DM In Focus: Valuations in Family Law

Davis Martindale

Your personalized TOOLKIT, complete with key takeaways drawn from our six-part series.

Blogs

We've included a selection of blogs that offer guidance on financial matters frequently encountered in family law.

- Information Request FAQ – Part 1: Financial Documents for Valuation Engagements
- Money Now vs. Money Later – Time Value of Money
- Free and Clear? Understanding Contingent Disposition Costs
- Understanding Accounting Concepts: Retained Earnings

Speakers Spotlight – Wine, fitness and direct flights – can you guess which presenter each one belongs to?

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Introduction

From Insight to Impact

A word from Ron Martindale, Partner, Valuation & Litigation and Louise Poole, Partner, Valuation & Litigation:

Welcome to this special edition of our new E-magazine – a personalized guide for McCarthy Hansen Co. packed with key takeaways from our six-part Valuations Seminar Series. On behalf of our team, it's been a pleasure spending time with all of you over the past year and we thank you for your engagement and commitment to learning.

Although our Roadmap series has ended, we've created this resource to help you recall key concepts and terminology essential to navigating the Valuations and Income for Support process. This e-magazine serves as both a recap and a curated resource designed to reinforce your learning by providing material related to Valuations and Income for Support calculations. This guide includes:

- **Key Takeaways**
- **Blogs**
- **Speaker Spotlight**
- **Meet the Team**
- **Common Terms and Definition**

Thank you for being a part of this learning experience. If you have any questions or would like to discuss specific valuation challenges, feel free to reach out—we'd be delighted to continue the conversation.

Best regards,

Louise

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Key Takeaways

We have compiled a summary of Key Takeaways from each session your team attended. These takeaways have been distilled into digestible insights and linked directly to the seminar presentation content.

Contents

Session 1: Understanding the Role of the Valuator

Valuation Reports: Purpose and Applications

- Valuation reports are essential in legal matters, providing critical information, such as estimated market values of privately held business interests for Form 13.1: Financial Statement (Property and Support Claims), as well as for equalization payment calculations.
- These reports offer valuable insights to support negotiations, mediations, arbitrations or trial providing an objective and clear basis for discussions in contentious matters.
- In the context of income for support (IFS) calculations, the balance sheet schedule is particularly useful for assessing the financial position of self-employed individuals or those with substantial investment interests.
- They are also crucial for contingent tax analysis, helping to project the potential tax implications of various transactions or asset disposals.
- Valuation reports not only inform financial decisions but also provide a foundation for fair and equitable resolutions in legal proceedings.

Income for Support Reports (IFS) and Guidelines

- IFS reports determine an individual's income for support calculations under the Federal Child Support Guidelines.
- Income is not solely based on Line 15000 of a T1 tax return - adjustments may be needed for corporate pre-tax income, normalizing factors, and other considerations.
- In the context of income for support (IFS) calculations, valuation reports are particularly useful for assessing the financial position of self-employed individuals or those with substantial investment interests.

Contingent Taxes in Valuation

- When assessing the Fair Market Value of a business for family law purposes, it is essential to consider contingent taxes.
- These taxes represent a liability that impacts net family property calculations and must be properly accounted for in valuations.

The Role of Counsel in the Valuation Process

- Legal counsel plays a crucial role in reviewing draft reports, facilitating mediation, and supporting trial testimony.
- Effective collaboration between counsel and CBVs strengthens case strategy and outcomes.

CBVs as Expert Witnesses and Advisors

- CBVs provide specialized expertise throughout the valuation process, from drafting reports to testifying in court.
- Understanding the nuances of valuation methodologies and financial reporting enhances legal arguments and settlement discussions.

View session slide deck here

Session 2: Understanding Disclosure, Financial Statements & Tax Returns

Importance of Disclosure & Common Challenges

- Proper disclosure is essential for transparency in financial reporting.
- Common challenges include incomplete information, delays, large volumes of documents, complex financial structures, and non-compliance.

Key Financial & Corporate Documents

- Essential documents for valuations include corporate records (e.g. articles of incorporation, shareholder register, articles of amendment), financial statements, tax returns, previous business valuations, and forecasts.
- Understanding documents like balance sheets, income statements, and cash flow statements is crucial for accurate financial assessments.

Types of Financial Statement Reports & Assurance Levels

- Three levels of assurance:
  - Notice to Reader (No assurance)
  - Review Engagement (Limited assurance)
  - Audit Engagement (Highest level of assurance)
- The level of assurance affects how much reliance can be placed on financial statements.

Understanding Financial Ratios & Their Impact

- Financial ratios (liquidity, profitability, leverage) help assess a Company's ability to meet its financial obligations as they become due.
- Example: The Current Ratio determines how much cash can be withdrawn while maintaining lending requirements.

Tax Considerations & Impacts on Valuation

- Personal and corporate tax returns provide insights into income, deductions, and potential liabilities.
- Understanding dividends, tax integration, and capital dividends is crucial for financial planning.

View session slide deck here

Session 3: Valuation Reports

Types of Valuation Reports & Their Applications

- There are three (3) types of Valuation Reports: Comprehensive, Estimate, and Calculation.
- Each report type varies in scope, the level of detail provided, and the extent of due diligence or corroborative analysis conducted by the independent valuator.
- The selection of the report type will depend on factors such as the availability of information, the purpose of the report, and the nature of the dispute, among other considerations.

Understanding Fair Market Value vs. Price

- Fair Market Value (FMV) is determined based on objective financial analysis.
- Price is influenced by market conditions, negotiation skills, synergies, and whether the sale is forced or voluntary.

Valuation Approaches & Methodologies

- Asset-Based Approach: Adjusted book value method, restating assets and liabilities at FMV.
- Income-Based Approach: Uses capitalized earnings/cash flow or discounted cash flows to determine value.
- Market Approach: Uses past transactions and comparable companies.

Key Components of Business Value

- Three Building Blocks of Value:
  - Redundant Assets – Non-operational assets affecting valuation.
  - Goodwill & Identifiable Intangibles – Divided into commercial, personal, and individual goodwill.
  - Tangible Asset Backing – Value supported by physical assets.

Enterprise Value vs. Equity Value

- Enterprise Value represents the total value of the business, including debt.
- Equity Value is what remains for shareholders after liabilities are deducted.
- Shareholder agreements can influence equity valuation conclusions through formulas or periodic third-party assessments.

View session slide deck here

Session 4: Contingent Taxes

What is a Contingent Tax Report & Why It Matters

- Contingent tax reports calculate income taxes required to realize the full Fair Market Value (FMV) of a business.
- These taxes represent a liability for net family property purposes, impacting valuation in legal and financial contexts.

Methods for Selling a Business: Assets vs. Shares

- Selling Shares: Typically results in lower taxes due to capital gains treatment and potential exemptions.
- Selling Assets: Can lead to double taxation - once at the corporate level and again when distributing proceeds to shareholders.

Impact of Capital Gains Inclusion Rate Changes

- Capital Gains Tax Inclusion Rate: Influences the effective tax rate on gains at the top marginal bracket.
- Lifetime Capital Gains Exemption (LCGE): Increased from $1,016,836 to $1,250,000, effective June 24, 2024, with inflation adjustments starting in 2026.

Tax Treatment of Different Dividend Types

- Eligible vs. Non-Eligible Dividends: Differ in tax rates based on corporate income type.
- Capital Dividends: Issued tax-free from a company's Capital Dividend Account (CDA), reducing tax burdens for shareholders.

Principal Residence Exemption & Division of Assets

- The Principal Residence Exemption (PRE) allows homeowners to shield capital gains from tax upon the sale of their primary home.
- Proper planning around PRE and business asset division is essential for minimizing tax exposure (when one owns multiple personal residences).

View session slide deck here

Session 5: Income for Support – Part I

Understanding an Income for Support Report

- An Income for Support Report determines a spouse's annual income based on Total Income (Line 15000) from their T1 personal tax return, adjusted per Schedule III of the Federal Child Support Guidelines.
- Adjustments account for items like taxable dividends, capital gains, and other income sources that may overstate or understate actual cash flow.

Key Adjustments to Line 15000 Income

- Dividends: Taxable dividends reported on tax returns are grossed up and need to be adjusted to reflect the actual cash received.
- Capital Gains Adjustments: Only 50% of a capital gain is taxable, but the full amount may be relevant for income determination (subject to double recovery and non-recurring considerations).
- Self-Employed Individuals: Special considerations include personal use of business assets, non-arm's length transactions, deduction of personal expenses, unreported income, and non-recurring revenue and expenses.

Determining & Adjusting for Unreported Income

- Various forensic methods are used to detect unreported income, including:
  - Lifestyle Analysis: Comparing reported income to spending habits.
  - Bank Account Tracing: Reviewing deposits and withdrawals.
  - Industry Ratio & Census Tract Analysis: Comparing income patterns to industry standards.
- Imputed Wage Research: Estimating reasonable earnings based on skills and market conditions.
- If unreported income is found, it is typically grossed up to reflect what should have been reported for tax purposes.

Imputed Income

- Imputed Income: Adjustments are made when an individual is intentionally underemployed, benefiting from tax exemptions, or diverting income.

Non-Recurring Items

- One-time income events (e.g., settlements, inheritance) are assessed based on whether they should be included in income for support, with consideration for retroactive and prospective impacts.

Avoiding "Double-Dipping" in Support Calculations

- Double-dipping occurs when the same income source is counted twice—once in a support determination and again in an asset division (e.g., pensions).
- Proper analysis ensures that financial settlements are fair and do not result in unintended financial penalties for either party.

View session slide deck here

Session 6: Income for Support – Part II

Income for Support Reports for Corporations

- Expert Reports estimating an individuals guideline income in accordance with the Federal Child Support Guidelines.
- Corporate pre-tax income, normalizing adjustments, and Section 17 and 18 guidelines are key considerations in determining the true income available for support.

Adjustments to Corporate Income for Support Calculations

- Various corporate income adjustments are necessary to ensure fairness, including:
  - Personal Expenses Deducted as Business Expenses (e.g., vehicle costs, travel, meals, and entertainment).
  - Related Party Wages that may not reflect true market compensation.
  - Shareholder Loans & Intercompany Dividends, which impact income distribution and accessibility.

Why Income May Not Be Available for Support

- Support Factors such as working capital requirements, debt obligations, bank covenants, capital expenditure reserves, shareholder loans, and shareholder agreements, may restrict access to corporate income.
- Business owners often reinvest earnings into the business rather than withdrawing them, which complicates income calculations for support.

Determining Unreported Income

- Various forensic techniques are used to detect unreported income:
  - Lifestyle Analysis: Comparing reported income to actual spending.
  - Census Tract & Industry Ratio Analysis: Evaluating whether reported income aligns with regional and industry statistics.
  - Imputed Wage Research: Assessing if an individual is underreporting income compared to market wages.
- Unreported income is typically grossed up to reflect the pre-tax equivalent that should have been declared.

View session slide deck here

DM University

Interested in more learning opportunities? Check out our other offerings below. Please note that all* of our sessions run for approximately 1 to 1.5 hours.

The Role of the Valuator

Introduces Valuation Reports, Contingent Tax Reports and Income for Support Reports

Intro to Business Valuations

This seminar examines business valuations as they relate to family law, and the intersection with financial accounting. We also discuss the valuation methodology for asset-based and earnings-based valuations.

Income for Support – Personal

This seminar examines the complexities that arise when computing income available for support.

Income for Support – Corporate

This seminar builds on what you learned in Income for Support 101 and delves deeper into Section 18 and Section 19 adjustments of the Federal Child Support Guidelines.

Trusts in Family Law

This seminar examines the concept of a family trust, and the role a Chartered Business Valuator plays in determining the value of a beneficiary's interest in a trust.

Dividends

This presentation covers the different types of dividends—non-eligible, eligible, and capital dividends—and their tax implications.

Contingent Taxes

In this seminar we explore contingent income taxes and their role in family law.

Executive Compensation

This seminar examines the basic types of executive compensation, with a focus on long-term incentive plans and how they relate to family law valuation and income for support reports.

Understanding Financial Statements and Tax Returns*

(Please note that this is a 3 hour session)

This seminar explores the intersection of accounting and family law, focusing on the different types of assurance engagements, the preparation of financial statements, and the importance of financial ratios.

Get to know Krystyna Slivinski

Questions? Or if you want to connect with any of our presentation speakers – please reach out to Krystyna who will help you get started! If you need more information on our topics, available dates or booking multiple dates – Krystyna is your one stop destination to our Learning Roadmap and Lunch & Learn Programming.

Krystyna Slivinski,
Senior Administrative Support, Valuations

Krystyna answered the leftover questions that didn't make the cut in our Speakers Section!

What do you consider the most overrated virtue?
"Patience."

What is your greatest fear?
"Being stuck in an elevator with someone eating Doritos."

How would you like to die?
"Quickly!"

Speaker Spotlight

Louise Poole

CPA, CA, CBV, CFF

Partner, Valuation & Litigation

Louise Poole is known for her expertise in business valuations and her role as a Partner in Valuation and Litigation Services at Davis Martindale. Her achievements include testifying in high-profile courts, receiving awards such as the Top CBV Under 40, and contributing significantly to her community through leadership roles and mentorship.

We asked, Louise answered...

What profession would you have pursued, if not accounting?
"I have always wanted to be a fitness instructor and own a fitness studio."

What do you most value in your friends?
"I value friendship where we can be open, honest, and our true selves around each other."

What is your motto?
"You can do hard things."

What do you consider your greatest achievement?
"Seeing my three children growing and becoming kind, happy and healthy humans."

Which talent would you most like to have?
"Cooking – Whipping up meals with whatever three ingredients are in my fridge!"

Ron Martindale

CPA, CA, CBV, CFF

Partner, Valuation & Litigation

Ron, the founder of the Val team, has led the organization for 30 years. He is a recognized authority on valuations, having worked across various industries and served as an expert witness in complex family law cases. Ron is also a seasoned speaker, sought after for his valuation expertise nationwide.

We asked, Ron answered...

What profession would you have pursued, if not accounting?
"Engineering."

What is your greatest extravagance?
"Red wine."

Which living person to you most admire?
"My father."

What is your idea of perfect happiness?
"Weekend at the cottage with my wife and kids."

Which talent would you most like to have?
"Playing the piano by ear."

Korab Ferati

CPA, CMA, CBV

Sr. Manager, Valuation & Litigation

Korab has extensive experience preparing business valuations and income analyses for matrimonial and litigation purposes. He is recognized for his thoughtful communication, practical approach, and ability to build trust with clients and legal professionals alike. His work spans a variety of engagements and industries.

We asked, Korab answered...

What profession would you have pursued, if not accounting?
"Sales. I enjoy connecting with people, building trust, and understanding what makes someone tick."

What is your greatest extravagance?
"Booking the direct flight. Every time."

What is your motto?
""Figure it out. Control what you can. Let the rest go". A mindset that keeps me grounded and moving forward, focused on solutions, not stuck in the noise."

What is your idea of perfect happiness?
"A fall morning with a strong coffee in hand, walking through the woods with my family. No emails, no deadlines - just peace, purpose, and the people I love."

What do you consider the most overrated virtue?
"Relentless positivity. Sometimes things suck, and it's okay to say so."

Meet the Team

Deonne Devonish

CFA, FRM, CBV

Sr. Manager, Valuation & Litigation

Deonne Devonish is a Senior Manager at Davis Martindale, specializing in business valuations for family law, corporate planning, and M&A purposes. With extensive experience in valuations consulting across various industries, Deonne brings a nuanced understanding of valuation matters in diverse legal and financial contexts.

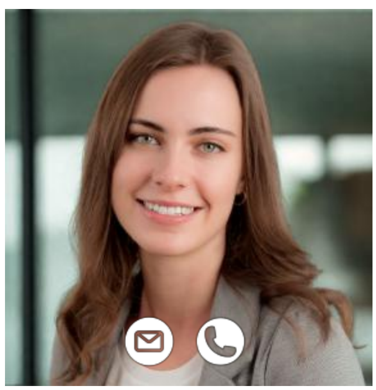
What profession would you have pursued, if not accounting?
"Ophthalmology."

What is your greatest extravagance?
"Spa days, just because."

Which living person to you most admire?
"My mom, her resilience and optimism."

What is your idea of perfect happiness?
"Family get togethers on the West Coast of Barbados."

Which talent would you most like to have?
"A green thumb, or at the very least the ability to not kill every plant in my vicinity."



Janece Boersma

CPA, CBV

Sr. Manager, Valuation & Litigation

Janece is a CPA and CBV with over five years of experience in valuations for litigation support. A recipient of the 2021 CBV Gold Medal, she brings top-tier analytical expertise to complex financial matters.

What profession would you have pursued, if not accounting?
"Something else with numbers."

Which words or phrases do you most overuse?
""From a valuation perspective…" and "It depends.""

Which talent would you most like to have?
"Fluency in multiple languages, or even just one other."

What is the trait you most deplore in yourself?
"Overthinking."

What do you consider the most overrated virtue?
"Blind optimism."

Blog

INFORMATION REQUEST FAQ:

Financial Documents for Valuation Engagements

Have you ever been the recipient of a long financial information request and thought, “do they really need all of these documents?”

As experts in valuations and litigation, we can assure you that compiling a comprehensive information request is one of the most important steps in preparing a quality valuation report. Whether you are producing or receiving a disclosure request, you should be aware of the most requested documents, as well as their intended purpose. That’s why we have prepared an FAQ series to provide you with a deeper understanding of information requests.

This blog is Part 1 of this series, which focuses on 8 specific financial documents required for valuation engagements.

1. Financial Statements

Arguably, the most important documents when preparing a valuation may be the financial statements.

Valuators rely on the financial statements as the basis to their calculations. Financial statements are often used as a tool to gain a better understanding of the financial side of the business, including the following:

- The inflows and outflows – revenues and expenses;
- Which assets are used to produce income – inventory, equipment, etc; and
- How the assets are funded – bank loans, equity, etc.

2. Trial Balances & General Ledgers

Trial balances provide a deeper dive into the financials of a business because they contain a list of all the general ledger accounts. While reviewed and audited financial statements typically contain detailed financial notes, this information is often lacking in compilations. For valuation engagements, experts may rely on trial balances to:

- Review a more detailed breakdown of financial statement accounts;

- Analyze different revenue streams, such as interest or rental, that may be non-recurring or redundant to the operations of the business; and
- To determine whether any personal expenses may exist.

In some circumstances, particularly when personal expenses are a primary concern, experts may request general ledgers as they contain a detailed listing of each accounting transaction the business records.

3. Corporate Tax Returns

The most commonly used schedules in the Corporate Tax Return for valuation engagements typically include:

- Schedule 1 – Net Income (Loss) for Income Tax Purposes – These allow experts to identify any differences between income for accounting and tax purposes, including any non-deductible expenses;
- Schedule 8 – Capital Cost Allowance – These allow experts to review historical spending and capital cost allowance claims; and
- Schedule 50 – Shareholder Information – These allow experts to identify the shareholders, particularly when the Shareholders' Register is not available.

4. Corporate Notices of Assessment or Reassessment

When a tax return is filed with the CRA, a Notice of Assessment (or Reassessment if revisions are made) is issued once it has been assessed by the CRA. Experts review these notices to confirm whether the CRA has agreed with the tax return filing.

5. Payroll Summaries for Shareholders & Related Parties

Shareholders and related parties may receive a salary from a business that is not at fair market value, meaning that it does not reflect their hours, duties, education, or experience. Accordingly, experts request payroll summaries in order to adjust related party wages to fair market value. This is one of the most common adjustments in valuations, as discussed in our recent blog "Understanding Valuation Earnings Adjustments."

6. Unusual or Non-Recurring Items

Although experts often rely on historical financial information, it is important to remember that a valuation is forward-looking. That's why it's important to identify any transactions that are not expected to occur in the future, such as professional fees from a lawsuit or revenues from a discontinued service line.

7. Unreported Transactions

While it's not permitted, in some industries there may be cash sales or expenses that do not get reported for tax purposes. As a result, experts explicitly ask about unreported transactions to ensure that all the business' revenues (and expenses) are accounted for.

8. Personal & Discretionary Expenses

In some cases, there are personal or discretionary expenses such as cell phones, vehicles, meals and entertainment expenses, buried in the financials. As a notional purchaser would not need to incur these expenses in order to successfully run the business, it is important that the expert is able to quantify and add back these expenses to one's income, in order to accurately value the business.

In Part 2 of our series, we will continue our discussion on information requests for valuation engagements, focusing on corporate documents, appraisals, forecasts, and much more!

If you have further questions or are in need of an expert, give the professionals at Davis Martindale a call. We have numerous experiences preparing disclosure requests for various valuation and litigation engagements.

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Blog

Money Now vs. Money Later – Time Value of Money

Would you rather receive $10,000 today or a year from now? The answer seems pretty obvious – almost everybody would take $10,000 today.

Now for a more challenging question – would you rather receive $10,000 today or $11,000 a year from now? If you asked a group of people, you would receive a mixed response. Thanks to the time value of money, the answer is not as obvious.

What is the Time Value of Money?

Time value is the concept that a dollar today is not necessarily worth the same as a dollar a day, week, month, or year from now. In most cases, a dollar received today is actually worth more than a dollar received in the future. While the idea may be simple enough, understanding the underlying theory takes a bit more thought.

The main principal is that money received today can be invested to earn income sooner than money received in the future. Seems intuitive, but the implications are exponential because of compounding interest (interest being earned on interest). For example, if you make a one-time investment of $10,000 in the stock market today, and the market is returning 7% per year, this will result in the following future amounts:

Applications of the Time Value of Money

Going back to the original question – would you rather have $10,000 today or $11,000 a year from now? Based on the above example, this will depend on what return you can earn on your investments. $10,000 today versus $11,000 a year from now implies a 10% return. If you can achieve a higher return elsewhere, then it is better to receive $10,000 today. However, if 10% is the best return you can achieve at your desired risk level, then you are better off to wait and receive $11,000 a year from now.

Similarly, would you pay $10,000 today to receive $11,000 a year from now? The same principal applies – this is a 10% return, and the answer depends on what return you could receive elsewhere. This principal applies whether you are saving for retirement, speculating on the stock market, or investing in new equipment for your business. For example, if you could invest $100,000 in new equipment for your business and you expect it would increase profits by $5,000 per year indefinitely, is this a worthwhile investment? Well, the answer again depends on what returns you could earn elsewhere.

Determining your desired rate of return – as well as your risk tolerance – is key when choosing between different personal and business investments. As Albert Einstein allegedly said, "compound interest is the eighth wonder of the world. He who understands it, earns it; he who does not, pays it." Best to be the former rather than the latter.

If you are thinking of making a significant investment, such as business acquisition or expansion, give the team at Davis Martindale a call. We would love to help determine your expected return, as well as answer any other questions or concerns you may have.

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Blog

Free and Clear? Understanding Contingent Disposition Costs

It is often said, ‘slow and steady wins the race’. After years of saving, it isn’t unusual for one to have acquired a family cottage, retirement savings in your RRSP, investments accumulating in your business, or a rental property on the side.

But if you withdraw the $1,000,000 from your RRSP, will you be left with the whole $1,000,000? Or if your real estate agent recommends a selling price of $400,000 for your rental property, are you free and clear to expect the whole $400,000 upon closing? Between real estate commissions, investment commissions, legal fees, income taxes, and other disposition costs there are many ways in which you might reduce your proceeds more than you’d expect.

Although planning for taxes, commissions, and other disposition costs is important when planning your future cash flow, it’s equally important when equalizing property in a matrimonial dispute. If the goal is an equitable splitting of assets between spouses, then it’s important to understand and account for which assets may lead to future disposition costs.

Common Contingent Disposition Costs

Just as there are seemingly endless types of assets, there are a wide variety of disposition costs associated with those assets. From the common income tax to the less common land remediation fees, it’s important to consider what future costs are likely to be incurred upon selling your assets. We discuss two common disposition costs below:

1. Income Taxes

As one of Benjamin Franklin’s certainties in life, income taxes seem almost inevitable. A few common sources of disposition-related taxes are:

- Capital gains – from selling an asset for more than the original cost (a few common exceptions are principal residence, TFSA investments, and certain small businesses, farms and fisheries)
- Dividends – from paying cash out of a corporation
- RRSP or pension income – from withdrawing funds from a RRSP or RRIF

- Recaptured capital cost allowance – from some circumstances where an annual capital cost allowance has been claimed.

For example – because of the tax differences – a $500,000 principal residence (which could be sold tax-free) is not the equivalent to a $500,000 cottage (which may have taxes upon disposition) for matrimonial equalization purposes.

2. Commissions

Typically paid to the individual that sells your assets on your behalf, commissions can be substantial and are often based on a percentage of the selling price. A few common commissions are:

- Real estate commissions – paid upon the sale of land and buildings
- Deferred sales charges – paid to investment advisors on the sale of some investments
- Broker fees – paid to the advisor that sells your business

Regardless of the type of disposition costs, it's important to factor the expected costs into the matrimonial equalization.

Disposition costs can result in a substantial reduction of proceeds resulting from a sale of assets. Whether currently engaged in a sale, planning for the future, or determining a fair and equitable matrimonial settlement, it is important to have an informed understanding of the potential disposition costs.

If you would like to discuss the potential costs in your situation, please contact the experts at Davis Martindale.

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Blog

Understanding Accounting Concepts: Retained Earnings

When a company reports net income at the end of any given year, the company has two choices regarding what to do with that net income:

1. Distribute it among shareholders in the form of dividends; or
2. Retain the earnings within the company.

In general, retained earnings is the summation of all the net income that a company has generated since the inception of the business, less any dividends paid.

In the case of a net loss, retained earnings is decreased by the amount of the net loss. When considered over a number of years, retained earnings can be referred to as "accumulated profits".

Many people might assume that one's retained earnings is a cash account holding funds that can be withdrawn at any point…However, that's not true.

Let's look at an example of how retained earnings is calculated:

		2020	**2021**	**2022**	**2023**	**2024**
Retained earnings - opening balance	**$**	-	100,000	125,000	85,000	115,000
Net income (loss)		100,000	50,000	(40,000)	30,000	45,000
Less: Dividends paid		-	(25,000)	-	-	(10,000)
Retained earnings - closing balance		100,000	125,000	85,000	115,000	150,000

Since retained earnings is simply the measure of reported year-end net income, less any dividends paid, it does not indicate what assets the retained earnings is funding.

For instance, income generated by the company could be used to fund the working capital needs of the business, purchase capital assets, or service debt, among other uses.

Take fiscal year 2021 in the above table, for example. The closing retained earnings balance of $125,000 is the cumulation of 2020 net income of $100,000, plus 2021 net income of $50,000, net of the dividends paid out in 2021.

Retained Earnings as a Measure of Value

On the balance sheet, retained earnings is part of the shareholder's equity section. Shareholder's equity is the difference between the net book value of the company's assets and the company's liabilities. If shareholder's equity is positive, it means that the company has more assets than liabilities.

Since retained earnings typically comprises the bulk shareholder's equity, it is approximately equal to the net book value of assets minus liabilities. In this sense, retained earnings represent the book value of the company above and beyond its financial obligations. Because of this, retained earnings can be an important indicator in determining a company's value if there is no expectation of goodwill. It is important to note that retained earnings represent the net book value of a company's assets net of liabilities, and not the fair market value; however, retained earnings can be a good starting point in determining value.

For example, consider when a business is valued using an adjusted book value approach (see our blog, Adjusted Book Value Approach). In this case, we begin by relying on shareholder's equity as at the valuation date to form the basis of value for the company. We then adjust the net book value of the company's assets to reflect fair market value, among other adjustments in order to determine the company's total fair market value.

Retained Earnings Misconceptions

Retained earnings is sometimes misinterpreted to be a company's net income for the year or a cash account of funds available to be withdrawn from the company. As discussed above, retained earnings is neither of those. While a company's retained earnings balance includes the net income for that period, it also includes the company's net income for previous periods, net of any dividends paid. Retained earnings also does not represent an account of funds available to be withdrawn as it is common practice for a business to use its retained earnings to fund operations and invest in the business.

If you need help navigating the complicated areas of business valuation, the experts at Davis Martindale can help you. Give us a call today for a personalized discussion.

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Terms & Definitions

In reference to CBV Institute, International Valuation Glossary – Business Valuation (2022).[1]

ABV	**Adjusted Book Value**	Book value of assets and liabilities adjusted to reflect fair market values.
BV	**Book Value**	The net value of an asset according to its balance sheet account balance.
CCPC	**Canadian-Controlled Private Corporation**	A private corporation that is controlled by Canadian residents and meets certain criteria under the Income Tax Act.
CAPM	**Capital Asset Pricing Model**	A model used to determine the expected return on equity based on its risk relative to the market.
CCA	**Capital Cost Allowance**	The Canadian tax system's method of depreciation for income tax purposes.
DCF	**Discounted Cash Flow**	A valuation method estimating the present value of expected future cash flows using a discount rate.
EBITDA	**Earnings Before Interest, Taxes, Depreciation, and Amortization**	A measure of a company's overall financial performance and used as an alternative to net income.
EV	**Enterprise Value**	The Market Value of Invested Capital, typically adjusted to remove all or a portion of cash and cash equivalents, and other Nonoperating Assets. See also Market Value of Invested Capital and Invested Capital.
FCF	**Free Cash Flow**	The cash generated by a business that is available for distribution among all the securities holders.
FMV	**Fair Market Value**	A Standard of Value considered to represent the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, each acting at arms-length in an open and unrestricted market, when neither is under compulsion to buy or to sell and when both have reasonable knowledge of relevant facts.

1. CBV Institute | International Valuation Glossary – Business Valuation | 2022

GRIP	**General Rate Income Pool**	A notional account that allows CCPCs to pay eligible dividends taxed at lower personal rates.
HoldCo	**Holding Company**	HoldCo holds investments or controls other companies.
IFS	**Income for Support**	The amount of income considered for support obligations under the Federal Child Support Guidelines.
IRR	**Internal Rate of Return**	The Discount Rate which equates the present value of expected net cash flows to the initial investment (cost).
LCGE	**Lifetime Capital Gains Exemption**	A Canadian tax exemption allowing individuals to shelter capital gains on qualifying shares up to a certain limit.
MVIC	**Market Value of Invested Capital**	The total market value of equity and debt invested in a company.
NAV	**Net Asset Value**	The difference between a business' total assets and liabilities restated at a particular Standard of Value rather than accounting book values.
NPV	**Net Present Value**	The difference between the present value of cash inflows and outflows over a period of time.
OpCo	**Operating Company**	OpCo carries out business operations.
RE	**Retained Earnings**	The amount of profit remaining after a company has paid all costs, income taxes, and dividends.
SDE	**Seller's Discretionary Earnings**	A measure of earnings that adjusts EBITDA to include owner compensation and discretionary expenses.
TAB	**Tangible Asset Backing**	The value of a company's tangible assets, often used in asset-based valuations.
WACC	**Weighted Average Cost of Capital**	The average rate of return a company is expected to pay its security holders to finance its assets.

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