WHEN IS A FIXED ASSET APPRAISAL NECESSARY IN A VALUATION?

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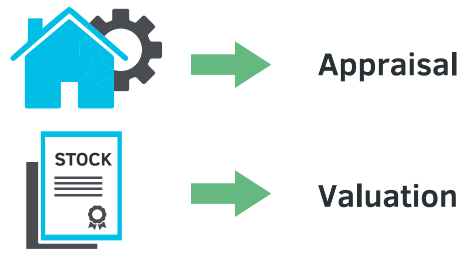
INTRODUCTION

Depending on the situation, fixed assets can have a significant impact on the value of a company. Determining the value of fixed assets can also help assess the value attributable to intangible assets, open the door for borrowing opportunities, or enable management to save on insurance and taxes. Understanding when fixed asset appraisals are required or beneficial enables management to make informed, strategic decisions.

APPRAISAL VS. VALUATION

In many cases, the terms appraisal and valuation are used interchangeably. In the world of business valuation, appraisal generally refers to an estimate of the value for tangible assets such as real estate, equipment, and other types of property. Valuation generally refers to an estimate or calculation of the value of a stock or security.



WHY ARE FIXED ASSET APPRAISALS NECESSARY?

The value of a fixed asset recorded on the balance sheet is generally defined as the book value of the asset. The term value is relative and has many different definitions. Depending on the situation, book value isn't always the best definition of value. The book value of assets, other than land, is generally depreciated over time to account for wear and tear on the asset. Land is not depreciated over time because it is considered to have an unlimited useful life. The systematic depreciation of assets for financial reporting or tax purposes on the balance sheet often skews the value of an asset.

For example, when an asset is purchased and recorded on the balance sheet, the book value of the asset is considered equal to the fair market value of the asset. The fair market value represents the value at which a hypothetical buyer would purchase the asset from a hypothetical seller; in this hypothetical, the purchase price represents the fair market value. As time goes on and the asset is systematically depreciated, the book value will differ significantly from the fair market value.

Appraisals are used to adjust the book value of an asset listed on the balance sheet to the correct definition of value relative to the event triggering the need for an appraisal. However, this adjustment isn't always necessary, and appraisals represent additional costs to the company. Identifying situations in which an appraisal may be beneficial helps management determine when an appraisal is worth the additional cost.

REASONS TO OBTAIN A FIXED ASSET APPRAISAL

INSURANCE

Knowing the actual value of a fixed asset is critical when making insurance claims. An appraisal establishes the value of the asset before it is lost, reducing back-and-forth negotiations with insurance companies and ensuring a quicker settlement. Appraisals can also impact insurance premiums. Insurance premiums decrease as the value of an asset decreases and increase as the value increases.

BORROWING

When seeking a loan, it may be helpful to obtain an appraisal to establish the amount of collateral available to the lender. Depending on the asset, the book value generally understates the value because of rapid systematic depreciation. Using an adjusted value can increase the amount of collateral, allowing the borrower to take out a larger loan.

TAXATION

Appraisals on fixed assets can help lower ad valorem taxes. The term ad valorem means according to value. Ad valorem taxes are generally taken as a percentage of the total value of an asset. If an asset appears to be overvalued, the owner may contest the value with a new appraisal to reduce the taxable amount.

GIFT AND ESTATE

Understanding the value of the underlying assets in a business or estate helps individuals perform effective gift and estate planning. Appraisals can help individuals understand the tax implications for their estate. Correct understanding of these tax implications allows them to maximize both charitable contributions and the inheritance they leave for family and friends.

IMPAIRMENT

When a company underperforms or experiences a significant decline in value, the fixed assets often need to be adjusted to reflect the company's poor performance. This adjustment is called an impairment. An impairment analysis often requires an appraisal to determine how much of the decline in value is attributable to a specific asset.

LIQUIDATION

In addition to an impairment analysis, struggling companies may also want to identify their liquidation value. Liquidation value is often considered to be the lowest possible value of a company because it reflects the combined value of the individual assets as if they were to be sold on the open market. An appraisal is the best and most accurate way to estimate the liquidation value of an asset.

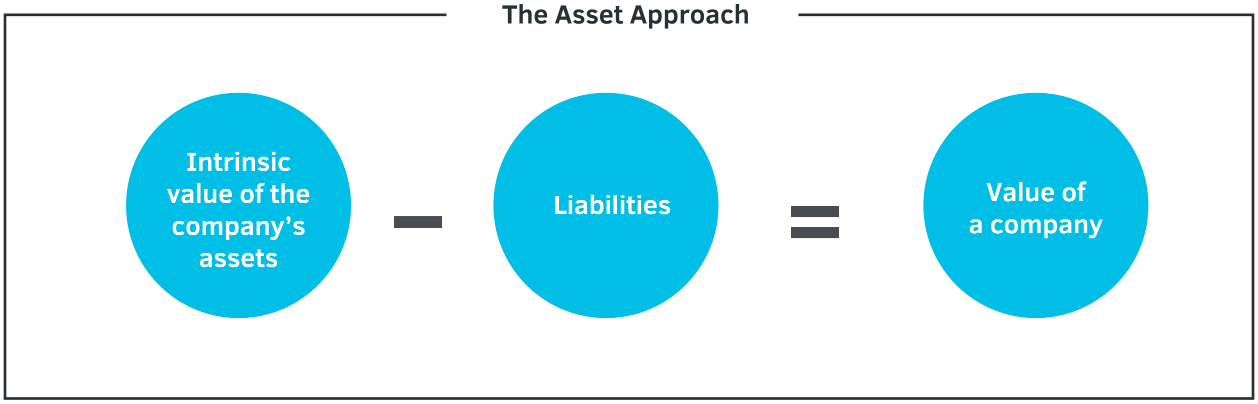
MERGERS AND ACQUISITIONS

Business combinations require purchase accounting, which includes a comprehensive look at the cost of the assets involved in the combination. Fixed assets involved in the transaction need to be adjusted and recorded at fair value. Fair values of the fixed assets help determine the amount of the purchase price attributable to intangible assets and goodwill. Additionally, appraisals conducted prior to a merger or acquisition are an important part of due diligence that enables buyers to make informed decisions.

APPRAISALS AND THE ASSET APPROACH

Most business valuation methodologies that require a fixed asset appraisal represent some form of the asset approach. The asset approach is one of three major approaches used to determine the value of a company. This approach generally captures the intrinsic value of the company's assets minus any liabilities. The asset approach is frequently used to value companies that are in very early stages, are approaching liquidation, or hold a significant number of fixed assets.

The Asset Approach



Most companies that are both pre-revenue and pre-financing haven't created a lot of value; therefore, most of their value lies in the company's assets. Companies at this early stage often lack a steady track record, market share, operating synergies, and technology. This essentially means someone with a similar idea could recreate the business by acquiring the same or similar assets owned by the company. The company's increased sales, acquired market share, and development of both strategic and technological advantages begin to create value for the business and are less dependent on just the value of their assets. Therefore the businesses' value becomes less dependent on just the value of the assets.

Companies that have stopped creating value and are no longer competitive in the marketplace are at risk of liquidation. As mentioned previously, the liquidation value is usually considered to be the floor of a company's value because it usually only represents the combined value of the individual assets as if they were sold on the open market minus any liabilities.

Certain companies derive most of their value from their fixed assets. Real estate portfolios derive a significant portion of their value from the individual property values in their portfolios. A significant amount of the value in manufacturing companies comes from large amounts of advanced machinery. The asset approach should be considered in some form whenever valuing companies with a large amount of fixed assets.

The asset approach can be useful when valuing very early stage companies, struggling companies, and companies with a large amount of fixed assets. Although there are some alternatives, fixed asset appraisals are generally the best way to determine the value of assets when using the asset approach to value a company in these categories.

CONCLUSION

Fixed assets are important when determining the value of a company. Understanding the correct definition of value when valuing a company enables both valuation professionals and management teams to make informed decisions and arrive at more accurate conclusions. Important reasons to look at obtaining an appraisal include insurance, borrowing, taxation, gift and estate, impairment, liquidation, and mergers and acquisitions. Fixed asset appraisals should also be considered whenever the asset approach is used in a valuation, particularly when a company is prefinancing, underperforming, or holds a significant amount of fixed assets that drive value.