

THE ASSET-BASED BUSINESS VALUATION APPROACH: ADVANCED APPLICATIONS (PART 1)

ROBERT F. REILLY

Business and security valuations may be necessary for various tax planning, compliance, or controversy purposes.

Closely held businesses and closely held business securities may need to be valued for various income tax, gift tax, estate tax, generation-skipping transfer tax, state and local property tax, and other taxation reasons. These business and security valuations may be necessary for various tax planning, tax compliance, or tax controversy purposes. Taxpayers and their professional tax advisers (including tax counsel) often retain independent valuation analysts (analysts) to develop these business valuations. Such analysts develop and report these business valuations in compliance with generally accepted valuation standards. Also, these analysts apply generally accepted business valuation approaches to reach their value opinions. These generally accepted business valuation approaches are typically called the income approach, the market approach, and the asset-based (or asset) approach.

Most analysts—and taxpayer business owners, tax counsel, and tax regulatory authori-

ties—are familiar with the concept of the asset-based approach to business enterprise valuation. Analysts rarely (if ever) apply the asset-based approach as a regular part of their business valuation analyses—whether those valuations are performed for taxation purposes or for other purposes. If analysts have ever applied the asset-based approach, it was in the valuation of a real estate holding company or an investment holding company. In these instances, the analyst simply may have obtained current “appraised” values for the real estate or the investment portfolio assets that were recorded on the company’s balance sheet. To these analysts, the simple substitution of the current values of these recorded assets for the historical costs of the recorded assets constituted an asset-based approach business valuation.

Most business owner/taxpayers, tax counsel, taxing authorities, judicial finders of fact, and other parties who rely on valuations are even less familiar with the application of the asset-based approach to closely held business valuation. These parties may not expect to see the asset-based approach performed—except with regard to a real estate or other investment holding company—in the typical closely held business valuation performed for taxation (or

ROBERT F. REILLY, CPA, is a managing director of Willamette Management Associates in the firm’s Chicago, Illinois, office. His practice includes business valuation, forensic analysis, and financial opinion services. He is a certified public accountant accredited in business valuation and certified in financial forensics, a certified management accountant, chartered global management accountant, accredited tax advisor, chartered financial analyst, certified business appraiser, certified valuation analyst, certified valuation consultant, accredited senior appraiser, certified review appraiser, certified real estate appraiser, and state-certified general appraiser.

other) purposes. These parties may not be comfortable interpreting or relying on asset-based approach valuation analyses and value conclusions.

In addition, many analysts may not be adequately trained and experienced in the preparation of an asset-based approach business valuation. Parties that rely on such business valuations may not be comfortable making taxation-related decisions based on an asset-based approach valuation. Often, both analysts and other parties are reluctant to prepare—or to rely on—asset-based approach business valuations because they are uncertain of the answers to the following questions:

1. Does the asset-based approach conclude a going-concern value or a liquidation value?
2. Which property (or asset) valuation approaches should be used in the application of the asset-based business valuation approach?
3. When is it appropriate to use the capitalized excess earnings method (CEEM) to conclude intangible value in the nature of goodwill?
4. When is it appropriate to measure economic obsolescence in the cost approach valuation of the entity's tangible assets and intangible assets?
5. When is it appropriate to measure selling expenses (or make-ready costs or holding period expenses) in the market approach valuation of the entity's tangible assets and intangible assets?
6. How should the analyst account for the capital gains tax liability associated with any appreciation of the value of the entity's tangible assets and intangible assets?
7. How does the analyst apply the asset-based approach when the subject entity assets cannot be immediately sold (due to contractual or other restrictions)?
8. Do the same (or different) level of value adjustments that apply to the income approach and the market approach (say discounts for lack of control and for lack of marketability) also apply to the asset-based approach?

Each of these procedural application (or “how to”) issues will be considered in this two part article. This discussion will be presented from two related perspectives. First, it will assume that the analyst has performed an asset-based approach analysis. Now the analyst has to decide: how do I interpret the value indication? For example, is the asset-based approach value indication a going-concern value indication or a liquidation value indication? Second,

the discussion will assume the analyst wants to complete a specified valuation assignment. For example, the assignment could be to estimate the fair market value (FMV) of a nonmarketable, noncontrolling interest in the taxpayer closely held company. The issue may be: what property valuation methods and procedure should the analyst apply to achieve the intended valuation objective?

Consensus regarding the asset-based approach

Before the above-listed issues are considered, consider what analysts generally do agree are consensus positions with regard to the use of the asset-based approach in a business valuation analysis.

1. The asset-based approach is a generally accepted business valuation approach. With the income approach and the market approach, the asset-based approach is one of three generally accepted business valuation approaches.
2. The asset-based approach can be used to value both asset holding (or property investment) companies and operating companies.
3. The asset-based approach can be used to value both tangible-asset-intensive companies and intangible-asset-intensive companies.
4. All companies (whether operating companies or asset holding companies) are asset-intensive companies. That is, all companies own tangible assets, intangible assets, or both types of assets.
5. The asset-based approach typically concludes a marketable, controlling ownership interest level of value for the subject entity. Therefore, the asset-based approach is more applicable to conclude this level of value.
6. The asset-based approach value indication can be adjusted to indicate a nonmarketable, noncontrolling level of value. However, the analyst should apply care in identifying and quantifying the appropriate discount for lack of control (DLOC) and discount for lack of marketability (DLOM).
7. The appropriate DLOC and DLOM adjustments to apply to an asset-based approach value indication may be different than the corresponding valuation adjustments to apply to the income approach or the market approach value indications. This is because the application of the asset-based approach assumes a high degree of asset liquidity and a high degree of ownership control (in order to initiate

the hypothetical asset purchase or the hypothetical asset sale process).

8. There are generally accepted asset-based approach business valuation methods. The two most common asset-based approach methods are the asset accumulation (AA) method and the adjusted net asset value (ANAV) method.
9. The AA method generally involves the discrete revaluation of each of the entity's individual asset and liability accounts. The ANAV method also includes the collective revaluation of all of the entity's asset and liability accounts in the aggregate. If all the analysis valuation variables are applied consistently, the AA method and the ANAV method should conclude the same value for the same business entity.
10. The asset-based approach valuation methods can be applied to conclude various alternative standards (or definitions) of value, including fair value, FMV, and other standards of value. The valuation procedures performed and the valuation variables selected should be consistent with the standard of value sought.
11. The asset-based approach valuation methods can be applied to conclude various alternative premises of value, including value in continued use and value in liquidation. The valuation procedures performed and the valuation variables selected should be consistent with the premise of value sought.
12. A going-concern premise of value implies that the business owner/operator will recreate the actual business entity. The analyst will typically apply cost approach valuation methods to conclude the value of the subject tangible assets and intangible assets as part of a business recreation analysis. A liquidation premise of value implies that the business owner/operator will liquidate the actual business entity. The analyst will typically apply market approach valuation methods to conclude the value of the subject tangible assets and intangible assets as part of a business liquidation.
13. The analyst will incorporate income tax considerations in an asset-based approach analysis as appropriate. Often, there are few income tax considerations in a going-concern premise valuation. A business typically would not incur an income tax liability if it were to incur the cost of recreating its own assets. A business may incur a deferred income tax liability if the value of its assets has appreciated over time. Often, there are many income tax considerations in a liquidation premise valuation. A business typically would incur an im-

mediate income tax liability if it were to sell its own assets.

14. For an asset holding company, an asset-based approach is often relied on to provide the primary value indication. For an operating company, the asset-based approach is not often relied on to provide the primary value indication. For an operating company valuation, the asset-based approach is often relied on in conjunction with other value indications. For an operating company, the asset-based approach is sometimes relied on to provide confirmation of the income approach and the market approach value indications.
15. 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. The valuation method and procedures applied in the asset-based approach are different from the valuation methods and procedures applied in the cost approach. Analysts often apply cost approach valuation methods to value certain tangible and intangible asset categories that are included in an asset-based approach business valuation. However, analysts also typically apply market approach and income approach valuation methods to value other tangible and intangible asset categories that are included in an asset-based approach business valuation.

The following section considers when to—and how to—apply certain methods and procedures in an asset-based approach business valuation.

When to apply the asset-based approach

A common nomenclature may be helpful to this discussion. Even the parties who rely on business valuations and valuation analysts often use asset-based approach jargon imprecisely.

First, the asset-based approach estimates the value of an entity's equity by reference to the value of the entity's assets minus the value of the entity's liabilities. The important point here is that this business valuation approach considers both assets and liabilities—not just assets. In applying asset-based approach methods, the analyst may conclude that the value of liabilities may (or may not) be represented by recorded accounting balance. However, the analyst should consciously and carefully reach that conclusion. An analysis that revalues the

entity assets only (and that ignores consideration of liability values) is not a proper application of the asset-based approach.

Second, the AA method involves the discrete revaluation of all of the entity asset and liability accounts. Effectively, this analysis starts with a blank balance sheet. The analyst identifies and values each financial asset account, real estate account, tangible personal property account, other asset account, identifiable intangible asset (or intangible personal property account), and a goodwill account value (positive or negative). Next, the analyst identifies and

analyst can incorporate such appraisals into the ANAV analysis.

The ANAV method aggregate equity revaluation is usually measured by the application of the CEEM. The conclusion of this CEEM analysis is the total amount of appreciation (over the recorded accounting balances) for all of the entity's net assets. Net assets are equal to total assets minus total liabilities. The result of this CEEM analysis is often called "intangible value in the nature of goodwill." This wordy title is deliberately intended to distinguish the analysis result from the goodwill amount that

The application of the cost approach (versus the market approach or the income approach) is important in determining whether the asset-based approach concludes a going-concern premise of value or a liquidation premise of value.

values each current liability account, long-term liability account, and contingent liability account. This liability valuation analysis includes any accounts that are changed or created as part of the asset valuation process. The sum of the individual asset values less the sum of the individual liability values indicates the entity's total equity value.

This total equity value is typically concluded on the same standard of value (e.g., fair value, FMV, investment value) that is used to value the individual asset and liability categories. This total equity value is typically concluded on the same premise of value (e.g., going-concern premise, liquidation premise) that is used to value the individual asset and liability categories. The total equity value is typically concluded (at least initially) on a marketable, controlling level of value basis. If another level of value is sought in the analysis, appropriate valuation adjustments (e.g., discounts) should be identified and quantified. The level of valuation adjustments appropriate to the asset-based approach value indication may be different than the level of valuation adjustments appropriate to the income approach or the market approach value indications.

Third, the ANAV method involves a collective or aggregate revaluation of the entity's total equity value. Often in the ANAV method, none of the individual asset and liability accounts are revalued. Sometimes in the ANAV method, the analyst may revalue one or more individual asset accounts. For example, the entity owner/operator may provide the analyst with a current appraisal of the inventory account or of the owned real estate. Further, the

would be concluded from an AA method analysis or from a fair value accounting purchase price allocation.

The intangible value in the nature of goodwill is added to the accounting balance of owners' equity. The sum of that addition indicates the defined value indication of the entity's net asset value. If the result of the CEEM analysis is negative, the result is often called economic obsolescence. The same analytical procedure is then called the capitalization of income loss method (CILM). Regardless of the name for the method, the negative intangible value is subtracted from the owners' equity accounting balance. The remainder of the subtraction still indicates the defined value indication of the entity's net asset value. The valuation variables used in the CEEM (or the CILM) should be consistent with the intended standard of value and the intended premise of value. Like the AA method, the ANAV method (at least initially) concludes a marketable, controlling level of value.

Fourth, the asset-based approach is not the same analysis as the cost approach. The asset-based approach is a generally accepted business valuation approach.

The cost approach is a generally accepted property valuation approach. The cost approach is often used to value some (or many) of the entity's asset categories in the application of the asset-based approach. The cost approach is typically not applicable to the valuation of the entity's liability categories.

In the valuation of an asset holding company, the analyst may rely on the cost approach and/or the market approach to value all of the

entity's individual asset categories. In the valuation of an operating company, the analyst may rely on the cost approach and/or the market approach to value some of the entity's individual asset categories. However, the analyst will usually rely on the income approach to value at least one intangible asset category in the valuation of an operating company. That asset category may be the entity's goodwill asset category.

The application of the cost approach (versus the market approach or the income approach) is important in determining whether the asset-based approach concludes a going-concern premise of value or a liquidation premise of value. As further described below, the primary use of the cost approach to value the entity's tangible or intangible property typically concludes a going-concern premise of value. The primary use of the market approach to value the entity's tangible or intangible property typically concludes a liquidation premise of value. The primary use of the income approach to value the entity's tangible or intangible property may conclude either a going-concern premise of value or a liquidation premise of value—depending on the individual valuation variables selected for the analysis.

Again, the analyst will apply the income approach (and typically the CEEM) in the valuation of at least one intangible asset in order to conclude a going-concern value for an operating company valuation. That income approach CEEM analysis will typically indicate any intangible value in the nature of goodwill for the profitable operating entity. The income approach CILM analysis will typically indicate any economic obsolescence for the less profitable operating entity. A significant amount of economic obsolescence concluded in the asset-based approach may indicate that the entity has a lower going-concern value than it does a liquidation value. In other words, the highest and best use (HABU) of that operating entity may be in liquidation (as compared to in continued operation). Of course, legal/contractual constraints and/or current owner desires may prevent the subject operating entity from achieving that HABU.

In terms of when to apply the asset-based approach, analysts should consider all three generally accepted business valuation approaches in the development of every business valuation. The asset-based approach is particularly applicable in the following circumstances:

1. It may be particularly relevant to the specific valuation assignment to identify the value of the entity's component asset categories. In addition to certain taxation-related purposes, this situation may occur in a business valuation performed for certain fair value measurement, bankruptcy, property tax, secured lending, and other purposes. For example, a potential acquirer may want an indication of what a purchase price allocation may look like before making an offer to buy the target entity.
2. It may be important for the party relying on the valuation to understand the factors that contribute to the subject entity value. In other words, the decision maker may want to understand the components of value of the subject entity. An asset-based approach analysis could inform the decision maker as to whether the primary entity value driver is real estate, tangible personal property, proprietary technology, trademarks, franchises, customer relationships, a highly skilled workforce, or any other asset category.
3. The analysis may require concluding alternative standards of value or alternative premises of value for the same subject entity. It is possible—but difficult—to adjust income approach and market approach analyses to conclude different standards of value and different premises of value. It is fairly straightforward to apply alternative asset-based approach procedures and variables to conclude different standards of value and different premises of value for the same entity.
4. The asset-based approach may be the default analysis when the income approach and the market approach are not applicable. The income approach may not be applicable when the entity does not have reliable financial statements—either historical or prospective. The market approach may not be applicable when there are not a sufficient number of comparable companies. That is, there may not be either sufficiently comparable publicly traded companies or sufficiently comparable acquired companies. In such instances, the asset-based approach may be the best valuation approach available.
5. The asset-based approach may be applied to provide a mutually supportive value indication to support the conclusions of the income approach and the market approach. One reason to develop any valuation approach is to provide confirmation of the results of the other valuation analyses.

6. Particularly in a tax litigation or other controversy context, an analyst may develop an asset-based approach simply to provide additional support for the analyst's expert opinion. The asset-based approach may be presented as either a primary or a supplemental value indication. However, it may be difficult for an opposing valuation expert to rebut if that expert did not perform his or her own asset-based approach analysis.
7. The asset-based approach valuation is particularly applicable if the subject entity would more likely sell in an asset sale deal structure—as compared to a stock sale deal structure. Smaller closely held companies often transfer as a sale of assets (instead of as a sale of stock). In addition, S corporations (and other tax pass-through entities) of all sizes often transfer as a sale of assets (instead of as a sale of stock).
8. The asset-based approach is most applicable when the intended level of value is a marketable, controlling ownership interest level of value. At such a level of value, the entity owner could buy or sell all of the assets of the subject entity. If the intended level of value is a non-marketable, noncontrolling level of value, considerable valuation adjustments (i.e., discounts) may be necessary to complete the valuation analysis. Further, the analyst may have to consider if a nonmarketable, noncontrolling valuation subject would even have the legal right (or operational ability) to buy or sell all of the assets of the subject entity.

The above discussion summarizes many of the instances when an asset-based approach analysis is particularly applicable to the business valuation. Analysts should also realize that there are several caveats related to the development of an asset-based approach analysis. Some of these analyst caveats include the following:

1. The analyst should be professionally qualified to perform (and explain) all of the procedures required in the development of the asset-based approach. The analyst should be competent to perform all of the asset valuation and all of the liability valuation analyses required to develop the AA method. Also, the analyst should be competent to perform all of the valuation analyses required to measure intangible value in the nature of goodwill (whether positive or negative) in the ANAV method. Analysts sometimes rely on third-party specialists to value certain property categories.
- However, the analyst concluding the overall business value should be able to explain the work of the third-party specialist. It may not be sufficient for the analyst to naively state “I relied on the third-party specialist” to value an important property category in the asset-based approach analysis.
2. The analyst should understand the standard of value that is applied in the analysis of each asset category. The analyst should be careful to ensure that all asset categories are valued to a consistent standard of value. Also, the analyst should ensure that the standard of value applied to all of the asset categories is the same standard of value appropriate to the overall business valuation assignment.
 3. The analyst should understand the premise of value that is applied in the analysis of each asset category. The analyst should be careful to ensure that all asset categories are valued to a consistent premise of value. Further, the analyst should be careful that the premise of value applied to all of the asset categories is the same premise of value applied to all of the asset categories is the same premise of value appropriate to the overall business valuation assignment. The analyst should understand that different applications of the asset-based approach could conclude either a going-concern premise of value or a liquidation premise of value.
 4. The analyst should be professionally competent to understand (and explain) all of the income tax considerations related to the asset-based approach analysis. The analyst may need to consult a third-party tax specialist to revalue deferred tax asset and liability accounts and to recalculate any income tax liability related to the asset revaluation process.
 5. The analyst should be professionally competent to perform (and explain) the valuation of the subject entity liability accounts (both long-term debts and contingent liabilities) related to the asset-based approach analysis. The analyst should consider that there may be liability accounts (including tax liability accounts) that are created as a result of the application of the asset-based approach.
 6. The analyst should be professionally competent to quantify (and explain) any valuation discounts that should be applied in the asset-based approach analysis. These discounts may include both entity-level discounts (e.g., key employee dependence, key customer dependence) and security-level discounts (e.g.,

DLOC, DL0M). The analyst should also understand that the magnitude of the security-level discounts may be different for an asset-based approach analysis than for an income approach or a market approach analysis.

7. The analyst should consider that the asset-based approach typically concludes a marketable, controlling ownership interest level of value. The analyst should consider if that approach is applicable (even with the application of valuation discounts) to estimate a nonmarketable, noncontrolling level of value within the context of a particular valuation assignment.
8. The analyst should understand that an asset-based approach analysis is based on the principle that either: (1) the business owner/operator will buy (recreate) all of the subject entity assets, or (2) the business owner/operator will sell (liquidate) all of the subject entity assets. The analyst should consider whether either principle is appropriate within the context of the particular valuation assignment. That is, the analyst should consider if there are legal, contractual, regulatory, or other issues that would prohibit the business owner/operator from either buying (recreating) or selling (liquidating) all of the subject entity assets.

Going-concern valuations versus liquidation valuations

As mentioned above, the asset-based approach can conclude a going-concern value or a liquidation value. In other words, the asset-based approach can conclude a value in continued use or a value in exchange. Within the value in exchange (or liquidation) premise of value, the asset-based approach can conclude either an orderly disposition (or sale) of the entity assets or a forced disposition (or sale) of the entity assets. That is, the analysis can assume that the entity assets are sold individually but with either: (1) a normal marketing exposure to the most efficient secondary market, or (2) a less than normal marketing exposure to a fast sale secondary market.

Which premise of value the analysis concludes is not a function of the analyst's intention. And, the concluded premise of value is not based on the analyst's (or the client's) assumption. In other words, tax counsel (and other parties that rely on business valuations) often believe: the analyst performed an asset-based approach valuation of the subject entity. Assume that the analysis conclusion is a going-

concern value indication. That belief is unsupported. Again, the premise of value concluded by the asset-based approach is not based simply on the analyst's (or the taxpayer's or the tax counsel's) assumption. Rather, the premise of value concluded by the asset-based approach is influenced by:

1. The selection of the valuation approaches and methods applied to value the entity's individual asset categories and individual liability categories.
2. The selection of the specific valuation variables and valuation procedures applied (within the selected approaches and methods) to value the entity's individual asset categories and individual liability categories.

This valuation principle seems elusive to many analysts—and to taxpayers and tax counsel. However, this valuation principle could not be more straightforward. If the analyst applies approaches, methods, and procedures that conclude the going-concern value for each asset category, then the asset-based approach analysis will conclude a going-concern value for the subject entity. If the analyst applies approaches, methods, and procedures that conclude the liquidation value of each asset category, then the asset-based approach analysis will conclude a liquidation value for the subject entity.

The confusion related to the above basic principle may be caused by the fact that most business valuation analysts (and most tax counsel) are not property valuation analysts. The business valuation analysts (and tax counsel) often rely on the work of third-party valuation specialists to conclude the value of the subject entity's inventory, real estate, machinery and equipment, intellectual property, and so on. The property appraiser's report may conclude FMV or market value or some other stated standard of value. The business valuation analyst (and tax counsel) may have seen a standard of value definition that included words like "willing buyer and willing seller" and "market participant." The analyst (and tax counsel) just assumed that the property appraisal conclusion was a going-concern value indication.

The analyst (and tax counsel) did not investigate the property appraiser's assumptions regarding how the "willing buyer and willing seller" or the "market participants" would get together and transact the sale of the subject asset category. Would all of the subject entity's assets be sold at the same time, for example, as

part of a business merger or acquisition? That transactional premise seems unlikely if the property appraiser was tasked with appraising one asset category (say real estate) only. Would all of the subject entity's assets be sold piecemeal, with each property category sold individually at its highest price after its own market exposure period? Would all of the subject entity's assets be sold, but in a transaction where all of the property categories have to be sold at the same time?

The above transactional scenarios could involve "a willing buyer" and "a willing seller" for each property category. However, each set of transactional assumptions would conclude a different value for the same property category. Some of these "fair market value" conclusions could be considered going-concern premise of value indications and some of these conclusions could be considered liquidation premise of value indications.

proach property valuation methods usually indicates a liquidation value for the subject asset categories.

The application of income approach property valuation methods may indicate either a going-concern value or a liquidation value for the subject asset categories. Accordingly, the selection of the individual valuation variables will determine whether the income approach indicates going-concern value or a liquidation value.

Therefore, the remainder of this section of the discussion will focus on the application of the property valuation cost approach and income approach within the context of developing asset-based approach going-concern value indications.

The property valuation cost approach is based on the economic principle of substitution. The value of an individual property is influenced by the cost required to obtain a substitute property. From a business buyer's perspective, a

The analyst should be professionally competent to understand (and explain) all of the income tax considerations related to the asset-based approach analysis.

Experienced property appraisers appreciate the subtle (but quantitatively significant) difference between these premise of value transactional assumptions. Even experienced business valuation analysts (and taxpayer and tax counsel) may not appreciate these property appraisal subtleties. Therefore, the valuation analyst (and the taxpayer and tax counsel) should not assume that the asset-based approach analysis concludes the intended level of value.

When the asset-based approach concludes a going-concern value

The asset-based approach concludes a going-concern business value when the property valuation approaches applied conclude a going-concern value for each of the entity's asset categories. So, the primary issues in the application of the asset-based approach are as follows:

1. Which property valuation approaches and methods conclude a going-concern value for each asset category?
2. Which property valuation approaches and methods conclude a liquidation value for each asset category?

Generally, the application of cost approach property valuation methods indicates a going-concern value for the subject asset categories. In addition, the application of market ap-

proach property valuation methods usually indicates a liquidation value for the subject asset categories. The buyer is faced with a make versus buy decision. The buyer will not pay more to buy an asset category than the amount of cost that would be required for the buyer to make (i.e., recreate) that asset category. The seller looks at the valuation problem from an opposite, but similar, perspective. The business seller would not sell the subject asset for a price less than the amount of cost that the buyer would have to spend to make (i.e., recreate) that asset.

There are various cost components (e.g., direct costs, indirect costs) that are included in a cost approach analysis. There are various cost metrics (e.g., replacement cost new, reproduction cost new) that may be measured in a cost approach analysis. And, all cost approach analyses should consider the various components of depreciation and obsolescence required to convert the cost metric into a value metric.

From the business owner/operator's perspective, all cost approach analyses answer the same question. If a business entity did not already own all of its component assets, how much would it cost to replace all of the entity's asset categories? That cost approach analysis would include all of the costs required to get the replacement asset in place and ready to operate. That is, the cost approach analysis quantifies the amount of cost required to reassemble a going-concern bundle of fully op-

erational assets. Considered another way, the cost approach measures the amount of cost required to reassemble the income-producing capacity of the entity's current bundle of operating assets.

Accordingly, the cost approach indicates a going-concern value for the entity's assets. In the cost approach, the business owner is not trying to sell off the entity's assets. In contrast, the business owner is trying to buy (i.e., reassemble) all of the entity's assets. The cost approach analysis answers the question: how much would it cost to assemble all of the subject entity's assets in place, ready to operate, and ready to generate income?

Therefore, the cost approach to property valuation does not consider any value reductions for sale make-ready expenses, sale holding period expenses, sale commission expenses, or income taxes related to the property sale. That is because the current business is not selling any of its property. Rather, theoretically, the current business is buying (i.e., replacing) all of its property. Also, there are no selling expenses incurred—or income taxes due—when a business buys property.

The asset-based approach concludes a going-concern business value when the property valuation approaches applied conclude a going-concern value for each of the entity's asset categories.

In an asset-based approach business valuation analysis, the cost approach may be particularly applicable in the valuation of either fungible tangible assets or contributory (sometimes considered "back room") intangible assets. For example, the cost approach is often used to conclude the going-concern value of an entity's inventory, real estate, and machinery and equipment. The cost approach is often used to conclude the going-concern value of an entity's computer software, proprietary formulas and technical documentation, databases, customer lists and other trade secrets, and assembled workforce.

The property valuation income approach is based on the economic principle of expectation, meaning that the value of the individual property is influenced by the present value of the future income that can be earned from the operation of that property. The determination of whether the income approach indicates a going-concern value or a liquidation value depends on the answer to the ques-

tion: who is the assumed owner of the subject property?

The property valuation income approach is based on the present value of the future income generated from the operation of the subject property or asset category. That income projection is present valued at a risk-adjusted present value discount rate. The important valuation variables included in the income approach analysis include:

1. The amount of the income projection.
2. The term of the income projection.
3. The present value discount rate.

The individual variables considered in the amount of the income projection include:

1. The level of (and growth rate of) revenue associated with the property.
2. The level of (and margin of) profitability associated with the property.
3. The amount of any investment (e.g., working capital, capital expenditures) required to support the income projection.
4. The level (and rate) of income taxes associated with the income projection.

The individual variables considered in the term of the income projection include:

1. The remaining useful economic life (UEL) of the property.
2. The shape and slope (usually, the decay rate) of the UEL curve.

The individual variables considered in the discount rate (or in the direct capitalization rate) analysis include:

1. The subject property cost of capital components.
2. The possibility of a residual value or a terminal value period.
3. Any income growth rate (positive or negative) in that residual value.

In selecting each one of the above-listed income approach variables, the analyst (implicitly or explicitly) makes the following decision:

1. Do I select the valuation variables that are appropriate to the current business owner/operator—that is, variables that assume a continuation of the current ongoing business operations? or
2. Do I select valuation variables that are appropriate to the typical (or specific) market participant, meaning the next business owner/operator—that is, variables that assume a change of ownership and a change of operation due to a sale of the subject business entity?

If the analyst selects the first above-listed option (i.e., valuation variables based on the current owner/operator), the income approach

analysis will indicate a going-concern value for the subject property. This analysis will indicate the value in continued use of the property category—as part of the current going-concern business operations.

If the analyst selects the second above-listed option (i.e., valuation variables based on the next market participant owner/operator), the income approach will indicate a liquidation value for the subject property. This value should not be construed as a forced or an involuntary liquidation value. Rather, this value simply assumes that the subject property is sold separately from the rest of the subject entity asset categories. The other business assets are left behind (or, likely, sold separately in an orderly disposition), but the subject property is sold to a new buyer. This analysis will indicate the value in exchange of the property category—that is, the value to the new buyer—but not the value as part of the current ongoing business operation.

In performing the income approach property valuation, the analyst could select growth rates, profit margins, income tax rates, UEL curves, discount rates, and direct capitalization rates that would be appropriate to the subject business entity. The application of such selected valuation variables would produce a going-concern value indication. Such an analysis would indicate the value of the subject asset category as part of the subject going-concern business entity. That value would measure the contribution of the individual asset category to the current business entity. The asset category continues to be owned by the subject entity. If there is an assumed sale transaction, the entire business enterprise would sell as one collective unit of operating assets.

In performing such a property valuation, the analyst does not have to consider holding period expenses, make-ready expenses, sales commission, or capital gains taxes. The individual property is not sold separately, so these sale-related expenses are not incurred and these sale-related liabilities are not created.

In an asset-based approach analysis, the income approach may be particularly applicable to tangible assets or intangible assets that directly generate a measurable income stream. Such tangible asset examples may include income-producing or rental property real estate, such as hotel, commercial office buildings, and residential apartment complexes. Such intangible asset examples may include customer re-

lationships, franchises, licenses, trademarks, copyrights, and development or commercialization agreements.

Goodwill and economic obsolescence

In the going-concern application of the asset-based approach, analysts typically apply an income approach analysis to value at least one intangible asset. In the AA method, analysts typically use a multiperiod excess earnings method (MEEM) analysis or a CEEM analysis to identify and value any residual goodwill. In the ANAV method, analysts typically use the CEEM analysis to collectively value all of the entity's intangible value in the nature of goodwill.

The use of at least one income approach analysis is an important procedure in the going-concern application of the asset-based approach. This procedure quantifies any residual intangible business value owned by the subject entity after appropriate value components have been assigned to all other tangible assets and identifiable intangible assets. This procedure is intended to prove that the value of the subject entity is at least equal to the value of the sum of its parts. That is, the value of the business entity is equal to (or greater than) the sum of the individual values of the component tangible assets and identifiable intangible assets. This additional value is measured as the present value of any excess income not attributable to the entity's tangible assets and identifiable intangible assets. The present value of this excess income is usually referred to as goodwill.

The other reason why analysts typically apply an income approach analysis to at least one intangible asset is because such a procedure is a test for economic obsolescence. This procedure is applicable when the analyst applies a MEEM to value, for example, a franchise, a license, or customer relationships. This procedure is applicable when the analyst applies a CEEM to measure intangible value in the nature of goodwill. The point is that either the MEEM analysis or the CEEM analysis sometimes indicates that there are no excess earnings being generated at the subject entity. In fact, there may be an income loss being generated at the subject entity. From a valuation perspective, an income loss occurs when the entity earns an amount of income that is less than a fair rate of return on the value of its tangible assets and identifiable intangible assets.

If the entity is earning an income loss based on the estimated value of its assets, the analyst capitalizes this income loss. This procedure is called the capitalization of income loss method (CILM), and it is a generally accepted method to measure economic obsolescence within a cost approach property appraisal. The CILM estimate of economic obsolescence is sometimes thought of as negative goodwill. However, since an entity cannot record a negative goodwill balance, the analyst will decrease the indicated value of the entity's other assets—until the negative goodwill is eliminated.

each of the entity's asset categories. Generally, the application of market approach property valuation methods indicate a liquidation value for the subject asset categories.

Depending on the individual valuation variables applied, the income approach property valuation methods indicate a liquidation value for the subject asset categories. This premise of value is concluded when the selected valuation variables relate to how the next property owner will operate the subject asset category. So, the analyst may select projected growth rates, UEL curves, revenue levels, expense levels, profit

In an asset-based approach analysis, the income approach may be particularly applicable to tangible assets or intangible assets that directly generate a measurable income stream.

That is, the analyst adjusts the value of all entity assets valued using the cost approach for this amount of economic obsolescence. This adjustment would apply to all asset categories valued by reference to the cost approach—both tangible assets and identifiable intangible assets. When the value of these assets decreased, the income needed to provide a fair rate of return on those assets is also decreased. When the value of the cost approach assets is sufficiently decreased by this recognition of economic obsolescence, the income loss is reduced to zero. At that point, the entity experiences no excess earnings, but the subject entity experiences no income loss either. There is no positive goodwill value to recognize, but there is no negative goodwill indication either.

There, the application of an income approach method (a MEEM or a CEEM) is an important procedure for two reasons. First, it identifies and quantifies any positive intangible value associated with any excess income (that is not associated with any other tangible asset or identifiable intangible asset). Second, it identifies and quantifies any economic obsolescence. Such an economic obsolescence indication indicates that an adjustment is needed to the appraised value of the entity's other assets—to avoid overstating the net asset value of the subject business entity.

When the asset-based approach concludes a liquidation value

The asset-based approach concludes a liquidation business value when the property valuation approaches applied conclude a liquidation value for

levels, investment levels, discount rates, and direct capitalization rates that relate to a "market participant" next owner. Such valuation variables will indicate a liquidation value for the subject tangible asset or subject intangible asset. In contrast, the analyst may select valuation variables that reflect how the current owner/operator will operate the property. Such valuation variables will indicate a going-concern value for the subject tangible asset or subject intangible asset.

As described above, the market approach or the income approach will conclude the price the current owner/operator business entity will receive when it sells the asset category to a new owner/operator business entity. Again, within the asset-based approach context, the term liquidation valuation premise should not imply either a forced liquidation sale or an involuntary sale. Rather, this valuation premise assumes that each asset category (or bundle of assets) is sold separately—in an orderly disposition and with a normal exposure period to the market—in order to maximize the sale price. The asset category may be (and likely will be) sold between one going-concern business entity and another going-concern business entity.

However, this valuation premise assumes that the asset categories are sold separately from each other. This valuation premise does not necessarily assume that the entire subject business enterprise is sold, as one collective bundle of properties, in either a public stock offering or a merger and acquisition transaction.

Since the market approach and the market-participant-based income approach assumes an asset sale, the analyst has to consider that

same process in the asset category valuation. For example, the analyst should consider the following factors when estimating the value contribution of the asset category sale to the subject entity:

1. The timing of the asset sale; will it occur immediately? In six months? In two years?
2. Any contractual, legal, or other restrictions associated with the timing of (or the ability to complete) the asset sale.
3. Any holding period expenses during the market exposure period; these expense categories may include interest expense, insurance expense, and property tax expense.
4. Any make-ready costs to get the asset category ready for sale; these expense categories may include R&D expense, deferred maintenance expense, and capital expenditures.
5. Any sale-related expenses; these expense categories may include legal fees, brokerage fees, and sales commissions.
6. Any tax-related expenses; these expense categories may include capital gains taxes—that are either payable at the time of the sale or deferred to a future period.

In the liquidation premise of the asset-based approach, the analysis ultimately measures the contribution of the entity's cash balance related to the sale of the entity's asset categories. The asset selling price is the amount the buyer would pay to the seller for that property category. However, the value contribution to the asset-based approach business valuation is the asset selling price—less any expenses incurred or liabilities created as a result of the property sale. In other words, the value contribution of the property category sale to the business entity is the amount of the net proceeds available for distribution to the business entity owners.

This issue illustrates an important quantitative difference between the going-concern-based asset-based approach and the liquidation-based asset-based approach. The going-concern analysis applies the cost approach or an owner/operator income approach to value the subject

entity asset categories. In this asset-based approach analysis, the subject entity buys or recreates all of its asset categories. There are no asset selling expenses or related liabilities. This is because there are no asset sales.

In contrast, the liquidation analysis applies the market approach or the market participant income approach to value the subject entity asset categories. In this asset-based approach analysis, the subject entity sells all of its asset categories. The analyst has to consider asset selling expenses and liabilities. This is because such expenses will be incurred and such liabilities will be created when the subject entity assets are sold.

Accordingly, the analyst (and the tax counsel and any other party relying on the valuation) should expect to conclude different value indications from the two different applications of the asset-based approach to business valuation. Therefore, the selection of which premise of value—and which property valuation approaches and methods—to apply is an important consideration in any asset-based approach business valuation analysis.

Conclusion

The asset-based approach is a generally accepted business valuation approach. The asset-based approach may be used to value closely held business, business ownership interests, and securities for taxation planning, compliance, and controversy purposes. In addition, the asset-based approach may be used to value closely held companies for transaction, financing, financial accounting, strategic planning, and litigation purposes. That said, many analysts (and taxpayers, tax counsel, regulatory authorities, and other parties who rely on business valuations) are not particularly familiar with the asset-based approach. Part two of this article will discuss future sales of the entity's assets; holding period costs and selling expenses; and income tax liability. It will also provide an illustrative example of a going-concern valuation. ■