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Standard, Premise, and Level of Value in Business Valuations

"It depends" – the oft-heard refrain from lawyers, parents, and shrewd negotiators. Now, you can add valuation analysts to the list as well. The old joke goes that "it depends" is a lawyer's answer to all questions. As valuation analysts who frequently work with lawyers, we started using this rather useful response as well.

Consider the question, "How much is this car worth?" Our answer is, of course, "It depends."

First of all, it depends on who is buying it and what their motivation is. Let's say that the car in question is a '56 Buick. It might have a high value to a collector who always envied their dad's prized '56 Buick that was destroyed years ago in a wreck. However, its value might be quite a bit lower to someone who is only looking for a fuel-efficient vehicle for commuting.

Second, it depends on how the vehicle is actually sold. Am I selling the car in one piece? What if I "parted it out" and sold off each piece individually?

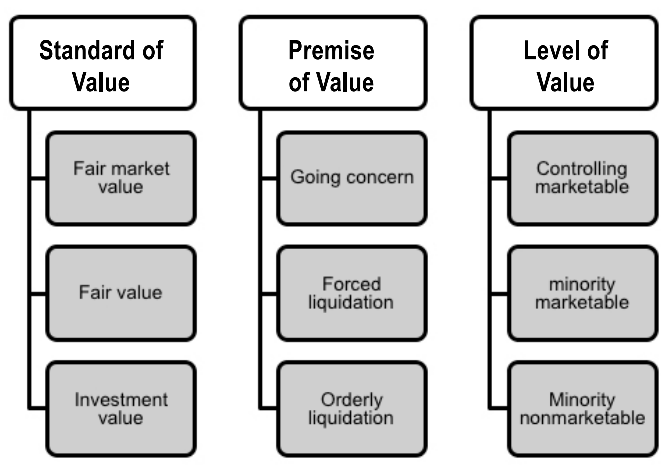
Third, it depends on the rights of ownership and the ability to resell the ownership interest in the vehicle. In college, my friend Mark and I shared ownership of a '67 Volkswagen Beetle, which we repurposed into a "Baja Bug." Sharing ownership of this car with a young man who regularly got the vehicle entirely airborne would no doubt diminish value to potential buyers.

(We'll save, for another article, Oscar Wilde's differentiation between price and value. "A cynic is a man who knows the price of everything, and the value of nothing.")

We value businesses, not cars, but the examples above illustrate three important concepts for business valuations. The first set of questions about the needs and characteristics of the buyer relates to the standard of value. The standard of value answers the question, "Value to whom?" The second set of questions about selling the car in one piece or in pieces relates to the premise of value. The premise of value identifies how the business will be sold, typically as either a going-concern business or in liquidation. The last comment about rights of ownership and salability relates to the level of value. Limitations on control and marketability of a business interest are typically associated with positions of less than 50 percent ownership in the business.

Correctly understanding the standard of value, premise of value, and level of value is important when drafting and interpreting governing documents and representing clients in matters involving business valuations. Just like in the car example above, changes to the circumstances surrounding a sale can have a substantial impact on the value of a business. Getting any of these three components wrong can easily reduce the value indication of a business by 30 percent to 50 percent or more.

Below is a table summarizing the most common options used for the standard, premise, and level of value.



Standard of Value

In their International Glossary of Business Valuation Terms (the BV Glossary), the National Association of Certified Valuators and Analysts (NACVA) lists three standards of value: fair market value, fair value, and investment value.

The first standard of value, fair market value, is considered in the majority of valuations done outside of the financial reporting realm. Fair market value applies to almost all federal and state tax matters including estate taxes, gift taxes, income taxes, and property taxes.

Fair market value is defined as "The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts."[1] Fair market value implies an equilibrium; it is the price for which half the people in the room would sell an asset, and half the people would decide to keep the asset.

In some jurisdictions, terms such as "market value," "cash value," or "just value" may be used as synonyms for fair market value. In these situations, check the definition of the standard of value and see if it aligns with fair market value.

Fair value is the second standard of value mentioned by the BV Glossary. Fair value has different definitions under legal and accounting contexts.

Fair value for legal purposes may vary by jurisdiction and application and also may be modified further by case precedent. This article is not intended to define fair value for legal purposes as that definition is often very fact-specific and beyond the scope of the current discussion. If not defined elsewhere in an agreement, fair value for legal purposes may restrict the use of discounts for lack of control or marketability when it would cause an undue penalty to a party in the dispute.

Fair value for financial reporting is an entirely different standard of value than fair value in a legal context. Fair value for financial reporting considers the price that would be received to sell an asset in an orderly transaction among buyers and sellers in the most advantageous market for the asset. Using the fair value for financial reporting is like selling an asset at an auction. If the market is deep and efficient, the winner at auction could turn around and sell the asset for the same price. The asset is only worth what the next buyer would pay (i.e., the value to the next person).

Rather than value to the next person, investment value—the last standard of value identified by the BV Glossary—represents value to a specific person. The BV Glossary defines investment value as "the value to a particular investor based on individual investment requirements and expectations." Investment value may be reflected in horizontal acquisitions (i.e., acquiring a competitor) and vertical acquisitions (i.e., acquiring a supplier or distributor). Investment value usually yields higher value conclusions than fair market value and is positively influenced by synergies between the acquiring company and the target.

The book value of equity (or accounting value) is rarely a reliable indicator of fair market value, fair value, or investment value. Accounting is historical in nature. Value is forward-looking. This creates a significant mismatch. While the book value of equity may be correlated to its value under one of the three previous standards of value, it may also yield a much higher or much lower value indication.

People often also confuse the terms "price" and "value." Warren Buffett once said, "Price is what you pay; value is what you get." Price represents an amount paid for an asset, while value is a conclusion reached based on available evidence. For example, my cousin offered to sell me his dirt bike at a deeply discounted price of $10 because he wanted to keep it in the family. This $10 price is much less than the dirt bike's value. I could estimate the value of the dirt bike by considering factors such as how much time I would spend using it, how much I like dirt bikes, alternative uses for my cash, the price of similar dirt bikes, and other factors.

Using the wrong standard of value can make a substantial difference in the value conclusion. "Fair value" and "fair market value" sound so similar that they can easily be mistaken for one another, but this error can be a costly one. Consider a buy-sell agreement for a sand and gravel company with three owners, each with a one-third interest. The three owners are unaware of the differences between fair value and fair market value, such as the fact that the fair market value standard allows for discounts for lack of control and marketability, while the fair value may not.

Unaware of these differences, the owners sign an agreement with buyout clauses based on the fair market value of their interests. They intend to simply value the business, then divide this value by three. Instead, under the fair market value standard, this pro-rata value may then be reduced by 30 percent or more based on its lack of control and marketability (these discounts are discussed further in the levels of value discussion below). To avoid errors such as this, we recommend defining what you mean by value and including the definition in the agreement.

Premise of Value

The premise of value identifies how a business is being sold: either as one functioning business, or sold off in pieces.

NACVA's BV Glossary defines premise of value as "an assumption regarding the most likely set of transactional circumstances that may be applicable to the subject valuation; e.g., going concern, liquidation."

The going concern premise of value means the business is being sold as an ongoing business enterprise. Alternatively, the business could be liquidated. Liquidation could happen through a forced liquidation in which assets are sold as quickly as possible such as through an auction, or through an orderly liquidation in which assets are sold over a longer period of time to maximize the proceeds received.

For valuations of controlling interests, the premise of value is typically selected based on the highest and best use of the valuation subject. The facts and circumstances of the business may also warrant a specific premise of value. If management states that they plan to continue operating the business as a going concern, then a liquidation premise of value may be inappropriate.

Level of Value

The level of value primarily relates to the control and marketability characteristics of the business interest in question. It is primarily dependent on (1) whether all or just a share of a business is being sold and (2) the restrictions on control and marketability in the governing documents of the business.

A noncontrolling ownership position is less desirable than a controlling position. This is because of the controlling owner's right to control any or all of the following activities: manage the assets, control major business decisions, set salary levels, admit new investors, acquire assets, sell the company, and pay distributions.

In the previous example of the shared ownership of the Baja Bug, my ability to make decisions about the car was limited because I had to get the other co-owner to agree on the decisions. This arrangement limited the value of this ownership position to me.

Minority interests in private companies also have limited marketability. The concept of marketability relates to the ability to quickly convert property into cash at minimal costs. All other things being equal, an interest in a business is worth more if it is readily marketable and, conversely, less if it is not. There is a relatively small market for minority interests in private companies. Therefore, a discount for lack of marketability should be applied. In the example of the Baja Bug, selling my ownership interest would be difficult because people would prefer to own a car rather than share a car.

The level of value can have a substantial impact on the value of a business interest. Discounts for lack of control are often around 10 percent, and discounts for lack of marketability may be 25 percent or higher.

The selected discounts for lack of control and marketability are influenced by the specific characteristics of the subject interest and its governing documents. The discount for lack of control is affected by relevant state statutes, the governing documents of the subject interest, and the current operational and financial policies established by management.

The degree of marketability is also dependent upon a wide range of factors. Each of these factors must be evaluated in selecting the appropriate adjustment for lack of marketability for any given investment. Some of the primary factors are listed below.

- Restrictions on transferability in governing documents
- Strength of financial position
- Dividend policy
- Size and nature of the business
- Operational and investment decisions of management

When drafting buy-sell agreements and other governing documents, make sure to specify the correct level of value. For minority interests, the "fair market value of the subject interest" can mean something very different than the "pro-rata share of the fair market value of the subject company." The former would likely consider discounts for lack of control and marketability, while the latter might not.

Buyers may be willing to accept different discounts for lack of control and marketability based on their plans for the asset under shared ownership and how these plans align with those of other owners. This goes back to the discussion contrasting price (the amount paid for an asset) and value (a measure of the amount of enjoyment generated through ownership of the asset, as measured in dollars or other term).

For my 50 percent ownership interest in the Baja Bug, I found price and value to be the same. I paid $250, and I saw no reason that the value of my interest should be inhibited through shared ownership with Mark. Mark and I had the same plans and goals for the vehicle. When I asked Mark if I could repaint the wheels, he was fine with it. When Mark decided to take the vehicle off a jump, I was literally along for the ride. I had no reason to discount the value for lack of control.

However, someone else might not have the same plans for the Baja Bug as Mark, and this misalignment would affect value. They may have concerns about Mark's aggressive driving style and may prefer to restore the Baja Bug rather than regularly exacerbate the decline of its mechanical capabilities. Hence, the value of shared ownership of the Baja Bug would be less than the pro-rata division of the price paid for the whole asset. The value of a 50 percent ownership interest may be $200, a $50 discount from the $250 price. Someone else might take $100 off the price of a 50 percent ownership interest. Why $100? That was the deductible on our insurance and a buyer might assume based on Mark's driving the deductible was as good as spent.

As this example illustrates, when ownership goals aren't aligned, price and value may be materially different.

When valuing a business, we usually seek to standardize value by eliminating the influences of specific buyers and sellers. Under most standards of value (but not investment value), we assess value to a hypothetical willing buyer and seller acting at arm's length. The value of an asset reflects the price that would be agreeable to rational actors in the marketplace—and not irrational young men who agree to share possession of a vehicle without any form of exit plan. We consider the DLOMs and DLOCs that most market participants would require, rather than focusing on the preferences of a single party. These discounts would depend on the characteristics of the underlying investment and how these characteristics would be perceived by market participants as a whole.

Conclusion

Terms such as "fair value" and "fair market value" sound very similar, but can mean something very different. Make sure to correctly identify and apply the standard, premise, and level of value in matters of business valuation. Mixing up these items may reduce the indicated value substantially.

The fair market value definition has been standard since 1959—but there is no guarantee that the definition won't change over the years to come. We would encourage including definitions in the shareholder/buyout/operating agreements that explicitly specify the standard, premise, and level of value to be used in different situations. This will reduce ambiguity and uncertainty when these agreements are needed—often decades after originally drafted.

ENDNOTES

1 Revenue Ruling 59-60, 1959-1 CB 237; Estate Tax Regulations §20.2031-1(b); Gift Tax Regulations §25.2512-1.