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In this Issue

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Editor's Column: Appraisal Assumptions

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The person who came up with the phrase, "The Devil is in the details" certainly knew what he or she was talking about! This concept was brought home to me as I recently reviewed a business appraisal report. The report was prepared for submission to the IRS to support gifts of stock to the owner's children. The report was well prepared, the financial analysis quite good, the valuation calculations well supported. It had one major problem though that was buried in the fine print – the appraisal included what was listed under "Hypothetical Conditions or Extraordinary Assumptions" the assumption that "We accepted Management's representation that the book value of the real estate is a fair representation for the fair market value of the real estate." This is a big problem.

First, it is important to understand what a hypothetical condition and an extraordinary assumption are as well as the difference between them. A hypothetical condition is something that is assumed for purposes of the analysis that is contrary to the actual facts. For example, if in valuing an old gas station site with known contamination due to leaks from old tanks the assumption is made to value it "as if" no contamination existed, this would be a hypothetical condition.

The official definition of a hypothetical condition is:

> That which is contrary to what exists but is supposed for the purpose of analysis. Hypothetical conditions assume conditions contrary to known facts about physical, legal, or economic characteristics of the subject property; or about conditions external to the property, such as market conditions or trends; or about the integrity of data used in an analysis. A hypothetical condition may be used in an assignment only if:
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> - Use of the hypothetical condition is clearly required for legal purposes, for purposes of reasonable analysis, or for purposes of comparison;
> - Use of the hypothetical conditions results in a credible analysis; and
> - The appraiser complies with the disclosure requirements set forth in USPAP (Uniform Standards of Professional Appraisal Practice) for hypothetical conditions.[1]

An extraordinary assumption is the assumption that some uncertain fact or facts are assumed to be true and if they are found to be false, the appraiser's opinion or conclusion would likely be different. The example the business appraiser used in this case of assuming that management's representation that the book value of the real estate is a fair representation of its market value is a good example of an extraordinary assumption.

[1] The Dictionary of Real Estate Appraisal, Fourth Edition, published by the Appraisal Institute, p. 141.