Editor's Column: Does a Historical Average, Weighted or Otherwise, Constitute an Income Forecast?

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Recently I have encountered a number of business appraisals that used a weighted historical average as an income forecast. This led me to wonder why some appraisers feel that this is appropriate.

I have come up with the following possible reasons:

1. Belief that an income forecast is not necessary.
2. Income forecasts are speculative.
3. Management may not develop income forecasts.
4. A weighted historical average is easy to compute
5. CPA rules are cumbersome to comply with if the appraiser is also a CPA.
6. Income forecasts are difficult and time consuming to develop.
7. The appraiser may not know how to support an income forecast.
8. Concern that the income forecast will be wrong.

Let's examine each of these possible reasons.

1. Belief that an income forecast is not necessary.

According to Revenue Ruling 59-60,

> The fair market value of specific shares of stock will vary as general economic conditions change from "normal" to "boom" or "depression," that is, ***according to the degree of optimism or pessimism with which the investing public regards the future*** at the required date of appraisal. Uncertainty as to the stability or continuity of the future income from a property decreases its value by increasing the risk of loss of earnings and value in the ***future***. The value of shares of stock of a company with very uncertain future prospects is highly speculative. The appraiser must exercise his judgement as to the degree of risk attaching to the business of the corporation which issued the stock, but that judgment must be related to all of the other factors affecting value.[i]

A forecast is the appraiser's attempt to illustrate his or her opinion of the expected future earnings of a business upon which an estimate of value will be based.

Also, according to Revenue Ruling 59-60,

> **Valuation of securities is, in essence, a prophecy as to the future** and must be based on facts available at the required date of appraisal. As a generalization, the price of stocks which are traded in volume in a free and active market by informed persons best reflect the consensus of the investing

public as to what the future holds for the corporations and industries represented. When a stock is closely held, is traded infrequently, or is traded in an erratic market, some other measure of value must be used. In many instances, the next best measure may be found in the prices at which the stocks of companies engaged in the same or similar line of businesses are selling in a free and open market.[ii]

The Revenue Ruling clearly indicates that a valuation must be based on future expectations.

The Revenue Ruling continues to discuss pertinent points.

The history of a corporate enterprise will show its past stability or instability, its growth or lack of growth, the diversity or lack of diversity of its operations, and other facts needed to form an opinion of the degree of risk involved in the business. … The detail to be considered should increase with approach to the required date of appraisal, since recent events are of greatest help in **predicting the future**; but a study of gross and net income, and of dividends covering a long prior period, is highly desirable. The history to be studied should include, but need not be limited to, the **nature of the business**, **its products or services, its operating and investment assets, capital structure, plant facilities, sales records and management**, all of which should be considered as of the date of the appraisal, with due regard for recent significant changes. Events of the past that are **unlikely to recur in the future** should be discounted, since **value has a close relation to future expectancy**.[iii]

History of the company should be used as a basis for the income forecast. This section clearly explains that the appraiser must thoroughly understand the business prior to developing a forecast.

Continuing with the Revenue Ruling,

A sound appraisal of a closely held stock must consider **current and prospective economic conditions** as of the date of appraisal, both in the national economy and in the **industry or industries** with which the corporation is allied. It is **important to know that the company is more or less successful than its competitors in the same industry**, **or** that it is **maintaining a stable position with respect to competitors**. Equal or even greater significance may attach to the **ability of the industry with which the company is allied to compete with other industries**. **Prospective competition** which has not been a factor in prior years should be **given careful attention**. For example, high profits due to the novelty of its product and the lack of competition often lead to increasing competition. The public's appraisal of the **future prospects of competitive industries or of competitors within an industry** may be indicated by price trends in the markets for commodities and for securities. …[iv]

A review of historical results is not sufficient. The economic and industry outlooks, an investigation into competitors in the same and related industries, and prospective competition must also be considered.

According to Gary Trugman, "The fundamental theory behind the income approach to valuing a business interest is that the value of an investment is equal to the sum of the present value of the future benefits it is expected to produce for the owner of the interest."[v]

According to Pratt, Reilly and Schweihs, "In theory, the value of a business or an interest in a business depends on the future benefits that will accrue to it, with the value of the future economic benefits discounted back to a present value at some appropriate discount rate. In other words, the basic concept of the income approach is to project the future economic income associated with the investment and to discount the projected income stream to a present value at a discount rate appropriate for the expected risk of the prospective economic income stream."[vi]

2. Income forecasts are speculative.

Income forecasts are speculative. Everything having to do with a business enterprise involves risk and unknown factors. The appraiser's job is to develop an income forecast that fairly represents both a knowledgeable and willing seller's and a knowledgeable and willing buyer's outlook for the company. Many appraisers neglect to consider the view point of the knowledgeable and willing seller. Use of some type of historical average clearly does not reflect the viewpoint of most sellers.

3. Management may not develop income forecasts.

Whether or not management develops income forecasts is not the issue. It is the appraiser's responsibility to value the business.

Occasionally, management forecasts are available. These should be used with some caution as management often has an ax to grind—they may be seeking a very high valuation for a sale or a very low valuation to be used to buy out a shareholder-partner.

When using management's forecast, I recommend that the appraiser still prepare their own forecast and compare the two. If management's forecast appears to be an "arms-length" type forecast, by all means use it. If however, it appears to be slanted one way or another, I recommend modifying it so that it conforms to the standard of reasonableness.

One way to check management's forecasts for reasonableness is to obtain copies of previous forecasts and compare them to actual results or budget vs. results.

If management's forecasts must be used, for whatever reason, adjust the discount rate to account for the additional risk of achieving an aggressive forecast or reduce it as appropriate for a very conservative forecast.

4. A weighted historical average is easy to compute.

A weighted historical average is very easy to compute as the process is mechanical and requires no thought. However, the following quote taken from Revenue Ruling 59-60 summarizes this the applicability of this methodology: "Prior earnings records usually are the most reliable guide as to the future expectancy, but to resort to arbitrary five-or ten-year averages without regard to current trends or future prospects will not produce a realistic valuation."[vii]

The ease of computation should not be a factor. The appraiser's responsibility is to do the job right.

5. CPA rules are cumbersome to comply with if the appraiser is also a CPA.

Many practicing Certified Public Accountants hate the idea of performing a "projection" because of the rules foisted on them by the American Institute of Certified Public Accountants (AICPA).

I understand the need for rules and believe it is appropriate for CPAs to be very careful when doing projections or income forecasts as part of preparing financial statements for a client often done as part of a loan application. However, when doing an appraisal, a CPA must take off his or her CPA hat and put on their appraiser hat. Appraisers must prepare supportable income forecasts as part of the appraisal process. Perhaps if the CPA is uncomfortable preparing an income forecast as part of an appraisal due to the client being an accounting client, consideration of referring the job to someone else may be appropriate.

6. Income forecasts are difficult and time consuming to develop.

The amount bid for a job is irrelevant. The appraiser must do whatever is necessary to produce a credible appraisal. The level of difficulty and the amount of time it takes to develop a supportable and credible income forecast is indeed irrelevant. If you goof and underbid a job, suck it up and do it right anyway. Next time, you will have a better idea of what to bid. Appraisers should never allow the amount paid influence the quality of job they do. Whatever is necessary to do the job right should be done.

7. The appraiser may not know how to support an income forecast.

If the appraiser does not know how to support and income forecast, it is time to learn how. Developing a supportable income forecast is an integral part of most business appraisals.

For additional information and assistance in developing a supportable income forecast, I suggest that IBA's course 1040, Forecasting Net Cash Flow, be considered. I am quite familiar with the course as I wrote it. This class covers the theory, but more importantly, it includes several hands-on case studies that illustrate step by step how to develop a supportable income forecast.

8. Concern that the income forecast will be wrong.

You can pretty well be guaranteed that your forecast will be wrong! If business appraisers were able to always accurately predict the future, business appraisals would be very difficult to obtain as all business appraisers would be independently wealthy and likely not very inclined to work hard.

There will always be some that refuse to look at or consider forecasts as they can always be considered speculative by definition. Business buyers do not buy historical results – they buy what they perceive the business is expected to generate in future earnings. This expectation is often highly influenced by past results, however, future prospects are the key. Future prospects means an income forecast.

The key question that should be asked about each and every forecast contained in a business appraisal report is not will the forecasted results actually occur? Instead, what should be asked is based on the economic outlook, the industry conditions and outlook, the specific company analysis of things like the product line, the competition, the condition of plant and equipment, and the historical financial analysis, does the income forecast make sense? Are the forecast assumptions well explained and supported?

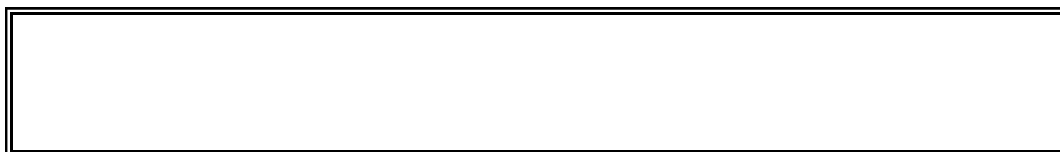
This is not all that different from the much maligned weather forecaster's daily opinion of what the weather will be like for the day, week or whatever. Based on the data available as of the date and time in question, is or was the forecast supportable? If it rains or snows when the weather forecast said it would be sunny, was the forecast wrong. Sure, it was wrong. But the key issue is based on the data available at the time the forecast was made, was it reasonable?

Summary

Now, to answer the question posed as the title of this article. Does a historical average, weighted or otherwise, constitute an income forecast? In a word, no.

The income forecast is probably the most important part of the appraisal. The reason we examine the economic and industry outlook and analyze the historical results of the business enterprise is to enable us to develop an income forecast and determine the risk associated with likelihood of the company achieving the forecast.

In times of even modest inflation, the use of an average of historical results, weighted or otherwise, is simply stating that the appraiser believes the company's revenue and earnings in the future are expected to decline. While this may be the case, the appraiser should clearly say so and explain the reasoning to support the outlook.



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[i] Internal Revenue Service Revenue Ruling 59-60, Section 3.02.
[ii] Internal Revenue Service Revenue Ruling 59-60, Section 3.03.
[iii] Internal Revenue Service Revenue Ruling 59-60, Section 4.02(a).
[iv] Internal Revenue Service Revenue Ruling 59-60, Section 4.02(b).
[v] Gary R. Trugman, Understanding Business Valuation: A Practical Guide to Valuing Small to Medium-Sized Businesses. (New York: American Society of Certified Public Accountants, Inc., 2002), p. 282.
[vi] Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs. Valuing a Business: The Analysis and Appraisal of Closely Held Companies. (New York: McGraw-Hill, 2000), p. 153.
[vii] Internal Revenue Service Revenue Ruling 59-60, Section 4.02(d).