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## Modern Methods of Estimation of Business Evaluation

**Abstract.** *The article analyses the problems of the imperfection of the target function of the estimation of business evaluation and modern methods of its carrying out. The influence of a wide range of methodological and legislative factors on the perfection of the methods of the estimation of business evaluation is also under analysis in the work. The peculiar feature of this research is a certain structure including some approaches to the business evaluation. The analysis of the essence of each approach of the estimation of business evaluation is carried out in the article. The authors of the article pay special attention to the application of each approach of the estimation of business evaluation. The effectiveness of the use of various methods of the estimation while business managing and reorganizing is also underlined in the article. The done research draws to the conclusion of the necessity of perfecting modern and inventing new methods of the estimation of business evaluation taking into account the principles of systematic approach and consumption properties of an enterprise. One of the main factors drawn into the focus is the formation of the integrated information area under up-to-date economic circumstances.*

**Keywords:** *business, an enterprise, evaluation (price), a method, profit, management, effectiveness, estimation, a structure, an advantage, profit.*

The present state of evaluation activities in the Russian Federation can be characterized from the point of view of positive changes in the sphere of law and methodology as well.

Before the global institutional changes affected Russia in the early 90-s the evaluation mechanisms were rather simple and they could not be changed for a long period of time.

Due to the economic reforms in Russia some recovery of the evaluation activities started as the beginning of the most important part to carry out the economic and law novation.

Meanwhile, as the managing practice of the middle 90-s showed, the process of the state properties privatization failed from the very beginning of putting into practice the primary idea. The point is that the state enterprises were sold at

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low cost to new owners (the value of an enterprise was charged up to the property complex cost or sometimes up to the liquidation value)<sup>1</sup>. Whereas the state stood for a seller all the deals resulted in the lack of the planned means in the budget of all levels (the guaranteed investment in the revenue was lost).

Nowadays it's necessary to define the business value in different cases, for example, in taking business public, reorganizing or developing business and in mortgage lending and operating at the stock exchange market<sup>2</sup>. Thus, defining and forecasting of the business value are used not only in solving a classical problem of the possible price at the business sale.

Besides, the business evaluation is likely to be the major managing tool, and for anti-crisis management as well, for increasing business value on the market, and for defining the productivity of the business management system.

The target function of business evaluation is objectively followed by a chain of problems to be solved at the legislative level by correcting of the existing methods and approaches while achieving the goal.

The urgent matters are considered to be the following:

- “the scantiness” and the lack of the standard methodical system providing evaluation activities;
- ineffective operating of the evaluation standard system that is supposed to meet any current tasks;
- the lack of the systematic approach in the present-day ways of defining business value and the failure;  
of considering the business use value.

The theoretical and methodological matters of defining business value were given special attention by many Russian scientists: V. Kovalev, S. Valdaytsev, E. Tarasevich, V. Grigoriev, M. Fedotova, G. Popov.

<sup>1</sup> Buloshnikova E., 2011. Model» diskontirovaniya buduschih denezhnyh potokov ili kapitalizacii dohodov? Konsul'tant. 9.

<sup>2</sup> Fernandez P., 2007. Company valuation methods. The most common errors in valuations. IESE Business School — University of Navarra. 2.

It should be mentioned the methodology applied by the Russian scientists was mostly based on the works written by foreign economists.

Those matters were analyzed by such scientists as H. Harrison, James C. Van Horne, N. Ordway, Charles T. Horngren, J. Foster, R. Ling, J. Friedman.

In spite of some significant achievements in the given sphere of the scientific research on business evaluation and its importance for the National economics, the analysis of scientific and practical economical and the Law literature gives us the opportunity to state that because of the certain character of this problem not all the sides of it are observed and developed in detail or described as the methods that are probably useful in practice.

The matters on the business use value are said not to be learned as goods and regarding economical organising technical characteristics the most important ones of the activities of any institution or company characterising technical, managing, marketing, exporting, social, developing and all the other opportunities of the company are not taken into account).

All the information above means that the problems under discussion refer to the further research in the development or methodology and investigative ways and methods of business evaluation.

Though a lot of articles on the matters of defining business value were published their analysis allows to see all the methods as a sort of a certain structure including some approaches to the business evaluation as following:

- business value as real estate;
- accounting approach;
- economic approach;
- expert approach;
- Olson's model and Black-Shaul's model.

We are trying to analyse the main point of every approach and included and make clear disadvantages and show advantages of each method and approach.

The defining of business value as real estate consists of three items:

- costs;
- profits;
- marketing comparison.

The point of the cost method is that of the primary cost of the real estate of a company is counted by the buying liabilities and construction costs (buildings and structures) exclusive of depreciation.

The basis of the profits method is the capitalization of the future profits that is discounted by the current period of time. In this method of the cost of buildings and structures, as well as a cost of the land is considered<sup>1</sup>.

The method of marketing comparison is based on selecting the items in the rendering and identical conditions. The average marketing price per a square metre is referred to the data given<sup>2</sup>. The marketing cost of the subject of evaluation is counted as the product of the marketing price for a square metre and the area of the item under observing.

Therefore, the advantage of the given approach is simplicity, but in view of the fact the business is presented on the market as an item of real estate, i. e. the total combination of the main stocks and no more, it is its disadvantage, as far as its in material assets and some other factors of business developing during some time are not taken into account. In the opinion of the authors this circumstance substantially decreases and the possibility of obtaining the true evaluation of the business.

Accounting approach includes the following methods:

- the method of net assets;
- the method based on the business cost evaluation;
- the method of liquidation cost.

The method of net assets provides evaluating the net assets of the business that are counted as the difference between the cost of all the assets of the business and all the liabilities.

The method that is considered to be traditional (accounting) for the business cost evaluation has one essential disadvantage. It takes into account only with the inventory cost of the property complex of the business (accounting and reporting

data) but doesn't consider the combination of consumption properties and the future profits of the business activities.

The method based on defining the business value takes into account its current net profits and expenses for the loan capital service. The set of tools of this method includes the concept of the average cost of the total business value.

This method based on the analysis of the business cost as well as the method of evaluating net assets doesn't reflect the future results of the business activities, otherwise it allows the following the business value referring to the evaluating of the loan assets value<sup>3</sup>.

The method of liquidation cost is usually used for evaluating the bankrupt businessor in case of high possibility going the business bankrupt in the nearest future. The liquidation cost reflects the remainder of the financial means after the assets realization and the liabilities liquidation. This cost is always the quantity of liquidation cost less than the balance property cost.

Thus, the main advantage of the accounting method is that it is based on the real value (properties and liabilities) owned by the business. Though all the methods in the frames of accounting approach have an important disadvantage — the lack of considering the consumption properties of the business.

In spite of some disadvantages, business evaluating by the accounting approach method can be integratedly carried out for the business with the sufficient total assets. The accounting approach is also applied in the case when the object being evaluated has no retrospective data on the financial activities or when it is impossible to make accurate analysis of profits and losses of the business and its future money flows.

There is a high degree of accuracy to evaluate the money flow of the business taking into account the time factor by the economic approach and the corresponding methods.

The economic approach of the business cost evaluation considers a long-term capability of the

<sup>1</sup> Harrison, David S., 2011. Business Valuation Made Simple: It's all about cash. Strategic Finance. 2.

<sup>2</sup> Harrison, David S., 2011. Business Valuation Made Simple: It's all about cash. Strategic Finance. 2.

<sup>3</sup> James R. Hitchner, 2003. Financial valuation: applications and models. By John Wiley & Sons.

business to operate adequately on the market, and as the result, to get regular profits.

The basis of the economic approach is as following:

- the method of discounted money flow;
- the method of the total value/capitalization;
- the method of a «price/profit».

The method of discounted money flows is seen as the most objective as it reflects the results of the business activities in the future and considers the process of generating the future business flows as an investment project demanding proper evaluation. However, in the author's opinion, this method does not consider all the variety of the consumption properties of the business<sup>1</sup>.

The method of the total value / capitalization is used when it is supposed that the future clear profits (money flows) will approximately match the current profits and their growth can be forecast. Meanwhile the money flows have always to be positive quantities, i. e. the business is to develop securely without any intention to quit. The given method is supposed to define an index of annual income and an appropriate rate of the total value<sup>2</sup>.

The main advantage of this method is that it shows the potential profitability of the business accounting is risks in this special branch (a market segment). The disadvantage of it is the lack of considering the consumption properties of the business.

The method of a «price/profit» coefficient is usually applied for the business which shares are on the stock exchange and their rates are usually listed. This method can go with the other methods in combination (e. g. the method of discounted future flows), but it doesn't give an opportunity to consider the future results of the business activities, its potential and its consumption properties either.

Considering the consumption properties of the business applying some correcting coefficients

and comparisons is supposed to have an expert approach including the following methods:

- the method of the capital market;
- the method of bargains;
- the method of branch coefficients.

Selecting all businesses in the list to compare should be carried out on the criteria of the location, the kind of economic activities according to the OKVED, its output (services), the diversification of the output (services), a life stage of the business, the size of the business, its strategy, financial characteristics and so on<sup>3</sup>.

The comparison of the market prices for the sharers of equal companies lies in the basis of the method of the capital market. Applying this method is possible in Russia while the financial market develops and some information for comparison is obtained. Despite this circumstance, and this method can be used for defining prices for the sharers of similar firms abroad, and the financial reporting all the Russian companies has to be quoted by the requirements of its forming in the frames of the International standards of financial reporting (MSFO).

The method of bargains is based on the analysis of the share prices of the interest owners of the similar companies. The point of the method is considering multipliers using all the tools of the financial analysis and forecast<sup>4</sup>. The difference of the method of bargains from the method of the capital market is in that the result of the method of bargains is the value of the control packet of shares of the business, meanwhile the method of capital market is proposed to compare the market prices for sharers of this or that business. It is necessary to consider the assets that are illiquid or excess, positive or negative changing of the net turnover capital, as well as the country risks and making amendments because of the insufficient activities liquidity when it is required.

The method of branch coefficients is used to analyse the total sales of the business in such a

<sup>1</sup> Kosorukova I. V., Sekachev S. A., Shuklina M. A., 2011. Ocenka stoimosti cennyh bumag i biznesa: Uchebnoe posobie pod red. I. V. Kosorukovoy. Moskovskaya finansovo-promyshlennaya academia.

<sup>2</sup> in the same place.

<sup>3</sup> Lawrence W., 2010. Uniform Standards of Appraisal Practice. The Appraisal Foundation. 4.

<sup>4</sup> Buloshnikova E., 2011. Model» diskontirovaniya buduschih denezhnyh potokov ili kapitalizacii dohodov? Konsul'tant. 9.

way that with the help of coefficients to set the correlation links between the sale price and some other index, e.g. profit, assets profitableness and so on.

Thereby, the method of an expert approach has got an advantage that they are based on the data considering the market indexes of the activities and reflecting demand and offer of the business. Otherwise, this group of methods doesn't fully take into account their consumption properties of the enterprises observed.

Observing of the methods and approaches above shows that the business value as the subject of buying and selling (investing) should be mostly defined on the basis of evaluation complex (considering the market cost of the business value), its future profitability, the correlation of demand and offer for the single subjects of business activities on the market.

Having made the analysis of the approaches, it should be pointed that they have both some advantages and disadvantages.

The advantages are actually rather simple to receive and to apply. One can obtain some useful results to spend minimum resources at a time.

The disadvantages of the pointed approaches should be mentioned as they do not consider the complex of the most important consumption properties of the business expressed in applying aggregated financial indexes like the coefficient of the current liquidity, the ability to pay, working capital turnover and so on, as well as ignoring the groups of important technical economic qualities, say, technical, innovational, managing, personnel, marketing, social. Lately, some special attention to business evaluation has been drawn to the methods that could be hardly referred to any certain approach spoken about above. These methods were given the names of Olson's and Black-Shaul's model. We are going to consider every of the given models of the business evaluation methods in detail. Olson's model stipulates the division of the business profits into two parts:

- normal profits;
- abnormal profits.

The normal profits are considered to be the quality of the business assets with discounting.

Some unplanned profits available are likely to come into the business thanks to a special position of the business of the market, therefore, it should be taken into account when the business value is defined in increasing or decreasing the general business evaluation in comparison with the quantity of the assets value<sup>1</sup>.

Applying the model it is stated that abnormal profits should always become stable during a long-term period of time, that is why they must be funded<sup>2</sup>. The model has been improved, and the quantity of abnormal profits is not considered as a constant no more. Abnormal profits as well as normal profits change in time.

And that made the given model rather complicated though it allowed to get rid of some of its disadvantages. So, with the help of this model it's possible to get the business value on the basis of the corrected market value of the balance assets cost and the discounted value of abnormal profits of the business.

The advantage of this model is that it allows to combine the discounting method (a profit approach) and the method of net assets value (a cost approach). However, using of this model in Russia meets some difficulties. They are connected with the lack of correlation between the assets value according to accounting reports and their market cost. That is why to apply Olson's model is necessary to define which kind of assets evaluation is needed for using the model and for what is considered to be abnormal profits of the business. The point is that in practice of business evaluation the data from the accounting reports on the assets, liabilities and profits available for the business without any directions are used. It is seen like a serious mistake, as far as it causes false results of the business evaluation.

But there is another model, Black-Shaul's model, based on this theory of options. The

<sup>1</sup> Fernandez P., 2007. Company valuation methods. The most common errors in valuations. IESE Business School — University of Navarra. 2.

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method of business evaluation called the method of real options or the ROV-method was offered by some foreign authors in the middle of 80s of the 20<sup>th</sup> century, but some kind of options — in the late 70s. The method became widely spread the middle of 90s. The peculiarity of the real options method is its ability to consider the external environment influencing the business. In Russia the most popular business evaluation model is Black-Shaul's model developed for defining the share cost on the stock market. In this model there is a basic state that an option price from buying assets should be like that profitability of a completely hedged packet of stocks is equal profitability of safe assets<sup>1</sup>. That means the given model is right to consider is the value of future money flows that apply it in the frames of the profit approach of evaluation.

Using the given model for the business evaluation is supposed to admit that the assets value is the current value of the business, and the cost of carrying out an option is a principal value of liabilities. Carrying out an option is understood as the «theoretical» liquidation of the business with offsetting of debts at the expense of the assets. So, applying an option in the given model is that the business organization sells its assets to the creditors keeping the right to buy them back at the price of the liabilities in some time. The cost of such an option in the given model is the business value. The business value according to Black-Shaul's model is defined by five variable quantities included, namely:

- assets value;
- liabilities value;
- safe interest;
- weight average turnover of duties;
- square average annual marketing deviation from the stock cost.

When accounting (financial) reports of the business organization is formed in accordance to the MSFO, then there are not any

serious difficulties in defining the necessary characteristics of the given model. As for the practice, applying the option method has been limited by the business spheres of extracting and manufacturing resources. It goes without saying that investment, for example, in a coal or oil project has much in common with carrying out a financial option. Nowadays the application sphere of this method is sufficiently widened at the expense of some other spheres of activities (manufacturing, transportation, agriculture, etc.).

It should be mentioned that the effective application of Black-Shaul's model in Russia is stipulated by the same factors as the application of Olson's model. Therefore, in this situation one must not state that the effectiveness of the method of real options is absolute.

### *Summary*

Thereby all the given above allows to come to a conclusion that:

1. Developing of combined approaches in business evaluating considering all the factors is one of the principal tasks of the evaluation activities. The membership of Russia in the WTO has sufficiently widened the sphere of the principal business evaluation. It's of great importance to gain a new economic instrument set that allows to better competitiveness and investing and innovation attraction of the business.

2. To make the business management more effective is to develop some ways and methods with the basis of the concept of economic profit built on the classical premises on the necessity of covering all the expenses with the business profits including costs for business attraction and alternative production costs.

3. Actually it is necessary to develop and put into practice some new methods of evaluation considering the principles of systematic approach, consumption properties of the business, and forming the integrated information area that is of great importance in the conditions of the modern market economics and business.

<sup>1</sup> Leonard J., 2005. Business Valuation Standards. American Society of Appraisers. 11.

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