Attorney CLE Series

Understanding Standards of Value and Levels of Value

A PRECURSOR TO THE APPLICATION OF PREMIUMS AND DISCOUNTS

October 22, 2014

presented by the GYF Business Valuation & Litigation Support Services Group

GROSSMAN YANAK & FORD LLP
Certified Public Accountants and Consultants

Grossman Yanak & Ford LLP

Headquartered in Pittsburgh, Grossman Yanak & Ford LLP is a regional certified public accounting and consulting firm that provides assurance and advisory, tax planning and compliance, business valuation and technology services. Led by five partners, the 24-year-old firm employs approximately 55 personnel who serve corporate and not-for-profit entities in Pennsylvania, Ohio, West Virginia and New York.

Our firm was founded on the idea that the key to successful, proactive business assistance is a commitment to a high level of service. The partners at Grossman Yanak & Ford LLP believe that quality service is driven by considerable involvement of seasoned professionals on a continuing basis. Today's complex and dynamic business environment requires that each client receive the services of a skilled professional with a broad range of experience and knowledge who can be called upon to provide efficient, effective assistance.

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Our professionals understand the importance of quality and commitment. Currently, the majority of the professional staff in our Assurance and Advisory Services and Tax Services Groups hold the Certified Public Accountant designation or have passed the examination and need to complete the time requirements for certification. Each of our peer reviews has resulted in the highest-level report possible, attesting to the very high quality of our firm's quality control function. The collective effort of our professionals has resulted in our firm earning an exemplary reputation in the business community.

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Robert J. Grossman, CPA/ABV, ASA, CVA, CBA

Bob brings extensive experience in tax and valuation issues that affect privately held businesses and their owners. The breadth of his involvement encompasses the development and implementation of innovative business and financial strategies designed to minimize taxation and maximize owner wealth.

His expertise in business valuation is well known, and Bob is a frequent speaker, regionally and nationally, on tax and valuation matters. He is a course developer and national instructor for both the American Institute of Certified Public Accountants (AICPA) and the National Association of Certified Valuators and Analysts (NACVA) and served as an adjunct professor for Duquesne University's MBA program. Bob has also written many articles for several area business publications and professional trade journals.

After graduating from Saint Vincent College in 1979 with Highest Honors in Accounting, Bob earned a Masters of Science degree in Taxation with Honors from Robert Morris University. He is a CPA in Pennsylvania and Ohio and is accredited in Business Valuation by the American Institute of Certified Public Accountants. Bob also carries the well-recognized credentials of Accredited Senior Appraiser, Certified Valuation Analyst and Certified Business Appraiser.

A member of the American and Pennsylvania Institutes of Certified Public Accountants (PICPA), Bob has previously chaired the Pittsburgh Committee on Taxation. He has also served as Chair of the Executive Advisory Board of NACVA, its highest Board. Currently Bob is the Chair of NACVA's Professional Standards Committee; he previously chaired its Education Board.

Bob received the NACVA "Thomas R. Porter Lifetime Achievement Award" for 2013. One award is presented annually to a single member, from the organization's 6,500 members, who has demonstrated exemplary character, leadership and professional achievements to NACVA and the business valuation profession, over an extended period of time.

Bob is a member of the Allegheny Tax Society, the Estate Planning Council of Pittsburgh and the American Society of Appraisers. He has held many offices and directorships in various not-for-profit organizations. He received PICPA's 2003 Distinguished Public Service Award and the 2004 Distinguished Alumnus Award from Saint Vincent College.

Bob and his wife, Susie, live in Westmoreland County. They have two grown children.

Melissa A. Bizyak, CPA/ABV/CFF, CVA

Melissa has practiced in public accounting for 20 years and has significant experience in business valuation and tax-related issues for privately-held concerns and their owners. Her experience is diverse, with clients including both private and publicly-held companies in a wide variety of industries.

Melissa has performed valuations for various purposes, such as Employee Stock Ownership Plans (ESOPs), equitable distributions, buy/sell transactions, dissenting shareholder disputes, value enhancement and gift and estate tax purposes. She also provides litigation support services, including expert witness testimony.

After graduating from the University of Pittsburgh in 1994 with a B.S. in Business/Accounting, Melissa spent more than two years with a local accounting firm in Pittsburgh. She joined Grossman Yanak & Ford LLP in 1997.

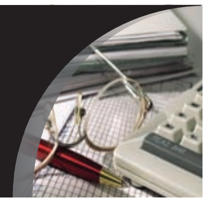
Melissa is a certified public accountant. She is accredited in business valuation and certified in financial forensics by the American Institute of Certified Public Accountants (AICPA). She has also earned the AICPA Certificate of Achievement in business valuation. Additionally, Melissa carries the credentials of Certified Valuation Analyst.

Her professional affiliations include the AICPA and the Pennsylvania Institute of Certified Public Accountants (PICPA), as well as the Estate Planning Council of Pittsburgh. She is also a member and serves on the Executive Advisory Board of the National Association of Certified Valuators and Analysts (NACVA).

Melissa has authored articles appearing in professional publications and has written business valuation course-related materials for NACVA and the AICPA. She serves as a national instructor for NACVA.

Melissa is a graduate of Leadership Pittsburgh, Inc.'s Leadership Development Initiative. She serves on the Board of Directors of the Children's Museum of Pittsburgh and is a member of the Executive Leadership Team for the American Heart Association's "Go Red for Women" initiative. Melissa is a mentor for women business owners in Chatham University's MyBoard program and serves on Robert Morris University's Professional Advisory Council.

Melissa resides in the South Hills of Pittsburgh with her husband and their two sons.



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Understanding Standards of Value and Levels of Value

Chapter I – *Introduction*

Arguably, no single aspect of the business valuation process is more difficult for users to understand than the application of premiums and discounts. Users of business valuation reports often look at the increase or decrease in total value attributable to premiums and discounts as an artificial means of modifying value to attain a certain end.

Unfortunately, in the legal arena, many valuators have used premiums and discounts to produce a result that is supportive of those positions beneficial to the side of the issue for which they are engaged. Such being the case, it is not at all unusual that counsel on both sides of the aisle often attempt to discredit the valuator's incorporation of premiums and discounts.

In the practice of gift and estate tax law, premiums, and especially discounts, have come under an increasingly severe barrage of challenges by the Internal Revenue Service (IRS), the U.S. Tax Court and other courts over the last decade. While the necessity and propriety of these value modifications are less often challenged, the size or level of the premiums and discounts, as well as the methodologies by which they were determined, have come under constant attack.

The ability of users to properly assess the propriety of premiums and discounts in business valuation is critically dependent on understanding the underlying foundational concepts unique to their correct determination and application.

These underlying foundational concepts include:

- ***Standards of Value*** – Understanding assignment requirements regarding the appropriate standard of value is at the center of all business valuations. Failure to determine the proper standard of value will, inevitably, result in incorrect conclusions, based many times on the misapplication of premiums and discounts.

- ***Levels of Value*** – This concept contemplates the broad spectrum of ownership characteristics generally associated with the attributes of control and marketability.

  Across this spectrum of ownership characteristics attributable to a specific block of equity ownership, it is commonly accepted that an ownership of a size sufficient to provide the holder with the ability to invoke a control owner's initiatives, thereby altering the course of the business's operations, is significantly more valuable than an ownership interest that does not provide the holder with control.

  Likewise, an equity ownership interest that is able to be quickly converted to a more liquid asset or cash is assumed to be considerably more valuable than an identical equity ownership interest for which no market exists and for which a quick conversion to a more liquid asset or cash is not possible.

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- *Approaches and Methodologies* – The value of equity ownership interests is determined under one or more of three broad approaches: the income approach, the market approach and the asset approach. Underlying each of these approaches are a number of methodologies commonly employed in business valuation.

  It is necessary that the inputs to the economic models under each method be fully understood so that valuators and users can determine those characteristics attendant to the results under each model. Depending on the inputs to each model, the result may be a controlling, marketable value when the valuation assignment calls for a noncontrolling, nonmarketable value. If such were the case, it is necessary, then, to apply a discount for lack of control and a second discount for lack of marketability.

- *Fundamental Theory* – The proper use of premiums and discounts is predicated upon a number of fundamental theoretical constructs that have been widely accepted by the business valuation community, finance and economic professionals, the IRS and the courts.

  While these theoretical constructs may, in some ways, seem exceedingly elementary and almost self-evident, it is all too common to identify errors in IRS rulings, court decisions and valuator reports wherein the errant party failed to respect fundamental theory.

- *Assignment Specifics* – It is imperative that the specific nuances of the business valuation assignment, as well as the attendant equity ownership interest, be fully understood.

  Consideration of a business valuation assignment, and of the propriety of utilizing premiums and/or discounts in that assignment, requires a careful assessment of numerous general factors that influence both the applicability and the size of any premium and/or discount that may be included. Often, these general factors require an understanding of the venue of the action and the history of court decisions in that venue, federal or state regulatory restrictions, and state incorporation and organization statutes, in addition to matters of finance, valuation, accounting and economics. Understanding such items is often predicated upon legal interpretation provided by counsel.

- *Mechanical Propriety* – All too often, premiums and discounts applied by valuators and/or the courts are incorrectly applied from a mechanical perspective. It is absolutely critical that the final premiums or discounts be mathematically applied on a multiplicative basis versus an additive basis. This fundamental concept will be illustrated in Chapter III.

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This seminar is intended to serve as a "primer" for those members of the legal community who encounter financial valuation of businesses and fractional business interests in their practice of law. The contents of these materials will familiarize the participants with the foundational concepts related to the application of premiums and discounts in business valuation and facilitate a greater understanding of the many facets of this complex matter. Should you have further questions about these topics, please feel free to contact us directly.

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Thank you for attending today. We do appreciate that all of you are exceedingly busy, and to have you spend part of your day with us is an honor and privilege for Grossman Yanak & Ford LLP.

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Chapter II – *Standards of Value*

A great deal of confusion in requesting a business valuation or interpreting its meaning could easily be avoided by properly focusing on the selection and utilization of the appropriate standard of value. Often, the appropriate standard of value is dictated by statutory guidance such as the Internal Revenue Code. On other occasions, the standard of value has evolved through judicial decisions and guidance issued by regulatory agencies and authorities. Finally, it is not unusual in a litigation environment for both sides to agree on a desired standard of value.

Understanding what exactly is a standard of value is not overly complex. Though labeled a "standard," it is nothing more than a definitional explanation of different commonly-utilized types of value. However, it is incumbent upon the business valuator and the user of his/her work product to fully understand the ramifications and implications of each definition.

> *Attorney Guidance: While it is generally the role of the business valuator to fully explain and educate the attorney as to the definition and nuances of each standard of value, it is the attorney's role to dictate the standard of value that is required in conjunction with his/her case. This is especially true where judicial history subject to legal interpretation sets the precedent.*

The standards of value most commonly encountered by business valuators and users of business valuator work product are: ***Fair Market Value, Investment Value, Intrinsic/Fundamental Value,*** and ***Fair Value***. These standards of value are detailed briefly below.

Fair Market Value

By far the most common standard of value, fair market value, is applied in income, estate and gift tax, marital dissolution[1] and, often, non-shareholder oppression litigation. Fair market value is defined in the United States Treasury regulations (20.2031-1(b)) and Revenue Ruling 59-60, 59-1 CB 237 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. 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."*

[1] Many states use the term "fair market value" in their marital dissolution cases. The definition of fair market value may vary from state to state and will not necessarily be the same definition applied for federal tax purposes.

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This definition requires that the valuation result be driven by a hypothetical sale transaction. Given that the definition requires consideration of a hypothetical sale, it stands to reason, then, that focus and attention must be given by a valuator to those hypothetical buyers and sellers and the types of concerns and issues that a potential hypothetical buyer and seller might consider prior to entering into a transaction.

A key component of this definition is that a value determination based on special motivations of either a specific buyer or a specific seller would not be considered fair market value. Fair market value also anticipates that both the hypothetical buyer and seller have the ability, as well as the willingness, to enter into the hypothetical transaction.

The definition of fair market value anticipates a value determination under prevalent economic and market conditions at a particular date of valuation. To assume an economic or market turnaround at a point in time beyond the date of valuation will result in a value other than fair market value.

The definition of fair market value also assumes that payment in the hypothetical transaction will be made in cash or its equivalent at the date of valuation. Thus, consideration of any deferred financing or special purchase arrangement is not appropriate when the goal is to identify fair market value.

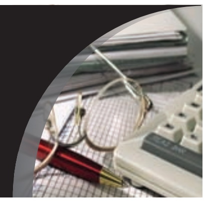
Finally, fair market value, by definition, must allow reasonable time for exposure in the open market. For equity ownership interests requiring longer periods of exposure, marketability, or rather the lack of marketability, presents a greater investment risk, and, therefore, a value detriment. Often this value detriment is addressed in the business valuation process as a discount.

Investment Value

Investment value is generally defined as the specific value of an investment to a particular class of investors based on individual investment requirements. In consideration of valuing an equity ownership interest, investment value differs from fair market value, which is not buyer- or seller-specific.

Often, investment value is also referred to as synergistic or strategic value. This reference reflects the impact of those synergistic or strategic benefits that one particular buyer may bring to the negotiating table in determining investment value. Such buyer-specific benefits might include:

- An ability to enhance future operating performance,
- An ability to mitigate certain risks inherent in the subject company,
- An ability to more efficiently finance the acquisition of the subject company, and
- An ability to assimilate current operations synergistically with the subject company.



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In most instances, investment value will exceed fair market value. This phenomenon is primarily the result of the supply and demand continuum for target companies. Simply put, demand for acquisition targets far exceeds available supply. As competitive bidding progresses in the negotiation process, the marketplace reveals that prospective specific buyers are generally willing to pay a premium beyond fair market value to close the deal. Very often, these premiums are justified on a cost-benefit approach by considering such items as the "cost to create" the target business in its current state and geographic location, as well as the time that it might require to recreate the target business. Additionally, anticipated post-acquisition cost reductions due to operational synergies may allow for the payment of a premium.

Intrinsic or Fundamental Value

Perhaps the most difficult standard of value to grasp, intrinsic value represents a specific analyst's judgment of value based on the perceived characteristics inherent in the specific investment. The intrinsic value does not contemplate the specific motivations of a particular buyer, but rather, how that one analyst's perception of the characteristics attendant to the subject equity ownership interest compares to other analysts' perceptions.

An easy way to envision intrinsic value is to consider how it might apply to a capital stock investment. Essentially, intrinsic value is that value, based on the analyst's "fundamental evaluation" of all available information, that the analyst believes reflects the "true" or "real" worth of that stock. When all analysts perceive the stock's value as the same number, the intrinsic value moves to fair market value.

The term intrinsic value is often discussed in case law; however, it is rarely defined. Attempts to utilize this standard of value in New Jersey family courts have been met with controversy.

Fair Value under State Statutes

In most states, fair value is the statutory standard utilized to resolve shareholder disputes for both dissenting shareholder and oppressed shareholder lawsuits and civil actions. Thus, fair value is a legally created standard of value.

Fair value, for these purposes, is generally defined, with respect to dissenter's shares, as the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable. While most states have a fair value statute, the majority of those offer little insight into its computation.

It is noteworthy that state courts have not considered fair value for these purposes as being equal to fair market value. Generally, damages to the harmed party are determined by the difference between the value of the dissenting shareholder's percentage ownership interest before and after the corporation action, without consideration of any discounts for lack of control or lack of marketability.

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Fair Value for Financial Reporting

As international accounting rules, including those used in the United States, move from an historical basis of accounting to a "fair value" basis of accounting, more attention has been focused on the definition of fair value for financial reporting purposes. Note that fair value for financial reporting has no relationship whatsoever to fair value under state statutes.

Issued by the Financial Accounting Standards Board (FASB) on September 15, 2006, Statement No. 157 (SFAS 157) is effective for financial statements issued for fiscal years beginning after November 15, 2007. (Note: SFAS 157 is now referred to as FASB Accounting Standards Codification 820 (ASC 820), *Fair Value Measurement and Disclosures*. It provides guidance on the measurement of fair value as a market-based measurement. A hierarchy for considering market-participant assumptions outlines and distinguishes between sources independent of the reporting entity and the reporting entity's own assumptions.

> ***FASB ASC 820 gives a single definition of fair value***:
>
> *Fair value is the price in an orderly transaction between market participants to sell the asset or transfer the liability in the market in which the reporting entity would transact for the asset or liability, that is, the principal or most advantageous market for the asset or liability.*[2]

It is clear from FASB releases that fair value for financial reporting is not fair market value, as noted in an earlier section.

> ***FASB ASC 820 expands on the difference between fair value and fair market value***:
>
> *The Board agreed that the measurement objective encompassed in the definition of fair value used for financial reporting purposes is generally consistent with similar definitions of fair market value used for valuation purposes. For example, the definition of fair market value in Internal Revenue Service Revenue Ruling 59-60 (the legal standard of value in many valuation situations) refers to "the price at which 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." However, the Board observed that the definition of fair market value relates principally to assets (property). Further, the definition has a significant body of interpretive case law, developed in the context of tax regulation. Because such interpretive case law, in the context of financial reporting, may not be relevant, the Board chose not to adopt the definition of fair market value, and its interpretive case law, for financial reporting purposes.*[3]

The balance of this presentation will be focused on determinations of fair market value and, where necessary, integration or reconciliation with investment value.

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[2] FASB ASC 820 - *Fair Value Measurement and Disclosures* (formerly SFAS 157), paragraph 5.

[3] FASB ASC 820 - *Fair Value Measurement and Disclosures* (formerly SFAS 157), paragraph C50.

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Chapter III – *Levels of Value*

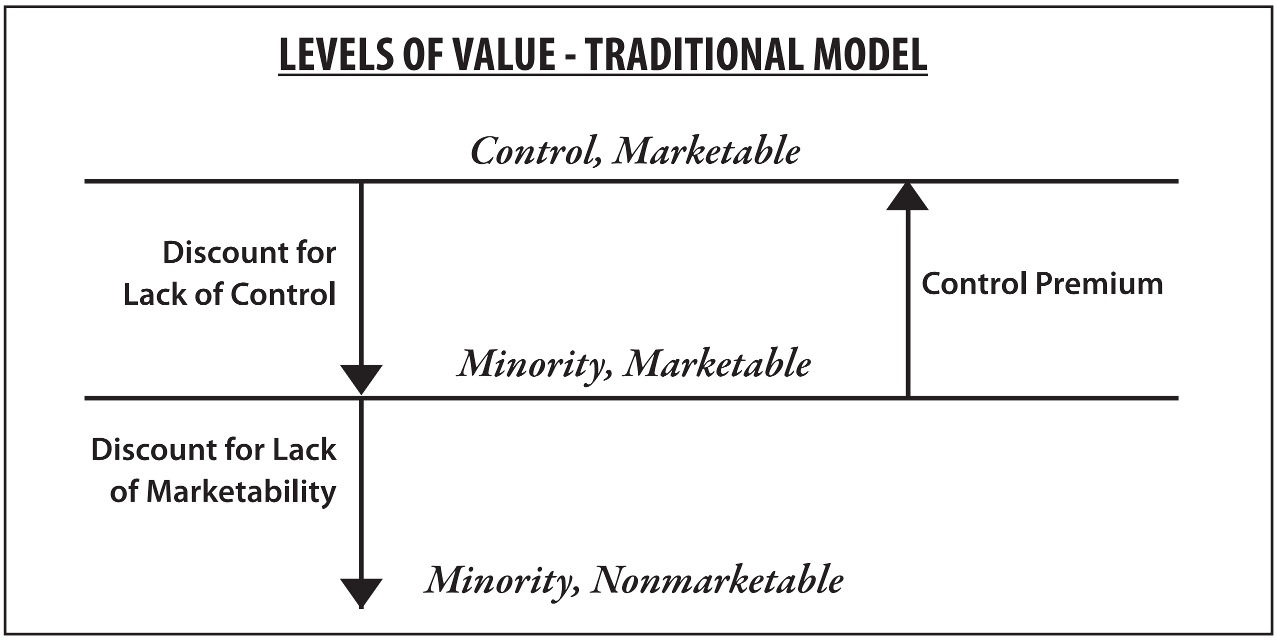
Implicit to determining the propriety of premiums and discounts is an understanding of levels of value. Such levels are usually defined by the attributes of control and marketability.

From a risk perspective, owning an equity interest that allows the holder all perquisites of control over entity operations is more valuable than an identical interest that does not allow for control. Similarly, the attribute of marketability adds value by lowering risk, while the lack of marketability does just the opposite.

Historically, the business valuation and finance communities have assumed three basic levels of value:

- Control, marketable interest value
- Minority, marketable interest value
- Minority, nonmarketable interest value

The traditional levels of value set forth above are often demonstrated in the following graphic:



In utilizing this "traditional" model, the critical presumption is that the type of value encompassed in the presentation is a financial value (the base for fair market value). In other words, the traditional model envisions the same measurement type with varying equity ownership interest characteristics.

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Note also that the mechanics of applying discounts in a multiplicative fashion (versus an additive fashion) results in the sum of the discounts for lack of control and lack of marketability producing an overall lower discount than simply adding the two raw numbers together.

An example illustrating this concept, assuming a twenty (20) percent discount for lack of control and a twenty-five (25) percent discount for lack of marketability, follows:

LEVELS OF VALUE - MULTIPLICATIVE APPLICATION OF DISCOUNTS

DISCOUNTS		VALUE
100%	*Control, Marketable*	$ 10.00
20%		(2.00)
80%	*Minority, Marketable*	$ 8.00
25%		(2.00)
60%	*Minority, Nonmarketable*	$ 6.00

Note that while the two discounts in the example add up to a total of forty-five (45) percent, in proper application, the two discounts net to forty (40) percent.

Another key element of understanding the mechanics of premiums and discounts is that the control premium is generally the algebraic inverse of the discount for lack of control. In fact, in the next program, which will focus on computing the actual discounts, it will be demonstrated that most discounts for lack of control drive from market -observable control premiums. The examples on the following page illustrate this inverse relationship.

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CONVERTING A CONTROL PREMIUM TO A DISCOUNT FOR LACK OF CONTROL

Formula: **x = 1 – [1 / 1+y]**

Where y = median premium paid

x = implied minority discount

Assume y = 24%

x = 1 – [1 / 1 + .24]

x = 1 – .806

x = 19.4%

Reversing the calculation results in the following formula:

CONVERTING A DISCOUNT FOR LACK OF CONTROL TO A CONTROL PREMIUM

Formula: **y = [1 / 1 – x] – 1**

y = [1 / 1 – .194] – 1

y = [1 /.806] – 1

y = 1.240 – 1

y = 24.0%

Over time, it has become apparent to the business valuation community that the use of discounts for lack of control developed by using the algebraic inverse of market-observable control premiums was not totally accurate. As a result, it is now the position of most valuators in the profession that market-observable control premiums include a synergistic or investment premium. Such thinking has led to an expansion of the traditional levels of value model, as illustrated on the following page.

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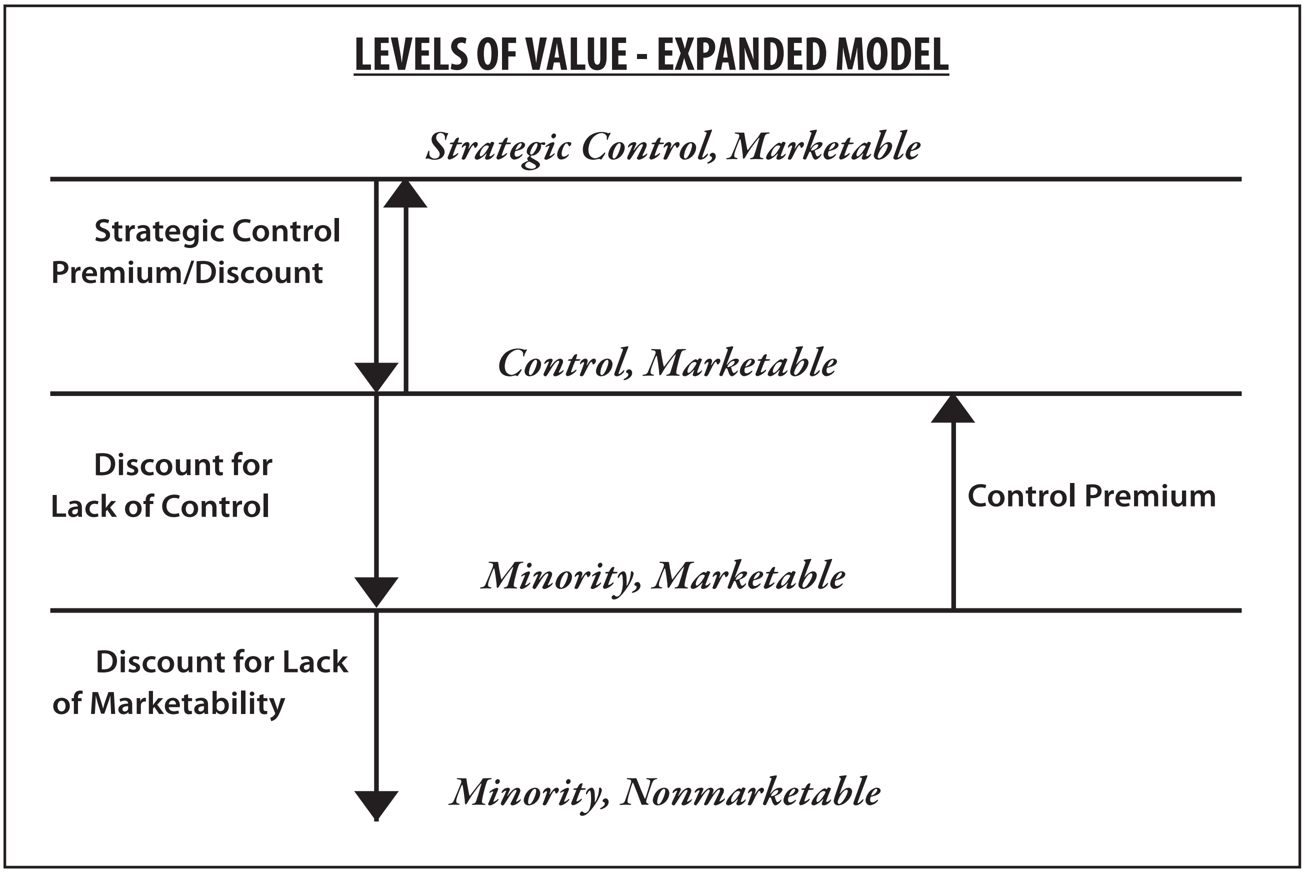

The key aspect of interpreting the expanded model of levels of value is understanding that the three levels from the traditional model are based upon a financial value, whereas the fourth level included in the expanded model is based upon strategic or synergistic value. This fourth level cannot be properly considered in the determination of fair market value unless the synergistic premium is removed. Unfortunately, at the current time, empirical studies have not been developed by which the strategic premium can be quantified.

As can be discerned, numerous alternative levels of value models have been proposed by commentators. Most of these have very defined and sophisticated variations that remain, as of the date of this program, highly theoretical and of little practical use in day-to-day application.

It is critical that users of business valuation reports fully understand the different levels of value in interpreting the information provided in the report.

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Chapter IV– *Fundamental Theory*

In understanding how business valuators develop premiums and discounts, it is important to set, as a foundation, certain fundamental concepts key to the business valuator's assessment and broadly accepted in the finance and business valuation community.

- ***The value of a business or business interest is determined by transactions between buyers and sellers.***

  It is obvious that only "real life" completed transactions reflect an accurate indication of value. Even then, the conclusion is likely something other than fair market value because there is a single buyer in each transaction that may have buyer-specific motivations. Nevertheless, it is difficult to discern how the value of any asset might be determined without some consideration of a sale of that asset.

  As value is determined by transactions between buyers and sellers, it necessarily requires business valuators to carefully scrutinize those issues of concern to *both* parties in the transaction. Failure to fully address the issues facing either party to the transaction will result in the failure to reach an agreeable negotiated value, either real or hypothetical.

- ***Investors are risk averse.***

  Perhaps the most common of all of the fundamental concepts, this notion is almost too simple to address. However, as with any investment asset purchase, the prospective parties to the transaction will look to a modification of value upward or downward depending on the investment risks. Ownership interest attributes that increase the risk of holding the investment will inherently depress the value of the ownership interest. Likewise, those specific characteristics that serve to diminish investment risk will increase that ownership interest's value.

- ***The propriety of any premium or discount is undeterminable until the base to which the adjustments are applied is clearly defined.***

  Utilization of discounts and premiums cannot produce a correct result if applied to an inappropriate base estimate of value. Understanding where a certain pre-valuation premium or discount value falls on the levels of value is absolutely critical to properly applying the adjustments.

  For example, assuming that the valuation professional selected an approach and method that results in a minority, marketable level of value, it would be inappropriate to apply a separate minority discount (lack of control) as this would constitute a duplication of consideration of the risk presented by holding a minority interest.

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- ***No "prescribed" levels or ranges of discounts or premiums exist from which the valuator can ascertain the proper adjustments for a specific case.***

  Moreover, the valuator cannot expect to use a common set of computations or formulas to determine the appropriate adjustments in cases with differing facts and circumstances. Often, users of valuation reports look to those reports as a basis for consideration of premiums and discounts in other valuations. Any application of a premium or discount is case-specific and must be reconciled to any base data or information that may be used in the development of that premium or discount.

  Much is made of court decisions in setting discount levels, in particular. This is an unfortunate and dangerous habit, as generally there is little to be gained from interpreting premium or discount levels from judicial findings.

- ***Though not totally mutually-exclusive concepts, the discount for a lack of ownership control (minority) and the discount for lack of marketability are generally held to be separate and distinct.***

  While it is true that some crossover exists, whereby a noncontrolling interest is less marketable than a controlling interest by the nature of the noncontrol feature, sufficient third-party information exists to support separation of the two. Otherwise, insurmountable difficulties arise in determining a proper level of combined discount.

  A number of court cases exist wherein the discounts are combined. However, this lack of separation is not determinative of proper application of discounts, and they should generally be considered as two separate adjustments.

- ***In instances in which the business valuator deems it appropriate to apply both a discount for lack of ownership control and a discount for lack of marketability, the application of the discounts is multiplicative, not additive.***

  The discount for lack of ownership control is generally applied first, principally due to the common understanding that both control and minority ownership interests may be subject to a discount for a lack of marketability. Moreover, the only empirical data for lack of marketability is available at the minority interest level, further supporting the concept of applying the minority discount first.

  Mechanically, if properly applied, the order in which the discounts are applied should not matter. However, as discounts for lack of control (minority) are almost always applied first, adherence to this order will serve to alleviate confusion by users of business valuation reports.

  The most important aspect of this fundamental concept is that the two separate discounts, if applicable, not be added, which will result in an overstatement of the discounts and an understatement of the value conclusion.

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- ***Due to specific characteristics requiring application of discounts for both a lack of control and a lack of marketability, minority ownership interests in privately-held businesses are generally worth much less than their proportionate share of the overall business value.***

  In other words, the sum of the parts may not add up to the whole. The Internal Revenue Service, in particular, continues to challenge this concept at the field examination and appellate levels of administration. Most often, the attacks focus on family limited partnerships, but they have evolved into challenges of other gift and estate tax strategies.

These fundamental concepts in applying premiums and discounts are integral to understanding the risk assessment process considered in each business valuation assignment.

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Chapter V – *Valuation Approaches and Methodologies*

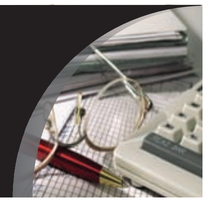
The discipline of business valuation focuses primarily on three broad approaches to value. The first is the **income approach**, which attempts to value future economic benefit streams (usually, cash flow) in present-value dollars at the date of valuation.

The second approach is the **market approach**, which requires the valuator to identify transactions that have occurred in the marketplace that are sufficiently similar to the subject company to afford some indication of value, generally through the use of various valuation multiples.

Finally, the third approach is the **cost/asset approach**, which requires the valuator to determine the cost to construct or develop an asset, less any adjustment downward for obsolescence.

Within these three broad approaches are numerous methodologies that require a variety of inputs and analysis – many of which are subject to the professional judgment of the business valuator. A synopsis of these approaches and the underlying methods are set forth below:

Income	*Capitalized returns*	• Capitalization of earnings • Capitalization of net cash flow • Capitalization of gross cash flow
	Discounted future returns	• Discounted net cash flow • Discounted future earnings
Market	*Value multiples using comparative company data or transactions*	• Price/earnings • Price/dividends • Price/gross cash flow • Price/book value • Price/revenues • Price/net asset value
Cost/Asset	*Underlying assets*	• Net asset value • Liquidation value
	Other	• Excess earnings • Rules of thumb • Sellers' discretionary cash flow • Company-specific methods



Understanding Standards of Value and Levels of Value

In the area of premiums and discounts, a user of business valuation reports must understand how valuator inputs influence where each method's conclusion falls on the levels of value model. Such an understanding, then, confirms or rejects the precept that use of a premium or discount is warranted.

Income Approach

The most common methods used by valuation professionals for privately-held businesses are *Capitalized Returns and Discounted Future Returns*. The conclusions attained using these methods are marketable values. Thus, if the equity ownership interest under valuation is not marketable, it is incumbent upon the valuator to use a discount for lack of marketability.

The primary theoretical justification for this position is that the data used by valuation professionals to construct risk rates (i.e., capitalization and/or discount rates) comes from public company information. As such, this data reflects equity returns in consideration of a high level of marketability and liquidity.

Whether these methods produce a control or minority value is a different matter altogether and is wholly dependent upon whether the forecast of future economic performance reflects the returns that a control owner would make as a result of control ownership.

It is clear, mechanically, that a control or minority conclusion under these methods is solely a factor of the adjustments to the numerator in the calculations. Note that the adjustments to the future economic benefit stream must be related to control perquisites to shift from minority to control. The example below emphasizes this concept and shows a calculation for a discount for lack of control using the income approach.

INCOME APPROACH – CONTROL vs. MINORITY

	Control		Minority
Cash Flow	$ 750		$ 750
Control Adjustment	250		0
	1,000		750
Capitalization Rate	.20		.20
	$ 5,000		$ 3,750
Difference		$ 1,250	
Discount for Lack of Control		**25%**	

Understanding Standards of Value and Levels of Value

Market Approach

The market approach, if properly applied, allows valuators the opportunity to tie their conclusions to marketplace data more directly. Since the data for both primary methods, the *Guideline Company Method* and the *Transaction Method*, trail public and private market activity, the results are generally deemed to represent marketable conclusions.

Historically, under a guideline company method, with valuation multiples developed from public stock market data, the business valuation profession presumed that the value conclusions were minority conclusions. This thinking is still the most prevalent position in 2014.

However, there is a newer school of thought gaining ground within the profession that the conclusions attained under the guideline company method are neither minority nor control. This position assumes that these companies (listed on public exchanges) are subject to a very high level of analysis and scrutiny by the Securities and Exchange Commission as well as financial and industry analysts and, therefore, are likely run at the highest level of performance attainable. Thus, there are no value detriments attributable to minority ownership.

The second market approach method, the transaction method, is also commonly referred to as the merger and acquisition method. This method simply requires the valuator to identify guideline companies from various private transaction databases comprised of completed transactions. As such, the conclusions garnered under this method are control, marketable values.

Cost/Asset Approach

The *Underlying Assets Methods* are more suited to valuing controlling interests. Generally, these methods should only be used to value minority interests if those interests can cause the company to sell its assets, or if the company is the type of company whose stock should normally be valued primarily on an asset basis (i.e. an investment holding company.) As a result, these methods generally produce a control, marketable value.

When utilizing *Excess Earnings Methods*, variations in model inputs can change the result to a minority value, but such a result is extremely difficult to reconcile and defend. As such, in most cases, the excess earnings methods produce a control, marketable value.

Because the inputs to models under the *Multiple of Discretionary Earnings Method* are based on purchase and sales transactions, the result is generally control, marketable values.

Understanding Standards of Value and Levels of Value

Summary

Necessity of any premium or discount is predicated upon the characteristics of the subject equity ownership interest in comparison to the pre-premium or pre-discount conclusion garnered under any particular valuation methodology. Failure of users of business valuations to fully understand the impact of valuation inputs into the models under these methods and the impact that they have on the conclusions may lead to a misinterpretation of the valuator's opinion of value.

Understanding Standards of Value and Levels of Value

Chapter VI – *Factors Influencing Premiums or Discounts*

Numerous business and planning situations call for the consideration of using premiums or discounts. Many applications of premiums and discounts, however, are limited by the purpose of the business valuation and other statutory, judicial or economic influences. A nonexclusive listing of the internal and external factors that might affect either the application or the size of a premium and discount follows.

- ***Purpose of the valuation*** – Different purposes absolutely affect the use of premiums and discounts. Marital dissolution in many states, including Pennsylvania, requires a determination of fair market value (which is inclusive of any applicable premiums and discounts).

  Alternatively, a business valuation undertaken for purposes of providing a conclusion of fair value in a dissenting shareholder action is not likely, in most jurisdictions, to include discounts for lack of control and often excludes discounts for lack of marketability, as well.

- ***Specific ownership interest attributes*** – Any restrictions attendant to the equity ownership interest under valuation related either to control or marketability will influence the applicability and size of any premiums or discounts required.

  For example, the presence of a shareholder agreement setting forth a restriction on the transferability of shares will affect holder risk and, therefore, the level of the discount for lack of marketability. Likewise, if the shares under valuation are subject to a "put," a market for the shares may be deemed to exist that would decrease any discount for lack of marketability.

- ***Ownership structure*** – Ownership structure is very important in the consideration of premiums and discounts. A highly-fragmented ownership structure will often nominalize any valuation premiums accorded a minority interest, while a very limited structure may result in just the opposite.

  For example, assume that the valuation assignment is to develop an opinion of value of a two (2) percent minority interest in two identical companies excepting capital structure. The first company has 50 shareholders who each own a two (2) percent equity ownership interest, while the second has two forty-nine (49) percent shareholders and one two (2) percent shareholder. From such a fact pattern, it is obvious that the value of the two equity ownership interests differ.

- ***Voting rights*** – Voting rights and the control perquisites encompassed in those rights have a substantial impact on perceived investment risk and, ultimately, value. Moreover, the lack of voting rights attendant to nonvoting shares generally makes those shares less desirable and less marketable.

Understanding Standards of Value and Levels of Value

- ***Size of the company*** – Greater revenue, capital, income and diversity of businesses all combine to combat equity ownership risk in larger companies. Accordingly, the size of the company under valuation is an important influence on risk and any use of premiums or discounts.

- ***Size of the block of stock under valuation*** – The most obvious influence related to size of the block of stock under valuation is whether that block is a controlling interest versus a noncontrolling or minority interest. As attributes of control are lessened, the general treatment under business valuation principles is to increase the discount for lack of control, thereby decreasing value.

  There is also a valuation issue related to the size of the block of stock when analyzed in conjunction with the dispersion of the remaining equity interests. Generally referred to as "swing vote" capability, the ability of a noncontrolling block of stock to join with another minority block of stock to exercise control will generally result in a lower discount for lack of control.

- ***Dividend/distribution history*** – Entities that have had a strong history of cash flow distributions through dividends or partnership distributions tend to require lower discounts for lack of marketability than entities that do not. The basis for this precept is that the lion's share of entity risk is remediated through regular cash flow distributions. If it is the valuator's position that the dividends or distributions will follow historical trends into the future, marketability is enhanced and a lower discount for lack of marketability is warranted.

- ***Financial condition of the subject company*** – Business entities with less attractive operating and financial results on a historical basis will garner a perception of greater investor risk in the future. These investment risks will equate to a decrease in value of the subject equity ownership position and may be accounted for through the application of a larger discount for lack of marketability.

- ***Federal and state regulatory restrictions*** – Treasury regulations regarding estates and gifts, Department of Labor rules regarding Employee Stock Ownership Plans (ESOPs), and FASB pronouncements, as well as state shareholder protection statutes, all influence the applicability and level of discounts applied in business valuations.

- ***State corporation statutes*** – States requiring supermajority control positions, such as Illinois and New York, have a significant influence on the propriety of premiums and discounts and the level of those valuation adjustments.

Understanding Standards of Value and Levels of Value

The previous listing is not intended to be all-inclusive, but rather, a sample of the factors that require consideration by a business valuator to meet professional standards and, more importantly, to provide an opinion of value that correctly measures the future financial rewards and risks associated with the equity ownership interest subject to valuation.

Understanding Standards of Value and Levels of Value

Chapter VII – *Implications*

As will be observed in future programs, the area of premiums and discounts is under constant challenge from users of business valuation reports. In particular, the Internal Revenue Service has had numerous successes documented in Tax Court decisions. Other users, such as fact finders in litigation and family court, continually struggle to fully understand how such significant portions of value can be eliminated simply by virtue of applying a discount. Finally, many equity ownership interest holders subject to shareholder buy/sell agreements do not fully understand the implications upon value resulting from the lack of definitions relating to value and the failure to fully understand the underlying standard of value set forth in the agreement.

In answer to all of these issues, we at Grossman Yanak & Ford LLP's Business Valuation Services Group carefully consider and integrate those fundamentals and concepts discussed in this program into a proper and complete determination of premiums and/or discounts utilized.

The framework developed herein is intended to serve as a foundation of knowledge on which future programs will be based. Another program will focus on premiums and discounts related to control and discounts for lack of marketability.

The greatest benefit to take away from today's program is that all opinions of value are fact-specific to the attendant equity ownership interest. The role that premiums and discounts play in that determination is also case-specific and requires careful consideration of all factors that might influence the overall risk associated with the particular block of equity under valuation. As noted within these materials, those factors are both internal and external to the company whose equity is being valued, as well as the specific block of equity.

Most often, the application of premiums and discounts is challenged on the basis that the valuator failed to reconcile third-party empirical evidence to the specific selected adjustment. That reconciliation is critical to successfully defending the premiums or discounts applied in any given case and requires careful consideration of those items discussed in this program.

Successful practice in the valuation discipline demands that the valuator provides well-thought-out reasoning for all positions taken in the project. Most users of business valuation opinions experience some level of difficulty in interpreting the process and resultant conclusions. This is not surprising, given the highly technical nature of valuing a business or an equity ownership interest therein. However, exploration of those items considered by the valuator in conjunction with his or her work will always add transparency and clarity to the process undertaken.

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  - *Education Expense Planning*
  - *Retirement Planning*
  - *Alternative Minimum Tax Planning*
  - *Charitable Giving Strategies*
- Family Tax Compliance and Planning Services
  - *Business Continuation Strategies*
  - *Minimizing Family Tax Costs*
- Business Tax Compliance and Planning Services
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  - *Compensation Planning*
  - *Inventory Methods Analysis*
  - *S Corporation Analysis*
  - *Tax Accounting Methods Analysis*
  - *Information Return Reporting Analysis*
  - *Deferred Compensation and Retirement Planning*
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