



What Does the Business Appraisal Process Look Like?

by Shawn Hyde, Executive Director ISBA

One of the most commonly asked question in all the various classes I have taught to new business appraisers is a two parter: "How do I start my first report, and once I've started, what do I do next?"

The following is how I generally answer these questions in class:

There is no easy answer to that question. The process looks different for each appraiser. There are certain steps that we all have in common, but the stage those steps occur in the process may vary. The best I can do, is provide an outline of how I go about my process and then answer any follow-up questions you all may have.



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1. I get the phone call asking about a valuation. During this call I find out the name of the client, the preferred phone number to contact the client with, the name of the business, the purpose of the valuation, the effective date of the assignment, when the deadline is to have the report delivered, the address (mailing or email) that I will deliver my engagement agreement and document request list to, the address where I will conduct my site visit and management interview, and tell the client what my fee will be for the project.

2. I submit my engagement agreement and document request list, together.

3. I wait for the signed engagement agreement and my retainer check.

My Errors and Omissions Insurance carrier explained to me that I will be able to pay the best rate possible for my insurance, IF I receive a signed engagement agreement for each appraisal assignment. Therefore, I do not begin any project before I receive the signed engagement agreement back from the client.

4. I wait for documents to be provided. I cannot begin much of my analysis of the value of a business before receiving the documentation providing the data I will be analyzing. I have had an assignment where I waited over nine months after being engaged for the first stack of financial information. Some clients are able to provide everything I asked for at one time, while others seem to prefer to hand me a single document every so often, and I am constantly chasing that next piece of information. Be careful of these types of clients as your hours invested in the project have a tendency to inflate without any real progress made.

5. I finally receive at least most of what I asked for, and I begin spreading financials in Excel.

6. Analyze financials and compare to industry data. I look for potential normalization adjustments to ask management about during my site visit and interview.

7. Schedule management interview and site visit.



- 8.** During management interview, ask about the operations. I am trying to learn about what non-operating expenses the business may have. Small business owners understand that there are generally certain expenses on the income statement that are not necessary for operations. What they may not understand is where those expenses are recorded. Be careful of double counting. I had a client who insisted I add back certain expenses, until I explained that those expenses were included in his own wages and I had already normalized his Officer's Compensation expense.
- 9.** After I am back at the office, incorporate what I learned during the management interview into my analysis as I go through my normalization adjustments schedule. I try to write up my notes explaining each adjustment as I make them, so I don't forget my reasoning later. This is also helpful to do so I have reminders of my thought process when I go back through the report in my proofreading process.
- 10.** Begin applying valuation methods. I want to see what indications of value the methods derive, so I can try to understand the story of the valuation I am writing. That means I compare everything to everything else and see if the numbers make sense. Have I incorporated sufficient risk into my discount rate based on how the financial ratios worked out? Does my market approach method make sense? Were the comparables I found sufficiently comparable? Are there any other issues I need to adjust for? Does the business have Goodwill and should I incorporate the Excess Earnings method? (I almost always include an Adjusted Book Value method, regardless.)
- 11.** Conclude to a final value. Please note that this conclusion of value is not the end of the process. Under the Uniform Standards of Appraisal Practice (USPAP), Standard 9 deals with 'Development of the Business Appraisal', and I still need to cover Standard 10, 'Reporting the Business Appraisal'.
- 12.** Test my conclusion of value. I have read many appraisal reports over the years where an appraiser concluded to an obviously over-inflated value conclusion. There is quite a bit of subjectivity involved in the practice of business appraisal theory and it is easy to incorporate an assumption or a flawed analysis. Once I have my value conclusion I check to make sure that BOTH a hypothetical buyer and seller who are reasonably knowledgeable about relevant facts, able and willing to conduct a transaction without any particular motivations on either side, would agree that the deal would be reasonable. It is not reasonable to assume that a buyer would accept a significant negative Return on Investment (ROI) for the life of a loan.
- 13.** Run through all my assumptions and make sure they mesh with the industry expectations and economic overview and what I expect to occur in the future with the subject.

I have also read reports where the appraiser included awesome data about the state of the economy and industry in which the business operates, but never mentions how this data impacts the analysis. It doesn't make sense to have a discussion of how the unemployment rate is declining without also discussing the risk of losing trained employees and having to hire replacements out of a limited labor market. The value conclusion in the appraisal report should be affected by the data one includes in the report, otherwise why include it? Yes, Revenue Ruling 59-60 says that economic and industry data should be included in a report, but the actual quote from RR 59-60 relating to the eight factors is, "The following factors, although not all inclusive are fundamental and require careful analysis in each case:" emphasis added.
- 14.** Assuming I am happy with my analysis and I believe my conclusions make sense, begin writing my report.
- 15.** At this point, as I begin to write the sections describing the subject company, I take care to make sure I mention the points I learned from my management interview or from my own analysis that will factor into my adjustments.



- 16.** As I describe the economic analysis, I watch to make sure there are not any surprises that I was unaware of that should impact some of my assumptions. Sometimes I see something that makes me fine tune my long-term sustainable growth rate or my overall projections.

Some people ask me why I don't write this section first, then do my analysis. The reason is that I like to have a basic understanding of what the value drivers are, and a conclusion of value so I can know what points the economic analysis will impact and then adjust them, but as I stated above, this is my process and any appraiser may change or modify their process as they see fit.

- 17.** I follow the same process with my industry narrative analysis. As I write it, I watch for things that may modify my assumptions, or reasons for why my assumptions may be different than what the industry predicts. **18.** I write the sections of the report dealing with my valuation methods, again watching for anything I may have missed previously that may impact my analysis. Sometimes I write out an explanation of one of my assumptions, then decide I don't like it based on everything else I had just written. Then I go back into my Excel file and adjust.

Sometimes I end up making several adjustments to my basic assumptions in my Excel file as I am writing my report. This is one of the reasons why I prefer to not include many specifics from my Excel file in my Word document. I prefer to simply refer the reader to the appropriate Exhibit in the back of the report. I understand that one could link Excel to Word, but I don't trust Microsoft that much. I have had too many links break and cause me extra work to fix them.

- 19.** I write the section explaining how I arrived at my value conclusion and why my conclusion makes sense. I describe my testing process and if I choose to incorporate the rules of thumb as well as part of my reasonableness checks, explain them. Be careful with rules of thumb. They are designed mainly for transactions involving MOST of the Company's operating assets. Typically a Seller will retain Cash, Accounts Receivable, and pay off all liabilities.

- 20.** My last step is to update my Table of Contents, then print the Word document to a PDF file. I then print my schedules from Excel to a PDF file as well and add them to the report file. Then I insert my Professional Qualifications to the very end, then I am done with the rough draft.

- 21.** I am a sole practitioner, which means I have no one to proofread my reports for me. I try to arrange things so I have a time gap between the previous step above and this finalizing process. I wait a day or two to let the report sit and to have time to occupy my mind with other things, before coming back to proofread my own report.

I have found that if I attempt to proofread the report immediately after having finished writing it, that I will skip over mistakes and errors in my report because I know what I meant to write, and I will read that instead of what I had actually written. When I come back to proofread my report, I look for logic mis-steps and spelling and grammar issues. I look for a nice and clear flow from section to section. I want to value conclusion to seem inevitable, that based on the analysis above, this conclusion is the only one that makes sense. If I see any holes, I go back to the appropriate area and plug them. Sometimes I print the report and Excel exhibits to a PDF file a couple of times before I consider the project completely done.

- 22.** The very last thing I do, is submit the report to the client along with my final invoice.