Ondernemend Waarderen : Waarderend Ondernemen. De subjectiviteit van het begrip economische waarde

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Summary

VALUING ENTERPRISE : ENTREPRENEURIAL VALUING
The subjectivity of the concept economic value

The concept of *economic value* is widely used, but poorly understood. This study takes the proper explanation of the concept of value, as derived from the economists belonging to the Austrian School of Economics, as a starting-point. The founding father, Carl Menger (1840 – 1921) became famous as one of the originators of what is nowadays called: the marginalist revolution. Menger observed a discrepancy between the theory of price determination and the way participants in the real world arrive at prices in the market process. He came to the conclusion that the old cost based theories of value are not able to explain the nature of value. In Menger's opinion the origin of value is marginal utility. Acting man is willing to sacrifice a good in return for a good that gives him more satisfaction. To put the actor centre stage means that value can only be understood from a subjective point of view. The marginalist revolution is in fact a subjectivist revolution.

In real life the concept of economic value plays an important role. From the founding of a company till its final closure questions about economic value are dominant. In the current finance literature several methods can be found, offering a solution to the calculation of economic value. In everyday life practitioners of corporate finance and business valuation calculate the economic value of companies and share capital. During the last decades a *mainstream* approach to business valuation developed. This study treats the question whether this *mainstream* approach is based on the ideas about value which developed in the Austrian School of Economics. If so, how? If not, is it possible to derive insights from the Austrian School in order to improve the way we value in daily life?

Based on five research questions – (A) which are the distinctive concepts of Austrian thinking; (B) how to base the notion of economic value on the distinctive concepts; (C) how is value determined by today's practitioners; (D) what are similarities and differences in comparing everyday practice with the Austrian concept of economic value; and (E) is it possible to improve on the way we value in practice by introducing Austrian based concepts? – the theoretical backgrounds and *mainstream* approach are investigated.

In order to understand the Austrian ideas an introduction is provided to acquaint the reader with their way of thinking. It was found that the key

elements of Austrian thought in this area can be broken down into 16 characteristic concepts. The concepts I thru IV follow from the creation of our universe and are labelled simple concepts. They form the basis of twelve so called composite concepts. The four simple components are: (I) time; (II) calculation; (III) object and (IV) subject. The twelve composite concepts are: (1) subjectivism; (2) praxeology; (3) uncertainty; (4) risk; (5) economic goods; (6) capital goods; (7) money; (8) market; (9) price; (10) equilibrium; (11) entrepreneurship; and (12) value. In this study the economic world is studied from the perspective of value.

Capital goods are pivotal in creating wealth. Based on the Austrian perspective only real savings can lead to the existence of capital goods. The real world is not like most textbook models featuring a circular flow. Man is able to create value and obtain a higher level of wealth. As an important sidestep a flow model, based on a so-called Petrinet, was constructed to show the growth creating character of capital goods.

In order to investigate the way mainstream economists and practitioners determine economic value a framework was developed to structure both the theoretical approach and everyday practice. The following five questions (chapter 4) constitute the framework: (1) the object of valuation and the specific purpose of that valuation; (2) the determination of the free cash flows; (3) the number of years for which free cash flows are determined; (4) uncertainty and the part of uncertainty that can be calculated; and (5) the calculation of the economic value. Two illustrative examples demonstrate how to calculate economic value based on Austrian principles. In the first example the strict assumption is made that an *Evenly Rotating Economy* (ERE) exists. In the second example this restriction is relaxed by assuming that the value is determined in a dynamic economic world.

The *mainstream* approach of valuation and three real life cases are presented on the basis of the five questions mentioned earlier. The three cases have various characteristics. The first case demonstrates the valuation of a company that will be the subject of a sale; the second case concerns the valuation of economic damages (the valuator involved acting as an expert witness to the court); and the third case treats the way a valuation is used in a dispute with tax authorities. Both the mainstream approach and the three cases are discussed from the perspective resulting from the ideas of the Austrian School.

The confrontation between the *mainstream* approach, the three cases, and the ideas of the Austrian School yields the following conclusions. From the four simple concepts the concepts of time and calculation need more attention. In practice little thought is given to the fact that time in real life is not infinite. Furthermore, it is overlooked that time and change are firmly linked. Current situations will not persist forever and economic subjects should be able to cope with an ever-changing environment. In calculations the most striking of observations is the very mixed character of the cost of capital. Not only methods which are questionable from an Austrian point of view are used, like the

Capital Asset Pricing Model, but there is a tendency to contaminate the concept of cost of capital with operational (risk) factors. The cost of capital should be kept free from operational risk as much as possible.

Taking into account the twelve composite concepts mentioned earlier, the following selection needs special attention. (1) Regarding subjectivism it seems that valuators are overlooking the subjective nature of economic value. This imposes a great danger on the parties involved. The determination of value for third parties should begin with a clear description of the position and situation of the subjects involved. (3, 4) Most people do not appreciate uncertainty, because it is impossible to calculate. Risk, as actuarial uncertainty, gets far more attention. The problem, however, is that the way risk is calculated is extremely doubtful. Economic phenomena are mostly of a discrete nature and that fact can be easily missed if one takes a purely mathematical or statistical approach. (6) The fact that our economy is based on a complex production structure should get more attention. Capital goods have a heterogeneous character. Furthermore, the entrepreneur combines specific capital goods for a specific purpose. Changes in the capital structure will cause changes in economic value. Valuators should pay more attention to this complex nature and its consequences. (7) In our world fiat money plays a dominant role. The problem is that the purchasing power of that money can be determined by forces outside the market. The interventions of central bankers are an illustration of this. If the unit of measure we use in determining economic value is false we cannot expect to arrive at correct answers to questions that help deciding whether or not to invest. The way inflation is treated in valuations should be improved. (8) The dynamic character of the market process does not receive the attention it requires. Markets make economic subjects aware of wants and the possibilities for satisfaction. Markets are necessary in order to generate prices and the markets allow observers to become aware of its negotiations and the prices they yield. Interventions create false signals and hinder the creation of value. (9) Due to the fact that prices are visible to outsiders they tend to play an excessively important role in matters of valuation. Some people might even overlook value completely and focus on prices instead. Prices are just the subjective outcome of a negotiation. Prices belong to the realm of economic history. Value, however, relates to the future. (11) Entrepreneurship is not a factor of production. It is a kind of alertness, which will be employed in the search for economic profit. The expected *free cash flows* are not gratuitous, but stem from voluntary deliberate acts in the marketplace. That requires people who are able to oversee the market and reach conclusions concerning the ways to profit from expected developments. (12) The calculated economic value has an ordinal character. The value of an object can only be determined by acting. When everything is at rest it is apparent that actors are satisfied with their current position and situation. No action is needed to improve on that. As soon as people act we are able to determine value, since the good sacrificed in the exchange is obviously of lesser value than the item acquired. Situation *A* is preferred over situation *B*. That is the ordinal character of economic value. Therefore economic value cannot be used as cardinal numbers. In everyday valuations more attention should be paid to the fact that economic value is expressed by an ordinal number. This means that potential alternatives and the connected opportunity costs should always be part of valuation reports.