

# Business Transaction Marketplace

Information about Business Valuations, Acquisitions, & Sales

June 2008

## Value vs. Price – Part I

In the [March 2008 Issue](#) of *Business Transaction Marketplace*<sup>SM</sup>, we discussed some of the biggest errors management makes involving M&A. The #1 error – “price paid was too high”. Fundamental in every business transaction is what the business is worth. However, “value” is not the same as “price”. The adage is:



“You determine *value* and negotiate *price*”.

Here are two points to remember about value:

- #1. The value of a business enterprise lies in its FUTURE. Historical financial results only reflect the past.
- #2. Arriving at the value for a business enterprise requires assessing the RISKS associated with the business achieving future operating cash flows.

In Part I of this two-Part discussion, we begin by describing what’s meant by value; then, describe the process of determining the value of a business enterprise.

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## What is *Fair Market Value*?



Before starting an engagement, every business appraiser needs to define the assignment. What should be defined is specifically described in an article ([click here](#)), aptly subtitled: “The Meeting of the Minds at the Start of a Business Valuation”.

One of the elements that needs to be defined in a business valuation assignment is the standard of value that the business appraiser will be following. In order to distinguish value from price, let’s examine the most common standard of value – *fair market value (FMV)* – the definition of which is as follows:

*The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy or sell, and when both have reasonable knowledge of the relevant facts.*

So by definition, when a business appraiser takes on an assignment to determine the *FMV* of a business enterprise, he or she must do so under these assumptions:

- The consideration passed between the buyer and the seller is a cash equivalent
- Buyer and seller are hypothetical
- Buyer and seller are willing and able to consummate the transaction
- Buyer and seller are acting at arms length
- The market for buyers and sellers is open and unrestricted
- Neither the buyer nor the seller is under any compulsion to consummate the transaction
- Both buyer and seller have knowledge surrounding the relevant facts of the transaction

In Part II of this discussion, we will examine each of these points in the “real world” of how businesses are bought and sold. That is, the factors that come into play when price is negotiated.

## How is *Fair Market Value* Determined and for What Purposes?

At Arne & Co., the *FMV* of a business enterprise is determined by following a Business Valuation Process ([click here](#)), the main tasks being as follows:



- Perform an internal analysis and risk assessment
- Perform an external analysis and risk assessment
- Make historical financial statement adjustments and/or obtain financial projections
- Apply valuation approaches and methods
- Arrive at a valuation conclusion

Generally, there are four (4) purposes for determining the *FMV* of a business enterprise:

1. Planning: internal use by owners and management
2. Taxation: external use by the IRS for estate, gift and income tax compliance requirements
3. Disputes: external use by the Courts; internal use in a mediation or settlement facilitation
4. Transactions: internal or external by buyers or capital providers; sellers and capital users

In the September 2008 issue of *Business Transaction Marketplace*<sup>SM</sup>, we will present Part II on this topic, and describe how buyers can price a business to help insure that the don't over pay.

## Marketplace Alert



As we approach the November Presidential elections, here are the tax plans for the leading Republican and Democratic candidates. Source: *The Kiplinger Tax Letter*

### McCain's Tax Plan

#### *Personal Income Tax:*

McCain would double the personal exemption to \$7,000, cutting millions from the tax rolls. He would also repeal the AMT for individuals. McCain's plan maintains the Bush tax cuts for all taxpayers, including high incomers by keeping the maximum 35% marginal income tax rate, the 15% top rate on dividends and long-term gains, and the \$1,000 child credit and marriage penalty relief.

#### *Corporate Income Tax:*

He would cut the top corporate tax rate from 35% to 15%.

### Obama's Tax Plan

#### *Personal Income Tax:*

A credit of up to \$500 per person or \$1,000 per family to offset payroll tax on the first \$8,100 of earned income. Seniors with incomes below \$50,000 would be exempt from income tax. Non-itemizers would get a 10% mortgage interest credit.

Higher-income taxpayers would pay the previous top marginal tax rate of 39.6%. The 15% top rate on capital gains would rise to 20% or more, and dividends would be taxed as ordinary income.

#### *Corporate Income Tax:*

Corporations also stand to pay higher taxes under Obama's plan. He wants to eliminate tax "loopholes" for large oil and gas companies, crack down on offshore tax havens, and tighten worker classification rules. But small firms would get some tax relief, including a 0% rate on capital gains for start-up businesses.

This announcement appears  
as a matter of record only



*Kinetico Quality Water Systems of Central  
New Mexico Albuquerque, New Mexico*

**Has sold substantially all of its assets to**



*TLC Company, Inc.  
Albuquerque, New Mexico*

The undersigned assisted in the  
negotiations and acted as advisor to  
Kinetico Quality Water Systems  
of Central New Mexico

