



GROSSMAN YANAK & FORD LLP
Certified Public Accountants and Consultants

Understanding Standards of Value and the Market Approach in Controversy



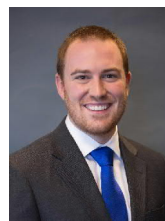
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Understanding Standards of Value and the Market Approach in Controversy

INTRODUCTION



Standards of Value and the Market Approach in Controversy

INTRODUCTION

- ***Valuation of equity ownership interests***
 - Often at the center of matters of controversy
 - Necessary to determine definition of “value”
 - Complex and difficult process
 - Rooted in foundational theory
 - Available authoritative guidance and professional standards



Standards of Value and the Market Approach in Controversy

INTRODUCTION

▪ ***Market Approach***

- One of three approaches to determine value
- Brings information from “real” market transactions into valuation process
- Predicated on economic concept of substitution
- Issues arise in the application of the approach and methods thereunder



Standards of Value and the Market Approach in Controversy

INTRODUCTION

▪ ***Market Approach***

- Numerous problems in misapplication of underlying theory
- Primary issues relate to:
 - Standard of Value
 - Premise of Value
 - Level of Value
 - Sufficient Similarity



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Understanding Standards of Value and the Market Approach in Controversy

METHODS AVAILABLE UNDER THE MARKET APPROACH



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Standards of Value and the Market Approach in Controversy

METHODS AVAILABLE UNDER THE MARKET APPROACH

▪ **Methodologies**

- Guideline Public Company Method
- Guideline Transaction (Merged and Acquired) Method
- Subject Company Past Completed Transaction Method
- Rules of Thumb



Standards of Value and the Market Approach in Controversy

METHODS AVAILABLE UNDER THE MARKET APPROACH

▪ **Guideline Public Company Method**

- Selected multiples developed from identification and analysis of companies traded freely on open stock exchange
 - Draw comparable guideline companies from large pool of candidates
 - Offers significant amount of quality financial, industry, and economic data due to SEC mandates
 - Observes actively-traded stocks price driven by independent third-party investors



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METHODS AVAILABLE UNDER THE MARKET APPROACH

▪ **Guideline Completed Transaction Method**

- Also referred to as “Merger and Acquisition Method”
- Observes value indicators produced through closed and completed transactions
 - Greater availability of transaction data
 - Transactions providing financial data to business valuers under this method are grouped into one of four categories



Standards of Value and the Market Approach in Controversy

METHODS AVAILABLE UNDER THE MARKET APPROACH

▪ ***Guideline Completed Transaction Method***

- Categories
 - Public company sale
 - Private company sale to public company sale requiring an SEC 8-K
 - Private company sale to public company sale with no SEC 8-K
 - Private to private company sale



Standards of Value and the Market Approach in Controversy

METHODS AVAILABLE UNDER THE MARKET APPROACH

▪ ***Subject Company Completed Transaction Method***

- Review and consider past transactions involving companies' equity interests
 - Control or minority transactions
- Ascertain the independent, objective and arm's length nature of the transaction
 - Identify and unwind those elements of the deal that are not arm's length



Standards of Value and the Market Approach in Controversy

METHODS AVAILABLE UNDER THE MARKET APPROACH

▪ **Rules of Thumb**

- Multiples set forth by various parties, publications, industry organizations etc.
 - Most based on suggested multipliers applied to a variable
 - Multiples of sales
 - Multiple of Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)
 - Multiple of Earnings Before Interest and Taxes (EBIT)
 - Multiple of Sellers Discretionary Cash Flow or Owners Cash Flow



Standards of Value and the Market Approach in Controversy

METHODS AVAILABLE UNDER THE MARKET APPROACH

▪ **Rules of Thumb**

- Lack of detail supporting the multiples
 - Rarely include
 - Where and when the transaction took place
 - Deal structure
 - Deal terms
 - Acquired company's profitability



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METHODS AVAILABLE UNDER THE MARKET APPROACH

▪ *Common Databases and Information Sources*

- Guideline Public Company Method
 - S&P Capital IQ, Ycharts
 - Both contain underlying financial information for publically-traded companies and current/historical price and enterprise value data
 - Alcara, Compustat, Disclosure, Hoovers, Reuters, Mergent Company Data Direct, OneSource
 - All contain data for currently-operating U.S. companies



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METHODS AVAILABLE UNDER THE MARKET APPROACH

▪ *Common Databases and Information Sources*

- Guideline Transaction Method
 - BIZCOMPS- contains over 12,650 private company transactions with median selling price of about \$167,000
 - DealStats- new platform that incorporates private-company transaction comparables from Pratt's Stats and Public Stats
 - Done Deals- contains 7,000 transactions for private/public mid-market companies
 - Institute of Business Appraisers (IBA) database- contains transaction data for sales of small to medium-sized businesses



Standards of Value and the Market Approach in Controversy

METHODS AVAILABLE UNDER THE MARKET APPROACH

- *Valuator must exercise care in selecting the most appropriate method to use in any particular assignment*
- *Often market approach conclusions are best utilized as sanity checks against results developed under another approach*



Understanding Standards of Value and the Market Approach in Controversy

STANDARDS OF VALUE AND THEIR APPLICATION IN THE MARKET APPROACH





Standards of Value and the Market Approach in Controversy

STANDARDS OF VALUE IN THE MARKET APPROACH

▪ *Standard of Value*

- Identification of the type of value being utilized in a specific engagement
 - Realizable result of completed transaction bargained at arm's length
 - Driven by purpose of valuation engagement
 - Guides valuation process



Standards of Value and the Market Approach in Controversy

STANDARDS OF VALUE IN THE MARKET APPROACH

▪ *Standards of Value – Types*

- Fair Market Value
- Investment Value
- Intrinsic or Fundamental Value
- Fair Value
- Fair Value – Statutory



Standards of Value and the Market Approach in Controversy

STANDARDS OF VALUE IN THE MARKET APPROACH

- ***Standard of Value – Fair Market Value***
 - Most common standard of value
 - Used for all income/estate tax valuations in U.S and in PA
 - Used in many family law venues (PA, OH, WV)
 - Often utilized in equity repurchase agreements
 - Shareholder, partner and member buy/sell agreements



Standards of Value and the Market Approach in Controversy

STANDARDS OF VALUE IN THE MARKET APPROACH

- ***Standard of Value – Fair Market Value***
 - Required to be driven by a hypothetical purchase/sale transaction
 - Price at which the property would change hands
 - Focused on hypothetical buyers and sellers participating in a hypothetical transaction
 - Excludes specific buyer and seller motivations



Standards of Value and the Market Approach in Controversy

STANDARDS OF VALUE IN THE MARKET APPROACH

- ***Standard of Value – Fair Market Value***
 - Financial value
 - Not strategic or synergistic
 - Price that provides the investor with a reasonable return considering the inherent risk of the investment



Standards of Value and the Market Approach in Controversy

STANDARDS OF VALUE IN THE MARKET APPROACH

- ***Standard of Value – Fair Value Statutory***
 - In most states, fair value is a legal concept and statutory standard utilized to resolve shareholder disputes
 - Many states statutes define fair value as fair market value without consideration of valuation discounts
 - Intended to be an equitable value



Standards of Value and the Market Approach in Controversy

STANDARDS OF VALUE IN THE MARKET APPROACH

▪ *Standard of Value – Investment Value*

- “Value to a particular investor based on individual investment requirements and expectations”
 - Value that drives M&A activity
 - Referred to as synergistic or strategic value
 - Reflects impact of synergistic or strategic benefits one buyer may bring to negotiating table



Standards of Value and the Market Approach in Controversy

STANDARDS OF VALUE IN THE MARKET APPROACH

▪ *Standard of Value – Investment Value*

- Buyer specific benefits
 - Ability to enhance future operating performance
 - Ability to mitigate certain risk inherent in subject company
 - Ability to more efficiently finance the acquisition
 - Ability to assimilate current operations synergistically with subject company



Standards of Value and the Market Approach in Controversy

STANDARDS OF VALUE IN THE MARKET APPROACH

▪ *Standard of Value – Investment Value*

- Will almost always exceed Fair Market Value
 - Supply and demand for potential targets drives a competitive bidding process
 - Synergistic buyer can pay premium over financial investor
 - Buyer will realize higher returns than financial buyer due to buyer's ability to influence current operations



Standards of Value and the Market Approach in Controversy

STANDARDS OF VALUE IN THE MARKET APPROACH

▪ *Considerations in Business Valuation Fundamentals*

- Desired standard of value driven by purpose of engagement
- Indicated standard of value is a result of methods applied by business valuator
- Must determine if indicated value resulting from valuation calculations provides value aligning with desired standard



Standards of Value and the Market Approach in Controversy

STANDARDS OF VALUE IN THE MARKET APPROACH

▪ *Fair Market Value or Investment Value?*

- Conclusion developed under guideline public company method aligns more so with fair market value conclusion
 - As part of public markets, active/freely-traded shares rarely incorporate strategic or synergistic perceptions regarding value of those equities
 - Public markets comprised of financial investors rather than strategic acquirers



Standards of Value and the Market Approach in Controversy

STANDARDS OF VALUE IN THE MARKET APPROACH

▪ *Fair Market Value or Investment Value?*

- Conclusions developed under guideline completed transaction method generally viewed as investment standard of value
 - Transactions represent acquisitions of controlling interests in target companies
 - Single, specific buyer motivations and attributes embedded in purchase price



Standards of Value and the Market Approach in Controversy

STANDARDS OF VALUE IN THE MARKET APPROACH

▪ *Fair Market Value or Investment Value?*

- Business valuers consider the following when analyzing specific transactions and amount of synergies embedded within:
 - Does the buyer provide a similar product or service to the target?
 - Does the buyer provide a complementary product or service?
 - Has the buyer made acquisitions in the industry previously?
 - Does the buyer have an existing business relationship with the target as a vendor or customer?



Standards of Value and the Market Approach in Controversy

STANDARDS OF VALUE IN THE MARKET APPROACH

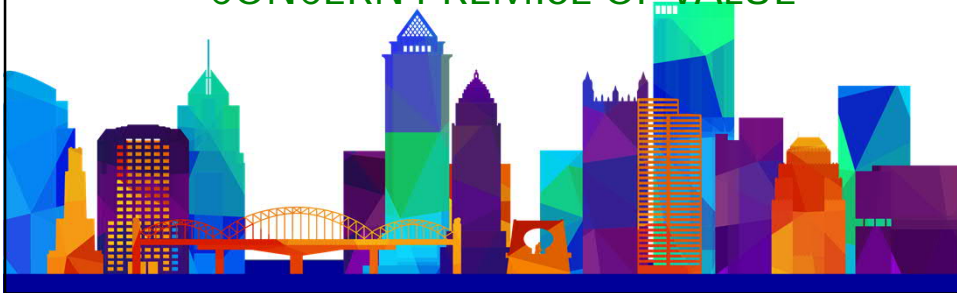
▪ *Fair Market Value or Investment Value?*

- If indicated standard of value does not align with desired standard, business valuator must:
 - Adjust indicated value so result aligns with desired standard, using reasonable inputs, and apply as primary method
 - Adjust indicated value so result aligns with desired standard, using best available inputs, and apply as secondary method
 - Dismiss the use of that particular approach if adjustment cannot be reasonably quantified



Understanding Standards of Value and the Market Approach in Controversy

ISSUES IN APPLYING GOING CONCERN PREMISE OF VALUE



Standards of Value and the Market Approach in Controversy

ISSUES IN APPLYING GOING CONCERN PREMISE OF VALUE

- ***Definition of “Premise of Value”***
 - An assumption regarding the most likely set of transactional circumstances that may be applicable to the subject valuation; for example, going concern or liquidation.



Standards of Value and the Market Approach in Controversy

ISSUES IN APPLYING GOING CONCERN PREMISE OF VALUE

▪ *Definition of “Premise of Value”*

- An **assumption** regarding the **most likely set of transactional circumstances** that may be applicable to the subject valuation; for example, going concern or liquidation.



Standards of Value and the Market Approach in Controversy

ISSUES IN APPLYING GOING CONCERN PREMISE OF VALUE

▪ *Definition of Premise of Value*

- Assumption
 - A thing or matter that is accepted as true or certain **without** proof
 - Usually, a predicated or professional judgement based on facts and circumstances



Standards of Value and the Market Approach in Controversy

ISSUES IN APPLYING GOING CONCERN PREMISE OF VALUE

▪ *Definition of Premise of Value*

- Assumption
 - All assumptions must be threaded through basic business valuation concepts to prove valid



Standards of Value and the Market Approach in Controversy

ISSUES IN APPLYING GOING CONCERN PREMISE OF VALUE

▪ *Basic Concepts*

- Valuation produces an opinion of value as of a specific date
- Valuator must only consider information that is known or knowable at the certain date
- Inappropriate to forecast future operational and financial performance that is not expected to result from the operational structure in place as of the date of valuation



Standards of Value and the Market Approach in Controversy

ISSUES IN APPLYING GOING CONCERN PREMISE OF VALUE

- ***“Most Likely” set of transactional circumstances***
 - Should be interpreted literally by valuers
 - Assess probability of operational/financial structure changes then forecast future expected economic benefits under set of circumstances that have the highest probability to occur
 - These probability estimates should be tied to specific “set of transactional circumstances that are applicable to the subject valuation”



Standards of Value and the Market Approach in Controversy

ISSUES IN APPLYING GOING CONCERN PREMISE OF VALUE

- ***Going Concern (varying definitions)***
 - IGBVT Common valuation definition is an ongoing business enterprise
 - Legal definition generally considers a company to be in a position in its lifecycle to continue its operations and current success into the future – Blacks Law Dictionary
 - Under accounting concepts, refers to the assumption that a company will continue to operate for the foreseeable future – International Glossary of Business Valuation Terms



Standards of Value and the Market Approach in Controversy

ISSUES IN APPLYING GOING CONCERN PREMISE OF VALUE

▪ ***Issues in Application***

- Going Concern Value
 - The value of a business that is expected to continue to operate into the future.. (IGBVT pg. 24)



Standards of Value and the Market Approach in Controversy

ISSUES IN APPLYING GOING CONCERN PREMISE OF VALUE

▪ ***Issues in Application***

- Going Concern Value
 - An operating, normally functioning business' worth to a buyer



Standards of Value and the Market Approach in Controversy

ISSUES IN APPLYING GOING CONCERN PREMISE OF VALUE

▪ *Issues in Application*

- Premise of Value and the Market Approach
 - Identifying market approach guideline companies that do not align properly with the premise of value required in the assignment



Standards of Value and the Market Approach in Controversy

ISSUES IN APPLYING GOING CONCERN PREMISE OF VALUE

▪ *Issues in Application*

- Some valuers suggest that the most likely buyers are strategic or synergistic buyers, also arguing that the resulting value developed from synergistic transactions is fair market value
- However, in many cases, the most likely buyer is not relevant as valuers are required to look at a hypothetical buyer
- Contemplating a single buyer in a synergistic transaction violates a fundamental precept in the definitions of fair value and fair market value



Standards of Value and the Market Approach in Controversy

ISSUES IN APPLYING GOING CONCERN PREMISE OF VALUE

▪ *Issues in Application*

- The only correct determination of fair value and fair market value is produced by assessing financial value with the subject company's expected operational and financial structure as of the date of valuation
- Equity owners are deemed to own their portion of the entities assets, reduced by its liabilities, as well as the net free cash flows associated with the employment of those net assets



Standards of Value and the Market Approach in Controversy

ISSUES IN APPLYING GOING CONCERN PREMISE OF VALUE

▪ *Issues in Application*

- The going concern premise of value should be interpreted to encompass just those assets and liabilities that are in place at the date of valuation (modified by any expected changes that are known as of that date)
- It is not appropriate to include unexpected changes, especially those related to strategic or synergistic benefits that may be afforded by an investment buyer



Standards of Value and the Market Approach in Controversy

ISSUES IN APPLYING GOING CONCERN PREMISE OF VALUE

▪ *Liquidation Value*

- The net amount that would be realized if a business in terminated and the assets are sold piecemeal
 - Orderly – assets are sold over a reasonable period of time to maximize proceeds received
 - Forced – assets are sold as quickly as possible (such as at auction)
- All costs of liquidation (including taxes) must be factored into determination of liquidation value, using the cost/asset approach



Standards of Value and the Market Approach in Controversy

ISSUES IN APPLYING GOING CONCERN PREMISE OF VALUE

- *Understanding and properly addressing premise of value, in general, and specifically in the application of the market approach, is critical to a conclusion of value that is technically correct as well as defensible and in compliance with professional standards*



Understanding Standards of Value and the Market Approach in Controversy

UNDERSTANDING LEVELS OF VALUE



Standards of Value and the Market Approach in Controversy

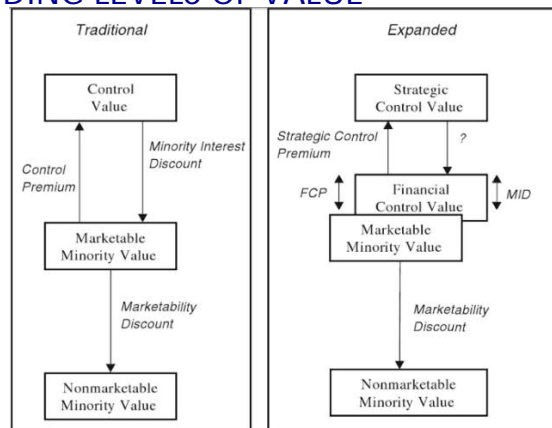
UNDERSTANDING LEVELS OF VALUE

- ***Level of value relates to the control and marketability characteristics of the ownership interest***
 - Ownership interest with control over the entity's operations is more valuable than a non-controlling interest
 - Higher level of marketability (can be quickly converted to cash at minimal cost) increases the value of the ownership interest
- ***Level of value is determined by specific characteristics of entity ownership interest, it is not judgmental***



Standards of Value and the Market Approach in Controversy

UNDERSTANDING LEVELS OF VALUE



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Standards of Value and the Market Approach in Controversy

UNDERSTANDING LEVELS OF VALUE

- *The traditional levels of value model has been expanded in recent years to include synergistic/strategic levels of value*
- *Generally results under guideline transaction method are control, marketable or strategic control, marketable values*
 - Most cases values are strategic control, marketable values



Standards of Value and the Market Approach in Controversy

UNDERSTANDING LEVELS OF VALUE

- ***Conflicting opinions about the level of value produced under the guideline public company method***
 - Stock prices based on trading of minority blocks, so value is non-controlling, marketable, and requires an upward adjustment to valuation multiples for the attribute of control
 - Others argue that the resulting conclusion of value is neither control nor minority value, and the application of a control premium is not required



Standards of Value and the Market Approach in Controversy

UNDERSTANDING LEVELS OF VALUE

- ***Valuators must understand the levels of value in order to reconcile the conclusion of value determined under the market approach methods by applying the appropriate discounts and/or premiums***
- ***As certain strategic transactions include specific-buyer motivations, valuers must make adjustments to account for these synergies; however, it is difficult to quantify the amount of the deal that relates specifically to the premium***



Understanding Standards of Value and the Market Approach in Controversy

SUFFICIENT SIMILARITY



Standards of Value and the Market Approach in Controversy

SUFFICIENT SIMILARITY IN GUIDELINE COMPANIES

- *“Sufficient similarity” criteria underlies both methods under the market approach*
- *Inferences of value must be taken from companies/transactions that are sufficiently similar to the subject company*
- *Process for determining appropriate level of similarity has not been defined in standards/guidance or judicial decisions*
- *As such, selections require professional judgment*



Standards of Value and the Market Approach in Controversy

SUFFICIENT SIMILARITY IN GUIDELINE COMPANIES

- ***Governing guidance of IRS Revenue-Ruling 59-60***
 - Companies must be in “same or similar” line of business
 - “Other relevant factors” may considered on case-by-case basis:
 - Main products and/or services; customers and clients
 - Markets served (current and future)
 - Product distribution capabilities
 - Competition, supplier and employee relationships
 - Financial performance



Standards of Value and the Market Approach in Controversy

SUFFICIENT SIMILARITY IN GUIDELINE COMPANIES

- ***ASA Professional Standards***
 - “Reasonable Basis for Comparison”
 - Factors to be considered in judging reasonable basis:
 - Sufficient similarity of qualitative and quantitative investment characteristics
 - Amount and verifiability of data known about similar investments
 - Whether or not price of similar investment was in arm’s length transaction, or in a forced or distressed sale



Standards of Value and the Market Approach in Controversy

SUFFICIENT SIMILARITY IN GUIDELINE COMPANIES

- ***The ability to opine on the value of the subject company requires an intimate understanding of all aspects of the company***
 - Financial statement analysis
 - Consideration of all historical and prospective information
- ***Only then can the valuator conduct a proper search for guideline companies***



Standards of Value and the Market Approach in Controversy

SUFFICIENT SIMILARITY IN GUIDELINE COMPANIES

- ***Selection of guideline companies begins with a search for companies operating within similar***
 - Standard Industrial Classification (SIC) code
 - North American Industrial Classification System (NAICS) code
- ***Further research is undertaken to establish that the identified companies are in the same or similar line of business***



Standards of Value and the Market Approach in Controversy

SUFFICIENT SIMILARITY IN GUIDELINE COMPANIES

▪ *Elements of Comparability – Size and Growth*

- Size most often evaluated in terms of revenue or sales
 - Common practice excludes companies over 10x measurement values; companies that fall within the acceptable range might require adjustments to compensate for size difference
- Growth rates must be consistent and comparable
 - Adjustments may be required to make expected short-term growth rates of public companies comparable to longer-term expectations of the subject company



Standards of Value and the Market Approach in Controversy

SUFFICIENT SIMILARITY IN GUIDELINE COMPANIES

▪ *Elements of Comparability – Sample Size Considerations*

- How many guideline companies or transactions are required to draw meaningful and accurate conclusions?
- No definitive answer due to limited availability of sufficiently similar guideline companies/transactions
 - Is it better to compare a larger sample of companies/transactions that are less similar to the subject company or a smaller group of more similar companies/transactions?



Standards of Value and the Market Approach in Controversy

SUFFICIENT SIMILARITY IN GUIDELINE COMPANIES

- ***Elements of Comparability – Sample Size Considerations***
 - Statistical significance established by variation in the underlying population
 - Calculate coefficient of variation to measure degree of dispersion
 - Other statistical analyses should also be performed to evaluate relevance of the sample before applying the multiples/metrics derived thereunder to the subject company
 - Failure to do so will lead to invalid and unreliable conclusions



Standards of Value and the Market Approach in Controversy

SUFFICIENT SIMILARITY IN GUIDELINE COMPANIES

- ***Elements of Comparability – Financial Analysis***
 - Valuator must perform detailed financial/operational analysis
 - Includes ratio, trend and vertical/horizontal integration analyses
 - Historical financial data of guideline companies must align with date of valuation for the subject company
 - Common financial performance measures used for both the guideline and subject companies



Standards of Value and the Market Approach in Controversy

SUFFICIENT SIMILARITY IN GUIDELINE COMPANIES

- ***Elements of Comparability – Fluctuating Multiples***
 - Important to consider historical trends in underlying data used to develop valuation multiples derived from public companies
 - Recent positive/negative events in public companies can result in multiples that lead to unreliable indicators of value
 - Meaningful fluctuations in market multiples of the guideline companies can cause variation in the valuation conclusions, and can cause such companies to be insufficiently comparable



Standards of Value and the Market Approach in Controversy

SUFFICIENT SIMILARITY IN GUIDELINE COMPANIES

- ***Other Comparability Issues***
 - Sufficient comparability is more difficult to determine under the guideline completed transaction method due to very limited information from transactions involving privately-held businesses
 - Specific buyer motivations influence transaction prices and inability to estimate synergistic premiums is problematic
 - Understanding deal structure makes it impossible to fully understand how price equates to value



Standards of Value and the Market Approach in Controversy

SUFFICIENT SIMILARITY IN GUIDELINE COMPANIES

▪ *Other Comparability Issues*

- Consideration of new tax regime
- Significant lack of information about these transactions leaves many additional questions unanswered
- Valuators should attempt to find as much information as possible to avoid challenges to their conclusions of value
- If limitations in application of this method cannot be overcome, it should be used to confirm or reconcile other conclusions of value



Understanding Standards of Value and the Market Approach in Controversy

CONCLUSION & PRACTICAL CONSIDERATIONS





Standards of Value and the Market Approach in Controversy

CONCLUSION & PRACTICAL CONSIDERATIONS

- *Complexity and inter-workings in application of methods under the market approach can lead to misunderstandings*
- *Improper application of the market approach and its methods can result in incorrect conclusions of value*
- *Difficulty lies in identifying “sufficiently similar” guideline companies and transactions, then adjusting results to arrive at the proper standard and level of value*



Standards of Value and the Market Approach in Controversy

CONCLUSION & PRACTICAL CONSIDERATIONS

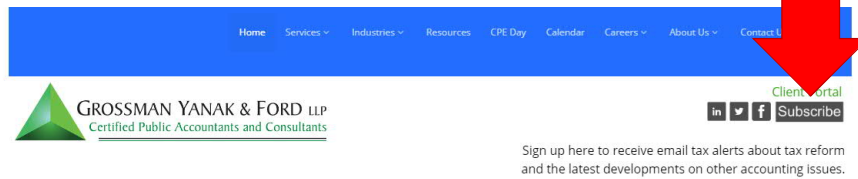
- *Professional judgment plays a significant role in many aspects of applying the market approach*
- *Valuator must exercise adequate care and due diligence*
- *Market approach often cannot be used as primary indication of value; rather should serve to corroborate other methods*
- *GYF valuation professionals can assist legal counsel to determine correct value and set realistic litigant expectations*



Standards of Value and the Market Approach in Controversy

CONCLUSION

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Standards of Value and the Market Approach in Controversy

FINAL QUESTIONS?

THANK YOU!