



THE INSTITUTE OF BUSINESS APPRAISERS

# IBA News

INFORMATION FOR TODAY'S BUSINESS APPRAISER—FALL 2006

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## Upcoming education

**December 11-15, 2006**  
Palm Beach, FL

**January 22-26, 2007**  
Fort Lauderdale, FL

**SAVE THE DATE**  
**FOR THE 2007**  
**IBA SYMPOSIUM**

**June 21-23, 2007**  
Denver, CO

Omni Interlocken Resort

*(limited to the first*

*150 registrants)*

## BREAKING NEWS

### IRS RELEASES GUIDELINES REGARDING APPRAISAL REQUIREMENTS

*On October 19, 2006 the IRS issued Notice 2006-96 providing additional information on the definitions of "qualified appraisal" and "qualified appraiser." The full text of the Notice is included in this issue of IBA News. Additional regulations will be issued and will be the subject of future articles.*

*Obviously, professional training and adherence to generally accepted appraisal practices are already the duty of competent business appraisals — to that extent, the Notice affects no change. It is the need to document and demonstrate training and following solid professional standards which may result in the exclusion of appraisers without formal training, professional membership, or accreditation.*

*Public comments are invited on the education, experience and accreditation requirements; the comments deadline is January 17, 2007.*

*IBA members are reminded that free technical support is one of the most important services offered to our membership, and that we welcome your contact by phone, e-mail or postal service. - IBA HQ*

Part III - Administrative, Procedural, and Miscellaneous

Guidance Regarding Appraisal Requirements for Noncash Charitable Contributions

Notice 2006-96

#### SECTION 1. PURPOSE

This notice provides transitional guidance relating to the new definitions of "qualified appraisal" and "qualified appraiser" in § 170(f)(11) of the Internal Revenue Code, and new § 6695A of the Code regarding substantial or gross valuation misstatements, as added by § 1219 of the Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (2006) (the "PPA").

The Service and the Treasury Department expect to issue regulations under § 170(f)(11). Until those regulations are effective, taxpayers may rely on this notice to comply with the new provisions added by § 1219 of the PPA.

#### SECTION 2. BACKGROUND

A deduction for charitable contributions is generally permitted under § 170(a), subject to certain limitations depending on the type of taxpayer, the nature of the property contributed, and the type of donee organization. Section 170(f)(11), as added by § 883 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004), contains reporting and substantiation requirements relating to the allowance of deductions for noncash charitable contributions. In particular, under § 170(f)(11)(C), taxpayers are required to obtain a qualified appraisal for donated property for which a deduction of more than \$5,000 is claimed. Under § 170(f)(11)(D), in certain cases the qualified appraisal must be attached to the tax return. For appraisals prepared with respect

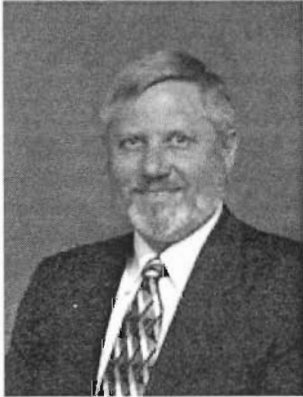
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FALL 2006

# An Average of Historical Earnings is Not a Forecast

-Paul R. Hyde, EA, MCBA, ASA, MAI

## The Mentor's Mind



Businesses are bought and sold based on what the parties involved expect the entity's future cash flow to be. Historical results are reviewed and analyzed along with the company's business plan in order to estimate likely future results.

According to Gary Trugman, CPA/ABV, MCBA, ASA, MVS, in his excellent textbook entitled

*Understanding Business Valuation: A Practical Guide to Valuing Small to Medium-Sized Businesses*, 2<sup>nd</sup> Edition published by the American Institute of Certified Public Accountants "One of the most important parts of the valuation process is the projection of the future benefits stream that will be used in the income approach. ... The starting point of the projection process is that historical income statements must be analyzed and adjusted (normalized if you are valuing a controlling interest) to reflect the economic income of the business being appraised. ... Historical operating results should also be analyzed to gain an understanding of the quality of the earnings reported. ... The appraiser should also look for trends that may help predict the future with respect to the direction in which the company is headed. These trends may indicate growing, declining, flat, or volatile income streams. If a company has been growing at an exceptionally high rate, the likelihood is slim that the same rate will continue into the future. Since this rate cannot be maintained, the appraiser must compensate in the projection by reducing the growth going forward. ... If the company's future appears to be flat, there is no reason to use a multi-period valuation model; in this situation, a single-period capitalization model will suffice. When a company's results are erratic, projections become extremely difficult and may have little value in the appraisal process. **An averaging of history may prove to be beneficial, but this should be done only as a last resort.**"<sup>1</sup> [emphasis added]

PPC's *Guide to Business Valuations* published by Thomson-Practitioners Publishing Company outlines how to develop a forecast in similar terms as described by Trugman. It also does not support using a historical average as a forecast.

According to the course material published by The Institute of Business Appraisers, Inc. for the class Forecasting Net Cash Flow, "Some appraisers use an historical average or a weighted historical average instead of a forecast. The use of historical data is simply stating that you believe that the future is expected to resemble the past. Since inflation is typically present, even in low amounts, an average of historical results typically states that the company is expected to decline in sales and profits. The following quote taken from the above Revenue Ruling 59-60 summarizes this nicely. '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.'<sup>2</sup>

I also surveyed a number of CPAs that are qualified business appraisers and asked them why some use a historical average in lieu of a forecast. The consensus was that CPAs are trained to record history and they typically do not do forecasts due primarily to tough accounting rules outlining how a forecast or projection must be done if you are a CPA. However, for business appraisers, forecasting is part of the job for the simple reason that it is what BUYERS do! And if the standard is Fair Market Value, how can we do something that a buyer would not consider?

In summary, there is no reputable valuation source that supports using any kind of an average, weighted or otherwise, in lieu of a forecast. The appraiser must either develop a forecast or appropriately use management's forecast when applying the income approach in a business valuation. The forecast must be well thought out and all assumptions carefully explained. Again, according to Trugman, "Performing a forecast is not a guarantee that the company will actually achieve the forecast results, but not doing a forecast is like not really doing an appraisal."<sup>3</sup>

Particularly in light of the IRS notice discussing qualified appraisers, it's important to recall that difficult, accurate work is the job—and averaging is not the answer.

Sincerely,

Paul R. Hyde, EA, MCBA, ASA, MAI

<sup>1</sup>Gary R. Trugman. *Understanding Business Valuation: A Practical Guide to Valuing Small to Medium-Sized Businesses*, 2<sup>nd</sup> Edition (New York: American Institute of Certified Public Accountants, 2000), p. 288-290.

<sup>2</sup>Paul R. Hyde. *Forecasting Net Cash Flow*. (Plantation, Florida: The Institute of Business Appraisers, 2004), p. 13.

<sup>3</sup>Gary R. Trugman. *Understanding Business Valuation: A Practical Guide to Valuing Small to Medium-Sized Businesses*, 2<sup>nd</sup> Edition (New York: American Institute of Certified Public Accountants, 2000), p. 293.