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Stefan Wrzosek

CHOSEN METHODOLOGICAL ISSUES OF COMPANY VALUATION¹

In the literature of the subject, there have been presented many methods of company valuation differing only by being based on diversified assumptions. The character of these assumptions alone influences the usefulness of particular methods in the valuation of Polish companies which are being privatized. These assumptions aside, the important factors are the legal/organizational conditions of privatization, the character of the companies, and the availability of information for the purposes of applying certain methods, etc. Combinations of these elements have given rise to many methodological problems (the choice of method and its modification, the interpretation of data and results). Some of these will be discussed in this article.

We start with the above-mentioned assumptions as a basis for methods of valuation. The literature of the subject usually reports the groups of methods based on the following assumptions (although most frequently we can only presume about their nature):

- that the price of the company should be equal to the sum of prices of the collected elements of material substance (assets methods),
- that the price of the company should never be valued at more than the total income discounted annually over the entire expected lifetime of the company (income methods),
- that the price of a company could be valued on the basis of the known (because they have been confirmed in many acts of sale-purchase either of whole companies or their shares) values of other companies sufficiently similar (market methods).

Naturally, one should always take into account the value of the foreign

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capital as a factor, directly or indirectly (for example through accounting for debt repayment in the yearly accounts) diminishing the value of a company. Also, methods vary due to differing characteristics, such as prices, which express the value of components of assets, definition of returns, indicator transferring the proportions of value of companies. Lastly there are also methods resulting from a search for a compromise between the above-mentioned methods, in particular the first and the second one (mixed methods).

Despite the 'wealth' of literature available, there is still a lack of one necessary assumption and the respective method of valuation. This assumption could be worded as follows:

– the upper limit of the company price is such an amount which, after allocating to the costs of plant assets, will allow in the expected conditions to reach a zero financial result.

The methods which could be accepted as related to this assumption are rare in the literature. As an example we could mention Bieńkowski's method (Martyniak 1990). The necessity of using such a method in the privatization process in Poland results from the imperfections of the existing assets methods, and is increased by certain legal solutions, especially through the rules of payment for using assets of the company privatized by method of liquidation. Notable accumulation of such payments, mainly in the third year of using the assets, can threaten the tenant or leasee with bankruptcy, even if the price set were to be lower than the one fixed by the income method. It means that at a certain price, the tenant could expect beneficial financial results in the long term, but would probably not survive the short term period of mounting expenditure. This problem is especially significant in cases of major investment and high costs of obtaining credit. Apart from valuation by the income method, or even instead of it, one should check the admissibility of the price from the point of its influence over the costs of the plant assets. The Bieńkowski method is very simplified and based on constant values (from the previous year, although it could be replaced by the averages of the past few years).

We can check the admissibility of the price more precisely by analysing yearly amounts of net financial flow (*Vademecum...* 1992, 229) and taking into account costs connected with using and eventual taking over of assets (which is not usually included in valuation by the income method). The negative amount of balance of the flow is acceptable in any given year, only when it was compensated in the previous year(s) by the positive amount. The price is admissible if such a condition is fulfilled every year. Obviously one should also consider compensating fluctuations of balance of the financial flow using loans, and – when they could be counted on – the deferment of certain expenses, etc. Such a test of the price is unnecessary when the user of the assets has other sources of income capable to balance the mounting expenses.

The second important problem is connected with one of the typical faults of

the assets method; namely its acceptance of the existing structure of assets in the company. This structure in the case of Polish companies is usually quite accidental. It is the result of, to say the least, restricted access to the means of production in the past, but also often because of inefficient management, an excessive tendency to invest, etc. In effect the companies usually do not have what is required, but what was available at the time, even if useless. For example, there were often stacks of superfluous materials kept 'just in case' only because they were purchased so long ago that without depreciation they managed to keep only their book value. If their prices, however, were updated, it would have been possible to sell them and avoid the necessity of taking on high turnover loans. In such conditions, particularly using the recovery method based on the principle of 'what expenditure would be necessary today to recreate a given set of means of economic activity?', which gives results not related to the usefulness of the existing set, and usually definitely over-estimated. The author thinks that to remedy that, one should use the recovery and liquidation methods at the same time. The latter method means valuation on the principle of 'what net profit could one obtain today out of the liquidation of the existing set of means of economic activity?' The method of recovery should be employed in cases of means necessary from the point of view of economic activity of the company and even its strategy and plans (if known) and existing in amounts suitable from this point of view.

The liquidation method, on the other hand, should be used in relation to superfluous means, ill-suited to the company needs (for example technologically outdated) or excessive. The price of liquidation, minus the costs of liquidation are, in the current state of the market, usually much lower than the reconstructed values at the price levels of new products, if need be corrected by estimated indicator of the physical wear (in the case of durable means) increased by purchase costs. The problem is, however, the huge difficulty of obtaining information on liquidation prices. Attempts to liquidate means of production are rarely successful due in part to the legal regulation of the liquidation procedures prescribed for the state-owned companies. There is also a lack of bodies concerned with gathering such information and allowing access to it. Before this situation is improved, it would be desirable that such information is gathered and given access to by those parts of the state administration concerned with company liquidations.

The lack of necessary information can make the task of a valuation of a company more difficult. Often the secrecy surrounding the completed transactions, the signed leasing agreements etc., make it impossible to use the comparative transactions method, which, despite being a primitive version of the market method, does give a wide selection of transactions among which to select a comparable one, and should give a relatively reliable result at a low cost. Also the quality of the obtained results, while employing the income

method, is connected with the availability of information on completed transactions. In particular, it concerns the level of the discount rate, or more precisely, including in it a risk bonus.

Theoretically it could be assessed subjectively, as done usually in the absence of other possibilities (Kufel 1992, 42), but it happens only at the responsibility of the entrepreneur for whom the valuating team works. In other words, it is permissible if the entrepreneur wants to find out how much the company is worth paying or how much to sell it for. Proving to the financially uninterested party, i.e. a representative of state administration, that the company has a value estimated, at such an assumption, is morally dubious. On the other hand, possessing a suitable amount of information about the completed transaction would make it possible to calculate what averages result from the specific groups of conditions of increasing discount rates due to the risk and that would mean substantial objectivization.

The last problem covered here seems obvious, although it is often omitted in the subject literature, and is not even reflected in currently used accounting methods. The problem in question is the necessity of including, in the valuation by the assets method, the value of expected returns from the right to real-estate hereditary tenure. Not going into detail here, it should be said that the rules of civil law (Kodeks Cywilny) and the decrees of 29 April 1985 concerning land management and property expropriation (with the later amendments) suggest that this right has certain recovery and liquidation values. Both of them fit into the 15–25% bracket of land value according to expert's valuation, therefore they should be added to the legal and non-material values. Including the land's value, in the balance sheet on the side of assets and its equivalent on the liabilities side, causes that the right of hereditary tenure does not influence the net value of assets and that it does not differ from other limited material rights.

In conclusion, one should add that it is both necessary and possible to improve the valuation methods in the process of privatization in Poland. The suggested directions are:

- implementing the admissibility test for company price from the point of view of the costs of assets influencing the financial performance,
- creating the information system for valuated companies, mainly presenting information about transactions,
- considering the value of the right to hereditary tenure of the land while using the income methods of valuation.

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