INSOLVENCY IN THE FORM OF OVER-INDEBTEDNESS AS A RESULT OF REVALUATION OF ASSETS TO THEIR FAIR VALUE

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Value Generation Potential of Assets

- From the business valuation perspective, assets are classified according to their **risk** and **income generating potential**
- The typical example of applying the **matching principle of risk and return** – sorting out non-operating assets (excess cash, non-core business units, non-operating land, equipment, inventories etc.) and the cash flow generated by these non-operating assets
- At the level of projects and/or strategic business unites the same principles apply, yet the different risk exposure as reflected in the individualized capital structure must be taken into consideration
- Financial accounting as regulated under local GAAPs does not go into this level of detail that is necessary for knowledgeable financial and business management
- By looking at the real performance of individual projects in companies, we get a very different picture of their performance and fair value (although it is not directly visible at the company level)
- However, no matter how unintentional the implications might appear, **the „real“ performance of projects interferes with the definition of insolvency in the form of over-indebtedness**

Over-indebtedness under applicable Czech insolvency law

- Pursuant to Czech Insolvency Act, an insolvency of a debtor shall mean, *inter alia*, a situation where a debtor is balance-sheet insolvent (over-indebtedness).
- Applicable to legal entities and natural person – entrepreneurs
- A debtor is *balance-sheet insolvent* if:

  i. it has two or more creditors; and

  ii. the sum of all its liabilities/obligations (whether due and payable or not) exceeds the value of (all) its assets taking into account the reasonably anticipated proceeds of the continued business activity (going concern principle).

Background Narrative: Case Study

- Sale by shareholder A of a 50% shareholding in AB, s.r.o., a company engaged in industrial production
- A precondition for the sale is the spin-off of a non-operating asset - the Freezer project, which the buyer is not interested to take over
- Shareholder B holding the remaining 50% shareholding in AB, s.r.o. has no economic interest in further running of the Freezer project as well
- What are the possibilities of separating the Freezer project from AB, s.r.o. and what are their economic implications?

Possible options of how to separate the Freezer project from AB, s.r.o.

1. **Option 1:** Transfer of the Freezer project as a part of the business enterprise under a contract for the purchase of part of the business enterprise concluded between AB, s.r.o. as seller and partner A as buyer
2. **Option 2:** Conversion by spinning-off the Freezer project under Czech Act No. 125/2008 Coll., on the transformation of companies and cooperatives, as amended
3. **Option 3:** Transfer of individual assets, rights and liabilities belonging to the Freezer project

On the valuation date, it is not *ceteris paribus* possible to carry out the divestiture of the Freezing project from the AB, s.r.o. by implementation of any of the above mentioned options, both economically and legally, due to its **negative fair value**.

Case study: Invested capital of AB s.r.o. as of Dec 31, 2016

Assets		Equity and Liabilities	
Operating assets	20 000 000	Equity	22 000 000
Freezer project	50 000 000	Debt (Freezer project)	48 000 000
Total	**70 000 000**	**Total**	**70 000 000**

- Financial statements according to the Czech Accounting Standards (Czech GAAP)
- The book value of the Freezer project as at Dec 31, 2016 is derived from the construction costs and lowered by depreciation
- The book value equals to the *new replacement value*
- What is the fair value of the Freezer project?

Step 1: Enterprise value of AB, s.r.o.

- Operating assets as of Dec 31, 2016 = 20 000 000 CZK
- WACC = 7 %
- Free cash flow as of Dec 31, 2017 (FCFF = FCFE) = 2 000 000 CZK
- Enterprise value as of Dec 31, 2016 = 2 000 000 / (7% - 2%) = **40 000 000 CZK**

Step 2: Fair value of the Freezer project

	2016	From 2017 on
WACC		10%
Growth rate (g)		2%
NOPAT	3 000 000	3 060 000
Invested capital (Dec 31)	50 000 000	51 000 000
Net investments		1 000 000
Debt (Dec 31)	48 000 000	48 960 000
Equity (Dec 31)	2 000 000	2 040 000
Free cash flow (FCFF)		2 060 000
Enterprise value (Jan 1)		25 750 000
Equity value (Jan 1)		**minus 22 250 000**

Option 1 and its financial evaluation

- Transfer of the Freezer project as part of a plant as an organized set of assets, rights and liabilities, as a whole, under which, under the conditions laid down by law, the whole of such a set, including the relevant employees, passes to the transferee (subject to the relevant legal conditions)
- The Freezer project is a separate organizational unit
- The issue here is: Loss of AB, s.r.o. In the amount of the difference between the realized selling price and the net book value of the Freezer project recorded in the financial statements of AB, s.r.o.
  - Book value of the Freezer project as of Dec 31, 2016 = 50 000 000 CZK,
  - Loan associated with the Freezer project as of Dec 31, 2016 = 48 000 000 CZK
  - Income based fair value of the Freezer project at the level of invested capital as of Dec 31, 2016 = 25 750 000 CZK

The result: Insolvency of AB, s.r.o. in the form of over-indebtedness

Option 2 and its financial evaluation

- Separation of the Freezer project through spin-off which would result in further existence of AB, s.r.o. whereas a part of its assets (the Freezer project as part of its business enterprise) would be transferred to a newly created project company (SPV) with shareholder A (with a 50% stake) and shareholder B (also with a 50% stake) becoming shareholders of the SPV.
- Subsequently, shareholder B, on the basis of the share transfer agreement, would sell its stake in a newly created project company (now owning the separated Freezer project) at a purchase price agreed with the shareholder, with the shareholder A being the sole shareholder of the project company with 100% stake.
- The issue here is: The equity value of the SPV being established would not be positive
- Solution: Supplementing the registered capital of the SPV from other sources (at least to the statutory minimum level)

Option 3 and its financial evaluation

- Transfer of each individual asset, right and/or obligation belonging to the Freezer project from AB, s.r.o. to shareholder A
- Material issues: Risk of failure (disagreement with even a small number of creditors), administrative and time requirements, financial difficulty
- Economic issue: AB, s.r.o. making a loss given by the difference of
  - the sale price of the Freezer project and
  - the book value of the Freezer project shown in the financial statements of AB, s.r.o.

The result: Insolvency of AB, s.r.o. in the form of over-indebtedness

Concluding remarks

- Incompatibility of the going concern principle as understood in accounting/financial reporting and the insolvency legislation – professional examination of the state of the assets and liabilities with the need for revaluation is desirable, it is not just possible to rely on the financial accounting statements based on the Czech GAAP.
- In light of its conservative nature, the Czech GAAP is not capable of adequately reflecting the economic reality (compared to IFRS).
- An accent on the precautionary principle in Czech GAAP does not allow a real identification of the debtor's assets and its value generation potential.
- First of all, it is necessary to assess the fulfillment of the assumption of going concern and, depending on its fulfillment or non-fulfillment, then to choose the appropriate methods for valuation of assets and liabilities.
- Expert input is, therefore, needed not only on the cash flow test but also on the balance sheet (over-indebtedness) test because such information is not usually directly obtainable from the balance sheet.

Questions and discussion

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