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The increasing role of companies valuation in the modern world

Loss of direct control over companies by increasingly fragmented owners has led to the emergence of increasingly aggresive incentive systems, prompting the managers to take action in order to increase the rate of return on invested funds. The careers and salaries of managers are now determinated by their ruthlessness in restructuring companies, laying off employees, and short-term increase in company value.

Changes in value of a company may be due to its competitive position, or short-term impact of macroeconomic factors. Macroeconomic factors are independent of the company, but managers through their decisions may better or worse adapt to them. The correct valuation of assets is one of the most difficult problems that face the investors. When valuating a company, most often attempts at establishing the so-called market value of its assets are made.

One of the main problems is the pro-cyclical pricing of assets. This in turn strongly affects companies' financial results and deepens the crises. There is a need for specific approaches to the valuation of companies during a crisis.

Increasing enterprise value as a main objective of activity

In theoretical science, lively discussions of theorists and practitioners concerning corporate goals have been going on for years[8)]. Despite the vast literature, various schools of economics and very different views on these issues presented by different people, the capital market has a rather unique and simple approach to these issues. Investors are interested primarily in a rapid increase in the value of firms they have invested in.

Investors in the capital market do not behave as it could stem from different theories. The authors of different theories look at them as they would like to see them, and not, as they actually exist. For example, can be found institutional theories that present an approach under which the companies do not seek to maximize profits, but only strive to achieve satisfactory profits, allowing for survival in the long term. Only such gains are achievable in a world of uncertainty. In turn, the contractual company theory speaks of a set of goals. The agency theory indicates a discrepancy of objectives that might arise between owners and managers, and their different willingness to take risks.

Management of goodwill has become more and more popular in recent years. This is not just a matter of fashion, but also the consequence of the growing importance of capital market. Investors (business owners) count their money in the first place and expect a rapid return on the investment made. Enterprise value management has become the dominant mode of governance used in many companies around the world. This is a consequence of looking at business from the perspective of shareholders. Maximizing their wealth becomes the target of the business, the basis for investment decisions and performance evaluation of managers. These issues have been widely described, inter alia, by Rappaport[6], Stewart[7] and Black, Wright, Bechman[1].

Obtaining the right information allows for better determination of the prospects of a company. Assessment of this information has a decisive influence on the valuation of projects. Negative assessment of the macroeconomic situation results in a lower valuation of different projects. In turn, over-optimistic assessment often leads to an over-valuation of projects.

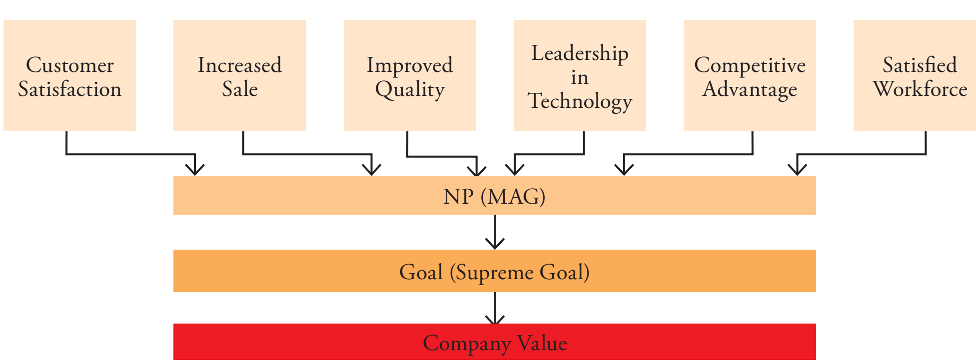
Value management includes rules, suggestions and solutions for making strategic and operational decisions with the objective of maximizing enterprise value for owners. It is often added, that also the interests of other interest groups affiliated with the company must be considered: customers, employees, suppliers, lenders, local communities and society. The result is that business managers must constantly ask themselves whether their activities contribute to an increase in goodwill. Ability to create value inherent in every action must take into account the highest possible value for shareholders. Otherwise, other managers may take advantage and try to manage the assets of an organization, as evidenced by numerous examples of mergers and acquisitions that have occurred in recent years[4], or changes in leadership positions in public companies.

Management of goodwill should indicate, in which areas investing capital would ensure the quickest return for the company. Hence, increasing pressure on the companies' boards of directors to implement value management systems. The very concept of value management stems from the essence of a market economy, as well as from the nature of human endeavour and enterprise. Business, thanks to the imagination, aspirations and desires of the people creates new demands and new markets for goods and services.

Understanding the aims of the shareholders (institutional and individual) is crucial from the point of view of decisions made by managers in order to increase the competitive position of a company. This applies especially to the competitive position in the process of raising capital necessary to gain access to knowledge and technology, needed for business development, mergers and acquisitions and consolidation of the company's position on the global market.

An activity makes sense only when the objective of the action has been correctly identified. Traditional microeconomic theory assumes that the main objective of activities is to maximize company profit. This is based on the assumption, that at a given

Scheme 1 **Company Goals – Capital Markets Perspective**



Source: Own. NP = Necessary Precondition, MAG = Means of Achieving Goals.

market a company, analyzing prices of factors of production, chooses such methods and scale of production, which together maximize the size of a profit. However, the modern theory of the firm, which is based on the relationship between the rate of return on capital and the risks incurred, points to maximization of the income of its owners as the main goal of an enterprise. This can be achieved by increasing the market value of companies, and dividends paid out of profits available for distribution.

Knight has created a theory of profit, which is the foundation for the theory of the firm. Profit, in his view, is a reward for risk that cannot be insured. Profit is a residue remaining, after payments for hired factors of production have been made and insurance premiums for risks, which can be insured, paid.

Often one can meet with another approach that indicates a number of other targets (goals theory), such as customer satisfaction, sales growth, or pure survival. A quite common situation occurs, when the objectives are confused with measures for their implementation. This may lead to a substantial primacy of measures for implementation of goals over the goals themselves.

Speaking about the goals, one must first determine from whose point of view these goals are being examined. Financiers look at goals from the point of view of the owner of the company, who bears the greatest risks. Employees tend to be more interested in their working conditions (wages) than the owner's profits. In turn, very often the politicians and scientists, who themselves never carried on any business, nor did invest their own money, see the company as an institution that should implement various important social goals (social mission of the company). However, the dynamic development of the capital market quite brutally verified this approach. The customer is only important when he permits the increase in the value of the company, especially in the short term. The development of capital markets and institutional investors contributed to a substantial reduction in the investment perspective.

Looking from the perspective of capital market it should be noted, that the main objective of managing the resources of a company is to maximise its market value by achieving the highest possible financial surplus on the invested capital, at acceptable risk levels. The crisis has shown, however, that the companies indeed try to maximize their market value, but not necessarily at an acceptable level of risk. No liability for decisions made often leads to taking excessive risk by managers. The threat of job loss, when confronted with the possibility of obtaining high bonuses for achieving an increase of the company value, will not deter managers from taking very risky decisions.

In many companies the transition from profit to increase in value, as a goal of activity, has been noticeable for a long time. This is mainly due to:

- dynamic development of capital markets,
- certain weaknesses of the concept that profit, as shown in company books, is a measure of success.

Situations, when companies presenting high profits go bankrupt because they do not have sufficient funds to settle liabilities, occur quite often. This is because they have unpaid receivables in their books, and their customers do not settle their obligations. On the other hand, also are known situations when loss making companies have enough cash to settle their obligations, and have no problems with liquidity and solvency. Profit making companies therefore, may go belly up, and those making losses may nevertheless function quite well. Loss does not necessarily translate itself into lack of cash. The company can benefit from advances, prepayments, etc. It is also important to understand the essence and the role of the so-called depreciation, as an element of the so-called non-financial costs.

Profit is the primary financial category, but its level is affected by a number of conditions, that cause that profit often does not reflect very well the true financial position of a company. Its level is an effect of the company's accounting policies. Various manipulations associated with costs and revenues sometimes take place. It is not possible to fully determine a company's profit at any given time. Analysis of cash flow allows for a far more complete evaluation of the financial situation of a company, and especially those aspects that cannot be fully explained by using the balance sheet and income statement. The cash flow report allows current and potential investors, borrowers and other users of information, to assess the amount, time and degree of certainty of occurrence of future cash receipts from sales, dividends, interest, repayment of loans, etc. Answering a previous question one may ascertain, that the situation is best, when a company is both profitable and has cash.

Revenue not always turns into cash, and this is largely independent of the company. However, there are situations when a company is faced with a choice, whether to go for greater profit, or keep more cash in the company. Such a situation may arise for example when the choice of a rate of depreciation is made. The higher rate of depreciation causes higher depreciation write-offs and higher costs. As a result, the company has reduced profits, but lower profit means that the income tax is also lower, and the outflow of cash from the company smaller. Conversely, a lower rate of depreciation results in lower costs and higher profits, but higher taxes and higher negative cash flow at the same time. Generally speaking, it should be noted that a company is usually interested in the earliest possible settlement of the expenses incurred for the purchase of fixed assets, or to put it otherwise, is interested in increasing depreciation rates as much as possible. This is consistent with the objective of increasing the company's goodwill. However, if the objective is profit because such is the incentive system adopted by the company for its managers, the situation will be reversed.

Valuation has several very important functions, mainly information, decision-making and negotiating functions. Development of capital markets has significantly influenced the increase in demand for business valuation.

The problem with the valuation of enterprises

It is often indicated, that various classes of assets are over-valued relative to their real or fundamental value. The correct valuation of assets is one of the most difficult problems that face the investors. When valuating a company, most often attempts at establishing the so-called market value of its assets are made. According to the International Valuation Standards, market value is defined as *the estimated amount for which the object should be exchanged on the date of valuation, between a willing buyer and willing seller in a direct transaction, after proper exposure to the market, and during which exchange the parties acted deliberately, prudently and without compulsion*.

A similar approach can be found in the standards of the European Group of Valuers Associations (TEGoVA), and the Universal Principles of Valuation in force in Poland. This approach aims to ensure objectivity in the evaluation. In the event of a large number of comparable transactions this objectivity is probably assured. The situation becomes more complicated when dealing with a large heterogeneousness of products, a small number of comparable transactions or restricted access to information.

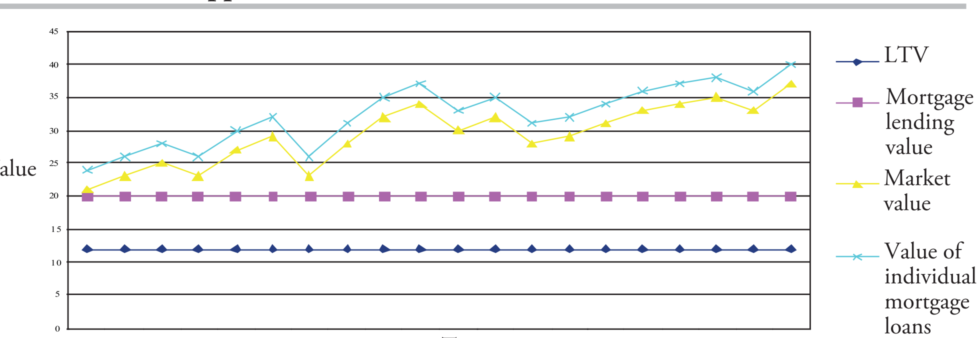
Another problem is that market valuation is made at a given moment. The valuer is trying to establish how much you can get, for example, for a given property at the date of valuation. For the bank it is more important to know how this value may change in the future, should any market distortions influence it. Banks usually solve this problem by obliging borrowers to perform periodical updated valuations. Another attempt to solve this problem is the concept of mortgage lending value (EMLV), a prudent assessment of the long-term, sustainable value of the property (regardless of the business cycle), without regard to speculative elements. The precursor of this concept is Germany. It is connected with a very strong position of mortgage bonds on the capital market of that country. Mortgage bond as a tool for long-term financing requires high investment safety. This is guaranteed under specific regulations, including prudent long-term valuation. In Germany property valuation cannot be higher than market valuation, in this case the market value of the property at the date of valuation. LTV in Germany may not exceed 60% of the mortgage lending value, which makes this segment very conservative, and gains during a property boom, as well as financial risk during a crisis, rather limited. In Poland, the guidelines to determine the value of the mortgage lending can be found in Recommendation F issued by the Financial Supervision Commission.

Whatever happens in the capital market has a significant impact on the value of individual company assets, and consequently, the company's book value. This is due, inter alia, to the necessity of making the valuation of the company's assets at the day of closing of its balance sheet. This applies for example to the valuation of investment properties. Companies using international accounting standards, and this applies to all public companies, must show the effects of changes in value of properties in their income statements. During the years before the crisis the value of these properties increased manifold, often causing several hundred percent growth of profit, value of assets, and book value of companies. Higher value of assets facilitated leveraging. When the crisis began, the situation reversed dramatically.

In accounting, the historical value is ever more often replaced by fair value, which is more important for investors. Historic figures were more secure, however (precautionary principle). We are, therefore, moving away from the precautionary principle and the realization principle, which include only the profits realized. The fair value also includes unrealized gains (gains on valuation), and therefore there is a lack of prudence due to accounting for uncertain and future events. Unrealized gains are not accompanied by a real increase in asset values. In the case of historical value, increases in value are not shown, only the decreases (impairment).

In the case of non-traded real estate another capital method is used, namely the replacement value, or the amount cor-

Draft 1 **Different approches to valuation**



Source: Own.

responding to the total cost of land acquisition and manufacturing costs of its components, taking into account depreciation (net replacement cost). Also in this case, changes in property market value lead to variability of the results.

Currently, there is a dispute going on within the European Union concerning the reform of accounting rules for banking and insurance. According to the proposal of the Council for International Accounting Standards, the assets which may generate income that can not be predicted (such as portfolios of shares, derivatives) would be subject to accounting in current prices (market value), which will undoubtedly lead to losses on assets during the bear market. This would have particularly negative consequences for banks engaged in large-scale investment banking.

Income methods, and particularly the discounted cash flow method, which attempts to estimate the value of future cash flows generated by the company, find wider use. The emphasis is put here on the ability of a company to generate income (profit, financial surpluses), and not on the book value of its assets. In applying the income method of company valuation it is assumed, that the primary motive of an investor is the income that he will receive on the capital invested. Income generated by the company in past periods is important only as a basis for forecasting future revenues. The problem in income valuation methods lies in the development of accurate predictions of future income. This is extremely difficult in an increasingly changing environment.

Changes taking place on the capital market have a significant impact on company valuation. All the issues raised here require a rethink. Shortening of the investment perspective makes predictions difficult. The forecasts are no longer reliable. Prediction for periods of several years becomes meaningless. It is difficult to establish reliable yields. It is difficult to assess investment risk. Analysis of financial statements and of the credibility of companies is difficult in this situation; especially when individual assets are valued by various methods, and each of these methods can give rise to serious doubts from the point of view of the valuation method itself, and from the point of view of different assumptions adopted under the different valuation methods as well. The increasingly quantitative nature of the valuation (using ever more complex models) makes some people quite certain, that the results of valuations are very reliable. This is very doubtful, even a kind of trap for the less experienced investors.

If a financial instrument is traded on a stock exchange, the basis of valuation is the valuation of the stock market. This assumption has huge implications, especially in times of crisis; then the values of the assets being valuated suddenly fall. Losses from valuation (unrealized) appear, leading to termination of credit agreements, or inability to enter into new loans (value of the collateral declines). Liquidity deteriorates, what may lead to bankruptcy. From the standpoint of public companies, the issue of the liquidity premium and the premium for control over the enterprise is also worth mentioning. Sale of securities with limited liquidity makes granting a discount to the buyer necessary, while the sale of stocks giving control over a company usually commands a bonus.

There is a need for specific approaches to the valuation of companies during a crisis. The different standards of valuation always indicate that a free decision of parties to the transaction must be the basis of valuation. The crisis often results, however, in a decreasing number of transactions, and those that are concluded are sometimes made forcibly.

Speculative bubbles have also this effect, that the capital market loses its ability to correctly valuate companies. The crisis leads to arise of the cost of capital in risk free assets, and the risk premium also grows immensely. The limited number of transactions becomes a problem, as there is no basis for comparison in valuations. The valuers react raising discount rates, and as a consequence the value of the assets valued takes a further decline.

In addition to the income methods, market (comparative) methods are quite commonly used, especially in the valuation of companies in initial and secondary public offerings, sales of companies to strategic investors, and in mergers and acquisitions. Here, again, we encounter similar problems.

The crisis led to lively discussions on the use of various options and their consequences. Correct valuation has become an important issue. Again, we are dealing with different approaches. Different models are commonly used. One of them is the Black-Scholes Model. The valuation of intellectual capital or other intangible assets is a major problem. You can use the real options valuation method, namely the valuation of events, opportunities that may arise in the future and bring tangible benefits to the company[9)]. It is a kind of variant valuation, which, given the increasing volatility of the business environment, has become essential. This method is not too widespread, inter alia, due to its complexity, and assumptions unrelated with the real world made in mathematical models[9)].

This large variety of methods has several consequences. Firstly, there is the question, which of those methods should be used. It is quite obvious that by applying different methods to the valuation of the same company, different results will be obtained. Some people do not care about that too much, and use different average values. Many approaches can be used, but it is impossible to prove that a valuation obtained in this way is the most appropriate. This gives great opportunities for those who want to manipulate company value. Market regulators and auditors have a problem verifying the valuations so obtained. Investors, in turn, often face a difficult situation on the market, when the same asset, at a given time, is valued differently, and therefore they have difficulties in establishing the rate of return and investment risk.

Rewarding short-term "success"

The salaries and bonuses paid to managers are causing most controversies in recent years. It is hard to explain to the man on the street, that companies that get into serious trouble and benefit from public support continue to pay huge bonuses. Salaries of CEOs of the biggest firms are often 200-300 times higher than the mean earnings of average workers. Several decades earlier the differences were ten times lower. Various options and bonuses constitute an increasing share of wages and salaries.

A report prepared by Attorney Andrew Cuomo indicates that Goldman Sachs, Morgan Stanley and JP Morgan paid U.S.$ 18 billion in various bonuses in 2008, which constituted over 20% of the Troubled Asset Relief Program. Citigroup and Merrill Lynch, whose loss in 2008 amounted to $ 27 billion, paid out, respectively $ 5.3 and $ 3.6 billion in bonuses. In nine banks surveyed the bonuses totalled $ 32.6 billion, while the total value of government assistance provided to these institutions amounted to 175 billion U.S. dollars. The highest bonuses were paid by Goldman Sachs; each of over 30 thousand employees of this institution received, on average, 160.4 thousand U.S. dollars.

The development of capital market and the desire to maximize the value of companies contributed to a number of incentive programs, that encourage managers to act consistently with the expectations of shareholders, namely to increase this value. Most owners are willing to pay managers additional sums in exchange for an above-average growth of goodwill. Incentive systems are ever more closely related to the increase in the value of the shares of a company. It is obvious that a properly functioning incentive system depends, inter alia, on developing adequate indicators that should be transparent and easy to monitor. Performance meters to measure management efficiency can be divided into short-term instruments, based on the static analysis of the book value of a company, and long-term, based on an analysis of models of growth of a company's goodwill. Each motivated person is usually assigned individual efficiency measurements, a target level of performance, and a method to tie the results achieved to the salary.

Most of these programs serve only one purpose – increase in company goodwill (increase in value of its stocks). Rewarding employees with shares makes them co-owners, and in theory this should contribute to the harmonization of their interests with the interests of existing owners. The belief that incentive programs will lead to a reduction in agency costs, or at least will reduce the cost of monitoring, underlies all these programs.

Analysis of the bonuses paid to managers shows that their level exceeds basic salaries manifold. This triggers a huge pressure on their behaviour. Obtaining a few bonuses makes a manager "set" for the rest of his life. It is naive, in such circumstances, to expect that managers will think long term. If in the longer term any problems arise they, with their bonuses, will survive. To say that managers are ruthless and have no principles is, in a sense, justified. From their point of view, however, they act rationally. Solutions functioning on the capital market do not leave them much choice.

The wide dissemination of these programs means that the ownership structure is further fragmented. The investment perspective is shortened even more. Sham operations, or manipulation of information to show that the objective is realized, appear very often. The desire to obtain a high bonus leads to a variety of frauds: moral hazard, manipulation of information, "creative accounting", etc. Various incentive programs that were designed in order to reduce agency costs may, in certain circumstances, lead to their growth.

The behaviour of managers and investors is affected by many factors. Various theories, ranging from the theory of rational expectations to different theories on behavioural finance, aim to describe the problem in detail. The market is so diverse that examples confirming any of the different theories may be always found. Many of these theories deal with various issues concerning the selection and acceptance of different risks. They can therefore be applied to the analysis of the behaviour of those investors, who invest their own capital and assume the risk of loss. The biggest problem of modern capital markets, as I see it, is the lack of risk (liability) of various decision-makers, who at the same time have very strong incentives to make risky decisions on behalf of companies, owners or lenders. Those who have huge capitals usually do not invest their money on their own.

Inadequate performance measurement, aggressive incentive systems, and the pursuit of material benefits led to various anomalies and imbalances (destructive greed and myopia), and consequently to a crisis. The effects of such actions are borne by others.

Development of capital markets was accompanied by a number of positive developments. New and numerous forms of financing enterprises appeared, while the cost of raising capital was greatly reduced. The decrease of financing cost did not apply to all companies, rather only to those with prospects for achieving a determined rate of return, at an acceptable – from the investors' point of view – risk level. This increased the pressure for better allocation of productive inputs, growth in productivity, competitiveness and in consequence – increase of company value. Unfortunately, at the same time short-term goals often prevailed – quick increase of the value of the company (share price growth) in the short run, withdrawal from investment, and quest for new investment projects, often in other countries. This contributed to shortening the investment perspective. Short-term activities aimed at quick profits become preferred. Resistance to making decisions whose effects will be visible after many years appears. The systems of manager evaluation and motivation favour short-term actions.

When rapid changes in the business environment occur, such behaviour has a major advantage – it forces a faster adaptation to changing conditions. There is a greater readiness to destroy the "old". Capital market development has facilitated excessive leverage and taking very high risks, by managers who are not cautious and at the same time are very strongly motivated towards such an approach. This resulted in positive effects (increase in profits and rates of return), just as long as the price of shares grew and the value of the property went up. Sooner or later this speculative bubble had to burst. These methods of management have brought, therefore, many companies to the brink of a precipice. In the present times of crisis mainly the threats are emphasized. But in discussing the changes in functioning of capital markets one must also keep in mind the positive effects of their development.

Investors expected the managers to perform – the only thing they wanted was rapid multiplication of money invested. A form of achieving this goal was an increase in the value of companies. Very aggressive incentives left managers little choice. The temptation was enormous (huge bonuses) and the risk limited. The risk was limited precisely because, as I mentioned above, there were instruments allowing the transfer of risk to other parties by using sophisticated financial instruments.

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