JBVal's

VALUATION PREPARATION SERIES

Enclosed are three valuable resources for you and your clients to utilize when preparing for a business valuation.

For questions or assistance, please reach out to us at TheTeam@jbval.com, or make an appointment through our website.

We look forward to working with you.

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Your First Steps

The Parameters to Determine Before Your Valuation Can Begin

You have decided to have your business valued. What needs to be decided before you engage a business appraiser?

Most Importantly

Whether you or your advisors require a business to be valued for trust and estate taxes, a buy-sell transaction, or any other purpose, certain parameters must be decided. The valuation opinion will be impacted by the decisions you make.

Our article outlines these key decision points must be established up front.

How do I Choose a Valuation Date?

Typically, the Valuation Date is the date of a transaction (e.g., the date of the transfer and assignment of shares, a date specified in buy-sell contract, when restrictive stock units or options are issued) or an event (e.g., death of a business owner). If the legal transaction has occurred, or the valuation is for an estate, the valuation date is set in stone.

In other cases, when you plan the transaction, consider what is *known and knowable* at your possible transaction date(s).

- What Does Known or Knowable Mean?

  Imagine I am holding a lottery ticket for which I paid $1. How much would you pay for it? Possibly a few dollars for the value of saving travel time and gas to purchase it directly. On the day I bought the ticket, I did not *know* I had won.

  Now imagine a day later I am still looking to sell the ticket. However, now it has proven to be a $1,000,000 winning ticket. It is now *known* to be worth more than a few dollars! Similarly, what is *known and knowable* as of the Valuation Date will impact the valuation conclusion.

  A defensible valuation considers information that is known and knowable as of the Valuation Date. For example, you have a Q1-Ended Valuation Date. On the last day of Q1, you receive a call from a customer informing you of a BIG multi-year contract win, with executed contracts to follow the next day (technically, Q2, after the Valuation Date). Should the contract be considered? Was this information known or knowable? Yes, it was and must be considered in the appraisal.

The Best and Most Current Available Data

A defensible valuation is based on accrual financial statements that are as current and as complete as possible. Inventory adjustments, payroll accruals and depreciation, for example, should all be recorded. Many closely-held companies make these adjustments only at the end of the year.

We understand why. You operate your business on a cash basis. You need to know what expenses are actually paid and what sales are collected and deposited in the bank. Adjustments for inventory counts and payroll accruals don't matter for your daily operations.

Your Valuation Date may be mid-month but your company's books are not organized to be closed on an interim basis. In these cases, our professional standards allow for us to utilize the best available financial information closest to the Valuation Date. However, during the gap period between the financial information date and the Valuation Date, all information that is known or knowable must be considered in the valuation.

Why Do the Characteristics of the Subject Interest Matter?

An interest will be either controlling or non-controlling. It will be either marketable or non-marketable. These parameters impact the valuation conclusion.

A controlling interest has more value than a non-controlling interest. Control reflects the legal constructs of the company and the subject interest. While your business may be run by family or other team members, they may not have legal control. Your shareholder, operating and other agreements help determine how control applies. For a company that has voting and non-voting classes, we look at the characteristic of the subject interest to determine if it is controlling or not.

An interest that is marketable is worth more than a non-marketable one. I can sell my Microsoft shares today and be cashed out in a day or two. Studies show it takes about 200 days to sell a closely-held company like yours. This time span, along with other factors, may support a discount against the total value to determine the value of the subject interest.

An interest that does not have control can be even less marketable than one that has control.

How Do I Select the Valuation Firm to Value My or My Client's Business?

I have made my upfront decisions, how do I decide which valuation firm to engage?

The American Institute of Certified Public Accountants (AICPA) estimates that tens of thousands of Certified Public Accountants (CPAs) perform business valuations at least on a part-time basis. There are also analysts that practice out of various types of organizations including appraisal companies, valuation boutiques and consulting firms.

Professional organizations in the U.S. provide education and guidance to their members in valuing closely held business interests. Look for these associations and the credentials awarded to business appraisers.

- AICPA grants an Accreditation in Business Valuation (ABV) and Certified in Financial Forensics (CFF)
- National Association of Certified Valuation Analysts (NACVA) awards a Certified Valuation Analyst (CVA) designation
- The American Society of Appraisers (ASA) awards an Accredited Senior Appraiser (ASA) credential

Business valuations is all we do at JBVal. Attorneys, tax accountants and public accounting firms routinely entrust their clients to us.

- Our appraisers hold the professional designations of CPA/ABV/CFF, CVA, and ASA. We are dedicated to our professional development and providing the highest quality service.
- Together, our team has valued thousands of closely held businesses across hundreds of industries nationwide.
- In your engagement, we will apply our past career experience in traditional accounting, operations, and M&A to provide a swift and accurate understanding of your or your client's business. We understand small and mid-market businesses and the challenges their owners face.

How to Prepare for a Business Valuation

You have decided to have your business valued. Now what?

Most Importantly

Most smaller businesses serve a niche that large companies cannot or will not compete in. You may provide a product or service that is just too difficult or costly for large companies to provide. You can react to changing customer and market needs much quicker than a large competitor. You are the speedboat that stops in seconds. The Goliaths are the tankers that require up to 20 minutes to come to a halt.

What Should I Expect From My Valuation Report?

You and your professional advisor require a *timely*, *fair*, and *defensible* valuation.

Timely

Few valuations are prepared on an emergency basis. But waiting months is not what you or your advisors want. Follow up with your chosen valuation firm should not be by on the to-do list of either you or your advisor.

Fair

Fair means fair to all parties. If your valuation supports a filing with a regulatory agency such as the IRS or the Department of Labor, the valuation's conclusion must pass the fairness test to any reviewer. The valuation opinion cannot be biased in any way. Any conclusion deemed unfair can lead to a long and costly audit.

Defensible

While a valuation is an opinion, all opinions are backed by facts. Lack of defensibility may cause the valuation to fall apart under a stressful, costly and time-consuming audit. Our expertise guides us to ask the right questions and gather the necessary facts to provide a valuation report that stands up to an audit.

What Data Will I Need to Gather?

At JBVal, we typically we ask clients for data such as financial statements, tax returns, financial forecasts, agings of receivables and payables, schedules of sales to key customers and purchases from key suppliers. Data gathering should be a simple process. The information we request can be easily obtained directly from your in-place accounting system or your outside CPA.

Why do we need this information?

Historical financial statements and tax returns tell your story. Forecasts speak of the future. Are sales rising, declining or flat? Are your margins improving?

Your receivable and payable agings point out potential difficulties in collecting invoices or in paying bills.

Sales to key customers and key suppliers show customer and supplier concentrations. Both are potential risks to the business.

It is imperative to work with a valuation firm that can analyze this data and write a report to narrate the story behind it. Let's say you have a concentration in customers and no long-term contracts. Compared to another competitor having similar earnings but no customer concentration risk and long-term contracts in place, your company may be worth less, all other factors being equal. Maybe you are one of the few players in your market and have long-term customer relationships backed by contracts. In this case, when compared to similarly profitable but riskier competitors, the company may be worth relatively more.

What Happens After I Submit This Data?

Your valuation professional will analyze this data and compile a list of questions for you in the due diligence interview. These questions are geared to find the story we reference above. Possible questions are:

- Who holds the customer relationships?
- Does one person make all sales and operating decisions?
- What products and services do you provide? To what markets? Why these products, services, and markets?
- Is your customer base changing? Is the need for your products and services growing? Why?

We compare your company's financial data to data of similarly sized companies in your industry. This financial comparison to your peers often spurs questions. For example, if you are more profitable, we'd want to know why and if that higher level of profitability will last.

Since we at JBVal are well prepared, our due diligence interview typically lasts at most an hour or two. If in person, there may be a facility tour. If by video conference, this tour may be virtual.

After the interview, our valuation professional will complete the valuation. Almost all valuations must comply to the same IRS standards. Revenue Ruling 59-60 is the most important of these if you care to look!

We issue a draft report to you and your professional advisors to review for factual accuracy.

The Final Step

The report is issued!

We receive feedback from our clients we are timely, our process is organized and our data requests reasonable and meaningful. As a result, our process should not require much of your time or your staff's time. The report should be completed in no more than 20 to 25 working days.

Building a Defensible Business Valuation

You have decided to have your business valued. What documents and information should you expect to share with the appraiser for them to prepare a defensible business valuation?

Your Privacy

You or your client have a closely held business where information is typically kept private and shared on a must-know basis only. As CPAs and members of the American Institute of Certified Public Accountants (AICPA), we adhere to the AICPA's Code of Professional Conduct that includes a Confidential Client Information Rule. We cannot disclose any confidential client information without your specific consent in writing. In addition, we maintain a highly secure portal for the easy sharing of all information.

What Information Will be Requested? Why?

The information request will be tailored to your specific situation, reflecting your business and the purpose of the business appraisal. For valuations for tax related or other regulatory purposes, the Internal Revenue Service has issued detailed guidance regarding the approach, methods and factors to be considered in valuing interests of your business (Revenue Ruling 59-60).

The type of information requested falls into several categories:

- Financial documents – both historical financial information as well as projections in some cases.
- Ownership information – who owns the company? Are the owners the operators? What is the owner/operator's compensation?
- Management information – who manages the company? Is the owner supported by key management that are employees (non-owners)? What are the responsibilities of key executive/officers and managers? Are non-compete agreements in place?
- Governance documentation – is there an operating/shareholder/buy-sell agreement or other agreement between owners? Do the agreement(s) in place dictate restrictions on transfers of ownership that would impact the valuation conclusion? What is the legal and tax structure of the company? Is there more than one class of stock? Are shares or units designated as voting and non-voting? Who holds what?

The tables that follow provide insight regarding some the documents commonly requested and how they are used by the business appraiser.

Sample Financial Information Requests	
Information Requested	How It's Used
Tax returns, financial statements – last 5 years and interim periods, if applicable	Often, history is a predictor of the future. We analyze a historical period long enough to observe the business' ebbs and flows. This helps us to determine sustainable cash flow.
Financial projections	If a company is a start-up, in a growth stage, or in decline, historical financial performance may not be available or relevant. We work with the owners to develop reasonable projections, and possibly multiple scenarios of outcomes used to value the company.
Accounts receivable and payable agings as of the Valuation Date	We assess operating and liquidity risks, which impact the valuation. We compare receivable and payable turns to the company's peers and assess relative effectiveness.
Schedule of sales to top 10 customers – last 2 years	This allows us to assess customer concentration risk, customer turnover, level of annuity business – all of which impact the valuation. This information impacts the risk factor used to value the company.
Schedule of purchases from the top ten suppliers – last 2 years	This allows us to assess vendor concentration risk, which impacts the risk factor used to value the company.
Loan agreements including owner and other related party loans	We analyze a company's leverage and assess its risk, which impacts the valuation conclusion. We also look to related party loans/terms and loans from the owner to assess whether these meet the definition of a loan or equity.
Lease for office(s)/facility(ies)	We identity if the leases are with related-party entities and where possible work to assess market rent vs. the expenses recorded by the operating company. This impacts cash flow and the valuation conclusion.
Compensation to owners/family members	We assess market compensation paid to the owner/operators and other family members, which impacts cash flow and the valuation conclusion.

Other Information Requests	
Information Requested	How It's Used
Schedule of shareholders and their holdings	We document ownership using articles of incorporation, operating/shareholder and other owner agreements. The characteristics of the ownership (controlling, non-controlling, voting, non-voting) impacts the valuation conclusion.
Governance	We look to the governance documents to identify restrictions on the transfer of ownership interests and determine how it impacts the valuation.
Schedule of key management	We analyze the key management structure including the owners and employees. We determine the relative responsibilities of the owners and key employees. In addition to assessing market compensation to the owners, we assess the risks pertaining to a key person. Does the majority owner control the key customer relationships? Is there thin management outside the majority owner? Do key employees have employment agreements with non-compete clauses? Can a buyer successfully operate the business?
Prior transactions	We'll request recent letters of intent and/or terms of recent transactions pertaining to the equity of the business. These are possibly strong indicators of value depending on the date of the transaction and changes since.
Goodwill/intellectual property	Are there royalty/franchise agreements in place? Is goodwill recorded from prior transactions? We will analyze cash flows and assess the related market value.

The Final Step

The requested information is provided… then what?

At JBVAL, once we receive and analyze the requested information, we reach out to schedule a due diligence interview with you. Since we are well prepared, our due diligence interview typically lasts an hour or two. If in person, there may be a facility tour. If by video conference, this tour may be virtual. After the interview, our valuation professional will be ready to complete your valuation. We issue a draft report to you and your professional advisors to review for factual accuracy. The report will be completed in no more than 20 to 25 working days from when we receive the information.