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DEBIT CREDIT

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

Last of two parts

I discussed in the first part of my article my hypothesis that only the only about 20% of a business enterprise's actual value is reflected in the balance sheet. I submit that a large portion amounting to about 80% of the value can be attributed to such factors as 'human capital', unrecognized brand name values, carbon efficiency, culture, or other intangibles which are currently not capitalized or reflected in the company's financial statements under accounting standards.

To look further into this, I evaluated the financial statements of two listed telecommunication companies in the Philippines, i.e., Globe Telecom, Inc. ("Globe") and Philippine Long Distance Telephone ("PLDT").

I used the following methodology and premises:

1. Extracted relevant 2015 business combination information from published financial statements
2. Intangible assets and goodwill recognised as a result of the business combination are summed in 'Total Intangibles' column
3. Fair value of net assets is based on the disclosed amount excluding the recognised intangible assets and goodwill
4. Percentage of the business acquired represented by intangible assets is determined as a percentage of the total net assets after the business combination (fair value of net assets and total intangibles)
5. Total intangible assets recognised out of negative net assets is assumed to be 100%

I arrived at the following results that clearly showed that the value of these two companies are attributable to the intangibles:

Company	Acquiree	Intangible Assets Acquired	Goodwill	Total Intangibles	Fair Value of Net Assets, Excluding Intangibles	% Intangible
Globe Telecoms	BTI	1,784,324,000	1,154,029,000	2,938,353,000	- 787,551,000	100.00%
PLDT	Takatack	-	229,500,000	229,500,000	3,700,000	98.41%

Intangible assets acquired by Globe from Bayantel Telecoms Inc.("BTI") in are related to the customer contracts, franchise and license held by BTI . What is interesting here is the amount related to goodwill. Goodwill is an interesting account in the financial statements which represents anything that cannot be quantified individually and is measured as the residual amount after allocating the purchase price to the fair value of the net assets.

Based on this simple test performed, it appears strikingly factual that intangible assets represent more than 80% of a company's value. It is incredible to see how much your business is actually worth if you have to consider these items floating in the air.

The purchase price determined by the valuator is generally determined based on a discounted cash flow model which assumes includes various discrete and non-discrete assumptions about the company's future cash flow. The cash flow model follows the accounting standards which can either be based on the acquiree's free cash flow, excess earnings, distributable reserves or other methods as appropriate. Effectively, the purchase price is actually the corporate value of a business at a <u>point in time</u>.

Understanding how the purchase price is determined is helpful in understanding why there is a significant gap between the company's balance sheet and the corporate value. The balance sheet accounts for historical transaction and allows only the recognition of actual events which have an exact (or almost) value, this avoids the risks that fraud will be perpetuated in the recognition of bogus assets. The corporate value takes into account the future performance of the company, economies of scale, process efficiencies and future harmonies between the acquirer and the acquiree amongst others. While the balance sheet provides an accurate picture at a point in time, the corporate value represents the saleable value of the business. The gap between the balance sheet and the saleable value is the so-called intangibles that we've discussed earlier.

Overall, what drives the business value of a company can be attributable to three key intangible items: (1) people; (2) culture; and (3) process. These three drivers together allows the company to run on autopilot and create future financial value for the business.

Understanding how this works is crucial for the long-term success of your business. Without a viable business and good process at the back end, the corporate value can either be equal or less than the balance sheet value of your business. Understanding how corporate value works can provide substantial leverage in business planning whatever stage you are.

A start-up would need to understand that business plans are not just about financials anymore. It is important that you start your business with a plan in mind to align your financial goals with the company's vision and to work on long-term investments which would allow better organic growth of the business.

An established business would need to revisit how much catch-up they need to do to redirect efforts on placing more focus on developing their people and establishing a culture of trust.

Businesses that projects too much financial focus will lose their people and create a culture of fraud and distrust.

It is important that business owners be more comfortable working with financial concepts. Business valuation is a rather niche market until today even in matured markets such as in the United Kingdom, where business valuations are mostly done in preparation for public offers or merger and acquisition transaction. However, there are simple approaches that business can do to determine and monitor their corporate values through business model templates. Understanding is the first step, curiosity is next.

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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.