

**THE CANADIAN INSTITUTE OF
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**PRACTICE STANDARDS, TAX VALUATIONS
AND VALUATION METHODOLOGIES —
CICBV vs. ASA**

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My paper is intended to present a comparison of:

- (a) The professional standards of The Canadian Institute of Chartered Business Valuators (CICBV) and the American Society of Appraisers (ASA);
- (b) The pronouncements of Revenue Canada and the U.S. Internal Revenue Service as regards the determination of fair market value; and
- (c) The valuation methodologies applied by respective valuers in each country.

1. STANDARDS

Both The CICBV and the ASA have respectively promulgated a number of business valuation standards in the last few years. The ASA Business Valuations Standards were first drafted in 1992, with additional standards promulgated thereafter, as recently as January of this year. The CICBV started to issue standards in 1993. Both The CICBV and the ASA are now taking a break; at this juncture neither society has any proposed standards on the drawing boards, except that The CICBV is drafting a guideline, “Glossary of Valuation Terms” and “Definitions” for publication later this year.

1.1 International Standards

From a practical perspective, standards have become more important at the international level. For example, because of the North America Free Trade Agreement (“NAFTA”), there are, and will continue to be, more and more situations where it will be increasingly important for a valuator in one country to place reliance upon the opinion of a valuator in another country. For example, a Canadian valuator may wish to rely on the opinion expressed by a Mexican valuator concerning the acquisition of a business interest in Mexico by a Canadian purchaser. If similar standards prevailed in Mexico, the Canadian valuation advisor would have comfort in relying on the Mexican valuator’s opinion. In fact, *reliance* on other experts is addressed in CICBV Standard 120. Similarly, a Mexican valuation advisor would wish to be satisfied that the opinion of a Canadian business valuator is in conformity with appropriate valuation standards.

Recognizing the need to standardize standards, a colloquium this topic was held exactly two years ago in Mexico City, *Il Coloquio Internacional, Homologacion de Normas Valuatorias entre Mexico-Estados Unidos-Canada*. This colloquium was sponsored by the Comision de avaluados de Bienes nacionales (the governmental agency responsible for valuing all property bought or sold by the Federal Government X referred to as CABIN). It centred on the *Uniform Standards of Professional Appraisal Practice* (USPAP) X in the context of NAFTA X and, more specifically, *appraisal standards, ethics and concepts* among Canada, the U.S. and Mexico. As a Past President of The CICBV and as ASA Governor for Canada, I had the good fortune to be invited by the organizers to address this two-day conference (which was attended by nearly 400 professionals, as well as Mexican government officials and the press). I outlined the standards of The CICBV as well as The Appraisal Institute of Canada (which is the only Canadian valuation society subscribing to USPAP) and discussed the structure of the appraisal profession in Canada. At CABIN’s request, I also outlined the respective pronouncements, policy statements and/or regulations promulgated by Revenue Canada, the Quebec Department of Revenue, the Ontario Securities Commission, the Quebec Securities Commission, Vancouver Stock Exchange, Alberta

Stock Exchange, the British Columbia Securities Commission and, where appropriate, the position of the Canadian courts on the interpretation of “fair market value”, “fair value” and “value to owner”.

The Mexican participants (who made up, by far, the majority of the attendees) were particularly interested in hearing about the development of the business valuation profession in Canada, as they see a number of similarities between Mexico and Canada when dealing with their “giant” neighbour on the other side of the border.

All this is to say that as we become more globalized, standards will be increasingly recognized at an international level and not simply restricted to the local level. It is not inconceivable that there will, in the not-too-distant future, be international standards whereby valuers around the world will conform to the same basic standards. For example, there is now a new appraisal group, the International Valuation Standards Committee (IVSC).

Forty countries have representation on the IVSC, of which ten countries form the “management group”.¹ At a meeting two months ago in Sydney, Australia, two draft documents were discussed in detail and are currently being modified for final draft printing and acceptance by the full Committee at their meeting this autumn:

- Applications and Performance Guidance No. 1: *Going Concern Concept of Valuation*.
- Applications and Performance Guidance No. 2: *Consideration of Environmental Factors in Valuation*.

(1) The ten countries include Canada, the United States, Mexico, France, the United Kingdom, Australia, Japan, South Africa, Norway and New Zealand.

Two other drafts, which were discussed in less detail, are still being reworked:

- Applications and Performance Guidance No. 3: *Valuation of Public Sector Assets*.
- Applications and Performance Guidance No. 4: *Plant, Machinery & Equipment*.

Gregory Gilbert, ASA Representative X IVSC, and a former Governor of ASA, was asked to submit Application and Performance Guidance level papers on Business Valuation and Intangible Asset Valuation. Greg intends to prepare drafts this summer for circulation within ASA before presentation to the International Valuation Standards Committee this autumn.

Finally, a Glossary of Terms as used in the various countries is being planned by IVSC and a paper is currently being prepared on *Accounting vs. Valuation*.

As my paper is intended to provide a comparison of the valuation standards of The CICBV and ASA, I shall focus only on the respective standards of these two appraisal societies.

1.2 The CICBV

Many CBVs are also ASAs or currently proceeding toward the ASA designation and, as such, must also have a sound knowledge of the ASA Standards, which include USPAP. In this latter context, a CBV aspiring to obtain ASA status X or wishing to maintain ASA status at recertification time (see below) X must now take a 15-hour course and successfully complete an

examination on USPAP promulgated by The Standards Board of The Appraisal Foundation.² This is in addition to earning sufficient recertification credits.

During 1993, 1994 and 1995, The CICBV issued Practice Standards and Recommendations relating to (a) the valuation of business ownership interests and (b) the quantification of economic damages:

	Valuation Reports Standards and Recommendations	Advisory Reports Report Disclosure Standards and Recommendations	Expert Reports Report Disclosure Standards and Recommendations
Report Disclosure	110*	210	310
Scope of Work Standards	120	220	320
File documentation	130	230	330

* Includes Appendix A (see below).

CBVs must apply The CICBV Standards in the performance of their work unless otherwise indicated (i.e., unless there is only a recommendation³ or explanatory comment). The CICBV Practice Standards were promulgated following comments received from The CICBV membership on Exposure Drafts which had been circulated earlier.

The Standards apply when the valuator issues an *opinion report*, rather than an informal report with comments or calculations. Where the latter type of report is issued, the standards may be viewed as recommendations instead of requirements.

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- (2) The Appraisal Foundation is authorized by the U.S. Congress as the Source of Appraisal Standards and Appraiser Qualifications. The USPAP standards must be adhered to when an appraisal is performed for a federally-related transaction pursuant to the *Financial Institution Reform, Recovery, and Enforcement Act*. The ASA recommends that USPAP be followed for all types of engagements, whether federally-related or not.
 - (3) Items noted as Recommendation are not mandatory but are encouraged.

Report summaries are exempt from the Standards and Recommendations, provided that they make clear reference to the more formal reports. While documents which are clearly marked as being in draft form are not subject to the Standards, a member may not use a draft report to circumvent the standards.

The Practice Standards and Recommendations apply to the following types of reports, each of which would be issued in connection with the undernoted separate and distinct types of engagements:

1.2.1 Valuation Report (Standards #110 and Appendix A, #210 and #310)

Defined as “any written communication on letterhead and/or where the author is identified, containing a conclusion as to the value of shares, assets or interest in a business, prepared by a valuator acting independently and which is not clearly marked as being in draft form”. If a valuation report forms part of an advisory report or expert report, it must follow the pronouncements of Standard 110 (see below).

1.2.2 Advisory Report (Standards #210, #220 and #230)

Defined as “any written communication on letterhead and/or where the author is identified, containing a conclusion as to the value of shares, assets or an interest in a business or as to quantification of financial gain/loss (economic losses, loss of income/profits) prepared by a valuator who is *not* acting independently and that is not clearly marked as being in draft form”. Examples include:

- Where the valuator is involved in mergers and acquisitions activity or operates as a business broker;
- Where the valuator is employed by and/or has an equity interest in a party to the transaction or dispute and is providing consultative services to that party; and
- Where the valuator has been engaged as an advisor to one party in a transaction or dispute and has prepared a report as part of the consultative and negotiating process.

1.2.3 Expert Report (Standards #310, #320 and #330)

Defined as “any written communication other than a valuation report, on letterhead and/or where the author is identified, containing a conclusion as to damages or the quantum of financial gain/loss, prepared by a valuator acting independently and that is not clearly marked as being in draft form”.

1.2.4 Valuation Report Issued for Securities Regulations/Policies Purposes

Valuation reports issued pursuant to securities regulations or policies of the Province of Ontario⁴, as specified in Appendix A to Standard 110, require substantially more disclosure (see Summary attached).

Appendix A to CICBV Standard 110 states:

(4) For example, *Policy 9.1* of the Ontario Securities Commission, Section 182 of the Regulation to the *Securities Act* (Ontario) and Section 190 of the Ontario *Business Corporations Act*.

“While it is not required that sufficient information be provided to enable the reader to perform his or her own independent valuation, a Valuation Report should contain sufficient narrative and schedules to support the opinion and calculations for the purposes at hand. The source of any fact which is material to the formal valuation must be clearly stated, including sufficient details so that the significance of the fact can be reasonably assessed by the reader of the report. Adequate disclosure will usually include a comparison of valuation calculations and conclusions arrived at through different methods, a discussion of the rationale for accepting or rejecting each methodology and the relative importance or weighting of relevant methodologies in arriving at a final valuation conclusion. A summary of a full Valuation Report will be sufficient only if it provides a sufficiently detailed review of all material factors contained in the Valuation Report so that readers can understand the valuer’s key assumptions and calculations made in arriving at its conclusion.

“A greater level of disclosure is generally required in valuations prepared for the above described purposes than in other circumstances and/or for other purposes However, the disclosure items set out herein are not necessarily exclusive to Valuation Reports to which this Appendix applies. These may or may not be appropriate in other circumstances.”

Valuation reports and expert reports which are likely to be disclosed to the public require a higher standard than with respect to reports which will be used only by well-informed management, directors and/or shareholders. The essential differences relate to the amount of detail as well as the sophistication of the information provided.

The CICBV interprets the disclosure standards for valuations and fairness opinions as contained in Securities Regulations or Policies (e.g., OSC Policy 9.1) as providing disclosure sufficient to allow a shareholder to understand the basis of the valuation or fairness opinion and to form a reasoned view on the opinion conclusion.

None of The CICBV Standards contains a departure provision.

The CICBV is also developing plans for the education of its members and students on the current Standards and reviewing the need for new or expanded Standards, particularly those relating to fairness opinions, future-oriented financial information and other matters related to OSC Policy 9.1, Quebec Policy Statement Q-27, and so forth. The CICBV has stated that it is a major strate-

gic objective of the Institute is to work with securities regulators and the investment community to ensure that valuation and fairness opinions are performed by professionally accredited valuers supported by effective Standards. Ultimately, a required qualification for a valuator preparing an opinion pursuant to securities regulations should be the CBV designation; this would result in The CICBV's Standards and Disciplinary Procedures applying to all such opinions.

During the year, one of The CICBV's committees conducted a review of disclosure adequacy in valuations and fairness opinions for the Vancouver Stock Exchange, similar to the one which was conducted for the OSC two or three years ago, the objective of such review being to develop recommendations which would enhance standards.

While the foregoing is encouraging, my personal and humble view is that The CICBV must adopt USPAP and secondly should be required to recertify every five years.

1.3 ASA

The ASA Business Valuation Standards (which are used in conjunction with the *Principles of Appraisal Practice and Code of Ethics* of ASA and with USPAP, were first draft in 1992. As the ASA has adopted USPAP, the USPAP Standards are therefore mandatory for members of ASA. Note that The CICBV has not adopted USPAP, whereas The Appraisal Institute of Canada (a real estate appraisal society) has.

Through its Business Valuation Committee, the ASA has promulgated a series of Business Valuation Standards, drafted by the BV Standards Subcommittee (on which I have been serving for five years). The approved ASA Business Valuation Standards include all standards approved through January 1996, and are for use in conjunction with USPAP as well as the ASA *Principles of Appraisal Practice and Code of Ethics*. These ASA Business Valuation Standards are as follows:

<u>Item</u>	<u>Title</u>
PREAMBLE	
BUSINESS VALUATION STANDARDS	
BVS-I	General Requirements for Developing A Business Valuation
BVS-II	Financial Statement Adjustments
BVS-III	Asset-Based Approach to Business Valuation
BVS-IV	Asset-Based Approach to Business Valuation
BVS-V	Market Approach to Business Valuation
BVS-VI	Reaching a Conclusion of Value
BVS-VII	Valuation Discounts and Premiums
BVS-VIII	Comprehensive, Written Business Valuation Report
DEFINITIONS	
STATEMENTS ON BUSINESS VALUATION STANDARDS	
SBVS-1	The Guideline Company Valuation Method
PROCEDURAL GUIDELINES AND/OR ADVISORY OPINIONS (To be issued when appropriate)	

Standard BVS-VII was approved by the ASA Board of Governors in January 1996. Even though the Standard is contained on only one page, as a member of the Standards Subcommittee who participated in the preparation of this standard, I can tell you that it took us one and one-half years to develop it.

The ASA Board of Governors approved the foregoing as standards providing minimum criteria to be followed in valuing businesses, business ownership interests or securities. However, if in the opinion of the valuator, circumstances of a specific business valuation mandate dictate a departure from any provisions of any particular standard, the valuator must disclose such departure.

The Preamble (which was revised in January 1994) states:

“These Standards are designed to provide guidance to ASA Appraisers conducting business valuations and to provide a structure for regulating conduct of members of the ASA through Uniform Practices and Procedures. Deviations from the Standards are not designed or intended to be the basis of any civil liability; and should not create

any presumption or evidence that a legal duty has been breached; or create any special relationship between the appraiser and any other person.”

Currently there are no other standards being drafted by the ASA Business Valuation Standards Subcommittee, although this member has suggested, for consideration, a Procedural Guideline (rather than a Standard) relating to Litigation Support services.⁵

1.3.1 USPAP

USPAP includes other standards as well as Statements on Standards and accompanying Advisory Opinions. Although only Standards and 10 apply specifically to business valuation, ASA business valuers must be familiar with all parts of USPAP. To satisfy the ASA five-year recertification requirement, an ASA must now take the 15-hour mandatory USPAP course and pass the USPAP examination as one of the criteria for obtaining recertification.⁶ Specifically, the ASA requires a minimum of 40% of the total hours needed in order to maintain accreditation to be in the field of continuing education. This includes successful completion of the USPAP course and examination as well as speeches, instruction and other program participation in the valuation profession, published articles, and other literary contributions to the profession.

(5) Note that both the Canadian Institute of Chartered Accountants and the American Institute of Certified Public Accountants have issued Practice Aids relating to litigation support services rendered by their respective members.

(6) Accredited members are required to “reaccredit” every five years by submitting evidence of professional growth through continuing education and/or professional activities. Senior members failing to reaccredit are “demoted” to the grade of Accredited Member. (There are authorized alternatives to the full five-year reaccreditation in that an ASA Senior Member who has accumulated less than the necessary and required hours (100 hours over a five-year period) may request reaccreditation for less than five years.)

USPAP’s contents are as outlined below. Advisory Opinions provide examples and advice in certain areas, but the USPAP standards as well as the Statements on Appraisal Standards are mandatory.

1996 UNIFORM STANDARDS OF PROFESSIONAL APPRAISAL PRACTICE	
Introduction	
Preamble	SMT-5 Confidentiality Rule of the Ethics Provision
Ethics Provision	SMT-6 Reasonable Exposure Time in Market Value Estimates
Competency Provision	SMT-7 Permitted Departure from Specific Guidelines for Real Property Appraisals
Departure Provision	SMT-8 Electronic Transmission of Reports
Jurisdictional Exception	
Supplemental Standards	Advisory Opinions
Definitions	AO-1 Sales History
Standards and Standards Rules	AO-2 Inspection of Subject Property Real Estate
Standard 1 Real Property Appraisal	AO-3 Update of an Appraisal
Standard 2 Real Property Appraisal, Reporting	AO-4 Standards Rule 1-5(b)
Standard 3 Review Appraisal and Reporting	AO-5 Assistance in the Preparation of an Appraisal
Standard 4 Real Estate/Real Property Consulting	AO-6 The Review Appraisal Function
Standard 5 Real Estate/Real Property Consulting, Reporting	AO-7 Marketing Time Estimates
Standard 6 Mass Appraisal and Reporting	AO-8 Market Value vs. Fair Value in Real Property Appraisals
Standard 7 Personal Property Appraisal	AO-9 Responsibility of Appraisers Concerning Toxic or Hazardous Substance Contamination
Standard 8 Personal Property Appraisal, Reporting	AO-10 The Appraiser-Client Relationship
Standard 9 Business Appraisal	AO-11 Content of the Appraisal Report Options of Standard 2
Standard 10 Business Appraisal, Reporting	AO-12 Use of the Appraisal Report Options of Standard 2
Statements on Appraisal Standards	AO-13 Performing Evaluations of Real Property Collateral to Conform with USPAP
SMT-1 Standards Rule 3-1(f) (Review Appraisal)	AO-14 Appraisals for Subsidized Housing
SMT-2 Discounted Cash Flow Analysis	AO-15 Using the DEPARTURE PROVISION in Developing a Limited Appraisal
SMT-3 Retrospective Value Estimates	
SMT-4 Prospective Value Estimates	

USPAP Standards include explanatory comments and begin with an Ethics Provision setting forth the requirements for integrity, objectivity, independent judgment and ethical conduct. In addition, the Standards include a Competency Provision which places an immediate respon-

sibility on the appraiser prior to acceptance of an engagement. Definitions applicable to these Standards are also included.

The Standards address the procedures to be followed in performing an appraisal, review or consulting service and the manner in which any of these is communicated. Standards 1 and 2 relate to the development and communication of real-property appraisal. Standard 3 establishes guidelines for reviewing an appraisal and reporting on that review. Standards 4 and 5 address the development and communication of various real-estate or real-property consulting functions by an appraiser. Standard 6 sets forth criteria for the development and reporting of mass appraisals for U.S. *ad valorem* tax purposes or any other universe of properties. Standards 7 and 8 establish guidelines for developing and communicating personal property appraisals. Standards 9 and 10 establish guidelines for developing and communicating business valuations.

The Standards include Statements of Appraisal Standards for purposes of clarification, interpretation, explanation or elaboration of a Standard or Standards Rule.

Standards 9 and 10 of USPAP relate directly to Business Valuation and intangible asset valuation; however, The Appraisal Foundation is currently considering the application of other USPAP standards to business valuation as well. In this latter respect, the Business Valuation Committee of ASA, on the advice of the BV Standards Subcommittee, will consider making representations to The Appraisal Foundation. We shall be meeting in Toronto in two weeks, just before the Annual International Appraisal Conference.

The Appraisal Standards Board of The Appraisal Foundation develops and amends appraisal standards through communications with appraisers and users of appraisal services. It is an active, on-going and evolving process. For example, changes that have been implemented between 1995 and 1996 include the following:

- Revisions to the Record Keeping sections of the Ethics Provision, clarifying the appropriate content of an appraiser's working paper file.
- Revisions to Standard 3 to discuss review-appraiser treatment of data which were not available as of the date of the original appraisal.
- Implementation of Statement on Appraisal Standards No. 8, *Electronic Transmission of Reports*, addressing the appraiser's ability to transfer appraisal reports electronically in accordance with USPAP, security of the appraisal report and a definition for "signature".
- Revision of Advisory Opinion A-10 on *The Appraiser-Client Relationship*, addressing regulated financial institution acceptance of an appraisal prepared by an appraiser engaged directly by another financial services institution.
- Adoption of Advisory Opinion AO-13, *Performing Evaluations of Real Property Collateral to Conform with USPAP*, which discusses and provides illustrations of appraiser's ability to perform valuations in accordance with USPAP.
- Adoption of Advisory Opinion AO-14, *Appraisals for Subsidized Housing*, addressing the appraiser's competency and value-definition issues relating to the appraisal of subsidized housing.
- Adoption of Advisory Opinion AO-15, *Using the Departure Provision in Developing a Limited Appraisal*, which discusses an appraiser's ability to utilize the Departure Provision in developing a value estimate and approval of a Glossary for USPAP containing technical words and phrases not included in the Definitions section, in order to help understanding USPAP.

As of the presentation of this paper, several issues were in the process of development by the Appraisal Standards Board:

- a proposed revision to the Ethics Provision with respect to avoiding bias in appraisals and appraisal reports;
- an accompanying proposed Advisory Opinion on *Avoiding Discrimination in Real Property Appraisals and Reports*, which modifications will discuss discrimination and the appraiser's obligation to be aware of and avoid bias in appraisals and appraisal reports;
- a proposed Advisory Opinion on *Prospective Appraisals or Current Appraisals of Real Property With Proposed Improvements Under Hypothetical Conditions*, which will discuss when a real-property current value estimate, based on the assumption of completion of improvements, is permitted under USPAP;
- working draft documents regarding the definition of client, the identification of the client and intended user(s) of an appraisal report and the identification and limited use(s) of appraisal, review and consulting reports;
- consideration by the Appraisal Standards Board of revisions to USPAP Standard 3 to include the review of all appraisals (not limited to real property appraisals) and expanding the reporting options of Standard 2 to other disciplines, including Business Valuation; and
- exposing for public comment revisions to Standards 4 and 5 and the Definitions section regarding consulting assignments.

In addition, Exposure Drafts have been circulated requesting written comments on proposed revisions to Standards Rule 1-3(a)⁷, a proposed Advisory Opinion on *Fair Housing Laws and*

(7) The proposed revisions delete language similar to that recently adopted in the *Conduct* section of the Ethics Provisions and replaced the term "neighborhood" with "market area".

Appraisal Content, a proposed Statement on *Identification of Intended Use in Appraisal, Consulting or Review Assignments and Reports*⁸, as well as a Second Exposure Draft of a proposed Advisory Opinion on *Appraisals of Real Property With Proposed Improvements*.

2. COMPARISON OF STANDARDS: CICBV vs. ASA

The following are the basic differences between the CICBV Standards and those promulgated by ASA:

2.1 Departure Provision

None of the CICBV Standards contains a Departure Provision. The Departure Provision under USPAP permits limited departures from sections which are classified as *specific guidelines*, not from *binding requirements*. The burden of proof is on the valuator to decide, before accepting an assignment and invoking this provision, that the result will not be confusing or misleading. The burden of disclosure is also on the valuator to report any departures from *specific guidelines*. Again, departure from the *binding requirements* of USPAP (which are analogous to the Standards set out in bold character in the CICBV Standards) is not permitted; departure is permitted only where specifically indicated, in a limited manner from *specific guidelines* rather than *binding requirements*. Moreover, the USPAP Departure Provision does not apply to the USPAP Preamble, Ethics Provision, Competency Provision and Definitions sections.

(8) The Exposure Draft addresses use-related information an appraiser is required to identify and consider in the course of accepting and completing an appraisal, consulting or review assignment and report.

2.2 Certification

The CICBV Standards do not require certification such as that specifically required by Section II, “Signature and Certification”, of ASA Business Valuation Standard BVS-VIII, *Comprehensive, Written Business Valuation Report*, as well as by USPAP. This certification, which is required by ASA business valuers, must contain a certification similar in content to the following form:

“I certify that, to the best of my knowledge and belief:

- the statements of fact contained in this report are true and correct.
- the reported analyses, opinions, and conclusions are limited only by the reported assumptions and limiting conditions, and are my personal, unbiased professional analyses, opinions, and conclusions.
- I have no (or the specified) present or prospective interest in the property that is the subject of this report, and I have no (or the specified) personal interest or bias with respect to the parties involved.
- my compensation is not contingent on an action or event resulting from the analyses, opinions, or conclusions in, or use of, this report.
- my analyses, opinions, and conclusions were developed, and this report has been prepared, in conformity with the Uniform Standards of Professional Appraisal Practice.
- no one provided significant professional assistance to the person signing this report. (If there are exceptions, the name of each individual providing significant professional assistance must be stated.)”

Departure from this binding requirement is not permitted.

2.3 File Documentation Standards

The CICBV has three full standards on file documentation, Standards 130, 230 and 330 each of which relates to Valuation Reports, Advisory Reports and Expert Reports, respectively. ASA's Business Valuation Standard BVS-I, *General Requirements for Developing a Business Valuation*, simply states that “[t]he appraiser shall appropriately document and retain all information and work product that were relied on in reaching the conclusion”.

2.4 Expert Report

The CICBV has promulgated a specific series of Standards with respect to expert reports (Standards 310, 320 and 330). Neither the ASA Standards nor USPAP contain such standards *per se*. However, the BV Standards Subcommittee of ASA may entertain a “procedural guideline” for expert reports. At a Subcommittee meeting two years ago, the members felt that a standard relating to expert reports would not be appropriate; however, if there were to be any pronouncements, they would be issued as procedural guidelines. The matter is still under review.

2.5 Review Appraisal

The CICBV has not promulgated any standards, to date, with respect to the Review Appraisal function of its members. The function of reviewing a valuation involves the preparation of a separate report or a file memorandum by the valuator retained to perform the review, which sets forth the results of his or her review process. The review process goes beyond checking for a level of completeness and consistency in the valuation report under review by providing comment on its content and conclusions. The review appraiser may, or may not, have first-hand knowledge of the subject property of, or data in, the valuation report.

Standard 3 of USPAP requires that, in reviewing a valuation and reporting the results of that review, a valuator must form an opinion as to the adequacy and appropriateness of the report being reviewed and must clearly disclose the nature of the review process undertaken.⁹ In performing the review appraisal function pursuant to USPAP Standard 3, the review appraiser is subject to the Ethics Provision, the Competency Provision and all applicable sections of USPAP.

USPAP Standards Rule 3-1 provides that, in reviewing an appraisal, an appraiser must, among other things:

- Identify the extent of the review process to be conducted;
- Form an opinion as to the completeness of the report under review in light of the requirements in these standards;
- Form an opinion as to the apparent adequacy and relevance of the data and the propriety of any adjustments to the data;
- Form an opinion as to the appropriateness of the appraisal methods and techniques used and develop the reasons for any disagreement;
- Form an opinion as to whether the analyses, opinions and conclusions in the report under review are appropriate and reasonable, and develop the reasons for any disagreement.

(9) The Appraisal Standards Board makes a distinction between the terms “technical review” and “administrative review”, the former being subject to USPAP Standard 3 and the latter (which mainly relates to due diligence functions, decision-making and providing professional advice) are not subject to Standard 3.

Finally, in reporting the results of an Appraisal Review under USPAP, an appraiser must include a signed certification similar in content to that required with respect to the Valuation Report itself.

2.6 Summary

The essential difference between the CICBV Standards and the ASA Business Valuation Standards relate to the relative thrust of each. The CICBV standards deal more with the valuation report, the conveying of its contents to the reader, the degree of disclosure depending on whether the report is directed to well-informed management, the public or is prepared for purposes of securities commission regulations or policies. The CICBV standards also address presentation and content relating to Advisory Reports and Expert Reports, the latter category being divided between those directed to the public and those directed to well-informed parties to the dispute or to their legal counsel. There are also Scope of Work Standards (Standards 120, 220 and 320) and File Documentation Standards (130, 230 and 330).

The ASA standards, on the other hand, deal much more with the requirements for developing the valuation, the carrying out of the valuation whether it be under the Income Approach, the Asset-Based Approach or the Market Approach and also defines and describes the requirements for reaching a final conclusion of value. The ASA standard on Written Business Valuation Reports (Standard BVS-VIII) does not categorize by type of recipient. Furthermore, Section II, Signature and Certification, requires that the type of certification set forth in Standard 10 of USPAP be included and the individual(s) responsible for the valuation conclusion(s) be identified.

As noted earlier, ASAs must recertify every five years or less and must demonstrate that they are totally up-to-date on standards. CBVs have no recertification requirement X not a good idea in my view!

3. PRONOUNCEMENT OF REVENUE CANADA AND THE U.S. INTERNAL REVENUE SERVICE ON BUSINESS VALUATION ISSUES

3.1 Revenue Canada

Revenue Canada issues Information Circulars and Interpretation Bulletins which outline the Department's position on various income tax matters under the *Income Tax Act*.

Revenue Canada's specific pronouncements on business valuation are contained in Information Circular 89-3, dated August 25, 1989, *Policy Statement on Business Equity Valuations*. This Information Circular outlines the valuation principles, practices and policies that the Department generally considers and follows in the valuation of securities and intangible property of closely-held corporations for income tax purposes.

Interpretation Bulletins containing valuation-related pronouncements of the Department include:

- IT-140R3, dated April 14, 1989: *Buy-Sell Agreements*.
- IT-169, dated August 6, 1974: *Price Adjustment Clauses*.
- IT-382, dated June 20, 1977: *Debts Bequeathed or Forgiven on Death*.
- IT-416R3, dated July 10, 1987: *Valuation of Shares of a Corporation Receiving Life Insurance Proceeds on Death of a Shareholder*.

A number of areas are similar to those in U.S. Internal Revenue Service *Revenue Ruling 59-60*. However, there are a few noteworthy differences between Revenue Canada's position and that of the IRS (whether the IRS's position is stated in *Revenue Ruling 59-60* or any of other revenue rulings including *Revenue Ruling 93-12*):

3.1.1 Valuation Methodology

Revenue Canada Policy Statement *Information Circular 89-3* states (Section 8) that “the earnings and asset value methods are the two most generally accepted bases for determining value”. the Policy Statement is silent with respect to the market approach to valuation, making no reference whatsoever to the guideline company method, etc. The only reference to “comparative data” appears in its list of factors which should be considered and analyzed in valuing shares of closely-held corporations, and this list is principally a copy of that set out in Section 4.01 of IRS *Revenue Ruling 59-60*.

“Sec. 4. Factors to Consider.

0.1 It is advisable to emphasize that in the valuation of the stock of closely held corporations or the stock of corporations where market quotations are either lacking or too scarce to be recognized, all available financial data, as well as all relevant factors affecting the fair market value, should be considered. The following facts, although not all-inclusive are fundamental and require careful analysis in each case:

- (a) The nature of the business and the history of the enterprise from its inception.
- (b) The economic outlook in general and the condition and outlook of the specific industry in particular.
- (c) The book value of the stock and the financial condition of the business.
- (d) The earning capacity of the company.
- (e) The dividend-paying capacity.
- (f) Whether or not the enterprise has goodwill or other intangible value.
- (g) Sales of the stock and the size of the block of stock to be valued.
- (h) The market prices of stock of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.”

Paragraph 5(i) of Revenue Canada *Information Circular 89-3* refers to “the stock market prices of comparable stocks of reasonably similar corporations in the same line of business, where these shares are actively traded in an open, unrestricted and public market”. This is analogous to Paragraph (h) of Section 4.10 of IRS *Revenue Ruling 59-60*, which refers to “the market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter”. Sections 4.02(g) and (h) of *Revenue Ruling 59-60* discuss the considerations when “comparable corporations” (guideline companies) are used for comparative purposes by the valuator. The Revenue Canada Policy Statement makes no mention of such comparative data for valuation purposes.

3.1.2 Family and Group Control

Until the IRS released *Revenue Ruling 93-12* concerning minority discounts in family-controlled companies, the IRS and Revenue Canada shared the same views. The IRS now takes the position that there will be no regard to the family relationship of the parties in valuing minority interests for gift tax purposes (and that the Service will follow the *Bright, Propstra, Andrews* and *Lee* decisions of the U.S. Tax Court): “A minority discount will not be disallowed solely because a transferred interest, when aggregated with interests held by family members, would be part of a controlling interest”.

Revenue Canada will not recognize a minority discount where either a related group or an unrelated group of shareholders who control a corporation owned, amongst themselves, at least 50% plus 1 of the issued and outstanding voting shares of the corporation at the same time and if they

have historically acted in concert as a group. “It is a rebuttable presumption that a family group has acted in concert to control a corporation.”¹⁰ The Department also notes:

An assertion by a minority shareholder that he/she is part of a family control group must be considered in light of all relevant factors, including the rights and restrictions attributable to his/her particular shares.

In a situation where the existence of family control is recognized, the Department will employ a *rateable valuation* for each family group member’s shares. (Emphasis added.)

On the other hand, an assertion of group control by family members will be accepted, provided that there is no contrary evidence that they did not act in concert. Groups of relatives other than persons connected by blood or marriage must provide proof that they were part of a controlling family group and acted in concert with that group.

The criteria necessary for acceptance of claims of group control by a group of shareholders dealing at arm’s length include:

- a written agreement under which all the shareholders in the group relinquish their rights to vote and to sell their shares independently at all times; or
- provision in the corporate letters patent, memorandum of association or the bylaws restricting individual rights to vote and to sell their shares independently at all times; or
- permanent release of the individual shareholder’s rights by giving of an irrevocable proxy to a designated person to vote and to sell the shares as he/she sees fit on behalf of all the shareholders in the group; or

(10) Paragraph 32.

- a pattern of conduct to demonstrate that the shareholders acted collusively in all matters relating to the control of the corporation.

Information Circular 89-3 states that, in order to determine whether a certain pattern of conduct is indicative of collusive action in all matters relating to control, Revenue Canada may undertake the following actions individually or in any combination:

- Shareholders' and directors' minutes may be examined to determine the extent of consultation among the group.
- A review of remuneration may be made to insure that all members of the group were treated fairly.
- Interviews with members of the group may be held to determine the role played by each member.
- Details of actual purchases and/or sales made by the claimants may be examined.

Where the Department is satisfied that the documentation provided indicates a consistent pattern of group control, it will apply a rateable valuation for each member's shares, and not apply a minority discount.

The Department also recognizes that effective control can exist in a public corporation where an individual or group has a large block of shares, where through unconditional proxies, a majority of votes at any shareholders' meeting controls management and where the remaining shares are widely dispersed. In these cases, satisfactory evidence of control must be provided.

Each case will be dealt with on its own merits.

3.2 U.S. Internal Revenue Service

The United States Internal Revenue Service have issued the following *Revenue Rulings*, some of which have been referred to above:

Revenue Ruling No.	Subject Matter
59-60	Valuing closely-held business
65-192	Extension of <i>Revenue Ruling 59-60</i> to all types of business interests and to income taxes, gift taxes and estate taxes
68-609	“Formula Method” (Excess Earnings)
77-287	Use of restricted stock studies in quantifying discounts for lack of marketability
83-120	Valuation of preferred shares
93-12	Minority discounts in valuing minority interests of family members in closely-held family controlled businesses

The IRS also issues other types of opinions in the form of Technical Advice Memoranda (TAMs) and private letter rulings. These relate to specific-fact situations with respect to which a taxpayer has sought advice from the IRS (much like Advance Rulings from Revenue Canada).

Perhaps the most significant difference between the pronouncements of Revenue Canada and those of the IRS relate to minority discounts in family-controlled corporations. The position of Revenue Canada is as outlined above, namely that the Department will not allow a minority discount where either a related group or an unrelated group of shareholders controlling a corporation own, among themselves, at least 50% plus 1 of the issued voting shares of the corporation at the same time and have historically acted in concert as group. The IRS, on the other hand, will permit a minority discount, although the size of the discount is not indicated.

However, it should be noted in this respect that *Revenue Ruling 93-12* relates to the U.S. *gift tax* and not income tax. For U.S. gift tax purposes, the fair market value of a gift is viewed from the donee's perspective. Furthermore, Revenue Canada does not address the issue of marketability in *Information Circular 89-3* or any of the above-noted Interpretation Bulletins. On the other hand, the IRS does address the marketability issue in *Revenue Rulings 59-60*¹¹, *77-287* and *83-120*¹².

The IRS *Revenue Rulings* also deal with certain other matters not covered in any of the Revenue Canada pronouncements including, among others, holding company issues, intangible assets, management remuneration, excess earnings and preferred share valuation.

The U.S. Internal Revenue Service has also issued a training guide to its Appeals Officers, *IRS Valuation Guide for Income, Estate and Gift Taxes*, published in January 1994. This publication includes the full text of the *Valuation Training for Appeals Officers* coursebook, which is an aid provided by the IRS in its Appeals Officer Training Program. Written primarily by appeals officers, the coursebook is geared towards trainees with little or no experience in resolving valuation issues. The concept of "fair market value" is discussed as it applies to valuation of real estate, *objets d'art* and closely-held corporations. Problems of comparability, evaluation of expert testimony and appraisal reports are included. Also covered is the determination of intangible value such as goodwill and patents. In summary, the Guide provides taxpayers and tax advisors with insight into the major valuation problem areas and the IRS's views as to the accepted methods and approaches in considering valuation matters.

Finally, as the context in which the respective pronouncements of Revenue Canada and the IRS specifically relate to "fair market value", it is important to bear in mind the definitions of fair market value on each of the border. In the U.S., fair market value is defined as "the price at

(11) Section 4.02(g).

(12) Section 4.06.

which property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts *as of the applicable valuation date*” (emphasis added). It is interesting to note that, except for “as of the applicable valuation date”, the definition contained in IRS *Ruling Revenue 59-60* comports with that contained in the *IRS Valuation Guide*.

An important point with respect to the definition of “fair market value” in each country: In Canada, special-purchaser considerations are taken into account in arriving at fair market value; in the U.S., this is not the case. If the price is affected by special purchasers or strategic purchasers in the marketplace, the value is “transaction value” or “investment value” as opposed to “fair market value”. However, there now appears to be a very recent trend where the U.S. tax courts are considering the effects of special purchasers on fair market value.

What may give rise to such difference is that, in Canada, the term fair market value refers to the “highest price” obtainable whereas in the United States the definition of “fair market value” refers simply to “the amount” at which property would change hands

With increasing cross-border transactions and cross-border valuations, practitioners will be facing many additional challenges and will be required to keep abreast of the business valuation standards and revenue-department pronouncements on both sides of the border, let alone the numerous valuation-related court decisions emanating south of the border.

It should also be remembered that “tradition” has a certain impact on how valuation methodology applied in practice in the respective countries. Traditionally, business valuations in Canada were conducted by Chartered Accountants, mainly for estate tax and gift tax purposes (going back to the pre-1972 *Estate Tax Act* and gift tax provisions contained in Part IV of the *Income Tax Act X* as well as the relevant provisions of the succession duties acts of various provinces). In this connection, for example, reference might be made to a textbook written 30 years ago by

two prominent Chartered Accountants, *Canadian Estate Planning*¹³, which makes the following introductory comment in its 15-page chapter entitled “Valuations”:

“There are two aspects to valuation in estate planning. There are minimum valuations which are commonly put forward in discussions with tax administrators which may be subject to differences of opinion. There are somewhat higher valuations on which general agreement may be more readily obtained. The latter may be more appropriate in the formulation of an estate plan because of the degree of certainty which they imply. They infer caution, not a double standard.”

As Chartered Accountants had been actively involved in estate planning and negotiating with the taxation authorities, they were the ones who were considered so-called valuation experts. Even following the repeal of the *Estate Tax Act*, the gift tax provisions of the *Income Tax Act* and the various succession duties acts of the provinces, the introduction of tax on capital gains under the 1971 *Tax Reform* created a far more significant need for tax purpose valuations. Again, Canadian Chartered Accountants were actively involved in preparing such valuations.

In this connection, *CA Magazine* published a special series of articles on business valuation, under the title “Solving The Valuation Problem”, authored by various Chartered Accountants.

(It is interesting to note that in England, as well, valuations were typically being performed by Chartered Accountants. For example, in October 1951, some 45 years ago, a major paper presented at the autumnal meeting of The Institute of Chartered Accountants in England and Wales was entitled, “The Valuation of Holdings in Private Limited Companies for Purposes Other Than Probate”.)

In addition to the series of articles published in *CA Magazine*, the first textbook in Canada devoted to the subject of business valuation (with respect to closely-held companies) was authored

(13) H.O. Spindler, CA and D.Y. Tembrell, CA, *Canadian Estate Planning*, CCH Canadian Limited (Don Mills, ON: 1966).

in 1971 by two Chartered Accountants, George Ovens (founder of The CICBV) and Donald Beach, *Business and Securities Valuation*.

Even in other parts of the world, the principal textbooks on the valuation of closely-held businesses were authored by Chartered Accountants. For example, one authority which Revenue Canada would refer to for many years was *Valuation of Private Company Shares*, by A.V. Adamson¹⁴. Chartered Accountants in other parts of the world were involved in the valuation of private-company shares: India (*The Chartered Accountant*), Australia (*The Chartered Accountant in Australia*), Pakistan (*The Pakistan Accountant*), New Zealand (*The Accountants' Journal*) and England (*The Accountant, Accountancy and Accountants' Journal*).

Apart from tax-purpose valuations, another Canadian text, *Professional Accounting*¹⁵ devoted 16 pages to the valuation of a business. The authors are Canadian accountancy professors.

Hence, as valuations of closely-held corporations and family businesses were typically being performed by Chartered Accountants, their training led them to perform a valuation “from the inside out”, i.e., concentrating more on the business enterprise itself, its financial statements, the composition of various overhead items, and finally developing a capitalization rate using a rough-and-ready build-up approach.

In the U.S., on the other hand, prior to the early 1980s very few CPA firms were performing business valuations. This was left to the investment banking firms and the professionals who had the Chartered Financial Analyst (CFA) designation. Unlike CPAs or CAs, CFAs typically work more from the “outside in”, placing emphasis on transactional and other empirical market data. A detailed analysis of the subject company’s accounts was more the exception to the rule; it was those having an accounting/auditing background such as a CPA or CA who would delve more

(14) *The Valuation of Company Shares and Businesses*, Australia Law Book Co. (Sydney: 1966).

(15) J.R.E. Parker, CA, and D.H. Bonham, CA, *Professional Accounting*, Sir Isaac Pitman (Canada) Ltd. (Kingston: 1965).

into those types of accounts of a closely-held corporation. In the early 1980s, a number of national accounting firms in the U.S. began to establish business valuation departments, primarily by acquiring independent valuation firms¹⁶.

4. COMPARISONS OF METHODOLOGIES

While the Canadian and U.S. valuation methodologies are essentially the same, there are two areas in particular where there are differences:

- Use of the Guideline Company Method under the Market Approach; and
- Valuing minority interests of closely-held corporations “from the bottom up”.

4.1 Guideline Company Method

Because of the overwhelming (compared with Canadian data) market and transactional data available in the U.S., American valuers have many more opportunities to apply X let alone consider X the Guideline Company Method in valuing a business or business ownership interest or, alternatively, in applying the Guideline Company Method to corroborate a valuation conclusion arrived at under, say, the Capitalized Earnings Method. Not only are there so many more public companies in the U.S. which may provide useful valuation ratios for use in the Guideline Company Method, and merger and acquisition activity as well, but there are a host of databases which may help to provide useful comparative data for purposes of valuing the subject company.

(16) Such as, for example, Valtec Associates, Stone & Webster, Standard Research Consultants and other similar firms.

While the business valuator must nonetheless ensure that any comparisons drawn are meaningful and that the companies selected do, indeed, possess the investment characteristics of the subject, because there are so many publicly-listed companies there necessarily are a host of data which the U.S. valuator can access.

In Canada, however, there is nowhere near the number of transactions involving mergers and acquisitions or, indeed, publicly-traded companies as there are in the U.S. Control premium studies and analyses of mergers and acquisitions are not formally prepared in Canada as they are in the U.S. There are no Canadian restricted stock studies to use in quantifying a marketability discount. In the U.S. there are:

- *Mergerstat Review* (Houlihan Lokey Howard & Zukin)¹⁷.
- *Control Premium Study* (Houlihan Lokey Howard & Zukin).
- BIZCOMPS
- Securities Data Corporation
- Institute of Business Appraisers
- *The Merger & Acquisition Sourcebook* (Quality Services Company)
- *The Merger Yearbook* (Securities Data Corporation)
- *Mergers & Acquisitions* (Investment Dealers' Digest X bimonthly)
- *Mergers & Acquisitions Report* (Investment Dealers' Digest X weekly)

(17) *Mergerstat* tracks transaction involving U.S. entities with equity value of U.S. \$1 million or more and equity interests of 10% or more. The acquisitions tracked are those of private seller, public sellers, foreign sellers and divestitures.

- *Mergers & Corporate Policy* (Securities Data Publishing)
- *Buy-outs* (Venture Economics Publishing Company X semi-monthly)

In addition to the traditional print sources, there are on-line databases which provide a wide variety of information relating to M&A activity, such as Standard & Poor's News and Moody's Corporate News.

While the foregoing U.S. databases provide extensive detail, data may still, of course, be gleaned from newspapers, trade and financial journals, news wire and press releases, radio and television, securities commission filings, the Internet and on-line information services.

For example, in 1995 there were 3,510 M&A announcements in the U.S. having a total dollar value of U.S. \$356 billion, with the average deal priced at U.S. \$205.2 million.¹⁸ The balance, which accounted for approximately 40% of net M&A announcements, comprised divestitures and foreign sellers. What is interesting is that of the more than 3,500 deals tracked, the price was disclosed in 1,735 of the announcements, with the vast majority of announced deals having prices below U.S. \$100 million (the median purchase price being U.S. \$30.5 million). Approximately 325 of the privately-owned companies transacted at U.S. \$15 million or less.

4.2 Valuation of Minority Shares in a Private Company

In valuing a minority interest in a privately-held company, particularly where the minority shareholder is not part of the controlling group by way of family relationship or through some type of shareholders' agreement, Canadian valuers tend to first value the entire company X arriving at enterprise value X and then calculate the rateable value thereof, and then deduct discounts in

respect of lack of control (minority discount) as well as lack of marketability (marketability discount).

Canadian valuers apply this procedure in the vast majority of notional-market valuations. Interestingly, our Past President, Joel Adelstein, made the following observation at an ASA Advanced Business Valuation seminar some eleven years ago:

“Starting with zero and trying to find some value is my preference X why try to value the total enterprise at all? For many minority interests, ownership is just a long-shot speculation on something happening to get something out of the stock. The interest they have may have value someday, but it’s sometime between now and never.”

Notwithstanding Joel’s valid observation, we still find that, in Canada, most valuers of minority interests in closely-held corporations still proceed to value the entire company and then attempt to quantify the minority and marketability discounts applicable to the interest.

In the U.S., however, there are two viable alternatives in many situations:

- Direct comparison with transactions involving other minority interests (either in the same company or, where the information is available (which is sometimes rare) in other similar companies); and
- Applying the “bottom-up” method, where the annual dividends (where there is an annual dividend stream) are capitalized or where there are expected proceeds to be realized on the liquidation of the interest. If there were no anticipated liquidation of the interest (there being no market and no “put” provisions in a buy-sell agreement), the

expected dividend stream could be projected into perpetuity and a discount rate applied to reflect the time-value of money, risk as well as lack of marketability/illiquidity.

For some reason, Canadian valuers seem to be reluctant to apply the “bottom-up” method. As regards the direct comparison with transactions of other minority interests, again there simply are no adequate data available in Canada to be able to apply such method.

In closing, while there is so much in common between business valuation practices in Canada and the U.S., I hope that my observations have highlighted the principal areas where there still continue to be differences in notional-market valuations. Notwithstanding such differences, we have certainly come a long way since the founding of our Institute!