

CHAPTER ONE

INTRODUCTION

I. INTRODUCTION

The purpose of this session is to bring together, summarize, and apply the concepts learned in previous sessions. Every effort will be made to provide practical guidance and real world examples. By the end of the day, the participant will feel as if they have experienced a representative business valuation engagement.

We will familiarize ourselves with the valuation process manual of the hypothetical JRB Consulting LLC.

Appendix I is devoted to detailed case study integrated with review and refinement of concepts studied in previous sessions.

There is great deal you can learn in a class room environment. The balance must be learned from experience, sometimes the hard way. It is the objective of this session to reduce the number of things that the participant might otherwise learn the hard way.

II. THE VALUATION PROCESS

Herein you will find the valuation process manual of a hypothetical valuation firm called JRB Consulting LLC ("JRB"). The guidance contained in JRB's "Valuation Process" manual is not authoritative. For authoritative guidance, the participant should look to *NACVA Professional Standards* and any other standards that may be applicable to them. For example, CPAs should look to the *Rules of Conduct* of the American Institute of CPAs and any valuation standards it may have promulgated.

JRB's manual is presented because it goes beyond compliance with professional standards to include useful practice management tips. While not authoritative and certainly not all inclusive, it is hoped JRB's Valuation Process will provide the participants with a practical reference until such time as they develop and document their own best practices.

A. JRB CONSULTING LLC—INTRODUCTION

There are many steps in the valuation process, which can take months for an experienced and well-qualified valuator to complete. The order or necessity of certain steps may vary based on the purpose or scope of the valuation. No single valuation method is universally acceptable for all valuation purposes. For example, valuations for estate planning or gifting purposes are subject to rulings and regulations from the Internal Revenue Service. As such, these valuations have stricter requirements than those prepared for internal parties. The process described in the following pages addresses many of the typical steps JRB Consulting LLC (“JRB”) takes during the valuation process. While each valuation is unique, requiring independent and creative thinking, there are certain aspects of the valuation process common to many valuations prepared at JRB.

B. OUTLINE OF THE VALUATION PROCESS

1. Preliminary

- a) Orientation
- b) Learn about the Valuation
- c) Decide Whether to Pursue the Valuation
- d) Approval from the Acceptance/Retention Committee

2. Pre-Hire

- a) Quote a Fee
- b) Send the Engagement Letter and Data Request
- c) Hired/Not Hired by the Client

3. Pre-Valuation

- a) Collect Necessary Client Information
- b) Assign the Valuation, If Necessary
- c) Prepare for the Due Diligence Meeting(s)
- d) Conduct the Due Diligence Meeting(s)

4. Valuation

- a) Review/Discuss Findings from Due Diligence Meeting(s)
- b) Write the Company Narrative
- c) Conduct Financial Analysis
- d) Normalize the Company’s Financial Statements
- e) Research the Economy and the Company’s Industry
- f) Decide which Valuation Approach(es) to Use
- g) Determine Whether any Discounts (or Premiums) are Appropriate
- h) Develop a Preliminary Value
- i) Complete Rough Draft of Report
- j) Peer/Supervisor Review of Report

5. Client Feedback

- a) Deliver Draft Report to Client
- b) Collect Feedback
- c) Determine Whether to Make Client Changes

6. Report Delivery

- a) Finalize the Report
- b) Deliver the Final Draft to the Client
- c) Send the Invoice and Collect Payment
- d) Ascertain Satisfaction with the Valuation
- e) Maintain Contact with Client

III. STEP 1: PRELIMINARY

The beginning of the valuation process involves the discovery and orientation of the valuation assignment, the process of learning about the valuation, deciding whether to accept the valuation, and gaining approval from the acceptance/retention committee (if applicable).

A. ORIENTATION

Like most businesses, valuation firms find customers in a variety of ways. While the valuing party (known hereafter as the “Valuator”) at JRB may proactively seek valuation assignments, referral sources usually provide most of the valuations for established Valuators. Common referral sources include law firms, accounting firms, and banks. Because of the importance of referral sources, valuers dedicate considerable resources toward maintaining relationships with them. The referral source will normally provide the Valuator the name of the company to be valued (the “Company”) as well as the hiring party on the valuation (the “Client”). In most instances, the Company is also the hiring party. However, other possible hiring parties include the Company’s accounting firm or the owner(s) of the Company.

It is also common for the Client to contact the Valuator directly. If the Valuator has prepared reports for the Client in the past, or if the Valuator has a strong reputation in the valuation industry, this may be a common way to receive potential engagements. Valuations prepared for public companies, which may be included in public reports filed with the U.S. Securities and Exchange Commission (“SEC”), are a common way for potential Clients to learn about valuers.

Lastly, because JRB is a subsidiary of an accounting firm, JRB’s valuers may be presented with potential valuations internally. If a client from the accounting department needs a valuation, the Valuator has an obvious advantage over a competitor. However, the Valuator may not be able to conduct the valuation in some instances if it violates the Sarbanes-Oxley Act of 2002. Included in the act was a statute prohibiting audit firms from doing a variety of non-audit work for their clients in order to address certain conflicts of interest. This may be true of non-public companies as well. CPAs should consult AICPA Ethics Interpretation 101-3.

B. LEARN ABOUT THE VALUATION

Once introduced to the Company, the Valuator should determine if the Client needs a valuation. Some clients may be under the impression that they need a valuation in situations when one is not required. The Valuator should make clear to the Client whether a valuation is necessary. Sometimes, a client who does not require a valuation may decide to proceed with one anyway; it is then up to the Valuator to decide whether to value the Company.

Once both parties agree to consider a valuation, the Valuator should learn:

1. What is the valuation date?
2. What is the scope of the valuation?
3. What is the purpose of the valuation?
4. What will be the standard (and premise) of value?

Because the value of a Company can continuously change, the date of the valuation is important. The Valuator may not use information arising after the valuation date when determining a value for the Company. The scope and purpose of the valuation will help an experienced valuator estimate the amount of time needed to complete the report as well as the valuation approaches he or she will likely take. The standard of value, which is determined by the purpose of the valuation, is also important. The most widely accepted and widely used valuation standard is fair market value, which, according to Revenue Ruling 59-60 from the Internal Revenue Code, is the amount at which property would change hands between a willing seller and a willing buyer when neither is acting under compulsion and when both have reasonable knowledge of the relevant facts.

While the Valuator is learning about the aspects of the valuation, he/she may also want to learn about the Company. An appropriate beginning to this discussion is often a discussion of the Company's history and the products or services the Company sells. The characteristics of the Company may have an impact on the fee the Valuator will seek for the engagement. For example, larger companies, with greater complexity in operations, will normally require more hours of work from the Valuator. As such, this will likely impact the fee for the valuation.

C. DECIDE WHETHER TO PURSUE THE VALUATION

After learning about the valuation, the Valuator is in a position to decide whether to accept the engagement. If the Valuator is unsure whether the Client will be able to pay for a valuation, or believes the Client will ultimately decide to use a competing valuation firm, the Valuator may choose to decline the proposal and end the relationship with the Client. Additionally, the Valuator may not possess the knowledge or expertise necessary to prepare the valuation correctly. Thirdly, if the Valuator is concerned about his or her ability to complete the engagement within the required timeframe, he or she may choose to pass (or ask for a higher fee).

D. APPROVAL FROM THE ACCEPTANCE/RETENTION COMMITTEE

Many firms, including JRB, have acceptance/retention committees ("ARC"s) which review potential valuations before they can reach a contractual state. The ARC's main purpose is to determine whether it would be in the firm's best interest to enter a contractual relationship with the Client. The ARC at JRB is mostly concerned with the Client's ability and desire to pay for the valuation. If the ARC rules that the firm should not be involved with the Client, the

Valuator will not be able to pursue the valuation any further under the current terms. The Valuator may request a retainer of payment in advance to alleviate concerns the ARC may have about the Client's ability and desire to pay for the valuation.

IV. STEP 2: PRE-HIRE

Once the ARC has approved the pursuit of the Valuation, the Valuator's focus becomes getting hired for the valuation. In order to be legally hired, the Valuator needs the Client to sign an engagement letter. Before sending the engagement letter, the Valuator needs to determine the appropriate fee for the assignment.

A. QUOTE A FEE

Many valuers look to their professional standards (whatever they may be) or the standards of NACVA when determining a fee for the valuation. The Valuator may set a fee as a fixed price, a range of prices, or based on an hourly rate. Clients usually prefer a fixed fee so the exact cost of the valuation is not ambiguous. The more clearly defined the engagement is, the more likely the Valuator will be able to quote a fixed fee (or narrow range of fees). The Valuator is required to value the Company independently, and therefore, cannot set a fee that is contingent on a certain valuation decision (or court decision in a litigation assignment).

There are numerous considerations when setting a fee for a valuation. The primary consideration is usually the estimated number of employee hours necessary to complete the valuation. As mentioned previously, characteristics of the Company (i.e., its size) may impact the amount of time needed. Also, when the Valuator is busy, employee hours become more valuable, and the Valuator may decide to raise the fee. Not only are the number of hours important, but the person expected to do the valuation is also significant. Some valuations are more difficult than others, and may require the expertise of a director or management-level employee. If the project calls for substantial management time, which is more costly, the fee should be priced accordingly.

A Valuator may be willing to charge a reduced fee for a valuation in certain instances. If the valuation will most likely lead to additional valuations in the future (i.e., updates for employee stock ownership plans), the anticipated steady future inflow of business may be worth reducing the price of the initial engagement. Also, the Valuator may apply a discount on a valuation for a preferred Client or at the request of an influential referral source.

B. SEND THE ENGAGEMENT LETTER AND DATA REQUEST

The Valuator is legally hired on the valuation when a signed engagement letter is received from the Client. The engagement letter must define the assignment, including the Company to be valued, the interest in the Company to be valued, the level of value, and the purpose of the valuation. The interest in the Company can be stated as a percentage or as a number of shares. The level of value states the degrees of control and marketability of the interest. The purpose of the valuation is possibly the most critical factor of the engagement letter. Different regulations and case precedent standards govern valuations for different purposes. The Valuator should explain to the Client that the valuation should only be used for the intended purpose stated in the engagement letter. A different use would possibly require different approaches to be taken by the Valuator, and thus, could lead to a different value. Also, the purpose of the valuation

significantly impacts the amount of time needed to complete it (and thus, the fees required by the Valuator).

Aside from defining the assignment, the engagement letter at JRB also includes the following items:

1. Timing

The Valuator should estimate the amount of time needed to complete the valuation, while admitting that unforeseen circumstances could change the timing of the project.

2. Fees

The Valuator should explicitly state the quoted fee for the project. Additionally, the fee should be allocated to the different services the Valuator intends to provide. If the Valuator requests a retainer, that should also be stated in the engagement letter.

3. Dispute Resolution

The engagement letter should detail the steps that should be taken by both parties if any dispute or controversy arises during the valuation process.

4. Indemnification

The engagement letter should also indemnify the Valuator and other employees at JRB against any liability, claim, or damage asserted by third parties arising from or in connection with the valuation process. This indemnification does not include gross negligence, unauthorized acts, or willful omissions.

5. Confidentiality

The engagement letter should set the confidentiality arrangement for the valuation. It is the responsibility of the Valuator and JRB to keep information regarding the Company strictly confidential. The Valuator may not release any of this information without the consent of the Company.

In order to simplify the communication process, the Valuator will often send the data request with the engagement letter. The data request explains the information the Valuator will need from the Client in order to do the valuation (examples of items included in the data request are included later in the report). It may take time for the Client to collect all of the Company information needed by the Valuator. By sending the data request prior to the hiring, the Valuator gives the Client additional time to collect the necessary information.

C. HIRED/NOT HIRED BY THE CLIENT

After the Valuator has quoted a fee and sent out the engagement letter, certain aspects of the valuation may be negotiated before the hiring decision is made. Specifically, the fee is often negotiated to a level that is acceptable to both the Client and the Valuator. If after these negotiations the two parties cannot agree on a reasonable fee, the Client may choose not to proceed with the valuation or hire another valuator.

There are other issues that may arise which cause the Client to refuse to sign the engagement letter. The Client may find some of the terms of the engagement unacceptable (i.e., the methods for handling disputes). Alternatively, the Company may wish to change the definition of the engagement (i.e., the interest to be valued). If these issues can be resolved, the Valuator is able to reissue an engagement letter (and may choose to revise the fee). If the issues cannot be resolved, the Valuator will not be able to conduct the valuation. Once the engagement letter is signed by the Client, the Valuator can begin the initial steps of the valuation of the Company.

V. STEP 3: PRE-VALUATION

Once the Valuator is hired, he or she can begin working on the valuation. Prior to writing the report, the Valuator must collect all applicable information and meet with the Company for the necessary due diligence meetings (“DD meetings”).

A. COLLECT NECESSARY CLIENT INFORMATION

Since the data request has already been sent to the Client, it is the Valuator’s responsibility to ensure that all necessary information is obtained. Recent financial statements (or federal tax returns) are usually the most important pieces of information and crucial to the valuation. These financial statements should include a balance sheet, income statement, statement of cash flows, and statement of stockholders’ equity. Financial statements that have been audited or reviewed by an external accounting firm may be more reliable than internal statements.

Aside from the financial statements, the following information may be useful to collect from the Client:

1. Previous Valuations

Reviewing prior valuations may give the Valuator insight and suggestions on how to value the Company.

2. Previous Transactions

Arms-length transactions involving ownership in the Company can provide insight into the Company’s market value and may be used as evidence in supporting a value.

3. Sales Materials

The Valuator should ask for sales and other promotional materials that the Company uses, including brochures, catalogs, and presentation pamphlets.

4. List of Key Personnel

If possible, the Valuator should try to obtain a copy of the Company’s organizational chart or list of officers. This information helps in understanding the organizational structure of the Company.

5. Customer Lists

Customer lists are important for many reasons. A list will help the Valuator understand the number and types of companies that the Company serves.

6. Budget or Forecast

A Company budget or forecast will help the Valuator evaluate the intended direction and future goals of the Company. This information is especially helpful when using the income valuation approach (to be discussed later).

7. Contracts

The Company's contractual obligations are important to consider when conducting a valuation. Contractual arrangements the Company may have include: leases on property or equipment, customer or supplier contracts, union contracts, executive contracts (i.e., non-compete agreements), and contracts involving the use of trademarks.

Through the course of the valuation, it may be necessary to ask for additional information, especially if special circumstances arise.

B. ASSIGN THE VALUATION, IF NECESSARY

At JRB, an upper-level employee is responsible for securing valuation assignments while an analyst or manager is responsible for writing the valuation report. Because the two tasks fall to different people, the valuation is normally introduced to the analyst after the Company information has arrived. Therefore, the analyst will be able to prepare for the DD meetings, which he or she will likely attend with the upper-level employee.

C. PREPARE FOR THE DUE DILIGENCE MEETING(S)

All of the information gathered from the Client should be reviewed by the Valuator prior to the visiting to the Company for the DD meetings. Anyone else from JRB who will be attending should also be familiar with the Company and the valuation. One of the Valuator's main focuses during the DD meetings likely will be the Company's financial statements. Prior to the DD meetings the Valuator will want to familiarize himself/herself with the Company's recent performance, specifically revenue and earnings levels. The Valuator should note any unusual expenses¹ or fluctuating revenue levels so it can be discussed during the DD meetings. By minimizing the time spent on the basic elements of the Company, the focus of the DD meetings can revolve around only on the most essential, value-affecting factors.

Many valuers prepare a list of questions for the DD meetings. The Valuator should request a list of the people he or she will be interviewing. Depending on the person to be interviewed, the appropriate questions may change. A questionnaire used by valuers at JRB includes the following topics:

¹ If the expenses are non-recurring, they may need to be adjusted to normalize the Company's performance (to be discussed later).

1. Product-Related Topics

Describe the Company's products/services. How diversified are the services? Do all sales depend on the same factors? Are sales cyclical? What economic factors (inflation, interest rates, etc.) affect sales?

2. Industry Topics

What is the size (in dollars) of the market in the industry? What is the Company's market share? How fragmented is the market? Is the market growing or shrinking? Who are the Company's major competitors? Where are they located?

3. Operational Topics

Describe the Company's organization structure. How old are the Company's facilities? What is capacity related to current operating levels? Are buildings/equipment owned or leased?

4. Management Topics

Discuss the Company's officers (age, health, education, experience, and current duties). Discuss any turnover in key members of management over the last five years. How easily can officers be replaced?

5. Financial Topics

Has there been any change in accounting principles during the past five years? Identify the key operating ratios of the Company. Has there been any non-recurring or extraordinary income or expenses during the last five years?

6. Company Expectations

Describe the Company's future expectations, goals, objectives, and long-range plans. Are there any expected spin-offs, mergers, or acquisitions?

D. CONDUCT THE DUE DILIGENCE MEETING(S)

The DD meetings are one of the most important steps to the valuation. Valuation guidelines require the Valuator to visit the Company prior to completing the valuation. The Valuator must leave the DD meetings with a solid understanding of the Company, or at least how the Company perceives itself and its industry.

The DD meetings consist of interviews with those persons who can give the Valuator information that is pertinent to the value of the Company. Most of the time, the Valuator will meet with the Company's management (specifically, President and/or CFO). However, in some companies, these responsibilities are carried out by people who are not employees of the Company. For example, in some smaller companies, the Company's consultant or accountant may have the best understanding of the Company's business and financial situation. The Valuator needs to work with the Client to determine who is able to provide the necessary information.

The previous section gave a list of questions commonly asked during the DD meetings. After the Valuator has asked every relevant question, he or she should ask a catch-all question to ensure that he or she has not missed anything important (i.e., “Is there any information or issues pertinent to this valuation that we have not discussed to this point?”). Even experienced valuers can forget an important question or fail to ask a question in a way that elicits the necessary response. By asking a catch-all question, the Valuator gives the interviewees the chance to cover important information that had not already been discussed.

Because the Valuator needs to acquire a sufficient understanding of the Company, it may be helpful for him or her to tour the operating facility (if the Company has one). This can be done before, after, or during the interviews. Touring the Company’s operating facility can give the Valuator a better understanding of the way the Company operates. The Valuator may get an idea of capacity constraints and future capital needs from seeing the Company’s machinery and equipment. The Valuator may also form opinions on the Company based on the interaction of its employees.

In some cases, it may be a good idea for the Valuator to interview individuals outside the Company after the Company DD meetings. Sometimes interviews with outsiders are helpful for learning technical information on the Company’s industry. Outsiders may also be able to provide an independent, unbiased view of the Company. However, for most valuation assignments, confidentiality arrangements make it inappropriate to contact outsiders, especially without the Client’s permission.

VI. STEP 4: VALUATION

The actual valuation step of the valuation process is highly complex and varies significantly for each assignment. The steps detailed below are common during valuations at JRB. However, these steps may not be included in every valuation, and some valuations may require additional steps.

A. REVIEW/DISCUSS FINDINGS FROM DUE DILIGENCE MEETING(S)

After the DD meetings, the Valuator should have a deep understanding of the Company. At this point, the Valuator can explain the reasons for the Company’s past performance and give an opinion on the anticipated direction of the Company in the future. If more than one employee of the Valuator’s firm was present at the DD meetings, the group can discuss the appropriate valuation method(s) and talk about potential problems or issues.

B. WRITE THE COMPANY NARRATIVE

It is important for the Valuator to show that he or she has adequate knowledge of the Company. Most of the information to be included in this section will probably be learned during the DD meetings. The narrative is normally located at the beginning of the report, giving a reader of the valuation a solid understanding of the Company. It is likely that the Company narrative will be referenced throughout the rest of the report.

The following sections are commonly found in the Company narrative:

1. Origin/History

Including the date and location where the Company was founded, the names of the founders, and the original business description. This section should include major events in the Company's history and give a general synopsis of how the Company has evolved over its life.

2. Ownership/Management

Including a list of shareholders (with shares owned), the number of shares of each class of stock, and any shareholder agreements. The Valuator should also give a list of the management team or officers, including tenure with the Company.

3. Products/Services

Generally, what does the Company do? This section could include a list of products/services offered, the Company's sales mix, as well as key suppliers and customers.

4. Personnel

Including the number of employees, allocation of employees at each location, employee compensation and benefits, and any pending or past labor issues.

5. Property and Equipment

Including location of the Company's headquarters and all other facilities, as well as size, age, and ownership of each. It is also important to include major equipment owned or used by the Company. This section can also mention capacity or expansion plans for the future.

C. CONDUCT FINANCIAL ANALYSIS

The financial analysis should include a detailed synopsis of the Company's financial performance, incorporating financial statements (preferably reviewed or audited) and other financial data used by the Company. The Valuator should state the source of all information he or she used in conducting the financial analysis.

The Valuator should give a detailed breakdown of the Company's historical balance sheets, income statements, and possibly statement of cash flows. The balance sheet analysis should mention the Company's main assets and liabilities. Specifically, the Valuator should talk about important current assets, the investment in plant and equipment, levels of debt, and changes to stockholders' equity. When analyzing the income statement, the Valuator should discuss changes and growth in revenue, expenses, and earnings. Aside from describing the financial statements, the Valuator should also include a list of financial statistics (i.e., current ratio, asset turnover, and return on equity/assets) that describe the condition of the Company.

D. NORMALIZE THE COMPANY'S FINANCIAL STATEMENTS

While conducting the financial analysis of the Company, the Valuator should attempt to distinguish between those events in the Company's past that represent the Company on a go-forward basis and those that do not. The Valuator should adjust the income statements to eliminate the effects of past events that would tend to distort the Company's current and future earnings capabilities. "Normalized" income statements can then be used to project future cash flows and compare to other companies.

In order to normalize the income statements to reflect typical Company performance, the Valuator should adjust (or remove) extraordinary, non-recurring, or unusual events in the Company's past. Examples of events that may fit this description include uninsured flood damage, legal expenses pertaining to a concluded lawsuit, insurance proceeds from the death of a key person, or a repair bill on a major piece of equipment. Leaving these anomalous events in place can distort the Company's earning capabilities. If the Valuator makes normalizing adjustments, he or she should explicitly show these adjustments and the reasoning behind them. The Valuator should also note when he or she is using normalized financial statistics (rather than actual, historical statistics) in valuing the Company.

E. RESEARCH THE ECONOMY AND THE COMPANY'S INDUSTRY

An understanding of the economic and industry outlook is essential in determining the Company's prospects for the future. As such, the Valuator should give a detailed analysis of each.

It is uncommon to find a Company that is not affected, either directly or indirectly, by the condition of the economy. Demand for a Company's products or services may rise or fall based on whether the economy is performing well or poorly. Also, companies which carry debt usually pay interest at floating rates, and interest rates are impacted by the condition of the economy. Even if the Company is not directly affected by the economy, it is still likely that some of its suppliers or customers are. Federal government agencies (i.e., the Federal Reserve Bank) are generally good sources for finding economic information. Many business periodicals (i.e., *Fortune* or *The Wall Street Journal*) also frequently report economic conditions.

While it may be more difficult to gather information on the Company's industry than the economy, the Company's industry outlook is no less important to the valuation. The Valuator needs to know the size, growth trends, competition, and position of the Company in its industry. Like the economy, understanding the industry conditions and position of the Company helps the Valuator formulate projections for the Company's future. The DD meetings are often the best way for the Valuator to learn about the Company's industry. If the Valuator can find public companies in the Company's industry, those company's annual reports will usually give insight on the conditions of the industry as well. Other outside sources of information on industries include firstresearch.com and valuationresources.com.

F. DECIDE WHICH VALUATION APPROACH(ES) AND METHOD(S) TO USE

There are three common approaches used in valuation theory – the market approach, income approach, and asset (or cost) approach. Some combination of these approaches is typically used for a valuation, and the Valuator may choose to use one, two, or all three of them. The Valuator may also use multiple methods for each approach. For example, the market approach has two

common methods – the guideline public company method and the guideline transaction method (each are discussed below). The Valuator may use both of these methods in a valuation. A description of each of the valuation approaches is presented below:

1. Market Approach

The market approach is a valuation technique whereby the value of a company is estimated based on pricing relationships associated with market transactions involving similar companies. These observations make it possible to estimate the value of shares that have no active market. The market approach includes two primary methods: the guideline public company method and the guideline transaction method. The criteria for comparability in the selection of publicly traded guideline companies or guideline transactions include business and operational characteristics, growth patterns, relative size, earnings trends, markets served, and risk characteristics. If the Company has a specific niche in its industry or an unusual operating structure, it is likely that the Valuator will not be able to use one (or both) of the valuation methods of the market approach.

- a) The Guideline Public Company Method—Involves comparing the Company to companies in its industry that trade on one of the public stock markets. In order to find comparable companies, valuers may search by the Company's SIC (stands for Standard Industrial Classification) code or NAICS (North American Industry Classification System) code on search engines such as yahoo.com. Also, business websites such as hoovers.com are good places to find competitors in a given industry. Since these companies report financial information with the SEC, it is not difficult for valuers to find their financial statements. Reuters.com and yahoo.com are good places to obtain financial statements because they report each company's financials using a common format.
- b) The Guideline Transaction Method—Involves comparing the Company to companies in its industry that have been sold recently. It is often difficult to find useful data of privately held companies, which do not report financial information with the SEC. Bvmarketdata.com (which includes the Pratt's Stats database) and bizcomps.com are commonly-used websites for finding transaction data.

2. Income Approach

The income approach is a valuation technique in which the value of a company is estimated based on the earning capacity of that company. The income approach consists of two basic income-driven methods to derive an estimate of value: single period capitalization and multiple period discounting. Both methods attempt to convert anticipated income to a present value. Because of the similarities of the two methods, an valuator will normally choose to use one or the other.

- a) Capitalized Cash Flow Method—Involves the application of one divisor to one economic income measure, which is normally the Company's normalized distributable cash flow. The divisor is the discount rate², which is a market-derived rate of return that would induce investors to commit funds to the subject investment. Single period capitalization is most appropriate when a company's current level of operations is believed to be representative of future operations, and the company is expected to grow at a relatively stable and modest rate.
- b) Discounted Cash Flow Method—The multiple period discounting approach is essentially a more complex version of single period capitalization. Under this approach, projected distributable cash flows are discounted back to present value using the discount rate described above. Multiple period discounting is more appropriate when the business' operations are expected to grow at widely varying or rapidly increasing rates.

3. Asset Approach

The asset approach is typically used in the valuation of holding companies and in the valuation of asset-intensive operating companies with modest profitability, and it is often an inappropriate approach to employ when valuing profitable operating companies. One form of the asset approach involves identifying all of the business' assets (both tangible and intangible) and liabilities (both reported and off-balance sheet) and restating them to fair market value either collectively or discretely, with the difference equaling the Company's value. An valuator will sometimes be able to judge the appropriateness of using the asset approach by the Company's book value of equity.

G. DETERMINE WHETHER ANY DISCOUNTS (OR PREMIUMS) ARE APPROPRIATE

Valuations often include discounts (or premiums) that are subtracted from (or added to) the concluded value of invested capital or equity. The most common valuation discounts include lack of marketability (for valuing a privately-held or infrequently-traded stock), lack of control (for valuing a minority interest), and lack of voting rights (for valuing an interest which lacks the capacity to vote). A nonsystematic risk discount may also be appropriate, especially in situations where the Company is dependent on a specific employee or customer.

The necessity of valuation discounts will normally be apparent at the onset of the engagement. However, sometimes the correct discounts will not be obvious—for example, a Client who owns a controlling interest in a company may ask for a valuation on a minority-interest basis for purposes of gifting portions of their interest.

An ownership interest is marketable if it can be converted into cash quickly, at minimal cost, and with a reasonable degree of certainty of realizing the proceeds from the sale. While a publicly-traded stock is normally considered fully marketable, ownership interests in private companies are not. Lack of marketability discounts, normally applied in valuing privately-held interests, are impacted by the perceived ability of the shareholder to sell his or her interest.

² The discount rate (or cost of capital) is the expected return by investors for a given investment. The discount rate used in the valuation of stocks incorporates a risk-free rate of return (i.e., a U.S. Treasury bond), an equity risk premium, industry risk (i.e., beta or an industry risk premium), size risk (which may necessitate a size risk premium), and a specific Company risk premium. Ibbotson Associates issues an annual book, Stocks, Bonds, Bills, and Inflation, which is helpful in determining a company's discount rate.

Issues to consider when quantifying the discount for lack of marketability include: the number of potential buyers in the subject interest, the estimated holding period before liquidation of the subject interest, the ability of the subject interest to control liquidation, and the distribution policy of the Company (generally, the higher the distribution level, the more marketable the interest, all else equal). Lack of marketability discounts typically range from 5% to 40%, but in some instances can be much higher.

Normally, a non-controlling interest in a business is worth less than its pro rata percentage of overall business value. The value of a non-controlling interest is lower due to the fact that its owner is not able to totally control the financial and operational aspects of the Company. As such, it may be appropriate to take a lack of control discount.³ Lack of control discounts typically range from 10% to 30%. The size of the discount is affected by the distribution level of profits to shareholders and any laws that govern the rights of the ownership interests.

Interests of non-voting shares often incorporate a discount for lack of voting rights because the owner of the Company's nonvoting shares can never, either individually or collectively, exert controlling influences on the Company, either in the direction of its operations or through major decision making. While the owner of a voting share can actively participate in the Company's strategic decisions and management process, the owner of a nonvoting share only has the right to receive economic distributions. Thus, nonvoting shares generally have a lower value than otherwise comparable voting shares. A discount for lack of voting rights is normally an incremental discount added to an already-established discount for lack of marketability or lack of control, and is typically smaller (5% to 10%).

H. DEVELOP A PRELIMINARY VALUE

The value conclusion is normally a synthesis of the values derived from the various valuation methods (assuming more than one valuation method was used). Theoretically, the values derived from each method should be nearly identical. In practice, however, they may vary to a certain degree. The Valuator must determine which valuation methods most accurately reflect the Company, and weight the values accordingly. Current valuation principles do not recommend merely averaging the different values. After making a decision on the appropriate value, any appropriate discounts, such as the ones described above, can be applied.

The preliminary value conclusion can be a single value ('the Company's fair market value is \$X'), a range of values ("the Company is worth between \$X and \$Y"), or a relationship value ("the Company is worth no less than \$X"). While the single value conclusion is most common, the range or relationship value may be preferred in certain situations. For example, when preparing a valuation for a proposed transaction, the Valuator may wish to give a range of values and allow the parties room to negotiate.

If the Company has been valued in the recent past (i.e., for an ESOP update), it may be necessary to reconcile those concluded values with the preliminary value of the current valuation. Considerable changes in Company value are not necessarily unacceptable, but those changes should coincide with changes in Company performance, organization, or size. If there is no apparent reason for the differing valuation conclusions, it is possible that the previous (or current) valuation was prepared incorrectly.

³ Sometimes, an valuator will value the Company's cash flows on a minority basis or use transaction multiples derived from minority interests in companies. In these instances, a discount for lack of control may not be necessary.

I. WRITE THE INITIAL DRAFT OF THE REPORT

A well-written, complete valuation report contains many detailed sections. Because an valuator will use many of the same sections in valuation reports, valuers at JRB have built a modifiable report template. The following sections are included in JRB's valuation report template:

1. Opinion Letter

The opinion letter introduces the valuation to the reader. The opinion letter should be addressed to the Client and should include important information such as the entity being valued, the valuation date, the purpose of the valuation, the standard of value, and the concluded value. Because it gives a value conclusion, the opinion letter may also reference the assumptions and limitations section of the report (see below).

2. Table of Contents

An extensive amount of material is included in the report, and a table of contents will help readers find specific areas of interest.

3. Overview

An overview section introduces the valuation much in the same way as the opinion letter does, and should include many of the same items. The Valuator should also state what factors he or she considered during the valuation (i.e., the book value of the stock, the earning capacity of the Company, the Company's history, etc.) as well as the information the Valuator used (i.e., financial statements, Company budgets, previous valuation reports, etc.).

4. Company Narrative

As mentioned previously, the Company narrative should be placed towards the beginning of the report because it describes the Company in detail to the reader.

5. Financial Statement Analysis

This section should include the Valuator's analysis of the Company's income statement and balance sheet, and if applicable, the normalization adjustments.

6. Economic Outlook

This section presents the Valuator's view of current and future economic conditions and how they relate to the Company, as discussed previously.

7. Industry Outlook

This section presents the Valuator's analysis of the Company's industry, as discussed previously.

8. Valuation Methodology

The Valuator should introduce the various valuation approaches used by valuers during valuations, then explain which approach(es) were used in the report and why.

9. Valuation Method(s)

The Valuator should include a separate section for each valuation method used in the report. These sections, along with the valuation worksheets (see below), should help the reader understand the steps taken to reach the concluding value of each method.

10. Reconciliation of Valuation Methods

If the Valuator used more than one valuation method, this section is used to reconcile the concluded values of each method. If the values cannot be reconciled, the Valuator may have to reevaluate the accuracy of the conclusions reached. As mentioned previously, the concluded value should be a synthesis of the values derived from the various methods.

11. Applicable Discounts

This section presents the Valuator's analysis of appropriate discounts to apply to the value of the Company. This section should also include published studies to support the Valuator's discount decision. One study that helps a valuator determine the discount for lack of control is the Mergerstat Review, which analyzes the control premiums paid for controlling interests in public companies. Studies of restricted stocks (i.e., stocks that have illiquidity issues) issued by FMV Opinions, Inc. and Management Planning, Inc. can help the Valuator determine an appropriate discount for lack of marketability.

12. Conclusion of Value

The Valuator should write a conclusion to the report that explicitly states the concluded value of the Company.

13. Financial Statements

Because the reader may want to reference the financial statements, they should be included as exhibits after the report. It is especially important to include financial statements that have been normalized.

14. Valuation Worksheets

Including the valuation worksheets used by the Valuator to reach a value helps the reader understand and follow the valuation approach(es) taken by the Valuator.

15. Qualifications of Valuation Professional(s)

By showing his or her qualifications, the Valuator adds credibility to the report. The Valuator should include his or her education, valuation experience, professional accreditations (i.e., Chartered Financial Analyst), speaking engagements, published articles/books, and membership in organizations (i.e., American Society of Appraisers).

16. Assumptions and Limiting Conditions

Stating assumptions and limiting conditions of the report can in some instances indemnify the Valuator and JRB from potential lawsuits. A comprehensive assumptions and limiting conditions section may include 10 to 20 items to protect the Valuator and JRB as much as possible. Examples of assumptions and limiting conditions are:

- a) This valuation contemplates facts and conditions that are known or knowable as of the valuation date. Events and conditions occurring after the valuation date have not been considered, and JRB Consulting LLC has no responsibility or obligation to update this report for such events and conditions.
- b) Our conclusion of value is applicable to the subject interest for the stated date and purpose only, and may not be appropriate for any other date or purpose. Any other use of this report may lead the user to an incorrect conclusion for which JRB Consulting LLC assumes no responsibility.
- c) The opinions expressed herein are not intended to be investment advice and should in no way be construed as such. Accordingly, this report is neither an offer to sell, nor a solicitation to buy securities, and/or equity in, or assets of, the Company.

17. Certification

The Valuator should assert, to the best of his or her knowledge, that the statements of fact in the report are true and correct and that that report conforms to the standards of valuation organizations such as the Uniform Standards of Professional Appraisal Practice (USPAP). The Valuator should also verify that he or she performed the valuation independently, that the fee is not contingent on any value, and that he or she has no interest (present or prospective) in the entity which was valued. If any employees at JRB (excluding those listed in the Qualifications of Valuation Professionals) assisted in completing the report, they are included in the certification.

After the rough draft has been written, it should be marked as a draft so it does not mislead readers into thinking it represents a final valuation report. Final reports may be reviewed by authorities such as the SEC, and the Valuator will not want to release a final report until it has been reviewed both internally and by the Client.

J. PEER/SUPERVISOR REVIEW OF REPORT

Once the initial copy of the valuation report has been completed, it is important to have another person review it. If an analyst was the Valuator, a supervisor may be the reviewing party. If a director prepared the valuation, another person at JRB will review his or her work. The reviewer should carefully evaluate the valuation methodologies used by the Valuator. The focus should be on whether the Valuator has used the correct valuation methods and followed the applicable regulations. The reviewer should also check for spelling mistakes and calculation errors, as either could potentially damage the accuracy or credibility of the report. JRB will not send out a draft of a valuation report until it has been reviewed by another party.

VII. STEP 5: CLIENT FEEDBACK

It will normally take the Valuator approximately a month to prepare a draft report for Client review. After reviewing the draft, the Client will likely provide comments and may request changes. The Valuator has the option of incorporating any or all of these changes. Each of these steps is detailed below.

A. DELIVER DRAFT REPORT TO CLIENT

Once the draft report is completed, copies should be sent to the Client for review. In order to save time, draft reports are often faxed or emailed to the Client rather than mailed. Some Clients will request that drafts be sent to other parties as well (i.e., the Client's attorney). It is important to mark the draft as such so as not to mislead the Client or any other party into thinking the draft is a final report (for the reasons discussed previously).

B. COLLECT FEEDBACK

Collecting feedback from the Client is an important step in the valuation process. If the Client does not request any changes, the report is ready to be finalized. However, it is likely that the Client will have some suggestions or changes. Changes requested by the Client vary in nature. The company narrative is a common section for Client changes. Because the Valuator does not have the same understanding of the Company that the Client has, the Client may find minor mistakes made by the Valuator in describing the Company. While changes to the narrative will most likely not affect the value, the Valuator must be weary of other changes requested by the Client that affect the value of the Company. The Client may have certain motivations for requesting a change of value (i.e., if the valuation is being prepared for the possible sale of the Company to a third party, the Client may desire a high value). By agreeing to change the value of the Company, the Valuator risks violating his or her status as an independent valuator.

The Client may also have a set of questions pertaining to the report, especially if he or she has trouble understanding certain aspects of it. A valuation can use complex finance concepts that may confuse those without a strong finance or accounting background. Depending on the knowledge of the Client, the Valuator may have to explain parts of the valuation.

C. DETERMINE WHETHER TO MAKE CLIENT CHANGES

Ultimately, the valuation report is the responsibility of the Valuator. Because the Valuator will certify the valuation, he or she is subject to the regulations that govern valuation assignments. The Valuator must determine if the changes desired by the Client are necessary, accurate, and legal. Once the Valuator has made a decision on which changes to incorporate, he or she has the option of issuing another draft to the Client or finalizing the report. If the Valuator determines the report needs additional Client feedback, the steps above are repeated. Otherwise, the report can be finalized.

VIII. STEP 6: REPORT DELIVERY

Once the report has been written and the Client has reviewed it, the Valuator is able to issue a final report, completing the valuation process. The finished product is typically the most important part of the valuation, so an valuator should take great care during the following steps.

A. FINALIZE THE REPORT

An accurate and comprehensive valuation report is the desired goal of most valuations. The final report must withstand the scrutiny of the Client and regulatory organizations. After the final report is written, JRB will bind and format the report into a finished product. The Client usually specifies how many copies need to be made. JRB will always keep a copy of the report in case it needs to be referenced in the future.

B. DELIVER THE FINAL DRAFT TO THE CLIENT

Once the report has been finalized, the finished product is delivered to the Client. The Valuator may wish to visit the Client to explain the valuation to the appropriate party or parties (i.e., the Client, Company management, and/or Company shareholders). This is especially important for clients who may not have a strong finance or accounting background.

C. SEND THE INVOICE AND COLLECT PAYMENT

After the delivery of the final report, the Valuator should collect the valuation fee (net of any retainer received at the onset of the project).⁴ If the valuation required any additional expenses from the Client, the Valuator should detail these expenses in the invoice. Similarly, if the valuation required additional hours from the Valuator (not covered in the originally quoted fee), the Valuator should provide the Client a detailed breakout of the additional hours spent on the project. Once the Client has the invoice, if the valuation is not paid for in a timely manner, it may be appropriate for JRB to pursue legal action.

⁴ For some clients, JRB will send the invoice with the draft of the report, with the intention of providing the final report after the Client has paid in full.

D. ASCERTAIN SATISFACTION WITH THE VALUATION

Following up with the Client to discuss their satisfaction with the valuation is an important step in the valuation process. By getting feedback from the Client, the Valuator is better able to objectively review his or her valuation process and strategies, making changes with the goal of better serving clients in the future. Ensuring the Client is satisfied can benefit the Valuator financially as well. If the Client is pleased with the valuation, the Client could hire JRB for additional valuation work in the future. The Client could also become a valuable referral source. At the same time, if the Client is not satisfied with the valuation, it could hurt the Valuator's and JRB's goodwill and reputation. This is especially damaging if the Client has contact with the Valuator's referral sources. Therefore, client satisfaction is important.

E. MAINTAIN CONTACT WITH CLIENT

After the valuation is complete, the Valuator should maintain contact with the Client. If the Client was satisfied with the valuation, continuing the relationship opens up the possibility of the Client seeking additional work in the future.

PARTICIPANT NOTES