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Barel Karsan , Barel Karsan August 17, 2010 6:06am 4 min read Comments

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As value investors, we are trained to look at the "Goodwill" and "Intangibles" lines on a company's balance sheet with great skepticism. After all, these supposed company assets are not hard assets like equipment or land or receivables and therefore can't be used to generate cash flows and furthermore they have no salvage value. But the future cash flows of companies with large intangible assets listed on their balance sheets can often be underestimated unless those intangibles are taken into account.

As Warren Buffett has reminded us time and again, an investment is worth the discounted future stream of cash flows that accrue to the investor. Often, we use earnings as a proxy for cash flow, since earnings are meant to be a smoothed out version of cash flow, which can be volatile from quarter to quarter and year to year (e.g. cash flows can vary dramatically as a result of inventory build-ups/reductions, receivable/payable timing issues, capital purchases/sales, bank loans, tax refunds/payments etc.).

But it's important to keep in mind that intangibles (apart from Goodwill) are amortized on the income statement, even though the cash to buy these intangibles has already been spent. As such, shareholders who do not add back the amortized intangibles to the company's earnings are underestimating the company's cash flow.

As an example, consider Dorel (DIIB), a company we discussed last year as a potential value investment. The company's intangible assets fell \$12 million in its most recent quarter, which is significant compared to the \$35 million the company earned in the quarter (some of the \$12 million change was likely due to currency effects, but the rest would have been amortized, thus subtracting from income). The extra cash "generated" by these intangibles contributes to the company's cash flow in a meaningful way, and can be used by the company to buy back shares, grow the business, or some combination of the two, which is what Dorel has been doing. Of course, it's important to determine if the intangible assets being amortized need to be replaced with future cash flows. Often, a note to the financial statements will describe exactly what line items are included in the intangible assets (e.g. customer lists, non-compete agreements etc.). Amortization for items that need to be replaced to keep the business at its current level should not be added back to income in estimating cash flows, as they should instead be treated similarly to depreciation of capital assets.

The money to purchase intangibles has already been spent, but the expenditure is not yet recognized on the income statement. As such, future income statements often underestimate the actual cash flows of a business when large charges for amortization of intangibles are taken. But the cash flow benefits of these assets accrue to the **current** shareholder. As such, the current shareholder should take these cash flows into account in estimating the future cash flows of the business. Disclosure: Author has a long position in shares of DIIB

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