Back to Basics: STANDARDS of VALUE

In business appraisals, the importance of understanding the standard of value cannot be overstated!

The three most common standards are:

· **Fair Market Value** – the value to ANY buyer and seller, relevant to tax valuations

· **Fair Value** – the statutory standard for dissenting shareholder litigations

· **Investment Value** – the value to SPECIFIC buyers and/or sellers in real transactions

The purpose of the appraisal *(how the client will use it)* dictates the standard of value. In Pennsylvania *(and other states)*, "fair market" and "fair value" are not identical. Definitions of **Fair Value** differ *(especially as to whether discounts for lack of control and/or marketability apply)*. In Pennsylvania for example, "fair market value" is the standard for divorce *(this varies greatly by state)*, but courts have frequently misinterpreted it.

Fair Market Value is defined by Revenue Ruling 59-60, several other revenue rulings, and a large body of case law. Under it, eight factors *(ranging from the nature of the business to the size of the block of stock to be valued)* must be considered, along with a healthy portion of "informed judgment, common sense and reasonableness". The most important aspect of fair market value is that it is hypothetical, assuming that there are many willing buyers and sellers of similar interests. Even though Revenue Ruling 59-60 has been around for over 40 years, there are still many gray areas in its interpretation.

By contrast, **Investment Value** is case-specific, depending entirely upon the characteristics of the individual buyer and seller. The fair market value buyer is assumed to bring only cash to the table *(the classic "financial buyer")*. The investment value buyer may be "strategic", with a business fit or other value-adding characteristics that allow them to justify a higher *(than fair market value)* price. In tax-related appraisals, business owners are often surprised by apparently low valuations. They invariably ask, "What's my business really worth?" They are essentially asking about "investment value".

Real-world transactions occur at investment value; tax-related transactions are at fair market value. **For many, many businesses these two values are very close.** For other businesses with unique assets and synergistic facts related to specific buyers there may be a substantial difference.

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<u>This difference has many implications, the most important of which are</u>:

- *All businesses have many values at the same time: the right one depends on the purpose of the valuation.*

- *In mergers and acquisitions, fair market value is the MINIMUM a seller should accept, since it is the value ANY willing buyer would pay. The seller should be striving for TOP dollar, which is INVESTMENT VALUE.*

- *This means that fair market valuations in contemplation of purchase and sale should only be the starting point for further analysis. (Many valuators recommend use of a limited restricted report for this purpose to provide required information at the minimum cost.) <u>Sellers need to understand the universe of buyers to develop reasonable price information before they can enter into any negotiations</u>.*

Fair market value also contains many premises. The most common is whether the business is valued as a going concern *(one that produces cash flow to its owners)* or in liquidation *(with its assets sold and liabilities extinguished)*. Other premises rarely arise in business valuations but are common in real estate, machinery, and personal property appraisals. These are case-specific, and must be addressed by the appraiser in consultation with the client, and other advisors.

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