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SFAS 141 Impacts Choice of Method Used to Value PP & E

The key question an appraiser asks when valuing assets is “what is the *premise of value?*” For purposes of valuing Property, Plant and Equipment (PP & E), the premise of value could either be value in-use or value in-exchange. Traditionally, appraisers have used the value in-use approach to value PP & E, but the FASB has indicated in SFAS 141 that it prefers use of the value in-exchange, or market approach. It is important for companies to understand that whichever approach they, or their auditors, decide to use will have implications for future financial reporting.

VALUE IN-USE

Value in-use refers to the replacement cost of an asset, less depreciation from all causes. Replacement cost is the price that would have to be paid to buy a new asset of equivalent utility, not necessarily a one-for-one replica of the asset. Value in-use is based on the assumption that, in a business combination, the buyer acquired a going concern. The buyer needs to identify what it would cost today to have the same or similar assets in place, up and running, and producing at the existing level.

The valuation methodology for value-in-use is rather straightforward. An appraiser identifies all the assets, determines the **cost new** today, including freight in, installation, testing and debugging. Then, based on physical inspection of the assets, the appraiser determines the age and actual condition of the subject and determines the depreciation from all causes.

The assumption is that while the assets *could* be replaced with new like-kind equipment, the fact is that they will not be replaced. Instead the old assets will be retained. But by using the older assets which are both physically worn and may be less than current technology, there is a cost penalty for the existing assets in contrast to a new complement. It is up to the appraiser to judge the amount of depreciation that exists at the date of the business combination.

VALUE IN-EXCHANGE

Value in-exchange takes a different perspective. In simple terms, value in-exchange looks at what comparable assets are being bought and sold for on the open market. On a value in-use basis, a new buyer would expect to pay for costs involved in breaking in and setting up a machine, as well as freight in and installation. On a value in-exchange basis, assuming a third party buyer wanted to acquire the asset for use elsewhere, these costs would be truly non-value added.

Consider the following example. If we were to value a Caterpillar model 9886 Loader, originally purchased in 2000 for \$605,000, the current replacement cost new (early 2003) would

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be approximately \$626,000. Our estimate of value in-use would be perhaps \$582,000, based on age and condition. However, if you were to call a dealer, he would only offer around \$290,000 to buy the Caterpillar Loader from you. But if you called the same dealer and wanted to *buy* the Caterpillar from him, he would offer to sell it to you for \$390,000. The difference between the value in-use of \$582,000 and the value in-exchange of either \$290,000 or \$390,000 indicates how much of a disparity there can be between value conclusions depending on which approach is utilized.

The price of an asset new from a manufacturer always puts an upper limit on the used equipment price. But there is no lower limit. Particularly when the economy is far from robust, dealer prices will be low. Valuation theory suggests that the two approaches *should* provide similar answers; in practice value-in-exchange is almost always lower.

We have often been asked, as part of an allocation, to determine the value of assets for potential use as collateral. Thus, we have often developed two different valuation reports — one for value in-use and one for value in-exchange — for the same assets at the same time. We have found that almost invariably the valuation determined by using the value in-exchange approach is lower than the number arrived at using the value in-use approach.

Traditionally, value in-use fairly reflects the economics of a specific transaction. But the FASB has indicated in recently issued guidelines, that it prefers looking to the market, rather than company-specific valuations. Regardless of which approach is chosen, future income statements will be affected. The value in-use approach will generally result in higher future depreciation expense and lower reported earnings. The value in-exchange approach will usually result in more of the initial purchase price being allocated to goodwill, which must be tested for impairment every year. But goodwill has no impact on quarterly or even most annual operating results. For more information regarding the approaches for valuing machinery and equipment, contact your Valuation Research representative or Joe Mickle at (609) 243-7011. **VR**