INTRODUCTION

The asset-based approach is also commonly known as the cost approach or the replacement cost approach. Sometimes you may even see this approach called the asset accumulation approach. In this approach, each component of the business is valued separately. This also includes liabilities. The asset values are totaled, and the total of the liabilities is subtracted to derive the value of the enterprise.

The valuation analyst estimates value by adjusting the asset values of the individual assets and liabilities of the business to fair market value. Some valuation analysts will use this approach for the tangible assets only and consider it to be complete. In fact, I used to do this. However, as we get older, we get wiser. This approach, like the market and income approaches, is intended to value the entire company. This means that the tangible assets, as well as the intangible assets, should be valued and the liabilities subtracted. You may have to use other approaches to value the intangible assets, but I will discuss that later. If you only use this approach to value a company, you could overstate the value of the business as a going concern because if there are insufficient earnings to support the asset base, you will end up with a higher value under this approach than the other approaches.

I used to think that valuing the tangible assets and liabilities would result in a “floor” value for an enterprise being valued as a going concern. I hate to admit it, but I was wrong. The purpose and function of the assignment (remember that from the beginning of this book?) has a lot to do with whether it can truly be a floor value. I will address this in greater detail later in this chapter.

COMMON APPLICATIONS OF THE ASSET-BASED APPROACH

The asset-based approach is most commonly applied to the following types of business valuations:

- Not-for-profit organizations
- Holding companies
- Manufacturing companies
- Asset intensive companies
- Controlling interests that have the ability to liquidate assets

In all of these instances, the valuation subject will have most, if not all, of its value in its tangible assets or identifiable intangible assets, such as copyrights, patents, or trademarks. Intangible assets, such as goodwill, will not play an important role in the value of this type of enterprise. If goodwill or another type of intangible value exists, it will be added to the value.

This approach is generally not used for the following types of business valuation assignments:

- Service businesses
- Asset light businesses
- Operating companies with intangible value
- Minority interests, which have no control over the sale of the assets

Service businesses and asset light businesses generally get the bulk of their value from intangible assets. Therefore, it seems logical that the asset-based approach would not be an effective means of valuing these types of entities. Operating companies are generally valued based on the ability of the company to
generate earnings and cash flow and, therefore, rely on a market or income approach for the
determination of their value. If you recall, Revenue Ruling 59-60 indicates the following in Section 5:

Weight to Be Accorded Various Factors. The valuation of closely held corporate stock entails the
consideration of all relevant factors as stated in section 4. Depending upon the circumstances in each
case, certain factors may carry more weight than others because of the nature of the company’s
business. To illustrate:

(a) Earnings may be the most important criterion of value in some cases whereas asset value will receive
primary consideration in others. In general, the appraiser will accord primary consideration to earnings
when valuing stocks of companies that sell products or services to the public; conversely, in the
investment or holding type of company, the appraiser may accord the greatest weight to the assets
underlying the security to be valued.

(b) The value of the stock of a closely held investment or real estate holding company, whether or not
family owned, is closely related to the value of the assets underlying the stock. For companies of this
type, the appraiser should determine the fair market values of the assets of the company. Operating
expenses of such a company and the cost of liquidating it, if any, merit consideration when appraising
the relative values of the stock and the underlying assets. The market values of the underlying assets
give due weight to potential earnings and dividends of the particular items of property underlying the
stock, capitalized at rates deemed proper by the investing public at the date of appraisal. A current
appraisal by the investing public should be superior to the retrospective opinion of an individual. For
these reasons, adjusted net worth should be accorded greater weight in valuing the stock of a closely
held investment or real estate holding company, whether or not family owned, than any of the other
customary yardsticks of appraisal, such as earnings and dividend paying capacity.

Minority interests will usually not be valued using an asset-based approach, because the minority
shareholder does not have the ability to liquidate the assets. However, do not take this as a hard and
fast rule. In chapter 21, I discuss valuing limited partnership interests in family limited partnerships,
which is similar in many respects to valuing minority interests. All of this stuff will be explained further in
my discussion about adjusting the balance sheet later in this chapter. Meanwhile, as a general rule, if
the shareholder cannot get to the cash flow that will be generated by selling off the assets, this
approach will not get to the value of the cash flow to the minority shareholder. After all, value is based
on the future benefits stream that will flow to the investor.