Lending Assumptions affect Value, Know your Banker

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In appraisals for Banks and the SBA (Small Business Administration), it is important to know the loan officer assumptions that went into the lending decision. Many banks and the SBA have various policies on what discretionary expenses can be added back (add backs) to earnings and the weight you use on the projections for the appraisal.

In most cases, the loan officer sends the appraisal request with financials and other information and the name of the contact person to interview at the business. In some cases, the buyer may be the contact person. During the interview with the contact person, information is gathered about the company including growth, machinery, and equipment, employees, competition, contracts, leases, customers, anticipated operational and financial changes, non-recurring expenses and expenses that would be discretionary to new ownership. All of this information is essential to the appraiser for the assumptions that must be made in the appraisal process.

The information gathered in the appraisal process that formed the appraiser's assumptions needs to be conveyed to the loan officer to make sure that it is similar to the loan officer's assumptions that led to the decision to make the loan. This is why a draft is sent to the loan officer to review prior to finalizing the final report.

Instructions sent with the draft, asks the loan officer to review several areas of the report that include the appraiser's assumptions and the results derived from these assumptions. Areas that have an impact on the final value are:

Management Compensation Expense Deduction: SBA has left this with the sole discretion of each bank. Normally when we do an appraisal, we research what management compensation would be for the respective industry. This is an acceptable method, but the SBA has given the loan officer the option to use a compensation that would be necessary to sustain the new buyer's lifestyle. This amount can be very different than a fair market compensation for the industry. Therefore, the loan officer always has the right to control this part of the calculation of value.

Add Backs and Non-Recurring Expenses: This can also include expenses that are necessary for the business that will be eliminated in the sale to a synergistic industry purchaser or a larger company that is similar to the subject company. Many banks have different policies or protocol on what they consider non-recurring or excessive expenses.

Rent Adjustments: Often, if the company owns the real estate, they may not be paying a fair market rent. They could either be overpaying or underpaying themselves, thus, the need for an adjustment for rent compensation. Imputing a rent expense or adjusting the rent to fair market can have a significant impact on earnings and in turn value.

Normalized Earnings

- **Income Statements:** In the case of small, privately held businesses, accounting elections are designed to minimize profits to lower tax liabilities. Therefore, in the appraisal process, adjustments must be made to restate the financials to depict performance that is meaningful to an investor. The adjustments are made when the financial statements or tax returns are inconsistent with true performance or fair market values. It is important for the loan officer to review these adjustments to make sure they are the same as presented to the bank in the lending decision.

- **Balance Sheet:** Adjustments to the balance sheet may consist of adjustments to accounts receivable, accounts payable, liabilities that are not likely to be repaid by shareholders, asset values, inventory and the removal of assets that are not to be included in the sale.

Growth and Future Projections: Projected financial performance of the business is inclusive in the earnings used in the calculation of value. This should be consistent with the loan officer 's assumption of growth. If not, reasoning by the appraiser for the different view of the future should be discussed with the loan officer.

Summary
Often, the information that is given to the appraiser by the contact person in the interview could be exaggerated for a higher value. Sometimes the appraiser finds negative information about the company that was not revealed to the loan officer. It is important that the loan officer reviews the information and the assumptions or explain the bank's position on the information that brought the appraiser to his/her conclusion. In many cases, banks have a financial analysis officer on staff that reviews all appraisals before completion to make sure that the assumptions in the report meet the bank's approval and understanding.