With the growing need for business valuation services among accounting firms, performing high-quality valuations has become more important than ever before in meeting expectations and competing for clients.

The most important factor in reaching the true value of a company is simply stated as “having a comprehensive understanding of each factor that goes into the calculation.” Sound like Vince Lombardi? “Yes, this is a football.”

This article includes an overview of capital expenditure (CapEx) and operating expenditure (OpEx), as well as considerations for how best to utilize these numbers in valuation engagements.

**A Brief Overview of CapEx and OpEx**

A company uses certain funds, most commonly known as CapEx, to acquire or upgrade physical assets. The cost of the capital items is first recorded on the company’s balance sheet as assets. Then, it appears as a depreciation expense on the income statement for each year of the asset’s depreciable life. Some examples of CapEx are building upgrades, software purchases, and new office equipment.

Any costs incurred in bringing the asset into its present location and condition are also considered, so even product delivery, installation, and replacement, if necessary, are categorized as a capital expense. Companies and organizations normally designate specific criteria that must be met for an acquisition to qualify as “capital,” such as a minimum useful life (usually one year or more) and a minimum purchase price.

Someone fresh to finance might confuse CapEx for OpEx. Operating expenses are shorter-term funds used to meet the day-to-day costs of running a business, such as utility costs or asset repair. Although it can be difficult to determine the difference, a simple way to distinguish the two is as follows. If the funds do not contribute value to the property and equipment of a business, then they should be classified as an operating expense.

**CapEx vs. CapManEx**

According to Equicapita, the effect of CapEx on a company’s valuation is dependent on the category of CapEx being spent by the company. CapEx can be used for either a company’s maintenance or growth purposes. Capital maintenance expenditures (CapManEx) represent the replacement, renewal, or restoration of assets. A company that uses most of its annual CapEx to maintain production usually has a lower valuation than a company that does not have high annual maintenance costs.

**Working Capital**

Working capital is commonly known as the difference between current assets – items that are cash or can quickly be converted to cash – and current liabilities, meaning debt obligations due within a year. It refers to the cash a business needs for its daily operations and is a common measure of a company’s liquidity, efficiency, and overall health. If a business requires large amounts of working capital, a valuation of that business is typically lower.

**An Alternative Approach**
Aswath Damodaran, a valuation expert and professor of finance at NYU’s Stern School of Business, offers a new look at CapEx and working capital. Accounting standards in the United States require the treatment of research and development (R&D) as operating expenses, but Damodaran suggests that they should be considered as CapEx. He argues that R&D is more long-term than investments in a company’s physical space and equipment.

Additionally, the expert explains that working capital should be defined not as the difference between current assets and current liabilities, but as the difference between noncash current assets and nondebt current liabilities. Also, he opts not to factor cash into working capital because it is considered to be an asset that does not lose value over time, unlike other assets, such as vehicles and machinery.

Whether you take Damodaran’s advice or not, your assessment of a company’s value must be well-documented and carefully approached, both to ensure accuracy and to create growth opportunity for your practice. Following a consistent process can reduce errors and create a repeatable system that can be used for other valuation clients.

For research-intensive businesses, considering R&D as a capital expense, for example, can have profound effects on the financial snapshot of a business. It is important for valuation experts to know how each aspect of a company’s finances – including the method of calculation – can impact the final valuation.

For the full story featuring Sageworks, visit Accounting Web - Understanding the Need for Clarity in Business Valuation.