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HYDE Valuations, Inc.

**We Value Both Real Estate and Businesses
Including Machinery & Equipment**

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The Asset (Cost) Approach

An appraisal is an informed opinion as to the value of something: i.e. real estate, a business interest, a piece of equipment. There are three basic appraisal approaches: the asset approach, the market approach and the income approach. Each approach includes several methods that may be employed and each method has some strengths and weaknesses.

The asset approach, also referred to as the cost approach or the replacement-cost approach, typically involves adjusting a business's individual assets (and sometimes the liabilities) to fair market value. In a real estate appraisal assignment, the approach typically involves determining the replacement cost new for the improvements then deducting the loss in value due to age, wear and tear, and any loss from functional or economic obsolescence. The asset approach often does not include any value that might accrue to the subject from intangible assets, or in the case of real estate, the replacement cost of the improvements plus the value of the land may differ from what a willing buyer would pay and from what a willing seller would accept for a variety of reasons.

In theory the asset approach appears to be quite simple to apply, however in practice it is sometimes the most difficult appraisal approach to develop. When valuing a business enterprise, the value of the tangible or hard assets, often does not tell the complete story. For example, suppose the subject of an appraisal is a small, profitable service business that owns only a few tools, a computer and a desk. Is the value of that business accurately depicted by an asset valuation conclusion of a few hundred dollars?

How about a large manufacturing company that literally owns millions of dollars of machinery, vehicles, and office furniture? On the surface this scenario sounds like a good fit, but what if the business has been shut down for three months because it had operated at a loss for some time, and now all the assets need to be liquidated? Or as a second alternative, what if that same business is operating at full capacity, and is looking to expand into a second facility within the next year?

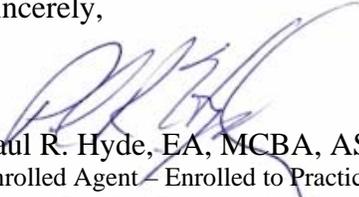
Each of these scenarios described above highlight some wrinkles in the use of the asset approach to value a business. Once those wrinkles are dealt with, the indicated value derived using the asset approach can be useful, but there are also assignments for which only the asset approach is applicable. For example, a special purpose real estate property usually cannot be valued using any approach other than the asset approach. Likewise, many family limited partnership type entities that are essentially a holding company, can only be valued using an asset approach.

It is important to understand the limitations and strengths of each appraisal method and approach with respect to the assignment. The appraiser should carefully explain the data used, the application of the appraisal method, and the degree of confidence that should be placed on the indication of value from that method. Depending on a large variety of circumstances, the confidence in any particular appraisal method can vary from very low to quite high. If possible, more than one appraisal approach should be used in order to provide support for conclusions from methods in other approaches.

Knowing how to apply each appraisal method within each approach is very important in any given assignment, but even more important is understanding and explaining the strengths and weaknesses of each method used so that the reader of the report can understand the final value conclusion.

Valuations play a part in all strategic transactions, tax, and many litigation matters. For additional information or advice on a current situation, please do not hesitate to call. **We value both real estate and businesses including machinery & equipment.**

Sincerely,



Paul R. Hyde, EA, MCBA, ASA, MAI
Enrolled Agent – Enrolled to Practice Before the IRS
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Accredited Senior Appraiser – Business Valuations
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