

October, 2010 Update

Small Business Administration SOP 50-10 5 (C)

and

Small Business Jobs and Credit Act

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Introduction

In the aftermath of the recent **flurry of regulatory and legislative changes** which impact various SBA loan programs that are in turn a source of business for many IBA members (*appraisers and brokers alike*), the time seemed right for an update which summarizes the recent alterations to the SBA's 7(a) and 504 programs **AND** the new law which seeks to promote small business and creates a large \$30 billion community fund for the nation's smaller lenders. Both the **SOP changes and the changes put forth through the Small Business Jobs Creation Act of 2010 will impact the demand for and the provision of BV and brokerage services.**

The past four years have seen a **wave of unprecedented change within the SBA and its loan programs**, with *James W. Hammersley, Deputy Assistant Administrator for Policy and Strategic Planning* at the SBA guiding and overseeing the changes through two diametrically opposed administrations and the worst recession in as many as 30 years or longer. With **no** revisions to the SOP occurring between 2000 and 2007, there have now been **FOUR (4) substantial revisions to this hefty document since August of 2008** culminating in the new **SOP 50-10 5 (C) version**. The revised SOP may be found at <http://www.sba.gov/aboutsba/sbaprograms/elending/reg/index.html>.

To the SBA's credit, there have been dozens of substantive and beneficial **changes which rightfully take into account both lender concerns and "taxpayer" risks**. The substantial "SOP" document is routinely supplemented by the issuance of **"Information Notices"**, which provide additional clarification and insight into the SBA's intentions with respect to a wide variety of lending issues and concerns.

Despite the depth and breadth of the changes implemented at the SBA (in the face of routine budget cuts for many years), the **"SOP" will always be a "work in progress"** with new and old issues alike in need of addressing – sooner or later. Although not a top priority at this time, this writer believes that there is **room for improvement with respect to the guidelines pertaining to the use of business valuation reports** as part of the loan process. It is incumbent upon brokers and appraisers to be familiar with the document as it relates to their day to day activities and for purposes of helping to craft any future changes which are deemed prudent. This topic will be *addressed at the end of this article*.

Two Major Developments

There have been **two key events during the past month** which will affect the economy **and** the demand for business brokerage and business appraisal services in the coming months and years:

- 1) **Passing of the Small Business Jobs and Credit Act of 2010 bill or the “SBJCA”, signed by President Obama on September 27th, 2010**
- 2) **Implementation of SBA’s SOP50-10 5 (C) by the Office of Financial Assistance with an effective date of October 1st, 2010**

The Small Business Jobs and Credit Act of 2010

Both appraisers and business brokers stand to benefit from this new legislation through a series of “direct” and “indirect” channels. Personal ideology aside, the overall effect of these legislative changes will ALSO benefit small businesses, small and large banks and the US economy. Like most bills coming from Congress, there are *myriad provisions filled with fine print which are subject to “debatable” interpretations.*

The new legislation provides a number of small firm **tax breaks** and **changes to the 7(a) and 504 loan programs** e.g. permanently increases certain SBA **loan limits** from \$2 million to \$5 million and temporarily **waives significant SBA loan fees.**

The **third area of the new legislation is the most controversial** and provides eligible banks (assets under \$10 billion) with **\$30 billion in new capital (100% advance rate)** to increase lending to small firms.

The **three “pillars” of the SBJCA** are as follows:

- 1) **The new legislation provides more than \$12 billion in tax relief provisions and creates eight new small business tax incentives aimed to encourage expanded business planning for investments in operations and hiring additional workers.**
- 2) **Implements temporary and permanent changes to the 7(a) and 504 loan programs.**
- 3) **The creation of a \$30 billion lending fund that community banks can tap for use in making loans to small businesses. The hope is that smaller community banks will use this money to increase their SBA lending.**

Pillar One: Tax Breaks

Like most “tax bills”, there is a plethora of breaks, incentives, reductions, stimulus, etc., designed to stimulate small business activity and employment. For example, there is an increase of the general one-year carry-back for general business credits to a **five-year carry-back period** (for firms with \$50 million or less in average revenues). Examples include the Employer Provided Child Care Credit and the Research and Development Tax Credit. These same firms are also no longer subject to the onerous AMT program (which in turn makes such firms eligible for the tax credits in the first place).

Another important change is the **immediate tax deductibility of up to \$500K** for purchases of new equipment in 2010 and 2011.

Pillar Two: Changes Which Affect the 7(a) and 504 Loan Programs

Although separate events, there is a “spillover” impact from the passing of the SBJCA into the operation of the SBA loan programs which are regulated largely through the newly issued SOP 50-10 (C) document.

For example, the SBJCA temporarily **increases the government loan guarantee** on the SBA's flagship 7(a) loans to **90 percent through December 31**. The bill also temporarily **waives loan fees** on both **7(a) loans** (the primary source of “change of ownership loans” and the required business valuations performed by IBA members) and **504 loans**, which primarily finance **real estate**. Both of these changes, unfortunately, are temporary (with a dollar “cap”). In addition, loans that have already been approved (assigned an SBA loan number) may NOT be cancelled and re-entered (only those loans in the “queue” or brand new submissions are eligible for the new benefits). The legislation will also **extend the life of the SBA's Dealer Floor Plan Program** (SBA DFP) to 2013, a stimulus provision previously set to expire this month. Note, however, that a “new” DFP will fully replace the “old” DFP within the next few months.

The loan guarantee and loan fee concessions **were originally funded by the economic stimulus bill, extended more than once and finally expired at the end of May, 2010. Since then, SBA lending has fallen sharply.** The SBA purportedly has a **\$500 million backlog** of small-business loans and lenders have been **holding as much as \$1 billion or more in SBA loan applications** in anticipation that these breaks would be renewed.

More importantly for the “long run”, the legislation also introduces important “**permanent**” changes such as:

1) Raise the maximum loan size in the 7(a) program from \$2 million to \$5 Million and in the 504 program from \$1.5 Million to \$5.5 million. The “combined” loan size could now be in excess of \$10 million.

The higher loan size will facilitate larger transactions ranging from business acquisitions to debt consolidation (refinancing) to lines of credit. While the percentage of 7(a) loans made for more than \$1.5 million has grown from 13% of all loan dollars in 2005 to around 21% in 2009, the loan size cap has not been increased in nearly a decade. By increasing the loan size, a proven business owner who has borrowed the maximum at the old 7A loan limit can now borrow additional funds for expansion purposes.

The next table presents general provisions and outcomes from the new legislation as published by NAGGL:

Selected Provisions Affecting 7(a) and 504 Reid Amendment 4594 to H.R. 5297 (Small Business Jobs & Credit Bill)

- **Fee Reductions** - - extends the authority for 7(a) and 504 fee reductions and 90% 7(a) guarantees through December 31 **or until** \$505 million in appropriations is obligated.
- **Maximum Loan Amounts (permanent increases)** - - the loan maximum on:

- 7(a) loans set at \$5 million gross and \$3.75 million net (or guaranteed amount).
- 504 loans, including public policy loans, set at \$5 million, except small manufacturer loans and energy loans are set at \$5.5 million.
- **Maximum Loan Amount of SBA Express (temporary increase)** set the maximum amount of an express loan at \$1 million for 1 year.
- **Division of Large Loans** - - upon request of a loan pooler, SBA will divide a large loan into \$500,000 increments for inclusion in separate pools.
- **Dealer Floor Plan Financing** - - new financing program for dealers for cars, RVs, boats and manufactured homes, but sunset September 30, 2013.
- **Alternative Size Standard** - - pending SBA establishment of an alternative applicable to both 7(a) and 504, establishes a standard of maximum tangible net worth of \$15 million and 2-year average net income after Federal income tax of \$5 million which will apply to both programs.
- **International Trade Loans** - - makes numerous changes in international trade loans, including working capital, primarily permanent loan size increases to \$5 million and 90% guarantees and making the export express program permanent.
- **Debt Refinancing** - - establishes a temporary 2-year program of business debt refinancing through the 504 program independent of the usually required job creation/preservation project.
- **Guarantees of 1st mortgage loans** - - extends the sunset on the new temporary program for partial guarantees of the bank portion of 504 financing. The program will expire 2 years after the date the first pool sale occurs.

Pillar Three: Lending Fund

The **most controversial** element by far is the creation of a lending fund. Eligible banks (assets under \$10 billion) receiving capital injections through the \$30 billion program would be **incentivized to make new loans due to the relationship between the amount of new loans and “cost of capital” paid by the lender** in the form of “dividend payments”. The base level 5% dividend payments made to the Treasury would be reduced by 1% for each 2.5% increment in total new small-business loans.

Current TARP participants stand to benefit the most as they are eligible to convert to the new program provided they have made timely TARP dividend payments to date. In addition to using the **“savings” on dividend payments to generate additional loans, these banks would escape the executive compensation restrictions** associated with TARP lenders. For example, a typical small bank currently paying a 5% dividend could pay as much as \$50,000 to \$100,000 per quarter or \$200K to \$400K per annum. A dividend reduction to 2% would decrease the payments to only \$20,000 to \$40,000 per quarter with savings of 120K to \$240K per annum. In addition, elimination of warrant-related costs could save such a bank as much as \$100K (one-time only).

Concerns include the TARP-like stigma of using such a program, uncertainty as to whether or not regulators will consider this capital as “Tier 1” caliber, the belief that banks will make “bad loans” in order to meet the required loan levels that reduce the dividend costs (moral hazard) and the fear that larger banks will use loopholes to operate as a “small bank” to take advantage of the program benefits. Others argue that the current problem is the state of the economy, not the

availability of funds to lend or borrow, i.e. small businesses do not want to borrow money due to economic uncertainty.

Funds from this program might **become available to community banks as early as the fourth quarter** of this year. The impact of this fund on the demand for business brokerage and appraisal services is difficult to estimate. At present, there are no stipulations requiring that this “capital” be used via SBA rules and regulations, i.e. there is **no definitive requirement for a business valuation** in relation to this fund.

Some lenders will opt for a valuation in any case (while real estate appraisals are still mandatory) and it is *possible that the SBA may become involved* in the administration of such loans due to a provision in “**SEC. 4104. ADDITIONAL AUTHORITIES OF THE SECRETARY**” on page 228 in the bill which reads as follows:

(9) The Secretary may, in consultation with the Administrator of the Small Business Administration, issue such regulations and other guidance as may be necessary or appropriate to define terms or carry out the authorities or purposes of this Act.

The “New” SOP 50-10 5 (C) Guidelines

As mentioned, this is the fourth major revision to the SBA’s SOP for 7(a) and 504 loan programs in two years. **Prior to two years ago, independent business valuations were only required in certain rare circumstances** such as transactions involving related parties. Even more recently, the required valuations were to be performed by “**qualified**” parties only (including the CBA and CVA). The newest “C” version officially **opens the door for “AVA’s”** as well, bringing the total number of qualified certifications to five.

The coverage of “Appraisal and Business Valuation Requirements” begins on page 193 in Subpart B of the new SOP with **provisions dealing specifically with “business valuation” requirements beginning on page 195**. Goodwill issues are addressed in large part on pages 148 and 149.

One of the challenges to reading and interpreting the SOP and its recent evolution concerns terminology. For example, the SOP (and the SBA in general) refers to real property engagements as “**appraisals**”, business engagements as “**business valuations**” and mixed-use engagements such as a hotel or golf course as “**going concern appraisals**”. With the **original focus of the SBA and the SOP primarily on real property loans**, it is not surprising that the “rules” are more detailed for real estate appraisals as they include both a **direct reference to USPAP and a specific choice with respect to the type of appraisal report** which is required (neither of these conditions explicitly exist in the realm of “business valuations”).

Although the question as to **whether** a business valuation (BV) is required is not subject to debate, the single *greatest source of confusion* among business appraisers today (experienced and newcomers alike) is the question as to **what type of analysis and report** are either required or acceptable. Common questions include “Will a Calculation Engagement” be sufficient or

“Does the report have to be “self-contained”” or simply “What do the rules require?” *Answers are available only through a series of assumptions which, unfortunately, can lead to different conclusions.*

With respect to “**when**” the BV is necessary, the current requirement mandates business valuations be performed:

“If the amount being financed minus the appraised value of real estate and/or equipment is greater than \$250,000 or if there is a close relationship between the buyer and seller (for example, transactions between family members or business partners)...”

Note that there is **no reference here to “goodwill”** (a more recent source of confusion which has been clarified in the new SOP), i.e. it is the amount of financing pertaining to the business acquisition which determines the need for an independent valuation. The **“goodwill” issue is now primarily one of determining how a loan request must be processed**, i.e. whether the loan can be processed solely by the lender with “PLP” status (so-called “delegated authority”) or whether the loan will require a second underwriting through SBA personnel in California or Kentucky. Note that pages 147 to 149 (in the section titled “Eligible Use of Loan Proceeds”) address the goodwill issue in detail.

In short, **if the “purchase price of the business” (which includes real estate) includes intangible assets in excess of \$500K, the borrower and seller must provide an equity injection of 25%** in order to be processed under “delegated authority” (much quicker funding). Seller equity is defined as a seller note that is on “full standby” for at least two years.

The new SOP 50-10 5 (C) actually includes a **revised definition for goodwill** on page 149, which can now be “calculated” in one of three different ways.

The value of the intangible assets is determined by either the book value as reflected on the business’s balance sheet, a separate appraisal for the particular asset, or the value of the business as identified in the business valuation minus the sum of the working capital assets and the fixed assets being purchased.

Proper determination of the **specific scope of work and report type is unfortunately not so clear**. As mentioned, the **“commercial real estate appraisal”** section of the SOP is clear as it specifically states that:

The appraisal must be prepared in compliance with Uniform Standards of Professional Appraisal Practice (USPAP) and use one of the following options:

- (1) a self-contained appraisal report; or**
- (2) a summary appraisal report.**

The **BV section** of the SOP **does not** explicitly state that USPAP compliance is required, nor does it indicate which report type is needed. Savvy appraisers will have already noted that **USPAP does not use the “self-contained” or “summary” appraisal (or “restricted use”)**

report distinction for business valuations; rather it is in effect the **“scope of work”** which drives the analysis and reporting. The current verbiage includes **“appraisal report”** or **“restricted use appraisal report” ONLY**, with the report **“prominently stating which option is used”**.

Despite the lack of definitive requirements regarding the use of USPAP for BV engagements, the interpretation of other federal laws coupled with its required use for real estate appraisals within the same SOP document lead most to conclude that **USPAP compliance is in fact required for all SBA business valuations.** Through the **“jurisdictional exception”** rule that is included in various professional standards for business valuation, it is a logical step to assume that USPAP takes precedent over other pertinent standards.

The new **USPAP 2010-2011** version included a **revision** related to the “jurisdictional exception rule” which essentially stipulates that **ALL USPAP standards and provisions apply in situations where “federal law or regulation” requires compliance.** To the extent that USPAP conformity is required for SBA-related business valuations, it is pertinent in its entirety – period. Standards 9 and 10 and the “Scope of Work” rule are presented next:

STANDARD 9: BUSINESS APPRAISAL, DEVELOPMENT

In developing an appraisal of an interest in a business enterprise or intangible asset, an appraiser must identify the problem to be solved, determine the scope of work necessary to solve the problem, and correctly complete the research and analyses necessary to produce a credible appraisal.

STANDARD 10: BUSINESS APPRAISAL, REPORTING

In reporting the results of an appraisal of an interest in a business enterprise or intangible asset, an appraiser must communicate each analysis, opinion, and conclusion in a manner that is not misleading.

Comment: STANDARD 10 addresses the content and level of information required in a report that communicates the results of an appraisal of an interest in a business enterprise or intangible asset developed under STANDARD 9.

STANDARD 10 does not dictate the form, format, or style of business or intangible asset appraisal reports, which are functions of the needs of intended users and appraisers. The substantive content of a report determines its compliance.

SCOPE OF WORK RULE

For each appraisal, appraisal review, and appraisal consulting assignment, an appraiser must:

- identify the problem to be solved;
- determine and perform the scope of work necessary to develop credible
- assignment results and
- disclose the scope of work in the report.

An appraiser must properly identify the problem to be solved in order to determine the appropriate scope of work. The appraiser must be prepared to demonstrate that the scope of work is sufficient to produce credible assignment results.

Comment: Scope of work includes, but is not limited to:

- the extent to which the property is identified;
- the extent to which tangible property is inspected;
- the type and extent of data researched; and
- the type and extent of analyses applied to arrive at opinions or conclusions.

As the **SOP requires the lender to formally request the appraisal**, it is logical to expect the request to incorporate the “scope of work” for purposes of “memorializing” this key aspect of the appraisal. It is the business appraiser’s responsibility to discuss and help shape the scope of work that is needed, both in general and with respect to a specific engagement.

This brings us full circle and back to the question as to what type of report is required. Following what is seemingly the most logical train of thought, a ***conclusion can be reached and justified as follows:***

- 1) Is USPAP compliance required? **YES** (code of federal regulations and SOP)
- 2) Does USPAP overrule ALL other professional standards? **YES** (jurisdictional exception)
- 3) Should the appraiser follow Standards 9 and 10 of USPAP in their entirety? **YES**
- 4) Is there more than one “intended user”? Normally, **YES** (lender and SBA at minimum)
- 5) Is an “Appraisal Report” required? **YES** (analyze and “summarize” rather than “state”)
- 6) Is a “Restricted Use Appraisal Report” acceptable? **NO**
- 7) Is a “Calculation Engagement” acceptable? **NO**

Note that this is **just my “opinion”** based on the aforementioned assumptions. I cannot and am not saying that this is the only or the correct interpretation. As inferred, this is **one area where future guidance from the SBA should be encouraged**. Based on their recent track record, they have proven a willingness to listen to stakeholders and make major changes if they are believed to be in the best interest of the SBA’s mission.

What Are the New Changes to the SOP?

The depth and breadth of overall change is quite substantial, with only a small portion of the alterations pertaining to the business valuation component of the SOP. The SBA issued **Information Notice 5000-1163** on 9-7-10 announcing the issuance of the **SOP 50 10 5 C** to become effective October 1, 2010. This SOP has been officially titled “**Lender and Development Company Loan Programs**” and it covers various operational aspects of the **7(a) and 504 loan programs (among others)** that are responsible for billions of dollars of small business lending every year.

The Information Notice presents a **summary overview of the changes** through two different categories:

- 1) **Simplification of the Loan Process**
- 2) **Improvement of SBA’s Risk Management**

Simplification of the Loan Process

The many **changes of this type do not directly impact business appraisers or business brokers**, but they will have an *impact on what types of businesses are financed* (appraised and brokered). For example, the **definition of “passive income”** has been modified to recognize changes in the business model for many types of businesses. This modification results in a more simplified definition that will permit more small businesses to be eligible for an SBA guaranteed loan. Until recently, businesses such as hair salons, nail salons, dance studios and others would typically hire the trades people that provided the services as employees. Now, many rent space to the tradesperson and then handle advertising, hiring cleaning services and the sales of merchandise. Under the previous guidance, these businesses were ineligible for SBA financing unless more than 50% of their revenue was from sources other than rent (the “sufficient services” test). The *new guidance eliminates the “sufficient services” test in order to make SBA loan guarantees available to more of these types of businesses.*

Debt refinancing: SBA has clarified a section of the SOP dealing with debt refinancing and partial change of ownership situations. The SOP has been revised to more clearly state that if a **loan will be used to finance a partial change of ownership and also refinance the existing debt** of the business, then the *debt refinancing provisions do apply* and need to be met in order for the application to be eligible.

Improvement of SBA’s Risk Management

The **most pertinent changes** involving business appraisers and business brokers are found in this category of the Information Notice.

With respect to **business brokers**, for example,

Source of Equity and documentation: The guidance on the permissible sources of equity and documentation of equity injection has been expanded and moved from SOP 50 51 (which deals with purchases and liquidations) to SOP 50 10. As a result, lenders will be aware of what SBA requires regarding documentation of equity injection prior to closing and disbursing a loan.

Although business brokers participate in many “business acquisitions” that are financed with SBA guarantees, many of the **changes in the new SOP directly impact the role played by business appraisers** in facilitating the sale of going concerns (referred to as “business acquisition” or “change of ownership” loans). The key changes affecting appraisers are discussed next:

Key Changes Affecting Business Appraisers

Business Acquisitions: The following revisions have been made:

- (1) **Tightening up the requirements defining who is qualified to perform a business valuation**
- (2) **Changing the timing of the requirement to obtain a business valuation to before the application is submitted to the LGPC or, for applications processed under delegated authority, after receipt of the SBA loan number but prior to closing**
- (3) **Adding a statement that precludes lenders from financing amounts greater than the appraised value of the business in change of ownership transactions (eliminates the previous 90% rule)**
- (4) **Adding language which emphasizes the requirement that the lender verify the financial information relied upon in the business valuation.**

Change Number One

One of the most significant changes from the perspective of business appraisers would be the **formal inclusion of the AVA designation** among those professional business appraisers who are considered a “qualified source.” The full list of “qualified” sources now includes the following:

CBA
ASA
CVA
AVA
ABV
CPA

It is important to recognize that the qualified source **must also “regularly receive compensation” for business valuations**, i.e. it is questionable if an individual who performs one or two such appraisals per year would be a qualified source. A similar requirement is found on page 148 that requires the appraiser to have **“proven experience in business valuation”**. In order to prevent unqualified individuals from performing the valuation work, the SOP requires that the **individual performing the valuation be the qualified appraiser**. The appraiser must also sign the valuation report *“certifying to the information contained in the valuation” and confirming the “conclusion of value.”*

Change Number Two

The “timing” change involving the submission of the business valuation will generally **lead to a further premium placed by lenders on the timely completion of valuation reports**. The SBA is simply stating that their underwriters must have access to the business valuation in conjunction with their analysis and not at the “last minute” before close of escrow. This means that some **borrowers will risk having paid for a valuation without having a formal loan approval**, but the purpose of the valuation is to make sure that the borrower does not overpay for the target enterprise and this should be part of the approval process.

Change Number Three

The third change above significantly **elevates the importance of the appraiser's conclusion of value** as lenders will no longer have the option of electing to finance a deal when the appraised value was between 90% and 100% of the actual deal price, i.e., ***“any difference between the sales price and the business valuation may not be financed with the SBA guaranteed loan”***.

Change Number Four

The change involving **verification of financial data used in the business valuation appears to be one of emphasis rather than a true change in policy**. Lenders are required to obtain original tax transcripts from the IRS for acquired businesses in order to ensure that the tax returns are accurate as submitted (to prevent fraud). As business appraisers, we may be more inclined to rely on financial statements prepared in accordance with GAAP (accrual basis accounting) rather than the federal tax returns.

In order to meet the intent of this change, it is **considered optimal for the lender to provide the business appraiser with ALL of the tax returns and financial statements** that will be used in the valuation. Should the appraiser obtain more current interim financials, it would be considered appropriate to forward such copies to the lender immediately. It is **incumbent upon the lender to understand and evaluate any normalization adjustments made by the business appraiser irrespective of which source of financial data is utilized**. The appraiser should prepare the valuation report in a manner which allows the lender to quickly and fully understand what these adjustments are and how they impact the value conclusion.

Final Comments

There are **other changes as well** which will influence the amount of work performed by appraisers such as franchise eligibility and refinancing procedures. The recent changes in the SOP are diverse but relatively inconsequential for business appraisers with respect to determining the **demand** for business valuations, i.e. the **SOP changes will have less impact on demand for BV services than the changes put forth through the SBJCA**. That said, it is incumbent upon all appraisers who work within the realm of SBA loans to be familiar with the contents of the new SOP – both in general and with respect to its “business valuation requirements”.

Just **how do business appraisers remain aware of such developments?** Four simple but important steps will help do the job:

- 1) **Become familiar with the SBA website (www.sba.gov)**
- 2) **Peruse the SOP 50-10 5 (C)**
<http://www.sba.gov/aboutsba/sbaprograms/elending/reg/index.html>.
- 3) **Join NAGGL* (www.NAGGL.org)**
- 4) **Sign up for the Coleman SBA Newsletter** (www.colemanpublishing.com)**

**The National Association of Government Guaranteed Lenders (NAGGL).*

***The free daily email is Coleman's Small Biz Banking Daily and the newsletter is the Coleman Report*

Business appraisers who seek to perform SBA-related work should become familiar with the “modus operandi” of the Department, ideally by joining the industry’s leading trade association known as the National Association of Government Guaranteed Lenders or NAGGL and signing up for the Coleman publications. There is simply no better way to stay abreast of important developments which could impact the **future course of SBA lending and the role played by Certified Business Appraisers, Certified Valuation Analysts and now Accredited Valuation Analysts**. It is important that we work together to proactively influence future policy changes which will benefit the membership, lenders, the SBA and of course the US economy.

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