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MEASURING INSOLVENCY: VALUATION GUIDELINES FOR ROMANIAN COMPANIES

Methodological article

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Abstract

Nowadays valuation has become an inherent part of business environment which has experienced dynamic changes in economic activity through mergers and acquisitions, organizational restructuring and repurchasing of shares. The dynamic centre of all these activities is valuation, whose methods are needed not only for accounting purposes, but to serve as information support to all stakeholders. Although there are many individual techniques of assessment businesses in difficulty, selecting the most suitable method of valuation is often difficult. The paper is a mini-guide that should be taken into account by all actors involved in the assessment of firms in difficulty when they pursue to carry out such activities. In this regard, we compare the financial and accounting aspects with the national regulation on insolvency, highlighting the usefulness or, where appropriate, the lack of consistency based on assessments completed to date. In the end we insist on the reconciliation of financial vision with the rule of law in order to simplify insolvency proceedings in Romania.

Introduction

The evaluation of different types of property involves different sources of information that reflect adequately the market in which the property is assessed. The estimation of any type of value, market or outside market requires to the assessor to apply one or more approaches known as assessment methods. (Buglea et. al., 2003)

The term approach refers to evaluation methodologies generally accepted commonly used. Each approach assessment has alternative methods of application. In general, approaches and assessment methods are common for all types of assessments, including real property, movable, businesses and financial assets.

In general, an assessment approach can be achieved through:

- Cost
- The sales comparison
- By income

While the appropriate evaluation methods are:

- Cost method
- Sales comparison method
- Income capitalization method.

Evaluations based on the market approach, normally use one or more methods in evaluation, by applying the substitution principle using information derived from the market. According to this principle a prudent person will pay for a good or service more than the cost of purchasing a good or service acceptable substitute in the absence of time factors, risk or inadequacy. Lowest cost of the best alternative for a good or identical substitute will tend to reflect market value. (PricewaterhouseCoopers, 2012)

The cost-based evaluation method is a comparative approach that considers for trading a certain property as a replacement alternative to build another property, either as an identical copy of the original, or as a property with the same utility. The method requires an estimation of depreciation for older properties with or without disabilities in operation. In the absence of market information, the net replacement cost is regarded as an acceptable method for the valuation of specialized assets, but the assessor must include in his report comments market on land value or current cost and depreciation allowances. (IVS, 2014)

The sales comparison valuation method is a comparative approach that takes into account sales properties similar or substitutable and information about the market, setting an estimate of the value of comparison processes. Property generally evaluated is compared with sales of properties similar traded on an open market, or taking into consideration the offers for sale. (Petrescu, 2012)

The Income capitalization valuation method is a comparative approach that takes into account information regarding income and expenses of assessed property and estimates value through a capitalization process. Capitalization links income (typically net income) of a particular type of value by converting income into an estimate of value. The income taken into calculation is the net income remaining amount available to a party concerned. The method uses capitalization rate (direct link) discount rates (reflecting fruition investment), or both. According to the principle of substitution, income stream produces the greatest recovery and fructification in correspondence to a certain level of risk, leading to the likely size value.

Valuation of buildings

The objective basis for estimating the market value of property is the specific values assigned to certain rights in the property by the participants in a market in which an asset is bought and sold.

Property assessment purposes are various:

- Financial reporting;
- *Transactions involving the transfer of property (including liquidation);*
- Loans or loans secured by the property;
- Litigation;
- Taxation issues (including enforcement);
- Advice;
- Making investment decisions

Market value is the basis for fixing the amount for the property, in situations where evaluations are used for:

- Financial reporting;
- Assist a buyer, a seller or to help both sides to determine the selling price for a particular transaction;
- *Laying the foundation for judicial reorganization;*
- Determining if bankruptcy liquidation value;
- Fusion of multiple properties;
- Estimate the value of a property that is guaranteed a mortgage or to establish a basis for insurance or guarantee of a loan with a property;
- Expropriation for public utility;
- Litigation or arbitration of disputes over some contracts or partial interests;
- Cover damages;
- Estimating the tax.

You can use several methods to evaluate property.

The assessor must reconcile the amounts resulting from simultaneous application of multiple assessment methods. Whether property is leased or subject to other partial interests the assessor must make adjustments to reflect property rights being valued.

For property valuation are used in generally, the cost approach, sales comparison, and income capitalization methods associated with these approaches. Their are based on the principle of substitution, establishing if any like or similar goods or services, those with lowest cost price or attracting the highest demand and probability of sale. (Petrescu, 2012)

The cost based method sets the property value by estimating the costs. An estimate obtained from the cost approach represents full value of a property.

Cost estimation of purchasing land and / or construction of a new building with equal utility or adaptation of old properties in the same use without related costs during the construction or adaptation is a widely used procedure. The land and building costs can add an estimated profit real estate promoter. For older properties, the cost approach takes into account an estimate of depreciation, including physical damage and functional impairment. For newer properties, cost and market value are closest. In evaluating specialized or limited market properties which are rarely sold, the method is particularly useful. It also can be applied depreciated replacement cost methodology to determine a surrogate for market value of specialized properties. (Buglea et. al., 2003)

The method based on the sales comparison sets the limits of the market value of the property by analyzing market prices paid for similar real estate properties. There must be a clear indication that the parties to the transaction were typically motivated while the prices that reflect different motivations must be disposed. Immovable property is compared with the sales prices or offers of similar properties that were recently traded in a free market. Prices are analyzed by comparison to the corresponding elements and adjusted for differences peculiarities. You must take into account the rights of property, which should be identical to those associated with comparable properties, otherwise necessary appropriate adjustments must be made. The method is applicable only when there is insufficient data on the market. The method based on the income capitalization assumes that the market value of property is determined based on their ability to generate income. Forecast is based on the principle according to which value is created by anticipated future benefits (net income flows).

The method takes into account information on revenues and expenditures compared to determine the net income of the property assessed. Capitalization is done by applying a single capitalization rate (total rate including all risks) on the income of a single year. It can be used the update procedure by applying a discount rate (which should reflect the return on investment or a cost of capital) on a series of forecasted net income for a given period. Assumptions to estimate the income capitalization can be compared with the performance of an alternative property and financial investment, because in both cases investors seek the rate of return. The method is useful for assessing the property in its entirety, implicitly capital leased properties.

2. Valuation of movable goods

Valuation of movable goods can be done by using the techniques included in the three major categories of assessment methods.

- The cost;
- Sales comparison;
- Income capitalization.

If the movable property included in an estate is either higher or lower than those on comparable properties it should be introduced corrections to adjust the different contribution to value of these goods.

If necessary, it should be measured the degree of physical deterioration, functional impairment and economic depreciation affecting movable elements, by considering the remaining economic life of the properties that are movable associated. (PricewaterhouseCoopers, 2012)

3. Valuation of financial assets

Measurement of financial assets is difficult involving a series of in-depth knowledge and expertise. The assessor must adapt the approach or methods to evaluate the nature of the financial asset.

The value of financial assets can be viewed individually or as a whole. As a general rule, first it must be determined the total of a property, before evaluating ownership fractions. (Petrescu, 2012)

In measuring financial assets, property rights must be clearly identified if it are in a majority or minority position, a contractual right or a right majority or minority mobilized on an investment property. Also there must be examined contractual or constitutive documents to verify the percentage of the property that is the subject of evaluation. Thus, the value of all financial assets, taken as a whole, on a property, may be lower or higher than the sum of all individual holdings on that property. Also in the case of financial assets can be used all three approaches (cost, sales comparison, income capitalization). (Buglea et. al., 2003)

Purchase options are considered at cost by the buyer when the option is exercised. Cost of exercised options to buy a property is added to the selling price of the property, but taking into account the effect of leverage product on the final price of the transaction. The share price of an investment is determined in markets where they are traded.

4. Business valuation

Businesses can be evaluated for different purposes:

- Estimate the value of shares held by shareholders of a company;
- The purchase or sale of an individual enterprise;
- Merger or division;
- Listing and delisting from the stock exchange;
- Assessing management performance;
- Obtaining credit.

The assessor must clearly define the evaluated enterprise and package shares that are subject to evaluation. Also he needs to consider the rights, privileges or conditions of ownership, and legal form of ownership.

Businesses assessments can be based on market value of the enterprise which is not necessarily equivalent to the value of use of enterprise. Evaluations by enterprises for financial reporting are generally required to rely on fair value, which may or may not be equivalent to the value of market. Business assessments based on the premise going concern utilize the value in use (if purpose of the assessment is to develop financial statements enterprise use value has a special meaning).

A property of a business can be indivisible or can belong to several shareholders and / or may involve a majority or minority position.

In business assessments are used three categories of approaches to reach value, but usually assessors reconcile the results obtained by two or more methods. (PricewaterhouseCoopers, 2012)

The approach based on the assessment of assets considers balance sheet of an enterprise by comparing all assets and all liabilities at market value or at an appropriate book value. Mandatory when using basic approach valuation of assets and businesses that will continue work, the value obtained must be considered together with value estimates obtained from other methods (ex: net asset corrected method).

The income capitalization approach calculates the present net revenue or anticipated profits, taking into consideration the developments and their estimated time of their production, the risk associated and time value of money. Income is converted into value either by direct capitalization of a representative level income or by update, in which case the net proceeds estimated to be collected in the future for many sequences are converted to present value by applying a rate of update (ex. the discounted cash flow method).

Sales comparison approach establishes value assessed by comparing similar enterprises with stocks or shares which were traded on a financial market.

The enterprise evaluated must be in the same compared field of activity and to depend on the same economic variables (ex. Market multipliers method).

5. Conclusions

As we can notice from the various methods of valuation presented above there are several distinctions that should be taken into consideration when assessing properties, movable, financial assets or an entire business. In the case of insolvency, all this methods can apply, the assessor having several options available. Usually, not all valuations of assessors are taken into consideration in a court of law.

The court is not bound by the conclusions of the assessor report, as these are only elements of persuasion, at the discretion of the judge, as, otherwise, the other evidence. But to be able to exercise judicial review, the court required that the solution in this regard (receiving or not the expert) to be motivated, especially when reaching other conclusions based on other evidence given. If the case, the court removes report expertise as unconvincing or retain it, although one of the parties demanded his removal.

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