depth and breadth of content in business valuation in both public and private businesses, but the emphasis is on private business valuation, which is what most of our small businesses in Canada are.

CBVs have been providing specialized business valuation services in Canada and around the world for over 50 years, and work in a variety of roles – anywhere a conclusion of value is needed – including business advisory, litigation support, transactions, financial reporting, corporate finance, private investments, corporate development, etc. The list of CBV workplaces is extensive.

SUCCESSION PLANNING – FRAMING THIS PAPER

A very simple definition of "succession planning" is used in the context of this paper – succession planning is the process and strategy of transitioning a leadership/ownership role in a business due to an exit of the owner. Inherent in succession planning is the orderly transfer of assets. In many cases, a business is transferred to new owners which could include an external third party buyer, or an internal party such as a business partner, family member or key employee. From the owner's perspective, succession planning ensures their lifelong goals and objectives are met upon exiting the business.

While succession planning is a complex process (as opposed to a one-time event) that necessarily involves a multi-disciplinary team, for the purposes of this paper we'll focus on what happens when a business is involved in the succession planning process.

WHY IS VALUING A BUSINESS SO DIFFICULT?

A common misconception is that the valuation of a business can be as simple as applying a rule of thumb, such as multiplying cash flows by a cash flow multiplier. If this was always the case, then 84% of business owners wouldn't feel that it is difficult to determine the value of their business! The reality is that there are complexities involved with the valuation of ANY business, regardless of its size, industry, or life stage.

Value is forward-looking in nature. At a very high level, a CBV's job is to:

1. Assess a business' potential cash flows,
2. Assess the business' risk of achieving said cash flows, including an assessment of internal risks such as financial, operating, governance, and strategic risks; and external risks such as industry, economic and geopolitical risks, and
3. Effectively communicate how they arrived a certain value.

This may sound straightforward, but there are numerous technical and professional complexities involved with the valuation process.

TECHNICAL COMPLEXITIES

From a *technical perspective,* business valuation is becoming more and more complex in many ways. Three examples are outlined here.

One, a common adage is that valuation is "part art, part science". While cliché, it's also true. The "science" part of a valuation is usually more straightforward – inputting numbers into a model does not require specialized knowledge or expertise per se. However, in most cases, the science part of a valuation is not where a valuation will fall apart – it's in the "art". And in many cases, valuation is actually more art than science. The art involved in a valuation is the informed (subjective) professional judgement that goes into calculating value (e.g. risk assessment, reasonableness of underlying assumptions, etc.) – and this can only be gained through the knowledge development as a result of comprehensive training and valuable experience.

Circling back to the science part of a valuation – while this is usually the more straightforward part of a valuation, as of late (with market and macroeconomic conditions rapidly changing due to COVID, high inflation, supply chain disruptions, geopolitical unrest, etc.) the considerations and assumptions in a valuation that were historically fairly clear-cut (such as the long-term equity risk premium, projected inflation and interest rates, a business' projected growth rates) are now no longer straightforward matters.

Two, businesses in certain sectors are increasingly using measures of value that are specific to that industry and/or are non-traditional in nature. For instance, e-commerce companies may use customer conversation rates or unique visitors as valuation metrics. Other industries have specific terminology and metrics that are used to ascertain value, such as the auto dealership industry which refers to goodwill as "blue sky" and has generally accepted formulae and risk factors considered to determine the blue sky value. And even within these industries, for the reasons noted above and others, these metrics are in a state of flux.

Three, as a result of increased digitization and data (and many other factors), balance sheets are changing – a business owner might not even be aware of certain internally-generated intangible assets that a business might have – and this intangible asset value could be significant. Internally-generated intangible assets are assets that a business has not acquired in a transaction, but has developed (knowingly or unknowingly) on its own as a result of its method of operations and/or strategy. Most business owners may not know how to value (or even recognize) such assets, but they could have significant value. For example, everyone is aware of the resources (time and money) it takes to hire, train, and retain staff. And everyone can recognize that there are inherent efficiencies within a broad team that has gelled and works well together (i.e., an "established workforce"). There is certainly value in an established workforce that an external purchaser would likely be willing to pay for, but how do you quantify it?

Each of these points underlines the need to use an expert in business valuation (such as a CBV) to value a business. Relying on a value that has been calculated using a rule of thumb (which are developed based on historical, and likely outdated, data) is irrelevant at best and misleading at worst. Similarly, relying on a practitioner who is not engaged in business valuations and transactions on a regular basis, is not up to date on relevant metrics, and/or does not know the right questions to ask (particularly when selling to an informed external party) could lead to money left on the table in the case of an external sale. A trained and experienced business valuator can bring clarity to a multifaceted process.

PROFESSIONAL COMPLEXITIES

It's clear that business valuation can be extremely complex from a technical sense. Turning to the professional aspects of performing a business valuation, CBV are trained to be independent and objective professionals. These characteristics are extremely important to the succession planning process regardless of the party to whom the business is being transferred. Further, many CBVs might say that the more challenging part of their job is communicating how or why they arrived at a particular value. More about both of these skills is outlined below.

TYING COMPLEXITIES TO DIFFERENT TYPES OF PURCHASERS

The CFIB Report outlined the various reasons why a business owner may wish to exit their business, the most common reason (with 75% of responses) being retirement.

There are several ways by which a transfer of assets could occur. Regardless of what type of succession measures a business owner is taking, a well-performed assessment of value (including the calculation of value and the communication of the value) will be required.

The CFIB Report notes that 49% of respondents indicated that they intend to sell their business to an unrelated (external) party(ies), 24% indicated that they intend to sell to a family member(s), and 23% intend to sell to an employee(s). To whom an owner transfers their shares (i.e., the "best" successor) will differ on a case-by-case basis, depending on the current owner's goals and motivations. There are commonly acknowledged pros and cons with each type of transfer, which we won't repeat here. Rather, the focus below will be with regard to how a CBV could maximize the succession experience.

UNRELATED/EXTERNAL PARTY

When selling to an external party, an owner may only get once chance to sell. This means that (1) value must be maximized so that money isn't left on the table, (2) value must be reasonable and supportable so the potential purchaser views it as a good investment opportunity and does not walk away from a potential deal, and (3) there must be a party who can effectively negotiate and communicate with potential purchasers.

We discuss how an owner can prepare their business for sale (and maximize their proceeds) later. In short, in order to maximize value on a sale, a business' financial results need to be clearly articulated, and may need to be interpreted or framed in a specific way. This is particularly important given that the pandemic may have impacted a business' cash flows and risk in unexpected ways. A CBV is able to assist a business owner in telling the story of their business pre-COVID, during COVID, and post-COVID, in order to maximize value.

In terms of effective negotiation and communication, a common occurrence is that there is a large gap between the owner's perceptions of what their business is worth and what the purchaser is willing to pay. If this gap is too large, negotiations could break down and the purchaser could walk away. An objective professional will assist an owner in understanding how much their business is really worth, which can help level-set the owner's expectations and assist in smooth negotiations. CBVs involved in transactions on a regular basis are aware of how businesses in particular industries are valued and can help an owner be on the same page as a potential purchaser when it comes to assessing value drivers and risk

FAMILY MEMBER

Historically, if a business owner sold their shares of a small business to a family member, the business owner was at a disadvantage, tax-wise, compared to if they sold such shares to an unrelated party. Sales to unrelated ("non-arm's-length") parties are taxed as capital gains (against which the selling owner could apply the capital gains exemption and reduce the taxable base), whereas sales to related ("arm's-length") parties were taxed as dividends. The result was that taxes paid on a sale of shares to a related party (i.e., family member) were much higher than taxes paid on a sale of shares to an external party.

Bill C-208, which passed royal assent in June 2021, enacted changes that allowed a business owner to sell the shares of a small business to a non-arm's length purchaser (such as their child) and treat the transaction as a capital gain instead of a dividend (which put the owner in the same place as if they had sold their shares to a non-arm's-length party). While many business owners did take advantage of C-208 in 2021, in the time since there has been some confusion on its application and what the legislation will and will not permit, resulting in the easing of activity. Amendments are anticipated, which will bring clarity to certain aspects of the bill. It is important to note that, as it stands right now, Bill C-208 requires an *independent assessment* of the fair market value of the shares to be provided to the Canada Revenue Agency.

Another option for a business owner to transfer shares in a business to family members is via an estate freeze, wherein the fair market value of the common shares of a private company are "frozen" in order to attribute future growth to new common shares of the private company. In estate freezes, the transferor does not sell their shares, but instead defers the income taxes on the capital gain of their shares to the time of their actual or deemed disposition[3].

Business transitions to family members are a nuanced situation, and engaging the services of an independent CBV who does not have a historical business relationship within the family could serve as an important proof point to family or outsiders that the owner is approaching the succession planning measures in good faith. As discussed earlier, independence is an important aspect of CBV training. CBVs can satisfy independent requirements in the Income Tax Act (including Bill C-208 as noted above) and can provide impartial input and opinions to family members to ease or prevent family disputes in a situation where emotions may already be heightened.

EMPLOYEES

A third group of potential successors are employees, who can purchase the shares of a business via an employee buyout or an Employee Ownership Trust. In the case of an employee buyout, the purchasing employees may need to use and raise capital from various sources (i.e., personal funds, external lenders, the seller).

Similar to with family members, a CBV who does not have a historical business relationship with the owner could serve as an important proof point to employee purchasers that the owner is approaching the succession planning measures in good faith. Further, a CBV is able to provide an independent report to a bank to arrange vendor financing if requested.

BUSINESS PARTNER

For companies with multiple shareholders, another potential purchaser could be a business partner (or another shareholder). For these companies, it is vital to have a shareholder agreement in place complete with an effective buy/sell clause which stipulates the process for determining value/price in the event of a future purchase of shares by the company or another shareholder (upon what is often referred to as a triggering event such as death, disability, dispute, divorce, etc.).

The key to success in these situations is to ensure the buy/sell clause sets out the process for determining value, such as having a pre-determined CBV conduct an independent valuation on a periodic basis (such as every 1 or 2 years), and does not simply rely on a potentially outdated fixed price per share or valuation formula.

TO-DOS FOR BUSINESS OWNERS – FROM A BUSINESS VALUATION PERSPECTIVE

The CFIB Paper offers great recommendations to business owners who are starting (or contemplating starting) their succession planning journey. Rather than rehash these suggestions (many of which involve interpersonal, legal, or tax aspects which are best served by other qualified professionals on an owner's succession planning team), the focus here is on *how an owner can maximize the value of their business, assuming that they: (1) sell their shares, and (2) want to maximize the proceeds from the sale of their shares (i.e., not leave money on the table).*

It's also important to note that regardless of the type of business transition being contemplated, a CBV or business valuator is only one key member of a trusted succession planning team. A CBV can provide a sound assessment of value and can participate or lead the divestiture process, but they must work closely with a business owner's wealth advisor, assurance/tax service provider, and legal counsel. Because a CBV's job is to understand what elements of a business contribute to value, they also understand what elements of a business need to either be cleaned up, eliminated, or enhanced to create value; and what needs to be done to "prove" the value of a business to an end user.

In general, an owner should begin the succession planning journey (including obtaining the services of a business valuation professional) well in advance of their retirement/transition date – optimally, 3-5 years, and set a clear schedule with timelines and milestones with respect to the business transition. The CFIB Report indicates that 15% of owners plan to leave their business within 1 year, 41% within 1 to 5 years, and 20% within 6 to 10 years. Despite so many owners planning on exiting within a relatively short window, the CFIB Report indicates that only 16% of owners planning on leaving within 1 year have a formal succession plan (11% for those with a 1-5 year window, and 6% for a 6-10 year window), and it is likely that even fewer have included a formal business valuation in this plan.

In the context of maximizing business value, a 3-5 year time horizon is essential because most of the tactics that can be employed to maximize the value of your business (outlined below) will require a multi-year time span which can serve as proof of historical precedent and/or demonstrate improving trend lines. Further, a multi-year timeline may be necessary to take advantage of certain income-tax minimization strategies. More on both of these points below.

In terms of maximizing business value, owners should consider the following:

1. Clean up cash flows so that a trend of stable or improving future potential earnings are clear and attractive to a potential purchaser. This can include:
    - Removing personal spending from business accounts
    - Diversifying revenues when possible
    - Investing in new equipment to minimize repair costs
    - Creating income statement budgets/forecasts to measure actual performance against and demonstrate to a potential purchaser the future growth potential of the business

2. Mitigate business risk where possible. Specifically, knowledge that resides solely in the owner's head should either be documented or shared with continuing employees (e.g. integral processes and procedures, important customer relationships, etc.). "Key person reliance or dependence" occurs when a business relies too heavily on the knowledge, ability, or relationships of one person. In such cases, a purchaser will significantly discount the price they are willing to pay for the business because the exit of that key person (typically the owner) means the loss of important knowledge, relationships, and cash flows (i.e., it increases the risk of the business).

    Another way to mitigate business risk is to reduce the dependence on one or few customers and strive to secure long-term customer contracts that create a recurring source of revenue, where possible. Further, the transition plan should be communicated to all key stakeholders (customers, suppliers, employees, etc.) to ease the continuity of operations (which reduces risk). The transfer of information and relationships can take years to be done properly.

3. Structure the business so that income taxes that will be incurred on the sale of the business are minimized. The business should be incorporated if it is not already, so that the business can qualify as a Small Business Corporation (SBC), and the owner can take advantage of the Lifetime Capital Gains Exemption. To qualify as an SBC, 50% of the business' assets must be used for business purposes in Canada for 24 months before sale, and 90% at time of sale (this is called "purifying the balance sheet"). This means that personal or redundant assets must be transferred from the business at least 2 years ahead of an owner's exit if they comprise more than 50% of asset value at that time.

TO WRAP UP…

With so much wealth being transferred in Canada over the next few years, it is essential that succession planning is done in a responsible way as there are implications not only to the business owner and other individuals, but from a macroeconomic perspective as well. The difficulty for business owners to understand and estimate the value of their business seems to be a major obstacle preventing them from creating a formal exit/succession plan, or even beginning the process. There is a huge opportunity for business owners to rely on CBVs to overcome this obstacle at a time where $2 trillion of business wealth is expected to change hands over the coming decade.

While this paper focused on the importance of business valuation from the owner's perspective, properly-planned succession initiatives will also benefit the business itself, family members, employees, as well as the business' community and the Canadian economy.

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1 This number is consistent with PWC's recent *Once in Lifetime* report, which reported that 70% of Canadian private company owners are planning to sell or pass on their businesses in the next few years.

2 For more information, see https://cbvinstitute.com/become-a-cbv/.

3 Note that there are intricacies involved and other scenarios such as setting up trusts, etc. that are not explored here.