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Proposed USPAP Revisions Highlight the Factors of the Quantitative Marketability Discount Model

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On December 2, 2004, the Appraisal Standards Board released an exposure draft on proposed revisions to Standards 9 and 10 of the *Uniform Standards of Professional Appraisal Practice* (USPAP). The proposed revisions fall into five broad categories, including the incorporation of the "concept of marketability/liquidity."

The proposed Standards Rule 9-4(d) reads as follows: Appraisers must "analyze the effect on value, if any, of the extent to which the interests appraised contain elements of ownership control and are marketable and/or liquid." The accompanying explanatory comment identifies three factors that must be analyzed in assessing the effect of illiquidity on value: "An appraiser must analyze factors such as holding period, interim benefits, and the difficulty and cost of marketing the subject interest." As noted below, these factors are consistent with the valuation framework of the Quantitative Marketability Discount Model (QMDM).

- *"Holding Period"* – This corresponds to, well, the **holding period** assumption of the QMDM. Investors in illiquid investments are keenly interested in when they will be able to sell their investments. They accept the fact that they cannot know the duration of the prospective holding period with certainty, but their investment decision is based on a range of reasonable holding periods in the context of their informed judgment.

- *"Interim Benefits"* – This factor corresponds to three distinct QMDM assumptions. Investors in illiquid investments assess not only the length of the expected holding period, but also the cash flow benefits to be received during the holding period. To borrow from the QMDM parlance, they consider (1) **dividend yield**, (2) **expected growth in dividends**, and (3) **expected growth in value**.

- *"Difficulty and Cost of Marketing the Subject Interest"* – There is greater risk associated with owning an illiquid investment than an otherwise comparable liquid one. Higher expected return is the investment reward for accepting incremental risk. The final QMDM assumption, the **holding period return**, is developed with explicit consideration to the difficulty and cost of marketing the subject interest.

Let's be clear: the drafters of the proposed revisions to USPAP are not endorsing the QMDM or any other quantitative rate of return model for developing marketability discounts. However, their appeal to common-sense factors affecting the value of illiquid business interests is entirely consistent with technique and spirit of the QMDM. A cogent analysis of these three factors while relying exclusively on the various benchmark studies could prove difficult.◆

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