Fair Market Value, Fair Value, Investment Value – What's the Difference?

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When attorneys and consultants encounter instances when their client needs a business valuation, most likely they hear the terms Fair Market Value, Fair Value and Investment Value bandied about interchangeably. But what do these terms actually mean? They do have different definitions and this article sheds some light on what they mean and their application.

Generally, there are five most frequently used standards of value:

- Fair Market Value
- Fair Value (states' rights)
- Fair Value (financial reporting)
- Investment (or Strategic) Value
- Intrinsic Value

Applying the proper standard of value is critical when utilizing a valuation specialist to estimate the value of your client's company, interest or asset. This is because there can be significant differences in value depending on the standard of value used. Also, applying the wrong standard of value will likely subject the valuation analysis/report to challenge by the IRS (for tax-related valuations), by the courts or opposing counsel in a litigation matter, or by third-party investors.

The bottom line is that the standard of value defines the type of value being sought and drives both the theoretical and practical aspects of the valuation assignment. So which standard should you use? That depends upon the purpose of the valuation discussed in more detail below. But first, let's look at how these standards of value are typically defined.

Fair Market Value (or FMV) is defined by the U.S. Treasury 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 to sell and both having reasonable knowledge of relevant facts".* Under the FMV standard of value, shareholder discounts *may* be applied to the shares of a closely-held company if they lack all or some of the prerogatives of control over the corporation or if the shares can't be sold or transferred as easily as a publicly traded stock.

The FMV standard assumes a hypothetical transaction with a willing buyer and seller dealing at arms-length. It also considers how the vast population of buyers and sellers would price the subject interest – i.e. - price is *not* influenced by any special motivations or synergies available only to a specific buyer.

FMV is commonly applied in regulatory compliance matters including federal gift and estate tax matters and, in some cases, judicial matters.

Fair Value (or FV) is defined by Ibbotson Associates as *" …. the amount that will compensate an owner involuntarily deprived of property. Commonly there is a willing buyer but not a willing seller, and the buyer may be more knowledgeable than the seller. Fair value is a legal term left to judicial interpretation. Many consider fair value to be fair market value without the discounts".*

FV is generally applicable in judicial matters and applicable in certain cases where, for example, a shareholder agreement calls for FV.

For judicial matters, such as divorce, shareholder dissent and oppression, there is no clear consensus on the definition among the states; however, most view it as the value of the shares on a pro-rata basis.

The statutory application of fair value among the 50 states is ubiquitous in shareholder dissenter's rights and oppression cases, but the term is rarely defined by those statutes. Many courts have weighed in on the appropriate definition.

Fair Value for financial reporting purposes (i.e. - purchase price allocations) has a very different definition and its own set of rules under Generally Accepted Accounting Standards. Any further discussion on FV for financial reporting is beyond the scope of this article.

Investment Value (also referred to as Strategic Value) is defined as the value of an asset or business to a specific or prospective owner or holder of the asset or business. For example, it can include the added value to a prospective acquirer of a business due to the synergies an acquisition would bring from cost savings or increased market share. Or, it can mean the value to the holder in some divorce proceedings, in which case the assumption as to a hypothetical sale (like fair market value) is irrelevant.

Intrinsic Value defined by Black's Law Dictionary is *"… the inherent value of a thing, without any special features that might alter its market value"*. Intrinsic value is not the legal standard in any federal or state statute. Nevertheless, the term is found in judicial opinions regarding business valuations in family law cases and dissenting shareholder or oppression cases. Like investment value, intrinsic value is often used synonymously with value to the holder. Many courts use the term "intrinsic worth" as closely associated with *fair value* in shareholder dissention and oppression cases.

As you may have already realized from the definitions, in some cases the standard of value is clear. For example, <u>fair market value</u> for gift and estate tax purposes and <u>fair value</u> for financial reporting purposes. In other cases, the applicable standard of value is not so clear. Take the divorce or marital dissolution cases in which the definition of fair value, fair market value and / or investment value are less explicitly defined by statute. States view these standards of value differently for divorce. To understand how each state interprets these terms, one looks to prior court decisions within the applicable jurisdiction since you won't find any state statute defining value. Pennsylvania, for example, adheres to the fair market value standard as do most states (approximately 40 or so). The other states are relatively split between fair value and investment value and a few states have adopted hybrid standards (i.e. - a combination of fair market value, fair value and / or investment value).

To further complicate things, for divorce cases there is the issue of what's considered a marital asset when there is goodwill value involved (which is typically the case). Goodwill is defined by the International Glossary of Business Valuation Terms as *"The intangible asset that arises as a result of name, reputation, customer loyalty, location and similar factors not separately identified."* Some states require goodwill to be separated into personal and enterprise goodwill. Personal goodwill is value that attaches to an individual (example: reputation, personal relationships with customers) whereas enterprise goodwill is associated with the business (example: location or trade name) regardless of personal attributes. Many states carve out the personal goodwill portion and don't consider it as part of the value being sought. On the other hand, some states consider the entire goodwill as part of the value being sought.

Below is a summary that helps explain the standards of value in terms of their applicability and differences. As you can see, divorce-related cases show up under multiple standards (FMV, FV and IV) depending upon the state (some states are noted as examples). Several states (Michigan, New York and Montana) use a hybrid – or a mix of standards such as investment value and fair market value. In addition, certain states include personal goodwill while others exclude it. Notice the contrast between the varying standards used in divorce-related cases vs. IRS-related and financial reporting-related cases where standards are consistent no matter the state.

Standard of Value	Application	Defined By	Treatment of Personal Goodwill *(included / excluded)*	Specific Features
FAIR MARKET VALUE	Regulatory / Tax Related	IRS	100% Included (ie: no carve out of personal GW)	Discounts for lack of control and marketability apply (if warranted)
	Divorce	State: eg: PA, NC, FL use FMV	Varies from state to state: PA excludes; NC includes; FL excludes	Discounts for lack of control and marketability apply (if warranted)
FAIR VALUE	Divorce	State: eg: MA, AL use FV	Varies from state to state: MA excludes; AL undecided	Discounts typically not applied
	Shareholder Oppression / Dissention	State	100% Included (ie: no carve out of personal GW)	For the most part, all states use FV standard where value = FMV without the discounts
	Financial Reporting	FASB	100% Included (ie: no carve out of personal GW)	Specific rules set by FASB to reflect GAAP-based financial statements
INVESTMENT VALUE	Divorce	State: eg: AZ, Wash. use IV	Varies from state to state: AZ includes; Wash includes	Discounts typically not applied; value to the holder
	M & A; Sale Transaction	not applicable	not applicable	Value to the specific individual or company as if in exchange or to the current owner

Note: For divorce and shareholder oppression cases, the above are generalizations as a particular state or jurisdiction may have differing interpretations, rules and policies on how value is defined

The following is an example of how the standard of value can affect value. Let's take an accounting practice owned equally by three accountants.

Scenario 1 – *Estate Tax*: The purpose is for federal estate tax valuation upon the death of one of the owners.

- The business would be valued as a minority interest in a closely-held corporation
- The standard of value would be fair market value and the decedent's share of assets of the business, including all goodwill, would be valued as if it were sold in a hypothetical sale.
- Discounts for lack of control and lack of marketability would be applied at the shareholder level.

Scenario 2 – *Shareholder Oppression*: Two shareholders oppress the third and a buyout option is exercised.

- Under the fair value remedy in his/her state dissolution statute, the oppressed shareholder is paid the fair value of his/her interest.
- The entity would likely be valued as a whole with the departing shareholder entitled to a pro-rata share of that value based on percentage of ownership.
- Generally, no shareholder-level discounts are applied.

Scenario 3 – *Divorce:* In divorce proceedings, a whole range of values can arise based on differing premises and standards of value. Depending on the statutes, case law and public policy, the standard of value may be fair market value (using the gift and estate definition) or even a more rigid application of fair market value that may carve out and eliminate personal goodwill altogether. Another possibility would be fair value at the enterprise level without applying the discounts. It may also be investment value including the personal goodwill of the individual CPA.

The differences in value under the above scenarios are depicted below using, of course, certain assumptions.

Assuming the value of the CPA firm is $1.0 million (for 100% of the equity), the concluded value could range from $60,000 to $333,333. Although these values are based on hypothetical scenarios, the purpose is to show how value can vary significantly depending upon the standard of value used – or purpose of the valuation.

Facts / Assumptions			Estate Tax (Fair Market Value)	Shareholder Oppression (Fair Value)	Divorce (Fair Market Value)	Divorce (Fair Value)	Divorce (Investment Value)
Value of entity equity			$ 1,000,000	$ 1,000,000	$ 1,000,000	$ 1,000,000	$ 1,000,000
Less: Minority interest discount	20%		$ (200,000)	*na*	(200,000)	*na*	*na*
			800,000	1,000,000	800,000	1,000,000	1,000,000
Less: Discount for lack of marketability	25%		(200,000)	*na*	(200,000)	*na*	*na*
			600,000	1,000,000	600,000	1,000,000	1,000,000
Interest Valued		x	33.33%	33.33%	33.33%	33.33%	33.33%
			200,000	$ 333,333	$ 200,000	$ 333,333	$ 333,333
					value if All GW is included		
Portion attributed to entity goodwill		x	*na*	*na*	30%	30%	30%
Value of subject interest			$ 200,000	$ 333,333	$ 60,000	$ 100,000	$ 100,000
					value if personal GW is excluded		

Note: the above assumptions used are not representative of anyone's opinion and are not supported by factual data. They are only used for the purpose of showing the possible differences in estimated value using different standards of value.

Concluding Thoughts - Within the valuation community, you often hear the term *"Value is in the eye of the beholder"*. We can go one step further and say that the beholder can mean "purpose" or "standard of value" as the above range of values suggest. It is critical to understand the purpose of the business valuation and define the specific standard of value to be used at the onset of any case requiring a valuation. Doing so can avoid costly mistakes in relying on a wrong or inappropriate value.