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What Is Fair Value?

In performing a valuation of a business the starting point is identifying and defining the standard of value that will apply based on the facts and circumstances surrounding the engagement. Common standards of value include Fair Market Value, Investment Value, Intrinsic Value, and Fair Value.

Fair Value is used for a number of purposes. It can be the legal standard of value in dissenting shareholder cases in some states. It is the core standard of value used in the preparation of a fairness opinion. It is also the standard of value used for the valuation of assets for financial reporting purposes.

Dissenting shareholder/oppression cases

Fair Value is commonly used in dissenting shareholder litigation. As a judicially mandated concept, it is subject to court interpretation and varies from state to state. Although the standard of Fair Value has not been clearly defined in the past, more recently it has been established as the value of shares on a pro rata enterprise basis. However, this can be more than simply, “Fair Market Value without the discounts.”

The definition of Fair Value differs from Fair Market Value. A *fair market value* valuation is the price at which a business would change hands between a willing buyer and willing seller both

knowledgeable about the relevant facts. As sometimes derived from the Model Business Corporation Act or the more recent Revised Model Business Corporation Act, *Fair Value* is generally defined as the value of the shares as of the day immediately preceding the corporate action leading to the dissent. Fair Value is intended to estimate a fair and reasonable amount. It is not intended to represent a market transaction price. Some states allow discounts in computing Fair Value while others do not.

In determining Fair Value for a dissenting shareholder action, it is important to analyze the specific facts and circumstances of the situation and understand the appropriate statutes and case law of the jurisdiction.

Fairness opinions

A fairness opinion is a formal review that assesses whether a transaction is fair to shareholders from a financial point of view. It is often used in a corporate merger or acquisition to support the suitability of the acquisition price. Fairness opinions are



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designed to protect the interests of minority shareholders. The key to the fairness opinion is a valuation of the business. As noted, Fair Value is often the standard of value used in fairness opinions.

Financial reporting

As the reporting on financial statements under generally accepted accounting principles moves away from historical cost accounting and toward Fair Value, the fair value measurement principles in the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 820, *Fair Value Measurements and Disclosures* have created yet another definition. The FASB ASC 820 incorporates SFAS No. 157 and 159 and states that Fair Value is “The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”

Fair Value is the standard of value required under the FASB ASC pronouncement for both financial and non-financial assets.

With respect to the measurement of Fair Value, Fair Value should be based on the assumptions that market participants would use when pricing the asset. Market participants are buyers and sellers in the market who are independent, knowledgeable, and able and willing to transact in the market.

To summarize, the definition of the fair value standard is highly dependent on the purpose of the valuation and the facts and circumstances of the particular valuation engagement. Due to this complexity, it is important to consult with and engage a qualified valuation professional.

What Is Fair Market Value?



Fair Market Value is the standard of value applicable to the most business valuation projects for divorce court, estate and gift taxation, accounting, and many private transactions. The definition of Fair Market Value for business valuations comes from Revenue Ruling 59-60 published by the Internal Revenue Service. The definition originated in the tax law, but it has become the applicable definition of value for nearly all venues:

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. 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.

Further refinements to the definition of Fair Market Value include (1) the presumption that the business interest is offered on the market for a sufficient period of time to attract several potential buyers, (2) the willing buyer is a typical buyer without specialized motive or knowledge, and (3) the transaction is a cash sale. This standard is also known as the “willing buyer/willing seller” standard.

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Although extremely concise, the nuances of this definition are many and complex. Consider the word “market.” It refers to a forum in which buyers and sellers of similar properties come together for the purpose of negotiating a transfer. A “market” requires the assumption of multiple, similar properties, multiple buyers, and multiple sellers. The terms “willing buyer” and “willing seller” imply that the price is measured by what hypothetical, typical persons might agree to. Characteristics of the actual owner, or a potential actual purchaser, are ignored in a Fair Market Value analysis.

For smaller businesses, the marketplace may be created by business brokers and other intermediaries who bring buyers and sellers together. Evidence of the terms and prices occurring in such a marketplace exists in the form of direct market transaction databases like Pratt’s Stats and BIZCOMPS. For larger companies, willing buyers may be publicly held companies. Evidence of such transactions exists in SEC filings and transaction databases such as Mergerstat. Finally, the public stock markets provide a forum in which we can observe the value of similar, publicly traded businesses.

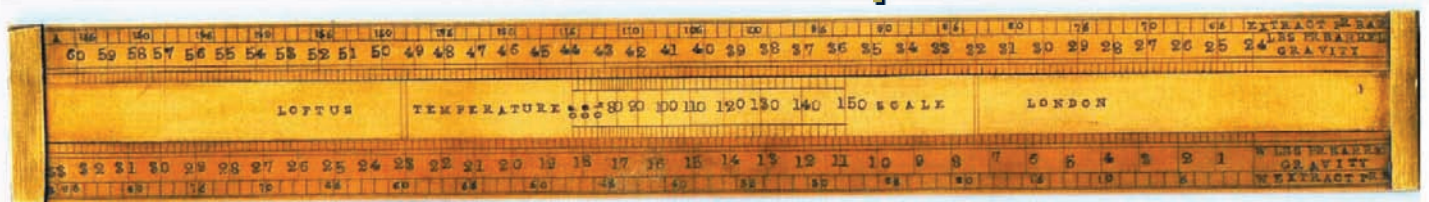
Another important nuance of the definition is that the “price” is an amount in money delivered now. In real deals, parties may agree to earn outs, seller financing, non-compete payments, and other contingencies, as a

way to reduce buyer risk and/or allow the buyer to pay for the business. But for Fair Market Value, these issues must be boiled down to an immediate cash price. For example, even though the usual terms of sale for a service business might provide for payments over five years conditioned on the seller refraining from competing, the fair market value price is what the buyer would pay in cash all up front. The present value of the usual deal terms is substantially less than the gross sum of the payments over time. In addition, the buyer would assume the risk of competition from the seller, with no financial leverage as protection, causing the buyer to demand an even lower cash up-front price.

The price at which the property would change hands is not reduced for broker commissions or other seller transactions costs. It is also not reduced for seller income taxes. However, the typical buyer may be influenced by his own expected exit costs and expected holding period.

As you can see, Fair Market Value in the context of a business valuation implies many intricacies not apparent from a casual reading of the definition. If you have specific questions or circumstances you would like to discuss on this subject, please call us at your convenience.

Rules of Thumb—It’s Not That Simple?



Rule of Thumb: An Italian restaurant should sell for 30% of gross revenue. Valuation completed! Draw up the paperwork, right?

Reducing the complexity of business valuation to rules of thumb is an appealing proposition. Avoiding complex cash flow calculations and side stepping necessary adjustments makes the process of valuation more appealing and more accessible to the lay user. However, one must still deal with the dilemma: “Should it be done simply because it can be done?” Is there value in the simplicity of rules of thumb?

The answer is “maybe.” It all begins with the intended purpose of the valuation. An early retiree seeking a second career might use the methodology to narrow down the number of potential investment selections. The business owner in the initial stage of succession planning may need a number to allow him to work through the steps in the process. The aging parents concerned with equitable distribution when leaving a family business to their children. There are many other examples where a “quick-fix” calculation is a necessary first step to addressing a specific situation. Later, as the process progresses, additional detailed analysis and more sophisticated methodologies can be

used to replace the rule of thumb value. The value determined by the rule is simply a bookmark to be replaced at the appropriate time.

Rules of thumb based on actual completed transactions are perhaps the most useful. These types of rules theoretically approximate the Market Comparison Approach. The word “approximate” should be used loosely, as there will no doubt be differences between the subject company and the rule of thumb “average.” These differences include but are not limited to: expense structure, age of equipment, building lease term, cash flow trends, and specific competition. Equally important are the terms of sale. A rule of thumb based on seller financing likely produces a different result from a rule based upon a cash purchase premise.

How does the rule address inventory, real estate, and debt? Unless the rule specifically states how these issues are addressed, one cannot know if they are accounted for in the rule. Is inventory and real estate added to

value? Is debt subtracted from value? The answer to either question can impact value dramatically.

Yes, rules of thumb are quick and simple. If properly understood and applied correctly, they can be useful in some valuation situations. Unfortunately, the only thing certain about their use is the uncertainty as to the comparability to the target situation. A single formula cannot address all of the company-specific differences. Furthermore, users should be aware that rules of thumb from different sources are not necessarily comparable. The source of the rule is important. Independent, professional sources utilizing data based on completed transactions would more likely provide market-driven rules.

Rules of thumb are useful. The source of the rule must be identified and the underlying assumptions understood. Professional business valuers can assist in determining the appropriate application of a specific rule in a given situation.

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**If you have any questions,
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