SECOND QUARTER 2009

THE INSTITUTE OF BUSINESS APPRAISERS

Business Appraisal Practice

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Editor's Column: Appraisal Assumptions

Paul R. Hyde, EA, MCBA, BVAL, ASA, MAI

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.

The official definition of an extraordinary assumption is:

> An assumption, directly related to a specific assignment, which, if found to be false, could alter the appraiser's opinions or conclusions. Extraordinary assumptions presume as fact otherwise uncertain information 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. An extraordinary assumption may be used in an assignment only if:
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> - It is required to properly develop credible opinions and conclusions;
> - The appraiser has a reasonable basis for the extraordinary assumption;
> - Use of the extraordinary assumption results in a credible analysis; and
> - The appraiser complies with the disclosure requirements set forth in USPAP (Uniform Standards of Professional Appraisal Practice) for extraordinary assumptions.

In the appraisal I reviewed, clearly the appraiser stated an extraordinary assumption, however, this extraordinary assumption was included only in the body of the report in small print. In this case, the real estate consisted of a large multi-acre property with a saw mill, planer mill, and other large buildings, some of which were purchased over twenty years ago. Clearly the book value of the real estate had nothing to do with the real estate's market value. Missing the value of real estate owned by the company and treating it as an operating asset almost always results in an erroneous value conclusion.

Not understanding assumptions and limiting conditions included in an appraisal can create big problems. The use of unrealistic hypothetical conditions or extraordinary assumptions can result in even larger problems. Whenever a hypothetical condition or an extraordinary assumption is encountered in an appraisal, some serious thought and consideration must be made to decide whether or not the value conclusion is useful for the appraisal's intended purpose. It should be understood that sometimes hypothetical conditions or extraordinary assumptions are appropriate and necessary, however, they are sometimes used to cover up incomplete work and may result in conclusions that are not useful and in fact may be misleading.

In the case I reviewed, the value conclusions were totally worthless based on the inappropriate extraordinary assumption. The appraiser should have, at the very least, obtained market rental estimates for the real estate from knowledgeable real estate brokers in the area to support management's representation. A better approach would have been to have the real estate appraised as issues of highest and best use should have been addressed in addition to determining the market rental rate of the property. The company had a history of volatile earnings with losses in recent years. A real estate appraisal would have let the business appraiser know if perhaps the highest and best use of the real estate was for some other potential use. It might have been better suited for residential development, for example.

The major point of this article is to suggest that appraisers think about assumptions and limiting conditions that are included in their appraisal reports to see if they accomplish the intended purpose without destroying the usefulness of the report. Also, to point out that users of valuation reports need to actually read the assumptions and limiting conditions before relying on the report conclusion.

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