

THE OPINION OF THE COLLEGE ON

Defining Value in Use

Initiation, Chair responsibility,
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Introduction

In appraising a business, it is not uncommon to use real estate appraisers to value the real property segment of the business and machinery appraisers to value the personal property segment. Among the most common reasons for business appraisals are sale or purchase of a business, allocation of purchase price, sale of a business asset, estate or inheritance taxes, gift taxes, etc. The business appraiser assembles the value of tangible assets prepared by knowledgeable appraisers and then values any intangible assets and concludes on the overall business value under the consistent-use theory. Since many tangible asset appraisers are asked to use an in-use value for this type of assignment, it is suggested that guidelines be formulated.

Need For Value in Use Definition

Pursuant to the request of the American Society of Appraisers' College of Fellows, this author wrote an article on value in use which appeared in *Valuation*, February 1987. The response to this article from members was favorable and most concurred that a value-in-use definition should be formulated and made a part of the American Society of Appraisers' official literature. There was one response from a member who believed that fair market value in exchange was the proper definition to use and that no continued use definition was necessary, even in the case of an allocation of purchase price appraisal. However, his response did not address the fact that the difference between fair market value in exchange on the tangible assets usually resulted in a high residual value for the intangible assets, which generally is in excess of their most reasonable value contribution. Generally, when a business is purchased at today's high net income multipliers, the price paid is more than value in exchange for the tangible assets. The premium that is being paid represents a turnkey operation.

Experience reveals that there is not always a suitable property for sale in the subject neighborhood of the business being purchased to fit the principle of substitution theory. The principle of substitution states that "when several similar or

commensurate commodities, goods, or services are available, the one with the lowest price attracts the greatest demand and widest distribution.”

Since it is usually impossible to find real and personal property in the condition required, along with the proper degree of maintenance, engineering design and layout that are necessary to go into business, purchasers tend to pay a premium for all assets in order to avoid the expensive startup costs and risk.

Therefore, it is clear that a value-in-use definition is needed. The term should be differentiated from market value or value in exchange in order to avoid confusion in the marketplace, which understands fair market value to reflect value in the open market. A new definition needs to be universally adopted to be used when a value-in-use appraisal is more appropriate than a value-in-exchange appraisal. Value-in-use appraisals would not be appropriate for financing purposes or when a general use property is vacant and for sale on the open market. The definition and its appraisal uses are reserved for business valuation and the allocation of purchase price. In some instances it is proper to appraise business-oriented real estate such as restaurants, hotels, bowling alleys, and the like using the value-in-exchange definition; however, verification of the sales used in the sales comparison approach should include a review of whether or not personal property and/or intangible business value or goodwill were included in the sales price.

Industry Support for a New Definition

The need for a special definition and approach on an in-use value appraisal has been taught for many years in other countries. For example, Great Britain has used the term “going concern value” for many years. Fair market value and going concern value are clearly differentiated. The Royal Institute of Chartered Surveyors (RICS) and the Incorporated Society of Valuers and Auctioneers (ISVA) use the following definition from RICS Guideline 2.1:

Basic accounting concepts postulate that accounts are on a going concern basis, that is to say that the enterprise will continue in operational existence for the foreseeable future. The normal basis of valuation of plant and machinery where the valuation is to be incorporated or referred to in the accounts, etc., of a company should, therefore, be its open market value on the assumption that the plant and machinery will continue in its present existing use in the business of the company. Normally, this existing use basis of valuation will be depreciated replacement cost, i.e., estimated cost as new at the date of valuation including cost of installation less an allowance for depreciation (i.e., wear and tear, age and obsolescence). Account should be taken in the valuation, however, of special factors such as scarcity value; or the possible limitation of value caused by limited natural resources or the building housing its plant having a limited life or being held on a limited tenure or the limited planning consent. Further it is necessary to consider both individual and overall values of this plant.

A similar definition of use-value has been adopted by the American Institute of Real Estate Appraisers and the International Assets Valuation Standards Committee of the European Group of Valuers. This group includes appraisers/valuers from most of the democratic nations of the world.

Excerpts from their guidance notes and background papers reflect their acceptance of the uses-in-value theory:

Guidance Note No. 1—1981

Basis of Valuation

1. The principal objectives of the European Group of Valuers of Fixed Assets (TEGOVOFA), at the present time, are to establish recognized procedures for the valuation of fixed assets—land and buildings: plant and machinery—for the purpose of such valuations being incorporated in financial statements or being used for purposes associated with such statements.

Valuation of Land and Buildings

3. There are two recognized bases of valuation of land and building, namely: Market Value; Replacement Cost.

Guidance Note No. 8—1982

The Valuation of Plant and Machinery-Basis of Valuation

The normal basis of valuation is the amount of the value on the assumption that it will continue to be used for the existing purposes by the owners.

This amount for the existing use is normally the net replacement cost which is the estimated cost new at the date of valuation, plus the cost of installation, less the amount of depreciation for age and obsolescence.

Background Paper No. 9—May 1985

Concept of the Value of Fixed Assets to the Business

2. The fixed assets form part of the undertaking and their value to the business will be in their continuing use for the purpose of the current activities of the business. The value of a fixed asset to the business is sometimes described as the deprival value, which is the cost to the business of replacing the particular asset as if the ownership had been lost. This is also expressed as net current replacement cost.

Background Paper No. 10—May 1985

The Depreciated Replacement Cost Basis of Valuation

1. The value to the business of properties which come within the category of those rarely, if ever, sold in the open market for their existing use can only be arrived at on the basis of depreciated replacement cost. Examples of the types of properties to which this basis will apply are:

1.1 oil refineries and chemical works where usually the buildings are no more than structures or cladding for a highly specialized plant;

1.2 power stations and dock installations where the buildings and site engineering works are related directly to the business of the owner and it is highly unlikely that they would have a value to anyone other than a company acquiring the undertaking;

1.3 properties located in particular geographical areas for special reasons or such a size, design or arrangement as would make it impossible for the valuer to arrive at a conclusion as to value from the evidence of open market transactions.

6. The Valuer should qualify every valuation prepared on a depreciated replacement cost basis as being subject to the adequate potential profitability of the business compared with the value of the total assets employed.

Guidance Note No. 3—February 1986

The Valuation of Land and Buildings

1. The basis of valuation of land and buildings as fixed assets for financial statements must reflect the fact that these are in continuing use by the undertaking for the purpose of its current activities.

In accountancy, the value of a fixed asset to an undertaking is:

- a. net current replacement cost, or, if a permanent diminution in value to below net current replacement cost has been recognized,
- b. recoverable amount.

2. Net current replacement cost represents the cost of replacing or recreating the particular asset in its existing condition. Conceptually, the valuer should approach the assessment of net current replacement cost of land and buildings on the basis of:

- a. value in the open market, or where a market value cannot be assessed,
- b. depreciated replacement cost.

Guidance No. 10—February 1986

The Valuation of Plant and Machinery

3. Where suitable market evidence is readily available, net current replacement cost can also be regarded as the cost of acquiring in the open market a similar asset, with the same remaining economic working life as the existing asset, plus an amount equal to the depreciated replacement cost of the installation of the existing asset. The valuer should report any net current replacement cost amount as subject to the adequate potential profitability of the undertaking having regard to the value of the total assets employed.

*Background Paper 3—May 1987***The Valuation of Land and Buildings**

1. Guidance Note No. 3 emphasizes that the valuation of land and buildings for financial statements is for the particular purpose as stated in paragraph 1. It is not necessarily the same amount as the asset might be expected to realize if sold on the open market separated from the undertaking which owns and uses the asset in its business.

4. There are certain types of land and buildings which are rarely (if ever) sold for a continuation of their current use, except by way of a sale of the business in occupation, due to their specialized nature. This may arise from their construction, arrangement, size, location or a combination of these factors. Uniqueness may be due to the nature of the plant and machinery and items of equipment the buildings or other structures are designed to house.

Examples are oil refineries, chemical works, buildings which are no more than cladding for a special plant, and traditional buildings in isolated or unusual locations. In these cases it is not practicable to ascertain a market value as no evidence is likely to exist of transactions involving comparable properties. Therefore such assets generally fall into the category known as "specialized properties," to be valued on a "depreciated replacement cost" basis.

9. In arriving at the market value for this existing use, the expression "existing use" should not be interpreted too narrowly.

*Background Paper C—February 1986***Existing Use Value and Alternative Use Values**

2. Market value for existing use presupposes a continuance of the business and that the property will continue as owner-occupied in its existing use.

Proposed Definition

Based on the support of the foregoing research and papers, it is recommended that the College of Fellows suggest to the members of the American Society of Appraisers the following definition for value-in-use appraisals:

Value-in-use is the market value of a going concern that reflects a value to a particular user, recognizing the extent to which the property contributes to the enterprise and/or profitability of the enterprise. Included in this value are installation costs, engineering design and layout fees, and miscellaneous cost savings resulting from an assembled operation.

Special criteria to be reviewed before completing an appraisal under the value-in-use definition are as follows:

1. Is the property fulfilling an economic demand?
2. Does the property have a remaining useful life?
3. Is there responsible ownership?
4. Would a diversion of the property to an alternate use be economically feasible?
5. Has consideration been given to the property's functional utility?
6. Are the net earnings of the business sufficient to show a fair return on the tangible asset's value?

Special Considerations

One of the conditions that has raised adverse comment is the condition that the business be sufficiently profitable to show a fair return on the tangible asset's value. Although clients often will not provide full financial statements and while some appraisers feel insufficiently trained to analyze them, it is incumbent upon the appraiser to verify that the business is profitable if the property is being sold as part of a going concern. If a client confirms that the business is profitable but will not provide verification, the Statement of Assumptions and Limiting Conditions should include a caveat that the appraisal assumes a profitable business enterprise.

Approaches to Value under Value in Use

Generally, the cost approach is most appropriate for a value-in-use appraisal. However the estimation of depreciation can vary depending on the value definition used. The estimate of physical deterioration and functional obsolescence are the same for value in use as for value in exchange. Economic obsolescence may be treated differently, however. While economic obsolescence due to governmental restrictions, long-term crime or union problems, and/or excessive noncurable taxation should be reflected under either valuation definition, economic obsolescence for lack of marketability due to the type and size of the building or machinery should not be reflected in a value-in-use appraisal. The rationale is that it would not be reflected in an offer by a business purchaser since those attributes are necessary to carry on the enterprise.

In the comparable sales approach, one is valuing a property or asset on the basis of general market sales. In order to adapt this approach for use in a value-in-use appraisal, the value of all special features and fixtures of the subject property must be added to the value supported by sales of general properties without those features and fixtures. Special features for which a user will normally pay a premium include power wiring, pits, drain trenches, crane ways, built-in fixtures, special room layouts, special floor plans, foundations, and numerous other items.

In addition to structural fixtures, there are other assets that should be considered in a value-in-use appraisal. These include such items as additional costs of

financing that were saved by not having to add features and fixtures, and savings on security, insurance, real estate taxes, etc. that would have been necessary if the building had to be specially constructed or remodeled over a long period of time. In addition, there are engineering fees for design and layout plus miscellaneous test-run machinery expenses that a user purchaser receives in a value-in-use valuation. These foregoing items are tangible assets and are a part of the real or personal property value.

Often, there are intangible assets included in a business sale, but they are excluded from this value-in-use definition. The intangible value-in-use assets include the net profit earned during the period of time it would have taken a manufacturer to find, locate, build, equip, test, engineer, and run a manufacturing operation. Those accumulated net profits are valuable, but they should be handled separately from the tangible asset valuation.

Conclusion

The American Society of Appraisers should officially endorse the definition of value in use for specific types of appraisals. It is a necessary addition to the definition of fair market value, which has been made generic by its long-term universal use. It is the desire of the College of Fellows that this definition be adopted universally within the appraisal community.