HERE ARE SOME QUESTIONS TO ASK AND ANSWERS YOU'LL RECEIVE AS YOU BEGIN TO DETERMINE THE VALUE OF YOUR ASSETS.

"So You Need an Appraisal?"

By Alfred M. King, CMA, CFM

Fair value (FV) is increasingly becoming a new standard in financial reporting, and many companies are being required to determine the fair value of some of their tangible and intangible assets. Management accountants are thoroughly familiar with the "cost" of assets and for years have applied depreciation to original cost to determine net book value. But the new FV paradigm doesn't rely on original cost from many years ago—it requires a determination of what something is actually worth today.

The use of fair value accounting has heightened awareness of how best to determine the new information, but there has been little knowledge transfer from professional valuation consultants that would allow corporate financial managers to determine fair value on their own. So how do you obtain today's value of an asset in the current market environment? For many companies, this has required the use of outside valuation consultants, sometimes referred to as appraisers. If you have to use an outside professional, how should you go about selecting an appraisal or valuation specialist?

There are literally hundreds of valuation firms as well as individual practitioners. They range from the major accounting firms, regional accounting firms, and specialized valuation firms to small, local practitioners. In this article I'll suggest what you, as a client who needs an appraisal, should ask of any prospective valuation provider. Then I'll give the kinds of answers you should expect along with an explanation of why you will receive the answers you do.

In the interest of full disclosure, I'm an appraiser with some 45 years of experience, and this article is based on my actual experience with hundreds of clients and prospective clients.

Questions and Answers

Let's look at the most common questions clients and potential clients ask valuation professionals and the answers they should receive.

The single most common question is very straightforward:

"Do you have experience doing X?"

Potential clients often presume that their own valuation assignment is unique and thus requires equally unique and specific valuation experience and expertise in their industry. Therefore, they ask what our company's experience has been in their industry or in a similar valuation situation. An analogy would be an advertising agency that is quizzed by a soap manufacturer about its experience with other toiletry products from other clients.

The fact is that there are certain basic principles of valuation that apply in all industries and in all valuation situations. The more experience a valuation specialist has in performing every type of valuation, across all industries, the better able he or she is to respond to any client's specific problems. Unlike medicine, however, where physicians may spend a lifetime treating diseases of the liver or the eye, valuation professionals usually don't specialize in an industry or a specific type of valuation, such as in a buy-and-sell situation, divorce, or estate tax planning.

At this point, you may be wondering about the relationship of fair value (financial reporting) and fair market value (FMV), which is the usual term in most business valuations. The business community's standard definition of FMV is:

"Fair Market Value is defined as the price for which property would exchange between a willing buyer and a willing seller, each having reasonable knowledge of all relevant facts, neither under compulsion to buy or sell, and with equity to both."

While the definition of FV issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) in Accounting Standards Update 2011-04, *Fair Value Measurement* (Topic 820), "Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS," (www.fasb.org) differs in certain ways from the FMV definition above, in most situations the valuation answers are the same or very similar. In either case, for each assignment a valuation specialist must determine for what price a willing buyer and a willing seller would buy and sell the asset(s) in question. But determination of a theoretical transaction price does *not* necessarily involve professional experience in that specific market.

Rather, it involves knowing how to develop current information about any market. There are no "secrets" to understanding markets. The growth of the Internet has

Valuation Is a Craft

Some people view valuation as an art because of the judgment involved; others view valuation as a science because of the required formulas and calculations. My personal opinion is that valuation of most hard assets, and most intangible assets such as brands and trademarks, is most closely approximated if viewed as a "craft." As defined by Denis Dutton in "The Difference Between Art and Craft" in his July 4, 1990, Radio New Zealand broadcast talk:

"Craft work is skilled work: any kind of craft must involve the application of a technique….Craft implies the application of human intelligence…and the craftsman has tools at his command."

The essential element of a craft is that experience improves performance, and the more experience a craftsperson has, the better is the likely outcome.

vastly increased the availability of market information and speeded up its access. And markets change over time. So even if you performed a valuation assignment for a software company last year, this year you would have to take into consideration the advancements in social media and cloud computing. Last year's experience, while helpful, isn't critical in doing this year's engagement.

The real question that potential clients *should* ask is "How deep is your (firm's) experience in all types of valuation?"

Thus a client's question about experience is appropriate as long as experience is defined in the context of valuation, not a specific industry.

"What are your references?"
"What industry is your primary focus?"
"Who are your current clients?"
"For whom have you done this type of work before?"

These are very reasonable requests from any prospective client, and valuation firms are always able to fulfill those requests. Unfortunately, from the perspective of the person asking the question, there will always be a feeling that the valuation firm has "cherry-picked" its references or previous client assignments. This is similar to when a candidate being interviewed for a job is asked by Human Resources to supply references. More often than not, when HR checks the references, the individual is given a good sendoff, but doubt still persists as to whether the references are truly representative.

Bottom line: You should ask for references and relevant experience with other clients, but don't be surprised when the answers to those requests come back favorable. Of course, an unfavorable reference should raise a red flag.

"What are the major issues you see with this work?"

"Our company is different; there is nobody else like us!" This phrase, repeated by many prospective clients, reveals a fundamental misunderstanding as to what a valuation report does and doesn't do. If you think about it, valuation specialists aren't tasked with running some other company; we're tasked only with *understanding* the client and his or her needs.

No two valuation assignments are the same, and the intellectual challenge inherent in valuation work is why there's very little turnover in the valuation profession. Put a different way, it's the *differences* among clients and valuation requirements that actually represent our professional expertise.

In practice, the major challenge facing us—and it's one that clients hardly ever recognize up front—is the availability of the client's historical financial information and reasonable projections about the client's future plans. If the proper historical and projected information is provided on a timely basis, valuation professionals can readily provide answers that meet virtually any client needs.

"Why should we work with you?"
"How are you different from other valuation firms?"
"Why work with you when we already have an established relationship with [your competitor]?"
"What is your firm's specific experience [related to our work]?"

When a prospective client asks us one or more of these questions, he or she is really asking about our qualifications and experience. If the same valuation assignment is given independently to two equally qualified appraisers, the respective answers should be within 10% of each other, but they will never be identical. This gets to the distinction between a craftsperson and a scientist. Ask two scientists or engineers to solve a technical problem, and they should come pretty close to each other. This isn't true of valuation work.

As a specific answer to this question, we appraisers can only respond, "Here is who we are, and here are our qualifications and experience."

"Are you involved in any industry associations?"

This question is a variant on questions about a valuation professional's experience. Though a few valuation firms specialize in a particular industry, such as media or telecom, most of us are generalists. We can't belong to specific trade associations unless we're assured of a continuing flow of business from firms in that one niche. The time and expense of joining a professional association could not be justified unless a significant number of client engagements would flow from the contacts made at the organization's meetings or from its publications.

On the other hand, it's reasonable to ask a valuation firm and its principals and employees whether they belong to and are active in professional *valuation* organizations. Accounting and tax requirements change, and court cases consistently require updating of professional valuation skills. Being active in professional valuation groups is evidence that the firm and its professionals are interested in and taking advantage of opportunities to keep current.

"How much will it cost to do X?"
"We are very cost conscious/this is a competitive situation, so can you do it for less?"

Appraisers bill clients based on the time involved in performing the assignment, not on the dollar amount related to the asset value. If you ponder just a moment you'll see that billing on the basis of time is the only way to assure the objectivity of the professional. If we were paid a percentage of the value, as many trial attorneys require of their clients, our answer would immediately be suspect.

In many cases we can come up with a reasonable time estimate and commit to a fee based on that time estimate. In other circumstances, say in a divorce case, it's very difficult to estimate time in advance. Then we'll provide the client with our billing rate and commit to informing the client periodically as we expend hours.

Thus, paraphrasing Abraham Lincoln, the fee will be what it takes to do the job. From *Personal Reminiscences of Abraham Lincoln* by Thomas Lowry comes Lincoln's famous quote:

"[Stephen A.] Douglas 'chaffed' [Owen] Lovejoy about his long legs and 'pot belly' and Lovejoy retorted as to his very short legs, etc. One of them asked Lincoln: 'How long should a man's legs be in proportion to his body?' and Lincoln replied: 'I have not given the matter much consideration, but on first blush I should judge they ought to be long enough to reach from his body to the ground.'"

Our fee—and time—will be what it takes for us to perform the assignment.

At times we're faced with a situation where someone else is willing to do the same work for a lower fee. In such cases, the competitor either may be "lowballing" the estimate and hoping to make up the charges during the engagement or simply will be doing less work. In the latter case, the client has to decide whether he or she is willing to take a chance that insufficient effort may render the proposed valuation by the competitor as unsupported and therefore not responsive to the real requirements. There are certain valuation firms that bid low fees, and then do only enough work to write a report. If the report is challenged, say by the IRS, the valuation firm will then go back and do the necessary work to support the value conclusions already developed. In such situations, the total cost to the client will be higher. Of course, if the original report is never challenged, the client may consider he has saved professional fees by not paying for more effort than was needed. How an appraiser responds to this issue is a matter of philosophy: Do it right the first time, or do as little as possible and hope for the best. Our firm's philosophy is definitely in the first camp. As noted, we can always do less work, but then it will probably be necessary to qualify our ultimate effort, informing the client that if, say, the IRS questions the value, it will be necessary for us to go back and do more work for an additional fee. "Pay me now or pay me later" is really the proper response, although common courtesy usually precludes such a sharp answer. Instead, we'll explain up front why we believe the extra work is necessary.

"How long will it take?"
"Can you meet our tight delivery time?"

These are two of the most frequently asked questions, and they are entirely reasonable. Why are prospective clients under time pressure to obtain value indications? Because they often wait until the last moment to complete a tax return, file a 10-K, or register a securities offering, and then they realize the transaction will be held up until they receive the valuation report.

As professionals, valuation specialists always try to meet client expectations. All other things being equal, a six-week elapsed time frame is considered reasonable. In that time we're able to understand the valuation issues and develop a preliminary estimate of fair value. We would also have time to discuss our proposed answers with the client. The six-week period would then require a short additional time to actually write the report. This approach allows for maximum efficiency on the part of professionals and eliminates any necessity for starting work, putting it down to meet a rush commitment, and then resuming work.

So the answer is "Yes, we can meet your time requirement, but there may be a small premium on the fee because of some necessary interruption on other engagements in progress."

"How will the engagement be staffed and from where [what office]?"

Valuation professionals perform in one or more of the three categories or approaches inherent in all valuations: We look at the *cost* to replicate the asset, we determine value based on projected *income*, or we look to the *market* to see what comparable assets are being sold for. Then we also categorize our work into disciplines as to *real estate*, *machinery* and *equipment* (hard assets), or *intangibles*.

Not every appraiser is equally skilled in all three disciplines or all three approaches. It's up to the valuation

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firm to staff each engagement with the best resources for that specific assignment. Thus asking the question, even though it's reasonable in terms of out of-pocket travel expenses, really misses the point.

Would you, as the client, rather pay an airline fare and living expenses for a day or so and have the most efficient time utilization, or would you want the engagement to take longer (with reduced travel) using a perhaps less experienced, locally based valuation specialist? When we point this out, most prospective clients realize that they really should leave specific staffing assignments up to the management of the valuation firm.

In addition, most valuation firms have specific quality-control procedures, so the work of each professional is reviewed at a higher level before values are provided to clients.

"What does doing this work for us entail?"

From the perspective of the valuation specialist, this is actually one of the most important questions that a client or prospective client *should* ask. The reason is simple. Even the most experienced and qualified appraiser must rely on information the client provides.

This starts with historical financial statements, ideally for at least the previous three years, plus current year-to-date operating results and balance sheet. This may strike many of you as not even worthy of being mentioned because "Of course we have financial statements going back as many years as you want." Right. Nonetheless, accurate financials quite frequently aren't available. Often we're handed some tax returns, inevitably with the comment, "Well, Al, there are certain things you have to understand about these tax returns…"

Equally important are forecasts or projections for at least the current year and ideally for the next couple of years. It probably isn't a surprise to find that such forecasts are available in about only half the companies we deal with. At that point we have to spend a fair amount of time with the client's marketing and financial staff to help them develop forecasts that we and they agree are realistic.

Clients should expect to spend a reasonable amount of time helping the appraiser truly understand the business and competitive conditions. In turn, the appraiser has to bring his or her understanding of basic valuation principles and have an independent view as to basic economic conditions. As economic conditions change, so do values, and there's never a static "the value" of a business. In fact, values are valid only for the date of the appraisal, and we aren't expected to, much less are able to, predict specific future conditions. We may expect that the economy in China will continue to grow at a certain rate and incorporate that into our financial analysis. But how that will impact a specific exporter to China is essentially unknown and unknowable.

Every appraisal incorporates key assumptions about the future. As long as our assumptions are reasonable and in accordance with knowledgeable opinion at the time, this is all we can do. We are never guarantors of future economic conditions. In many situations, basic corporate values can change significantly in as few as six months. To validate this statement, look at today's *The Wall Street Journal* at the biggest percentage gainers and losers in yesterday's market. Rises and falls of 10% or more in one day are more frequent than you might imagine. And if a stock drops 10% in a day, isn't it reasonable to assume that a valuation report, written the previous week, might now be out of date?

To sum up the answer to this very important question, any prospective client who wants to engage a valuation consultant should expect to devote a certain amount of management effort and time to working with the appraiser. We usually require far less commitment than an annual audit does, but engaging a valuation specialist to write an appraisal report is never the same as buying a ream of paper from Staples. The Staples motto to the effect "that was easy" may be true for office supplies, but it definitely doesn't apply to valuation work.

All of the previous questions are very common, and we don't mind clients asking them. The answers I've given are realistic and should, perhaps with different terminology and different emphasis, be answered the same way by most appraisers and appraisal firms.

Most financial officers *should* ask these questions, and there will be few surprises for those who have read this article. But there's one more question that we must discuss. It's both difficult and unpleasant, but we must face it squarely.

"Here is the transaction we contemplate, and we have to get to X as the value. Can you do it?"

This is the one question that we *don't ever* want to hear at our firm, yet in one form or another it's very common. In effect, a prospective client will imply that we will get the engagement, but only if we can commit to some predetermined answer. Some 15 years ago, a colleague of mine gave what is still the best answer to this question: *"We don't rent out our letterhead, and we don't sell answers."* But just as we can't bill as a percentage of the value of the assets appraised, we can't commit to a specific answer in advance. Having said that, the client still has a valuation problem, and, if it can be resolved, there's no reason that our firm shouldn't at least make the first effort.

Now before I sound too "goody-goody" about ethics, and in the interest of full disclosure, I have to admit that in more than 40 years in the valuation industry I can only recall three or four instances where the client really had no preconceived ideas regarding what answer he or she expected and just wanted our best professional opinion. In more than 99% of our assignments, we have a good idea of what the client would like and hopes or expects our value(s) will be.

That attitude shouldn't be a surprise. If you are selling your house, you would like an appraisal close to the asking price, and the buyer of a house would like an appraisal at or above the purchase price. Homeowners and homebuyers have a good feel for their local market and ahead of time usually come pretty close to our appraised value.

Similarly, the owner of a business continually talks to vendors, customers, and competitors about industry conditions. In every industry there are standards, norms, or "rules of thumb" about what businesses are worth. Such common knowledge isn't always correct, but business owners at least usually come into the valuation process with certain expectations.

I'll admit that I do like to know what my client's expectations are so I can be prepared in advance to discuss my preliminary value conclusions. That way I know how close to or how far away from those expectations I am. Invariably, there are give-and-take discussions about my preliminary values, primarily because I may not have fully understood the client's business model, projections, competitive conditions, and the like.

These uncertainties almost always are resolved. I'm pleased to report that, in more than 40 years, in only about four engagements, after all discussions had been exhausted, did my client pay our bill and then file our report away unused. Interestingly, all four cases involved family disputes where our client was so emotionally involved in a valuation dispute with his relatives or an ex-employer that he wouldn't listen to reason and was determined to proceed without us. I imagine the client was hoping to find a more malleable valuation specialist, but we were out of each case and never found out what ultimately transpired.

Bottom line, as a client you should candidly tell the valuation specialist what you think the business or the asset is worth. This doesn't commit the appraiser to coming up with that answer, and in most cases we don't arrive at the initial amount in the client's mind. But if the essence of business is good communication, and virtually every management guru urges good communication, then there's no reason to play "gotcha" with a professional valuation consultant. If we know what the client expects or would prefer, then we can be prepared with the facts that support our conclusion, and subsequent discussions can be minimized.

No Surprises

Again, prospective clients should ask the valuation firm they are thinking of engaging several questions. I hope I've answered a number of those questions, at least in general terms. Valuation is a craft, which means that the more experience the appraiser has, the better the outcome will be. The one thing I always promise my clients is: "There will be no surprises during or after the engagement." Clients can take bad news; they can't take surprises. **SF**

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