GUEST COLUMN

Part Two On Business Succession Planning

How The Advantage May Be Given To The Child Keeping The Business

By Andrea Pontoni

As a result of questions posed to me from my first article on "Business Succession Planning," I thought a follow-up article would be in order. The original article is in the November/December 2018 issue of ***Biz X*** magazine (available in the "Back Issues" section at: BizXmagazine.com).

The main and common question was, "Andrea, I thought the value of a business is a mathematical formula, so how can the advantage be given to the child retaining the business? Isn't the value of a business a proven methodology and calculation?"

Well, to answer the above question you have to understand that a business valuation involves some science and some subjective components. Let's call these subjective components the art of a business valuation.

The science of a business valuation are the mathematical formulas and theories used to attempt to quantify the value of a business based on assumptions of expected future cash flows/earnings and the expected risks associated in achieving these cash flows.

It is correct to say that the mathematical formulas themselves leave little room for manipulation, unless they have been applied incorrectly. This issue is fairly obvious and is a matter of competence and training,

The **Canadian Institute of Chartered Business Valuators** and the **American Society of Appraisers** have extensive training and accreditation programs designed to ensure these valuation mathematical formulas are applied correctly and in the right circumstances, essentially governing valuation bodies protecting the public's interest.

The art of a business valuation typically involves the variables/data that are inserted into these mathematical formulas for the purpose of generating a business value. Some of these variables, which involve professional judgement and affect a business valuation, include the following . . .

• The assessment of normalized or sustainable earnings and cash flow

• The assessment of sustainable capital reinvestment

• The assessment of the potential growth rate of the company

• The assessment of the risks associated with the company in achieving future cash flows

• The assessment of a normal financial capital structure

• The assessment of normal related party compensation and expenses

• The assessment of a normal cost structure for the organization

• The assessment of, and the selection of, the appropriate valuation approach and methodology

• Etc…

Therefore, the quality of these variables and professional judgement is crucial in ensuring a fair valuation. The quality primarily stems from various source information, which may include the company's records, external research databases and independent professional judgement.

The first two sources are self explanatory; professional judgement however, is based on a significant amount of experience developed over an extensive period. In some respects, even the most experienced professional continues to refine his or her professional judgement.

Professional judgement, on the selection of the appropriate data and variables to be inserted in these mathematical valuation formulas, is where the manipulation of business value lies.

Not unlike a Trial Judge, it is crucial for the business valuator to be of the right mindset when assessing these subjective variables used in a business valuation. Any bias in the business valuator's assessment will be reflected in the end values. That is "Garbage In, Garbage Out."

So, just like a Trial Judge, you want your business valuator to be as independent as possible and of the right mindset, so the highest level of standards and integrity are reflected in a quality business valuation.

If your business valuator is of the wrong mindset and possesses bias towards one party or the other, they can easily manipulate and disguise the variables discussed above to suit their purpose, thereby favouring one party over the other and producing a substandard valuation.

So let's go back to the original question posed to me, "How can the child retaining the business be given the advantage in a succession plan?" Well, if the corporate accountant or any other individual prepares the business valuation and is motivated to retain the annual recurring accounting, tax and consulting fees from the child ("child 1") who is being transferred the business, they can easily manipulate any of the valuation variables to suit child 1. A lower value would be in child 1's best interest. This of course would be to the disadvantage of the other siblings in the family who chose not to retain the business.

This is why, in a succession plan, it is to all family members' best interests to ensure the business valuator is indeed independent, in fact and appearance. ***You truly want to understand and evaluate the business valuator's past and future relationships to all stakeholders connected with the valuation outcome.***

In an estate situation when the parents pass, these succession planning transactions might be scrutinized further. All siblings are typically beneficiaries of the parents' estate, and if the parents' estate has been depleted due to a biased valuation of one of the parents' most significant assets, this may then become a significant issue in resolving the estate distributions.

If you are in this situation, I would recommend consulting your own independent legal counsel and business valuator in order to assess the issues.

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