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Valuation Concepts

inside: FASB Statement No. 144 ◇ Making strategic decisions

Tangible benefits of intangible assets

Although prepared in accordance with Generally Accepted Accounting Principles (GAAP), many clients' balance sheets are missing their most valuable assets. A recent study by the Association for Financial Professionals revealed that the average U.S. company's book value represented only 28% of its market value in 1998 — down from 95% two decades earlier.

The primary reason the study cited for the decreased correlation between book value and market value is the growing importance of intangible assets, also known as intellectual property.

Conservative accounting conventions only require a company to record intangible assets when purchased from an outsider or as part of a business combination. Therefore, if a company develops its intangibles in-house — as many do — its balance sheet will not reflect its intellectual property.

In large part, the significance of intangible assets depends on the company's industry. For example, retailers, manufacturers and construction companies typically rely more on hard assets than intangibles. Conversely, professional service companies and high-tech companies rely heavily on intellectual assets.

Recent accounting standard

At one time, intangible assets were commonly lumped into one catchall category called "goodwill," which represented a company's incremental value beyond its net tangible value. Because intangibles now play a pivotal role in many companies' success, however, companies must differentiate goodwill from other types of intellectual property.

In 2001, the Financial Accounting Standards Board (FASB) issued Statement No. 141, *Business Combinations*, which provides five categories of intangible assets: customer-related; artistic-related; contract-based; technology-based; and marketing-related.

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FASB Statement No. 144 helps clarify GAAP ambiguities

In recent years, the Financial Accounting Standards Board (FASB) has made great strides toward improving the quality and clarity of financial statements.

Among the murkiest of accounting conventions were FASB Statement No. 121 (*Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*) and the accounting and reporting provisions of APB Opinion No. 30 (*Reporting the Results of Operations — Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*).

Long-lived asset categories

Although FASB Statement No. 144 (*Accounting for the Impairment or Disposal of Long-Lived Assets*) contains many of the same basic features as its two predecessors, it aims to remedy generally accepted accounting principles' (GAAP's) former ambiguities.

To clarify matters, Statement No. 144 provides companies with four categories for their long-lived assets (such as property, plant, equipment and long-term prepaid assets):

1. **Long-lived assets to be held and used.** This category will usually comprise the bulk of a client's long-lived assets. Statement No. 144 requires companies to assess their annual (or, if applicable, interim) impairment for each long-lived asset or asset group. (See "Asset impairment flowchart" at right for guidance about how to assess impairment.)

2. **Long-lived assets to be disposed of by sale.** If a client plans to sell a long-lived asset within a year (with a few exceptions), the asset may fall within this category. To ensure the category fits for a specific asset, Statement No. 144 provides six criteria that must be met.

   For instance, the asset (or asset group) must be available for immediate sale in its current condition and reasonably priced relative to its fair market value. Further, with some exceptions, management must commit to a plan to sell the asset within a year.

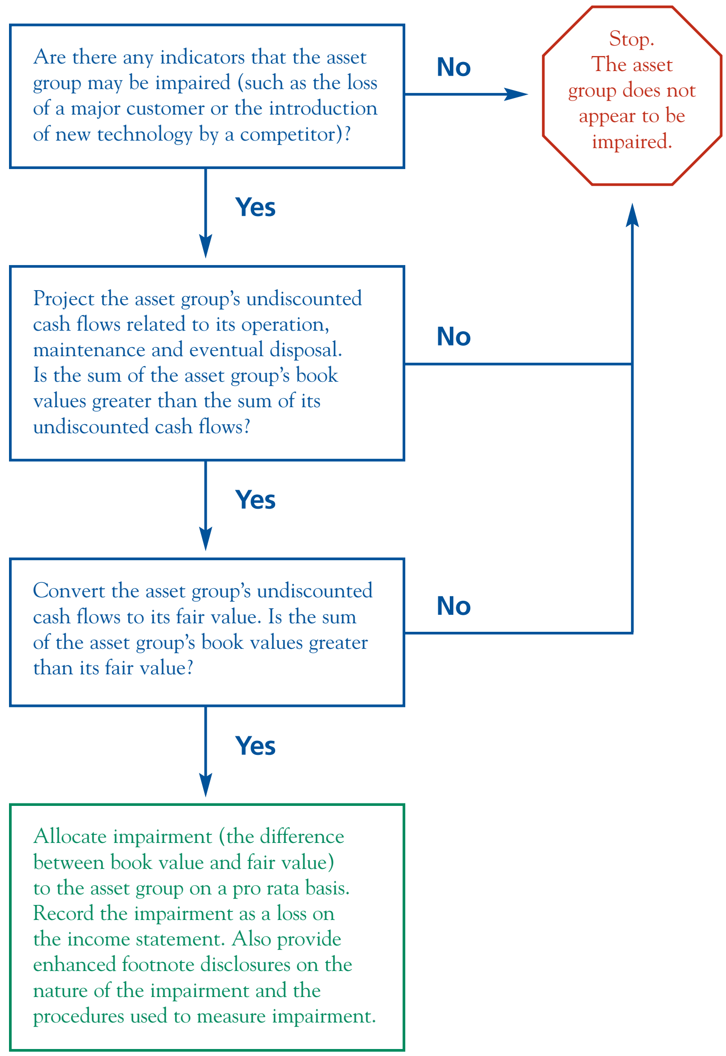
   If the asset meets all six criteria, depreciation stops and the asset's book value is reduced to fair value, but only if fair value (net of selling expenses) is less than book value.

3. **Long-lived assets to be disposed of other than by sale.** Contrary to Statement No. 121, the new rule requires companies to report assets it plans to dispose of through alternate means as "held and used" until disposal. Such alternate disposals include abandonment, exchange or distribution to its owners in a spin-off.

4. **Discontinued operations.** If a company will no longer be involved in a "component of the entity" following a long-lived asset disposal, it must report the discontinued operations in a special section of its income statement. To provide financial statement users with better information, the new rules expand the scope of disposals that fall within this category.

Nearly every company owns long-lived assets and, therefore, must comply with Statement No. 144. Many clients will need to hire a valuation professional to help them assess fair value and impairment issues related to their long-term assets.

Asset impairment flowchart



Making strategic decisions with confidence

Owners and managers face many tough questions in the normal course of operating a business. Should I expand into new product lines or geographic markets? Can I afford to buy a cutting-edge piece of equipment? Does it make sense to build this component in-house or to outsource its production? Which investment alternative will give me the greatest return?

For most day-to-day decisions, managers only have time to make rapid choices based on experience and acumen. But as the dollars at stake grow to tens or hundreds of thousands, so will sleepless nights if managers base strategic decisions solely on those factors. For big-ticket items — and greater peace of mind — managers often turn to feasibility studies.

Case in point

To illustrate how feasibility studies can facilitate management's decision-making process, consider the fictitious example of Dom's Tool & Die Co. Dom's operations manager recently suggested that his tool-and-die shop could win several large jobs from a nearby competitor if the company purchased a $1 million state-of-the-art piece of machinery.

Initially, Dom was skeptical. Although the purchase made sense from a selling and operations perspective, Dom and his overworked controller, Louise, lacked the time and knowledge needed to fully evaluate this decision from a financial perspective.

After discussing the prospective investment with his company's attorney, Dom decided to hire Bob, a valuation professional, to help him crunch the numbers. Bob created a detailed spreadsheet that coordinated information gathered from the company's sales, operations and accounting departments.

One of the features of Bob's spreadsheet that most appealed to Dom was its flexibility. He could modify one cell — let's say increase the company's cost of capital from 18% to 20% — and instantly see how the change affected the rest of the spreadsheet.

In arriving at his conclusions, Bob assumed an eight-year useful life, a $25,000 salvage value and a constant $250,000 increase in annual cash flows from the new machine.

Most important, Bob summarized his findings with three easy-to-understand metrics. These allowed Dom and his management team to effortlessly evaluate the potential purchase's key components: payback period, net present value and internal rate of return.

In this case, it will take Dom's Tool & Die four years to recoup its initial investment from the equipment's incremental cash flows. Though some managers rely exclusively on the payback period to gauge an investment's viability, the payback period alone doesn't consider differences among the useful lives of multiple investment alternatives or the time value of money.

The slightly more complex net present value (NPV) and internal rate of return (IRR) aim to remedy any payback-period shortcomings. NPV provides a summation of an investment's cash inflows and outflows at a specific discount rate.

Bob estimated the tool-and-die shop's cost of capital at 18% and arrived at an NPV of approximately $26,000. To the extent that an investment's NPV is greater than zero, the investment makes sense.

Finally, IRR estimates an investment's yield over its useful life. It is also the point at which the investment's NPV is zero. In evaluating this metric, many managers will compare it to a subjective "hurdle rate," which is the minimum rate of return management requires before it will accept a project. Frequently, management uses a company's cost of capital as the hurdle rate that a project must clear for acceptance. If the IRR is greater than management's predetermined hurdle rate, the investment makes sense.

Back to our example. Dom was initially disappointed at the machine's lengthy projected payback period. When he questioned Bob about it, the valuation professional brought up some of the less obvious benefits of the strategic purchase that Dom hadn't previously considered.

When Dom and his management team finally decided to purchase the new machine, they were confident that they had evaluated all of the relevant information and that their choice was the right one.

Drawing conclusions

While large public companies may have the staff and resources needed to perform complex feasibility analyses, small to midsize businesses often turn to outsiders for assistance. Professional valuators are perfectly suited to handle these types of consulting engagements.

Unlike many traditional accountants who focus solely on the latest accounting standards rulings and IRS codes, valuators are more comfortable with discounted cash flow techniques, as well as how to construct malleable, interactive spreadsheets that answer their clients' tough questions en route to educated choices.

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Within each category, FASB provides specific examples; for instance, a copyright is an artistic-related intangible and a patent is a technology-based intangible.

When to value intangibles

With the growing significance of intangible assets has come an increased need for their valuations. Common situations that require companies to estimate their intellectual property value include:

Management consulting. To make informed decisions, a company's management often needs to estimate an intangible asset's value. Such estimates, for example, help management select reasonable royalty rates or decide on the viability of an asset purchase or business combination.

Tax planning. In some cases, a valuator must know an intangible asset's value to calculate a company's federal or state income taxes. For instance, a valuation expert may need to calculate an intercompany transfer price or a charitable deduction that involves an intangible. Furthermore, intangible assets may also be valued for a business owner's personal estate-planning purposes.

Because intangibles now play a pivotal role in many companies' success, companies must differentiate goodwill from other types of intellectual property.

Litigation support. Bankruptcy, economic damages, marital dissolutions and shareholder disputes are just a few examples of the types of lawsuits that might necessitate an intangible asset valuation.

Your assets' market value

As FASB continues its efforts to bring financial reporting closer to market reality, the fair market value of companies' assets — including their intangibles — will be increasingly relevant.