In the Middle of Somewhere

Often one of the most important steps in the valuation of a business, and at the same time a step not given the recognition and respect that it demands, is the issue of taking an average (or not) of the normalized net income of some, or all, of the years (or otherwise) detailed in the report. When valuing a business, typically one of the most important numbers is the net income which is going to be capitalized in determining value. That net income is the result of a forensic analysis addressing, and then normalizing, one or more years of a business's operations. Very commonly, we experts apply this normalization process to five years. There is nothing particularly magical or mandatory about that – in theory it can be virtually any number of years, with the idea being that it is supposed to provide the reader with an understanding of the business' performance, and a reasonable foundation for expectations going forward. Also, an IRS Revenue Ruling references the possible (not mandated) use of five years. Thus, we experts often start with the five years ending with the valuation date (or possibly overlapping that date), and apply our forensic analysis and normalization adjustments to varying degrees to those five years.

That was in a sense the easy part – though by no means do I really mean it was easy, but conceptually, that was the easy part. We now need to choose/determine the appropriate income to use for valuing this business – that is, what is the income we're going to capitalize in order to determine value. What we have is five years of normalized (adjusted) income. What we don't have is a single number (that's the purpose/aim of this article) to use for the valuation process. What we have are five discreet numbers that, with our experience and professionalism, we use to arrive at an income number we believe is appropriate for projecting into the future and thus capitalizing for valuation purposes. The "trick" is, how do we get to that number? There are several possibilities, each with its strengths and weaknesses.

- <u>A straight average of those five years</u> – this has the virtue of being perhaps the most obvious and straightforward; it requires the least judgment call; it might be the easiest to support and explain. It also provides a blend of good and bad years (or perhaps similar years). However, it effectively ignores trends, it ignores whether a five year average is right; and absent further insight, it can be too simplistic. An illustration of a major shortcoming in this approach is assume you have two identical businesses. For the five years analyzed, one of them has net income of one million dollars, two million, three million, four million and five million, for the five most recent years, starting with the most recent year. The other has normalized income of the reverse – five million dollars, four million, three million, two million and one million, for the most recent five years. A simple straight arithmetic average for these two would be exactly the same – but it is unlikely anyone would look at these two businesses as being worth the same. Also, many averages wind up with the income to be used in valuation at some point below (possibly above) what the company had already achieved in the last one or even two years. In a typical averaging situation, it might take a few or several years of growth to the income of the averaged year before you reach what already has been established by the company in the most recent year or two. Thus, how reliable is an average that doesn't even get you close to what the company has already proven it can do?;

- A weighted average of the five years – weighted here means taking the most current year and giving it a five times weighting, the next most current a four times weighting, etc. The concept and justification of this approach is that it gives the most weighting to the most current years. That is generally considered a good idea. However, similarly to the preceding, it also ignores the issue of whether one or more of those years is an aberration, and perhaps whether or not there is a trend, and if so, is weighting adequate under the circumstances? Also, other than arithmetic convenience and simplicity, even assuming weighting is appropriate, what makes a simplistic five, four, three, two, one, weighting the right weighting?;

- Eliminating one or more years – it may be that one or more years are truly aberrations, and should not be relied upon going forward. If so, then they should be removed, and not considered in any average or whatever. A problem – it is clearly a subjective call, and it is possible that someone else looking at the same set of numbers may not agree with any one expert's sense of omission of a year or two. Also, while dropping one year out of five, if that one year is clearly out of the norm, is a relatively easy decision (even if wrong), once you talk about dropping two years out of five, then the decision is not so obvious and begs the issue as to whether, if two years out of five are in someone's sense an aberration, does that suggest there is no simple norm, or that it might take more than five years analysis to establish that norm? Also, what if the aberration is the most recent year, or even more difficult, the two most recent years?;

- Instead of simply using an average of some kind, perhaps looking to see if there is a trend and using that trend. The advantage here is that a trend may provide strong guidance for what might be expected going forward. A problem with using a trend is that you have made the assumption that there is in fact a trend that can be relied upon for projecting forward. Does the expert really know, or have a strong comfort level, that the perceived trend is in fact a trend? Perhaps instead, it is really one end of a cyclical situation, and we are about to see a turn;

- What if we've got a situation that involves a business with a longer business cycle than merely five years? The use of five years assumes, as a general concern, it will cover a timeframe broad enough to give a comfort level that we understand the fiscal operations of the entity, and that we've got enough data to project forward for valuation. What if we are involved in a business that has a longer cycle – perhaps ten years – and the five years that are being used are let's say in the early part of a ten year cycle, or in the later part of a ten year cycle?

Obviously, any and all approaches – whether using subjective selections or simply accepting the numbers as is with no interpretive selection – in reality involve subjective determinations and interpretations. Taking all five years and using a straight average requires an assumption/interpretation; using any kind of a weighted average, a trend, deleting one or two years, requires an interpretation, a subjective determination. The ultimate issue here is that the expert needs to do this in as an unbiased and arm's length, intellectually justified approach as possible – and that almost any approach can be open to challenge. An expert acting professionally and using reasonable judgment, most of the time can be expected to use a foundation that is reasonably supportable. It would not be surprising to find, with the same set of numbers, two different experts concluding somewhat differently as to what is the ultimate normalized level of income to use for valuation. However, if their starting point of five years of normalized income is reasonably close, then their interpretations of the use of that data should not have them ultimately that far apart in the income to be used for valuation.