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THERE ARE DISTORTIONS LURKING IN THE FASB'S PROPOSED RULE FOR FAIR VALUE MEASUREMENT.

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THERE'S AN ISSUE brewing about how to determine the fair value of property, plant, and equipment (PP&E) in a business combination.

The Financial Accounting Standards Board's (FASB) new rules for mergers and acquisitions, Statement of Financial Accounting Standards (SFAS) No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets," have gone into effect, and the Board is writing an exposure draft (ED) of a new SFAS called "Fair Value Measurement."

I'm an appraiser, and the standard methodology all appraisers have developed to determine the fair value of PP&E on an accurate and cost-effective basis has worked well for 35 years. We refer to it as a "Value In-Use" (VIU) premise of value. But the FASB is now proposing an alternate approach, referred to as "Value In-Exchange" (VIE), which the Board seems to prefer. But VIE departs dramatically from VIU and almost always values tangible assets at a *different*, and usually *lower*, value.

So, appraisers wonder, are we moving forward or backward if we adopt the FASB's new concept of fair value?

LOWER VALUE?

Let me explain.

Corporate financial officers should welcome this change allowing VIE because it boosts reported income immediately. For example, under VIE, fewer dollars are allocated to PP&E, so more of the purchase price goes into goodwill. Fewer dollars allocated to PP&E means lower annual depreciation charges, and the more that's allocated to goodwill—which is not amortized each year—the higher the reported income.

Why does VIU produce a higher value? Stated simply, under VIU, machinery and equipment are valued assuming the acquirer will continue using them, while VIE is based on prices for the machinery and equipment in secondary markets. Such market prices don't include all costs necessary to have the equipment up and running, producing the product(s) for which they were acquired.

Specifically, Valuation Research Corporation, my former appraisal company, uses the following definitions for VIU and VIE:

> **Value In-Use**
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> Value In-Use is an amount of money that would be exchanged between a willing buyer and a willing seller with equity to both, neither being under any compulsion to buy or sell and both being fully aware of the relevant facts, as of a certain date, *assuming that the assets will continue to function in their present capacity as part of an ongoing business enterprise at their present location.*
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> **Market Value (Value In-Exchange)**
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> Market value (Value In-Exchange) is an amount of money that would be exchanged between a willing buyer and a willing seller with equity to both, neither being under any compulsion to buy or sell and both being fully aware of the relevant facts, as of a certain date. *(Market value excludes the cost of installation, transportation, foundations, piping, and power wiring applicable to each machine unit and doesn't consider its contributory value as a part of an ongoing business enterprise at its present location.)*

What I've italicized above highlights the differences between the two concepts.

VALUE IN-USE

VIU is premised on the assumption that the buyer is acquiring a going concern. The buyer should identify the cost of having the same or similar assets in place, up and running and producing the same level of output that the seller is currently producing.

Some of the equipment may be new and state-of-the-art, while other equipment may be older, even fully depreciated, but still capable of cost-effective production. The assets were working and producing the day before the business combination, so we presume—quite realistically—that there is no change the next day simply because of new ownership. The purchase price for the business—because it is a going concern—includes the fact that existing equipment has been installed, tested, and debugged; that the various components in an assembly line are balanced; and that everything's working synchronistically and efficiently. This implies that the seller already has a skilled and assembled workforce to run this machinery, which adds value, but SFAS No. 141 doesn't allocate for it.

In short, the VIU approach takes the buyer's perspective. Appraisers look at the specific company and its associated assets on an "as-is, where-is" basis. The purchase price for the overall business presumably was determined after the buyer's due diligence, and they understood what productive capacity they were or weren't acquiring. The valuation methodology we use for VIU is straightforward: In theory, we identify all the assets and determine the cost new today, including freight-in and installation, testing, and debugging. Then, based on physical inspection of the assets, we determine the age and actual condition of the assets and depreciation from all causes. Although we assume the assets could be replaced with new like-kind equipment, the fact is they won't be; the old assets will be retained. But by using the older assets, which are both physically worn and may not be current technology, there's a cost penalty for the existing assets in contrast to an all-new complement of equipment.

It is the appraiser's duty to apply his or her professional judgment to determine the depreciation from all causes that exist at the date of the business combination. The appraiser's definition of depreciation is based on physical inspection and current technology, not on arbitrary accounting lives applied to original cost.

But as a practical matter, we don't determine the cost of every asset as if it were new, nor the freight-in, installation, testing, and debugging costs. There aren't enough appraisers to do this. As a shortcut, we often use the client's property record system. If the original cost of the assets is available along with the original date of acquisition, we're able to apply either standard or proprietary wholesale price indexes to that original cost. Some of the indexes are developed by the government, some by commercial information providers, and some by the appraisal firm itself. That provides us with a reasonable approximation of the cost today to acquire the same complement. Obviously, for major pieces of equipment, we test the indexing. The indexes are usually accurate, and we, as well as other appraisal firms, find this approach provides a highly accurate and cost-effective answer.

It's cost effective because we don't have to contact dozens—if not hundreds—of vendors to obtain quotes of the current cost of new or used comparable assets. We and others have used VIU for more than three decades, and it works. The answers have been audited, they have been accepted by the Securities & Exchange Commission (SEC), and the resulting values have been included in financial statements and used by investors, creditors, and other financial statement users. To the best of our knowledge, this approach has never been challenged, until recently.

VALUE IN-EXCHANGE

Value In-Exchange takes a different perspective. It asks one of two questions: What would it cost if we bought these assets in the open market, either from a dealer in used equipment or at auction? Or, alternatively, what could we sell the assets for, as-is and where-is, to a dealer or at an auction?

Of course, in one case we're buying, and in the other we're selling. The dealers' costs and profit margin make up the difference. So, for example, if we had to value a Caterpillar model 9886 Loader, originally purchased in 2000 for $605,000, and the current replacement cost new is approximately $626,000, our VIU would be perhaps $582,000, based on age and condition.

If, however, you want a dealer to buy the Caterpillar from you, he or she might only offer roughly $290,000. 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, which reflects the fact that the asset isn't new. The difference between the VIU of $582,000 and the VIE of either $290,000 or $390,000 illustrates the difference in valuation methods.

The Caterpillar that the general contractor uses is part of an ongoing business. The stand-alone price from the dealer is interesting, but unless you have a use for the equipment, you wouldn't buy it. And if you do have a use for it, you also must have a lot of other related assets, a workforce, and a customer base. Put a different way, one stand-alone Caterpillar loader can't generate income by itself. It requires all of the business's assets, working together, to generate cash flow.

Before we can apply a VIE approach to comply with SFAS No. 141—if that is the desired methodology—someone has to tell us whether the "exchange" is *buying from* or *selling to* the market. In the used equipment business, because of relatively low asset turnover, the difference between the "bid" and "ask" price can go as high as 50%, while the difference in our real-life example above is 34%.

Assuming that we choose to perform the valuation using market prices as though we were the buyer, then the methodology an appraiser uses under VIE is straightforward. We go to "the market"—i.e., call or write dealers who specialize in the particular type(s) of assets in question and obtain quotes from them. Alternatively, we can now go to published prices from recent auctions on the Internet.

Admittedly, with this approach, it isn't feasible to inspect the dealers' inventory physically, so we don't know with certainty whether the condition of the client's assets is completely comparable with the condition of the asset from the dealer. For example, a 2001 Chrysler PT Cruiser may not be the same as the one offered by a used-car dealer at $14,000. The dealer's car may be better or worse, but the cost of an appraiser's investigation may exceed the increase in precision as long as we are dealing with a large number of assets. Unless there is a bias one way or another, obtaining quotes from dealers and auctions has been proven to be a valid approach.

While we haven't used a VIE approach very often in allocations of purchase price, we do use VIE in valuations for financing. VIE is a recognized and established approach, one with which every appraiser is comfortable, and, by and large—at least at the date of the valuation—we are usually comfortable with the answers. But historically, the only parties interested in VIE are lenders and insurance companies, not investors in the company's securities. As part of an allocation, we often have been asked simultaneously to determine the value of the assets for potential use as collateral. Thus, we often have developed two different valuation reports for the same assets at the same time, one using VIU and the other VIE, and almost invariably the latter is lower.

WHAT'S THE DIFFERENCE?

Some observers assume the valuations from VIU and VIE should be similar, if not identical. But this isn't the case.

By and large, VIE—even using the price from the dealer—is going to be lower than VIU. The price of an asset new from a manufacturer always puts an upper limit on prices of used equipment. But there is no lower limit. Particularly when the economy is far from robust, auction prices, and, hence, dealer prices, are low because auction prices are determined in a bankruptcy or liquidation sale, where there is pressure on the seller. Dealers who buy at auction and then resell to customers are pressured to turn their inventory as quickly as possible, and, because the inventory was bought at a lower price, it can sell for a lower price.

A second difference occurs because the VIE approach uses freight and installation, testing, and debugging, and it often takes a significant period of time for a new production line to run efficiently. Many companies capitalize the costs of getting a production line running well as appropriate costs of installation. On the other hand, if we are pricing out for an allocation the current used market price of the existing assets, we aren't likely to assume a correct amount for the cost of testing and debugging because the existing production line is already up and running. At this point in time, we, and probably our clients, don't know or remember all the pain (and cost) incurred at start-up. Thus our estimate today to take the equipment from dealer inventory to the factory floor may be less than was actually incurred and captured originally in the accounting records.

WHICH SHOULD WE USE?

So, which should we use? VIU or VIE?

Here is a direct quote from SFAS No. 142, paragraphs 23 and 24:

> Quoted market prices in an active market are the best evidence of fair value and *shall* [emphasis added] be used as the basis of measurement, if available…If quoted market prices are not available, the estimate of fair value shall be based on the best information available, including prices for similar assets and liabilities and the results of using other valuation techniques.

There is an "active market" for used assets in many if not most types of PP&E. This is what the FASB is asking for in the above paragraph and what many corporate financial officers are now starting to demand.

On the other hand, auditors from several of the major firms are accustomed to the VIU approach. They are uncomfortable switching to a VIE, which, as noted earlier, they see is likely to place fewer dollars in PP&E and more in nonamortizable goodwill. But we have seen one accounting firm permit its clients to adopt a VIE methodology.

Whichever approach is chosen, one thing is certain: Future income statements will be affected. Value In-Use has higher depreciation expense and lower reported earnings. Value In-Exchange puts more into goodwill, which must be tested for impairment every year. But goodwill has zero impact on quarterly or even most annual operating results.

Appraisers are in the middle. We can do either or both. Tradition says Value In-Use is appropriate, and—in our judgment—fairly reflects the actual economics of the specific transaction. On the other hand, the FASB is leery of company-specific valuations and prefers looking to "the market" for asset values.

UNIFORMITY NEEDED

To settle this issue, we recommend the FASB rethink its hierarchy of valuation evidence that the Board discussed in its December 17, 2003 meeting. The hierarchy of valuation evidence always uses "quoted market prices" as the most reliable measure of fair value—irrespective of the facts and circumstances.

Alternatively, the FASB's Emerging Issues Task Force (EITF) could add this to their agenda and make a decision one way or the other. Uniformity of approach may be better than two thirds of companies doing it the way we think it should be done and one third doing it a different way. If everyone is forced to take the less desirable route, at least we'll have fair comparisons between and among companies.

Finally, if the FASB and EITF can't—or won't—decide this issue, the SEC will have to step into the breach. Corporate financial officers of firms that are involved in business combinations have a stake in the outcome of this debate. (At the time this article was written, the Board expected to issue an ED of the proposed SFAS, "Fair Value Measurement," by the end of June, with at least a 75-day comment period and a public roundtable discussion to follow the comment period.)

We encourage a full and open dialogue. ■

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