AICPA® Forensic and Valuation Services Section

QUICK REFERENCE GUIDE

STANDARDS AND PREMISES OF VALUE

OVERVIEW OF GUIDE

Under AICPA's "General Standard Rule" (AICPA, *Professional Standards*, ET sec. 1.300.001 and 2.300.001),[1] states that a member shall "undertake only those professional services that the member or the member's firm can reasonably expect to be completed with professional competence."

Performing a valuation engagement with professional competence involves special knowledge and skill. Statement on Standards for Valuation Services Number 1 states that a valuation professional should consider, at a minimum, the scope of the valuation engagement, including applicable **standard of value** (for example, ***fair value or fair market value***), and the applicable **premise of value** (for example, ***going concern***) when completing a valuation engagement.

The primary purpose of this quick reference guide is to provide an overview of the relevant premises and standards of value used in valuations and to assist the valuation professional with understanding those differences.

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[1] Formally Rule 201, *General Standards*.

PRIMARY PREMISES OF VALUE

The International Glossary of Business Valuation Terms ("Glossary") defines premise of value as *"an assumption regarding the most likely set of transactional circumstances that may be applicable to the subject valuation."*

Two Main Premises of Value in Business Valuation:

A. Going Concern Value — The Glossary defines this as *"the value of a business enterprise that is expected to continue to operate into the future. The intangible elements of Going Concern Value result from factors such as having a trained work force, an operational plant and the necessary licenses, systems and procedures in place."* This concept is based on the assumption that a business enterprise is expected to continue operations into perpetuity.

B. Liquidation Value — The Glossary defines liquidation value as *"the net amount that would be realized if the business is terminated and the assets are sold piecemeal. Liquidation can be either 'orderly' or 'forced.' — liquidation value, at which the asset or assets are sold over a reasonable period of time to maximize pro or liquidation value, at which the asset or assets are sold as quickly as possible, such as at an auction."*

OTHER PREMISES OF VALUE

A. Value as an assemblage of assets — Value in place, as part of a mass assemblage of assets, but not in current use in the production of income, and not as a going-concern business enterprise.[2]

B. Fair Market Value in Continued Use (For Going Concern) — The estimated amount, expressed in terms of money, that may be reasonably expected for a property in an exchange between a willing buyer and a willing seller, with equity to both, neither under any compulsion to buy or sell, and both fully aware of all relevant facts, including installation, as of a specific date and assuming that the business earnings support the value reported. This amount includes all normal direct and indirect costs, such as installation and other assemblage costs to make the property fully operational.[3]

C. Fair Market Value — Installed (For Going Concern) — The estimated amount, expressed in terms of money, that may be reasonably expected for an installed property in an exchange between a willing buyer and willing seller, with equity to both, neither under any compulsion to buy or sell, and both fully aware of all relevant facts, including installation, as of a specific date. This amount includes all normal direct and indirect costs, such as installation and other assemblage costs, necessary to make the property fully operational.[4]

D. Fair Market Value — Removal — The estimated amount, expressed in terms of money, that may be reasonably expected for a property, in an exchange between a willing buyer and a willing seller, with equity to both, neither under any compulsion to buy or sell, and both fully aware of all relevant facts, as of a specific date, considering the cost of removal of the property to another location.[5]

[2] Shannon Pratt, Valuing a Business, (Fourth Edition, page 33).
[3] Hitchner, Financial Valuation: Applications and Models (3rd Ed., p []).
[4] Ibid.
[5] Ibid.

OTHER VALUATION CONSIDERATIONS

A. Value in Use — The value of real estate to a particular entity; for example, pharmaceutical manufacturing plant.

B. Highest and Best Use — ASC 820 defines highest and best use as the use of an asset by market participants that would maximize the value of the asset or the group of assets within which the asset would be used. Highest and best use is determined based on the use of the asset by market participants, even if the intended use of the asset by the reporting entity is different.

i. In-use — The highest and best use of the asset is in use if the asset would provide maximum value to market participants principally through its use in combination with other assets as a group (as installed or otherwise configured for use).

ii. In-exchange — The highest and best use of the asset is in-exchange if the asset would provide maximum value to market participants principally on a standalone basis.

STANDARDS OF VALUE

Standard of Value (Reasons for the Valuation)

The Glossary defines this as *"the identification of the type of value being used in a specific engagement; for example, fair market value, fair value, investment value."*

1. Fair Market Value

A. For general use, the Glossary defines fair market value as:

"… the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and 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" should be replaced with the term "highest price").

B. For federal tax purposes, U.S. Treasury Regulations define fair market value[6] as:

"The price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts."

2. Fair Value (Financial reporting) — Accounting Standards Codification 820: Fair Value Measurement is the primary source of authoritative guidance (with some enumerated exceptions) on how entities should measure and disclose fair value in their financial statements under U.S. Generally Accepted Accounting Principles.

i. ASC 820 defines fair value as 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.

ii. Fair Value Measurement assumes the hypothetical transaction occurs in a principal market, the "the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability." In the absence of a principal market, the asset or liability is assumed to be transferred in the most advantageous market, "the market in which the reporting entity would sell the asset or transfer the liability with the price that maximizes the amount that would be received for the asset or minimizes the amount that would be paid to transfer the liability, considering transaction costs in the respective market(s)."

3. Fair Value (State Law) — For state legal matters only, some states have laws that use the term fair value in shareholder and partner matters. For state legal matters only, therefore, the term may be defined by statute or case law in the particular jurisdiction.[7]

4. Investment Value — The Glossary definition is "the value to a particular investor based on individual investment requirements and expectations."

5. Intrinsic Value — The Glossary definition 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. When the term applies to options, it is the difference between the exercise price or strike price of an option and the market of the underlying security."

[6] Treasury Regulation Sections20.2031-1 and 2525.12-1

[7] Valuation professionals should review each state's fair value standard since the definition of fair value will differ from state to state.

STANDARDS OF VALUE UNDER SPECIAL CIRCUMSTANCES

These standards of value are merely guides when dealing in a litigation situation:

Divorce

i. Determine from counsel the specific state law governing the standard of value. May be fair market value, fair value or investment value.

ii. Be informed as to the treatment of or lack thereof adjustments for control and/or marketability. (Standard of Value).

iii. Be informed if personal goodwill is permitted by the court.

Dissenting Shareholder

i. Definition — Research state legislation that allows shareholders of a corporation the right to receive a cash payment for the fair value of their shares, in the event of a share conversion merger or acquisition to which the shareholders do not consent. Dissenters' rights usually allow dissenting shareholders an equitable resolution to withdraw from a company if they do not want to be included in the merger.

ii. Be informed as to the treatment of or lack thereof adjustments for control and/or marketability. (Standard of Value).

Oppressed Shareholder

i. Definition is the unfair treatment of a minority shareholder's interest by the control shareholder(s). It may involve the lack of receiving timely financial statements, detrimental financial decisions, lack of distributions, having shareholder meetings without the minority interest, etc.

ii. Determine from counsel the specific state law governing the standard of value

iii. Be informed as to the treatment of or lack thereof adjustments for control and/or marketability. (Standard of Value).

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American Institute of CPAs | 220 Leigh Farm Road | Durham, NC 27707-8110 | February 2015