

**Appendix D - UNIVERSITY HONORS PROGRAM  
SENIOR PROJECT - APPROVAL**

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PROJECT TITLE: VALUATION IN THE NEW ECONOMY

I have reviewed this completed senior honors thesis with this student and certify that it is a project commensurate with honors level undergraduate research in this field.

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Comments (Optional):

# **Valuation in the New Economy**

**Senior Honor Project**

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## **Introduction**

On February 15, 2000, Arthur Andersen hosted a live satellite broadcast titled Interactive Recruiters Broadcast. This film introduced a new method of thinking concerning valuation. Steve Samek, U. S. Managing Partner, presented Value Dynamics as a new way of looking at the value drivers of a company. Later in the semester, Dr. Jon Woodruff gave a lecture on the "Future Direction of Assurance Services." This lecture, adapted from thoughts by a KPMG managing partner, revealed the need for accounting methods to become adaptable to the New Economy that was ushered in by the Information Age. From this point forward, this project developed to examine the steps that accounting professionals were taking to adapt the reporting standards. Arthur Andersen published a book, *Cracking the Value Code*, explaining a new method for valuation in the New Economy. The concepts presented in this book are the basis for this project. Grasping the Value Dynamics model was the first step in the project. The application and evaluation of this model are the final stages of this project. Dr. Jack Kiger oversaw this process from beginning to end.

## Accounting in the New Economy

The dawning of the information age makes valuing a company more daunting than it has ever been. The traditional way of accounting for assets and understanding a client's business does not work effectively in the New Economy. The accounting system of debits and credits is over 500 years old. Can this method measure the true value of businesses today? This system focuses on transactions between third parties, not transactions occurring in the environment that affect the business. "A company's value is determined daily as millions of shareholders buy and sell its stock" <sup>1</sup>. Third parties or outsiders value a company by the price they pay for the stock. These shareholders look to numerous sources to find the information that helps them value a company. The gap between the book and market value of a company shows that the shareholders are not simply looking at a company's physical and financial assets. They are placing a value on the company's intangible assets that traditional financial statements fail to measure. As the economy shifted from the industrial age assets, intangible assets such as processes, brands, intellectual property, supplier relationships, and others appeared as the assets that are driving the New Economy. Greenspan said, "virtually unimaginable a half-century ago was the extent to which concepts and ideas would substitute for physical resources and human brawn in the production of goods and services" <sup>2</sup>. Accounting professionals must understand these "concepts and ideas" as an integral part of a company's value.

Arthur Andersen develops one way to approach valuing a company's tangible and intangible assets in *Cracking the Value Code*. This approach also proposes that understanding these concepts unlock the key to create value for the organization's stakeholders. The creation of value lies in determining what drives the value of a

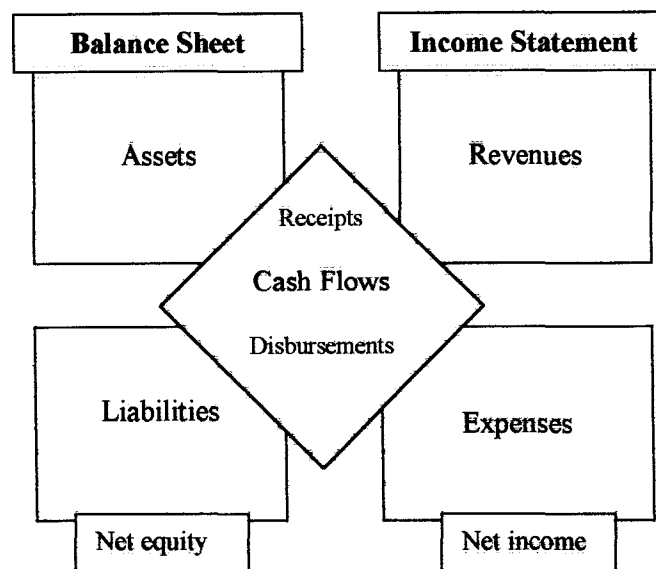
business. The current methods of reporting do not identify the value drivers. This model looks beyond the financial statements to see the value drivers of a company. The goal of this project is to grasp the concepts presented in Andersen's model and apply them to a smaller company. Will the concepts of understanding value hold true for a privately owned agricultural business? Can use of these concepts lead small organizations to create value for their stakeholders. This question is a true test of the flexibility and usefulness of Andersen's model.

The framework for testing Andersen's model is first to explain the model and then to apply it. The traditional methods must be understood before examining the new approach. Then, the project moves toward explication of the model. Incorporated in the model is an approach to assess the challenges facing a company. The next step is the application of the concepts to a relatively small manufacturing company. The final stage is the evaluation of the advantages and disadvantages of the Value Dynamics model to see if this model goes beyond the financial statements in identifying the value drivers of a company. An accounting professional, David Evans, is an integral part in the completion of the final two steps.

### **The Traditional Method of Accounting for Assets**

Over 500 years ago, a Franciscan monk developed the system of debits and credits to "keep accurate records of acquisitions and outgoings, in money and kind, and to expose any losses due to dishonesty or negligence" <sup>3</sup>. The joint venture owners wanted an honest account of how subordinates were spending their money. As the industrial age dawned, absentee ownership grew with the advent of the stock market. These tangible

assets consisted of inventory, machinery, building, land, etc. In the past, financial statements accounted for the assets that drove the value of the company. These concepts continue attempting to place a value on the companies of the New Economy. The balance sheet, income statement, and cash flow statement determine a company's "book value." Both management and shareholders depend on the information presented by these financial statements. Andersen presents a visual image of the traditional reporting framework.

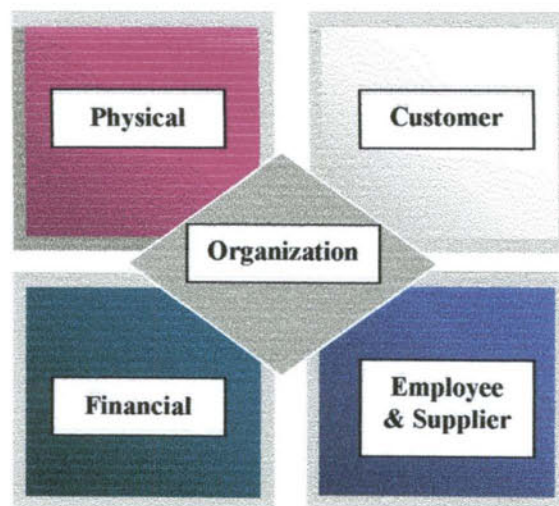


In examining this system of measurement, problems begin to surface. The balance sheet does not take into account customers, employee, or supplier assets. The balance sheet may account for a small portion of a business process in the form of a patent, but it does not account for other organizational assets such as leadership or corporate culture. In fact, the income statement expenses employees in the form of a wage and salary expense when employees are truly one of the firm's most valuable assets.

The real problem with the "book value" of the current system lies in the absence from the balance sheet of assets that drive a company's value. The value drivers are the assets that the outsiders, such as stockholders, consider in placing a value on the company.

### **Value Dynamics Framework**

Arthur Andersen seeks to "identify and classify appropriately the assets of our time" <sup>4</sup>. In order to assess a company's value, Andersen designed the *Value Dynamics Framework*. The creators base this system on five asset classes. While the traditional physical and financial assets are present, the system also includes customer, employee & supplier, and organization assets. Andersen presents a visual image to show how the asset classes fit together.



The premises that form this framework involve what assets include and how to handle them. The underlying assumptions are

- Assets are both tangible and intangible.
- Assets are defined more broadly as sources of future values.
- Assets are both owned and un-owned, controlled and not.
- Assets in each category produce outputs.
- Assets have distinct life cycles.
- Assets must be managed to create, rather than destroy value.
- Assets include internal and external sources of value.<sup>5</sup>

### **Physical Assets**

The first asset class in Value Dynamics is the physical asset class which includes inventory, equipment, buildings, land, and other tangibles. These are the assets measured on the balance sheet. Even though the balance sheet accounts for these assets, most are not measured at fair market value. Companies must look beyond the book value of these assets and to how the assets are working to create value. Every company, even virtual ones, needs physical assets somewhere along the way. The New Economy is not making these physical assets obsolete. Amazon.com still must depend on physical assets such as warehouses and equipment. David S. Pottruck highlighted the need for physical assets when he said, "It's a false dichotomy to think you're either doing business on-line or you're doing it in the old-fashioned way. We're all embedded in the real world."<sup>6</sup>

In view of this "clicks and bricks" economy, there is a continuing need for assessment of physical assets. However, the historical methods of accounting for these assets do not show how the assets are currently creating value. At this point, companies should go beyond the current reporting standards. With the advent of the Internet, many

of these assets are being actively traded. A current market value of the physical assets is relatively easy to obtain. To measure the physical assets for value creation, Andersen suggests measuring some key performance indicators (what drives the value of a company). For inventory, this measurement would involve considering inventory on hand, turnover, and carrying cost. For internal reasons, the company usually already tracks these indicators. However, these should not only be available internally, but they should report these in the financial statements presented to the external stakeholders

### **Financial Assets**

Financial assets are the assets that define a company's viability. In the Arthur Andersen model, financial assets include cash, receivables, investments, and "relationships with providers of debt and equity"<sup>7</sup>. The question to ask concerning financial assets focuses on how to use these assets to effectively create value. To answer this question, Andersen takes a different view concerning some assets. Cash, the most liquid of all assets, continues to be used in the traditional ways to create value. The value of receivables lies in a firm's ability to convert them to cash. Therefore, a company can create value with its receivables by minimizing the cash-conversion cycle.<sup>8</sup>

Companies can also create value by using investments in other companies. Investments, such as investing in technological companies, give a corporation rights to assets that would be too costly to create in-house. The greatest difference between a traditional view of financial assets and the Value Dynamic's view comes in the definition of debt and equity. Andersen does not consider debt as only a liability, but sees the "ability to issue debt as an asset."<sup>9</sup> Even though equity is not an asset, the view of equity is similar

to the view of debt. A company's ability to acquire capital through the issuance of stock is an asset.<sup>10</sup>

After recognizing how these financial assets create value, a company can quantify the value of these assets. For example, a company which minimizes its cash conversion cycle may be able to place a value on the use of this asset. Financial assets are probably the most easily measured assets because of the balance sheet and cash flow statements. Companies also have many other methods of examining financial assets such as the debt-to-equity ratio, return on investment, cash flows, receivable turnover, etc. This type of information should also be compared with information from external sources in order to give a clear assessment of financial assets.

### **Employee and Supplier Assets**

Beginning with employee and supplier assets, the Value Dynamics framework departs completely from the traditional framework. Under this heading, there are actually three areas of assets. Employees, the first asset, can define how customers view a corporation. Their view can either create or detract value. "The value of employee assets lies in their skills, knowledge, experience, and attitudes and is enhanced by an organization's ability to hire, train, motivate, and retain the best people."<sup>11</sup> The second asset in this grouping focuses on a company's suppliers. The value of supplier assets can primarily be found in the relationship with a supplier. Because of a company's potential dependence on a supplier, this asset has the ability to affect all other assets. The third category under this heading focuses on partner assets. Companies create value by decreasing risk and increasing market reach by using partner assets.

Each of these employee and supplier assets needs to be measured in some way in order to assess the value it is creating. The quantifiable measurement of human capital is extremely difficult because of its abstract nature. Internally, companies can look at employee turnover/retention, the recruiting process, and the employees' interaction in the culture. With employee markets growing, companies can also externally assess the "fair market value" of their employees through the Internet. Many companies are using scorecards or criteria to grade suppliers. Partner assets can be measured by the value of the physical and financial assets which the company has access to through the joint venture. Though these assets are difficult to quantify, a company will be rewarded if it strives to assess and use them.

### **Customer Assets**

Customers are the assets that truly drive a business. Without customers, businesses cannot sustain the other assets for long. Because of this asset's importance, a company must evaluate its customer assets. Andersen defines a customer asset beyond the simply final buyer. Customer assets also "include a company's channels and affiliates, because each is an essential link in the chain that runs from originator of a good or service to its ultimate consumer."<sup>12</sup> Corporations are placing greater emphasis on creating lifetime relationships with customers. Companies leverage their customer assets by pulling information from a large customer base in order to know their customers and learn to serve them better. Another part of this asset class is a channel, which is the medium between the producer and the customer. A channel includes direct mail, wholesalers, retailers, and door-to-door salesmen. The Internet is the one of the best

channels because it permits scalability, a corporation's ability to increase its growth exponentially. The final asset under this fourth class is an affiliate. Once again, the Value Dynamics model broadens the traditional view by characterizing an affiliate as an alliance even if it does not meet the technical standards. Drawing from an affiliate's customer base is an effective way to leverage this asset.

Because customer assets are realistically outside the control of a company, measuring these assets can be very complex. Companies should consider market share, customer satisfaction, and customer loyalty. Externally, companies can also observe how competitors are using their customer base. Are competitors gaining market share through innovative channels? Are they using affiliates to increase their customer base? The answers to these external questions combined with the internal information can enable a corporation to maximize its customer assets. Though these answers may not change the actual numbers on the balance sheet, they should be reported to give stakeholders a more complete view of the company.

### **Organization Assets**

Organization assets are the most difficult to identify, but they are the assets that potentially generate the greatest wealth. Andersen's organization assets include leadership, structure, processes, systems, culture and values, brands, and propriety knowledge. Leadership can control the process of value creation through designing and implementing strategy that capitalizes on all of a company's assets. Structure, centralized or decentralized, has an immense impact on the other organization assets. Processes are a company's activities that produce the final product or service. Improvements in process

can completely redefine a company's business. Michael Hammer states, "companies' processes [are becoming] even more important than their products."<sup>13</sup> Systems are the procedures that govern how a company functions. A system that enables a smooth flow of information will create value. Corporate culture has become part of the business language. However, developing a strong culture is a daunting task. Firms that have established an effective culture will have a competitive advantage that translates into value for all stakeholders. Andersen does not group brand assets under the customer asset class because "they relate as much to a company's ideas, culture, employees, and suppliers as to its customers."<sup>14</sup> The final organization asset is propriety knowledge or intellectual property.

Companies should look toward qualitative analysis in order to assess the value that is being created by organizational assets because of the limits of quantitative systems. In this area, benchmarking can also be an extremely useful tool. Assessing organizational assets has the potential to create the greatest value for the stakeholders.

### **Using the Value Dynamics Model**

The key to the Value Dynamics model is knowing your assets and optimizing them. The five asset classes are not independent of each other. A company can not choose to only pursue value through one asset class. The classes fit together in one framework, but there is no perfect combination. The Value Dynamics model is a tool to understand this combination. Andersen also introduces "Value Imaging" to present a visual representation of this new business model.

The New Economy introduces a need for companies to change their business models to optimize all of their assets. Analyzing a company's assets in the Value Dynamics

framework gives a comprehensive view of the value that the assets are creating or destroying. After this assessment, Andersen offers another model that leads a company to redefine its business in view of the Value Dynamics framework. Andersen illustrates the "four challenges of value creation."



- **Design your business model for value creation.**
- **Master risk in an uncertain environment.**
- **Manage your business as a portfolio of assets.**
- **Use information, measure and report all your assets.**<sup>14</sup>

### **Strategy**

In designing a business model, a company begins by examining all of its assets and how these are being used compared to the old and new competitors. The next step is to form an asset strategy using the information from the first step. Andersen lays out five strategies that are focused on assets:

1. Building assets by developing or creating new sources of value.
2. Enhancing assets through new techniques
3. Connecting assets to other assets
4. Converting an asset to a different function
5. Blocking a competitor from building a similar asset portfolio<sup>16</sup>

## **Risk**

In the New Economy, companies that take risks create value for their stakeholders. However, these companies strive to master their risks. Risks include environment risk, process risk, and information for decision-making risk. Environmental risk relates to designing and implementing strategy, process risk corresponds to the third challenge of value creation, and information risk refers to gaining useful information. "Effective communication of risk-management strategies can change the perception (and value) of your company in the marketplace."<sup>17</sup> Therefore, companies can create value by managing risk. In assessing and managing risk, a company must consider all assets in the Value Dynamics framework. Finally, companies must combine strategy with risk management to truly master risk.

## **Processes**

Managing an asset portfolio mirrors designing the business model, but takes it to another level. After designing the business model, a company focuses on the processes that are supporting its objectives concerning the use of its assets. At this stage, a company must again look to competitors and its industry to broaden its view of processes.

## **Information**

Information is a key to value creation. Stakeholders demand information that reflects the current and future state of a business. Andersen sees the need for companies

to move toward an information system that "continuously measures and reports all assets at fair value to all users."<sup>18</sup> Information that goes beyond current standards will influence decisions concerning every step of the business model.

Value Dynamics is a new business model that claims to create value for its users in the New Economy. Andersen developed this model by focusing on the practices of successful companies. In the next section, the focus will turn from explaining the Value Dynamics model to examining whether the model can give insights to value creation for any type of company. The next section also addresses the issue of whether the costs of implementing the Value Dynamics framework would outweigh any benefits.

### **Application of the Value Dynamics Model**

To evaluate the principles of valuation presented by the Value Dynamics model, these ideas must be applied to a company other than the ones presented in *Cracking the Value Code*. After applying the model to a company, one can see the advantages and disadvantages of this model. David Evans, a manager at Crisp, Hughes Evans accounting firm, discussed his views of how to apply the Value Dynamics model to a manufacturing company that grosses approximately \$50 million in sales. This company is relatively small compared to the models. It is also a privately owned corporation, unlike Andersen's examples of publicly traded companies. David Evans began by answering a set of question I developed to assess the company in view of the five asset classes.

### **Physical Assets**

The physical assets that are driving the value of the company are manufacturing equipment and inventory. Other assets include the warehouse and the land. However, these assets do not hold a large amount of value because of their rural location. Raw materials, work-in-process, finished goods, and materials from outside suppliers comprise the inventory. Currently, the company is using its inventory efficiently because its finished goods are made to order. The sophisticated machines also work to maximize use of materials. For example, one of the pieces of manufacturing equipment is a laser that cuts metal sheets from a computer image. The computer identifies the most efficient way to cut all of the pieces needed from the sheet. However, David Evans also recognizes that these machines are more sophisticated than needed. Because of this deficiency, the machines are not being used as effectively as possible. In order to create more value using this area of physical assets, the company could develop more product lines that use the equipment more effectively.

### **Financial Assets**

The primary financial assets of this company are its cash and marketable securities. The company manages its excess cash through investments in securities. Their stock portfolio has grown to be an immense asset. Because this company does not issue debt to bondholders, it raises capital through borrowing while using the stock portfolio as collateral to finance the debt. This use of cash that affects the company's ability to finance debt is exemplary of value creation.

### **Customer Assets**

Without customers, no company can exist. The key to creating value with customer assets is to develop lifetime relationships with customers. In assessing this company's use of the five asset classes, David Evans identifies the company's customer assets as the core for value creation. One of the company's strengths is its ability to retain customers. Sixty to seventy percent are "very good repeat customers." This strength is due to its organization assets, which will be examined later. The company also uses its channel assets to create value. Its arrangements with distributors add to the value of the company's customer assets by effectively delivering the final product.

David Evans also recognizes a shortcoming of the company concerning customer assets. The company does not have a global marketing strategy. With the advent of the Internet, a global opportunity exists for this company. This shortcoming also concerns the Employee & Supplier Asset class. A sales force would be able to expand the customer base through a global marketing strategy.

### **Employee and Supplier Assets**

According to the Value Dynamics model, a company's ability to create value using this asset class rests on the employee's "skills, knowledge, experience, and attitudes" and relationships with suppliers. Though professional employees, such as engineers, are difficult to attract due to the company's rural location, the company is leveraging its employee assets to create value. The turnover is very low for the salaried employees because of a good working environment. Therefore, the company does not

need to focus its efforts on recruiting. However, the turnover is high for the hourly employees, but this is typical due to the nature of the work.

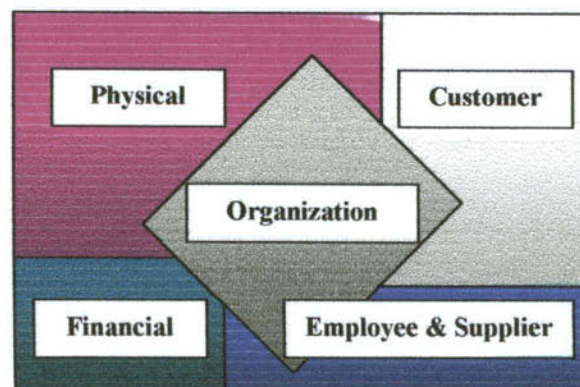
Companies who are using supplier assets to create value focus on building long-term relationships with loyal suppliers. This company maintains good relationships with a small number of suppliers.

### **Organization Assets**

Even though this asset class is the most difficult to evaluate, David Evans sees the company's use of organization assets as the easiest to identify. The president of the company is one of its strongest assets because his strength lies in developing strong customer relationships. The patents on the machine that the company makes are crucial to its success. Another organization asset is the company's brand value and reputation. In its niche market, many customers see this company as the best and only manufacturer for the machines it makes. The company's unique combination of leadership, patents, processes, and culture create value through a competitive advantage.

### **Value Imaging**

Assessment of each asset class separately produces a picture of the firm's combination of assets that maximizes the value of the company.



### **Professional View of Value Dynamics**

After evaluating a company in terms of Value Dynamics, David Evans gave his view on the overall use of the principals given in the Value Dynamics model. He recognizes the model as useful to identify the value drivers of a company. However, the model cannot be used to value a company's worth because the tools are not available for connecting the effects of the Customer, Employee & Supplier, and Organization Assets to the bottom line. He sees the bottom line for valuing a company in two ways. One way is to value the company in terms of the fair market value of the balance sheet assets. If someone were to buy a company today and fire all the employees, the company's worth would be the market value of the assets. The second way to value a company is the present value of the cash flows that the company expects to make.

Value Dynamics cannot place a value on a company because currently there are no tools available to quantify three of the five asset classes (Customer, Employee & Supplier, and Organization Assets). A tool that would directly tie the affect of using these asset classes to the bottom line would revolutionize the current methods of accounting. For now, however, the three asset classes that are not reported on the balance sheet could become required disclosures. Reporting the size of the customer base, criteria for suppliers and employee turnover gives the user of the financial statements a broader view of the company.

## Conclusion

The changes in the New Economy call for changes in our current standards of accounting. *Cracking the Value Code* presents Value Dynamics as a model that points to the true value of a company. This model does identify the assets that drive the value of a company, but does not place a value on these assets. Because the current tools of measurement for the asset classes have not caught up to the importance of these classes, a new standard of reporting is not yet available. As technology advances, however, new tools could be developed that measure Customer Assets, Employee & Supplier Assets, and Organization Assets. These tools could yield specific results that would affect the creation of value for every company from the Fortune 500 corporations to the privately owned rural manufacturing companies. The principals set forth by the Value Dynamics model open our eyes to the possibilities of a revolution in the accounting industry.

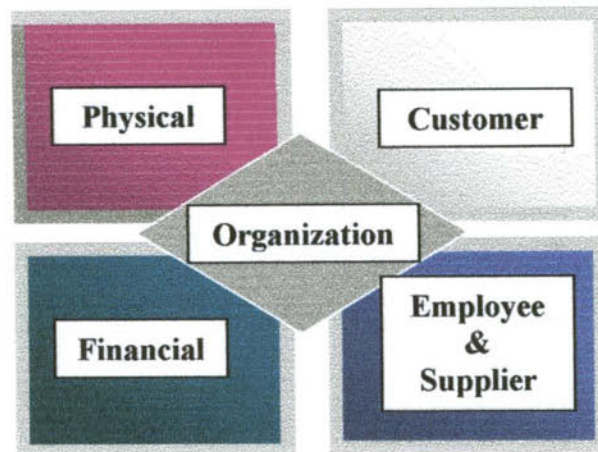
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## Appendix A

### Value Dynamics Summary

In view of the New Economy and the changing needs of stakeholders, Arthur Andersen designed a new business model that "makes it possible for managers to better identify and leverage all of the assets essential to success in the New Economy--intangible as well as tangible." The Value Dynamics Framework focuses on five asset classes: Physical, Financial, Customer, Organization, and Employee & Supplier.



- Physical Assets include inventory, equipment, buildings, land, and other tangibles.
- Financial Assets include cash, receivables, investments, and "relationships with providers of debt and equity."
- Customer Assets include the final buyer, the marketing channels, and affiliates
- Employee and Supplier Assets are employees, suppliers, and partners.
- Organization assets include leadership, structure, processes, systems, culture and values, brands, and propriety knowledge.

The starting point for this model is to identify all the company's assets. The next step is to assess how the assets are currently creating value for the company. Included in this step is the need to evaluate how competitors are leveraging their assets. In evaluating these company assets, there is also a need for companies to move toward an information system that "continuously measures and reports all assets at fair value to all user." Information that goes beyond the current standards will influence decisions concerning every step of the business model. Once this evaluation is complete, the company can move forward in designing a model that would maximize the use of all assets to create value.

In examining some of the most successful businesses of the New Economy, no single business combination is the magic key to create value. The common thread running throughout successful companies is ability to create new business combinations using all assets in the five categories effectively.

## **Appendix B**

### **Value Dynamics Questionnaire**

#### **Physical Assets**

One way to create value using physical assets is to eliminate as many assets as possible. Dell exemplifies this idea by focusing on inventory velocity and number of days of total inventory.

To assess use of physical assets, the company could examine inventory on hand, inventory turnover, inventory carrying cost, fixed asset investment, return on assets, machine utilization, square feet office space, growth in office space, and occupancy.

- What are the physical assets of the company in broad terms? (inventory, land, buildings, etc.)
  
- Could these physical assets be used more effectively? How?

#### **Financial Assets**

Creating value through financial assets includes minimizing the cash-conversion cycle for accounts receivable. Andersen also considers the "ability to issue debt and equity as assets."

Methods of examining financial assets include investment value, free cash flow, days of receivables, debt-equity ratio, return on investment, and cash flow per employee.

- What financial assets are creating value for the company?
  
- How does the company view the ability to issue debt or equity (as a liability or as a potential asset)?

## Customer Assets

The key to creating value with customer assets is to develop lifetime relationships with customers. The value of customer assets depends on customer loyalty and the number of customers. Manufacturers can also use the merchandise channels to create value. For example, Duracell's "channel assets are the products and services developed by other companies" that run on the Duracell battery.

Number of customers, customer satisfaction, number of complaints, number of channels that use the product, and market share can be used to evaluate customer assets.

- In what ways are customer assets a key to value creation for the company?
- How can the company use more effectively customer assets such as channels to deliver the final product?

## Employee & Supplier Assets

This asset class focuses on creating value through employees' "skills, knowledge, experience, and attitudes" and relationships with suppliers. Companies who are using supplier assets to create value focus on building long-term relationships with suppliers with loyalty.

Tools for assessing this asset class include number of employees, employee turnover, recruiting costs, number of suppliers, strategic criteria for suppliers, and ability to change suppliers.

- How is the company currently leveraging employee and supplier assets?
- Could employee and supplier asset be used more effectively? How?

## Organization Assets

These assets can potentially generate the greatest wealth. One asset that is creating value for manufacturing firm is the process by which the firm creates the final product.

This asset class is also the most difficult to evaluate, but companies can examine leadership, competitors' processes that are creating value, patents, systems unique to the company, and the culture and values of the company.

- What are the company's current organization assets? (i.e. leadership, unique processes, culture, etc.)
- In the manufacturing industry, what are the organization assets that are crucial to success?
- What are organization assets that the firm could work toward gaining?

Creating value for a company using this business model does not mean that the company must focus on only one asset class. The company should find the combination that maximizes the value of all its assets.

- What combination of assets is the company currently using?
- What combination of assets are competitors using to create value?

**This set of questions focuses more on the specifics of Value Dynamics.**

1. What are the drawbacks of using Value Dynamics? (cost versus benefit, no exact measuring techniques, etc.)
2. What assets should definitely be included in a business model? (physical, financial, customer, employee & supplier, organization)
3. Would some areas of this business model be less useful than other areas?

**This set of questions deals with broad evaluation of Value Dynamics.**

1. Is there a need for a new business model for the New Economy or would a new model only be beneficial to the large technologically oriented companies?
2. Could Value Dynamics be applied to small businesses to create value?
3. Do you foresee a revolution in the accounting profession moving toward ideas like Value Dynamics?