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Valuing Very Small Companies

There are a number of types of challenging appraisal assignments. Some are tough because they are large, complicated, there is an enormous amount of data – i.e. they take a lot of time and effort. However, in my opinion, the most challenging assignments are the valuation of very small companies.

The definition of a very small company is problematic – the definition of a “small business” is not widely agreed upon either. The Small Business Administration (SBA) has different definitions of what constitutes a small business depending on the industry – these range from some agricultural related companies with a maximum annual revenue of \$750,000 to a number of other industries in which the maximum allowed annual revenue to qualify as a small business is \$38.5 million with up to 1,500 employees. Quite a range.

What I am talking about when I say a very small company is a business with annual revenue of under \$250,000 and typically one or two employees in addition to the owner/operator.

The valuation of a very small business is so difficult for a number of reasons (some of these apply to larger companies as well):

1. Usually the financial records are terrible, if they exist at all. I have had a number of instances in which I sat down with the owner and he or she drew up the Company’s balance sheet and income statement – with some help from me, on the back of a large envelope. Other times, the Company may use something like QuickBooks; however, it is very common to find that the owner or the employee tasked with the bookkeeping job, has no ideal what they are doing. Often, personal expenses and business expenses are comingled and/or some expense category is a dumping ground for lots of weird stuff.
2. The owner may work 50 or 80 hours a week and not take a salary or alternately, pay himself or herself something like \$1,000 a month in salary. Determining “reasonable compensation” for the owner can be a challenge.
3. Companies with inventory – such as a retail shop of some kind – usually have terrible records. The amount of useable, good inventory is unknown and likely unknowable. It is common for many very small companies that have been in business for a number of years to have the same number each and every year for inventory. These very small companies often operate on an unusual inventory accounting system: FISH; which stands for First In, Still Here.
4. A very small company’s accounts receivable can be very interesting. Often, the records are poor which makes it challenging to figure out. Even when the accounts receivable records are pretty good, examining an aging report often shows large amounts of overdue receivables that have been on the books for over six months and at times for several years. Obviously, some adjustments for bad debts need to be made in these instances. A dentist’s office or a chiropractor’s office are great examples of small companies that encounter past due accounts receivable problems. I saw an ad in a professional dental publication which summed it up best. The ad had an old roll-top desk covered with stacks of bills piled up on it. Sitting at the desk holding a bill in his hand was the husband. His pretty wife was looking over his shoulder. The husband said, “it’s only the dentist. He can wait.” The ad had a logo and phone number for Master Card / Visa.

5. Many very small companies operate from a leased location; sometimes on a month-to-month basis. It is often very difficult to determine with any degree of certainty whether or not the Company will be able to remain in its current location for any foreseeable time. Dealing with the cost of moving, a potential large increase in rent, the possible loss of many customers/clients from a move, etc. is challenging.
6. Comparison to industry data to determine the strength or weakness of the Company versus the “typical” company in the industry is a skill or art developed by experienced appraisers over time. Applying industry data to the financial statements of very small companies for analysis purposes is sometimes similar to comparing apples to pomegranates.
7. “Skimming” or the non-recognition of some or even all of the cash that is received by a Company is common. Depending on the purpose and use of the appraisal, this may be a real problem. There rarely is a budget for a forensic accounting study, even if one is really needed. In order to deal with this issue, I sometimes am forced to make a number of assumptions and use “typical” industry data instead of the very limited and questionable actual company data to arrive at a hypothetical value.
8. Instead of skimming, some very small business operators pay their employees “under the table” or pay for supplies using cash in order to hide or disguise profits. Again, in cases where this is suspected, sometimes industry “typical” data must be used to arrive at a hypothetical value, i.e. the likely value should the Company be run using “standard” revenue and expenses.
9. Customer concentration issues may be a factor. I have run into situations in which a Company does most of its work for another non-related entity; sometimes this has gone on for many years. The likelihood of this continuing or coming to a sudden halt at some point is very difficult to estimate and support. Certainly, most of the revenue coming from one customer increases the risk associated with the Company’s revenue continuing, but quantifying and supporting this risk is problematic.
10. The money available to pay the fee for appraisals of very small companies is usually minimal – yet these assignments often take considerable time and effort to get right. I actually enjoy the appraisals of very small companies as I find them and the people that operate them fascinating. When I take on one of these assignments, I do so knowing that my hourly rate is going to suffer a significant downturn, but they need to be done by someone who understands these very small companies and knows how to value them.

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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