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Commentary

Financial statements: Uses and limitations of valuation

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Valuation plays a crucial function in the capital markets. Investors want to know the value of the investments, assets and liabilities under their stewardship. In the course of valuation, companies are dependent on the availability of value-relevant information such as financial statements.

VALUATION OF ASSETS AND LIABILITIES

The different assets and liabilities in a balance sheet are valued using different measurement methods, including historical cost, net realisable value, carrying amount, fair value, transaction price, amortised cost with impairment, cost less accumulated depreciation and accumulated impairment losses, and present value of future payments.

The key principle behind the different measurement methods for assets and liabilities is to produce information that is as useful or relevant as possible.

However, the values are often stuck between historical costs (which are the easiest to verify) and fair value (which is value-relevant but can be less reliable or more difficult to be reliably measured).

This results in the unintended consequence where comparing or aggregating the values of assets and liabilities may not be meaningful.

Therefore, readers of the balance sheets need to be aware that the numbers produced are dependent upon the measurement methods used and the economic circumstances in which the numbers were derived.

This was the case in the 2009 global financial crisis when the value of assets on the balance sheets of companies took a drastic turn. This dampened market confidence, giving rise to a domino effect, which caused the collapse of some "too big to fail" entities in the world.

At the end of the day, caveat emptor still applies to those who look to balance sheets to derive a valuation of the assets and liabilities of a company.

VALUATION OF A COMPANY

The value of a company can be viewed as the sum of the values of its net assets or the perceived value arising from the use of its net assets to generate earnings and cash flows.

If the assets and liabilities are measured using different bases, how can the aggregate value of the net assets be useful for decision-making? This is one of the fundamental challenges in using balance sheets for valuing a company.

The income statement presents the net income of a company for a defined period of time called the financial year.

The net income can also be used to estimate the value of a company. It serves as a proxy for its future earning capability. The value of a company then becomes the present value of all the future income streams it generates.

But there are major problems.

The net income from the income statement is a result of the applications of accounting rules, estimates and assumptions. It may not represent real cash but the result of the company's earning process.

The statement of cash flow allows a user to have a better understanding of the actual amount of cash generated by a company. The cash flow from operations measures the cash generated by a company through its operations over the financial year.

The cash flow from operations will be most useful in estimating the value of a company if there are no spikes or unusual transactions for the year.

In addition, the net income or the cash flow from operations are historical in nature, namely, they provide information on what had been earned, and not what the company will earn in the future.

WHAT TO MAKE OF COMPANIES WITH LARGE INTANGIBLE ASSETS

In this age where more digital businesses such as platform or marketplace companies have emerged in the capital markets, this new breed of companies with sizeable proportions of intangible assets in their balance sheet represents a red herring for valuation. This is because intangible assets (including goodwill) are generally measured based on the initial cost of purchase.

This adds more uncertainties to the derivation of the value of assets and the net income from these intangible assets.

In fact, one study found that the "properties of earnings have changed dramatically over the past 40 years" and earnings quality has been declining. The evidence seems to attribute the decline to the impact of higher intangible intensity.

With cost measurement of intangible assets and the declining quality of earnings, these make valuation using the financial statements almost arbitrary or impossible.

In conclusion, financial statements provide critical information in the valuation of assets, liabilities and the company as a whole. However, without a good understanding of the assumptions and premises in which the numbers were created, the financial statements can be misused.

At the end of the day, users of financial statements for valuation purposes should do so with their eyes wide open.

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