

**ATTORNEY BEWARE**  
**BUSINESS VALUATION IN THE CURRENT ECONOMIC CLIMATE**  
**IT MIGHT BE THE RIGHT METHOD –**  
**BUT IT COULD BE THE WRONG ANSWER**

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With 2009 being one of the worst economic times in most of our lifetimes, we now have to ask ourselves an interesting question. When you ask an expert to prepare an opinion of value for a closely held entity owned by your client, **“Is it still business as usual”?**

If the appraiser is using a discounting of future benefit streams, 2009 is only a benchmark to measure the reasonableness of our future expectations. The future projections reduce the chance that the 2009 information will taint the final valuation. That is a luxury for most appraisers.

Since most small businesses do not have the capacity to accurately prepare forward looking income statements, business valuation professionals have routinely relied on historical information for purposes of valuing the entity. We routinely ask for the financial statements, the tax returns, and other supporting documents. We rely on history to show us the future. However, with the devastating financial results of some entities in the last 12 – 18 months, is that reliance on historical information flawed? The answer is simple, it might be yes, and it might be no.

First, let’s look at normal practices, before we begin to explore why those practices might not be the best answer for present day valuations.

We all are familiar with the practice of looking at a number of years of historical financial information, whether that be financial statements or tax returns. Some valuation experts use a weighting of that financial information because most recent history is more important to the valuation than the older information.

Remember, it is a basic tenet of valuation that when historical financial information is being used, it must be considered a proxy for the future operations of the business. As Shannon Pratt reminds us “the capitalized economic income method is a forward-looking analysis, just as the discounted economic income method is. A simple average – or a weighted average – of past operating results is not an adequate procedure, in and of itself, to develop this projection. The historical average should be used only if the analyst is able to justify the notion that this past average is indeed a reasonable proxy for future economic income expectations.” (See Valuing a Business, The Analysis and Appraisal of Closely Held Companies, 5<sup>th</sup> Ed., Shannon P. Pratt, with Alina V. Niculita, McGraw Hill, 2008, pg 247)

If we were to just do “business as usual”, we would take the last 5 years of profits, and using the traditional 5, 4, 3, 2, 1 weighting, we arrive at a weighted average for our historic earnings. But think this through. If the most recent year is an anomaly, and we are giving that year 33% of the total weighting, are we really looking at a realistic picture of the future earnings? Let’s assume that 2010 returns to a more historic level of revenues and profits, our methodology has more than likely significantly reduced the fair market value of the entity being valued.

This is not a theoretical discussion. I have seen several recent valuations, where the use of a heavy weighting on the most recent (down) year, that results in a valuation opinion that, when viewed in the light of reasonableness, is obviously low. In a recent matter, an appraiser used the 5, 4, 3, 2, 1 weighting, thus giving the 2009 information a 33% weight in the overall average earnings that were to be capitalized. The business owner testified in his deposition that it was not the recession that caused the down year, but it was the weather. The mechanics were correct, but the application of those mechanics resulted in a substantial undervaluation of the Company.

So what is the solution? Certainly, the 2009 information must be considered in the valuation. But what consideration should it receive? This is where the experience and judgment of the valuation professional must come into play. What is the future expectations of both the industry and the specific entity? Is 2009 really an anomaly? Will it have some impact on 2010? Does full recovery come in 2011? Where is our crystal ball when we really need it?

My suggestion is that our economic outlook must be looked at very closely. The appraiser must be able to present a cogent argument, for or against, the expected recovery of the entity, or why it will take a longer period to get back to normal. The appraiser needs to understand that it is okay to weigh the down year in a different manner to put the magnitude of importance in place as to what the real impact of the 2009 numbers have on our future outlook. It may be appropriate to weight the 2009 numbers as the lowest of the data points.

The appraiser must spend more time analyzing the capital structure of the company, and its need for funds to fuel the recovery. A well capitalized company probably has a greater advantage than a very debt laden company, of returning to a level of past profitability. Every industry can have a different recovery expectation.

The real solution – more research, more analysis, and more explanation of our opinions – is mandatory in future valuations. This problem will be with the appraisal community for several years, until the 2009 results can work their way out of the calculations.

No, it cannot be “business as usual”. The appraiser owes the client his experience, judgment, and expertise. The appraiser needs to “think through” the impact of the 2009 recession, and the impact on the future earnings of the entity we are valuing. The appraiser needs to accurately measure the abnormal year’s impact on future operations. And, after that analysis, the appraiser needs to clearly explain the conclusions to the client.

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