

DEFINITION OF VALUE



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It is well known that a buyer and a seller often have differing opinions on what a business is worth. This article, however, is not about a buyer's and a seller's opinions, but rather the different value a business has based on various definitions of value. It is important to understand and properly apply these definitions in the business world. The value of a business for estate planning is one thing. The sale price to a competitor may be something else as may be the value in a divorce or litigious situation. Understanding the definitions of value will help you understand the differences.

There are three basic definitions used to value a business,

especially as they pertain to a closely held business. They are: 1) fair market value, 2) investment value, and 3) fair value.

Fair market value is the phrase that is most commonly used to talk about value. Its definition, however, makes it non-applicable in all the situations in which it is used, and it is not synonymous with a particular "sales price." Fair market value, as defined by the Internal Revenue Service in Rev. Ruling 59-60 is "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." A willing buyer and a willing seller means any buyer or any seller acting in a rational way with other options for investing their funds. All relevant knowledge includes what is known or should have been known by both parties. In a minority position, the investor has no control and, therefore, cannot enhance or diminish the value of the company. Based on this, there is often a discount off the full price of the company. This is the definition of value that is mandatory in estate and gift tax situations and all other values presented to the IRS.

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Investment value is not a commonly used term as it pertains to the value of a business, but it is the most synonymous with a particular sales price. It is the value of a business to a particular buyer or a particular seller. It encompasses the synergies that a buyer might bring to the business, making the business more valuable to them than to the “any buyer” in the definition of fair market value. It also encompasses the special value a business may have to a particular seller, including emotional ties to the business that makes it more valuable to them. This is an increase in value that the “any seller” who

is acting in a rational way would not have.

Fair value is defined by state statute and case law and used most often in a court setting such as dissenting shareholder cases or divorce. State statutes must be reviewed for a definition, but the best guidance for definition of value is found in court cases. For example, Delaware courts have held that in determining fair value for dissenting shareholders, minority and marketability discounts are not appropriate when the purchaser of the stock is either the majority shareholder or the cor-

poration itself. Other courts have held differently, but a general definition often used is fair market value of an interest without minority or marketability discounts. The value of a minority interest is its pro rata share of the whole.

Incorrectly applying the definition of value for a business can be very costly. When drafting documents that describe value, or when requesting some type of valuation work, make sure the appropriate definition of value is used. Contact your valuation consultant.