

Valuing Assets

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Most individuals involved in selling and or appraisal of complete companies usually underestimate the importance of the fair market value of the assets of the business. Many appraisers and intermediaries merely rely on "Book Value" or the owners best estimate and even an arbitrary discount or premium based on the type of asset involved. The theory of not really doing a value analysis on the assets is mainly derived by the assumption that the business is worth what the market will pay, or in other words its "Fair Market Value" and that the assets are merely the basis for producing the income stream. It is also a common philosophy that because goodwill is the difference between the assets and the company's fair market value, that if you are slightly off on the value of the assets, the only factor influenced is that the company will show more or less intangible value, but the fair market value of the complete business is still the same.

If you look into the accepted approaches that are used to value businesses, several aspects begin to cloud the above scenario. For instance, appraisers do, and should use historical as well as projected financial analysis to normalize discretionary net profit. Correctly done, the cost of new equipment to handle future increases in revenues for the business in the projected years and a deduction for true (sometimes called economic depreciation or a capital reserve) depreciation for historical years to arrive at a true earnings picture of the company. If the cost of the assets are off, keep in mind that at a capitalization rate of 25%, every one thousand dollars of discretionary net profit can equal 4 times that amount when capitalizing the income, thereby having a drastic impact on the overall value of the company.

Another aspect that one must consider is that many of the calculations in the various approaches take into consideration the value of the assets. Those that are not directly impacted by methodology involving the assets are still derived from capitalization of the income stream, and as stated above can result in some drastic differences in value. One of the most popular methods used by intermediaries and appraisers is a combination of assets plus a multiple of earnings, or mainly just a multiple of earnings associated with the type of business being valued. Almost all accepted methodology relies on the normalized income stream. Again, assets can play a significant role in the overall estimate of value of the business. Depending on the size of the company and the various methods used, an error in valuing the assets can have more of an effect than one might think. Also, although most business appraisers do not value the real estate, one must be thorough to research this asset to determine the fair market rent to be deducted from expenses to allow the real estate to be added to the fair market value of the company as an "Investment Value".

When discussing hard assets, there are various categories such as Furniture, Fixtures and Equipment, Vehicles or rolling stock, inventory (both for resale and parts for everyday repairs), Leasehold improvements, as well as Licenses, Patents and Trademarks. Each category of assets has to be analyzed individually and some research is required. Keep in mind that in addition to the fair market value of each item, you may have to arrive at a "Value in Use" of the equipment. "Value in Use" is defined as:

"The value of an economic good to its owner/user is based on the production (privacies in income; utility or amenity form) of the economic good to a specific individual. This is a subjective value however, and may not necessarily represent market value."

When valuing Furniture, Fixtures and Equipment, several things can happen when trying to research the values. For instance, you will usually encounter two scenarios that stand out when calling used equipment dealers, sometimes auctioneers (although you are mainly looking for fair market value, in some cases auction value is the market), and trade association magazine classified ads as well as the owners own estimate and owners of similar businesses; one is that everyone seems to know the value of the various pieces of equipment or that no one can give you a straight answer until they see the equipment and its condition. In most cases, it is wise to research these items or to have a competent equipment dealer come out and value each piece separately. This is usually a nominal fee for a value per item, estimated at a retail selling price.

Once you have completed this, you can adjust the equipment on the Balance Sheet by adding to or deducting from depreciation to reflect the fair market value of the assets. This gives you an economic adjustment that is based on fair market value rather than a taxed based value as set forth by IRS schedules that are usually only for tax purposes and probably do not reflect the true value of the equipment.

The second scenario whereby, hardly anyone knows the value of the equipment until they see it, is an indication that age, condition and model has a significant impact on value. Although each (including the owner) dealer or contact may not be sure what the equipment is worth, all will definitely know how long each piece of equipment will last. This is where the "Remaining Useful Life" (RUL) Method applies best. Again, keep notes as to who you talk to and their estimate of useful life of each piece of equipment. Based on a range of life expectancy, you can deduct a fair and reasonable life for each piece of equipment. The calculations are a simple mathematical method of re-doing the depreciation schedule that the accountant has used. Sometimes you will find that the depreciation schedules the accountant has applied, accurately represent the true life expectancy of the equipment and therefore do not need adjustment. This is usually true in hi-tech electrical or computerized equipment. In most cases this is not the case and a new depreciation schedule must be established from the research you have collected. An example of the methodology and calculations to determine the value (again, sometimes referred to as changing it to an economic depreciation) for instance, in a restaurant, the accountant has used a seven year life on a stove, when the true life expectancy of that stove is at least fifteen years and the original cost was \$2,000. Therefore, if the owner paid \$2,000 and has used it for 5 years, then this piece of equipment has a remaining useful life of 10 more years. The calculations are as follows: $\$2,000 \div 15 \text{ years} = \133.33 per year in loss of value. With 10 years left it is a simple calculation, the stove is worth \$1,333. ($\$133.33 \times 10 \text{ years} = \$1,333$.) Since the accountant's value on the books is \$750 ($\$2,000 \div 8 \text{ years} \times 3 \text{ more years of life}$) or $\$2,000 - \$750 = \$1,250$ in depreciation), you can add back \$583. to the \$1,250. This will add a positive \$667 to reflect a depreciation of \$583. to the minus \$1,250. Therefore $\$2,000$ (original cost) minus $\$667 = \$1,333$.

This simple mathematics must be judged by the condition of the equipment. The preceding example assumes that the equipment is in good condition and has been maintained routinely. However, some equipment may have been severely abused or neglected and have no "on-going" maintenance program in place, thus forcing the appraiser to lower the remaining useful life. Although this seems extremely subjective, the following criteria, based on common sense should be helpful in determining condition.

DEFINITIONS OF CONDITIONS

The following definitions of conditions have been developed for use in Business Evaluation Systems appraisals. They are intended to promote a good understanding of conditions assigned to items appraised and an effective means of communicating the impact of condition, on value. Care must be taken in assignments of condition ratings to accurately reflect the impact on value.

EXCELLENT

New/near new or practically new mechanical condition, extremely low hours of use, no defects, and may still be under warranty.

VERY GOOD

Exceptionally good condition. May have just recently been completely overhauled or rebuilt with new or near new materials and/or has had such limited use that no repairs or worn part replacements are necessary. Very low hours of use.

GOOD

In complete 100% operating condition. No known or obvious mechanical defects but may have some minor worn parts that will need repair or replacement in the near future. May have high hours of use but no defects are obvious.

FAIR

Has very high hours or extended use. Defects are obvious and will require repair or general rebuild soon. Not 100% functional or efficient, may be operational or functional but questionable.

POOR

Has seen very hard and long hours of service. Requires rebuild, repair, or overhaul before it can be used. Not operational or functional.

SCRAP

Cost of repair exceeds value or cost of replacing with like equipment. Past useful or functional life and should be sold as scrap.

CONDITION CODES (E) (V) (G) (F) (P) (S)

DETERMINING CONDITIONS

It should be noted that in determining conditions, the appearance of the particular item is important. However, the equipment must be judged on mechanical and electrical

working conditions and not just on appearance. Paint, lubrication, and general clean-up should be part of general maintenance and should not be used to cover up defective equipment. The appraiser must use experience and first hand knowledge of the equipment to make accurate judgments for condition ratings.

The physical condition, deterioration, depreciation or state of repair is a major factor in values. Loss of value due to curable or incurable depreciation is a consideration of market value.

Please keep in mind the element of common sense, and if possible obtain a repair schedule or a maintenance schedule. For instance, sometimes in the case of oilfield equipment, although an engine, or drawworks on a rig may appear to be in severe need of repair, check with the head of maintenance and you may find that after every so many hours, that piece of equipment is pulled and completely rebuilt and the parts are in the warehouse ready for this repair. Now, what you have is an engine that is in "Poor Condition", but all of the new parts are in the warehouse and it is scheduled to be totally rebuilt soon, and this is a normal expense represented in the profit and loss statements and treated as a normal cost of doing business. How would you rate this?. The answer is "Good", since it is running and the parts to rebuild it are already in the warehouse and labor is an everyday function of the repair department. Be extremely careful when valuing Leasehold Improvements. Buyers will not pay for used leasehold improvements if they can get a new "Build Out" for free in a similar space. Also, if the owner didn't pay for improvements - neither should the buyer.

Assuming the current owner paid for leasehold improvements and the local lease market is not providing spaces built to the tenant's specifications, use the following schedules:

A. Long Lived Improvements (10 to 25 year life)

Walls, electrical wiring and plumbing can be valued at the original cost of installation with no deduction for depreciation. (Inflation rates will compensate for depreciation)

B. Intermediate Lived Improvements (5 to 10 year life)

Signs, water heaters, air conditioners, air compressors, furnaces, etc. Use a "straight line" depreciation based on actual useful life.

C. Disposable or fashionable (0 to 5 year life)

Carpeting, blinds, draperies, etc. are subject to rapid wear and fashion trend and will be worth;

75% of original cost if in new condition.

50% of original cost if in good condition

25% of original cost if in fair condition

0% of original cost if in worn condition

In the case of vehicles or rolling stock, there are three good sources for price information:

A. Blue Book Value. This guide is available at many book stores for a nominal fee

and is extremely reliable.

B. Classified Ads. Many local publications and newspapers advertise vehicles and the average price from a number of ads will represent the prevailing market.

C. Depreciation Schedule Model. Minimum value is 20% of original cost.

ENTER Mechanical Equipment original value, then **DEDUCT** accumulated depreciation. The total is the mechanical equipment value. Remember 20% of cost is the minimum.

Every business has some inventory of stock for internal use or products for resale. The actual value of stocks or inventory is usually determined by a physical inventory completed the day the business sale is consummated. You can use the following sources for information: (A) Have a professional inventory service determine market value. (B) Use last years tax statement to find your "ending inventory" and "beginning inventory". Be careful, since many people make year end adjustments to inventory levels for tax purposes. Look for the value on a "Normal Day".

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