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CORPORATE BUSINESS VALUATION FOR MERGERS AND ACQUISITIONS

Bioye Tajudeen ALUKO and Abdul-Rasheed AMIDU

Department of Estate Management, Obafemi Awolowo University, Ile – Ife, Nigeria
E-mail: btaluko@yahoo.com, amidrasheed@yahoo.co.uk

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ABSTRACT. Business combinations including mergers and acquisitions are important features of corporate structural changes. The Investments Securities Acts (ISA), 1999 charge the Securities and Exchange Commission with the responsibility to review and approve all business combinations in Nigeria. And, real property is an integral factor in many of such strategic business decisions and, need to be set in a business context.

This paper, therefore, examines how corporate business entities are and could be valued for mergers and acquisitions through exploratory research. It also explains the relevance of goodwill, marriage value, and fair value concept in corporate business asset valuation. The paper found out inter- alia that the value of holding property to the business needs to be measured against the return that the equity could achieve both within the business and elsewhere. It also, prima facie, shows that the role of the valuer is not one of accountant but interpreter of financial and physical information with a clear understanding of the nature of the business under consideration in merger and acquisition.

KEYWORDS: Merger; Acquisition; Valuation; Replacement Cost; Fair Value; Marriage Value

1. INTRODUCTION

Business combinations which may take forms of mergers, acquisitions, amalgamation and take-overs are important features of corporate structural changes. They have played an important role in the external growth of a number of leading companies the world over (Pandey, 1999). In Nigeria, mergers and acquisitions are not so common, until recently. For example, the first merger attempt was in 1982 between United Nigeria Insurance Company Limited and United Life Insurance Company Limited, which was, however, not consummated. The first successful merger was between AG Leventis and Company Limited, and Leventis Stores Limited in 1983 where 100 ordinary shares of 50 kobo each of Leventis Stores Limited were exchanged for 83 ordinary shares of 50 kobo each of AG Leventis and Company Limited. And, there have been a fair number of mergers and acquisitions since 1983 in the country. Nonetheless, the present economic climate in the country which is characterized by shortage of foreign exchange for the importation of goods, low exchange rate of the Naira, the restrictive credit policies coupled with the agenda of privatization and globalization worldwide have increased business risks and pose serious threats to their long term survival. As a result, previously autonomous businesses have recently, since the year 2000, been taking advantage of mergers and acquisitions, particularly in the oil and gas, textile, insurance, banking and conglomerates sectors of the economy to form larger concerns needed to reduce their risks and guarantee better chances of survival (Director – General, Securities and Exchange Commission (SEC), 2004).

The Investments and Securities Act (ISA)

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No. 45 of 1999 is the enabling law governing the Nigerian Capital Market. Section 8 (0) and 99 (2) of the Act charge the Securities and Exchange Commission with the responsibility to review and approve all mergers, acquisitions and other forms of business combination between and among Nigerian Companies – private and public. The ISA have specific provisions contained in sections 99-122, and Rules 235-238 of the Commission, which were made to give effect to the ISA. On the other hand, the Companies and Allied Matters Act (CAMA) 1990 in sections 590-609 of part XVII now made the same provisions for regulating Mergers and Takeovers and further vested the administration of part XVII on the Securities and Exchange Commission.

However, mergers and acquisitions are corporate investment decisions requiring property advice mainly at strategic level of portfolio reviews, and, at times, at operational level in space planning, allocation and efficiency evaluation (RICS, 1995b; Greenalgh, 1997; Nourse and Roulac, 1993; Evans, French and O'Roarty, 2001; Wyatt, 2001). Strategic decision-making refers to the identification and implementation of major issues that affect the whole organization and its long-term relationship with its business environment (Greenalgh, 1997). Property including land and real estate asset is an integral factor in many business decisions and has unique characteristics of being simultaneously a major input into production activities (agriculture, industry, and services), and into consumption by households of residential real estate and infrastructure services (Galal and Razzaz, 2001). Thus, the property advice needs to be set in a business context. Companies regard property as an active part of the company that should be as responsive as other parts of the business. The value of holding property to the business needs to be measured against return that equity could achieve elsewhere.

However, a growing perception amongst, business occupiers is that valuations do not provide the right information to business occupiers. This has arisen partly because business occupiers do not recognize valuers in a strategic role; they see valuers providing a single valuation service, estimation of market value for purchase/sale decisions and corporate disclosure (Calborne, 1995; Wyatt, 2001; Aluko, Ajayi and Amidu, 2004). It is also stated that valuations are asset-specific but increasingly the demand from business occupiers is for strategic property advice. And, there has also been public outcry on the poor standard of work produced by many in our calling as a result of either incompetence or (more rarely, thankfully) malfeasance (Whipple, 1990; Agbebiyi, 2000; Aluko, 2000; 2004). Besides, the valuation profession around the world is in serious trouble. It faces growing competition, particularly for high value instructions, from other professions that have a pedigree of servicing the wider needs of business occupiers (Grasskamp, 1977; Baum, 1984; Rothwell, 1984; Barnard Report, 1986; Howard, 1988; Whipple, op cit; Boyd, 1992; Aluko, 2000).

Against the foregoing, major institutional investors or business owners may not accept a single unsubstantiated figure on a signed piece of paper as the correct interpretation of market value. Much more will be expected of valuers if valuation is to be used in measuring corporate efficiency in mergers and acquisitions. Arguably, real estate markets are, also no longer defined by national borders. Businesses are now footloose on a global scale (due to the establishment of, say, for example, ECOWAS, European Union and African Union) and chose locations for their enterprises at an international level. The need for international real estate advice is increasing and the requirement to value without national boundaries is becoming implicit in international accounts and corporate real estate decisions, particularly during merger and acquisition processes where market value of fixed assets have to be estimated (Wyatt, op cit). Consequently, valuation methods developed at the national level are under scrutiny as occupiers become more international in outlook. As a profession, it is

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more important to look for ways of improving our service than spend our energies attempting to justify our position. This article is intended to fill the gap so that the estate surveyor and valuer will be armed with a full set of tools when asked to provide input into a situation requiring business valuation related directly or indirectly to corporate mergers and acquisitions. This article, therefore, considers some important questions below such as: what are manager's true motives including contextual issues driving mergers and acquisitions in Nigeria? How could valuation advice be made more responsive and relevant to merger and acquisition decisions? Is there element of marriage value in mergers, acquisitions, take-overs and conglomerate business decisions?

In order to address some of the above questions the paper is structured and discussed, inturn, below into five additional sections: the meaning of merger and acquisition, contextual issues promoting business combinations and asset valuations, property in the context of corporate asset valuation, valuation methodologies, issues and problems and conclusions emanating therefrom.

2. MEANING OF MERGERS AND ACQUISITIONS

What amounts to a 'merger' is not defined in the ISA No 45 of 1999. However, in the rules and regulations made thereunder, a merger is defined as an amalgamation of the undertakings or interest in undertakings or any part of the undertakings of one or more companies and one or more bodies corporate. A merger contemplates a transfer of properties and liabilities of one or more companies to another, such transfer does not include rights and obligations, which are not transferable such as contracts of personal service. Thus, one or more companies may merge with an existing company (through absorption) or they may merge to form a new company (through consolidation). Nonetheless, a fundamental characteristic of merger (either through absorption or consolidation) is that the acquiring company (existing or new) takes over the ownership of other companies and combine their operations with its own operations.

On the other hand, the term 'acquisition' has not been defined in the Act but it has been said to describe an act of acquiring effective control by one company over assets or ownership and management of another company without any combination of companies. Thus, in an acquisition two or more companies may remain independent, separate legal entity, but there may be change in control of companies. In this regard, acquisition connotes a take-over, that is, the acquisition of control over the target company. And, in business and commercial terms, the expression 'acquisition' is properly used interchangeably with the term 'take-over' as distinct from a merger. For example, in the United Kingdom (UK), ownership of 50% or more of the equity of a company is considered as acquisition, whereas acquisition of up to 90% of a company is only what can be considered as a take-over, since the holders of the remaining 10% equity may have little choice than sell their interest to the acquirer. In Nigeria, however, acquisition of 331/3% (one third) or more of the called-up share capital of a company is considered as acquisition in accordance with section 104 (1c) of the ISA No 45 of 1999. The thresholds of the quantity/value of shareholdings for control purposes are generally determined by the level of business and financial sophistication of shareholders. The more sophisticated and organized the shareholders are, the more the minority shareholders can come together to have sufficient say in the affairs of a company, thereby diluting the control of a single major shareholder. More developed economies are therefore more likely to have higher thresholds than the less developed economies, in order to be able to exercise control over the affairs of a company (Famoroti, 1989; Ehighibe, 1989; Adegbite and Carew, 1989; Orojo, 1992; Pandey, op cit; Bala, 2004; D. G. (Sec.), op cit; The Registrar - General (CAC), 2004) This distinction is often

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blurred in practice. What is an acquisition is often called a merger in order that the directors of the acquired company do not lose face.

2.1. Types of Mergers and Acquisitions

The following types of business combination are easily recognizable (Famoroti, op cit; Pandey, op cit):

(a) Vertical Integration - Combination of two businesses in the same industry but at different levels in the process of producing and selling a product. For example, a company taking over the supplier of its raw materials.

(b) Horizontal Integration - This is a combination of two or more firms in similar type of production, distribution or area of business. Examples would be combining of two book publishers or two luggage manufacturing companies to gain dominant market share.

(c) Conglomerate mergers or take-overs - combination of businesses in unrelated or indirectly related industry e.g. an insurance company taking over food processing company.

3. MOTIVES AND CONTEXTS WHERE ASSET VALUES HAVE BEEN REQUESTED IN BUSINESS COMBINATIONS

Why do business combinations take place? A number of reasons and motives give rise to business mergers and acquisitions as indicated below:

(a) Size could be a great advantage in relation to costs. It may assist, therefore, in enhancing profitability, through cost reduction resulting from economies of scale, operating efficiency and synergy. These savings could be in various areas e.g. finance, administration, capital expenditure, production and warehousing.

(b) A company with good profit record and strong position in its existing line of business, may wish to reduce risks. Through business combination the risks could be diversified, particularly when it acquires businesses whose income streams are not correlated.

(c) It may help to limit the severity of competition by increasing the company's market power where a company takes over the business of its competitor. Thus, the company, conscious of its monopolistic position, may, for instance, raise prices to earn more profit.

(d) In a number of countries, a company is allowed to carry forward its accumulated loss to set-off against its future earnings for calculating its tax liability. A loss-making or sick company may not be in a position to earn sufficient profits in future to take advantage of the carry forward provision. If it combines with a profitable company, the combined company can utilize the carry forward loss and saves taxes

(e) There are many ways in which business combination can result into financial synergy and benefits. This may help in eliminating the financial constraint, deploying surplus cash, enhancing debt capacity and lowering the financial costs.

(f) Growth is essential for sustaining the viability, dynamism and value-enhancing capability of a company. A company can achieve its growth objectives by expanding its existing markets or by entering in new markets. For instance, if the company cannot grow internally due to lack of physical and managerial resources, it can grow externally by combining its operations with other companies through mergers and acquisitions.

(g) A business with good potential may be poorly managed and the assets underutilized, thus resulting in a low return being achieved. Such a business is likely to attract a takeover bid from

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a more successful company, which hopes to earn higher returns.

As earlier stated, the increasing wave in business amalgamations started in the year 2000. And, most of the recent mergers and acquisitions are in the oil and gas, textile, insurance, banking and conglomerates sectors of the economy. And, although most recent merger and acquisition activities in Nigeria were spurred by offshore acquisitions, the on-going reforms in the economy are expected to increase the scope. Thus, questions about valuation in business combination have been raised in different contexts as given below:

(i) It is trite knowledge today that the world economy continues to be shaped by the forces of globalization, deregulation, and advancement in technology. All these forces combined tend to break barriers of trade and control and thus, expose the economy to change and competition. Mergers and acquisitions may help to reduce this completion. Then the property must be valued so the conditions of the transfer of the property can be determined.

(ii) The Insurance Act, 2003 increased the minimum paid-up share capital of insurance companies to carry life, general and composite insurance businesses to N150, 000,00 (about £600,000.00), N200,000,000.00 (£800,000.00) and N350,000,000.00 (£1,400,000.00) respectively. Depending on the class of business, these translated to capital increases that ranged between N180,000,000.00 (£720,000.00) and N260,000,000.00. Similarly, the minimum paid-up share capital for reinsurance business was raised from N150,000,00.00 (£600,000.00) to N350,000,000.00 (£1,400,000.00). Out of the 117 insurance companies 103 were able to meet the minimum capital requirements. All of the 4 reinsurance companies were about to recapitalize. But about 14 insurance companies were unable to meet the capital requirements and they opted for mergers to prevent their operating licenses from being cancelled

(iii) With the present economic situation in the country, most companies are now experiencing serious cash flow problems, and these have made it difficult for them to meet debt obligations to their bankers. Consequently, an increasing number of companies are now faced with receivership and foreclosure threats from their bankers. For examples, more than 35 banks were reportedly liquidated since inception, by the Nigerian Deposit Insurance Corporation by the end of the year 2002. A merger or acquisition could reduce and eliminate such threats, and valuation is needed in this situation.

(iv) Another influence potentially affecting valuations in business combination is the changing structure of corporate land holdings. The increasing realization that property is an asset to be pro-actively managed (See for example Dubben and Sayce, 1991; Debenham, Tewson and Chinnock, 1992) has implications for both tenure and valuation. This action requires the periodic revaluations to be carried out on the basis of investment holding.

(v) The on-going reforms in the banking industry and requirement of the minimum legal reserve ratio of N25 billion (£100,000,000.00) have initiated the present merger and acquisition moves in the sector as well as the need for asset valuation for investment decisions.

(vi) The interest in privatization of publicly-held businesses numbering over 600 raised issues of pricing of real estate assets that were sold or leased out or acquired or combined with other business entities as part of the privatization.

Business combination is said to add value to the new company more than the physical

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and financial asset previously owned by the separate entities. To evaluate the benefits, it is important to examine the rationale for the deal, the possible sources of added value and the way that value is assessed and apportioned amongst parties to the deal.

All these factors lead to a strategic importance of valuations in business investment decisions, especially, in merger, acquisition and takeover of companies. Thus, a successful merger and acquisition will require the input from various professionals, such as accountants, stockbrokers, estate surveyors and valuers, lawyers and bankers, etc. These professionals, may be required to advice on issues such as the following: business valuations, valuation of assets, acquisitions strategies, statutory regulations, business investigations, taxation and post-acquisition advice. Some of these professionals could also assist in the negotiation process.

4. REAL ESTATE AND LAND ASSETS IN THE CONTEXT OF CORPORATE ASSET VALUATION

Land and real estate assets have the unique characteristics of being simultaneously a major input into production activities (agriculture, industry, and services), and into consumption by households of residential real estate and infrastructure services. For agriculture, land is the most important factor of production. For enterprises, especially of small and medium size, land and real estate are the largest cost centre second only to labour. For poor households, land and real estate are the single most significant vehicle for saving and the largest item of expenditure (Galal and Razzaz, 2001).

From the above, property is an integral factor in many business decisions and, as such, property advice needs to be set in a business context. Evans, French and O'Roarty (2001) comment:

"From the viewpoint of an operational company, property fulfils two roles. First, it provides space from which the business can operate. In this role it is simply one of the three factors of production. The other 'factors' are money (capital) and people (labour). As a factor of production it will be viewed as a cost to the company - that cost being deducted, in the case of leasehold properties, as rent paid and, in the case of freeholds, as a charge (depreciation) for usage. The second role of property to a company is as a financial asset. This applies principally, although not exclusively, to freehold property. The ownership will be seen as an asset; a holding that benefits the company".

Property is, thus, seen as an active part of the company that should be responsive as other parts in mergers and acquisitions. Property represents the ultimate means for participating in the economic appeal of a different region. And, the appeal of a particular investment parcel is a function of its relative attraction as a place for commerce in the global market. Operationalizing this idea, the question to be addressed is why an economic enterprise would choose to conduct business at a particular place. More specifically, what role do the attributes of that place have in attracting households to live and enterprises to do business there? To be effective in attracting business, places need to have and facilitate access to human capital and property resources, to customer markets, suppliers complementators, those market participants that facilitate economic activity (Brandenurger and Nalebubb, 1996; Roulac, 1996; 1998).

Arising from the above, the original classification of four factors of production: labour, land, capital and entrepreneurship has been retained. But, the neo-classical school is divided between three, two and one factor of production premises. In the three-factor perspective, the entrepreneurial effort is simply another form of labour. In the two-factor perspective, land is another form of capital. In the one-factor perspective, given the research description of human capital, labour is a capital issue also; therefore, it is argued that all factors collapse to capital. It is no wonder then that property is now likened to units of investments or secu-

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rities that are now mobile as other factors of production. Nevertheless, the most predominant view appears to be the concern for two factors, labour and capital, with the Austrian branch of classical economies still insisting on the power of entrepreneurial innovation to stimulate economic activity (Palmquist, 1989; Grissom and Liu, 1994).

Following the abstraction process of neo-classical economies, Graaskamp (1976a) reduced the essence of real estate product to space available for use overtime. He delineated the constraints on space-time choices in the format of a process. The capital components of time via Fisher (1954) and Markusen (1979) are introduced into the process with the Graaskamp's formulation of the space-time to money-time equation. With this simple abstraction, Grasskamp reduced the study of real estate from a highly institutionalized procedure to one of converting space available for use over time into money or capital measures subject to the constraints of interacting parties. Grasskamp asserted that these interacting parties often have diverse goals. Despite the varying objectives of the parties, the ultimate goal is the cash cycle conversion represented by the space-time to money-time equation. All these views have implication on the concept of property as a corporate asset.

Thus, against the above background, some of the primary forces redefining the real estate markets and which have implication on asset valuation for business combinations (according to Raulac, 1989; 1994) are the following:

- Geographic orientation - property including land and real estate assets is now footloose on a large scale and, operates beyond national boundaries. Thus, the orientation of the real estate participants is now, very much national and international rather than local or regional levels. This has implication on valuation advice in measuring corporate efficiency or providing investment advice in mergers and acquisitions.
- Securitization - Due to globalization and privatization, real estate assets are now mobile and traded in the stock exchanges, as less emphasis is placed on ownership and uniqueness of location. Thus, increasingly real estate transactions are dominated by financial structures in the form of securities, where the deals are presented as prepackaged securities rather than as generalized investment opportunities whose structures, price and terms are subject to refinement, open to negotiation, and susceptible to customization.
- Institutionalization - Concurrent with the change in geographic scope and securities orientation, the business has become institutionalized. Larger players, many of whom have strong connections to financial institutions now exert an ever-more dominant role.
- Sophistication - The decision makers in all aspects of the real estate markets are more knowledgeable, more discriminating, and more demanding than in earlier times. Thus, contemporary management techniques and systems, coupled with modern business environment bring the potential for more informed asset valuation and business decisions.
- Fiduciary Asset Management - There is a growing demand for fiduciary asset management rather than a "one-time" deal orientation, as was previously prevalent. The emphasis represents a transfer of responsibility and a relocation of risk, a development with profound implications for the nature of business valuation services desired and the types of merger and acquisition arrangement that might be structured.

The interplay of the many facets of the real estate system means that professionals and their firms must be aware more than ever of what is going on. Thus, the valuation of many assets which are primarily real estate in any

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entity, requires consideration of their operating cash flows, which are often of a business nature as well as real estate nature. The expected net income before interest and taxes from a business enterprise, for example, will be determined as much by its competitive position in a business setting as from pure real estate parameters, such as location and reproduction cost. Thorough valuation, therefore, should deal explicitly with the business, as well as the real estate, sources of value.

5. VALUATION METHODOLOGIES, ISSUES AND PROBLEMS

Property (including land and real estate assets) is an essential element of many businesses. It is often used as collateral for borrowing by the owners and is one of the key "factors of production" in most businesses. The value of holding property to the business needs to be measured against the return that the equity could achieve both within the business and elsewhere. Usually, in business decisions including mergers and acquisitions, investors will usually want to review financial statements - balance sheet, profit and loss account, auditors' and directors reports - (for the current status and a report on recent history) and a business plan.

The balance sheet, which in most countries, reflect assets on historical cost concept, is a yearly snapshot of the assets and liabilities of the firm. People turn to the balance sheet for an impression of the firm's general nature, size, and ownership structure: they look to it also for help with more detailed problems of asset strength, liquidity, etc. The balance sheet model of a firm, as provided by Ross *et al.* (1993, p. 5) is shown below.

The assets of the firm as shown below in Figure 1 on the left side of the balance sheet include both current and fixed. Fixed assets are those, which last a long time and are durable, such as buildings and plant. Some fixed assets are tangible such as machinery and equipment, others are intangible such as patents, goodwill and trademarks. The other category of assets are current assets, which have short lives and are intended to be turned into cash. For a property company, the distinction may be between properties held for investment and those which it intends to trade in short term. On the other hand, a company must raise the cash to pay for the assets, and this is shown on the right side of the balance sheet. Claims are sold by firm to its assets in the form of debt (loan agreements) or equity shares liabilities, like assets, are also classified as long or short-term. Short-term debt is a current liability and consists of loans and other obligations, which must be repaid in one year. Long-term debt is that one whose repayment date is more than one year from issue.

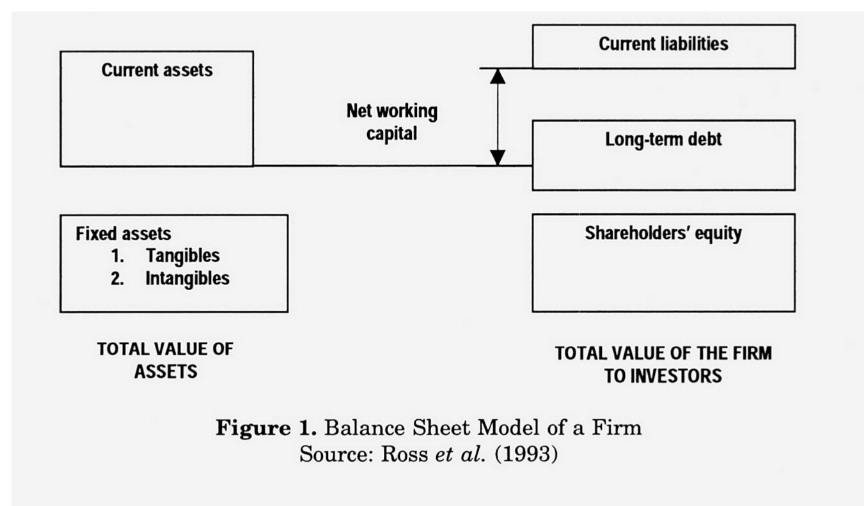

Figure 1. Balance Sheet Model of a Firm
Source: Ross *et al.* (1993)

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Shareholder's equity, which represents the net worth of firm, is the difference in value between the assets and debt of the firm and is thus a residual claim. The net worth of a company, as shown below, consists of the capital invested and the retained profit: **Total Assets - Total Liabilities - Net Assets (Net Worth).**

A balance sheet is simply the tabular representation of these assets and liabilities at a particular point in time. In a nutshell, balance sheet model must provides adequate response to the following questions: In what long-term assets should company invest? How can a firm raise cash for the required capital expenditures? How should the short-term operating cash flow be managed? What is the financial position of a company at a particular point in time? What prospects lie in business combinations from the financial reporting point of view? (Isaac, 1996; Aluko, 2004). The information should be comprehensible to those who have a reasonable understanding of business and economic activities in mergers and acquisitions and are willing to study the information with reasonable diligence.

However, the valuation of the assets and liabilities is difficult for many reasons. The net asset position shown on the balance sheet is often based on historical costs and, therefore, does not take into account subsequent changes in the value and condition of the assets. Resources which once had value, particularly productive assets, might now be valueless because they embody automated technologies. There is also the problem that some items may be missing from the balance sheet, such as land, certain intangibles, and various liabilities such as pension benefits, post-retirement health-care costs, and contingencies for environmental damage because they were not required to be recorded according to the accounting principles used in the country (United Nations, 1993; Aluko, op cit).

Proponents of value-based accounting models challenge the informational value of the historical cost model and suggest that after acquisition, accounting measurement should continue to express market values (Aluko, 1989; Kinsendal, 1995; Nnadi, 2001; Edge, 2002; Muyingo, 2003). Market value can be expressed either as "replacement cost" or "fair value", that is, what the sales price for the asset would be (as if sold). The three models of accounting values and their sub-models, which are further examined later, are as shown diagrammatically below:

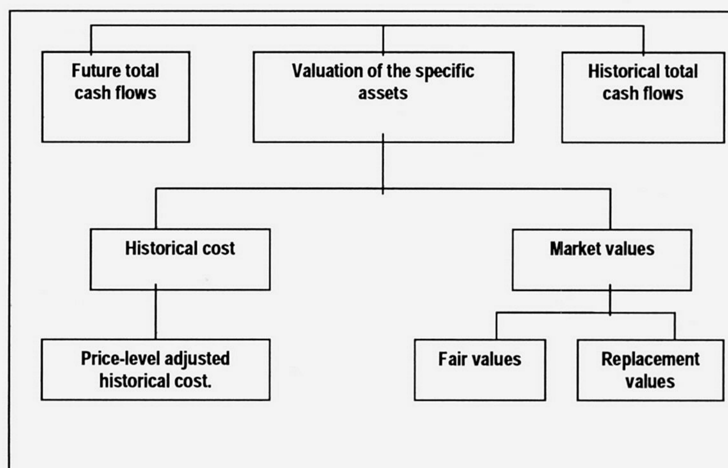

Figure 2. Three accounting models and their sub-models
Source: Kinserdal (1995) and Muyingo (2003)

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5.1. Fair Value

Fair value of land and real estate assets is the amount for which they could be exchanged between knowledgeable, willing parties in arm's length transaction (International Accounting Standards Board (IASB)). Investment property in companies involved in merger and acquisition is measured at fair value. Gains or losses arising from changes in the fair value of such property are included in net profit or loss for the period in which they arises. In relation to owner-occupied property, it can encompass market value or its surrogate (in the absence of an identified market), depreciated replacement cost (DRC). Fair value is synonymous with the definition of market value given by the International Valuation Standards Committee (IVSC). For financial reporting purposes IASB has endorsed the definitions of market value as laid down by IVSC and TEGoVA in the Approved European Property Valuation Standards. Market value is defined as:

"The estimated amount for which an asset should exchange on the date of valuation between a willing buyer and a willing seller in arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion".

It is stated that the best evidence of fair value is normally given by current prices on an active market for similar property in the same location and condition and subject to similar lease and other contracts (Muyingo, op cit). The acquiring and consolidating companies have to take fair value into consideration in their respective negotiation or bargaining positions. Nonetheless, the unique and localized nature of property market including absence of reliable and centralized data bank resulting in wide variation or accuracy in value estimates may mar the adoption of this concept of business value. Besides, Nordlund (2002) concludes that the inclusion of capital gains or losses (which is inherent in valuations undertaken by valuers) arising from changes in the fair values in the net profit or loss of the period will have wide ranging effects on the net income or loss of the companies in business combinations. For example, solidity, which is the equity/assets ratio, will increase as the fair value of the investment properties increases, if the fair value model is applied. Again, total equity, (shareholder's equity) which is the sum of restricted equity and the retained earnings will increase tremendously as value changes will be included in the profit. And, volatility in the net income will increase if the fair value model is applied. In view of the above, Sayce and Connellan (2002) agreed that fair value is an imprecise term designed to give flexibility to accountants and their corporate clients. This may conflict with the needs of valuers who require specificity in order to give consistent advice.

5.2. Replacement Cost

The depreciated replacement cost of the buildings and plant including other assets in business combinations would take into account the cost of modern substitutes using modern materials and technology and having the same service capacity - that is, the same output. As earlier reiterated, it is the surrogate figure, not a market - based valuation, used in the absence of a provable value. The advocate of this approach observe that given the continuity of the entity, even in consolidation, absorption or acquisition, the selection of appropriate measure of value for non-monetary assets would have to be based on the distinction between what is essential to the continuance and non-continuance of operations. If any asset or component of an asset is essential to the continuance of operations, it is worth to the entity no more than it would cost to replace the operating capability, which it provides. If it is not essential to operations, it is worth no more than its net realizable value (NRV), equivalent of market value (Bonbright, 1937; Parker and Harcourt, 1969; Edge, op cit).

This method is based on land value plus modern equivalent replacement cost of the building or plant asset, suitably discounted for

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age and obsolescence. More often than not the value arrived at here may be either of "value to the business" or "value in use". The International Accounting Standards Board (IASB) defines "value to the business" as:

The recoverable amount is the higher of value in use and net realizable value. Value in use is essentially the "worth" of the property to the business. Net realizable value is, in effect, the same as market value, which would be the equivalent of the contract price in the sale document, but less costs of disposal".

On the other hand, "value-in-use" which is entity-specific and, a non-market assessment is defined by IASB as "the present value of estimated cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life. "The IVSC, however, defines the term as "an apportionment of business value of an overall enterprise as allocated between individual assets contributing to that enterprise".

In Nigeria, being a former colony of the then British Empire, the U.K's definition of value to the business is adopted by the accountants. It is the lower of the recoverable amount and replacement cost. Replacement cost is the lowest cost or deprival value of an asset and is normally equated with existing use value (plus costs). But, by the IASB's approach, value to the business is the recovery amount, which equals the higher of value-in-use and Net Realizable Value. It is important here to distinguish Existing Use Value (EUV) from the above definitions. EUV is a market-based assessment and assumes a hypothetical occupier, not the actual occupier. Therefore, any special reason for occupation, over and above that which would be recognized in the marketplace, must be disregarded.

The replacement cost method to arrive at EUV of assets of an enterprise is highly favoured by valuers in the country. It also meets with the requirement of inflation accounting (as described above) rather than the use of historical cost concept. Usually, in practice, DRC is a ceiling amount and subject to a test of adequate profitability, both potential and current, as compared with the total capital employed. Unfortunately for those businesses involved mergers and acquisitions in the public sector there is no test of adequate profitability against which to benchmark the DRC (Andrew and Pitt, 2000). The assets in these businesses are used for non-profit making social benefit objective. For these the Red Book, which is being adopted in the country, stipulates that DRC "should be expressed as having regard to the prospect and viability of the continuance of the occupation and use". (Ps 3.5.4b, RICS, 1995). This is an imprecise and very vague which has continued to be subject of varied interpretations. In most cases, it is up to the directors, who may "write down" the valuer's figure, to make this judgment. At this point, the DRC valuation moves away from being a surrogate for a market-based assessment and toward a value in use concept, which may be problematic. Besides, the determination of allowance for depreciation and obsolescence is often based on fairly subjective criteria. It is often difficult to separate how the owner uses and occupies the property from how a hypothetical owner might use it. Also, the argument against the adoption of DRC in the valuation of assets of an on-going entity is that given the assumption of enterprise continuity it does not follow that particular operations of the enterprise are also viable. The continuity of a specific operation is a function of economic factors and is a decision choice in a decision context, which subsumes the present value consideration. And, in respect of a specific operation, the relevant factors to be considered in assessing the viability of that operation, are the services generated by assets, not the assets themselves. This may be true of, especially, assets surplus to company requirement, redundant or investment properties, and, are usually valued on alternative use basis adopting fair value concept. Either of the fair value or the replacement cost may not work out well for the valuation of goodwill, patents and trademarks.

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5.3. Accounting/Financial Ratios

The key ratios in financial accounting may be helpful in analyzing the value of business entity in merger and acquisition. This will assist to condense huge amount of data in financial statements into a manageable form in order to measure the company's performance. Some of these ratios as recognized in the literature (see, for example, Isaac, op cit; Aluko and Olaleye, 2003; Muyingo, op cit) include:

(i) Profitability Ratios used in analyzing the profitability or return that an enterprise earns on its investments. For example, trading profit as a percentage of turnover, dividend per share, payout ratio which is dividends/earnings, profit before interest and tax as a percentage of average capital employed and, assets per share to assess the asset backing of shares based on the value of the net assets divided by the number of shares.

(ii) Market Value Ratios, which indicate how highly the firm is valued by investors. This consists of the following:
- Price-earnings ratio (P/E) equal Stock Price over Earnings Per Share.
- Dividend yield is given by Dividend Per Share divided by Stock Price.
- Market to book ratio is expressed as Stock Price over Book Value Per Share.

(iii) Leverage ratio is also used to determine how heavily a company is in debt. And, it is done through debt ratios and times interest earned.

(iv) Efficiency ratio measures how productively a company is using its assets by comparing sales (revenue) to assets value.

(v) Liquidity ratio assesses how easily a company can lay its hand on cash by examining the current ratio (assets).

Furthermore, according to Muyingo, op cit especially for property companies, some of the other information relevant to assessing their value include total rental or lettable space, annual rent, total return, and surplus ratio which expresses operating surplus as a percentage of rental revenues.

5.4. Discounted Cash Flow (DCF) Evaluation

In a merger or acquisition, the acquiring firm is buying the business of the target firm, rather than a specific asset. Thus, merger is a special type of capital budgeting technique (Pandey, op cit). What is the value of the target firm to the acquiring firm after merger? This value should include the effect of operating efficiencies and synergy. The acquiring firm should appraise merger as a capital budgeting decision, following the DCF approach. The acquiring firm incurs a cost (in buying the business of the target firm) in the expectation of a stream of benefits (in the form of cash flows) in future. The cash flows can be determined through profit stream of the affected concern. Thus, merger will be advantageous to the acquiring company if the present value, that is, the fair value, is greater than the cost of acquisition.

The adoption of profit method in determining the cash inflows is regarded as being specialist, with most valuers receiving only nominal training in the method during their formal training (Sayce, 1996). This is reflected in the standard texts on the subject. Richmond (1985) maintains that the method is "specialized" and therefore devotes little attention to the method; Modern methods of valuation, written by Britton, Davies and Johnson (1989), perhaps the longest text on valuation, devotes only three of its 713 pages of texts to the method and two of those are in respect of rating valuation. The above explains why the DCF is hardly employed by valuers in the country in merger and acquisition valuation. The foregoing also explains while goodwill valuation in respect of merger, may pose serious practical problems in the country.

5.5. Goodwill

The assets of a going concern usually include goodwill, that is, the reputation a busi-

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ness enjoys with its customers, which gives the business value over and above the value of its physical assets. In acquisition and merger by absorption, where an existing company completely takes over another one, the inherent goodwill which is attached to the name and reputation of the business is usually valued by accountants using either super-profit method or total capitalization method. While the super-profit method depends on the ability of the business to earn a rate of profit in excess of the 'normal' rate based on the balance sheet value of the net tangible assets, in total capitalization method, the total net profit is capitalized and the value of the tangible assets is deducted therefrom leaving the balance sheet value of the goodwill. On the other hand, in a merger by consolidation where a new company emerges, the discounted momentum value is recommended since the benefits to be gained from purchasing goodwill fail as that goodwill gradually ceases to exist, while other benefits are gained from new goodwill created by the new company (Aluko, 1989; Horsley, 1990). It must be emphasized here that estate surveyors and valuers in Nigeria are not schooled in goodwill valuation. Perhaps, at best, in inflation accounting, they supply information on the open market value on alternative use basis of the physical assets engaged in companies undergoing mergers and acquisitions. Nonetheless, in business combinations, goodwill is an essential asset that must be considered.

5.6. Marriage Value

A merger will make economic sense to the acquiring firm if its shareholders benefit. Thus, considerable entrepreneurial effort is devoted to creating and adding value; one firm may take over another believing that the combined firm will be more valuable than the two separate entities. Similarly a real estate developer may assemble, through a series of discrete purchases, a site that can yield additional value when developed as an entity. (Lizeeri and Ward, 2001). Within the area of valuation, this is referred to as "marriage value" (Baum, Mackmin and Nunniagton, 1997) or "abutter/enhancement value" (Albert, Banton and Pearson, 1982; Berrry, 1984; Reenstierna, 1988). This situation reflects the recognition that by combining or recombining two assets - legally or physically - it may be possible to create a third asset that is more valuable than the sum of parts.

Therefore, merger and acquisition creates an economic advantage (EA) when the combined present value of the merged firms is greater than the sum of their individual present values as separate entities. Citing example, Pandey, op cit, graphically present thus:

If firm P and firm Q merge, and they are separately worth V_P and V_Q respectively, and worth V_{PQ} in combination, then, the economic advantage will occur if:

$$V_{PQ} > (V_P + V_Q) \quad (1)$$

And equation (1) can also be expressed as

$$EA = V_{PQ} - (V_P + V_Q) \quad (2)$$

He explains further that suppose firm P acquires firm Q. after merger P will gain the present value of Q, i.e., V_Q, but, it will also have to pay a price (say in cash) to Q. Thus, the cost of merging to P is:

$$\text{Cash paid} - V_Q \quad (3)$$

For P, the net economic advantage (NEA) arising from marriage or enhancement value is positive if the economic advantage exceeds the cost of merging. Thus,

$$\text{Net economic advantage} = \text{Economic Advantage} - \text{Cost of Merging} \quad (4)$$

i.e.

$$NEA = [V_{PQ} - (V_P + V_Q)] - (\text{Cash paid} - V_Q) \quad (5)$$

Perhaps, the economic advantage represents the benefits resulting from operating efficiencies and synergy when two firms merge. Valuation of marriage or enhancement value, though difficult in practice, may involve several steps: identification of the value created

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or abutters, before - and - after analysis of the potential for marriage value or enhancement value in merger and acquisition, and reporting of the conclusion to the acquiring and acquired firm respectively. Enhancement or marriage value is the amount by which the value of a property is increased through assemblage of another property into the same ownership. This is distinct from market value in that it is an additional amount that may be fully achieved in the event that the advantage in negotiation goes entirely to the owner of the subject. For example, if the acquiring firm pays the value of the acquired firm, then the entire advantage of marriage value in merger will accrue to the shareholders of the acquiring firm. In practice, the acquiring and the acquired firm may share the economic advantage between themselves. Nonetheless, it depends on each party's negotiation and bargaining position or strength. And, property valuers must, on continual basis, sharpen their skills to meet the needs of corporate clients in this regard.

6. CONCLUSION

The paper provides relevant information on how corporate business entity can be valued for mergers and acquisitions. It examines valuation concepts (based on accounting concepts), the need to incorporate goodwill and marriage values, and, the trend towards the fair value convention, and the consequent benefits to the valuation profession in the country. Also, in the paper, the property asset is perceived as integral with business and operates as a "shell" within which profit is generated. Therefore, property advice to business occupiers needs to be linked to the core functions of the relevant business and valuers need to appreciate the implications that property has for business processes. The implication of this is that valuers need to convince their clients that they are not only overly technical in their outlook, but, have broad business skills that include strategic thinking and an awareness of business issues. Likewise, property assets should be treated uniformly by accountants and valuers both within the accounts of an individual company and in comparison between companies. This requires a formidable partnership and collaborative efforts between The Nigerian Institution of Estate Surveyors and Valuers (NIESV) and The Institute of Chartered Accountants of Nigeria (ICAN) in the education and training of their professional members. Perhaps, through preparation of asset valuation standards unifying accounting and valuation concepts, the quality of corporate business valuations could be guaranteed. And, there is also the need for joint sponsorship of conferences, seminars, workshops and researches by both professional bodies in order to clear doubts arising from these varying concepts and standards.

Furthermore, the knowledge of professional valuer as it relates to business profit, whether based on single multiplier or DCF is, and will continue to remain critical to the valuation. In effect, valuers have to be more than just "pricers" of property: but, needs to be in a position to give real investment advice to clients. Therefore, rather than profit method being dismissed as difficult to adopt or unable to provide a viable alternative to the other methods for the establishment of business value for business combinations, the method should be reappraised with a view towards possible wider application in the light of clients' changing needs for valuation advice. Clearly, there is also the need to encourage valuers to adopt accounting ratios in analyzing the viability of corporate real estate investment decisions. Thus, in addition to studying the actual or projected accounts, they must be cognizant of, inter alia competition, statutory requirements that could impact on the operation of the business, quality of management, economic advantage of business combination, locational potential, style, etc. The role of valuer, therefore, is not one of accountants, but, interpreter of financial and physical information and for this a high level of market research is required, together with a clear understanding of the

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profit or DCF method including the nature of the business under consideration in merger and acquisition. The above issues merit further discussion – professional debate and research – within the whole context of corporate business valuation.

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SANTRAUKA

KORPORATYVINIO VERSLO VERTINIMAS ĮMONIŲ SUSIJUNGIMO IR PIRKIMO KONTEKSTE

Bioye Tajudeen ALUKO, Abdul-Rasheed AMIDU

Verslo įmonių susijungimas ir pirkimas yra svarbios korporatyvinės struktūros savybės. Investavimo į vertybinius popierius aktas (*The Investments Securities Acts* (ISA)) nuo 1999 metų įpareigoja Vertybinių popierių ir biržų komisiją vykdyti priežiūrą ir tvirtinti tokio tipo verslo sandorius Nigerijoje. Nekilnojamasis turtas yra integralus veiksnys, padedantis priimti daugelį tokių strateginių verslo sprendimų ir turi būti aptariamas verslo kontekste. Šiame darbe nagrinėjama, kaip korporatyvinio verslo įmonės yra ir gali būti vertinamos atliekant žvalgomąjį tyrimą. Darbe taip pat aiškinamas tokių korporatyvinio verslo vertinimo sąvokų relevantiškumas, kaip gera valia, susijungimo vertė, teisinga vertė. Be kita ko, darbas atskleidė, kad turimo turto, skirto verslo reikmėms, vertė turi būti vertinama atsižvelgiant į pajamas, kurias šis turtas galėjo atnešti dalyvaudamas tiek šiame versle, tiek ir kituose. Darbas taip pat akivaizdžiai parodo, kad vertintojas turi atlikti ne tiek apskaitininko, kiek finansinės ir fizinės informacijos interpretatoriaus vaidmenį, aiškiai suvokdamas vertinamo verslo specifiką įmonėms susijungiant ir jas perkant.

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