
Valuation of Entrepreneurial Organisations Global View: A Review of the Factors Involved in Business Valuation for Strategic Purposes.

Mike Spark, Swinburne University of Technology, Australia

This paper notes past and present approaches to the valuation of an organisation, and assesses their adequacy and applicability for strategic organizational decisions, which may include purchase and/or disposal of the operational entity. It introduces a framework based on five categories of assets, including a People category to encompass the complex and diverse people-based factors that should be involved in valuation of the business. It proposes a more practical and comprehensive approach to business valuation than the currently acceptable (but rather simplistic) accounting-based version. The concept of Synergistic Capital (SC), a term coined by the author, is introduced. Its proposed relationship to the term Imaginative Capital (IC), a term starting to appear in the academic literature, is examined. The need for global consistency in business valuation is addressed, along with the need for further discussion and research on a worldwide scale to match the perceived global implications.

Objectives and Methodology

The primary objective of this paper is to stimulate more discussion on the role, benefits and methodologies of the independent valuation of businesses and other organisations, along with greater global acceptance of the uncertainties encountered when performing such valuations. It emanates from interviews with a range of interested parties (from Business Brokers to Company Directors and Accounting academics), and uses commonly used terms from business as well as the management and marketing literature.

Background

The paper derived from discussions with a well-known Australian business broker, Robert Hurst, on the problems of valuing the more entrepreneurial activities and enterprises with which business brokers are most commonly engaged. These (typically smaller) entities have limited past operating and financial data, along with less industry

precedent, on which valuers can base business valuation decisions, and hence they have to rely heavily on subjective valuation criteria (including, but not limited to, projections or estimates of future profitability).

However, the problem is not only the domain of smaller businesses. Speakers at a recent Australian Institute of Company Directors (AICD) seminar on Mergers and Acquisitions (M&A) confirmed that large corporate entities encounter similar difficulties in arriving at a "fair" valuation (Pringle, 2000). Nor is it simply a problem for one country or even a few. As global trade and investment continues to increase, the international implications need to be addressed, with globally workable approaches agreed upon.

Both business brokers and CPA firms typically use a methodology of ascertaining EBIT (Earnings Before Interest and Tax) and applying a factor (a number of years) to that figure to arrive at a value for the entity (Pringle, 2000). EBIT is the most commonly used basis of earnings capitalisation, and is determined after comparison with the "true and fair" accounting valuation, or "book value", of the business. This book value typically has to be suitably adjusted for one-off or extraordinary items as well as for unusual accounting treatments.

Current common approaches to assessment of an entity's value include:

- Discounted Cash Flow (common for capital investment purposes)

- Capitalisation of maintainable earnings (used for valuation of a private company or a division of a public company)

- Capitalisation of maintainable dividends (primarily for valuing minority shareholdings)

- Rules of thumb, e.g., percentage of revenue or number of weeks revenue (bakeries), and Realisation of assets (most commonly used for liquidations).

The majority of valuations appear to involve some form of capitalisation of future earnings (Hurst, 1999 and Pringle, 2000).

The human asset valuation problem is certainly not new. In 1922, Paton observed "In the business enterprise, a

well-organized and loyal personnel may be a more important "asset" than a stock of merchandise. At present there seems to be no way of measuring such factors in terms of the dollar; hence, they cannot be recognized as specific economic assets. But let us, accordingly, admit the serious limitations of the conventional balance sheet as a statement of financial condition". Henderson and Peirson quoted Paton in their 1975 accounting text at the start of a chapter dealing with Human-Resource Accounting, which went on to give examples of how some progressive firms in the USA had approached the vexatious measurement and reporting aspects. Chartered Secretaries were similarly exhorted by Lourens in 1976 to consider "Valuing Human Assets" in a proper and systematic manner rather than continuing to "seldom pay more tribute to the contribution by its labour factor than the cursory acknowledgement to the effect 'that our employees are our most valuable asset'...in most annual reports"

Top management had already been invited earlier (in the mid-1960's) by Hekemian and Jones in the HBR to "Put people on your Balance sheet... to optimize the use of scarce resources, human as well as physical". The calls were topical, practical and forward-looking, but mainly fell on deaf ears.

In more recent times, the Swedish school of Leif Edvinsson, Johan and Goran Roos, and Karl Eric Sveiby have contributed greatly to the theory and practice of valuation of Intellectual Capital. In Edvinsson's case, the theory was put into practice by the large Swedish financial services firm Skandia, and an informative book on Intellectual Capital was also written in conjunction with Malone (Edvinsson & Malone, 1997). The literature of the Swedish school has evoked a lot of comment, including a fiery negative one by Rutledge (1997), which is worth reading simply to provide some balance to the somewhat controversial arguments.

The paper wishes to provoke in-depth review of the assumptions used and methodologies employed to evaluate the measurement and reporting of organisational "health and wealth", and points to the need for reclassification and redefinition of the diverse components which together make up the perceived "worth" or "value" of a business. It is hoped that publication of this paper will not only lead to further definition and explanation of the full spectrum of factors (and not merely the physical assets!) which should be involved in the independent valuation of any organisation. It should also lead to further research and inquiry into *internationally acceptable* methods of business valuation, in particular those which embrace the currently missing link (the "People" factor).

In recent times, there has been much discussion in management journals regarding the need for the correct and fair valuation of a business so that all stakeholders' interests are fairly represented (i.e., not just those of the seller).

There has also been increasing attention given in the business media (as in the Director, the journal of the AICD) to the need for self-regulation by business - or risk, in its absence, the imposition of regulation by government. Such self-regulation should ideally ensure that transactions and trades occur openly and not only have commercial gain to the participants but also provide society with financial and social equity benefits.

The increasingly high prices being paid globally for hi-tech stocks (and Internet stocks in particular) have set many unhealthy precedents. These stocks can in reality be quite risky investments for the growing number of relatively uninformed individual investors now being lured by widespread media promotion into equities markets. The attraction is typically on the basis of "estimated" high returns and the supposedly "assured" long-term growth rates of the investments. The share prices traded appear to be totally out of proportion with the value of the physical assets involved and cannot in any way be justified by their profit records (or, for most Internet stocks, their consistent record of losses).

Past Bases of Valuation

In the past, the many issues involved in the valuation of a business have been clouded or ignored by its being regarded by most managers as primarily an accounting problem. I remember (as a newly graduated young accountant in the 1960's) being confronted with the reality that people did not simply pay the "book value" (as determined by the proper and consistent application of accounting standards) to arrive at a "true and fair" view of companies being traded, sold or merged. Very substantial payments, often in multiples of the accounting figure for Equity or Shareholders' Funds, were being made over and above that magical accounting "Book Value" figure. It brought clearly into focus for me the fact that accounting principles and techniques were only designed to provide consistency of approach with respect to data collection and manipulation, and had little to do with giving an accurate representation of what was happening in the business or "real" world.

The taxation aspects of valuation again show the difficulty of determining what may be considered "fair market value". In the USA, Palaszynski and others report, under Fair Market Value for Estate and Gift Tax Purposes, "According to Treasury Regulations section 20.2031-1(b), and as restated in Revenue Ruling 50450, fair market value is the amount at which the property would change hands between a willing buyer and a willing seller when the former is not under compulsion to buy and the latter is not under any compulsion to sell, both parties having *reasonable knowledge* of the relevant facts.

This one sentence contains a world of insight as to what Congress had in mind as acceptable asset valuations for tax purposes. There are three basic premises: a willing buyer and seller, no compulsion, and *reasonable knowledge*.The third major item in the definition is *reasonable knowledge* of the relevant facts. Knowledge of relevant facts does not mean insider information. *Reasonable knowledge* is not the kind that might be obtained by auditing the company records. *Reasonable knowledge* is the amount of knowledge the average investor has before investing in the market. For example, how much knowledge does the average investor have before investing in a publicly traded stock? The average investor would not have performed due diligence as if (s)he were buying the entire company. Most CPAs will know more about the entity being valued than is contemplated in this part of the definition. Because of their extensive knowledge regarding the company, their opinion may be biased." (Palaszynski et al, 2000 - my italics) Discussions with Hurst (2000) on the often 4:1 degrees of discrepancy between accountant's valuations, depending on whether they act for the buyer or the seller, indeed show how bias can easily enter into the valuation.

However well the accountants feel they have fulfilled their professional duty for consistency in the application of accounting conventions, even given the difficulty of trying to have them conform to taxation requirements, they have generally ignored a multitude of important business factors in arriving at "book value" or the differential amount in the Balance Sheet called "Goodwill". The term Goodwill has been used to represent the difference between A) the net valuation of assets and liabilities assumed under the contract of sale and B) the amount actually paid in cash or kind to represent the total financial consideration for the deal. (One must note that the net valuation is not necessarily the same as the book value, and the accounting profession has often campaigned for diminishing the potential difference between the two.)

The accounting treatment of asset valuation and determination of goodwill has been often quite variable between industries and even between accounting practitioners and this variability has often been criticised (by management and government) for its lack of verifiability. However, it must be recognised that the final price determined by the seller and the buyer is (at best) a subjective assessment of the value of an organisation which owners and potential buyers regard as being unique in some commercial or organisational way. Indeed, if they did not attach some measure of uniqueness of value to the existing organisation, they could simply buy plant, materials and other physical assets needed and openly compete with the existing business! As every sale situation is, by its very nature, non-standard and/or unique in some significant respect (with the transaction timing and other factors unable to be replicated or repeated), verifiability is thus practically

impossible. Trust in, and reliance on, the resulting valuation arrived at by the accountant or business broker suffers accordingly.

The commonly accepted accounting conventions can never hope to accurately represent what is, in reality, a combination of many complex factors which should rightly be taken into account in arriving at a total transfer or compensation amount for an organisation. The total compensation amount is normally well in excess of the accounting valuation of the mere physical assets, and is mostly arrived at after long, intense and often personally confronting negotiations. Accounting principles and procedures (which demand certainty, consistency and measurability) were never constructed to take due account of these somewhat irrational, and difficult to measure, human factors.

In the 1970's, accounting professional bodies around the world attempted to come to grips with the more complex human valuation factors, and tried to introduce Human Resource Accounting principles. The human assets of the organisation were eventually deemed to be incapable of being consistently measured with a degree of certainty acceptable to the profession, and the professional bodies accordingly instructed their members to ignore the human factors in construction of accounting statements for the foreseeable future. The current Australian accounting standards maintain this stance.

This paper proposes that we must look further than the mere valuation of physical assets, with their assumed certainty of valuation (a position which is really only useful for accountants trying to account for transactions after their occurrence!). We must instead try to appreciate, determine and value (in some generally agreed way) the variety of factors (both physical and human) which make up the total consideration paid for the transfer, merger or purchase of an organisation as a going concern. Liquidation is deemed to be still relevant to this discussion, because while dissolution of the entity is assumed to merely concern itself with the realisation of physical assets, the human asset factors are currently ignored

The Five Factors

The valuation of an autonomous business or organisation depends on assessment of a complex mixture of various assets or factors of production – to simplify the analysis, I propose their representation by Five P's, namely: -

- Purse (representing cash or other similar assets),
- Property (including physical place or location)
- Plant (including equipment and inventory)
- Patents (encompassing TradeMarks, Copyrights and other legally protectable assets), and
- People (encompassing Intellectual Capital).

Valuation of the initial four categories to date has been dealt with generally satisfactorily, through commonly accepted market-based and/or legally prescribed registration and transfer mechanisms. The problem of valuation of people, and in particular the value of their labor-based and intellect-based efforts in helping to build a successful, saleable ongoing business, does not appear to have been addressed to date in an enduring or globally consistent manner.

To elaborate briefly on the five P's: -

"PURSE" encompasses all cash and monetary assets (Cash, Debtors, Investments, etc.). It is constantly and easily valued by reference to the existing range of money markets.

"PROPERTY," similarly, is also relatively easily valued as again the alternative uses are limited by land availability and by allowable applications thereon, and there are specialist real estate marketers constantly monitoring and tracking the value of this "real" property. Another potential "P" is "Place" (or the value attaching to a precise location) is a major determinant of the property value.

"PLANT" is relatively easily valued as the alternative uses for most industrial plant are limited and there are experts who assist in valuation of such assets. It includes all equipment and inventory categories needed to carry on the core activities of the entity.

"PATENTS" includes TradeMarks, Copyright and other legally recognised business assets. They have been recognised in accounting and legal terms for some time, but have generally not been valued consistently (at all in some cases, and badly in others). This lack of consistency has often resulted in substantial windfall gains to alert (and/or unscrupulous) buyers who purchase a business and then sell the intellectual property rights off to quickly recover their purchase price. (The definable and registerable output of people, Intellectual Property, is an indeterminate area recently discussed in both business and academic areas. It still awaits consistent methodology and global application with respect to apportionment and/or allocation of legal protection between person and corporation, along with the vexed question of determining a "fair and reasonable" valuation).

The fifth and final category, **"PEOPLE"**, is the one most fraught with difficulty from a valuation or recognition (in financial statements) viewpoint in accounting terms. There is no common methodology acceptable, even though people have been trying to formulate solutions in this area for a long time. A methodology is needed which effectively tries to value the inputs of person-based intellectual and physical skills to arrive at an acceptable value of the impact of those individual and team efforts in determining the value of the overall business, over and above the value of the physical assets employed in the business.

The expanding literature of entrepreneurship extols the additional value-added functions that people bring to improving the practice and profit of trade and business. However, the valuation of the expanded business value developed by the entrepreneur has only ever been accepted in accounting terms as being roughly akin to Goodwill, and valued by the accounting conventions mentioned above.

The Challenge and Onus

The problem we face from a Strategic Management viewpoint is more than just inserting figures into a balance sheet (i.e., the accounting approach to valuation). There are strategic implications attaching to the correct and justifiable valuation of the business. In prosperous times, the sale, merger and acquisition of ongoing businesses happens more frequently and at inflated valuations, mostly generated by optimism and fuelled by greed (in the form of promised higher than normal expectations of future profitability). In times of recession, businesses (and the people dependent on them) can go to the wall because of unrealistically low valuations of the true worth of the organisation. Short-term valuation assumptions and techniques based on a restricted single-discipline (i.e., accounting) approach are inappropriate and inequitable in these very dissimilar times, when the long-term and consistent viewpoint necessary for determining a fair valuation is often disregarded or even discarded.

If we are to make sensible and far-reaching strategic decisions about the direction and impetus of an organisational unit, we need better data on which to base such decisions. Impartial and verifiable data on the value of the business, in realistic terms and encompassing all relevant factors, is essential to an impartial reasoned approach to corporate decision-making.

The onus is on us as practising managers and academics to develop a business valuation philosophy and accompanying methodology which: -

- a) is inherently fair to all stakeholders and interested parties (not just shareholders),
- b) looks at organisations as holistic dynamic entities on a long-term basis, and (importantly)
- c) attempts to place some kind of overall monetary value on what is essentially much more than just a mix of property and physical plant put together in a particular location (i.e., tangible or visible assets).

The role of federal and state governments in the formulation and implementation of the business valuation policy and methodology will need to be extensive and ongoing. Not only will they be interested from the point of view of national and state social equity (as well as taxation flows), but governmental regulation and enforcement may

well be crucial to the full and prompt acceptance of any new approach.

What Is To Be Valued?

An entity is a composite of all of its talents and resources, and not just the talents of the entrepreneur or intrapreneur. It is successful as a result of the diverse skills of the many people who have been responsible in either a) developing products that give enhanced value to the user(s) and/or b) developing a series of transactions with customers and other stakeholders into durable and close relationships. Together, over an extended period of time, the human efforts and the material resources employed collectively constitute the entity's "competitive advantage", as described by Michael Porter. Sustainable close customer relationships leading to product innovation and superiority in the long term can well become the organisation's most significant "core competency", in Prahalad and Hamel (1990) terms.

In the last decade, marketing and management literature from Cranfield in the UK as well as a host of academic faculties in the USA has focussed less on Transaction Marketing and more on Relationship Marketing, engendering a whole new area of teaching and consultancy known as CRM (Customer Relationship Management). This modern approach to marketing recognises that the business relies on a succession of future income streams in order to survive and grow, and that generation of future income streams can only be occur from enduring customer loyalty through constantly and repeatedly satisfying the ever-changing market demands of consumers and users. The valuation of the entity must therefore be based on a reasonably accurate and verifiable assessment of those future income streams.

In the past, the valuation of physical assets and assessment of their potential in generating income streams has been primarily emphasised. There must now be more emphasis on recognising the impact that the People category as a whole have had on ensuring those future streams, and determining their fair share of the increased value of the organisation. This is very opportune in view of the global trend to higher growth rates in primarily people-based Services Marketing industries, typically at the expense of more traditional Product-based industries.

An Assumed Accounting Approach

One could propose that an assessment of the "book value" of people (to use common accounting terminology) could be based on the total of moneys invested in them over time by way of training programs and higher levels of education. However, it is known and accepted that not all

education and training results in perceivable or measurable productivity to the person individually or the employing firms. Indeed, much of the benefit of higher education flows to the community, rather than the student, by way of different social attitudes and consumption behaviour (Chipman, 2000). Chipman's article in Quadrant illustrates the differing views on the value of higher education efforts, and gives some selective data. An accounting-oriented approach cannot attempt to deal with the diversity of inputs and outcomes of education and training with respect to their personal contribution to either the nation's or the entity's success. The problem is accentuated when one considers global differences in needs, culture and business environments.

Further, questions of how to deal with a) the transferability of human "value" between firms and organisations employing an increasingly mobile workforce, and b) the problem of determining the levels of "knowledge obsolescence" in an increasingly dynamic and fast-changing technology-based global business environment, would be difficult to resolve. The accounting profession's stance on measurability tends to the valuation of human efforts on the simplistic basis that "what they're paid by way of wages or salary in an open market thereby constitutes value". In this view, a simple total of salaries will give an adequate valuation for the people assets of the firm as a whole. The approach ignores the synergy that comes from people interacting positively with each other and creating something "greater than the sum of the parts".

A Synergistic Approach

The increasing trend to smaller operational units, even by large global organisations in the form of "Intrapreneurship" programs and directions, lends hope for another approach, which of necessity does not attempt to value the individuals' efforts but tries to gauge the overall increased effectiveness and efficiency emanating from the combined human assets of the organisation. I contend that the future income streams for output of the small entity, team or group could be reasonably determined and compared to current and projected costs, any residual becoming "nominal team profits".

For these observed excess profits over the normal expectations for a comparable mix of human and physical resources within the same or similar industry, I have coined the term "Synergistic Capital" (SC). Such excess profits derive from the essentially entrepreneurial process of assembling, organising and coordinating human and physical assets in such a way that operational synergy (or a "supernormal" return) is gained from the process (i.e. $1 + 1 + 1 = 3.5$, for example).

This synergistic approach is somewhat analogous to the described practice of entrepreneurship over the last few centuries. The entrepreneur's return for his efforts has been categorised as the difference he/she obtained from the assembly of all factors of production in such a way that "super-profits" accrued to him from his liaison, control and coordination efforts.

Imaginative Capital

This "personnel asset valuation" approach can be refined and possibly implemented for a single autonomous business unit with a defined product/market, as then the impact of the team can be reasonably estimated by comparison with equivalent others. But what happens when the results are not just one-off outcomes of a unique blend of people and resources applied to a particular market problem? How do we deal with the valuation of organisations which constantly and consistently stretch their human and other resources in a constructive and fruitful manner to achieve "super" results, both on and off the Balance Sheet?

Many large firms have adopted flexible organisational structures and instituted a corporate culture that allows a questioning, creative, opportunistic orientation (or what would in a smaller external firm be called an entrepreneurship philosophy) to permeate throughout the organisation. The net effect is that many "intrapreneurial" activities are happening constantly at the same time, and that (more to the point) a constant and relatively controlled succession of such innovative outcomes and activities will inevitably lead to long-term market success for the larger firm as a whole.

The increased value accruing to the organisation can be classified as Imaginative Capital (IC), that is, the return to the firm for the time and money spent in continuously fostering the generation of the lower-level and one-off forms of innovation excellence described above as Synergistic Capital. 3M, GE and Microsoft, among many others, would be examples of organisations whose "market value" (as defined by stock exchange valuation) is many times higher than the physical assets by virtue of their innovation development systems and procedures, and their people-oriented philosophies and attitudes. This extra margin can be attributed to their ongoing professionalism and operational excellence in harnessing the intellectual and attitudinal skills of their management and employees over extended periods of time.

Determination versus Reporting

The question of *determining* business valuation is but one component of the need to re-evaluate our treatment of

operational (and hence saleable) organisations. The recent Swedish school of thought appears to have concentrated on the production of a large number of measures to assess the human capital, possibly giving too complex an appearance to the overall area. The other component, which is possibly harder to implement, is how to get some consistency in reporting the People assets. This is what the accounting bodies in the 1970's found was the main stumbling block to the introduction of what was to be Human Resource Accounting. Comparisons are necessary between firms (e.g., to determine fair market value for mergers, acquisitions and like inter-firm activities). Comparisons are also necessary within firms, to see which people are contributing to the entity's future and with what results. Domestic comparisons between reporting organisations can be facilitated by intra-national regulation and oversight and audit by the national accounting bodies and regulatory bodies. International and global comparisons can be expected to be more difficult because of the obvious differences in culture, business practices, reporting standards for both government and market purposes, etc.

What Do We Want?

Attention is again being given by sections of the accounting profession to the valuation of "the most valuable resource - measuring and managing intellectual capital" (Barsky & Marchant, 2000). It is also being readdressed by the management theorists and training gurus (Cohen & Backer, 1999). The predictable and real difficulty anticipated on the reporting side must not be allowed to deter academic researchers, governments and business people from joining together in the necessary process of re-examining the bases and assumptions on which business valuation is currently predicated. A workable globally acceptable framework must be found and agreed to by the majority of business reporting regulators, policymakers, implementers and users around the world.

And ..When Do We Want It?

The proposed re-examination is needed urgently, before the increasing pace of global trade produces more and possibly larger inequities in treatment, such as when businesses are sold or traded without adequate evaluation and in many global markets where even the currently acceptable but inadequate accounting and reporting practices are likely to be ignored.

It is also needed urgently to provide global guidelines for rational and reasonable treatment before the pace of implementation of e-commerce and other high-technology forms of performing domestic and international business increases.

The quickened pace of technology change the world is currently encountering will inevitably be sustained, and probably increased. E-commerce and other high-technology developments in both Computers and Communications (C&C) and Biotechnology industries will engender substantial changes in business operations of all kinds, which current valuation practices and procedures are ill prepared to cope with. A globally accepted solution must be found, and quickly!

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