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Enterprise Appraisal Company Newsletter

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Dear Tom

When considering an acquisition, most organizations will utilize an internal "hurdle" rate to determine whether the cost to acquire an asset or the price to be offered will provide a pre-determined return meeting corporate goals. But, there are many questions to be answered in this process, including whether the required internal rate of return is the best way to value an acquisition. This month, Bob Dean, of St. Joseph's University in Philadelphia, and a member of our Appraisal Team, discusses the challenges of making the right offer for a business entity.

Corporate Hurdle Rates versus Business Valuation Discount Rates:

The CFO's Dilemma

Since 2001, when Fair Value accounting (SFAS 141 and 142) was adopted for acquisitions, Chief Financial Officers have faced new challenges in its implementation. We have come a long way since 2001, and we have many revised standards from FASB and the IASB. In spite of all this progress toward transparency, issues over which Discount Rate to use remain.

For every new deal, the question of the appropriate Discount Rate for measuring the relative economic value creation in Discounted Cash Flow methodology is debated. There are three avenues for the CFO:

- Should the rate reflect the acquirer's average or marginal cost of capital?
- Should the rate reflect the internally-accepted company "policy" hurdle rate (if different).
- Should the rate reflect those methodologies employed by third parties such as those employed by valuation analysts in appraisal firms or auditors?

Consistency is a tenant of accounting principles, after all.

As every CFO knows, faced with these questions, internally-developed hurdle discount rates developed for internal decision making and measurement will **not** be the same as those developed by Business Valuation analysts from Financial Accounting standards. The valuation analysts employ observable market-based rates developed from a sample of guideline public companies. Internal methodologies are well-established in Finance for measuring relative investment value creation using the firm's capital.

Governance applications use hurdle discount rates in decision-making for such things as:

- Capital expenditures budgeting and analysis
- Economic Value Analysis, measuring the economic contribution of a number of operating divisions using a pre-defined hurdle rate or rates

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"Hurdle" Rates

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We Can HELP!

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IFRS 3/IAS 38

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FAQ

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International

Fact Sheet

- Equity capital allocation or assignment of risk-based equity capital costs to a firm's different operating divisions

However, a Discount Rate developed under a Fair Value Standard will have an entirely different premise. It reflects the expected return required by a market participant of the assets or business being valued on alternate investment opportunities with equivalent risk, acting on all publicly available information in an efficient market. This essentially broadens the definition of what an appropriate rate is from a "one-on-one" situation to an unspecific buyer. It frequently, in fact, results in a Discount Rate higher than the internal hurdle rate, as a result of the build-up methodology commonly used in Business Valuations.

The prudent thing for a CFO is to address the Fair Value standard early on. This is simply recognizing the fact that the development of a Discount Rate for Purchase Price Allocation will be different from the hurdle rate used by the firm in its proprietary internal decision processes. The CFO must bridge that gap in perspectives by:

- Recognizing that they will never be the same
- Reaching out to Business Valuation professionals for a preliminary opinion, early in the acquisition process, especially if the acquisition's objective is to diversify or to vertically integrate

This will go a long way to preventing later misunderstandings and minimize surprises both internally and from your company's audit firm.

Robert G. Dean is a member of the faculty at St. Joseph's Haub School of Business in Philadelphia, where he teaches Mergers and Acquisitions, Derivatives, and Special Finance Topics. He is also a member of ASA and has 30 years experience in Corporate Planning and M&A. Bob is a key contributor to Enterprise Appraisal Company's appraisal team.

Enterprise Appraisal Company provides accurate, timely and defensible fair value and market value appraisals of industrial and commercial real estate, machinery & equipment and intangible assets and valuations of minority stock and overall business entity for financial reporting, including purchase price allocation and goodwill impairment, tax, insurance, lending, estate and corporate planning requirements. We provide these services to both public and private companies, meeting the reporting requirements of the Financial Accounting Standards Board (FASB), the International Accounting Standards Board (IASB), and the US Internal Revenue Service (IRS). We have delivered more than 10,000 appraisals to more than 1,500 clients, ranging from multi-billion dollar multi-national companies, to small privately held companies and partnerships.

We can assist you in your overall evaluation of a pending acquisition or sale. By applying market derived discount rates, our valuation service can provide a true market estimate of the value of the asset being considered.

Frank L Merenda
President
Enterprise Appraisal Company

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Corporate Hurdle Rates

How much should be offered to acquire a business asset? Is the internal rate or a market derived Weighted Average Cost of Capital (WACC) appropriate?

Bob Dean discusses the dilemma faced by organizations today.



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