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Editor's Column: Precision vs. Accuracy

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

The purpose of an appraisal is generally to determine the "value" of something using some specified standard of value typically "as if" the subject of the appraisal changed hands between a willing and able buyer and a willing and able seller in terms of cash equivalency. An appraiser uses his or her special knowledge, experience, and training together with data gathered regarding the subject and comparables to develop an estimate of the subject's worth as of the specified date following the selected standard of value. Inherent in this process are typically numerous assumptions and often a number of subjective decisions and judgments. When possible, appraisers use an asset approach, a market approach, and an income approach. Sometimes, multiple methods within one or more of these approaches are applied. Each of the indicated values generated by the methods used must then be reconciled into a final value conclusion.

Appraisals, by their very nature, can be accurate or inaccurate, but they cannot be very precise. The definition of precise that I am referring to, according to Webster's Dictionary is "minutely exact". According to the Appraisal Institute, precision is defined as "how finely something is measured. The more digits, the more precise the measurement is. For example, a distance that is measured to the nearest tenth of a foot is more precise than one measured to the nearest foot." What I mean by accurate is "free from error" or "reliable". The Appraisal Institute defines accuracy as "how close the specified number is to reality. The digits are meaningful. In the previous example, if the measuring tape was properly manufactured and has not shrunk or stretched, the numbers "2", "3", and "4" from the tape are all meaningful because they convey accurate information. If the tape has stretched by one-half percent, the number "3" is precise because it was read off of the tape, but it is not meaningful because it is incorrect.

It is virtually impossible to measure anything with perfect accuracy. An infinite number of digits can exist to the right of the decimal point for each measurement. The same principle applies to value indications derived in an appraisal. The accuracy of any indication of value is totally dependent on each component that went into the process. The following example is from a real estate appraisal, but it applies to all appraisals.

If a side of a building is measured at 33 feet, two and 5/8 inches, what is the appropriate number to use? I would typically round the measurement to the nearest foot or on smaller measurements, perhaps the nearest half-foot. Suppose a simple building is measured at 33 feet, two and 5/8 inches by 93 feet, seven and 3/8 inches. What should the stated square footage be? I would call it 3,102 square feet having rounded the measurements to 33 feet by 94 feet. However, it could also be called 3,100 square feet or 398.625 inches by 1,123.375 inches or 3,109.75944 square feet. Later on, after applying all of the data gathered, this square footage would be used to help determine estimates of value. During this process, typically a number of subjective decisions are made each of which lessens the precision of the process, however, as it is the appraiser's job to "mirror the market" meaning to determine value according to how market participants would view it.

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In a similar fashion, when appraising a business entity, we must decide things like should inventory shrinkage be five percent or three percent? Should bad debts be accounted for at last year's level or at the average level of loss over the last five years? Or, should the capitalization rate be 20.5% or would 19% better represent the risk of achieving the forecast income stream. Each of these decisions and many others like them impacts the value conclusion reached using each applicable appraisal method. Just how each indication of value should be rounded must be considered.

I cannot help but laugh when I see an appraisal conclusion stated something like the following:

Nineteen Million Seven Hundred Eighty-Six Thousand Seven Hundred Thirty-Six Dollars and
22 Cents
\$19,786,736.22

Knowing all of the subjective decisions that went into the appraisal process, a conclusion stated with this much precision is ludicrous and misleading. An appraisal conclusion simply cannot be accurately stated to this level of precision. Instead, rounding to what is determined to be "significant digit" should be employed. A "Significant Digit" is a digit "that is believed to contribute accuracy, not simply precision, to a measurement.

In the above example, the value conclusion could be stated accurately a number of ways depending on the data used in the assignment and the level of adjustments required to arrive at the conclusion. I would typically state such a value conclusion as follows:

Nineteen Million Eight Hundred Thousand Dollars
\$19,800,000

This type of statement is accurate, but not so precise as to mislead the reader into thinking that the data available and the processes applied allowed the result to be stated as precisely as shown above.

Valuations can and should be "accurate" meaning that they should be reliable in that they should fairly represent what market participants would pay or receive for the subject property as of the effective date of the appraisal following the selected standard of value.

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Please submit articles for *Business Appraisal Practice* by email to: prh@hydevaluations.com.