Thought Leadership Discussion

Fundamentals of the Asset-Based Business Valuation Approach

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Valuation analysts ("analysts") value closely held business and business ownership interests for various transaction, financing, taxation, accounting, litigation, and planning purposes. Analysts should consider the application of all three generally accepted business valuation approaches in these analyses: the income approach, the market approach, and the asset-based approach. However, most analysts rarely apply the asset-based approach, at least in valuations of going-concern operating companies. This discussion describes the theory and application of the asset-based approach. And, this discussion explains how this approach can be used to value operating companies—as well as asset-holding investment companies—on a going-concern basis. The asset-based approach is not usually recommended as the sole basis for the business valuation. However, due to data or other constraints, the income approach and the market approach are not always available to value an operating company. In addition, the asset-based approach may be used as a complementary or confirmatory analysis in conjunction with both income approach and market approach valuation analyses.

Introduction

Valuation analysts ("analysts") are often asked by clients, by their clients' legal counsel ("counsel"), or by their clients' other professional advisers to value closely held businesses and professional practices, business ownership interests, and securities for various reasons. The value of the closely held business or professional practice may be important for a variety of client purposes.

These client purposes may include transaction pricing and structuring, taxation planning and compliance, financing collateralization or securitization, forensic and economic damages analyses, corporate strategy and personal financial planning, financial accounting and public reporting, and regulatory compliance or controversies.

The value of the business, business ownership interest, or security could be important to the client (or counsel) with regard to business estate planning, a business ownership transition, or a business merger and acquisition structuring. In addition, the current and ongoing value of the business may be important when the client (or counsel) is designing or implementing buy/sell agreements or other shareholder agreements.

The business or security value can be important for various taxation planning, compliance, and controversy reasons. These taxation-related reasons include gift tax, estate tax, generation-skipping transfer tax, and income tax.

Some of the income tax issues may include worthless stock deductions, charitable contributions, stock or asset basis determination, insolvency related to debt cancellation income, intercompany transfer price determination, reasonableness of shareholder/employee compensation, and others.

The value of the business or security may be important when the client is involved in a family

law dispute, commercial bankruptcy matter, shareholder dispute, lender liability claim, infringement claim, many types of breach of contract claims, and many types of breach of fiduciary duty or other tort claims.

Such litigation-related matters may include dissenting shareholder appraisal rights claims and shareholder oppression claims.

Generally Accepted Business Valuation Approaches

Regardless of the purpose of the closely held business or security valuation, analysts should consider all three generally accepted business valuation approaches. These approaches (or categories of related business valuation methods) are as follows:

1. The income approach
2. The market approach
3. The asset-based approach

Although less commonly applied than the income approach or the market approach, the asset-based approach is a generally accepted business valuation approach. The asset-based approach is described in most comprehensive business valuation textbooks. In addition, consideration of the asset-based approach is required by most authoritative business valuation professional standards.

For example, professional standards such as the American Institute of Certified Public Accountants ("AICPA") *Statement on Standards for Valuation Services* ("SSVS") and the *Uniform Standards of Professional Appraisal Practice* ("USPAP") require the valuation analyst to at least consider the application of the asset-based approach (in addition to other business valuation approaches).

That is to say, such professional business valuation standards require the consideration of—but not necessarily the application of—the asset-based approach.

In practice, however, many analysts (and many clients and legal counsel) immediately reject the use of asset-based approach methods in a business, professional practice, or security valuation. These analysts conclude that this approach is too difficult, too time consuming, too client disruptive, or simply (and only without adequate explanation) not applicable to the subject closely held company.

In truth, many analysts (and clients and counsel) do not seriously consider applying the asset-based approach in the typical closely held business or security valuation. This is because these analysts (and clients and counsel) are not sufficiently familiar with the generally accepted methods and procedures within this business valuation approach.

In addition, many analysts (and clients and counsel) labor under misconceptions about when—and when not—to apply this valuation approach. And, many analysts (and clients and counsel) also hold misconceptions about interpreting the quantitative results of the asset-based valuation approach.

Hopefully, this discussion will correct many of the common misconceptions about this business valuation approach. This discussion will present the most important considerations that analysts, clients, and clients' professional advisers need to know with regard to the asset-based approach valuation of closely held companies, professional practices, and business securities.

As will be discussed below, the proper application of this business valuation approach requires a slightly different set of skills than does the application of the income approach or the market approach. Not all analysts have the experience or expertise to perform a comprehensive asset-based approach business valuation analysis.

It is also true that the completion of the asset-based approach often requires more analyst time and associated cost than other business valuation approaches. That additional analyst time typically translates into additional professional fees charged to the client. Therefore, clients often discourage the use of the asset-based approach when they come to learn of both (1) the additional elapsed time and (2) the additional costs associated with this particular valuation analysis.

Also, the successful performance of this valuation approach often requires more data from—and more involvement by—the subject closely held company executives. Again, when these additional commitments are understood, many clients may discourage the use of the asset-based approach.

In many dispute-related business valuation assignments, the analyst may not be granted sufficient access to the closely held company facilities or to the closely held company executives in order to practically implement this valuation approach.

In addition, particularly in a retrospective assignment, the subject company data that the analyst needs—and the subject company personnel that the analyst needs access to—are simply no longer available. In many of these controversy-related contexts, it may simply be impractical for

the analyst to perform some asset-based approach valuation methods.

This first discussion in this three-part series of *Insights* discussions relates to the application of the asset-based business valuation approach within a transaction, taxation, or controversy context. This *Insights* discussion describes the theory of—and the general application of—the asset-based approach.

The second discussion in this three-part series of *Insights* discussions describes and illustrates a common asset-based approach valuation method—the asset accumulation ("AA") method. The AA method involves the identification and valuation of each individual category of the company assets (both tangible and intangible).

And, the final discussion in this three-part series of *Insights* discussion describes and illustrates the adjusted net asset value ("ANAV") method. The ANAV method involves a single aggregate allocation of all of the company's total collective assets.

Theory of the Asset-Based Approach

The asset-based approach is sometimes called the asset approach to business valuation. Either name for this approach is generally accepted among valuation analysts and in the valuation literature.

The asset-based approach encompasses a set of methods that value the company by reference to its balance sheet. In contrast, income approach and market approach valuation methods primarily focus on the company's income statement and/or cash flow statement.

One of the very first procedures in any closely held business valuation is to define the business ownership interest subject to valuation. That is, the assignment should specify whether the valuation intended to conclude a defined value for the subject company:

1. total assets,
2. total long-term interest-bearing debt and total owners' equity,
3. total owners' equity, or
4. one particular class of owners' equity.

Each of the above descriptions is a valid objective of a business valuation. And, each conclusion is often referred to as a "business value." Yet, each of these business value conclusions will be quantitatively different for the same company. And, each of these business value conclusions will be perfectly appropriate in the right circumstance—usually based on the actual or hypothetical transaction that is being analyzed.

For example, knowing the company's total asset value is necessary in an acquisition structured as an asset purchase (instead of as a stock purchase). The company's total invested value ("TIC")—often called the market value of invested capital (or "MVIC")—is the value of all long-term debt plus all classes of owners' equity. Knowing the value of the TIC is important in a deal structure where the buyer will acquire all the company's equity and assume all of the company's debt.

Knowing the value of the total owners' equity is important when only the company's equity securities (say all common stock and all preferred stock) are at issue in the transaction.

And, knowing the value of one particular class of equity only (say only the company's common stock) is important when only that class of security is the subject of the proposed transaction.

In any event, the asset-based approach is based on the principle that the value of the subject company is equal to:

the value of the subject company's total assets

minus

the value of the subject company's total liabilities

If properly applied, this valuation formula can be used to indicate the value of any of the valuation objectives listed above. There are two particularly important words in the asset-based approach valuation formula defined above:

1. Value
2. Total

First, the asset-based approach is based on the value of (and not the recorded balance of) all of the assets and all of the liabilities of the subject company. The standard of value in the analysis has to be defined. And, the valuation date of the analysis has to be defined. The standard of value is determined by the assignment.

Common standards of value for various business valuation purposes include fair market value and fair value. Other common standards of value include the following

- Investment value
- Owner value
- Use value

> "In the information age, . . . intangible asset categories often represent the major sources of value for any subject business entity."

- User value

Whatever the assignment-specific standard of value is, the value conclusion is likely going to be different from the recorded account balances presented on the subject company's balance sheet. Those balance-sheet-recorded account balances are probably presented in compliance with GAAP, which typically includes a combination of historical cost-based measures and GAAP-based fair value measures.

Second, the asset-based approach is also based on the total of all of the subject company's assets and liabilities. GAAP-based balance sheets typically exclude major categories of company assets and company liabilities. For example, GAAP-based balance sheets do not record most internally created intangible assets.

In the information age, such intangible asset categories often represent the major sources of value for any subject business entity. This statement is obvious for technology-related entities. However, this statement is also true for most companies.

Under U.S. GAAP, the values of an entity's internally created employee relationships, supplier relationships, customer relationships, and goodwill are not recorded on the entity's balance sheet. Likewise, the value of the entity's contingent liabilities are not recorded under U.S. GAAP. Therefore, employee lawsuits, environmental claims, unresolved income tax audits, and other claims against the company are typically not recorded on the entity's balance sheet.

Unlike the company's GAAP-based balance sheet, the asset-based approach value-based balance sheet recognizes the current value of:

1. all of the company's assets (tangible and intangible) and
2. all of the company's liabilities (recorded and contingent).

To conclude the assignment—defined value for the company's assets and liabilities (whether individually or collectively)—the analyst applies generally accepted asset (and liability) valuation methods.

These valuation methods are categorized into the three categories of generally accepted property valuation approaches: the income approach, the market approach, and the cost approach.

When to Apply the Asset-Based Approach

First, it is noteworthy that, under most business valuation professional standards, the analyst should consider the application of generally accepted valuation approaches. Accordingly, the relevant analyst question is not: when should I perform the asset-based approach? Rather, the relevant analyst question should be: when can I not perform the asset-based approach?

That is, as a general principle, the asset-based approach should at least be considered (if not completed) in every business valuation assignment. The reasons why an asset-based approach analysis is not performed should be described in the business valuation report. And, these reasons should be substantive and not perfunctory. In other words, the statement that "the subject company is an operating company" may not be a sufficient explanation.

Second, the analyst's selection of the applicable valuation approach is a function of four primary factors:

1. The type of subject company
2. The type of subject business interest
3. The type of subject transaction
4. The availability of necessary data

Many clients (and their counsel and other professional advisers) believe that the asset-based approach is only applicable to so-called asset-intensive companies. This statement is technically correct. However, this conclusion ignores the reality that virtually every company is an asset-intensive company.

The fact is that the asset-based approach is applicable to tangible-asset-intensive companies and to intangible-asset-intensive companies.

Virtually all companies are either tangible-asset-intensive or intangible-asset-intensive (or a combination of both asset types). Therefore, at least for analysts who are qualified to perform intangible asset valuations, the asset-based approach is applicable to most types of companies.

Many clients (and their counsel and other professional advisors) also believe that the asset-based approach is only applicable to so-called asset holding (or investment management) companies.

Rather, this valuation approach is applicable to any company that owns assets. Therefore, the asset-based approach may apply in the valuation of asset holding companies, and the asset-based approach may apply in the valuation of asset operating companies. And, just about every company falls into one (or both) of these two descriptive categories.

In other words, at least for analysts who are qualified to perform asset valuations on a going-concern premise of value basis, the asset-based approach is applicable to the valuation of most types of closely held companies or professional practices.

The type of valuation subject interest may influence the selection of the valuation approach. This is because the asset-based approach (without adjustment) concludes a controlling, marketable ownership interest level of value. Therefore, asset-based approach is particularly applicable to the valuation of an overall business enterprise—a valuation objective that often relates to a business purchase or sale transaction.

Alternatively, the asset-based business valuation approach is not particularly applicable to the valuation of a nonmarketable, noncontrolling block of nonvoting common stock—a valuation objective that often relates to (say) a tax planning, compliance, or controversy assignment.

As the previous paragraphs imply, the type of the subject transaction (or the type of the subject assignment) influences the selection of the valuation approach.

An overall business valuation is well-served by the asset-based valuation approach. That is, this valuation approach is particularly applicable to a company merger and acquisition analysis, a stock exchange ratio analysis, a fairness opinion, a solvency opinion, or to the analysis of any other transaction involving the overall business enterprise.

It is noteworthy that the asset-based approach is particularly applicable to the analysis of a company acquisition that is structured as an asset purchase transaction (as compared to a stock purchase transaction). This is because the deal price is directly related to the value of the subject company tangible assets and intangible assets.

The asset-based approach is also applicable to the analysis of any transaction that is structured as a taxable transaction (as compared to a nontaxable transaction tax structure). This is because the transaction deal price will depend on the prospective depreciation and amortization expense and income tax rates associated with the revalued tax basis of the transferred assets.

The asset-based valuation approach is particularly applicable to analyses performed for asset-based secured financing purposes. In such an instance, different creditors could have different claims on different asset classes. And, this valuation approach is particularly applicable for various taxation-related assignments, such as a closely held company conversion from C corporation tax status to S corporation tax status.

Finally, the quantity and quality of available data affects the analyst's selection of a business valuation approach. For example, the fact that there are no sufficiently comparable publicly traded companies in the subject industry sector affects the analyst's ability to use the market approach guideline publicly traded company method.

The fact that there are no sufficiently comparable merger and acquisition transactions in the subject industry sector affects the analyst's ability to use the market approach precedent transaction method.

Likewise, the fact that there is no prospective financial information in existence at the subject company affects the analyst's ability to use the income approach discounted cash flow method.

If the analyst has no access to company asset-specific information (e.g., no available information regarding the company's individual tangible assets or intangible assets), this fact will affect the analyst's ability to use the asset-based approach AA method.

If the analyst is working for the outside party in a transaction or in a litigation proceeding, this fact may affect the analyst's ability to obtain sufficient data (or sufficient asset access) to use the AA method. And, if the valuation is retrospective—and all of the company's tangible and intangible assets have materially changed since the valuation date—this fact may affect the analyst's ability to use the AA method.

Nonetheless, the above-mentioned data limitations primarily relate to the AA method. Asset-specific data limitations, asset access limitations, and retrospective valuation dates are less important in the application of the ANAV method (than they are to the application of the AA method).

Therefore, these issues may affect the analyst's selection of which asset-based approach valuation method to apply. But, these issues do not necessarily eliminate the application of all asset-based approach considerations.

Finally, the most relevant reasons why analysts do not apply the asset-based valuation approach in law-related engagements are as follows:

1. There are additional costs and time requirements associated with this approach.
2. The audience for the valuation (including company board of directors, legal counsel, and the judicial finder of fact) may not be particularly familiar with asset-based valuation analyses.

The Asset-Based Approach Is Not the Cost Approach

The asset-based approach is a generally accepted business valuation approach. The cost approach is a generally accepted property valuation approach. This is a very important distinction.

The objective of the asset-based approach is to estimate a business equity (or total net asset) value. The objective of the cost approach is to estimate the value of an individual tangible asset or intangible asset.

In the asset-based approach, the individual asset categories may be valued using the cost approach, the market approach, or the income approach. In the typical asset-based approach analysis, the analyst may expect that all of the property valuation approaches will be used.

Some asset categories will be valued by reference to cost approach methods. Some asset categories will be valued by reference to market approach methods. And, some asset categories will be valued by reference to income approach methods.

In fact, as a general rule, at least one of the subject company's asset categories will be valued by reference to an income approach property valuation method, typically either:

1. a capitalized excess earnings method ("CEEM") or
2. a multiperiod excess earnings method ("MEEM").

In the typical asset-based approach analysis, these income approach property valuation methods are used to conclude whether:

1. there is intangible value in the nature of goodwill for the subject company (i.e., a positive CEEM indication) or
2. there is an economic obsolescence adjustment that needs to be made to the cost approach tangible and intangible asset values (i.e., a negative CEEM indication).

There are several generally accepted cost approach valuation methods. The following cost approach methods can be used to value many tangible asset categories and intangible asset categories:

1. Reproduction cost new less depreciation method
2. Replacement cost new less depreciation
3. Trended historical cost less depreciation method

However, these cost approach methods are not particularly applicable to all tangible and intangible asset categories. Many tangible and intangible assets are more efficiently valued by reference to the market approach. And, in particular, many intangible assets are more efficiently valued by reference to the income approach.

For example, in a business valuation, it is possible to value a company's goodwill by reference to the cost approach (e.g., the capitalization of the lost income opportunity cost during a total asset recreation period). However, in the typical business valuation, it is more common for analysts to value a company's goodwill using the CEEM of the income approach.

In summary, the cost approach can be used to value various categories of company tangible assets (e.g., machinery and equipment) or intangible assets (e.g., a trained and assembled workforce). However, it is practically impossible to value all of the assets of a going-concern company by using the cost approach exclusively. Such an analysis may ignore the income generation capacity of the company, and it may not appropriately encompass either:

1. the company's goodwill (positive capitalized excess earnings) or
2. the company's economic obsolescence (negative capitalized excess earnings).

The asset-based business valuation approach typically incorporates cost approach property valuation methods to value certain tangible and intangible asset categories. However, the asset-based approach also incorporates other property valuation approaches (i.e., the income approach and the market approach) to value certain other tangible and intangible asset categories of the subject company.

Analysts (and clients and counsel and other professional advisers) who confuse the nomenclature or the methodology of the cost approach versus the asset-based approach may not understand either valuation approach.

The Asset-Based Approach Is Not Limited to Asset Holding Companies

The premise of the asset-based approach is that the value of the company's assets minus the value of the company's liabilities equals the value of the company's equity.

This formula doesn't only work for the valuation of holding companies that passively own investment assets. This formula also works for the valuation of operating companies that both own and operate tangible and intangible property.

In practice, the asset-based approach often works as well for operating companies as it does for investment holding companies. The primary differences in the two types of companies are the categories of the individual assets that are included in the valuation analysis.

For example, the illustrative categories of assets and liabilities included in an investment holding company valuation analysis may include the items listed in Exhibit 1.

Exhibit 1
Client Investment Holding Company
Illustrative Asset and Liability Categories

	Assets
	Cash and money market instruments
	Publicly traded stocks and bonds
	Oil and gas exploration/production interests
	Land and land improvements
	Options and other derivative securities
	Interests in private entities
Less:	Liabilities
	Accounts payable and taxes payable
	Mortgages payable
	Notes payable
Equals:	Net asset value

An alternative example applies the same asset-based approach valuation formula to an operating company. Illustrative operating company categories of assets and liabilities may include the items listed in Exhibit 2 on the following page.

All assets can be valued using the generally accepted property valuation approaches and methods. This statement is equally true for tangible assets and for intangible assets. And, this statement is equally true for investment assets and for operating assets.

When an analyst asserts that the asset-based approach is only applicable to investment holding companies, often the assertion should really be: "I only know how to apply the asset-based approach to investment holding companies; I really don't know how to value operating tangible and intangible assets."

The more correct analyst assertion may be: "The asset-based approach is ideally suited to the valuation of investment holding companies; however, the asset-based approach is also applicable to the valuation of operating companies."

Exhibit 2
Client Operating Company
Illustrative Asset and Liability Categories

	Assets
	Cash, receivables, and inventory
	Land and buildings
	Machinery and equipment
	Trademarks and trade names
	Trained and assembled workforce
	Current customer (contract) relationships
	Goodwill
Less:	Liabilities
	Accounts payable and accrued expenses
	Taxes payable
	Bonds, notes, and mortgages payable
	Contingent liabilities
Equals:	Net asset value

The Asset-Based Approach Does Not Conclude a Liquidation Value

Many analysts (and clients and counsel) believe that the application of the asset-based approach concludes a liquidation value (that is, not a going-concern value) for the subject company. These analysts (and clients and counsel) maintain this (erroneous) belief whether the asset-based approach is applied to an investment holding company or to an operating entity.

These analysts (correctly) believe that the asset-based approach is based on a defined value for the subject assets. And, the defined value (whatever standard of value applies) is usually based on the expected sale price of the subject asset between some defined parties.

However, these analysts (incorrectly) assume that any sale of any asset is a liquidation transaction that yields a liquidation value. This analyst belief is simply misplaced.

Let's use the fair market value ("FMV") standard of value as an example. An FMV transaction occurs between a hypothetical willing buyer and a hypothetical willing seller. Presumably, the asset buyer is always willing to enter into the subject FMV transaction.

If the asset seller decides to sell the subject asset by the end of the week (say, because a loan payment is coming due), that transaction may result in a liquidation value. Even if the seller exposes the subject asset for sale during a normal market exposure period—if the buyer will not continue to operate the asset in a going-concern business—that asset sale transaction may result in a liquidation value.

Now, let's extend the example to assume that the seller has been operating the subject asset as part of a going-concern company. Let's assume that the seller exposes the asset for sale during a normal market exposure period. The buyer acquires the subject asset and then uses the acquired asset as part of the buyer's going-concern company. Certainly, even the above-mentioned analysts would recognize these asset sale transaction-based FMV indications as going-concern value (and not liquidation value) indications.

In addition to individual operating assets being sold from one going-concern seller to one going-concern buyer, going-concern companies themselves are often bought and sold. The purchase price allocation of that company sale price will indicate the going-concern value of the acquired assets. These overall company transaction-based FMV indications obviously conclude going-concern value (not liquidation value) conclusions.

In summary, it is true that the asset-based approach may conclude a liquidation value for the subject company if all of the individual asset values were concluded on a liquidation premise of value basis.

Likewise, it is also true that the asset-based approach will conclude a going-concern value for the subject company if all of the individual tangible asset and intangible asset values were concluded on a going-concern premise of value basis.

Valuation of Liabilities in the Asset-Based Approach

Most analysts (and clients and counsel) focus on the valuation of the company assets during the application of any asset-based approach valuation method. However, the valuation of the company liabilities can also be an important procedure in this valuation approach.

The first procedure in the liability valuation is to understand the appropriate standard of value

objective and the subject assignment purpose. That is, the analyst may conclude a different value for the same liability if the standard of value is fair value versus fair market value versus investment value versus some other standard of value.

For example, if the valuation purpose is a solvency analysis prepared within a bankruptcy context, then the analyst will typically consider the recorded balances in the company liability accounts. After all, those are the liability amounts that the creditors can claim in a bankruptcy proceeding. And, one objective of the bankruptcy solvency analysis is to determine if the value of the debtor company assets (based on a fair valuation amount) exceeds the amount of the debtor company liabilities (based on a recorded amount).

Outside of a bankruptcy solvency analysis, however, the analyst may be more concerned with the current value of the company liabilities than with the recorded balance of the company liabilities. Depending on the applicable standard of value, the analyst may be more concerned with an expected trading price for the company's debt instruments.

That is, the analyst may conclude: how much would an investor pay to own, say, the company's note payable? Or, the analyst may conclude: how much would the debtor have to pay to the creditor (i.e., how much would the creditor be willing to receive) to extinguish the company's note payable?

In an analysis of the current value of the subject company liabilities, the analyst typically considers factors such as the following:

1. The debt instrument's term to maturity
2. The entity's historical debt service record
3. The debt instrument's embedded interest rate versus a current market interest rate
4. The debt instrument's liquidation preference
5. Whether the debt instrument is callable (and what are the call triggers)
6. Any security interests related to the debt
7. The company's current credit rating
8. The company's current financial condition
9. The company's budget or financial projections
10. Any prepayment or other penalties related to the debt
11. Any recent trades of guideline debt instruments
12. The subject debt amortization (payment) schedule
13. The existence and timing of any debt balloon payments

So, as one part of the asset-based approach, the analyst may revalue all of the company recorded bond, note, mortgage, and debenture liabilities. This analysis would include the entirety of the company liability accounts, including any long-term debt amounts that are recorded as a current liability for financial accounting purposes.

In addition, the analyst may identify and value all of the company contingent liabilities. Such contingent liabilities do not meet the GAAP requirements to be recorded on the company balance sheet for financial accounting purposes. Nonetheless, such unrecorded liabilities could have a material effect on the value of the subject company's equity.

There are several generally accepted methods that may be used to value contingent liabilities. Often, the analyst attempts to estimate the net present value ("NPV") of the expected future cash payments associated with extinguishing that liability. That NPV analysis considers the expected amounts of—and the expected timing of—the future cash payments.

Such an NPV analysis typically considers the probabilities associated with the company future contingent liability payments. This consideration may be quantified either through scenario analysis or through a risk-adjusted present value discount rate.

Such contingent liabilities may include the following types of claims against the subject company:

1. Tax audit or other taxation-related disputes
2. Employee-related disputes
3. Environmental claims and other clean-up issues
4. Tort (such as infringement) litigation claims
5. Breach of contract litigation claims

Unlike liabilities that are recorded on the company balance sheet, there is no single data source for the analyst to identify off-balance-sheet contingent liabilities. If such interviews are available, the analyst may interview the company management and legal counsel.

In addition, analysts often review board of directors meeting minutes, company management committee meetings records and documents, and company financial plans and forecasts in order to identify possible contingent liabilities.

Treatment of Income Taxes in the Asset-Based Approach

There is a diversity of practice with regard to the treatment of income taxes in the asset-based approach analysis. The issue is this: The asset-based approach assumes the sale (not a liquidation sale, but a going-concern transfer) of the company assets. Such an asset sale would normally be a taxable event.

In an actual sale transaction, the asset seller would be responsible for income taxes related to any gain on the sale. And, that gain on the sale would be calculated as (1) asset sale price (based on the concluded asset value) minus (2) the asset tax basis.

For many of the intangible assets included in the valuation analysis, the tax basis for such assets is often zero.

Most analysts implement one of three alternative procedures with regard to the treatment of income taxes in the asset-based approach:

1. Ignore all income tax consequences related to the revaluation of the company assets
2. Calculate the expected income tax liability associated with the asset revaluation and recognize that specific liability on the revalued balance sheet
3. Calculate a deferred income tax liability account based on the present value of the expected future income tax payments

The use of the first procedure is often justified by several explanations.

Some analysts may say that they often do not have the data they need to calculate the exact income tax liability related to the asset revaluation.

Some analysts may also say that they are not income tax accounting experts, and they do not have the expertise to calculate the implied income tax liability.

And, some analysts may say that the company assets will not actually be sold and the income tax payment will not actually be made. The company asset revaluation is just a hypothetical transaction that is part of a theoretical valuation exercise.

The use of the second procedure is often justified by several explanations.

These analysts recognize that they may need data from company management or technical assistance from the company (or other) accountants. However, these analysts recognize that the hypothetical asset revaluation in the asset-based approach will not be tax-free to the hypothetical transaction participants.

That is, if the company assets are hypothetically sold by the asset seller, then that asset seller will incur a corresponding hypothetical income tax liability. And, these analysts conclude that if the asset revaluation occurs on the valuation date, then the corresponding tax liability should be recognized on the valuation date.

The use of the third procedure is also justified by several explanations.

These analysts recognize that there is a built-in capital gain associated with the asset-based approach revaluation of the company assets. This built-in capital gain is analogous to the built-in gain ("BIG") valuation discount that is often associated with stock valuations prepared for federal gift, estate, and generation-skipping transfer tax purposes.

These analysts recognize that an actual asset revaluation (that would occur in, for example, post-bankruptcy fresh start accounting) would result in a deferred federal income tax liability being recorded on a GAAP balance sheet.

And, these analysts recognize that there is some uncertainty as to:

1. how much income tax will ultimately be paid (i.e., what the company's effective income tax rate will be) and
2. when the income tax liability will ultimately be paid (i.e., when the asset would actually be sold in real life).

Since there is a divergence of analyst practice regarding the treatment of income taxes in the asset-based approach, this discussion does not recommend a right or wrong procedure. However, this discussion does recommend that each analyst make a conscious decision as to which income tax liability convention to implement.

And, the analyst should document the rationale for this decision in the valuation work paper file. In the asset-based approach analysis, the default decision (to ignore income taxes) has a direct impact on the valuation analysis and on the net asset value conclusion.

Why the Asset-Based Approach Is Not More Commonly Used

For most types of closely held companies—and for most business valuation assignments—the asset-

based approach is the less commonly applied valuation approach. That is, in most engagements performed for legal, transaction, or taxation purposes, analysts more commonly gravitate to the income approach and the market approach.

That said, the asset-based approach is still a generally accepted business valuation approach. And, both the professional literature and the professional standards guide analysts to consider applying the asset-based approach in a business valuation analysis.

Although particularly applicable for many closely held business, professional practice, and security valuation assignments, the asset-based approach is less commonly applied for the following reasons:

1. Analysts need more data to perform this approach than they may otherwise need to perform other valuation approaches.
2. This valuation approach is more client-intrusive than other valuation approaches.
3. This approach typically takes more analyst time to complete than other valuation approaches.
4. Due to the increased analyst time required, this approach typically costs more to complete (in terms of client fees) than other valuation approaches.
5. This approach requires the analyst to demonstrate expertise in the valuation of both assets and liabilities.
6. This approach requires the analyst to identify and value both tangible assets and intangible assets.
7. This approach requires the analyst to identify and value both recorded liabilities and contingent liabilities.
8. This approach requires the analyst to demonstrate some expertise with regard to both financial accounting matters and income tax accounting matters.
9. Compared to other valuation approaches, the application of this approach typically requires a much more comprehensive discussion in the written or oral valuation report.
10. This approach is less well known to (and less understood by) lenders, potential transaction participants, lawyers, and judicial finders of fact.

The above-stated observations should not invalidate the use of the asset-based approach. And, these observations should not discourage the analyst from performing the asset-based approach.

However, analysts should be aware of these considerations when performing the asset-based approach analysis, reaching the value conclusion, and preparing the business valuation report.

The Asset-Based Approach and the Valuation Synthesis and Conclusion

In valuations performed for transaction, taxation, controversy, or many other purposes, analysts should consider asset-based approach value indications—along with income approach and market approach value indications.

It is unlikely (but possible) that the analyst will rely solely on the asset-based approach value indication. Likewise, it is unlikely (but possible) that the analyst will rely solely on the income approach or market approach value indications.

As with any other business valuation synthesis and conclusion, the analyst may assign either a quantitative weighting or a qualitative ranking to each value indication.

The analyst may assign either this explicit weighting or implicit weighting to the asset-based approach value indication based on:

1. the quantity and quality of available data for this approach,
2. the degree to which market participants consider this approach in the subject industry transactions,
3. the degree of confidence the analyst has in the analyses performed,
4. the degree of confidence the analyst has in the value conclusions reached, and
5. the amount of due diligence the analyst was able to perform with regard to the application of this approach.

Ideally, the asset-based approach value indications will reconcile reasonably well with other value indications. When there are differences in value indications between approaches, these value differences should be explainable.

If there are material differences between value indications, the analyst may have to perform additional due diligence with regard to all of the business valuation analyses.

If the asset-based approach value is materially lower than other value indications, that may indicate one or more of the following:

1. The company owns additional intangible assets that were not included in the valuation.
2. One of the intangible assets—such as goodwill—could be undervalued.
3. One or more of the company liabilities could be overvalued.

If the asset-based approach value is materially greater than other value indications, it may indicate one or more of the following:

1. There is unrecognized economic obsolescence that should be considered in both the tangible asset and the intangible asset valuations.
2. One or more intangible assets may be overvalued (potentially due to the double counting of intangible asset value).
3. The values of the company liabilities (particularly contingent liabilities) could be understated.

The analyst's additional due diligence procedures should be able to identify and correct any of these situations.

Summary

The asset-based approach is a generally accepted business valuation approach. The asset-based approach to business valuation should not be confused with the cost approach to property valuation.

The cost approach is a generally accepted approach to value individual tangible assets and intangible assets. In the application of the asset-based approach, analysts often use the cost approach to value certain categories of the company tangible assets or intangible assets.

The asset-based approach is based on the following relationship:

the value of the total company assets
(both tangible and intangible)

minus

the value of the total company liabilities
(both recorded and contingent)

equals

the value of the total company equity

Since the values of the company tangible assets and intangible assets are typically estimated based on a value in continued use premise of value, the asset-based approach normally concludes a going-concern value for the subject company. However, with numerous specific adjustments, the asset-based approach value may be adjusted to conclude a liquidation value for the subject company.

Normally, the asset-based approach will conclude a controlling, marketable ownership interest level of value for the company equity. If the subject assignment calls for a noncontrolling, nonmarketable ownership interest level of value, then the analyst may have to consider a discount for lack of control and a discount for lack of marketability to the unadjusted value indication.

There are several generally accepted asset-based approach business valuation methods. The most common methods within this approach are the AA method and the ANAV method.

Both of these methods are intended to conclude the value of all of the owned and all of the operated assets of the company. Therefore, while this valuation approach is applicable to the valuation of an asset holding company, it is also applicable to the valuation of an operating company.

The conduct of the asset-based approach may require additional data, additional client disruption, and additional analyst time and associated cost—compared to other business valuation approaches. There are numerous instances when the asset-based approach is perfectly applicable to the business, practice, or security valuation engagement.

Relevant valuation professional literature and valuation professional standards guide the analyst to consider the asset-based approach in every business valuation.

Accordingly, the analyst should conclude and document the reasons for performing—or for not performing—the asset-based approach in each business valuation analysis.

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