“...ACCOUNTING STANDARDS APPLYING TO RECOGNITION AND MEASUREMENT OF A COMPANY’S ASSETS CAN BE COMPLEX AND NEED TO BE INTERPRETED AND APPLIED WITH CARE TO ENSURE THE VALUATIONS ARE FIT FOR PURPOSE”

Asset-based valuations: Valuation floor or flawed valuation?

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SYNOPSIS

Asset-based valuations, such as ‘book value’, are often applied in one of two ways: (1) as a floor or cross-check for values assessed using Discounted Cash Flow (DCF) or market-based approaches; or (2) to value assets not reflected in a DCF or market valuation, such as non-operating assets. However, the utility of these applications is sometimes misjudged because of misunderstandings about the content of financial statements – in particular, because the requirements (or ‘financial reporting standards’[2]) governing the preparation of financial statements have changed and become more complex in recent decades.

In this article, we discuss the application of asset-based methods and, in particular, why asset values and related information in financial statements both need to be carefully assessed as part of an overall valuation or damages analysis.

BACKGROUND

An asset-based valuation is a method of valuing an entity as the sum of the value of each of its assets and liabilities. Strictly speaking, it does not represent a valuation approach[3] (such as the market, income and cost approaches, which are based on economic principles of price equilibrium, anticipation of benefits or substitution[4]). Rather, an asset-based methodology provides a framework in which individual assets and liabilities are identified and valued, but which does not specify the approach(es) to apply when valuing those assets and liabilities.

Asset-based valuations are often performed using balance sheet information from the financial statements of an entity. This connection to financial statement information (particularly where that information has been independently audited) is sometimes considered attractive to tribunals because of a perception that such information is comprehensive and reliable and can, therefore, be used directly in the valuation or damages analysis. However, as we explain in this chapter, financial reporting standards govern the recognition and measurement of assets and liabilities, and the details of these standards need to be considered carefully when applying an asset-based approach.

In the remainder of this chapter, we discuss: (1) the identification of assets and liabilities for financial reporting purposes and their recognition in financial statements; (2) the measurement or valuation of those assets and liabilities eligible for recognition; and (3) the application of the asset-based valuation approach in different circumstances. We give specific examples to illustrate the issues.

IDENTIFICATION AND RECOGNITION OF ASSETS AND LIABILITIES IN FINANCIAL STATEMENTS

A common starting point for identifying an entity’s material assets and liabilities is the assets and liabilities identified in the financial statements; in particular, those recognised on the balance sheet.

There are two potential limitations to this approach:

1. the balance sheet may not include all relevant assets and liabilities. That is, there may be assets and liabilities that have economic value, but that are not recognised in the financial statements because they do not meet the definitions of assets and liabilities under the relevant accounting standard;[5] or
2. there can be circumstances where certain assets meet the relevant definition of an 'asset' (and similarly for liabilities) but are, nevertheless, not permitted to be included on the balance sheet under the relevant accounting standard.

The first of the above limitations can apply in respect of what are termed 'contingent' assets or liabilities; that is, resources or obligations for which the future economic benefits or costs are contingent on uncertain future outcomes or hard to quantify, such as securing a major contract, the granting of intellectual property rights, the outcome of litigation, the extent of environmental or clean-up obligations, or the exercise of an option over certain of the entity's assets. These contingent assets or liabilities may well affect the economic value of the entity but will not be reflected on the balance sheet, given the associated uncertainties.[6]

The second of the above limitations can apply to entities with significant intangible assets. For example, companies that prepare their financial statements in accordance with IFRS generally do not include on their balance sheet intangible assets that are internally generated.[7] These assets, which can be highly valuable, may include brands, customer contracts and relationships, technologies and skilled workforces.[8]

Notwithstanding the above, where one entity acquires another entity, many accounting standards (such as IFRS and US GAAP) require that as well as revaluing acquired tangible assets and inventory previously included in the financial statements, what are termed 'separately identifiable'[9] intangible assets and liabilities are recorded in the consolidated financial statements (the purpose being to inform the user of the accounts of the nature of the underlying assets and liabilities obtained via the purchase of the acquiree's shares). In these cases, information may become available on the assessed value of certain intangibles, including those which previously were not recognised on the acquiree's balance sheet (for instance, because they were internally generated). One may, therefore, end up with a mixed outcome, whereby, following the acquisition, the acquiror's financial statements include values for intangible assets it has acquired but not those it has generated itself.

The categories of intangible assets capable of recognition in financial statements following an acquisition vary between accounting regimes. There is also, in our experience, no clear consensus as to how certain assets are treated. For example, in some cases trademarks, customer contracts and customer relationships may be recognised and valued separately, and in other cases they may be subsumed into a composite 'brand' value.[10]

As we discuss below, the values of intangible assets reported in financial statements, and assets more generally, need careful review, given the assumptions and conventions adopted for financial reporting purposes.

MEASUREMENT AND VALUATION

In principle, an entity's discrete assets and liabilities can be measured, or valued, using one or more valuation approaches. In practice, valuers will often rely, at least to some extent, on the amounts reported in the entity's balance sheet:

- the simplest application adopts the balance sheet amounts for all assets and liabilities. This is sometimes described as a 'book value' approach and uses the balance sheet both for the list of assets and liabilities to be assessed and their respective values; and
- more complex applications entail replacing some or all of the balance sheet amounts with an alternative assessment of value. This is sometimes described as an 'adjusted book value' approach.

The amounts reported in financial statements can be the result of a more complex valuation approach than is often appreciated. As explained below, the amounts for many assets are valuations drawing on standard valuation techniques such as DCF and market-based methods. However, there is sometimes a misunderstanding that the balance sheet amounts (or 'book values') for assets necessarily reflect historical costs, for example:

> *"Book value is an accounting concept; it represents the original (historic) cost of an asset, which is adjusted downward for the loss in value associated with the ageing of the asset (depreciation or amortisation)."*[11]

While some types of asset may be measured for accounting purposes by reference to their historical cost, other assets and liabilities are measured based on their assessed value. For instance, IFRS and US GAAP require or permit a variety of assets (including commonplace assets such as plant, property and equipment) to be measured at their 'fair value'.[12] In this context, fair value is effectively a measure of market value.

Different types of assets and liabilities can be reported on a book value basis that may not accord with either historical cost or market value. Whether or not this is the case depends on the circumstances of the entity, the relevant accounting standards and the application of those standards. However, by way of illustration, the types of assets and liabilities whose book value may differ from (and often be lower than) market value includes the following:[13]

1. Fixed assets such as plant, property and equipment may be reported at historical cost, subject to annual depreciation.[14] However, the current value of an asset may differ materially from its historical cost,[15] so the latter may not be a reliable guide to the former.[16] Furthermore, assets that are substantially or fully depreciated (such as storage facilities, pipelines, dies) for financial or tax accounting purposes may still have significant economic value.

2. Inventory is held at the lower of cost and what is termed 'net realisable value'.[17] The market value of inventory may, therefore, differ from its carrying amount in the financial statements where the inventory is subject to long development or sales cycles, such as whisky or diamonds, or involves commodities whose value can fluctuate markedly over short periods of time.
3. Investments in associates (namely influential but non-controlling interests in other entities) are often 'equity accounted'. Broadly, this involves taking a pro rata share of the associate's net asset value as the carrying value in the entity's financial statements, rather than the market value of that holding.
4. Other assets may be held at fair value as at a historical date, such as acquired intangibles and real estate developments.
5. Several asset classes, such as tangible and intangible fixed assets and investments in associates and subsidiaries, should also be subject to regular impairment reviews to assess if what is termed the 'recoverable amount'[18] exceeds the amount reported in the financial statements. If not, the carrying amount is written down (that is, reduced) such that the revised amount reflects an estimate of the recoverable amount. In contrast, if their value increases above their cost or assessed fair value on their original acquisition, their carrying values are not increased.
6. Financial assets and liabilities, depending on how they are classified by the entity, may be 'marked-to-market'. In effect, they are repriced, to the extent possible, to reflect market changes since the last financial statements were prepared.

As a result, the accounting policy and other notes in the financial statements need to be reviewed carefully to understand the basis on which different assets and liabilities have been assessed.

As a further illustration of the complexity that can arise, in one valuation of a real estate company in which we were involved, the underlying properties were held at a mix of historical cost, fair value (investment and development properties), and the lower of cost and net realisable value (properties considered as 'trading stock'). The picture was further complicated by some of the properties being held via subsidiaries or minority interests in associated companies, as opposed to directly, which had resulted in the investments being held at historical cost and not always revalued (upwards, given market movements in the interim) based on the underlying property assets.

It is also important to appreciate the valuation requirements or conventions under financial reporting standards, and the extent to which these accord with the valuation or damages question that the expert is addressing. For example:

1. Interests in quoted shares may be valued using the prevailing share price. However, this price typically reflects the price at which small parcels of shares are traded, and may not reflect the price that a significant block of shares would command (where a premium or discount (termed a 'block discount') to the prevailing share price may be appropriate, depending on the specific circumstances of the sale, the depth of the market in the shares, and the distribution of ownership of the entity's share capital).
2. Intangible assets, such as acquired trademarks, are valued on the presumption the trademark is capable of sale for use by a third party. However, the acquisition strategy may involve retiring an acquired brand and migrating the brand value to the acquiror's brand, such that the value of the acquired trademark is not, in reality, separately realisable.
3. The fair values of intangible assets acquired via a share acquisition may be increased ('stepped up') for potential tax effects on the acquisition of an asset directly, when these tax benefits may not be available in practice.

The book value of various classes of liabilities is often adopted unadjusted for an asset-based valuation. This can be appropriate for liabilities such as trade payables and debt when (as is often the case) the amount owed is both unambiguous and taken as the book value. However, the measurement of book value can be more complicated for financial liabilities where these are marked-to-market and for pension obligations. The different bases on which any financial liabilities or pension deficit are assessed (or reported) need to be understood in assessing their value under an asset-based valuation analysis.

Materiality[19] can also be an important consideration when considering whether it is appropriate to rely on the book value of assets and liabilities for an asset-based valuation. This issue can be particularly pertinent where a subsidiary or operation that forms part of a (much) larger group is sold (which circumstance is relevant for many post-acquisition disputes). The financial statements of members of the seller's group may reflect materiality considerations for the overall group as opposed to the company disposed of on a standalone basis, including as regards recognition and measurement of assets and liabilities. That is, the audited financial statements of the company sold may have been prepared in one context (namely as part of a larger group) and not in the context of a disposal where different materiality thresholds may apply.

In summary, the calculation of the balance sheet amounts for assets and liabilities can involve complex and subjective assessments (in particular, where the carrying amount is calculated as a fair value[20]). This is not always appreciated as it often assumed that because a figure is taken from the audited financial statements it must be objective and reliable. As noted by one observer:

> *"despite the fond hopes of many arbitrators and commentators, looking to asset values rather than income-based methods does not eliminate the subjectivity of business valuations. The proper amount to be shown on the balance sheet for many items calls for the exercise of judgement by the company's management and its accountants."*[21]

It is important, therefore, for the valuer to understand the basis on which the balance sheet amounts have been assessed so that they can consider whether to adopt that amount or perform their own valuation. In the context of an arbitration, it may assist the tribunal if the expert valuer explains:

1. the basis on which material assets and liabilities are measured for financial reporting purposes; and
2. their decision regarding whether to adopt the balance sheet amount or replace that figure with a different valuation.

Where valuers choose not to adopt a balance sheet amount, this is often because:

1. the relevant amount has been measured by reference to historical cost. As explained, the current value of an asset may differ from the price paid to acquire it at some past date, so historical cost may not provide a reliable guide to current value; or
2. there has been a material change since the balance sheet date such that the balance sheet figure is not a reliable measure of value at the valuation date.

USE OF ASSET-BASED VALUATIONS

Asset-based valuations are typically not the primary method used to value a company or business. However, they are often applied:

1. where the business is not a going concern (for instance, because it is not profitable or is financially distressed) and the highest and best use of its assets would be realised by liquidating the business;
2. for start-up or early stage businesses that do not have a track record of generating profits; or
3. where the underlying assets, as opposed to the ongoing operations, are responsible for a significant proportion of the value of the firm. This is sometimes the case for companies whose value principally stems from physical assets (such as property-based businesses that own, for example, offices, hotels, care homes, restaurants or shopping centres), natural resources (where the financial statements may already contain a valuation of the underlying asset), or financial assets (as held by hedge funds, private equity vehicles, or investment trusts).

More generally, the net asset value of the company or business is often seen as a lower bound cross-check when a value has been assessed using another valuation approach.

VALUATION IN LIQUIDATION

An asset-based valuation approach is often used when a business is to be liquidated. In such circumstances, the value of the assets is determined based on their 'liquidation value', which is defined as 'the amount that would be realised when an asset or group of assets are sold on a piecemeal basis, that is without consideration of benefits (or detriments) associated with a going-concern business'.[22]

Where the subject company has in fact been liquidated, the valuer may be able to rely on the amounts actually realised. If not, the valuer will need to consider the amounts expected to be realised. This can depend on the circumstances of the expected or notional liquidation. In particular, valuers distinguish between:[23]

1. an orderly liquidation, where there is a reasonable period of time to find a purchaser (or purchasers); and
2. a forced sale, where the compulsion to sell is such that a proper marketing period is not possible.

Book values act as a starting point for liquidation valuations (other than where, as noted above, valuable intangible assets are not reported on the balance sheet). However, because financial statements are generally prepared on a going concern basis, the book values may need to be adjusted to reflect a liquidation or break-up basis.

VALUATION OF START-UP OR EARLY STAGE BUSINESSES

Tribunals sometimes prefer asset-based valuations when the subject business has only recently been established and does not have a track record of generating profit, which may be the case in arbitrations concerning, say, the expropriation of a mining concession or exploration rights, or a production facility under construction. In its award for the Siemens AG v. the Argentine Republic arbitration, the tribunal stated:

> *"Usually, the book value method applied to a recent investment is considered an appropriate method of calculating its fair market value when there is no market for the assets expropriated. On the other hand, the DCF method is applied to ongoing concerns based on the historical data of their revenues and profits; otherwise, it is considered that the data is too speculative to calculate future profits."*[24]

Uncertainty about a new business's ability to generate profits also concerned the tribunal in the Asian Agricultural Products Ltd (AAPL) v. Republic of Sri Lanka arbitration. This led the tribunal to award damages based on an asset-based valuation and further to limit, given the early stage of the business, the award to the value of the tangible assets (in other words, excluding any value in respect of goodwill and other intangible assets).[25]

In the context of a dispute relating to a start-up or early stage business, a tribunal may be minded to allow the claimant to recover the cost of their investment.[26] However, depending on whether costs are capitalised or expensed, reported book values may not accord fully with the cost incurred.

BOOK VALUE AS A CROSS-CHECK

As noted above, the primary valuation method(s) applied to going concern businesses will typically be the discounted cash flow method (DCF) or multiples method (whereby value is assessed by reference to a value multiple observed for comparable businesses that are either listed on a stock exchange or have been acquired relatively recently).[27] Nevertheless, the book value variant of the asset-based approach may still provide a helpful lower bound value to cross-check the value calculated under the primary valuation method(s). For instance, an equity value derived from the DCF or multiples method can be compared with the net asset value at the balance sheet date immediately prior to the valuation date.

The reason that the book value may provide a lower bound indication of value is that the balance sheet has inbuilt conservativism (from a value perspective) when assets:

- are not recognised for accounting purposes; or
- are carried at less than their current value (for instance, because they are measured by reference to their historical cost, or are not revalued upwards following an acquisition).

Notwithstanding the above, the value of a business at a particular time may be less than the book value in the most recent financial statements. This may be the case where:

1. the financial statements have not been prepared on a basis suitable for the current purpose;
2. there are significant off-balance sheet liabilities, such as tax charges that would arise on disposal of assets; or
3. the valuation date is after the balance sheet date and value has declined in the interim.

A further important cross-check is whether the treatment of an asset or investment in the financial statements is consistent with a position being advanced in a dispute. For example, a claimant may contend that they overpaid substantially for an acquisition because of a breach of warranty or misrepresentation, or that a breach of contract has damaged the value of an investment. However, this may be inconsistent with the position adopted in the financial statements if the investments are not treated as impaired by the matters that are subject of the dispute (or not to the same extent).

Similarly, summary[28] valuation information such as forecasts, discount rates, and growth rates informing a DCF valuation that is referred to in the financial statements (such as for an impairment review) may need to be reconciled to the assumptions in a DCF-based damages calculation if they are materially different.

SUMMARY

Asset-based valuations can appeal to tribunals, especially where the financial statements from which the information is taken have been audited. However, the accounting standards applying to recognition and measurement of a company's assets can be complex and need to be interpreted and applied with care to ensure the valuations are fit for purpose.

Book values or adjusted book values remain useful, provided the meaning and natural limits of the information are properly understood. Importantly, financial statements often contain extensive information that reflects valuation judgments by management (or an entity's auditors). This can inform a valuation prepared in a dispute, or be used to cross-check a valuation or its key inputs.

NOTES

1. Mark Bezant is a senior managing director and David Rogers is a managing director in the economic and financial consulting practice at FTI Consulting.
2. References to financial reporting standards in this article are predominantly to International Financial Reporting Standards (IFRS), although similar issues may arise under other financial reporting regimes.
3. Paragraph C14 of the 2011 edition of International Valuation Standard (IVS) 200: Business and Business interests.
4. Paragraph 55 of the International Valuation Standards Framework.
5. Under IFRS, an asset is defined as 'a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity', and a liability is defined as 'a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits' (part 2.6.2 of the International Accounting Standards Board's Conceptual Framework).
6. Notwithstanding this, the narrative reporting and notes to the financial statements may still provide guidance as to the existence and potential value of contingent assets and liabilities that are not included on the balance sheet.
7. 'International Accounting Standard (IAS) 38 – Intangible Assets', paragraphs 63 and 64. Similar considerations apply under other accounting standards such as US Generally Accepted Accounting Principles (GAAP).
8. The economic benefits from such assets should typically be reflected in a DCF or market-based valuation of the subject entity as such valuations seek to capture the entity's ability to generate profits using all of its operating assets and liabilities. As a consequence, when a DCF or market-based valuation is performed, it is typically appropriate not to value such assets separately.
9. The assumptions as to 'separability' for the purposes of financial reporting may not (fully) reflect the contractual or commercial position as regards the ability to separate from an entity and then dispose of a specific intangible asset.
10. For instance, 'IFRS 3 – Business Combinations' states the following at paragraphs IE20 and IE21: 'The terms brand and brand name, often used as synonyms for trademarks and other marks are general marketing terms that typically refer to a group of complementary assets such as a trademark (or service mark) and its related trade name, formulas, recipes and technological expertise. IFRS 3 does not preclude an entity from recognising, as a single asset separately from goodwill, a group of complementary intangible assets commonly referred to as a brand if the assets that make up that group have similar useful lives'.
11. Page 221 of Damages in International Investment Law (2008) by Sergey Ripinsky and Kevin Williams.
12. Under both IFRS and US GAAP, fair value is defined as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date' (paragraph 9 of 'IFRS 13 – Fair Value Measurement' and paragraph 5 of the Financial Accounting Standards Board's 'Statement of Financial Accounting Standards No. 157 – Fair Value Measurements').
13. The following list is intended to illustrate the issues as they can affect the application of asset-based methods, and is not intended to be a comprehensive summary of the accounting considerations or standards, or valuation implications.
14. Specialist properties or plant and machinery are sometimes valued on a 'Depreciated Replacement Cost' basis, as opposed to by reference to historical cost, with the replacement cost of the asset reduced to reflect technological or economic obsolescence (such as through use or age) of the asset at issue.
15. For instance, the current value of many properties is significantly different to the expenditure historically made to acquire or construct the asset.
16. As one commentator noted, 'the single greatest limitation of the book value method is that it ignores the value management may have added to the assets. The whole point of management is to make the assets worth more than their cost. By building and training a work force, by developing a reputation in the marketplace, by learning how to produce the goods or services at low cost, by creating opportunities for expansion, and in other ways, management (and past managements)

should have – and in most cases has – created value in excess of the cost or book value of the assets' (Financial Statements Analysis and Business Valuation for the Practical Lawyer (2006) by Robert Dickie).

17. Under IFRS, net realisable value is defined as 'the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale' ('IAS 2 – Inventories').
18. 'IAS 36 – Impairment of Assets' defines the recoverable amounts as 'the higher of an asset's or cash-generating unit's fair value less costs of disposal and its value in use' (see paragraph 18). Value in use is usually assessed with a DCF approach, and market value using methods such as the valuation multiples of comparable companies.
19. 'Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature and magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report' (International Accounting Standards Board's Conceptual Framework).
20. 'IFRS 13 – fair value measurement' extends to over 100 pages, illustrating the issues at hand.
21. Page 244 of Valuation for Arbitration – Compensation Standards, Valuation Methods and Expert Evidence (2008) by Mark Kantor.
22. Paragraph 80 of International Valuations Standard 104 – Bases of Value (Exposure draft, dated 7 April 2016).
23. Paragraphs 170 and 180 of International Valuations Standard 104 – Bases of Value (Exposure draft, dated 7 April 2016).
24. Paragraph 355 of the award.
25. Paragraphs 113 and 100 of the award.
26. The approach (as sometimes adopted by tribunals) of disregarding DCF analysis for early stages businesses is contentious: in principle, a DCF approach may be appropriate for valuing such businesses.
27. The DCF method represents an application of the income approach, whereas the multiples method represents an application of the market approach.
28. The valuation-related information presented in financial statements will typically be the resulting valuation and potentially summary valuation information, rather than detailed supporting calculations or commentary.

This article first appeared in the Global Arbitration Review's 'The Guide to Damages in International Arbitration', December 2016

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