

Machinery and equipment appraisals: they're all about levels of trade

Appraisal expert provides tips for several scenarios



By Jack Young,
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Every machinery and equipment appraiser is most likely familiar with the phone call — “I’ve got some equipment that I need to have appraised. How much will it cost?”

And every appraiser should answer that question by saying something like, “The cost of an appraisal always depends on what kind of appraisal, location, volume and type equipment we are talking about.”

The answer to the “how much” question depends not only on the amount and location of the equipment, but, just as importantly, on what machinery and equipment appraisers call “premise of value,” also referred to as “levels of trade.”

Beyond knowledge of the location, volume and type of equipment, there are two questions I need answered right away:

1. What is the purpose of the appraisal? Or more directly put by our good friend Roger Durkin, ASA, of Durkin Valuation Consultants, Boston: “When the client has the appraisal in hand, what are they going to do with it?”

As we all know, the reasons for an appraisal can be varied and multiple. Will the appraisal be used for collateral values in a loan, in an attempt to settle a loss claim with an insurance company, or to resolve a family law matter? A clear answer to this first question is crucial because that answer leads directly to the next

question:

2. What premise of value will best meet the needs of the purpose of the appraisal, the answer to question No. 1?

Premise of value is a very interesting aspect of the machinery and equipment appraisal industry. Because we machinery and equipment appraisers deal with a variety of assets, most of which can be moved or sold in many different markets, or trade levels, it is necessary to recognize that items have different values depending on which market they’re sold within. When we look at premise of value, or what some appraisers call levels of trade, we are determining the basic marketplace that one is presuming in the valuation.

I prefer the term “level of trade” to “premise of value” because clients seem to understand the meaning more clearly. Also, “premise of value” has a different, specific meaning to business valuation appraisers than it does in the equipment and machinery arena. Whatever term you prefer, levels (or premises) can be broadly divided into categories, which are distinguished mainly by an asset’s anticipated use.

Four trade levels

Generally, we have four major levels of trade with various subsections within each. These levels are liquidation, sale for removal, continued use, and, of course, the catch-all category “other.” Once we determine and confirm which of these values will be used in an appraisal, the Uniform Standards of Professional Appraisal Practice (USPAP) requires that the report “identify the type and definition of value.” Being diligent in defining the definition of value used in the

appraisal report is not just a good idea for compliance with USPAP, it is critical in preparing an understandable and useful report.

Liquidations

Forced and Orderly Liquidation values refer to what an appraiser terms “compelled sales,” as neither assume a willing seller. We often see these sales in bankruptcy, repossession, divorce and for certain other legal situations. The compelling difference between the two is that a Forced Liquidation scenario assumes a “sense of immediacy,” while an Orderly Liquidation scenario assumes “a reasonable period of time to find a purchaser(s).”

In some cases, there may not be a lot of difference between the final values when using these two premises. For many standard items of equipment, such as a John Deere 6330 tractor, for example, a properly advertised auction could produce the same value under both scenarios. With more specialized equipment; however — especially in a case where the center of industry may be thousands of miles away and there are a limited number of specialty buyers — there can be quite a difference in the price received by the seller who is “given a reasonable period of time to find a purchaser” and one who is “compelled to sell with a sense of immediacy.”

Below is an example of the probable difference in value, assuming liquidation on specialty manufacturing equipment such as a LOH Model RF3A Automatic Curve Generator with attachments, tooling and upgrades. This is a piece of equipment generally used in the manufacturing of high precision optical equipment.

Scenario No. 1: Forced Liquidation

This item is being sold at auction to the highest bidder regardless of price, and the buyer must remove it from the premises within five days of purchase. The auction is 25 days from now, meaning there are 25 days to market the item. There is no time to advertise the item in any trade journal, identify and locate the key wholesale buyers or to properly market the item in a manner that is usual and customary for the industry.

This is one example of a Forced Liquidation Value, which is defined as the estimated gross amount expressed in terms of money that could be typically realized from a properly advertised and conducted public auction, with the seller being compelled to sell with a sense of immediacy on an as-is, where-is basis, as of a specific date. (American Society of Appraisers, Appraising Machinery, second edition)

Scenario No. 2: Orderly Liquidation

In this scenario, the same item is being sold through a liquidator (possibly an Auctioneer) who identifies and contacts several of the key dealers around the country and tells them about the item in great detail. The item is properly marketed in a manner that is usual and customary for the industry, including advertisements in trade journals, etc. In addition, the buyer generally has a more flexible time frame during which to remove the item. In this scenario, the seller has about 90 to 120 days to have the items sold and removed. Although the price received will still likely be a wholesale price, it is likely to be higher than the Forced Liquidation Value scenario above.

This is an example of an Orderly Liquidation Value, which is defined as the estimated gross amount expressed in terms of money that could be typically realized from a liquidation sale, given a reasonable period of time to find a purchaser(s) with the seller being compelled to sell on an as-is, where-is basis as of a specific date. (American Society of Appraisers, Valuing Machinery, second edition)

It's worth emphasizing that even when the appraiser and client agree on a level of trade, they may still have different values in mind. I recently provided an appraisal report on the assets of a specialty manufacturing company using Orderly Liquidation Value, as discussed and as specified in our agreement. After receiving the report, the bank for which the equipment appraisal was done contacted me, concerned that the in-house appraisal department was finding values considerably lower than those I had submitted. When I spoke with the in-house appraiser, we realized that they were looking at figures from forced liquidation auctions. After we got our definitions aligned, everything was fine. The moral of the story is to be clear and thorough when providing definitions of value used in the appraisal report.

The next "level"

The next level of trade is most often referred to as Sale for Removal. With this category, we move into the many different types of fair market value and an almost dizzying list of definitions. Roger Durkin once told a group that the U.S. Bankruptcy Code has more than 30 different definitions of market value. To complicate matters, these days, appraisers can be caught in a confusing landscape lacking clear and universally accepted definitions as the Financial Accounting Standards Board (FASB) moves toward International Accounting Standards by adopting Fair Value Accounting. In this environment, it becomes critical that appraisal reports clearly define and explain the terms being used. It may help to keep in mind that generally the key aspect in this category is the assumption of both a willing buyer and willing seller with equity to both.

Here are a couple of examples:

Scenario No. 1: Internal Revenue Service Fair Market Value

A client calls requesting an appraisal for some welding equipment being donated to a local nonprofit vocational rehabilitation center. The client's tax preparer told the client that she needs a qualified appraisal in order to list the

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In this case, you are appraising the fair market value based on the IRS definition — the price that property would sell for on the open market. It is the price that would be agreed on between a willing buyer and a willing seller, with neither being required to act and both having reasonable knowledge of the relevant facts. If a restriction is put on the use of property donated, the fair market value must reflect that restriction. (IRS Publication 561)

Scenario No. 2: ASC 820 Fair Market Value, Assets In-Exchange

As part of a client's upcoming financial statement audit, in order to comply with ASC 820 (formerly SFAS 157), the business needs an equipment appraisal of a recently acquired manufacturing plant. Some of the newly acquired installed manufacturing equipment is redundant and will be sold. Some of it, though, will be kept in use.

ASC 820 dictates that the appraiser not value all of the newly acquired equipment assuming the same level of trade. The equipment to be kept in use will require an appraisal of Fair Market Value in Continued Use, which will be discussed in the next section, while the redundant equipment should be valued as "In-Exchange," assuming it will be sold on a stand-alone basis, independent of the other assets in the newly acquired manufacturing plant.

Continued Use and Fair Market Value

Fair Market Value in Continued Use assumes that the assets being appraised will remain in place and in their relative current utility. Often these types of appraisals are needed for such events as business property taxation, due diligence relative to an acquisition or accounting purposes. The key in these cases is the ability to include installation costs in the valuation.

Scenario No. 1: ASC 820 Fair Market Value in Continued Use for financial statements prepared under Generally Accepted Accounting Principles (GAAP)

The same company above, with assets held for sale relative to the business acquisition, also has equipment that it is going to keep in use, and it needs that equipment valued under ASC 820 for its financial statement audit.

ASC 820 Fair Market Value in Continued Use for GAAP is defined as the estimated amount, expressed in terms of money that may be reasonably expected for a property in an exchange between a willing buyer and a willing seller, with equity to both, neither under any compulsion to buy or sell, and both fully aware of all relevant facts, including installation as of a specific date and assuming that the business earnings support the value reported. This amount includes all normal direct and indirect costs, such as installation and other assemblage costs to make the property fully operational. (ASC 820 (formerly SFAS 157))

Scenario No. 2: Fair Market Value in Continued Use

A client calls and needs an appraisal for purposes of an internal stock transaction of a closely held corporation. The transaction is to be based upon the asset value of that company. The subject assets are several network computer systems that are installed at several locations around the region. Right off the bat you realize that a lot of the costs are associated with installation, set-up and testing. (This also may be a good time to consider cost approach to value, but that topic is beyond the scope of this article.) Fair Market Value in Continued Use is the estimated amount, expressed in terms of money, that may reasonably be expected for a property in an exchange between a willing buyer and a willing seller, with equity to both, neither under any compulsion to buy or sell, and both fully aware of all relevant facts, including installation,

as of a specific date, and assuming that the earnings support the value reported.

As you can clearly see, these definitions are very similar. Because it is important to get the right definition for the particular intended use, it may be well worth your while to have a discussion with the company's accountant or auditor to ensure that everyone is in agreement regarding the exact definition in use.

Lastly, we have the "other" premises of value. For the most part these situations deal with specific definitions stipulated in contracts and insurance policies. Stock purchase agreements in closely held corporations may have specific language stating how assets are to be valued. Insurance policies often state how loss claims are to be calculated.

Answer the question

So when you get the inevitable call — "I've got some equipment that I need to have appraised. How much will it cost?" — you will now know not to answer until you have a good understanding of the appropriate premise of value. From there, you'll be able to prepare a report that meets the intended use of the client.

Determining that level of trade will most likely involve good communication with the intended users of the appraisal as well as a good understanding of the values used in professional appraisal practice today. And, of course, you will be sure in your USPAP compliant reports to "identify the type and definition of value" being used within the broad and varied valuation options available to an equipment and machinery appraiser.

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