

READING

ASSET ANALYSIS

Current Assets

Current assets are expected to convert to cash within 12 months or within the normal operating cycle of the business. A temporary investment in current assets, to be converted to cash within one year, usually is financed by short-term bank debt and accounts payable (suppliers). A permanent investment in current assets, which may be converted to cash but requires reinvestment to maintain the viable core business, is financed either with long-term debt or the firm's net worth. Current assets are listed on the balance sheet in relation to their liquidity or convertibility to cash. Cash, which is the most liquid asset, is followed by marketable securities, accounts receivable (which must be collected to be converted to cash), and inventory (which, when sold, usually becomes cash or an account receivable that, when collected, is converted to cash).

Cash

The cash account includes petty cash a business keeps on hand to process transactions that cannot be paid by check or credit card. Most business operating cash is held in checking accounts, either non-interest-bearing or interest-bearing accounts.

Although cash holdings generally are small in comparison to other current assets, it is worthwhile to determine their availability as a source of funds for a business. Also, the level of cash provides some insight into the philosophy of the firm's management. For example, a conservatively managed company may keep a larger balance of cash on hand as a hedge against unforeseen developments. A lender should be careful and avoid making decisions based solely on high cash volumes, because the cash may be used to fund operations when problems begin.

Because the level of available cash can vary from day to day, looking at the average cash balance in the company's bank accounts usually provides a more realistic figure. When assessing the cash available to a business, a lender discounts cash held at banks to satisfy a minimum requirement to avoid service charges or as a pledge against existing debt (sometimes called **compensating balances**).

Compensating balances

The balance that a customer must keep on deposit with a bank to ensure a credit line, to gain unlimited checking privileges, and to offset the bank's expenses in providing various operating services.

Most businesses need a minimum amount of cash to operate. This minimum varies by the type of business. With \$22,000 on hand, Dry Supply's cash seems adequate for this type of business.

Marketable Securities

For most businesses, marketable securities represent temporary investments of excess funds in U.S. government or high-grade corporate stocks and bonds. For balance sheet purposes, investments in a closely held business, an affiliated business and low-grade public companies are considered noncurrent assets and listed as *other securities*. Because an investment in a closely held business is not readily marketable, converting it to cash usually takes longer than one year. Similarly, most affiliated businesses are also closely held, with ownership that is not readily marketable, plus the tendency to maintain the affiliation for longer periods of time than one year. Low-grade stocks are generally those valued at less than \$1 per share, at low trading volumes or listed on a regional or informal stock exchange.

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To be listed as a current asset, the intent must be to sell or to cash in the marketable security as it matures in the coming year and use the proceeds in operations. If the securities continue to be held, the business banker asks the following types of questions:

- Does the company truly have excess funds for investment?
- Are the securities subject to decline in value due to trading or interest rate risk?
- Is the company borrowing money from the bank to carry the securities?

Business tax returns list marketable securities in two categories—U.S. government obligations and tax-exempt securities. They are positioned below accounts receivable and inventory in the listing of assets on Schedule L in the tax return or balance sheet.

Accounts Receivable

Accounts receivable include amounts owed as of the balance sheet date from customers of the business resulting from extensions of credit for the products or services of the business. The account debtor is the party responsible for paying the accounts receivable. Because they take time to collect (usually 30 to 90 days) and because they may never be collected, accounts receivable are considered less liquid than cash and marketable securities. For accounting purposes, *trade accounts receivable* are created by a business when credit is granted for selling a product or rendering a service only. Credit extended to officers, employees, affiliates, or for the sale of other assets is considered *other receivables* and should be listed as a noncurrent asset on the balance sheet.

In addition to being a less liquid form of current assets than cash and marketable securities, accounts receivable are also riskier since they must be collected before cash is available to repay debts. Further, the size of this balance sheet account, as well as the corresponding credit quality, is of great interest to a business banker because accounts receivable often are used as collateral for bank loans.

The size of accounts receivable is a function of sales growth and credit terms the business offers. If accounts receivable have increased rapidly, a business banker looks first at the income statement to determine whether or not there has been a corresponding increase in sales. If not, then the increase may be attributable to a liberalization of credit terms or the lack of good collection efforts. If the borrower is relying on the collection of these receivables to repay bank debt, an increase in the outstanding receivables without a corresponding increase in sales poses a greater risk of delayed repayment or even non-repayment of bank debt.

Business tax returns include trade notes receivable along with accounts receivable as listed in the balance sheet. If the business maintains an *allowance for bad debts* (discussed later in this course), this amount is subtracted from accounts receivable on the tax return balance sheet.

For Dry Supply, the company's accounts receivable and sales have remained level. Apparently, new and existing customers are offered similar terms.

The illustration on the following page shows the income statement for spread Dry Supply. Sales have been fairly consistent at about \$900,000 for the three years shown. Accounts receivable show a similar pattern over the three years shown.

DRY SUPPLY FINANCIAL STATEMENT SPREAD

Income Statement Spread: Dry Supply						
Income Statement (\$ in 000s)	Review 20xx		Review 20xy		Review 20xz	
	Amount	%	Amount	%	Amount	%
Net sales	\$895	100.0	\$937	100.0	\$918	100.0
Cost of goods sold	645	72.1	667	71.2	631	68.7
Gross profit	250	27.9	270	28.8	287	31.3
Selling, gen. and admin. expense.	157	17.5	173	18.5	180	19.6
Officer's compensation	36	4.0	31	3.3	28	3.1
Rent expenses	15	1.7	18	1.9	20	2.2
Bad debt expense	2	0.2	1	0.1	0	0.0
Profit sharing expense	7	0.8	7	0.7	0	0.0
Depreciation expense	12	1.3	12	1.3	13	1.4
Total operating expenses	229	25.6	242	25.8	241	26.3
Operating income	21	2.3	28	3.0	46	5.0
Other income	0	0.0	0	0.0	0	0.0
Interest income	2	0.2	2	0.2	2	0.2
Rental income	3	0.3	3	0.3	3	0.3
Interest expense	6	0.7	7	0.7	11	1.2
Net profit before tax	20	2.2	26	2.8	40	4.4
Taxes	11	1.2	12	1.3	17	1.9
Net profit after tax	\$ 9	1.0	\$ 14	1.5	\$ 23	2.5

Accounts receivable aged listings and concentrations

An aged listing of accounts receivable (often called an aging or ageing) is simply a list of the customers to whom the company sells, the amount owed by each, with the length of time the amount has been outstanding. This listing helps identify older and past-due receivables, plus any concentrations.

When reviewing an aged listing of accounts receivable, lenders must know whether the list was prepared from the invoice issuance date or the due date. The preferred format is from the invoice date, so if 30-day terms are offered to customers, accounts are not past due until shown in the “31-60 day” column, which follows a “1-30 day” column. If aged from due date, those same accounts are past due if shown in the “1-30 day” column, which follows a “current” column. The aged listing also should include the customer address, phone number and contact person—information needed to facilitate collection in liquidation situation.

A primary consideration is the overall trend in amounts in the different aged columns. If the proportions of accounts in the older columns are increasing, then the overall age of the receivables is getting older. The older the receivables, the less likely they will be paid. Further, accounts that are severely past due (usually 90 days past due) may never be collected. For such delinquent accounts, many lenders discount the value of any receivables generated from more recent sales. This exclusion is called a cross-aging.

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A business banker also must be sensitive to concentrations, generally defined as individual customer receivables exceeding 20 to 25 percent of the total receivables. Both concentrations and relative age of receivables influence credit risk. In most situations, the more diversified the customer base of a business, the less likely a few defaults will severely affect the ability of the business to generate cash.

A high concentration in accounts receivable makes the business economically dependent on those concentrations. If the business loses a large customer, the effect is felt more deeply in the income statement, and the sales volume may be more difficult to replace with multiple customers. With some businesses, such concentrations may be difficult to avoid, or even a strategic decision by management. The business banker should assess the scope of concentrations and the relative risk involved.

Another risk is dealing with a large account where invoices remain unpaid or are paid late. A few larger accounts generally pose more risk, compared to a larger base of small accounts. Smaller accounts are not always preferable, if any resulting unpaid accounts are so small that they do not justify the costs to collect them. Also, smaller firms with smaller accounts may have more credit risk than larger firms with larger accounts.

In analyzing a company's accounts receivable, a business banker looks beyond the mere numbers involved and considers the following several key characteristics of the customers:

- Credit quality
- Length of relationship
- Size of relationship
- Adherence to payment terms

Beyond the risk of concentrations and relative age of accounts receivable, a lender should inquire about any written or unwritten agreements about those accounts. For example, if the owners of a retail furniture store agree to supply their external accountant with office desks and chairs in exchange for services, the payment of the receivables is not collected as cash, but rather as the value of work done (a form of bartering). Where such agreements exist, accounts receivable may be offset by entries to trade payables. This example shows that the amount of receivables does not always represent cash to be collected.

The illustration on the following page shows an *abbreviated listing* of the accounts receivable for Dry Supply at the end of 20xz. About 90 percent of Dry Supply's receivables are 30 days old or less, and the accounts shown appear to be paying in a timely manner, since they have few invoices older than 60 days. Only 2 percent of all accounts were seriously delinquent. Assuming that its credit terms are 30 days, Dry Supply's accounts receivable appear to be of a good quality. Furthermore, with access to the entire list, you can determine if there are any concentrations of receivables. Even without the entire list, problem or delinquent accounts are small and pose little risk. For the one account shown that is over 90 days past invoice issue date, Dry Supply appears to have not been making current sales until the delinquency is resolved. Or, it could be that current sales to Anytown Quick Clean have been paid and an older sale is under dispute.

Abbreviated Accounts Receivable Aged Listing for Dry Supply as of December 31, 20xz (from invoice date)				
Customer	0-30 days	31-60 days	61-90 days	Over 90 days
ABC Cleaners	\$ 4	\$ 6		
Anytown Quick Clean				\$ 1
Better Cleaners		\$ 1	\$ 1	
Cleaners R Us	\$ 8	\$ 1		
...
...
...
Yours Next	\$3			
Total	\$105	\$ 8	\$ 2	\$ 2

Allowance for Doubtful Accounts

Businesses have two options for handling accounts that are determined to be uncollectible:

- **Direct write-off**—Uncollected receivables are recognized as a bad debt expense on the income statement. Sales that occurred in a prior period may not be written off until a subsequent year, causing a potential overstatement of profits in the earlier year and understatement in the later year. Also, earnings can be more volatile if large amounts of write offs occur at the same time, followed by periods of fewer write offs
- **Establish an allowance for doubtful accounts**—To reduce earnings volatility (potential overstatements and understatements of profits), many businesses using the accrual method of accounting will establish an allowance for doubtful accounts, where the amount of the bad debt expense to the income statement usually is determined by considering the historical losses and the quality of existing accounts receivable. The bad debt expense is actually a provision for bad debts that is added to the allowance account. Then, as accounts are deemed uncollectible, they are charged off and the reserve is decreased

The amount of write offs (net of recoveries) is calculated in the following way:

$$\begin{aligned}
 & \text{Previous year-end balance, allowance for doubtful accounts} \\
 & + \text{current year bad debt expense [provision]} \\
 & - \text{Current year-end balance, allowance for doubtful accounts} \\
 & = \text{net charge offs of uncollectible accounts receivable}
 \end{aligned}$$

Whether the business uses direct write offs or an allowance, the percentage of charge offs each year not only help to assess the quality of the customer base of a business, but also the effectiveness of credit and collection procedures. For 20xz, Dry Supply has no current year bad debt expense (\$0) and its current year allowance for bad debt is the same as the previous year-end (\$5,000), resulting in no charge offs of uncollectible accounts receivable during 20xz.

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Inventory

Inventory consists of merchandise purchased for resale, or finished goods manufactured and held for sale, together with related raw materials and work-in-process. In general, inventory is intended for internal consumption or sale. Raw materials, work-in-process, and finished goods are the three basic components of inventory. If the financial statement or tax return does not provide a breakout of these components, the business banker should get this information from the customer. In addition, the business banker needs to know the **inventory valuation method** used. Depending on the method used, inflation, or rising product costs can have a differing impact on reported earnings.

Because businesses need liquidity, they often avoid tying up cash by holding excess inventory. In particular, if bank financing is required, holding onto inventory during periods of high interest rates can be expensive. However, if management is concerned about the ongoing availability of raw materials or products, they may decide to purchase large quantities of inventory.

Since the majority of accounts payable are created by purchases of inventory, the level of accounts payable tends to move in the same direction as inventory levels. A business that stockpiles inventory may need to stretch the accounts payable repayment time frame as a source of financing. This is sometimes called “riding the trade.”

Whenever management competes more aggressively by keeping inventory levels high, the risks are that demand for the product will drop suddenly or prices may drop significantly.

Because obtaining goods from overseas often is difficult or entails lengthy delivery times, companies may keep large inventories of items ordered from abroad.

Raw materials inventory

Manufacturers purchase raw materials inventory to use in the manufacturing process. Agricultural, wholesaling, retailing, service, and construction businesses generally do not have significant holdings of raw materials.

Lenders evaluate raw material inventory on the same basis as finished goods—that is, in terms of marketability. The end use of raw materials determines the marketability. Raw materials sold to various industries have better marketability than raw materials used in a single manufacturing process. A manufacturer of custom draperies, for example, carries bolts of fabric and specialized materials for opening and closing drapes. The fabric is readily salable to fabric retailers, but the specialized materials can be sold only to another manufacturer of draperies.

A large raw materials inventory account can result from speculation in inventory due to expected price increases or concern over the potential loss of a supplier or some other type of disruption in supply. A business may try to hedge on prices by buying inventory in bulk at a low price with hopes of selling it later at a higher price, or to avoid having to purchase it at a higher price in the future. If the price of the raw materials, however, decreases unexpectedly, the company may suffer a large loss. For this reason, it is important for the business banker to understand management’s approach to raw materials purchases, especially how they manage price risk.

Inventory valuation methods

The choice of an inventory accounting method is important in determining the collateral value. However, the actual physical flow of inventory is not a key consideration. LIFO charges to expenses the most recent (last-in) cost of inventory because the company has to replace the used inventory at current values or costs. This leaves ending inventory, a balance sheet asset, at an older, lower value, assuming rising prices. FIFO expenses the old inventory costs first and leaves the current value of ending inventory on the balance sheet. Assuming rising prices, FIFO inventory would be valued higher on a balance sheet than LIFO inventory. A third inventory valuation method, the weighted-average method, values ending inventory on the balance sheet approximately half-way between the LIFO and FIFO methods.

Some businesses adjust inventory values up or down to control net profit levels. Although this may be valid, only CPA-prepared audits and reviews provide adequate footnotes to fully explain such adjustments. Sometimes an interim statement uses an estimated number or an unchanged year-end number for inventory. If so, the business banker should question the income statement and balance sheet. The cost of goods sold listed will be inaccurate, and it will not be possible to determine the correct net profit or loss. Any subsequent adjustment to net profit or loss will change the retained earnings on the balance sheet.

READING**Work-in-process**

Generally, as with raw materials, manufacturers are the only type of businesses that have significant levels of work-in-process inventory. From a lender's standpoint, work-in-process inventory is the most problematic. If liquidating inventory, it may be hard to sell since the product is not finished, nor are the materials in a raw state that can be used by other businesses.

Beyond being more difficult to sell, partially completed products have a market value that is less than accumulated costs to produce them. Additional costs are needed for completion and achieving the value of finished goods, and not all purchasers may have the internal capabilities to convert the work-in-process to finished goods. Lenders, therefore, typically do not assign a value to work-in-process inventory as loan collateral.

The amount of work-in-process inventory depends primarily on the length of the production process. With a short production cycle, the value of the company's work-in-process should be small in relation to its raw materials and finished goods inventories. But if the production process is longer and more complex, a more significant portion of a company's assets may be tied up in work-in-process.

A manufacturer of customized products usually has a large work-in-process inventory but a much smaller finished goods inventory—its products are delivered almost immediately to the buyer upon completion. Because the general marketability of custom-made products is low, the manufacturer may require substantial up-front deposits or progress payments while producing the items, to reduce the risk of custom orders not being accepted. For most lenders, custom-made inventory has almost no collateral value due its limited marketability.

Finished goods inventory

Finished goods are salable merchandise. Wholesale and retail finished goods are purchases of a product for resale and are the primary type of inventory. For manufacturers, finished goods inventory includes finished products not yet shipped or sold.

In a service or construction business, consumable supplies used to provide a service or for construction are considered finished goods inventory, but usually are relatively small related to other assets. Occasionally, finished goods for a construction/development (that is, a firm that does not build for its own account, but for others under contract) business include land held for sale or completed buildings for sale. For an agricultural business, finished goods are the harvested crop or livestock.

For many businesses, the risk that finished goods inventory will not sell is related primarily to the style sensitivity or utility of the merchandise. A lender, therefore, assesses a company's inventory account in terms of the present and future marketability of the inventory. Some items have more predictable and longer-term marketability.

For example, an office retailer sells paper and pens that are staple items and hold their value because they are a basic need subject to continuous demand. But if the company's inventory included specialized software that has a limited need and is subject to obsolescence, a sudden drop in market demand could render the inventory worthless. Perishable inventory adds an unusual degree of risk, and a business banker has to move quickly to liquidate product inventory subject to spoilage or requiring refrigeration or freezing.

In evaluating a company's inventory account, a business banker should determine if it includes obsolete inventory that fails to meet market specifics and/or demand. If so, the value of the company's inventory and profits in recent years may have been overstated. Inventory is not expensed until sold or is considered obsolete and written off. Obsolete inventory does not represent liquidity for the company or good collateral value for a lender to support or secure debt repayment. Most companies write off obsolete inventory annually as a part of taking the physical count of the inventory.

In the Dry Supply example, inventory is growing at about the same rate as sales. This means that management is doing a consistent good job of converting products into sales.

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Other Current Assets

Other current assets, including income tax refunds due, are generally insignificant. Categorizing these assets may vary from bank to bank, depending on the bank's method of spreading statements. Dry Supply lists no other current assets, so the line is omitted in the computer-generated spreadsheet.

According to the balance sheet, Dry Supply had the following current assets at the end of 20xx, 20xy, and 20xz:

Current Assets: Dry Supply (\$ in 000s)			
As of December 31st	20xx	20xy	20xz
Cash	\$ 3	\$ 12	\$ 22
Accounts receivable, net	109	113	112
Inventory	73	72	67
Other current assets	0	0	0
Total current assets	\$185	\$197	\$201

While financial statements usually provide a subtotal for current assets, the business tax return format does not.

Noncurrent assets

Noncurrent assets either will not be converted to cash within 12 months (or the normal operating cycle of the business) or may have little or no liquidation value. A prepaid annual, term life insurance premium, for example, is considered by most lenders to be a noncurrent asset because it has little liquidation value. Fixed assets, other securities, notes receivable, amounts due from officers and employees, amounts due from affiliates, prepaid expenses, cash-value life insurance, and intangibles are noncurrent assets.

Fixed assets

Fixed assets—items of a long-term nature required to operate a business—are not expected to convert to cash within 12 months or the normal operating cycle of a business. Fixed assets consist primarily of land, buildings and improvements, equipment, vehicles, furniture, and leasehold improvements used in operating a business. Depending on the type of business, the size of the fixed assets can vary significantly.

In financial statements, land usually is listed along with machinery and equipment and other fixed assets. However, because land is not depreciated, it is listed separately on business tax returns. Similarly, depletable assets (usually natural resources) are listed separately because they are amortized rather than depreciated. Depreciation will be explained later in this reading.

Most manufacturing companies and agricultural businesses must invest heavily in fixed assets before producing that first widget or bale of hay. At the other end of the spectrum, many service businesses begin operations with a comparatively small fixed-asset base. A small law firm, for instance, may have minimal fixed assets—perhaps books, computer equipment and nominal leasehold improvements. Some businesses own their land and buildings; others rent.

READING**Fixed-asset valuation**

In analyzing fixed assets, it is important to consider how they are accounted for on the balance sheet. Issues include the following:

- Cost at which the assets are recorded—All costs needed to bring the fixed asset into operating condition are recorded as part of the cost of the asset. Examples include freight costs, installation costs, and set-up costs that may or may not add value to the asset
- Rate at which the cost is allocated to future periods—A fixed asset's recorded cost is depreciated each year after it is acquired. Depreciation is the process of allocating the cost of the fixed asset (less salvage value, if any) over its estimated useful or depreciable life, whichever is less. A depreciation charge on the income statement is treated as a noncash expense, since no cash has been paid out for the expense

A \$25,000 company car depreciated over five years, for example, could be partially expensed at \$5,000 per year, depending on the depreciation method. Each year, the depreciation is expensed on the income statement, and the company car listed on the balance sheet as a fixed asset is reduced by a like amount. The value on the balance sheet is called book value. Finally, when the asset is fully depreciated, the asset is considered to be without value or to have reached a salvage value below which it cannot fall.

- Record of asset's eventual disposal—If a fixed asset is sold, there can be a gain or loss, depending on whether the proceeds exceed the book value of the asset at the time of sale. Some assets may be fully depreciated, but remain in use in the operations of the business, and may have value in the open market

Depreciation

Companies often calculate depreciation differently for financial reporting purposes than for tax purposes. The following are the two primary methods of calculating depreciation:

- Straight line—To calculate straight-line depreciation, divide the cost of a fixed asset, less salvage value, by its initially estimated useful economic life. This amount is recorded on the income statement as depreciation each year
- Double-declining balance—To calculate double-declining balance depreciation, multiply two times the straight-line rate by the declining asset balance

The illustration on the following page compares calculations for depreciation of a fixed asset that costs \$100,000 and has a useful life of five years, using straight-line and double-declining balance methods. The annual depreciation expense, which appears on the company's income statement as an operating expense, and the asset's value are reduced to zero during a five-year period.

Depreciation Calculation Examples				
Depreciation Method	Straight-Line		Double-Declining Balance	
Cost of asset	\$100,000		\$100,000	
Useful life	5 years		5 years	
Salvage value	\$10,000		\$10,000	
Depreciation/year	20%		40%	
End of Year	Depreciation	Book Value	Depreciation	Book Value
1	\$18,000	\$82,000	\$40,000	\$60,000
2	18,000	64,000	24,000	36,000
3	18,000	46,000	14,400	21,600
4	18,000	28,000	8,640	12,960
5	18,000	10,000	5,148	7,776
Formula	Each year: 20% x (\$100,000 - \$10,000)		Each year: 40% x (Book Value at Beginning of Year)	

The following are accounting entries to record depreciation:

- Debit depreciation expense (as is the case with any expense)
- Credit accumulated depreciation (reduces the value of fixed assets)

Debit	Credit
+ Depreciation expense	+ Accumulated depreciation

Notice that in the above accounting entries cash is not involved. The business pays out cash only when the fixed asset is purchased. Because depreciation is a noncash, tax-deductible expense, it is a tax advantage to depreciate the asset as quickly as possible. Businesses can do this if they have taxable income or can deduct current year losses from a previous year's taxable income (known as a tax loss carry-back) and receive a tax refund. To assist businesses, the Internal Revenue Service (IRS) has published guidelines for how quickly companies can depreciate fixed assets for tax purposes.

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A company may use the straight-line method for internal reporting and a more accelerated method (such as double-declining-balance) for tax purposes. This results in having two different income amounts in a current year. In most cases, the accelerated method initially produces lower taxes due, but ends up giving a business a higher taxable income in the future, if it did not continue to purchase any more equipment and it runs out of depreciation expense. To prevent this situation, Generally Accepted Accounting Principles (GAAP) requires a business using the accrual method of accounting to establish a liability for deferred taxes to offset the actual tax savings. The deferred taxes are essentially a reserve and goes on the balance sheet as a noncurrent liability.

For specific asset categories, the **IRS code on depreciation** specifies the length of the depreciation period (depreciable life) and the depreciation method. Despite this basis for standardization, variations in the way companies depreciate fixed assets make it difficult to analyze the account. Although land is not depreciated, all other fixed assets are depreciated over time. Some may be worth less than reported. Others—primarily land and buildings—usually appreciate and can represent hidden asset value. A business banker, by obtaining current valuations or appraisals to support fixed asset values, can sometimes justify lending to a business where leverage appears higher because the value of land and buildings is understated on the balance sheet.

IRS guidelines define depreciation with the following questions:

What can be depreciated?

A business can depreciate many different kinds of property. The property can be depreciated if it meets all the following requirements:

- It must be owned by the business
- It must be used in the business or held to produce income
- It must have a useful life that extends substantially beyond the year it is placed in service
- It must be something that wears out, decays, gets used up, becomes obsolete, or loses its value from natural causes

What cannot be depreciated?

- Land
- Property placed in service and disposed of in the same year
- Equipment used to build capital improvements
- Inventory
- Repairs and replacements that do not increase the value of property, make it more useful, appreciably lengthen its useful life, or adapt it to a different use

The amount of the deduction depends on the following:

- How much the property cost
- When the owner began using the property
- How long it will take to recover the cost
- Which of the several depreciation methods is used

For more information, see Publication 946, *How to Depreciate Property*

READING**Fixed-asset capacity, efficiency, and specialization**

Business bankers also assess the efficiency, capacity and specialization of fixed assets. Inefficient or technically obsolete equipment limits a firm's ability to compete, unless substantial capital outlays will be made in the near future. Furthermore, outdated or specialized equipment offers little marketability as collateral. A specialized bread-cutting machine, for example, has a lower resale value than a lathe, which can be used by many types of businesses. Idle equipment, however, may indicate that a business can increase future sales-generating capacity without additional **fixed-asset purchases**.

Certain expenses recorded as fixed assets are called capitalized expenses. Costs incurred in overhauling a major piece of equipment usually are capitalized, whereas minor repairs and routine maintenance typically are treated as current year expenses. This treatment depends on the timing of when the benefits will be received. Benefits from a complete overhaul will be received for several years, so they are to the cost basis of the machine and allocated by means of depreciation expense. For a minor repair, benefits are derived in the current period, and the expense is charged against current income.

Leasehold improvements

Leasehold improvements—costs to improve a leased building such as carpeting, special lighting, general renovations and decorating—are not directly expensed on the income statement. They are capitalized on the balance sheet and amortized. Amortization, like depreciation, is a noncash expense, and allocated the fixed asset costs on the income statement over their useful or depreciable life, whichever is less.

An important risk with leasehold improvements is that they usually stay with the building and become the property of the building's owner should the tenant company move to a new location. For this reason, banks generally give very little value to leasehold improvements as collateral. It is not unusual for some retail and service businesses to have leasehold improvements as the largest category of fixed assets. When calculating tangible net worth, some lenders include the discount to the value of leasehold improvements as a reduction to net worth.

Valuing fixed assets

One of the best ways to value fixed assets is to look to credible independent appraisers who have experience in identifying the proper value range of an asset. If a borrower has recently arranged for an appraisal of its physical assets, the appraiser's value can be a starting point.

The following are other resources that lenders use to conduct their own independent valuation:

- Calling companies in the same industry to randomly verify the values presented
- Employing specialized appraisers with experience valuing similar fixed assets
- Contacting the company's insurance agent for current values

A lender explains to the appraiser precisely the type of valuation sought. Valuations are prepared on several bases: liquidation, auction, market value, or replacement value.

Small business equipment purchases*Section 179 Provisions*

Starting with tax year 2002, the long-standing Investment Tax Credit of \$25,000 for small business equipment purchases was renamed and expanded by Congress to \$100,000 and indexed to inflation. By tax year 2008, the write-off had increased (due to inflation) to \$125,000 and was doubled by Congress to \$250,000. In tax year 2010 Congress doubled it again to \$500,000. As a company's purchases of qualifying equipment begin to exceed \$2,000,000 there is a dollar-for-dollar reduction in the deduction allowed.

The following is property that may be written off in the tax year of purchase, rather than depreciated over the asset's useful life:

- Machinery and equipment
- Furniture and fixtures
- Most storage facilities
- Single-purpose agricultural or horticultural structures

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Dry Supply's Fixed Assets

The fixed assets for Dry Supply are summarized below. The company does not own its land or building. Fixed assets are composed primarily of company vehicles and equipment used to test products. With fixed assets heavily depreciated, the lender better understands the request for new equipment.

Also, with the fixed assets depreciated approximately two-thirds, a business banker will want to determine the future fixed asset needs and if the pending loan request includes all needs over the next year or so. In 20xz, Dry Supply added a used delivery truck at a cost of \$15,000. This purchase raises the question of whether the company might need other vehicle replacements in the future.

Dry Supply Fixed Assets						
as of December 31 (\$ in 000s)	20xx		20xy		20xz	
Furniture and fixtures	\$ 76	31.3%	\$ 75	28.8%	\$ 78	28.9%
Leasehold improvements	1	0.4%	1	0.4%	0	0.0%
Transportation equipment	53	21.8%	70	26.9%	85	31.5%
Gross fixed assets	\$130	53.5%	\$146	56.2%	\$163	60.4%
Less: Accum. depreciation	85	35.0%	97	37.3%	110	40.7%
Net total fixed assets	\$ 45	18.5%	\$ 49	18.8%	\$ 53	19.6%
Percent depreciated	65.0%		66.0%		67.0%	

Other securities

Other securities include stock in closely held companies, investments in affiliates and stocks with marginal value. If a publicly held stock falls below \$1 per share, it is usually considered an *other security* because the market has become limited. Also, most investors purchasing low-grade stock generally hold the stock for a long time. Other securities can be listed within *other investments* on business tax returns.

Notes receivable

A note receivable is written with terms for repaying credit extended by a business. It may be used for selling costly merchandise or for resolving slow-paying accounts receivable. Generally, the amount carried for notes receivable is insignificant on a balance sheet. Because the terms are generally more than one year, notes receivable are classified as noncurrent assets.

Due from officers and employees, or loans to shareholders

Due from officers and employees represents loans or advances made by a business to its owners, officers, or employees. These loans are classified as noncurrent assets because often there is less pressure on an owner, officer, or employee to repay the debt on time. It is, therefore, less liquid than debts from other parties and is not considered as having collateral value.

Whenever there is a large change in this account, a business banker should determine the cause. Sometimes, small business owners borrow from the company to inflate earnings (via additional interest income paid to the company) and decrease personal taxes (via additional interest expense incurred by the owner), and also to maintain their lifestyle rather than take a salary. This action, however, would reduce net income and might result in a loss. To avoid payroll withholding taxes, owners also will make a loan to themselves rather than take a salary distribution. Since the amounts are not likely to be collected promptly, they usually are deducted from net worth to determine tangible net worth.

READING**Due from affiliates**

Affiliated businesses are related to each other by common ownership. Due from affiliates represents an obligation of a related business. As with loans to officers, the close relationship between the creditor and the debtor relegates this loan to the status of a noncurrent asset. Without pressure to pay, due from affiliates may not be available for timely conversion to cash. A business banker should obtain and analyze the financial statements of the appropriate affiliated companies in order to assess the quality of this asset, particularly if the amount due from affiliates is large.

Prepaid expenses

Prepaid expenses (sometimes called *prepaid assets*) are items paid but not yet expensed on the income statement. Classified as noncurrent assets, they have little liquidation value for a lender. Many accountants classify prepaid expenses as a current asset, so a lender will need to reclassify the account when spreading financial statements. Examples include insurance premiums paid at the start of the year and rent paid at the first of the month or one or more months in advance.

Cash value life insurance

Cash value life insurance is the amount a whole life insurance policy is worth if the policy is surrendered. It also is added to the amount payable (face value) upon the death of the insured person. Many businesses carry life insurance on the owners or key officers. The company receives the benefit of the cash value and face value. If needed, the company can even borrow against the cash value. It is usually considered a noncurrent asset because it is unknown when the cash value will be realized. Insurance policies, unlike accounts receivable and inventory, generally are not converted to cash during the course of an operating cycle.

Intangibles

Assets with no physical existence are reported as intangibles. Intangibles include many items referred to intellectual property, which has become a specialty area within many law firms. In general, intangibles include the following items:

- Goodwill arises when the purchase price of an acquired company exceeds its book value or the value of its tangible assets. This occurs during a merger or acquisition because a company's good reputation, favorable location or customer base may be of great value, even though they do not appear as an asset account on a balance sheet. The value of intangibles, excluding goodwill (which is governed by regulatory, governmental and SEC rules), generally is amortized over an estimated life of the patent or copyright
- Patents give a company the exclusive right to manufacture a product. The intangibles account reflects only the purchase price of the patent or the legal cost of recording internally developed patents, although the value of a patent for a highly successful product may be greater than these costs
- Trademarks are the registered names of products or services. Trademarks can be bought and sold or licensed in exchange for royalty payments. Although the current value of a trademark may be greater, the balance sheet account reflects the purchase price or legal cost of recording the trademark only
- Copyrights are exclusive rights to make copies, license, distribute or sell a literary, musical, or artistic work, whether printed, audio, or video, etc. Similar to patents and trademarks, the value shown on the balance sheet usually reflects the purchase price or legal cost of obtaining the copyright
- Operating rights include special rights granted by government regulatory agencies. Telephone companies, airlines and television stations are examples of businesses that must obtain operating rights for their geographic areas. Because companies sell or lease these rights, they often represent a value greater than shown on the balance sheet
- Customer lists have considerable operational value; but due to uncertain dollar value, they are classified as intangibles without value

READING

Other than fixed assets, the only noncurrent asset for Dry Supply is cash-value life insurance. Having proceeded through all of the current and noncurrent asset accounts on the balance sheet, the total assets of Dry Supply can now be determined for the following December 31, 20xx, 20xy, and 20xz:

Current Assets + Noncurrent Assets = Total Assets (\$ in 000s)			
December 31, 20xx	\$185	+ \$58	= \$243
December 31, 20xy	\$197	+ \$63	= \$260
December 31, 20xz	\$201	+ \$69	= \$270