



What to Expect from your Fair Value Specialist: Consistency, Communication—and Sensitivity Analysis

Fair value for financial accounting is here to stay, and as a result independent valuation analysts have grown more sophisticated. Now, financial auditors, lawyers and executives should expect: 1) clear, comprehensive explanation for the reasonableness of fair value assumptions; 2) additional support from sensitivity analyses; and 3) improved communication from their financial experts.

Fair value litigation will increase. Most auditors and economic authorities agree fair value accounting is not responsible for the current financial crisis. At the same time, corporate executives and securities lawyers are looking for a wave of fair value litigation during the next two to five years—in particular, disputes focusing on fair value measurements based on today's contingencies (earn-outs, etc.) that play out differently in the future. The difficulties of valuing and tracking IPR&D are also likely to lead to disputes. Plaintiffs are likely to target company insiders and auditors first and then only if they lose, turn on valuation providers.

One way to protect against litigation: More auditors are requesting a reasonable range of values supported by a “confidence interval.” In the international arena, for example, the G20 (group of 20 international finance ministers) has already requested standards for determining the “confidence” underlying an assumption of value; i.e., what is the tightness of the range of values, and what is the sensitivity? *The problem:* Companies cannot express a range of values on their balance sheets. A possible solution is to include confidence intervals in the footnotes to satisfy investor disclosure requirements. Sensitivity analysis in valuation reports should also emphasize: 1) modeling the distribution of possible outcomes, and 2) more complex valuation techniques.

Question exit assumptions. In today's market, valuation specialists are also re-examining the exit-pricing assumptions they used to take for granted in valuing equity compensation and stock options. For example, is three years still a fair exit assumption? Probably not, but many of the traditional, commonly accepted stock option pricing models have built-in, limiting variables that might not be appropriate under the current financial circumstances.

By the same token, valuation analysts are re-examining their former reliance on prior transactions to determine fair value of stock options. The more thorough analysts are polling investors for their perspectives before “back-solving” from the latest investment round. If investors do not believe their involvement reflects fair value, it may not be appropriate for the specialist to rely on a back-solve to derive an implied equity value of a company. Instead, the specialist should establish some alternative method for implying fair value along with the audit review team.

On that note, specialists are working hard to forge strong relationships with auditors and reviewers, to improve best practices and service. Clients should now expect the following:

- **Better communication.** Valuation specialists should initiate conversations with the audit review team *before* starting any project to resolve any potential issues before they become problems. Active communication should continue throughout the valuation process to ensure adequate support for all of the assumptions used in the report, especially those generated by management. Effective communication improves the process and makes reduces reviewing time and expense.

- *More stringent standards.* Audit standards are getting more stringent and audit firms are coming under greater scrutiny. Staff reviewers can no longer simply state that they support the valuation specialists' assumptions as reasonable; they must now document why and anticipate questions regulators might ask in light of elevated standards.
- *Internal improvement.* To remain current, more audit review firms are establishing protocols (ongoing internal communications) by which staff discuss trends in recent fair value reports and accepted standards
- *Consistency.* When multiple valuations exist for a single company under various scenarios or standards, the specialist must ensure that all assumptions remain consistent and acknowledge any conflicting outcomes. For example, it's inappropriate to use the same discount rate for two DCF analyses when the market surrounding those cash flows has demonstrably changed.
- *Reasonable ranges.* Similarly, it's a challenge for reviewers to support a valuation specialist's subjective assumptions within a range of reasonableness. Valuers should provide clear narrative support for all assumptions, especially regarding industry and market conditions.
- *Comprehension.* Ideally, the valuation report contains everything the reviewer needs to arrive at the same conclusions, including a clear understanding of the company's potential in light of current economic trends, the company's stage of development, its business lines and specific performance.
- *Sensitivity.* Once again, reviewers need to establish the reasonableness of assumptions in a valuation report, and will look to see that the specialist has tested the stated assumptions. Sensitivity analysis can offer support for the key variables driving value.