

# EXPERT insights

A Quarterly Newsletter for the Legal Community

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## Welcome to the fall edition of Expert Insights – a quarterly newsletter for lawyers

**IN OUR PREVIOUS NEWSLETTER** we discussed and provided practical tips for lawyers who work with financial experts. These tips came from our decades of experience working with clients in the financial and legal communities.

**IN THIS EDITION OF EXPERT INSIGHTS** we begin our series on financial concepts and frameworks commonly used in business valuation, and discuss the valuation of intellectual property for the purpose of litigation.

We hope you find this newsletter to be informative. We of course appreciate any feedback you may have. Please feel free to contact us at [info@cvpl.com](mailto:info@cvpl.com), or by calling 416.597.1198.

Note: This newsletter is meant to encourage general best practices only and is not intended as a substitute for professional advice. Specific situations or circumstances may warrant alternative approaches.

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# WHAT IS THE BASIS FOR MEASURING VALUE?

by *Dennis Leung, CA, CBV, CF, Director, Campbell Valuation Partners Limited*

As we begin our series on financial concepts and frameworks commonly used in business valuation, we start at square one, what is the basis for measuring value? Generally, there are two scenarios where the value of a business needs to be determined:

- in contemplation of an open market transaction, where the price of a business is negotiated between a vendor and purchaser acting at arm's length; and
- where it is necessary to determine the value of a business in the absence of open market negotiations.

In the first instance, the value of a business is ultimately determined when the vendor and purchaser agree on a price and the relevant terms. In the second instance, in the absence of open market negotiations, a "notional" market valuation is undertaken. Notional market valuations are usually required for:

- transaction between various "non-arm's length" parties as that term is defined in the Canadian Income Tax Act. Provisions in the Canadian Income Tax Act state that transactions between non-arm's length parties must be consummated at fair market value;
- transaction pursuant to income tax reorganization;
- transactions pursuant to the Provincial Family Law Acts, the Federal Divorce Act, and the Federal and various Provincial Expropriation Acts;
- "fairness opinions" required pursuant to Provincial Securities Acts;
- appraisal remedies and oppression remedies pursuant to Federal and Provincial Corporation Acts;
- commercial litigation and business interruption claims; and
- negotiation of financing with banks and lenders.

When determining a notional market value for a business, the term "value" needs to be defined. The most common definition of value is "Fair Market Value".

## Fair Market Value

In a notional market context, the definition of fair market value generally accepted by Canadian Courts 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."*

Fair Market Value is quantified on a "best effort" basis and includes a degree of professional judgment, as the valuation in a notional market context is based on assumptions and conditions that may or may not necessarily exist in an open market context.

## Highest Price Available

Determination of the highest price available considers that both vendor and purchaser would transact at a price deemed fair by each. Conceptually this price is the equilibrium price between the vendor's interest (to maximize price) and the purchaser's interest (to minimize price). The vendor will transact with the purchaser willing to pay the highest price. Without exposing the business for sale, the highest price can never be ascertained in any notional market valuation with certainty due to the possible existence of "special interest purchasers" and the price they may be willing to pay for expected post-acquisition net economic value added (or "synergies"). In this regard, without open market negotiations, it is seldom possible to accurately quantify the post-acquisition net economic value added that a purchaser would be willing to pay for. As a result, valuations in a notional business context are often based on a stand-alone or intrinsic value, without consideration of post-acquisition synergies. However, in situations where special interest purchasers are readily identifiable, the post-acquisition synergistic value added can, on occasion, be quantified.

## ***Open Market***

An open market refers to the assumption that no potential purchasers are excluded from participation in the notional market for the business being valued. It is assumed that the business is exposed to all potential purchasers with the will and resources to transact, notwithstanding the fact that this rarely occurs during the course of an actual business sale.

## ***Unrestricted Market***

An unrestricted market refers to the assumption that statutory, contractual, or other restrictions influencing the marketability of a business are lifted in order to facilitate a sale in a notional market. An example is a restriction on ownership transfer specified in a shareholder's agreement in privately held companies.

However, prevailing jurisprudence suggest that in a notional market context, the assumption of an unrestricted market does not extend to the complete disregard of restrictions on a hypothetical sale of a business. Rather, these restrictions are reflected as a discount from the fair market value determined without consideration of the restrictions.

## ***Between Informed Parties***

This relates to the assumption that both the vendor and purchaser are informed with respect to all facts important to value determination. In an open market transaction, a purchaser may not be fully informed with respect to the vendor's financial position, competitive issues and near term prospects, while the vendor may not be able to meaningfully quantify the purchaser's perceived post-acquisition synergies.

Canadian jurisprudence supports the proposition that full and open disclosure of information relevant to a purchase and sale that was available at the date of value (the valuation date) is assumed in a notional market value determination. It is generally accepted that hindsight evidence is not considered in the determination of fair market value. This is consistent with the notion that the price negotiated between a vendor and purchaser in an open market transaction is done so without the benefit of knowledge of future events that will take place. While Canadian Courts generally have found that

hindsight evidence is inadmissible when determining value in a notional market context, it has accepted that it may be utilized to determine whether actual events subsequent to the valuation date are generally consistent with assumptions made and conclusions reached in the determination of fair market value.

## ***Between Prudent Parties***

Assumes a marketplace where both vendor and purchaser exercise reasonable and appropriate diligence and care when consummating a transaction.

## ***Acting at Arm's Length***

This relates to the contemplation of negotiation between parties with opposing interests, each of whom has only an economic interest in the outcome.

## ***Under no Compulsion to Transact***

This relates to the contemplation of negotiations between parties where neither party is unduly compelled to transact nor constrained in any way from acting with full choice. This is not always the case in open market transactions, where a business is compelled to sell. An example would be a business in financial difficulty that requires the assistance of a purchaser to continue as a going concern. In these instances, a purchaser will attempt to take advantage of the vendor's weakened negotiating position.

## ***Expressed in Terms of Cash***

Notional market valuations are expressed on a cash equivalent basis and assume a transfer of the risks and rights associated with the business. Open market transactions are frequently consummated in circumstances where a portion or the entire price is not in the form of cash or cash equivalent. The non-cash component can include shares of the acquiring corporation and or an earn-out component.

## **Open Market Price vs Fair Market Value**

The difference between fair market value under a notional market and price as determined in an open market can be significant. The differences arise from factors that

are contrary to the assumptions and conditions in the determination of Fair Market Value in the notional market context. For example:

- open market price may include consideration for post-acquisition synergies, while fair market value in the notional market context is often determined on a stand-alone or intrinsic basis, which does not consider these synergies;
- legal and contractual restrictions that impact the sale of a business and results in a downward impact on value, contrary to the fair market value assumption of an unrestricted market;
- prices are negotiated between parties with differing knowledge, contrary to the fair market value assumption that vendor and purchaser are fully informed of all facts relevant to value determination;
- open market price may be based on imprudent decisions by the vendor, purchaser or both, contrary to the fair market value assumption that a transaction occurs between prudent parties;
- both vendor and purchaser may not be dealing at arm's length, contrary to the fair market value assumption that negotiations between parties are at arm's length;
- the open market price can be from a forced or compulsive act by the vendor, purchaser or both. Fair market value assumes that the transacting parties are under no compulsion to transact; and
- the open market price paid may be a combination of cash and non-cash consideration. Fair market value is based on the assumption that cash or cash equivalent is paid for the acquisition of a business.

## DOCUMENT DISCOVERY TIPS

### Uses and Limitations of Financial Statements in IP Litigation

by *Suzanne C. Loomer, MAcc, CA, CBV, Managing Director, Campbell Valuation Partners Limited*

With changes in financial reporting rules, and the adoption of International Financial Reporting Standards (IFRS) around the world, the value of intellectual property is featuring ever more prominently in financial statements. But what are the implications of this additional disclosure when it comes to litigation involving IP?

As intangible assets such as IP account for an ever-increasing proportion of the value of many companies, IFRS are intended to provide more transparency regarding their values. Thus for lawyers involved in IP litigation matters, these standards will facilitate access to more information in financial statements about the value of intellectual property.

#### Treatment of Acquired IP in Financial Statements

Up until about 2001 (in Canada), acquired intangible assets including patents, trademarks, trade secrets, copyrights,

logos, customer lists/relationships, agreements, contracts etc. were all lumped together into "goodwill."

Under changes in Canadian GAAP that took effect in about 2001, the purchase price paid for an acquired business was required to be allocated to tangible and specific intangible assets acquired, with any residual then going to goodwill. The rules under IFRS are similar.

Annual impairment testing of these assets – whether there has been a decline in value of the assets - are (and will continue to be) required under IFRS. Should testing reveal reduced value, the business must take an immediate charge to its accounts.

While in principle IFRS and Canadian GAAP are similar when it comes to accounting for IP, there will be a lot of analyses and disclosure that will come about as a result of the conversion to IFRS, and this may provide discoverable information should litigation arise relating to certain acquired IP.

## Values for Financial Reporting versus Litigation

It is important to recognize that there are differences between the value of IP determined for financial reporting purposes and the value determined for litigation purposes, including the definition of “value” that is used. While the former is governed by Canadian GAAP and soon IFRS, value for litigation purposes may be defined in common law or by statute.

The methodologies used to value IP, however, are relatively consistent regardless of the reason for valuation:

- The income approach involves determining the present value of cash flows attributable to the asset being valued.
- The cost approach values an asset by looking at the costs that went into creating it or the costs needed to re-create it.
- The market approach would determine the value of an IP asset by identifying comparable assets recently sold in the marketplace.

The assumptions underlying the calculation and the selection of a methodology may vary according to the purpose of the valuation and according to which accounting standards are

used (IFRS, Canadian GAAP, US GAAP, etc.). This can create a difference in the conclusions. However, useful information may still be gleaned as part of a litigation matter.

## Documents for Discovery

Lawyers may draw valuable information from company documents prepared for financial reporting purposes, such as the purchase price allocation analysis where values are assigned to individual intangible assets and liabilities.

Annual asset impairment analyses of intangible assets may provide useful information in IP litigation cases because they consider such influences as market conditions, obsolescence, adverse environmental changes (technological, market, economic, legal), etc. to determine how IP is performing and whether it has lost value. These analyses may be prepared by management or by an independent valuation firm.

Understanding documents that are compiled for financial reporting requirements relating to IP under Canadian GAAP and the increased focus on IP (on balance sheets) as companies convert to IFRS, can be another source of discovery information that historically has not been available in cases involving intellectual property.

## ANNOUNCEMENT

We are pleased to announce that Suzanne Loomer, MAcc, CA, CBV, has joined Campbell Valuation Partners as a Managing Director. Suzanne has more than 15 years experience in the areas of succession planning, intellectual property and intangible asset valuation, and litigation support.

We are also pleased to announce the recent addition of Neil de Gray, CA, to our team of professionals. Neil was on the National Honour Roll in the 2008 Chartered Accountancy exams.

### DID YOU KNOW?

Campbell Valuation Partners Limited is affiliated with [Veracap Corporate Finance](#), which helps business owners and executives maximize shareholder value through acquisitions, divestitures, private equity financing and related services. This real-world experience provides us with valuable insight which guides the CVPL valuation practice.

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## **Campbell Valuation Partners Limited**

Campbell Valuation Partners Limited (CVPL) is Canada's longest established independent valuation firm specializing in business valuation, damages quantification and related litigation support services. Veracap Corporate Finance - a subsidiary of CVPL - helps business owners and executives to maximize shareholder value through acquisitions, divestitures, private equity financing and related services.

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