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Valuation and Fair Value Accounting
November 10, 2004 Peter Leitner, CMA, CFM, Managing Partner, Waterford Advisors LLC

Value is the heart of business combinations and financial professionals are tasked with creating it, or at least, not destroying it. But it must first be measured, and the Financial Accounting Standard Board's (FASB) move toward fair value means less reliance on historical cost and more concern about mispriced corporate deals that, gone awry, can quickly sour banking relationships with credit hurdles and rating downgrades. So when the CEO asks finance, "Do we really want to do this deal?" the answer must be clear and informed.

Traditional Valuation Methods
To say "value is in the eyes of the beholder" verges on understatement, so the Financial Accounting Standards Board (FASB) recently defined fair value as *the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties*. It also stated its preference of valuation methods, but they differ considerably often yielding different answers.

The Income Approach
The income approach is based on the present value of the firm's income stream, explicitly considering the timing, size and uncertainty of future earnings, plus the capital needed to generate them. The best known variation—discounted cash flow (DCF) analysis—sums the present value of projected cash flows and then divides it by a percentage reflecting the cost of capital and cash flow growth rate. To this a terminal value may be added.

When done properly, the income approach produces an excellent estimate of intrinsic value, but critics cite the assumptions that are required, especially the cash flows. No firm can forecast perfectly and valuation experts can disagree on assumptions, so DCF valuations may range widely. Assumptions also allow for nudging valuations up or down to support a desired outcome, so *caveat emptor*.

Despite these and other shortcomings, the income approach is a powerful tool for evaluating major decisions like acquisitions and changes in strategy.

The Market Approach
The market method compares the target to other firms, which investment bankers favor because prior deals influence investor decisions and intrinsic value becomes less relevant in unusual market conditions.

Analysts start by selecting like-sized firms of the same industry and similar performance, and then calculate benchmarks like the average revenue and average net operating profit after tax (NOPAT). They are then divided into the average market capitalization to produce valuation multipliers.

For example, a private software company with $100 million in revenue and $20 million in NOPAT is an acquisition target. From analyzing ten publicly-traded firms that resemble the target, we get multiples of 1.2x revenue and 6.5x NOPAT, thus implying the target firm is worth $120 million to $130 million (averaged to $125 million).

When done well, the market approach offers a substantive and realistic estimate of current corporate value, but there are high hurdles to clear. First, there's no such thing as an identical company. Like children in a family, each firm is so unique that generalizations can be deceiving. Second, even similar firms' shares may not trade regularly and recently to be of unqualified use. Finally, when valuing a firm for acquisition purposes, large subjective adjustments are usually required.

Our $125 million valuation doesn't reflect a controlling ownership stake, and control premiums are usually negotiated by the buyer and the target's board, so we use our judgment—say, 30%—and our valuation rises above $160 million. Then we adjust for the target's illiquid stock with a discount of 33%, arriving at $108 million.

The market method is useful, but requires discretion.

Cost Approach
The cost method says value equals the cost of building an identical firm. This may not be realistic, especially for companies with a lot of intangible assets. It is more appropriate for valuing projects in development, but with reservations.

Consider a software company whose new product may reach $80 million in sales; with our revenue multiple of 1.2x, it could one day be worth $96 million. But after $10 million in R&D and another $20 million budgeted to break-even, the company will stop the project and sell it to a competitor. The cost method values it at $10 million, but that requires the following assumptions:

- The buyer could replicate this with $10 million
- $20 million are needed to break-even
- The buyer has new product launch resources
- An acceptable (Internal Rate of Return) IRR is possible

These assumptions are very big *ifs*, underscoring the need for more than the cost of assembled assets.

Fair Value Accounting
FASB's exposure draft is a framework to clarify fair value measurement, given the limited and inconsistent guidance in various Generally Accepted Accounting Principles (GAAP) pronouncements and the unreliability of fair value estimates. The new pronouncement takes effect in June 2005.

In addition to the three valuation methods, FASB requires sources of market inputs based on a fair value hierarchy and present value calculations using probabilistic scenarios. The pronouncement also affects accounting for investment securities, valuation when identical or similar comparables aren't available, and disclosures when remeasuring assets and liabilities.

Firms should consider the implications of these standards now, particularly for acquisitions and investments whose disclosures may jeopardize banking and rating agency relationships. Value will remain in the beholder's eyes, but there are new ways for all to see it.