Valuation of Intangibles – by Dan Sautner

As an accountant I have often met with the frustration of clients over the fact that their financial statements do not reflect the "true value" of their companies. As a business owner myself, I share this frustration but there is just nothing within the practice of accounting that allows for this recognition. This frustration is magnified when financial statements are presented to third parties for purposes of raising additional capital or at a time when you want to put the company on the market for sale. Just as owners are interested in the extras a company has, investors and buyers are also interested.

Essentially the balance sheet represents the original assets and liabilities at the time of formation plus all increases in tangibles (buildings, equipments, receivables, debts etc.) accumulated since that time. These statements do not include the value of a solid customer list, franchise contracts, brand name and general goodwill developed. These intangible assets often can reflect more value than the tangible assets within the company. Most companies have two or more types of intangibles and it is important not to forget about these when looking at any company.

The gross value of the intangibles can be simply calculated by determining an overall value (multiple of sales, earnings, current replacement value etc.) and then subtracting this total from the net value of the assets. Once you have calculated the total value of the intangibles the real work begins.

Examine the company from the prospective of what rights it owns. Example of this are trademarks, franchise contracts and exclusive distribution rights. If there are any proprietary products these should also be included. What we have here are real strengths that cash flows can be determined from. In franchise contracts for instance determine the average royalty from each contract and develop a net present value for the cash flows based on a cost of capital and the remaining life of the agreement. For a trademark, consider the costs of duplicating this effort from a legal and marketing point of view. Proprietary products can be examined on the basis of market share achieved and the value of the longevity of the nature of the product. There are no hard and fast rules here, but with some imagination you should be able to come up with two or more ways to value each of the major classes of intangibles within the company.

I suggest two or more methods of valuation of these items as you want to ensure that both methods deliver a value close to each other. In this area you can often miss the key issues that deliver (or subtracts) substantially from the total. When two methods deliver vastly different values, find out why.

Work through each of these off balance sheet assets and determine a collective value. Compare this amount to the total derived from the total value less net tangible assets. Once again you are looking for ways to validate each amount in reference to different standards. In all likelihood there will be a difference. Usually this has simply been called the most intangible of intangibles - goodwill.

In the past it was critically important to separate out the types of intangibles as the tax treatment differs. When my company was purchased we were able to assign a major portion of the purchase price to the contracts we purchased and as a result we were able to write off the value over a significantly faster schedule than if we had identified the difference in purchase price and net assets as goodwill. The IRS, probably tired of fighting the classification battle of intangibles, has since changed the rules. If it is not tangible, then it is intangible and must be written off over 15 years.

While the tax treatment has changed, the importance of properly valuing your intangibles has not. Over the years we have invested heavily in brand name, training and development of new products. While some of these items might have been capitalized, we chose to keep a cleaner balance sheet and wrote them off in the year incurred. Nevertheless, we are positive of the ongoing benefit of these investments.

Your opinion of the intangible values is almost worthless without some solid working papers. Be prepared to demonstrate the calculations and the underlying assumptions. Generally I have found that when these steps are taken, a higher value is often realized. Even if you are not looking to sell, buy or raise capital, these periodic reviews of the intangibles help you better invest in the strength of your business, even if accountants refuse to put it onto the balance sheet.