Valuation of business and going concern

Drs. Saut Simanjuntak MSc.

VALUATION OF BUSINESS AND GOING CONCERN

INDONESIA:

VALUATION OF SHARES OF SUPERANNUATION FUND IN CLOSELY HELD COMPANY, A QUESTION OF MINORITY AND MARKETABILITY

Drs. Saut Simanjuntak MSc

9th ASEAN VALUER CONGRESS
BANGKOK, THAILAND

VALUATION OF SHARES OF SUPERANNUATION FUND IN CLOSELY HELD COMPANY IN INDONESIA, A QUESTION OF MINORITY AND MARKETABILITY

INTRODUCTION

Decree of Indonesian Minister of Finance (SK Menteri Keuangan No.23/KMK.017/1993 and SK Menteri No.76/KMK/.017/1995) on Superannuation Fund Investment marks the beginning of a new era not only for the Superannuation itself but also for the valuer in Indonesia.

The Decree outlines investment direction for Superannuation Fund in Indonesia, and set the limits of types of investment that can be carried out to ensure and to protect the interest of each member of the Superannuation Fund.

One form of investment that is allowed by the Decree is investing in a closely held company, on condition that it should not be more than 10% of the total shares issued by the particular company. This means, a Superannuation Fund which invests in a closely held company basically only holds a minority of shares.

Further, the decree also requires every Superannuation Fund to have its assets reported, including shares in closely held company; based on the value which is assessed by a registered valuer.

As the Superannuation Fund only holds a small number of shares in the particular company, and they usually do not have "control" over the management of the particular company, this results in difficulty in applying a thorough and orderly approach to be able to make a realistic business valuation. The only accessible data is the company Balance Sheet and Profit and Loss Statement, while interviews with the owners, managers, and other related parties, for some reason, is an almost impossible mission.

A valuer then faces two main issues in valuing these shares. Firstly, a valuer should be able to analyse the financial statements 'smartly', and look meticulously for any abnormality before applying the method of valuation to arrive at market value of each shares. Secondly, due to the nature of minority shares which will be explained further in the latter part of this paper, how much discount should a valuer give to such shares, or even, should he give any at all ?

The following paper presents study on business valuation and from there tries to resolve the problem faced by Indonesian Valuers in valuing minority shares in closely held companies.

BUSINESS VALUE DEFINED

What does one expect when he or she buys a business? Expectation of future benefits is the likely answer, and it is mostly the reason why a superannuation fund diversify its portfolios through investing in shares of closely held companies.

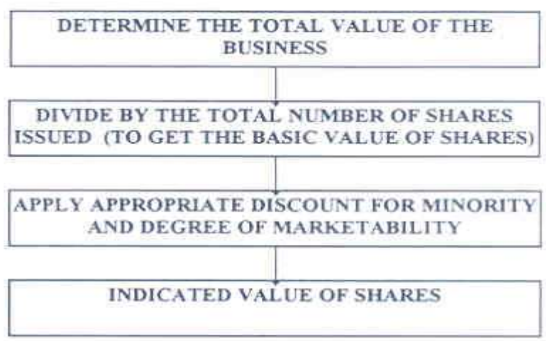
Value attached to such minority shares should be "market value". When minority shares are up for sale, however, there are some market constraints such as under:

1) Right of "first priority to buy" goes to majority share holders.
2) Difficulty in obtaining a comparable price benchmark.

STEPS IN VALUING BUSINESS

As with other business valuation assignment, there are certain steps that a valuer must take to carry out his valuation assignment.

To value shares in the closely held company, the steps are as described in the following diagram:



To be able to arrive at the total value of the business, Desmond and Kelley gave a ten steps approach to business valuation:

1. Determine the date of valuation
2. Define what is to be valued
3. Obtain and analyze the financial statements
4. Interview the owners, managers and others
5. Prepare adjusted and projected financial statements
6. Develop comparative data
7. Value individual tangible assets
8. Value goodwill and other intangibles
9. Apply established valuation methods to the business
10. Correlate data and develop value opinion

The above steps are applicable in determining total value of the closely held company in which shares of Superannuation Fund is invested.
There are three methods of valuation to arrive at total value of the business, as recognised by Indonesian Valuers. The methods are :

a. Adjusted Book Value Approach
b. Market Approach
c. Income Approach

Adjusted Book Value Approach basically determines the value of assets and liabilities of subject company, based on balance sheet of the company. Financial statements of subject company is then an important source of information. It is useful to determine the business value if the client is concerned with full value of business enterprise or with control interest of the subject company.

Market Approach is a general way of determining a value indication of a business, business ownership interest or security using one or more methods that compare the subject to similar businesses, business ownership interests and securities that have been sold (Business Valuation Standards, American Society of Appraiser). The comparison must be made in a meaningful manner and must not be misleading. The problem in applying this method in Indonesia is that trading of businesses are not yet (at least not legally or publicly) a common practice. Therefore, it would be difficult to find comparable.

Income Approach is carried out either by capitalising net adjusted income of the subject company or by discounting series of future income.

In either three approaches, financial statement of the subject company is the only main available source of information for the case of Superannuation Fund shares in Indonesia. Therefore, a valuer should be 'witty' to analyse the financial statement as explained in the next paragraph.

FILLING THE GAAP

General Acceptable Accounting Principle (GAAP) is recognised in Indonesia. However, as the case in other country, the financial statement prepared with GAAP do not truly reflect current market value for several reasons. For its nature, the financial statements report all asset based on its cost and for a valuer, this is a matter of concern. Moreover, the financial statements received from the company is most likely the unaudited one, which may include transactions which are not related to the operation of the business itself. Owner's personal expenses sometimes are included in those statements, and this again does not truly reflect the operating expense of the business being valued.

How then should a valuer treat such a thing?

- Arrange statements in comparative form
- Compute Analytical ratio
- Look for unusual, misvalued or omitted items

HAVE YOU GOT ANY DISCOUNT ?

Since the problem in valuing Superannuation shares in closely held company is the minority of shares owned by them, it raises a question on whether to apply discount for minority.

The most common method of valuing shares is to divide the total value of the company's asset by the number of shares issued. This widely accepted method can be misleading for the fact that it does not take into account the marketability of minority shares. Will there really be any buyer in the market for such shares? Another question that could be raised is the liquidity of such shares. Is there any expectancy of a dividend to be paid within the foreseeable future? Is there any possibility that the share could be liquidated for cash other than for its nominal value? (Callard, 1994)

Therefore, marketability and liquidity of minority shares should be taken into account when a valuer undertakes the valuation.

Discount rate should then reflect a composite factor relating to liquidity and marketability.

There are three method to reflect degree of marketability and liquidity in valuation of minority shares as suggested by Desmond and Kelley. Those methods are :

- Cost to Market Method

  This method is based on the expenses required to create market for minority shares. Total expenses is divided by the numbers of minority shares to arrive at discount per share. Deduct the basic share value with this figure to arrive at the value of minority shares. The problem for this method in its application to valuation of superannuation fund's shares is that the expenses to create market is too high that it becomes economically unviable.

- Comparable Share Method

  This method applies discount factor used by comparable share of similar degree of marketability. However, it is not applicable in Indonesia for the current being.

- Dividend Yield Method

  This is probably the most applicable method in the case of valuation of minority shares in Indonesia. By using this method the valuer compares the actual dividend payment history of the subject company with what the probable payment would have been had the company's shares been publicly traded.

CONCLUSION

Decree of Finance Minister of Indonesia regulates investment of Superannuation Fund in Indonesia. As one form of investment which is allowed according to the Decree is investing in shares of closely held company, of which should not exceed 10% of total shares issued by the company. The Decree also obliged each Superannuation Fund to report its asset based on the value which is determined by a registered valuer.

The first problem with valuing such minority shares is limited available information which is only the financial statement of the company, since the Superannuation Fund does not have control over the management of the subject company. This limitation should be overcome by looking meticulously over such financial statement.

The second problem is how much would degree of marketability and liquidity affect the value of such minority shares. To overcome this problem, firstly a valuer should determine the total value of the business based on the three methods of valuation and then divide it by numbers of shares issued. The next step is to apply discount factor to account for marketability and liquidity of such minority shares.

REFERENCE

Adamson, M.S., "The Valuation of Company Shares and Businesses", 7th ed, Sydney: The Law Book Company Limited, 1989.

Callard, Lloyd M and William J Pallot, "Business Valuation Practice", Sydney : The Law Book Company Limited, 1994.

Desmond, Glenn and Richard Kelley, "Business Valuation Handbook", Los Angeles : valuation Press, 1989.

Pratt, Shannon ., "Valuing a Business : Analysis and Appraisal of Closely Held Companies, 2nd ed. Homewood : Dow Jones Irwin, 1989.