## THE OPINION OF THE COLLEGE ON

# Defining Standards of Value

**Initiation, Chair responsibility,**
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*"It is impossible intelligently to discuss methods of valuation without reference to some assumed definition of value ."*[1]

## I. Introduction

Many terms are used to describe various notions of value; but, unfortunately, such terms mean different things to different people. As one experienced attorney put it:

> Many terms are used to define value. ... Only a few of these terms have some definition. Others have the definition which the parties choose to place upon them.[2]

In this Opinion, the College recognizes the necessity to identify and define the applicable standard of value as an integral part of any appraisal report or appraisal engagement. It also recognizes that there legitimately can be different definitions of the same appraisal term in different contexts, based on either widely accepted usage or legal definition through statutes, regulations, case law, and/or legally binding documents. It also recognizes that the standard of value and the definition of value in the context used legitimately influences, and sometimes compels, the approaches to value and specific methodology used by the appraiser.

The Opinion then discusses accepted definitions of certain valuation terms in certain contexts. These definitions recognize consensus of authoritative discussions of usage as well as legally accepted definitions. Quotations that are included in discussions of various definitions of standards of value have been selected as being generally representative of consensus found in the literature of financial and appraisal theory.

## II. Need to Define Standard of Value

Every appraisal report or engagement should identify and define the applicable standard of value.

### A. Specification of Standard of Value

The standard of value should be specified, such as "fair market value," "fair value," "investment value," and so forth.

### B. Definition of Standards of Value

Acceptable definitions of the above valuation terms, as well as others, vary depending on what is being appraised, the use to which the appraisal is to be put, and the legal context within which the property is being appraised. Therefore, the appraiser should define as well as specify the standard of value. For example:

> For the purpose of this appraisal, fair market value is defined as the cash or cash-equivalent price at which property would change hands between a willing buyer and a willing seller, both being informed of the relevant facts and neither being compelled to buy or sell.

### C. Citation to Authority for Definition of Standard

If the appraisal is being conducted in a context that requires compliance with some statutory or regulatory definition of value or with some legally binding document (such as a buy/sell agreement), such authority should be specifically cited. In many cases, it is helpful to quote such authority in its entirety. For example:

> The standard of value was fair value, as set forth by Section 30-1-81 of the Idaho Code.

As noted above, the applicable standard of value, as set forth in Idaho Code Section 30-1-81 (Appendix B), is "fair value." According to the statute, "'fair value' of shares means their value immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of such corporate action unless such exclusion would be inequitable." Since this is the first dissenting stockholder action under the current Idaho statute, there is no Idaho case law available as a precedent.

## III. Impact of Definition of Value on Approaches and Methodology

The approaches and methodology employed in the appraisal must be consistent with the applicable definition of the standard of value.

The College reaffirms its position taken in an earlier Opinion[3] that the so-called "three approaches to value"—doctrine that requires that all three approaches be applied to any one property, regardless of its characteristics, and then that the three results be "correlated" to reach a conclusion as to value—is economically unsound and produces unreliable results.

The choice of both the broad approach or approaches and the specific methodology employed should be based on the type and characteristics of the property being appraised, applicable legal requirements (if any), and sound economic analysis. In selecting approaches and methodology, the appraiser should take prece-

dent into consideration but may not be bound by precedent if there are compelling reasons to depart from such precedent.

## IV. Definitions of Standards of Value

### A. Fair Market Value

The most widely recognized and accepted standard of value is fair market value. It is the standard that applies to all federal and state tax matters, such as estate taxes, gift taxes, inheritance taxes, income taxes, and ad valorem taxes. It is also the legal standard of value in many other—though not all—valuation situations. The general definition of *fair market value* is almost universally accepted as the cash, or cash-equivalent, price at which property would change hands between a willing buyer and a willing seller, both being adequately informed of the relevant facts and neither being compelled to buy or to sell. There is also general agreement that the definition implies that the parties have the ability as well as the willingness to buy or sell. The "market" in this definition can be thought of as all the potential buyers and sellers of like businesses, business interests, or property. The definition also assumes that the property will be exposed to the market for a reasonable period of time. What constitutes a reasonable period of time depends on the type of property and market conditions.

In legal interpretations of fair market value, the willing buyer and willing seller are hypothetical persons dealing at arm's length, rather than any "particular" buyer or seller. In other words, a price would not be considered representative of fair market value if influenced by special motivations not characteristic of a typical buyer or seller.

The concept of fair market value also assumes prevalent economic and market conditions at the date of the particular valuation. One often hears statements such as "I couldn't get anywhere near the value of my house if I put it on the market today" or "The value of XYZ Company stock is really much more (or less) than the price it's selling for on the New York Stock Exchange today." The standard of value contemplated by such statements is some standard *other than* fair market value, since the concept of fair market value means the cash or cash-equivalent price at which a transaction could be expected to take place under conditions existing at the valuation date.

It is important to recognize that the above represents only a broad discussion of the concept of fair market value. There are literally hundreds of statutes, regulations, and other authoritative sources that define fair market value with slightly different shades of interpretation and, in some cases, even with the inclusion of some guidelines or methodology for determination of fair market value.[4] Where a legal definition of fair market value is involved, the appraiser should consult the source of that definition.[5]

The terms *market value* and *cash value* frequently are used interchangeably with the term *fair market value*.[6] However, this is not necessarily true in all legal contexts, so the appraiser should not automatically assume the equivalence of these terms.

Machinery and equipment can be valued under a number of concepts of fair market value if that concept of fair market value is properly defined. For example, machinery and equipment can have a "fair market value in place" as part of a total operating facility. This, then, is the fair market value in place of each individual item of machinery, equipment, and fixtures comprising a total operating plant in place and capable of operating as a total manufacturing or production facility.

Normally, and under standard conditions, it is assumed that the assets being valued are capable of generating a return that would justify the investment required to purchase the facility. There are times, however, when the economic factors clearly indicate that the income generated could not support the reported fair market value in place. Under normal conditions, the machinery and equipment appraiser can measure and estimate physical depreciation and functional obsolescence as it pertains to individual items or a group of items. However, economic obsolescence cannot be measured by the machinery and equipment appraiser apart from either a complete business valuation or a partial business valuation sufficient to measure the impact of the economic obsolescence on the value of the tangible assets being appraised in their context as a part of an operating facility. If economic obsolescence is present, then it must be applied to all assets being valued—real estate, machinery and equipment, intangibles, etc.—on the basis of some rational method of allocation.[7]

There are many times in actual practice where a machinery and equipment appraiser is called upon to estimate the fair market value of equipment when the purchaser is going to dismantle the item and move it to another location. This value has been defined as: "The price that the subject may reasonably be expected to bring, expressed in dollars, for removal from its present location to another similar facility." This definition must be clarified as to who is responsible for disconnecting the equipment, and its removal cost should include any damage to the real estate caused by its removal. This essentially means fair market value on a liquidation basis as opposed to fair market value on a going-concern basis. The term *fair market value* as applied to machinery and equipment has little or no meaning until the exact concept of fair market value is defined.

### B. Fair Value

The expression *fair value* is an example of ambiguous terminology used in the field of commercial appraisal. In order to understand what the expression means, it is necessary to know the context of its use. The accepted definition of *fair value* in real estate appraisal terminology is totally different from the interpretation the courts have given to fair value as a statutory standard of value applicable to a business appraisal.

It is generally accepted in the context of real estate terminology that *fair value* is synonymous with *market value* or *fair market value*.[8]

However, in most states, fair value is the statutory standard of value applicable in cases of dissenting stockholders' appraisal rights. In these states, if a corporation merges, sells out, or takes certain other major actions and the owner of a minority interest believes that he is being forced to receive less than adequate consideration for his stock, he has the right to have his shares appraised and to receive fair value in cash. There is no clearly recognized consensus about the definition of fair value in this context; but precedents established in the courts of most states

certainly have not equated it to fair market value. When a situation arises of actual or potential stockholder dissent, it is necessary to research carefully the legal precedents applicable to each case.

### C. *Investment Value*

There is virtually universal consensus that the term *investment value* means a value based on expected earnings or monetary return to an investor. However, within that broad meaning, there are important differences in the perspective from which the concept is defined in different contexts.

In real estate terminology, *investment value* is defined as "value to a particular investor, based on individual investment requirements, as distinguished from the concept of market value, which is impersonal and detached."[9] In real estate appraisal, calculations of investment value conventionally involve the discounting of an anticipated income stream. One generally accepted real estate appraisal text makes the following comments regarding the distinction between market value and investment value:

> The income capitalization approach is typically used in market value appraisals of income-producing properties. The approach may also be used to estimate value, or the subjective value of a property to a particular investor. Market value and investment value may coincide when a client's investment criteria are consistent with those that are typical in market. In this case, the two value estimates may be numerically the same, but the two types of value are not interchangeable. Market value is objective, impersonal, and detached; investment value is subjective and personal. In estimating market value, an appraiser must be satisfied that all data and assumptions used in the income capitalization approach are market oriented.[10]

In the text *The Stock Market: Theories and Evidence,* Lorie and Hamilton discuss investment value by reference to the classic work of John Burr Williams:[11]

> He considers the appropriate rate of discounting, the effects of stock rights and assessments, risk premiums, the effect of the capital structure of the firm, and the marketability of the security. His treatment of these various subjects leads to the grand conclusion that the investment value of a stock is determined by discounting the "expected" (authors' term) stream of dividends at the discount rate appropriate for the individual investor as determined by his "minimum wages for abstinence" from current consumption.[12]

There can be many valid reasons for the investment value to one particular owner or prospective owner to be different from the fair market value. These reasons include the following:

1. Differences in estimates of future earning power
2. Differences in perception of the degree of risk
3. Differences in tax status
4. Synergies with other operations owned or controlled

The discounted future earnings or cash flow appraisal method is oriented essentially toward developing an investment value. Whether or not the value thus

developed also represents fair market value depends on whether the assumptions used would be accepted by a consensus of market participants.

If sound analysis leads to a valid conclusion that the investment value to a particular owner exceeded market value at a given time, then the rational economic decision for that owner would be not to sell at that time, unless a particular buyer could be found to whom investment value would be higher than the consensus of value among a broader group of typical buyers.

In the context of dissenting stockholder suits, the term *investment value* is also based on the earning power of the property being appraised. However, in this context, investment value does *not* reflect the specific characteristics or perspective of any *particular* buyer or owner. Most state statutes defining value for the purpose of dissenting stockholder actions specifically exclude considerations of any synergies or other special motivations that might induce a particular acquirer to pay a higher price than any typical investor without any synergistic motivations would pay.

### D. Intrinsic or Fundamental Value

Intrinsic value (sometimes called fundamental value) differs from investment value in that intrinsic value represents an analytical judgement of value based on the characteristics inherent in the investment, not tempered by characteristics peculiar to any particular investor.

The *Handbook for Financial Decision Makers* defines *intrinsic value* as follows:

> *Value, intrinsic of common stock.* The price that is justified for a share when the primary factors of value are considered. In other words, it is the real worth of the stock, as distinguished from the current market price of the stock. It is a subjective value in the sense that the analyst must apply his own individual background and skills to determine it, and estimates of intrinsic value will vary from one analyst to the next.[13]

Lorie and Hamilton comment on the notion of intrinsic value as follows:

> The purpose of security analysis is to detect differences between the value of a security as determined by the market and a security's "intrinsic value"—that is, the value that the security *ought* to have and will have when other investors have the same insight and knowledge as the analyst.[14]

If the market is below what the analyst concludes is the intrinsic value, he considers the stock a "buy." If the market value is above what he considers to be the intrinsic value, he suggests that the stock be sold.

Further concurrence on the meanings of *intrinsic value* and *fundamental value* is found in the following definitions from an authority in the accounting field:

> **Intrinsic value.** The amount that an investor considers, on the basis of an evaluation of available facts, to be the "true" or "real" worth of an item, usually an equity security. The value that will become the market value when other investors reach the same conclusions. The various approaches to determining intrinsic value of the finance literature are based on expectations and discounted cash flows. See expected value; fundamental analysis; discounted cash flow method.[15]

> **Fundamental analysis.** An approach in security analysis which assumes that a security has an "intrinsic value" that can be determined through a rigorous evaluation of relevant variables. Expected earnings is usually the most important variable in this analysis, but many other variables, such as dividends, capital structure, management quality, and so on, may also be studied. An analyst estimates the "intrinsic value" of a security on the basis of those fundamental variables and compares this value with the current market price of this security to arrive at an investment decision.[16]

### *E. Going-Concern Value*

The concept of joint concern is not a standard of value but an assumption about the status of the business. It merely means that the business, practice, or property is being valued as a viable operating entity: It has its assets and inventory in place, its work force in place, and its doors open for business with no imminent threat of discontinuance as a going concern.

As noted earlier, fair market value, fair value, and investment value are examples of standards of value. Thus, in many instances, it would be correct to characterize the value being estimated as "fair market value on a going-concern basis," "fair value on a going-concern basis," or "investment value on a going-concern basis."

When valuing machinery and equipment, an acceptable alternative to the term *going concern value* is *market value in place*, making it clear that the individual assets are being valued as part of an operating facility. This does not necessarily mean that the value of such assets on a going-concern basis exceeds the liquidation value of the assets. In some cases, the value of machinery and equipment under liquidation conditions may be greater than its value in place if economic obsolescence is properly measured.

In most cases, the term *going-concern value*, when used to value a business or business interest, is used to mean the total value of the entity as a going concern. Sometimes, however, if the total value of the firm on a going-concern basis exceeds the net value of its tangible assets, the term *joint-concern value* is used to refer to the difference between the two, that is, to the intangible value that exists over and above the net tangible asset value.[17]

### *F. Liquidation Value*

Liquidation value is, in essence, the antithesis of going-concern value. *Liquidation value* means the net amount that can be realized if the business is terminated and the assets sold off piecemeal. The term *orderly liquidation* means that the assets are sold over a reasonable period of time, attempting to get the best available price for each asset. The term *forced liquidation* means that the assets are sold as quickly as possible, frequently all at one time at an auction sale.

When computing liquidation value, it is essential to recognize all costs associated with the liquidation of the enterprise or property. These costs normally include commissions, the administrative cost of keeping the company alive until liquidation is completed, taxes, and legal accounting costs. It is not uncommon to find that some assets, such as machinery and equipments or buildings, have no liquidation value, since the cost to dismantle and remove is greater than any value

realizable in a resale. In fact, the cost of removing such assets may actually detract from the value of the business or property to which they are attached. Also, in computing the present value of a business or a property on a liquidation basis, it is necessary to discount the estimated net proceeds, at a rate reflecting the risk involved, from the time the net proceeds are expected to be received, back to the date of the valuation.

### *G. Book Value*

Book value is something of a misnomer because it does not represent any standard of value at all. It is an accounting term, not an appraisal term. Book value means the sum of the asset accounts, net of depreciation and amortization, less the liability accounts, as shown on a balance sheet.

Assets usually are accounted for at historical cost, less depreciation computed by one of various methods. Some assets having considerable value may be completely written off the books. Liabilities are usually shown at face value. Intangible assets normally do not appear on the balance sheet unless they were purchased or the actual cost of development was recorded. Neither contingent assets nor contingent liabilities are recorded on the books.

The longer the time after an individual asset or liability item is placed on the books, the less likely is the book value of that item to bear any identifiable relationship to any standard of value for the individual item, much less for the entity as a whole.

## V. Summary

The applicable standard of value must be specified and defined to provide the basis for any appraisal report or engagement. The selection of the applicable standard of value is determined largely on the basis of the use to which the appraisal is to be put, such as determination of a tax liability or determination of a price at which a particular transaction will take place.[18] Often the standard of value for a particular appraisal engagement is dictated by statute, regulation, case law precedent, or a binding legal document governing a transaction. It is important to recognize that many value terms have different definitions when used in different contexts. It is essential that the appropriate standard of value is defined and that the approaches and methodology employed conform to the defined standard of value.

## Notes

1. James C. Bonbright, *The Valuation of Property: A Treatise on the Appraisal of Property for Different Legal Purposes, I* (Charlottesville, VA: The Michie Company, 1937), p. 128.
2. John E. Moye, *Buying and Selling Businesses* (Minneapolis: National Practice Institute, 1983), p. 25.
3. "The Opinion of the College on Definitions, Concepts and Principles of Appraisal Practice," *Valuation* (June 1975), pp. 85–87.

4. For example, see Henry A. Babcock, *Appraisal Principles and Procedures* (Washington, D.C.: American Society of Appraisers, 1980), p. 139; *The Appraisal of Real Estate*, 9th ed. (Chicago: American Institute of Real Estate Appraisers, 1987), pp. 16–20; *The Dictionary of Real Estate Appraisal* (Chicago: American Institute of Real Estate Appraisers, 1984), pp. 194–195.
5. For example, for a definition of fair market value for real estate loans, see "Focus: Appraisal Guide," Federal National Mortgage Association, pp. 34–35; for a definition for federal acquisition of land, see "Uniform Appraisal Standards for Federal Land Acquisitions," 1973, Section A-2, pp. 3–4; for a definition of fair market value for eminent domain in California, see "California Code of Civil Procedure," 1263–320; for a definition and discussion of fair market value of closely held businesses for federal gift and estate taxes, see Revenue Ruling 59–60. State statutes and regulations have various definitions of fair market value for the purpose of ad valorem taxes.
6. An authority on real estate appraisal terminology in the United States says that *market value* is synonymous with *fair market value* (Byrl N. Boyce, ed., *Real Estate Appraisal Terminology* [Cambridge, Mass.: Ballinger Publishing Company, 1982], p. 98). A Canadian business appraiser draws a slight distinction between the two terms: "*Fair* in *fair market value* means that the market (and the price) must have some consistency and cannot be affected by a transient boom or sudden pause; that is, the word *fair* qualifies the market on which the valuation is based." (Richard M. Wise, "The CA's Role in Valuations: An Inside-Out Perspective," *CA Magazine* [September 28, 1984], pp. 28–40).
7. See also "Defining Value in Use," Opinion by the College of Fellows of the American Society of Appraisers.
8. *Real Estate Appraisal Terminology*, p. 98.
9. *Real Estate Appraisal Terminology*, p. 140.
10. *The Appraisal of Real Estate*, 8th ed. (Chicago: American Institute of Real Estate Appraisers, 1983), p. 336.
11. John Burr Williams, *The Theory of Investment Value* (Cambridge, Mass.: Harvard University Press, 1938). Reprinted in Amsterdam by North Holland Publishing Co. in 1956.
12. James H. Lorie and Mary T. Hamilton, *The Stock Market: Theories and Evidence* (Homewood, Ill.: Richard D. Irwin, Inc., 1973), pp. 116–117.
13. John J. Hampton, *Handbook for Financial Decision Makers* (Reston, VA: Reston Publishing Company, 1979), pp. 543–544.
14. *The Stock Market: Theories and Evidence*, p. 114.
15. W.W. Cooper and Yuri Ijiri, eds., *Kohler's Dictionary for Accountants*, 6th ed. (Englewood Cliffs, NJ: Prentice-Hall, 1983), p. 285.
16. Ibid., p. 228.
17. For a more complete discussion of the phrase "going-concern value" in this latter context, see Benjamin N. Hanszley, "Going Concern Value after Concord Control, Inc.," *Taxes* (November 1983), p. 699.
18. For a more complete discussion of the relationship between the purpose or use of the appraisal and the standard of value, see Shannon P. Pratt, FASA, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 2nd ed. (Homewood, Ill.: Dow Jones-Irwin, 1989), chapter 1, "Defining the Appraisal Assignment."