PART I

Foundations: Valuing a Business
CHAPTER 1

Fundamental Concepts for Defining Value

This chapter discusses the concepts and framework for defining value. These include the standard of value, the level of value, and the premise of value. Using this basic foundation for defining value, Chapter 2 moves through the primary defining elements of an appraisal engagement that include the value definitions discussed in this chapter.

When we say the word *value*, we all presume that we know what that means. However, it is just not quite that simple. This chapter defines and distinguishes between the standard of value, the level of value, and the premise of value, including the differences within each of those fundamental building blocks of business valuation.

Standard of Value

According to *Merriam-Webster*, the literal and conceptual meaning of the word *value* includes the following:

*A fair return or equivalent in goods, services, or money for something exchanged;*

1. *The monetary worth of something;*
2. *Relative worth, utility, or importance;*
3. *A numerical quantity that is assigned or determined by calculation or measurement;*
4. *The relative duration of a musical note;*
5. *Relative lightness or darkness of a color or the relation of one part of a picture to another with respect to lightness or darkness;*
6. *Something (as a principle or quality) intrinsically valuable or desirable.*

Defining value is not as easy a task as you might initially believe (as it turns out, naivete is not so blissful). There are quite a few trees and paths in this forest that need to be marked or users of valuation reports will potentially wander.
aimlessly and never find their way home. Casual reference to the value or use of terms like fair value and fair market value can be highly misleading. There are very specific meanings attached to various concepts of value. In the world of financial valuation, care must be taken to define and understand what standard of value is being used. Gift, estate, and corporate tax matters require the use of fair market value. Litigated matters often invoke the standard of fair value, which varies from state to state or between state and federal jurisdictions. More confusing, fair value is also a defined standard of value promulgated for financial reporting in the public accounting domain. Also in the mix are a few more standards like investment value, intrinsic value, and fundamental value. The standard of value serves a specific purpose in every valuation. Without the proper standard of value clearly defined and its tenets strictly adhered to, the valuation methodology and resulting analysis can be meaningless for the purpose for which the report was developed.

**Intrinsic value**, as defined by the American Society of Appraisers (ASA), is the value that an investor considers, on the basis of an evaluation or available facts, to be the true or real value that will become the market value when other investors reach the same conclusion.

Intrinsic value (also known as fundamental value) is appealing both logically and intuitively as the standard of choice for most valuation situations. However, the most widely recognized standard of value in the United States is **fair market value**, which is defined by the ASA as:

*The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing buyer and a hypothetical willing and able seller, acting at arm’s length in an open unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts. (Note: In Canada, the term “price” is replaced with the term “highest price.”)*

Fair market value is a standard of value used for virtually all tax matters in the United States. Internal Revenue Service Revenue Ruling 59–60 provides additional clarifications to the definition of fair market value:

*Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well-informed about the property and concerning the market for such property.*

Fair market value is an arm’s-length standard that assumes willing and informed buyers and sellers (collectively investors), no compulsion on the behalf of investors, and investors have the financial capacity to engage in transactions. Under the standard of fair market value, both the buyers and sellers are hypothetical, and the transactions contemplated by the standard are also hypothetical. In other words, appraisal conclusions are based on hypothetical transactions involving hypothetical parties. Fair market value also assumes that the contemplated hypothetical transactions are transacted in terms of cash (equating the currency of the expressed value to the cash equivalent of a freely traded public market place).
Table 1.1 is borrowed from *Valuing a Business*, 5th edition\(^1\) and provides an overview of the standard of value typically employed for valuations developed for numerous purposes.

Lay and experienced users alike often unwittingly employ an intrinsic value mindset. However, fair market value can differ greatly from intrinsic value. There are some significant differences between the world of fair market value, where appraisals fashion a hypothetical transaction, and the real world where actual investors have little in common with hypothetical investors.\(^2\) We find the comparisons of the assumed conditions and elements of fair market value and the realities of the actual transaction universe to be useful instruction in the attainment of the appropriate mindset on standard of value as shown in Table 1.2.\(^3\)

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**Table 1.1 Matching the Standard of Value to the Purpose of the Appraisal**

<table>
<thead>
<tr>
<th>Purpose of Valuation</th>
<th>Standard of Value Utilized</th>
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<tbody>
<tr>
<td>Gift and estate taxes, charitable contributions</td>
<td>Fair market value</td>
</tr>
<tr>
<td>Purchase or sale</td>
<td>Can be fair market value but most often is investment value reflecting unique circumstances and/or motivations</td>
</tr>
<tr>
<td>Marital dissolution</td>
<td>Varies greatly by state and may include hybrid consideration of fair value and fair market value</td>
</tr>
<tr>
<td>Buy-sell agreements</td>
<td>At the discretion of the agreeing parties; requires agreement at a point in time and proper wording in the agreement documents; often multiple value definitions depending on the nature of the triggering event of the agreement</td>
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<tr>
<td>Dissenting shareholder actions</td>
<td>Fair value in most states; may be specified by statute and/or derived from case law in each jurisdiction</td>
</tr>
<tr>
<td>Minority oppression actions</td>
<td>Often fair value; likely consistent with dissenter actions</td>
</tr>
<tr>
<td>Employee stock ownership plans</td>
<td>Fair market value (promulgated by U.S. Dept. of Labor)</td>
</tr>
<tr>
<td>Ad valorem (property) taxes</td>
<td>Fair market value</td>
</tr>
<tr>
<td>Going private</td>
<td>Fair value in most states</td>
</tr>
<tr>
<td>Corporate or partnership dissolutions</td>
<td>Fair value</td>
</tr>
<tr>
<td>Antitrust cases</td>
<td>Damages quantified according to case law and jurisdiction</td>
</tr>
<tr>
<td>Other damage cases</td>
<td>Damages quantified according to case law and jurisdiction</td>
</tr>
<tr>
<td>Bankruptcy</td>
<td>Fair market value but can vary; must consider premise of value for various assets of the bankrupt estate</td>
</tr>
<tr>
<td>Financial reporting</td>
<td>Fair value, pursuant to the accounting codification standard for which the report is developed</td>
</tr>
</tbody>
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\(^3\) Z. C. Mercer and T. W. Harms, *Business Valuation: An Integrated Theory*, 2nd ed. (Hoboken, NJ: John Wiley & Sons, 2008), Figure 8-2, 328.
<table>
<thead>
<tr>
<th>Table 1.2  Fair Market Value versus Real World</th>
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<tbody>
<tr>
<td><strong>Fair Market Value Hypothetical Market</strong></td>
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<tr>
<td>Market participants</td>
</tr>
<tr>
<td>At arm’s length</td>
</tr>
<tr>
<td>Willing to trade</td>
</tr>
<tr>
<td>Reasonable knowledge</td>
</tr>
<tr>
<td>Absence of compulsion</td>
</tr>
<tr>
<td>Bargaining parity</td>
</tr>
<tr>
<td>Ability to trade (financial capacity)</td>
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</tbody>
</table>
Rational, economic values  
Each party approaches a transaction rationally and makes decisions based on financial and economic consequences (costs or benefits). Transactions occur at consensus pricing of rational (hypothetical) investors based solely on the financial and economic characteristics of the subject interest, and not the highest price that might be obtained.

Transactions may be influenced by strategic motivations, operating synergies, sentimental values, psychological factors, or other factors, all of which may distort the economics of pricing from the viewpoint of the seller, the buyer, or both. Transaction pricing may or may not reflect rational pricing based solely on the financial and economic characteristics of the subject interest.

Cash-equivalent values  
Hypothetical transactions are assumed to be conducted in terms of cash, i.e., in terms of money or money’s worth, or dollars of present value as of the date of the transaction. The price agreed upon is the value of the subject interest and not the proceeds of the sale (value minus expenses).

Negotiated deals may contain elements of consideration that disguise their effective economics, including earn-outs, puts, debt instruments with above or below market rates and/or terms, or restrictions on the ability to sell stock or debt instruments received by sellers.

Rational markets  
The market for the subject property is rational and consistent.

Real world markets experience booms and panics that can swing value widely or wildly and over very short time frames.

Impact of restrictions  
Restrictions, whether legal or contractual, which might preclude a transaction, are normally assumed to lapse long enough to permit the transaction; however, the economic impact of the restrictions is considered in determining value.

Restrictions can preclude or hinder transactions, or affect their outcomes in unpredictable ways.

Transactions occur  
Hypothetical buyers and sellers negotiate and a hypothetical transaction consistent with the definition of FMV (and the elements above) occurs. Further, the transaction is assumed to occur as of the valuation date.

Real buyers and sellers negotiate. An actual transaction may or may not occur. If a transaction occurs, it may or may not reflect some or all the elements of FMV, and it may or may not be indicative of the FMV of the traded interest. This point is particularly true the further removed in time an actual transaction is from a FMV valuation date regarding the same or a similar interest.
A standard of value that typically applies to dissenter’s rights or shareholder oppression cases is that of **fair value**. As a matter of practicality and often the money issue in litigated matters, the fair value statutes (case law, etc.) for a given jurisdiction generally determine whether minority interest discounts and/or marketability discounts are to be applied in shareholder rights litigation. Statutory law may also provide guidance about whether the circumstances giving rise to the litigation are relevant in determining a fair value for the interests in question. Because most fair value appraisal assignments are developed in preparation for potential conflicts or in response to disputed matters, attorneys are often involved in the process of defining the specific attributes of fair value in a given jurisdiction. In such a process, the appraiser may be asked to review case precedents in order to provide feedback from a valuation perspective regarding what the functional and prescriptive attributes of fair value are for the subject interest in the instant case.

There is no universal definition of fair value for business appraisers. Fair value is typically described statutorily in a general sense. The Uniform Business Corporation Act defines fair value as follows:

*Fair value, with respect to dissenter’s shares, means the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable.*

This definition of fair value provides no valuation guidance for appraisers about how value is to be determined. When fair value is defined in a state’s statutes, it must be interpreted judicially. Some states, such as Delaware, have relatively well-developed case law defining fair value under various specific circumstances and for specific events. Other states do not. The appraiser should require an attorney’s interpretation of the applicable state’s statutory case law. Legal interpretations must be condensed into actionable terms from a valuation perspective.

**Fair Market Value—A Platform for Developing and Communicating a Business Valuation**

Revenue Ruling 59-60 provides a framework for the development (due diligence) and communication (reporting) of a business valuation report. As shown in the following section, there are eight general categories of consideration that the IRS deems obligatory for an appraiser to consider when valuing a closely held ownership interest. Most appraisal reporting products rendered by accredited appraisers make use of content outlines and other disclosures and qualifications that flow directly from these standards. Familiarity with these standards, as well as those of the accrediting entity of the appraiser, is highly recommended to users of valuations reports. Of course, not all appraisal reports are developed by accredited appraisers. Nonetheless, appraisals for a great many tax-compliance purposes must live up to certain
requirements, and no person rendering an appraisal report is exempt from the following required procedural and documentation requirements. Revenue Ruling 59–60 is also a platform for valuations of virtually all types.

Revenue Ruling 59–60—Critical Considerations for Valuing Closely Held Entities and Ownership Interests Therein

In the valuation of the stock of closely held corporations or the stock of corporations in which market quotations are either lacking or too scarce to be recognized, all available financial data, as well as all relevant factors affecting the fair market value, should be considered. The following factors, although not all-inclusive, are fundamental and require careful analysis in each case:

1. The nature of the business and the history of the enterprise from its inception
2. The economic outlook in general and the condition and outlook of the specific industry in particular
3. The book value of the stock and the financial condition of the business
4. The earning capacity of the company
5. The dividend-paying capacity
6. Whether the enterprise has goodwill or other intangible value
7. Sales of the stock and the size of the block of stock to be valued
8. The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over the counter

Level of Value

Can there be more than singular measure of fair market value for a given business or business ownership interest? Are different value attributes associated with owning all of a business versus just a piece of it? Is there empirical evidence and investor behavior in real markets from which we can reasonably fashion hypothetical investors who will transact their interests at differing values based on the nature of the interest and the facts and circumstances both existing and expected? The answer to all of these questions is yes.

Valuation practitioners, their clients, the courts, and other stakeholders have long grappled with the concept that a business and/or an ownership interest can have differentiated values, which in theory exist at the same time. When faced with this concept for the first time, most stakeholders seem incredulous with the notion, as if a secret panel convened in a smoke-filled room to contrive some confusing concept just to justify their existence and generate fees. Although a great many transactions in the real world may take place in such a setting, there is no diminishing the fact that investors transact their interests at differing valuations based on the relative size (percentage) of the interests and the circumstances of the transactions.
The levels of value shown in Figure 1.1 is a conceptual framework that helps explain and reconcile the facts, circumstances, and actions of individuals and businesses as they contemplate and engage in transactions of businesses and/or business ownership interests. It harmonizes and organizes the maze of facts that exist in individual transactions involving a particular business interest and describes, generally, the valuation relationships that emerge from the universe of all transaction activity.

It is understandable for the user of a valuation report to confuse the various levels of value. Business owners most often think and speak of business value in terms of an enterprise basis or perhaps a sale basis. Enterprise value is also used to describe real-world transactions that most often represent sales of assets as opposed to transactions of equity securities. Valuation professionals rely on terminology like controlling interest basis or minority interest basis.

The various levels of value are described below starting from the highest level of value and descending to the lowest level.

**Strategic control value** refers to the value of the enterprise as a whole, incorporating the strategic intent that may motivate particular buyers and the expected business and financial synergies that may result from an acquisition. Higher expected cash flows relative to financial buyers enable strategic purchasers to pay a premium, often called a strategic control premium, relative to financial control value. A strategic buyer may also increase the price it will pay based on the use of its own, presumably lower, cost of capital.

**Financial control value** refers to the value of the enterprise, excluding any synergies that may accrue to a strategic buyer. This level of value is viewed from the perspective of a financial buyer, who may expect to benefit from improving the enterprise’s cash flow but not through any synergies that may be available to a strategic buyer.

**Marketable minority value** refers to the value of a minority interest, which lacks control but enjoys the benefit of liquidity as if it were freely tradable in

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**FIGURE 1.1** Traditional and Updated Levels of Value

![Diagram](https://example.com/diagram.png)
an active market. This level of value is also frequently described as the as-if-freely-traded level of value.

**Nonmarketable minority value** refers to the value of a minority interest, which lacks both control and market liquidity. Value at this level is determined based on the expected future enterprise cash flows that are available to minority shareholders, discounted to the present at an appropriate discount rate over the expected holding period of the investment. The nonmarketable minority level of value is derived indirectly by applying a marketability discount to marketable minority indications of value.

Levels of value can co-exist, with one shareholder owning a controlling interest, one a marketable minority interest, and one a nonmarketable minority interest. The appropriate level of value often depends on the purpose of the valuation. Stakeholders do not get to choose their level of value; there are clear guidelines about which level of value applies to which circumstance. Understanding the three primary levels of value is critical to the valuation process from the standpoint of the professional, the client, and other stakeholders. A thorough overview of considerations when valuing partial interests is included in the ASA’s PG-2.

**Premise of Value**

The standard of value is directly impacted by the underlying premise of value. An appraiser’s premise of value is either that of a going concern value or liquidation value. Going concern value assumes that the business enterprise is expected to continue to operate into the future. Conversely, liquidation value is defined as the net amount that would be realized if the business is terminated and the assets are sold. Liquidation can be either orderly or forced, as defined below:

- **Forced Liquidation Value**—liquidation value at which the asset or assets are sold as quickly as possible, such as at an auction.
- **Orderly Liquidation Value**—liquidation value at which the asset or assets are sold over a reasonable period of time to maximize proceeds received.

Most business valuations employ the premise of a going concern value in which the business is assumed to have a perpetual life and is not expected to be liquidated. However, the appraiser may be required to consider regardless of whether the value of subject interest would be maximized under a liquidation scenario. The level of value in the appraisal may also play an integral role in the consideration of value premise because minority shareholders and controlling shareholders have differing prerogatives to achieve the most economically desirable value outcome. Likewise, minority shareholders and controlling shareholders may have differing expectations regarding the timing for such events and the outcome.

Liquidation scenarios and assumptions can be dramatically affected by the state of the economy, the cycle of the business or industry, and market conditions for certain types of assets. In dire economic situations, the normal value disparity between orderly and forced liquidation can narrow or disappear. Under liquidation scenarios,
an appraiser may incorporate more explicit considerations for transaction timing and costs, which are not typically considered in the hypothetical transactions of ownership interests in a going concern. Accordingly, the differences between value and transaction proceeds can become blurred.

A potential element of confusion can also surface when business appraisers rely on specialty appraisals of specific assets (real estate, machinery, etc.) where the specialty appraisal conclusion is defined using a premise of value different than may be appropriate for the valuation of a given business interest in a going concern. Based on our experience, the premise in the specialty appraisal world can have twists and caveats that differ from the seemingly same premise in the business valuation. Thus, appraisers should understand the specifics of any underlying specialty asset appraisal relied upon in rendering a business valuation conclusion.

Conclusion

This chapter explains and distinguishes:

- The various standards of value:
  - Intrinsic value
  - Fair market value
  - Fair value

- The various levels of value under fair market value:
  - Strategic control
  - Financial control
  - Marketable minority
  - Nonmarketable minority

- The various premises of value:
  - Going concern
  - Liquidation
    - Forced liquidation
    - Orderly liquidation

Specifying the definition of value is a core element for defining an appraisal engagement. Chapter 2 incorporates these important aspects of defining value as a part of developing the overall engagement agreement.