CRACKING THE RATE MODEL

Part One: Depreciation & Amortization: The Forgotten Piece

In this four-part series I will discuss the rate model, how it can be broken down into individual parts and how this knowledge can be applied to the way you negotiate your rates. As business advisors in the forestry industry, this is an area we focus on to help our clients be competitive and profitable. I will discuss the parts of the model where I see clients succeed in calculating as well as the parts missed most often when clients attempt to put together a model on their own. Miss just one part of the model and your results can be disastrous.

Top of the list for forgotten items in the rate model is depreciation and amortization. Many models I've seen are great cash-based models with many costs covered. However, they rarely have the wear and tear on the equipment factored in. Models built like this are bound to fail in the long-term because what happens when the gear is tired and you have little or no profit available to reinvest in new gear?

Depreciation and Amortization - What is it?

Depreciation and amortization are different words for the same thing—an assignment of an assets' costs over its useful life to give a representation of the cost of the wear and tear on an asset each year. For example, if a business purchases an excavator with a cost of $500,000 and it is expected to be used for 10 years, the business might have depreciation expense of $50,000 in each of the ten years. (The amounts can vary depending on the method and assumptions used.)

What's the Right Way to Calculate it?

There are a variety of ways to calculate depreciation, but they all start at the same place—the original cost of the equipment. This original cost may include all costs needed to get the equipment operational including purchase price, financing costs and shipping. The most common method used for rate models is the straight-line method. This method takes the original cost less any salvage value and spreads it over the useful life of the equipment. The useful life and salvage values are assumptions determined by your past experiences with similar equipment and the market trends for used equipment.

The second method used is the declining balance method. This method takes the undepreciated cost base and

multiplies it by a rate based on the life of an asset. Generally rates of 20-30 per cent are used for equipment (in line with Canada Revenue tax depreciation rates). The difference with this model is the amount depreciated gets smaller and smaller each year compared to the first method where it remains steady for the life of the asset.

How Does it Affect the Rate Model?

Depreciation can make or break a rate model. A model not properly showing depreciation can be deceptively profitable when in reality it is a loser. By including depreciation in the model you are giving the model a representation of the wear and tear on the equipment being used. This is not the actual maintenance and repair costs; these are reflected elsewhere on the model. This is the devaluation of the equipment as it is used to log. Any good rate model should have this cost represented in one form or another; by omitting it you are only fooling yourself. People are quite often shocked at the large effect depreciation can have on a rate model when it is added to an existing model.

Questions to Consider When Building the Depreciation Part of the Puzzle

- What is the equipment purchase price?
- Is it in Canadian dollars? If not, will exchange rate changes affect the purchase price?
- Is shipping built into the purchase price or is it extra?
- What is the useful life of the equipment under a regular maintenance and operating schedule?
- Will the equipment have any value at the end of its useful life?
- Does the equipment have other uses or is it solely used for the purpose the model is being prepared for?

These are a small sample of some of the questions you should consider when building depreciation into a rate model.

Next time you're working to determine the fair rate model for your equipment remember to factor in depreciation and amortization. A model including these is a far better model than one without. Don't let anyone fool you into believing otherwise.

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