**BANISTER FINANCIAL, INC.**
***Business Valuation Specialists***
www.businessvalue.com

1338 HARDING PLACE • SUITE 200
CHARLOTTE, NORTH CAROLINA 28204
PHONE: 704-334-4932
**Contact: George Hawkins, ASA, CFA**
**Michael Paschall, ASA, CFA, JD**

FAIR VALUE™

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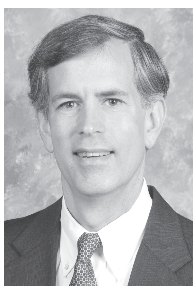
# Avoiding "Good" and "Bad" Economy Bias in Business Valuation Matters

*By: George Hawkins, ASA, CFA, Managing Director*

**Introduction.** Business appraisers and users of valuation reports must avoid the bias towards business values that might develop with a “good” or a “bad” economy. This issue most frequently arises with attorneys who must deal with family law or shareholder dispute valuation matters and unintentionally enter a matter with a bias as to how the economy will impact the value. Consequently, this bias can lead to the wrong conclusions about what is said in valuation reports, in depositions of the business owner, and in a general willingness to accept values commensurate with the bias that might not be true.



**George Hawkins**

Below are some of the “bad” economy myths:

- All business values are down.
- All valuation multiples are down.
- All company earnings are down or uncertai.n
- Things are so bad it will take years for companies to recover.
- Housing demand and values may never recover, nor the companies that serve the industry.

Below are some of the “good” economy myths:

- All business values are up.
- All company earnings are up or improving.
- Things are great. This is not ending soon!
- Housing values will keep going up, up, up!

**Effects of a “Good” or “Bad” Economy**

One well-documented psychological tendency of human beings is that our future expectations are conditioned by our most recent past- we tend to extrapolate the most recent past into the future. This is the reason why studies show that many economists miss turning points up or down in the economy, and why we think booms will continue and downturns will persist. Unfortunately, this myopic human tendency can lead us to incorrectly assess the value of a business.

The truth is that every industry and company is unique. While we might perceive the overall economy as poor or good, there will always be industries going in opposite directions, so it is not possible to generalize to specific situations. In fact, some industries are counter-cyclical, performing well when general times are tough, while others do poorly when the general economy is booming.

Also, even if the outlook for a given industry is “bad” or “good” does not mean the specific company will also fit that mold. Poorly run businesses fail in “good” economies and well-managed companies can thrive in “bad” economies. Also, “bad” economies put many competitors out of business, setting up the chance for those that remain to reap strong rewards when conditions turn around. “Bad” economies also cause companies to get rid of unnecessary fat and expenses so they can do well when things rebound. “Good” economies can mask inefficiencies and excesses and can make all managers look like geniuses, even mediocre ones.

**How to Avoid the Problem**

How should a valuator, a user of a valuation report, or the attorney taking a business owner's deposition avoid this tendency towards bias and see the true picture? The answer is simple- back to basics, overcoming one's natural biases with a return to the fundamentals. This means asking the detailed questions necessary to fully understand the company, its customers, industry, and forces that impact it, its earnings, and its outlook. Banister's Financial website (see *Tools* page at businessvalue.com) provides an extensive list of questions appropriate for a valuation interview or deposition. Obtaining the answers to those questions will force the issues present in any situation, both good and bad, to become apparent and lead to a reasoned understanding of factors that will ultimately affect business value. There is simply no shortcut to arriving at a sound valuation, whether times are "good" or "bad" in general. Following this kind of framework will help avoid the tendency towards our own preconceptions of how things ought to be.

**Warnings Signs Things May In Fact Be "Bad"**

The truth is that things might really be bad for a specific company. Consequently, attorneys involved in valuation-related litigation matters should learn how to spot potential warning signs that might point towards their need to pursue strategies that minimize their client's risks in a matter. For example, it is not uncommon for a non-owning spouse to also be a guarantor of a company's bank loans, a guarantee the spouse may have long since forgotten. If things deteriorate and the company fails it is possible that the spouse may be exposed to substantial financial claims from the bank. Therefore, with knowledge of the pending company problems before they become terminal, the smart attorney might attempt to get the spouse released from his or her guarantee while it is still possible.

While there are many potential indicators that a company might be in distress and at risk of going out of business, here are some of the more common "red flags":

- Having tax liens filed for non-payment of payroll taxes. This is often bad news since payroll tax money is being used as a lender of last resort.
- Payments to suppliers (in days of turnover) are very slow, extending well beyond terms. This presents a risk that suppliers will stop shipping to the company and force it out of business.
- Abnormally late issuance of financial statements.
- Departures of key personnel.
- Officers advancing loans from a company to themselves (which they took directly as salary in the past) to avoid the company falling below minimum shareholder equity or debt to total net worth bank loan covenants.
- Large losses.
- At or near limits on a bank line of credit.
- Non-compliance with loan covenants that may lead to a cutoff of credit.
- Strained banking relationships.
- Frequent changes of accounting firms.
- Losses of long-time or key customers or suppliers.
- In contractors: difficulty obtaining project bonding, and/or a shrinking backlog.
- Books show large negative cash balances, but positive cash balances shown on bank account statements. This might indicate that the Company is "kiting" checks or is heavily reliant on float in check clearing to finance itself.

These are certainly not the only warning signs that might be present, nor are they failsafe indicators that a business is indeed in trouble or about to fail. However, being observant for these and similar types of clues may increase the chances that a situation of possible distress and impending failure is spotted before it is too late.

**Additional Steps if Concerned**

Most companies use at least some bank credit. If things really are deteriorating rapidly there is a very good chance the bank will be aware of it, either through non-compliance with loan covenants, slowness in the payment of interest and principal, bounced checks, etc. The attorney might decide to obtain and/or subpoena bank records and credit files since the bank will probably document problems before others know about them. If the company really is troubled there is a reasonable chance it will already be listed by the bank internally as a "watch" credit. All banks must grade their loans on a scale of risk for Federal Bank Examiners.

If warnings signs are present this also does not necessarily mean a company will in fact die. But the astute attorney or valuator can then find out what steps (if any) are being taken to attempt to change the company's fortunes and ascertain their prospects for success. Also, efforts might be made to determine what conditions are necessary, internally or externally, for the company to rebound, and if the prospects for these conditions occurring are realistic, unrealistic, or highly optimistic. If no rebound appears likely and the appropriate valuation method and/or outlook for the company is liquidation, be sure to avoid overlooking patents, trademarks and intangible assets that might have still have value and which might not be reflected on a company's balance sheet.

**Summary**

Unintentional bias can creep into the best intentioned of business valuations. Similarly, the user of a business valuation, whether it be an attorney for estates, gifts, divorces or disputes, can read into a valuation report what he or she wants to see, impacted by the individual's own bias and world view. In addition, in the discovery process in litigation matters the attorney who is trying to gather facts needed for a valuation must ask sufficient questions to get at a truly global and unbiased look at the business and to avoid letting his or her bias reach a pre-determined conclusion that may or may not be present. ♦