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Asset based methods – Part 3, valuation and the financial crisis

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This is the third and final article in a three-part series summarising the main valuation methodologies used for the purposes of determining economic loss. In parts one and two, I provided an overview of the market-approach and income-based methodologies. I now conclude by reviewing the asset-based approach.

To what extent, if any, is the sum of a company's net assets and liabilities – as shown in the financial statements – a reliable indicator of the company's fair market value or capacity to generate profits? A similar question: In what circumstances is the historical expenditure incurred in developing a start-up business or new project a dependable guide to the market value of this enterprise?

As I explain below, there are times when arbitrators have misgivings about valuations produced under the DCF or market approaches, perhaps because (for DCF) it is extremely difficult to forecast likely future cash flows for a given project/ business, or (for the market approach) no genuinely comparable companies can be found. In these situations, it may be appropriate for arbitrators to consider whether the asset-based approach could instead help in determining what compensation, if any, should be awarded. If arbitrators do find themselves in this position, in my view, it is critical that they understand a number of key issues that influence the usefulness or otherwise of asset-based approaches to valuation. The questions raised in the introductory paragraph are of particular relevance.

By way of preamble, as I said in the first article of this series, the asset-based approach is only one of several possible methodologies; its applicability in any given situation will depend on the particular circumstances.

The asset-based approach generally may be an appropriate method of valuation where dealing with a controlling interest over a business. In respect of a minority shareholder with no control over a company's assets, a valuation would normally focus on the value of future dividends the minority shareholder could expect to receive. As always, there are certain exceptions to this rule such as the sale of a minority shareholding in order to give another shareholder overall control of the business or else recent transactions in the respective shares.

The valuer should consider carefully whether the asset-based approach is an appropriate method of valuation where the company to be valued is a going concern and generates positive cash flows. A

good understanding of the separate assets and liabilities of a company is often important for the purposes of forming a reliable valuation of its equity.

Overview of the asset-based approach

As we shall see, there are a number of different methods within the overall asset-based approach, of varying degrees of sophistication and appropriateness.

Under the most-simplistic approach, in general terms, the value of a company is said to be the net amount of its assets and its liabilities. So, if a company's balance sheet shows it owning land, property and equipment with a stated value (or, in accounting terms, "book value") of 100 in total, and amounts owed to its bank and other creditors of 80, the company has net assets and hence a 'value' of 20. As we shall see below, however, not all assets are recognised and measured in companies' financial statements for the purposes of financial reporting.

A variation on the above, the adjusted net-assets basis, seeks to address the problem of the (accounting) book value of certain assets (as shown on the balance sheet) bearing no relation to their actual market value. A strategic plot of land in London acquired for £1 million in 1990, for example, may today be worth many multiples of the historical cost; under the adjusted net-assets method, a formal valuation of the land would normally be made and the resulting amount, rather than the book value, would be taken into account in the valuation method applied.

Along similar lines, items of plant and machinery acquired by a company many years before may have minimal book value in the financial statements due to their having been depreciated/amortised (i.e. their purchase cost being written off over their expected useful lives) in the accounts; however, despite initial expectations, these assets could still be in working order, critical to the company's production efforts (on a going concern basis), and their replacement or realisable value of these assets significantly in excess of their accounting book value.

Under the adjusted net-assets basis, therefore, the book values of all assets and liabilities are reviewed and, where necessary, adjusted to reflect their realisable (or replacement) values. Other items that may require adjustment include start-up costs (e.g. the cost of research and development) which may have been included as assets in the balance sheet rather than expensed through the profit & loss account. It will readily be appreciated that if each asset has to be valued individually, the use of the asset-based approach can be time-consuming. It should be understood therefore that there is often no 'shortcut' to a reliable valuation; this is as true for asset-based methods, properly applied, as it is for DCF methods or methods based on the observed terms of other transactions.

Limitations to the usefulness of the adjusted net-assets basis

The adjusted net-assets basis may be an improvement on the non-adjusted basis; however, there are other potential limits to its usefulness that need to be considered. Firstly, a company's balance sheet will not always include all its assets and liabilities; it may even exclude those assets which are of most importance to generating revenue. A cursory glance at the published financial statements of law firms set up as LLPs, for example, provides testament to this. The 2011 financial statements of one 'magic circle' firm showed that it had total assets of around £800 million, of which the largest balances were 'client and other receivables' (i.e. unpaid bills – c. £500 million), 'cash and cash equivalents' (c. £100 million) and 'property, plant & equipment' (i.e. office buildings, computers, and perhaps the contents of wine cellars....c. £110 million). The most important assets of all – its know-how and its relationships and reputation with current or

prospective clients, employees and suppliers – appear nowhere on the balance sheet. Whilst such an omission may be in accordance with accounting conventions, users seeking to use financial statements to value companies need to be aware of this, and recognise the limitations of focusing only on reported asset values.

Referring again to the law firm example, it is not the firm's offices, whiteboards and artwork which, in isolation, drive revenues but rather these assets used in combination with the human element. Allowing for some important exceptions, the critical point to be aware of is this: future profits/ cash flows, payments of dividends etc, that result from the assets being put into use by labour, are what usually drives a business's value; the value is not simply the net of assets and liabilities. This example demonstrates clearly why the asset-based approach is sometimes not appropriate for established companies with a significant workforce in place or with significant intangible assets that are not recognised as assets in the company's balance sheet.

It is for the above reasons that the asset-based approach will often be most suitable for companies whose value is largely determined by its tangible assets such as mining companies. Where a company's fortunes are strongly dependent on less tangible factors such as customer relationships, entrepreneurial decision-making, a skilled work force etc, the asset-based approach may be less useful to determining a business's value and/ or profitability.

Investment spend approach

Another variation of the asset-based approach is known as the investment spend approach; here, the valuer simply aggregates all expenditure/ sunk-costs incurred in developing a given project or business and the total amount is used as a proxy for the value of said project. The cost of investment may cover not only the expenditure incurred to acquire or develop fixed assets but also all other costs involved in developing the project including the cost of financing, market research, salaries, administration etc.

Awarding damages under this approach can be attractive to tribunals, however, since establishing actual investment spend is a straightforward exercise and can be ascertained with a high degree of certainty. Moreover, it allows tribunals to effectively reimburse investors for the monies expended without having to deal with the uncertainties inherent in a forward-looking DCF, especially if the monies spent had not had time to demonstrate their revenue generating capacity.

It should be noted, however, that actual investment spend may not equate to the actual market value of the project/ business. In some circumstances, given the passage of time, the current value of an asset (such as an investment) may be very different from the costs that were incurred to acquire or create it. In order to rely on historical costs, it is necessary to understand the specific circumstances. Given that many start-ups fail, the mere fact of investing €x million may not in itself be indicative of likely future returns, and this may be evident at an early stage. Conversely, in the hands of an inspired and energetic entrepreneur, a small investment can sometimes yield large returns with the likelihood of such success being reasonably identifiable from the outset.

In short, an award made on the basis of actual investment spend can lead to either over or under-compensation. In the case of the latter, tribunals have sometimes sought to avoid treating claimants unfairly by adding an amount to the sum invested to represent the likely future return on the investment absent the given breach/ action.

Finally, knowing the actual investment-spend can be helpful when cross-checking the overall

reasonableness of a valuation produced under a different method (e.g. DCF). If a DCF valuation gives a fair market value for a project of €100 million when only €10 million has been spent, this should cause the valuer to go back and re-check his assumptions for reasonableness!

Impact of the financial crisis on the application of the asset-based approach

A detailed discussion of the relationship between business's accounting net worth and the financial crisis is beyond the scope of this short article. It is clear, however, that the financial crisis has had a major impact (usually negatively) on companies' balance sheets, both through decreased asset values as well as increases in liabilities. The following are just some illustrative examples of the ongoing impact of the financial crisis.

- Increased counterparty risks (that is, credit risks) that may not be fully reflected in the measurement of financial assets.
- Asset write-downs – In countries where the relevant accounting conventions require assets to be stated on the balance sheet at their 'fair value', asset values have often been 'written-down' to reflect their recoverable amount. This is also true where accounting conventions require non-current assets (e.g. long term investments, plant, property, machinery) to be recognised at the lower of their historical cost and recoverable amount.
- Goodwill impairment – in the United States, for example, many billions of dollars of goodwill have been written-off companies' balance sheets in accordance with the requirements of the Financial Accounting Standards Board's standard for the accounting for goodwill. For those not familiar with the term, purchased goodwill, which arises on acquisition of a company, may be defined as the excess of the purchase price of the business over the fair market value of net assets acquired. Given the high volume of business combinations/ acquisitions in the years leading up to the financial crisis, goodwill represented a major asset on many companies' balance sheets.
- Pension liabilities – due to the financial crisis, under certain accounting conventions, many businesses have discovered that their existing provisions for defined and other benefit plans are now insufficient to cover their likely eventual exposure. Whilst some businesses have made additional provision on their balance sheet to cover these deficits, due to a certain degree of flexibility allowed under accounting conventions, much of this deficit is off-balance sheet. It was recently reported in the UK Daily Telegraph, for example, that the deficit at all UK private sector pension schemes rose to £176bn.

Conclusion

Whilst the asset-based approach can appear conceptually simple, it is often misunderstood and easy to get wrong. Proper application of this approach requires inter alia dealing with complex concepts such as the recognition and measurement of assets for the purposes of financial reporting, the effects of inflation, the competitiveness and dynamics of markets for inputs, the role placed by replacement costs, the true economic costs of replicating assets (including time to rebuild and the costs of failure).

Where the asset-based approach is applied, careful consideration needs to be given to the relative weight provided by its results, given the factors affecting its reliability identified in this article.

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