

## The Devil is in the Projections

It seems like we're getting more and more questions from valuation reviewers on issues relating to projections for assignments related to intangible assets and goodwill. To me, this makes complete sense, given the fact that almost all intangible assets (aside from those valued at replacement cost, like assembled workforce, for example) are valued using an income approach. With that said, this area is one that is truly at the intersection of the audit firm, valuation practitioner, and the company's management. All too often I think too much of the onus is placed on the valuation practitioner. My belief is the practitioner should be provided this information, upon which he can then apply his expertise in modern portfolio theory and risk assessment to come up with an appropriate estimate of value. He or she cannot however, and should not, be asked to either construct projections or perform extensive due diligence on them. While I understand the notion that one can check within a band of reasonableness (can the company really grow 65% in year two and EBIT margins expand from 5% to 25%?), smaller fluctuations can lead to enormous deviations in value. Market participants, let's just say a private equity firm, for example, looking to buy a company, can spend months and hundreds of thousands of dollars digging into a company's industry, operations, strategy, etc., all for the purpose of determining what projections are truly achievable. Valuation practitioners cannot be expected to engage in the same exercise. Company management, however, can, and in the event such data is required should be primarily responsible for supporting this information.

Now don't get me wrong – I think a set of well vetted free cash flow projections is the very best valuation data one can get in the absence of timely information of trades in the identical interest on an arm's length basis. But the devil is in the amount of thought and diligence that has gone into constructing such projections. I think there should be a grading system for projections – with each particular kind receiving a different name – like financials, for instance.

**Compiled projections** – developed by management. No supporting documentation with the exception of historical financials.

**Reviewed projections** – developed by management. Growth, margin, and cash flow assumptions sourced from industry studies, publicly traded comparable companies, IRS tax filings in the same SIC code, etc.

**Audited projections** – developed by management. Revenue growth expectations independently verified by market research firm who performed a study on behalf of the company, margin and cash flow assumptions supported by granular model which provides commentary on expansion plans. When capital improvements will be required, how long are payables/receivable expected to be outstanding, etc.

I realize this seems excessive, and I also realize the practical reality that beyond one year, few companies maintain financial projections. When dealing with smaller private companies, many will ask the valuation practitioner themselves to construct the projections. Think about that for a second. Most will agree that almost 70 percent of a service company's balance sheet value is allocated to intangible assets. And yet some individual with no operating experience whatsoever can be tasked with developing the very data set that will determine the valuation of these assets? If the accounting community ever wants fair value and intangible assets to be taken seriously – to be reliable and relevant for investors, then projections must be separately audited.

