

BUSI 452

Answer Guide 1 Business Valuation Fundamentals

Marks: 1 mark per question.

1. Answer: 1

Business valuation generally involves the analysis of many tangible and intangible business assets. In business valuation, emphasis can be on the after-tax or pre-tax scenarios and reliance is placed on expected future cash flows. Business valuation does not require direct adherence to CUSPAP.

2. Answer: 2

Option (2) is false because it is estimating the cost of reproducing a large business that is unreliable and extremely speculative. In certain small businesses, a replacement cost can be estimated. Options (1), (3), and (4) are true.

3. Answer: 2

Option (2) is false; the CBV Institute is a Canadian-based organization. The IIBV is the globally focused business valuation institute. The other options are true.

4. Answer: 4

All of the statements are true; therefore, Option (4) is correct. Factors that might affect the amount of a minority discount include the size of the shareholding and its importance relative to the size of other shareholdings, nuisance value, and whether an organized market exists for shareholders.

5. Answer: 4

The rights attaching to control block shareholding include the power to elect a majority of the board of directors [Option (1)], the right to place a company in liquidation [Option (2)], the right to sell control of the company [Option (3)], the indirect ability to have oneself appointed an officer of the company, and the indirect ability to determine the timing and amount of dividend distributions. However, controlling shareholders cannot be dictatorial [Option (1)] since minority shareholders have some legal protection, as set out in federal or provincial business corporation statutes or common law. Minority shareholders who have been treated unfairly can apply to the courts for an oppression remedy. These remedies vary across the country, but they can include requiring the company to buy out minorities at a fair price or fixing the situation that caused their discontent.

6. Answer: 1

Option (1) is false because Situation 1 illustrates a clear minority position for Shareholder X and some discount would normally apply. Options (2), (3) and (4) are true.

7. Answer: 2

Option (2) is true. Option (1) is false because value is often determined within the context of a notional market. Notional value occurs where value must be determined without exposing the business interest for sale on the open market. Options (3) and (4) are false because price and value can potentially be equivalent, but are certainly not always equivalent.

8. Answer: 2

The generally accepted definition of fair market value for business enterprises in Canada is the highest price available in an open and unrestricted market between informed and prudent parties, acting at arm's-length and under no compulsion to act, expressed in terms of cash.

9. Answer: 4

Options (1), (2), and (3) are all false; therefore, Option (4) is correct. Option (1) is false because the market approach is often used when a large company must be valued or when publicly traded companies in the same sector of the subject business can be found. Option (2) is false because purchasers generally prefer *asset* transactions. Option (3) is false because vendors usually prefer a *share* sale.

10. Answer: 1

Notional valuations are applied when a business is not actually up for sale. Rather, circumstances may include matrimonial disputes [Option (2)], shareholder disagreements [Option (4)], income tax matters [Option (3)], expropriation, and litigation matters – basically anything other than an actual sale transaction. Therefore, Option (1) is correct.

11. Answer: 4

The fair market value definition is specifically for notional valuations. All the other options could be a challenge.

12. Answer: 4

Adjustments are required for unnecessary bad debt allowance [Option (1)], obsolete inventory [Option (2)], and current value of land and building versus book value [Option (3)]. No adjustment is required for depreciation as this has already been reflected in book value. Therefore Option (4) is correct.

13. Answer: 3

Total assets per the balance sheet	\$350,000	
Adjustments to current value:		
Add back bad debt allowance not needed	\$2,000	
Inventory write down	<u>-\$2,000</u>	0
Adjust land & building to current value:		
Current value	\$300,000	
Book value	<u>-200,000</u>	<u>\$100,000</u>
Total current value of assets		\$450,000
Deduct the liabilities		<u>-50,000</u>
Net asset value		\$400,000

Note: since it is a going concern asset, selling costs and taxes were not deducted.

14. Answer: 4

A portfolio discount is a reduction in price that results from the total package to be valued lower than the sum of the individual components. It may be that the mix and quantity of the properties in a business held by the company is less attractive as a group than each property viewed individually. Each of the statements accurately describes a portfolio discount; therefore, Option (4) is correct.

15. Answer: 3

A blockage discount refers to the difficulties in selling a large block of publicly traded shares during times of either low or non-existent trading volumes. This is similar to the problems selling a large parcel of land that cannot be easily absorbed in the marketplace – it will presumably sell at a discount relative to smaller parcels.

16. Answer: 4

All of the options are factors that should be considered in the valuation of nearly all professional practices.

17. Answer: 1

In estimating the fair market value of Quikcraft, the asset method (liquidation approach) [Option (1)] is considered appropriate for the following reasons. First, Quikcraft has generated historical losses. Second, there is recent intense competition in the industry and overall consumer demand is decreasing. This will put downward pressure on margins, which may further increase losses in the future. Finally, there is a breach of the bank covenants, coupled with the fact the bankers appear unwilling to provide further financing, and it is unclear whether the company will continue as a going concern. As such, Quikcraft is not expected to generate a positive return on investment in the future.

18. Answer: 3

Option (3) is false. Negligent claims are different from other recorded liabilities. In most cases, the current value of a liability is deducted from the assets. However, this is a contingent liability [Option (2)]: only if the company is found guilty will it have an actual liability. This makes it difficult to know if this will become a liability – and if so, the amount. The buyer may insist on holding back a portion of the purchase price until the issue is resolved [Option (1)]. Lawyer fees incurred, but not yet billed, should also be deducted if they are to be paid through the business [Option (4)].

19. Answer: 4

Present value of tax shield on existing UCC:

$$\frac{\$27,000,000 \times 45\% \times 4\%}{4\% + 15\%} = \$2,557,895$$

Present value of tax shield on purchase: (land is not depreciated)

$$\frac{(\$44,400,000 - \$3,500,000) \times 45\% \times 4\%}{4\% + 15\%} = \$3,874,737$$

$$\text{Present value of lost tax shield} = \$3,874,737 - \$2,557,895 = \$1,316,842$$

20. Answer: 4

There are a number of real estate situations where aspects of business value come into play. Some simple scenarios may involve a real estate professional applying basic business valuation principles. More complex situations may require the involvement of a CBV, such as separating business value from real estate value in an assessment appeal of a hotel [Option (1)], valuation of a seniors housing complex [Option (2)], and valuing a real estate holding company [Option (3)]. Therefore, Option (4), all of the above, is correct.