

# EXPERT insights

A Quarterly Newsletter for the Legal Community

Published by Campbell Valuation Partners Limited

Volume 2, Issue 2 Spring 2011



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

### IN OUR PREVIOUS NEWSLETTER:

- we continued our series on business valuations concepts, discussing the approaches generally used to determine value; and
- we discussed how the recent ruling in the Uniloc USA, Inc. et al v Microsoft Corporation case impacts the evaluation of royalty rates used as a basis of determining damages.

### IN THIS EDITION OF EXPERT INSIGHTS:

In this issue we present an article outlining issues to consider in the determination of maintainable earnings. This issue will be of interest to litigators engaged in disputes involving the value of a business interest or business income losses.

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.

# WHAT IS MAINTAINABLE?

by Neil de Gray, CA, Director, Campbell Valuation Partners Limited

As discussed in our previous edition of EXPERT insights, a business that is considered to be economically viable is generally valued using a going concern approach. One of the more common techniques used to assign value under the going concern approach is the Capitalized Earnings Methodology. This methodology is typically adopted for mature businesses with relatively stable earnings that can be reasonably estimated into perpetuity and/or when a reasonable forecast of cash flows is not available.

Two principal components of the capitalized earnings methodology are:

- (a) the annual after-tax maintainable earnings; and,
- (b) the after-tax risk adjusted rate of return. The maintainable earnings after-tax is “capitalized” by this rate of return.

The focus of this article is to provide insight into what comprises maintainable earnings and to explain how the level of maintainable earnings is evaluated and computed. We will discuss rates of return in our next newsletter.

## Maintainable Earnings

Maintainable earnings equates to the prospective average annual income expected to be produced from the operating activities of the business. In other words, maintainable earnings represent the best estimate of the expected future discretionary income from operations of the business. Maintainable earnings can be expressed as a point estimate or as a reasonable range of values.

Assessing an objective and reasonable maintainable earnings level requires professional judgment and analysis of:

- (a) the business and its prospects; and,

- (b) the prevailing and prospective economic and industry conditions and how these conditions affect the entity’s operations and reported results.

In arriving at a reasonable estimate of maintainable earnings the following factors may be considered:

### Historic Operating Results

Historic operating results, if available, are often the starting point in estimating a reasoned maintainable earnings level. The results of operations from previous periods provide an

objective benchmark upon which future operating levels may be estimated; however, it is important to obtain reasonable assurance that past performance is indicative of future periods and that the business conditions have not materially changed. There are many common situations in which historic results may have to be adjusted to reflect the prospective operations of the business. For example:

- significant changes to the competitive landscape and industry. The consolidation of the industry, arrival or exit of competitors or changes in consumer behavior can have a material impact on the prospective operating results of a business;
- revenue and expense items have to be adjusted for non-recurring and/or unusual items to reflect potential operating results on a go-forward basis. Such items may include one-time litigation costs, large and unusual single sale contracts, moving expenses, and restructuring charges;
- in owner-managed and privately-held businesses, compensation expenses often require adjustment to reflect the market value for services rendered;

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**“...maintainable earnings represent the best estimate of the expected future discretionary income from operations of the business.”**

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- non-arm's length transactions consummated at non-commercial rates must be adjusted to commercial terms to reflect the market value of the underlying transaction; and,
- income or expenses derived from redundant assets (those assets considered unnecessary to the day to day operations of the business) are excluded as these assets are valued separate and apart from the ongoing core operations.

When reviewing financial projections, and the rigour of the company's budgeting process, it is important to understand the purpose of the projection. Useful budgets are clear of bias

and are prepared by individuals with the ability and knowledge to accurately anticipate future performance. Reviewing and testing the historical forecasting abilities of management versus actual results is one technique that can assist in establishing the reliability of financial projections.

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**“...results must be analyzed in the context of prevailing and prospective market conditions and business developments.”**

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### ***Prospective Operating Results***

Management frequently prepares an annual budget representing their best estimate of the operating results for the upcoming year. A well formulated budget provides insight into management's expectations and may reveal business trends or factors that should be considered in assessing maintainable earnings. That is because management often has significant insight into the industry, the business and its participants and has a wealth of knowledge about the business that can only be developed through experience. In this capacity, management's assumptions may highlight risks and opportunities that are important to the valuation analysis.

### ***Other Considerations***

In situations where historical or prospective cash flows are not, in isolation, a reasonable estimate of prospective operating results, it may be necessary to use a combination or average thereof. Depending on the particular facts of the case, a simple or weighted average of past and prospective operating results may provide the best estimate of projected cash flows.

### ***Conclusion***

It is most often the case that reported and projected operating results provide a foundation upon which a reasonable estimate of maintainable earnings can be predicated, but these results must be analyzed in the context of prevailing and prospective market conditions and business developments.

## **DID YOU KNOW?**

Did you know...that financial experts who are retained at the discovery stage of a legal matter can assist counsel in identifying required documents necessary for damages quantification, and can assist in identifying discovery questions.

## SEMINARS

## THE CREATING VALUE™ SERIES

### Creating Value...Creating Choice

*part of a Breakfast Seminar Series for Business Owners*

Do you know how much your business is worth?

What return on investment does your business give you?

Do you have a succession plan?

Our panel of experts will share valuable insights and real life experience on value measurement, value creation and value realization strategies for owner-managed businesses. Having an “end game” and planning ahead for it means you can maximize the value of your business and create choice in how that value is realized.

#### WHEN & WHERE:

May 4, 2011  
Toronto Sheraton Airport Hotel  
801 Dixon Road, **Toronto**

May 5, 2011  
The Oakville Club  
56 Water Street, **Oakville**

#### ITINERARY

7:30 am – Registration &  
Continental Breakfast  
8:00 am – Presentation begins  
9:30 am – Q&A  
10:00 am – Adjournment

### SPACE IS LIMITED

Advanced Registration Is Required

Register At:

[www.eplyevents.com/valueserieseply](http://www.eplyevents.com/valueserieseply)

**COST:** \$75.00 + HST

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# EXPERT insights

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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.

For more information or to access other publications, seminars and resources, please visit us online at [www.cvpl.com](http://www.cvpl.com).

70 University Avenue, Suite 320  
PO Box 11, Toronto, ON M5J 2M4  
tel: 416-597-1198 fax: 416-597-9779

