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HYDE Valuations, Inc.

We Value Both Real Estate and Businesses
Including Machinery & Equipment

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THE MANAGEMENT INTERVIEW

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So you've engaged a business appraiser to develop a supportable opinion of value of your company. The appraiser has done his homework, analyzed your historical financial records, investigated the current economic picture, and has even developed an awe inspiring forecast that covers every eventuality imaginable … & even some that aren't! The finished and polished report gleams softly in the sunlight as it is delivered into your eagerly awaiting hands, and you can't wait to take it to your accountant, lawyer, potential buyer, or whomever else might be reading the report.

Too bad that this business appraisal report is completely incorrect and cannot be used for anything other than a beautiful (and spendy) coaster for your morning coffee.

"Why?" you ask, "What could possibly be wrong with this report I paid so much money for?"

The problem lies in the management interview, or rather, the lack of one.

During a management interview certain details come to light that should have an impact on the valuation conclusion, but are simply not available from financial statements.

Some of these are as follow:

1. The real estate is owned by a related entity,
2. There are non-essential personnel on the payroll (typically family members),
3. The budget is inflated with discretionary personal expenses,
4. Management is planning a significant change to operations, and/or
5. The recent transaction of company stock was not at arm's length.

The question thus becomes: How can these items interfere with (or outright invalidate) a valuation conclusion? The following is a brief description of problems that could have been avoided if only a management interview had taken place:

1. The rental rate could be higher or lower than market rates, which could lead to an under or over-valuation due to the business' income not having been adjusted to meet the definition of fair market value.
2. Non-essential personnel are employees who receive full wages, but do not necessarily contribute any labor or expertise to the company. These should be added back and if they haven't been, lead to an under-valuation of the company.
3. We have seen advertising budgets that included a race car, cabins in McCall for employee retreats that are only used by the Owner and his family, and even all personal expenses down to the weekly grocery bill run through a company. If these expenses are not adjusted for, it leads to a very significant under-valuation of the company.
4. The value of a business is based on expected future economic benefits, and if the appraiser bases the expectation of future earnings on historical results without taking into consideration

planned changes to the operation, the appraiser would not actually have been appraising the subject at all. Instead he would have been appraising the subject "as if nothing changes" which would be a hypothetical condition and not be reflective of fair market value at all!

5. A very good indication of the fair market value of a privately held business would be an arm's length transaction in company stock between knowledgeable parties, neither having any motivation to buy or sell. However, most of these are between family members, or are fueled by special motivations that can lead to some rather wacky valuation conclusions when used blindly.

Another complication sometimes occurs when an appraiser is engaged to do an assignment for a party not involved in the management of a company. The most common occurrence is for a divorce when one spouse is not really involved in the business. In cases such as this, the appraiser must do the best he/she/it can. Often this requires management questions to be asked by the attorney during a deposition. When management simply cannot be interviewed, and questions that need to be asked are not answered or the information is not available for some reason, appraisers typically include an assumption and limiting condition in the appraisal report to make certain the reader is aware of this fact, and that the value could be different if the unavailable information were known.

Now, not all assignments require a formal management interview, and not all assignments include "landmine" information that could drastically alter the appraiser's opinion of value, but one never knows when one will pop up.

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 both real estate and businesses including machinery & equipment.**

Sincerely,

Paul R. Hyde, EA, MCBA, ASA, MAI
Enrolled Agent – Enrolled to Practice Before the IRS
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Accredited Senior Appraiser – Business Valuations
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