Viewpoint on Value

Consider the cost approach in M&A

The cost approach has intuitive appeal: A company's value equals the difference between its combined assets and liabilities. A cost approach analysis is laid out similar to a balance sheet, a document that most business owners are familiar with. However, it requires a substantial amount of work to convert a cost-basis balance sheet to the required standard of value.

Despite the extra effort, buyers and sellers are increasingly using this approach in mergers and acquisitions (M&As) to help break down the components of value, facilitate deal structure discussions and prepare for postsale purchase price allocations. Here are the basics of this valuation approach.

Retooling the balance sheet

Under the cost approach, valuation experts identify all of the subject company's assets and liabilities, including those that aren't recorded on the balance sheet. Next, they assign a value to each item, based on the appropriate standard of value (typically, fair market value).

The book value of equity may not be a reasonable proxy of its fair market value for many reasons. For example, assets are recorded at historic cost under Generally Accepted Accounting Principles (GAAP). Over time, historic cost may understate market value for appreciable assets, such as marketable securities and real estate. In addition, some intangible assets — such as customer lists, brands and goodwill — are excluded from balance sheets prepared in accordance with GAAP, unless they were acquired from other companies. Balance sheets also might not include contingent liabilities, such as pending litigation or an IRS audit.

Companies that use cash- or tax-basis accounting methods present additional valuation challenges. A valuation analyst will usually convert the financial statements to an accrual basis. Their balance sheets may exclude accruals (such as accounts receivable and payable) and rely on accelerated depreciation methods that understate the market value of fixed assets. This process results in the creation of a market-based balance sheet. Revaluing certain assets — such as machinery, equipment and real estate — may require separate appraisals by outside specialists.

Understanding the advantages

Courts often appreciate the perceived simplicity of the cost approach, especially when it's used for asset holding companies and small manufacturers that rely heavily on their

"hard" assets. It may also be useful when the parties present conflicting appraisal evidence.

In some cases, the cost approach provides a useful "floor" for a company's value that serves as a sanity check for the other valuation approaches. After all, reasonable sellers typically won't accept less than net asset value in M&A unless they're under duress to sell.

In addition, many buyers and sellers turn to the cost approach in M&A, because it assigns a specific value to the individual assets and liabilities that are owned by the business. That's different from either the income or market approach, which may indicate that a business is worth, say, 1.5 times annual revenues, but doesn't assign value to assets and liabilities.

With a cost approach analysis, the buyer and seller can negotiate exactly which assets and liabilities to include (or exclude), allowing them to more effectively bridge gaps between the asking and offer prices. Then, after the deal is closed, a cost approach analysis can be used to allocate the company's purchase price for tax and accounting purposes.

Weighing the pros and cons

Although the cost approach can provide valuable insight, it often requires significant time and effort to identify and revalue everything separately. In some cases, it's easier and more cost-effective to apply the income or market approach — even though these methods may seem more complicated on the surface.

Do you have a **Question?** or want to speak to

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