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Dealing with “Hiding the Ball” Scenarios

Occasionally, a client is not able to obtain all of the data necessary to clearly support the value of an asset needing to be appraised. This seems to happen most often in some type of litigation scenario.

I recently received an inquiry from a former student in a business appraisal class that I taught a number of years ago. This appraiser has been actively involved in doing business appraisals for the last eight years. Here is more or less his question:

Hi Paul –

I have a valuation quandary that I haven't run into before in the eight years I have been doing valuations. I am doing a valuation for a minority interest (5% partner) that was fired from a company. It appears to be headed to litigation.

The company would only turn over three years of P&L's out of Quickbooks – no balance sheet info, no tax returns, nothing else. I was able to do a forecast from the P&L's and industry projections – the industry is expected to grow modestly 3% annually and capitalize earnings. I calculated the Direct Market Data Method (ratios of Price to Sales and Price to Earnings) and it supported the income approach I developed.

I reviewed a draft with my client (the fired guy). Of course, he didn't think that the value is high enough. To complicate matters, his son-in-law is a business broker and told him that the business would “easily sell for three to four times revenue.” Note: Not a chance! 3 to 4 times EBITDA maybe, but not 3 to 4 times revenue!

The client informed me that the owner's wife is paid a \$200,000 a year salary by the business, but doesn't work there; the business rents a warehouse from the owner at a rate far above market rent; and the business leases much of its equipment from the owner at considerably over market rates.

The client has no proof of any of his claims and I have a conference call with the client's attorney on Monday – what do you suggest that I do?

This situation, while frustrating, is not at all uncommon. I have experienced a number of similar variations of this scenario in my years as a business, real estate, and equipment appraiser.

I suggested my former student emulate the solution I have developed for when I encounter a “hide the ball” scenario similar to that described:

I prepare both an appraisal based on the facts as shown by the company's books and records and a hypothetical appraisal using the facts that the client claims are true.

A hypothetical appraisal is based on the premise that facts contrary to what is true or can be proven to be true, are used for illustrative purposes "as if" they are true. In this hypothetical appraisal, all of the assumptions that are assumed to be true are clearly described so that it cannot be misunderstood or construed that I am trying to change what can be proven. Essentially, the hypothetical appraisal illustrates what the value would likely be if the facts claimed are true.

Having both values – the value based on the known and proven facts and the value based on the claimed facts (which usually involve something that would not pass IRS scrutiny if audited) -- gives the attorney an opportunity to negotiate a settlement. I have found that most of these scenarios do not actually go to court as most involve some type of income tax shenanigans and attorneys rarely want their client to admit to committing income tax fraud under oath in court!

Interestingly enough, I am aware of one case in which a divorce was so acrimonious that the parties were planning on discussing tax fraud in open court. Somehow a representative of the IRS was tipped off to this fact in advance, and was present in the courtroom to hear the testimony. As a result of that decision, marital problems and divorce soon became the least of that couples' problems!

Valuations play a part in all strategic transactions, tax, and many litigation matters. For additional information or advice on a current situation, please do not hesitate to call. **We value real estate, businesses, and personal property including livestock and machinery & equipment.**



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