Filbert Tsai

DEBIT CREDIT

The most valuable asset of your company is missing, what's next?

First of two parts

Doing business is getting more and more complex as we begin to realize that the profit or loss and net assets are no longer reflective of the real value of business. The argument that financial statements are not reflective of a company's financial wellness is now getting a much bigger blow with recent publications stating that only 20% of a company's actual value is reflected in the balance sheet. This is an alarming statement that needs to be understood more by the public.

Where did the remaining 80% go? There's a wild speculation out in the market by various journalists and researchers pointing out that the value might be attributable to 'human capital', unrecognized brand name values, carbon efficiency, culture, or other intangibles which are currently not capitalized under accounting standards. While the 80% figure seems to be finger in the air, this argument holds true when tested.

Intangible assets that are internally generated, such as brand names and contact lists, are not allowed to be capitalized under current accounting standards. A general concept why this is treated this way is because the cost incurred to generate these intangible assets are not identifiable. Just imagine the trade name Jollibee®. I presume that this brand cost practically nothing to Jollibee Food Corporation other than to register the brand with the Department of Trade and Industry and Securities and Exchange Commission of the Philippines,. Yet the name itself is much more valuable than the value of the physical assets of the company.

Once the business is sold to a third party, accounting standards would then allow the purchase price to be allocated to these intangible assets since the acquirer paid good money to acquire primarily the 'brand name' and the 'established processes' of the business rather than physical assets. The issues pertaining to the purchase price in a business transaction is a highly complex accounting and valuation exercise. The general principle is that the valuator (usually a third party expert in transaction diligence) will use specific business valuation methodologies to value the business as a whole. The purchase price would then be allocated to the identifiable net assets of the with the excess allocated to separately identifiable intangible assets and goodwill.

I have been curious for sometime whether the pareto split of 80-20 is valid and realistic since it came as a surprise to me to realize that accounting books is just a slice of cake. Since my own investigation is not for academic purpose, I followed a practical approach to test whether this assertion is realistic.

Rather than testing the fair value of the business which would take so much time to construct a working business valuation model, I used the 2015 acquisition information of certain companies which removes valuation ambiguity related to assumptions used in the business valuation. The results of my experiment will be discussed in the second part of my article.

.

Filbert Tsai is a Filipino accounting advisor in the UK with global and public sector experience. He's key areas of interests are start-ups and MSMEs. His blog and page, Ask the Accounting Advisor, provide relevant insight for start-ups and MSMEs in the Philippines.

This column accepts contributions from accountants, especially articles that are of interest to the accountancy profession, in particular, and to the business community, in general. These can be e-mailed to boa.secretariat.@gmail.com.