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.

555 Broadhollow Road, Suite 411 | Melville, NY 11747 | 516-794-4264
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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.

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# 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 more quickly than a large competitor. You are the speedboat that changes course in seconds. The Goliaths are the tankers that require up to 20 minutes to come to a halt.

A valuation is performed from the perspective of a hypothetical buyer. Simply put, what would a third party pay for the business under the assumption they will run the business similarly to current owners. What a third-party buyer will *not* do is pay rent other than market rent nor pay officer/owner compensation other than market compensation.

## What Should I Expect from My Valuation Report?

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

Why a third-party perspective? Most buyers have other motives in determining a purchase price. They want to sell your products and services to your customers, and vice versa. They may realize operating cost savings from the acquisition. These are factors specific to the buyer. That's why, instead of guessing what these factors can be, the IRS approach takes them completely out of the mix.

### Timely

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

### Fair

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

### Defensible

While a valuation itself is an opinion, these opinions must be backed by facts. Lack of defensibility may cause the valuation to fall apart under an audit.

## What Information Will be Requested? Why?

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

Information requested falls into several categories:

- Financial documents – both historical financial information as well as projections. This may include agings of receivables and payables, lists of key customers and suppliers.
- 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 executives/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 below look at several of the documents commonly requested and how they are used by the business appraiser.

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| 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. Your valuation professional will analyze a historical period long enough to observe the business' ebbs and flows. |
| Financial projections | If a company is a start-up, in a growth stage, or in a decline, historical financial performance may not be available or relevant. Many valuation professionals will 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 | These agings help assess operating and liquidity risks, both of which impact the valuation. Comparing receivable and payable turns to the company's peers, for example, points out relative strengths and shortfalls. Long past due receivables may point out an operations problem. |
| Schedule of sales to top 10 customers – last 2 years | Is there a customer concentration risk? What is customer turnover (churn), how deep is the level of annuity business? This information helps determine the risk factors in valuing the company. |
| Schedule of purchases from the top ten suppliers – last 2 years | Is there a vendor concentration risk? Are all vendors overseas? COVID pointed out the risk with that scenario. This information helps determine the risk factors in valuing the company. |
| Loan agreements including owner and other related party loans | The type of the company's debt and its lenders have a potential impact on the valuation conclusion. Related party loans and loans from the owner are examined to assess whether these truly meet the definition of a loan or of equity. |
| Lease for office(s)/facility(ies) | If the leases are with related-party entities, where possible, the valuation professional may determine if market rent is paid. This may impact the valuation conclusion. |
| Compensation to owners/family members | For valuation purposes, market compensation should be paid to the owner/operators and family members. Any difference between market and actual compensation will be an adjustment to reported profits. This impacts the valuation conclusion. |

| Other Information Requests | |
|---|---|
| Information Requested | How It's Used |
| Schedule of shareholders and their holdings | Documentation of 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 | The analyst looks to the governance documents to identify restrictions on the transfer of ownership interests and determine how it impacts the valuation. |
| Schedule of key management | An analysis of the key management structure including the owners and employees is performed. The analyst will determine the relative responsibilities of the owners and key employees. In addition to assessing market compensation to the owners, what are 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 | Recent letters of intent and/or terms of recent transactions pertaining to the equity of the business are possibly strong indicators of value depending on the date of the transaction. |
| Goodwill/intellectual property | Are there royalty/franchise agreements in place? Is goodwill recorded from prior transactions? The analyst will analyze cash flows and assess the related market value. |

## What Happens After I Submit This Data?

Your valuation professional will analyze your data and compile a list of questions for your due diligence interview. These questions are geared to find the story behind your company. Among the common questions are:

- 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? Declining? Why?
- Who holds the customer relationships? The owner? Several employees?
- Does one person make all sales and operating decisions? Can middle management make decisions?

A due diligence interview typically lasts at most an hour or so. If in person, there may be a facility tour. If by video conference, this tour may be virtual.

After the interview, your valuation professional will complete the valuation. All valuations for trust and estate purposes must comply to IRS standards. Revenue Ruling 59-60 is the most important of these if you care to look!

The valuation analyst will 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, why? Will that higher level of profitability last?

## The Final Step

A draft report is issued to you and your professional advisors to review for factual accuracy and to allow questions. The draft should be completed in no more than 20 to 25 working days.

## Your Privacy

You have a closely held business where information is typically kept private and shared on a must-know basis only. CPAs and members of the American Institute of Certified Public Accountants (AICPA) adhere to the AICPA's Code of Professional Conduct that includes a Confidential Client Information Rule. Other valuation accreditation groups have similar codes of ethics. A valuation professional cannot disclose any confidential client information without your specific consent in writing, with minor exceptions.