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VALUATION REPORT
WINTER 2021

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Building Business Value Before Sale

In the valuation arena, it's not unusual for analysts to see lost opportunities—cases where owners could have improved their company's value and its purchase price before selling.

Maximizing value takes thoughtful strategy, careful decision-making, and time. Following are some of the areas you'll need to tackle as you prepare to sell.

Clean Up

Corporate housekeeping is a good place to start. There are many small steps you can take to get your business "house" in order before opening the door to potential buyers.

For example, buyers want to see clean financials. Work with your accounting team to tidy up the books. Make sure any personal expenses are separated from business expenses. Take any old, uncollectible receivables off the books, and remove obsolete inventory. Your company's finances should reflect an efficient, organized operation.

The same goes for your contracts, leases, and other legal arrangements, including non-compete and buy-sell agreements. Get everything in order so that buyers can see that you're thinking of the company's future. If you have any pending disputes or lawsuits, try to get them settled as quickly as possible.

Invest in Management

While the owner may exit after a transaction, buyers might want to keep the existing management team, so your executive team and key employees must be impressive. If you aren't confident that you have the right people in the right jobs, now's the time to hire or promote the next generation of leaders. Present buyers with a finely tuned team that knows their jobs, has a track record of success with the company, works well together, and can move the business forward.

Training, mentoring, and professional development programs also show that you are committed to building a robust workforce. A succession plan—regardless if the new owners use it—shows that you are serious about the future.

Improve Cash Flow

It goes without saying but, above all else, buyers want positive and growing cash flow. Look at your company's historical and projected sales, profit, and growth—these are strong selling points if they're beating industry standards. Take steps to improve financial trends across the board, and ask your trusted financial advisors for their input and suggestions.

Consider Customers

Is a disproportionate amount of revenue coming from just a few customers? A diverse customer base reduces risk for buyers.

Brainstorm with your sales team about what they need to attract new customers, whether it's a different product, a wider footprint, or updated positioning. They will have ideas.

Get Tough

When you're running a company day to day, it's easy to lose sight of the bigger picture. Getting ready to sell means making tough decisions. Look at the company through the eyes of a potential buyer.

Are there family members or long-time employees who should move on? Is it time to close an underperforming location or phase out a marginal line of business? Is there a sales or marketing opportunity you're missing or haven't staffed for? Put resources in place to show that you're taking appropriate steps to grow the business and help it thrive.

Take Time

Many of these improvements won't happen overnight, so give yourself time to examine the business, consider options, and implement changes. Many transaction specialists suggest three to five years to get a business in shape to sell.

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How to Work with a Neutral Valuation Professional

In most valuation disputes, each side hires its own valuation expert. Naturally, the two experts often disagree about the value of the assets in question. In court, the experts present their opinions, the attorneys argue the merits of each valuation, and the judge or other "finder of fact" decides the outcome, often leaving one side unhappy.

There is another way: In some circumstances, a neutral expert can represent both sides—an option that is becoming more popular in cases of divorce, shareholder disputes, and other business disagreements.

The Benefits of Neutrality

Valuations can be costly, time consuming, and stressful for both parties. Using a joint, neutral valuation professional can move a case along efficiently.

Save money. There's no question that hiring one expert instead of two (or sometimes more) saves money for both sides. This is the most obvious and compelling reason for using a neutral appraiser and is especially appealing to divorcing spouses who want to preserve assets.

Save time. Because the expert is working for both parties, there's less time waiting for document production, fewer scheduling conflicts, and less back and forth between parties. This often expedites the case or settlement and lets the parties move ahead more quickly.

Ensure flexibility. Using a neutral valuation analyst is not a rigid arrangement. Clients can decide how to use the professional, whether it's for a final opinion, a negotiable opinion, or a "yes/no" acceptance, where both parties agree to accept the opinion.

Agree to Ground Rules

Once the parties have agreed to hire a neutral valuation professional, they must set ground rules. For example:

Communication: All communication should be transparent. Everyone should be copied on correspondence so that all parties have the same information. One way to ensure this—and avoid any privileged conversation by one party or the other—is to require all communication to be in writing.

Disclosure: The neutral valuation analyst must have access to all documents, data, and other information related to the case, from tax filings to interview notes.

Engagement details: Engagement letters are especially important when a neutral analyst is involved because they clearly define the scope of work and the process involved. For example, do the parties want a formal valuation or will a calculation of value do? How will the appraiser gather information? What's the proposed timeline?

Fees: Typically, both parties contribute to the cost of the valuation. Payment in advance eliminates the possibility that one party will be dissatisfied with the outcome and refuse to pay.

Finding a Neutral Analyst

Both parties should be involved in selecting the neutral valuation analyst. Look for credentialed candidates with exceptional communication skills. Both parties should feel satisfied with the choice and confident that the selected professional can indeed be neutral.

Hiring one valuation professional doesn't guarantee a good outcome or even a pleasant experience in heated litigation, but a neutral analyst can save time and money in most circumstances.

Valuation vs. Calculation: When Is a Calculation Appropriate?

When it comes to valuations, CPAs must follow the guidelines of The American Institute of Certified Public Accountants (AICPA), specifically the AICPA's Statement of Standards for Valuation Services No. 1 (SSVS).

SSVS describes the two types of valuation engagements CPAs can perform to estimate value: valuations and calculations.

Here are some questions and answers to clarify the differences between the two engagements and when they might be used.

How are they different?

A valuation requires more procedures than a calculation and results in a *conclusion of value*. In a valuation, the analyst estimates the value of the asset by applying whichever valuation methods he or she deems appropriate given the circumstances. The conclusion can be expressed in a range or a single amount.

In a calculation, the analyst and client agree on the valuation methods and approaches to be used and the extent of the limited procedures to be performed. It is a less rigorous process than a valuation and results in a less detailed analysis and report. A calculation results in a *calculated value*. Like a valuation, calculation results can be expressed in a range or a single amount.

When is each used?

All things being equal, a valuation is better in most litigation settings and for IRS compliance (see the following), financial reporting, and specific types of corporate planning.

Because a calculation is limited in scope and includes only approaches and methodologies to which the client agrees, it is generally more appropriate for lower-level corporate planning, preliminary or transaction discussion, and mediation or negotiations.

For employee stock ownership plans (ESOPs), the U.S. Department of Labor expects a full valuation rather than a calculation.

In litigation, if a calculation has been done for preliminary planning purposes, it is likely that the valuation analyst will insist on performing a full valuation if the case goes to trial.

What are the benefits of a calculation?

Calculations typically take less time and are less expensive than valuations. They are sufficient in the right circumstances for the right purposes.

What does the IRS say?

The IRS and tax courts generally demand a valuation rather than a calculation. However, depending on the jurisdiction, there are cases when the IRS has accepted calculations for estate and gift tax purposes. Note that the agency doesn't officially confirm this.

Which is right for you?

SSVS is nuanced but in many cases doesn't prohibit analysts from choosing a calculation or a valuation. The right choice largely depends on the purpose of the engagement, the intended use of the analysis, and the audience it is prepared for.

There is certainly a place for calculations. But to decide which type of engagement to pursue requires a discussion between the client and the valuation analyst and, in dispute cases, the client's attorney.

The Secret to Valuing Trade Secrets

Every few years, the same intriguing trade secret rumors circulate the internet. “The formula for Coca-Cola has been discovered!” “The ingredients for KFC’s 11 herbs and spices has been revealed!” Doubletree’s chocolate chip cookie recipe has been disclosed!

Unfortunately, most of these proclamations are untrue. They do, however, reinforce the nature and value of trade secrets and their competitive edge. While these examples may be the most well-known, many businesses have trade secrets, from proprietary processes to software and formulas.

In accounting, trade secrets are considered intellectual property, which is a type of intangible asset. Intangible assets are non-monetary assets without physical substance.

They must meet three criteria:

1. Identifiability
2. Control
3. Future economic benefit

Determining the value of a trade secret can be useful in tax and strategic planning, to raise capital, in licensing transactions, or to support litigation, bankruptcy, or dispute resolution.

Valuation analysts use several techniques to determine the value of intangible assets depending on the valuation purpose.

The discounted cash flow (DCF) method is a popular option, which takes into consideration the estimated future cash flows associated with the asset, discounted using cost of capital to reflect its present value.

Among the elements used in this calculation are the costs associated with developing and protecting the trade secret; how and when the secret might become obsolete or less valuable; its associated benefits, such as greater sales, improved efficiencies, or licensing potential; and associated risks.

Because of the nuanced nature of these types of valuations, it’s important to choose an analyst with experience in trade secret valuations.