Ivey Business Journal

IMPROVING THE PRACTICE OF MANAGEMENT

The search for moral capitalism and the Holy Grail of business valuation

By Stephen B. Young

Reprint # 9B04TB09

IVEY MANAGEMENT SERVICES • March/April 2004

The search for moral capitalism and the Holy Grail of business valuation

Critics often contend that capitalism will never be able to reconcile the public good with the self-interest of the firm. But this author clearly and persuasively argues that it is possible and desirable to be concerned about the public welfare and pursue profitability. Such a form of capitalism can be a moral one, less deserving of criticism on the grounds of social justice.

By Stephen B. Young

Stephen B. Young is the Global Executive Director, The Caux Round Table, an international network of business leaders working to promote moral capitalism. He is the author of *Moral Capitalism: Reconciling Private Interests with the Public Good* (Berrett Kohler, 2003).

Business decision-making is driven, rightfully, by valuation analysis. The prices of inputs, the return on capital, the value of a product or service in the minds of consumers and customers, calculations of gross and net profit margins, and similar financial considerations provide a workable intellectual framework for market capitalism. Using such data permits sound decisions to be made for at least short-term success.

But a question has been asked of capitalist decision-making almost since Adam Smith's treatise, *An Inquiry into the Origins and Causes of the Wealth of Nations*, came off the press in 1776: Are such micro-economic calculations of intersecting supply and demand curves sufficient for the sustainable success of free-market individualism?

Some in the tradition of Karl Marx look to the advantages that capital has over labor to argue that free markets lead to unjust outcomes in the short run and to the collapse of demand in the long run. Others object to the self-seeking motivations that seek one-sided outcomes from market dynamics. Still others point to the externalities - the costs to others, such as communities and the environment - that are not included in the prices used by business to calculate their profits as grounds for regulating private business while enhancing public interests.

The argument is therefore made that capitalist calculations of value may work well for the owners of capital, but, to the contrary, do not embrace a more encompassing range of values that are needed for sustainable social justice. Private business is placed by these critics in permanent and contumacious opposition to the public good.

This opposition to capitalism would naturally evaporate if it could be demonstrated that business decision-making, though driven by self-interest, did, in fact, embrace vital externalities of consequence to the public interest. Those, like me, who believe that free market capitalism should be the economic system of choice are searching for a Holy Grail of analysis, one that would resolve the contradictions between capitalist valuation techniques and other ethical and moral frameworks of concern.

The end of inquiry should be an integration of virtue and self-interest. Self-interest emphasizes the internal rationality of capitalist calculations, while virtue brings into consideration needs and concerns external to the intersection of supply and demand curves. Such a Holy Grail of valuation is a theory of the firm that aligns stakeholder concerns with the strategic needs of owners of capital.

Why seek the Holy Grail of valuation

The importance of finding such a Holy Grail of valuation is twofold. First, at the level of politics and struggles over social justice and economic regulation, the Holy Grail would tilt the argument in favor of private-sector autonomy and the freedoms of capital accumulation. Second, at the level of the firm, the Holy Grail would guide management towards sustainable profitability.

Let us consider the application of a more strategic understanding of business success to business decision-making. In his books *Built to Last* and From *Good To Great*, Jim Collins demonstrates that certain approaches to business lead to greater sustained success than others. In particular, he suggests that using a "both/and" analytical capability rather than an "either/or" mindset maximizes returns, and so the capitalized value, of the company. The same approach produces higher quality returns that have greater certainty and less risk volatility.

Concern for reputation is indeed a concern for the values of customers, but simultaneously shows a concern for the firm's profitability

The "both/and" analytical capability implies the possibility of integrating virtue and self-interest within the world of business rationality.

Should returns increase in quality - lowering expected risk - then the wealth creation of business can be maximized. High risk correlates with expected high returns but not necessarily with maximum value. In a high-risk environment, risks may be expected to materialize and destroy yields. Stability and certainty of returns seem more likely to induce investment and growth of enterprise than the converse possibilities.

In addition, the integration of external factors into the cost and capitalization equations would forestall "surprises" - social and political events arising in political and social arenas that have an unexpected - and negative -- impact on the firm's profitability. We have recently seen the workings of such externalities in the cases of Enron, Tyco and WorldCom. The manipulation of financial reporting at Enron was an unexpected development external to the risk/return calculations of participants in the market for Enron stock.

Adverse consumer reactions to Shell's practices in Nigeria or Nike's use of Korean sub-contractors in Vietnam were also negative factors impinging on the internal expectations of profit of those companies. Both Shell and Nike had to respond with new and more costly ways of doing business in order to sustain customer good will.

The Holy Grail: A comprehensive approach to value drivers

Business success - more in the long term than in the short run - flows inexorably from various value drivers. (see, Samuel Di Piazza and Robert Eccles, *Building Public Trust*) The totality of value drivers for a firm includes more than the pricing considerations of micro-economic calculations. The intangibles of changing consumer preferences, labour productivity, employee loyalty, brand reputation, social capital environments, to name only a few, will play more to enhance sustained profitability than will marginal and average costs of production alone. The capacity, for example, of brand distinction to lift a product out of the inevitable descent into commodity pricing can have a great impact - one way or the other - on the long-term revenues of a firm.

In my recent book, *Moral Capitalism*, I suggest that every firm has eight arenas of value drivers.

- A firm relies on five forms of capital: social, reputational, finance, physical and human.
- A firm must convert capital into a product or a service in its core business operations
- A firm must have output - a good or a service
- A firm must have customers

A failure in any one of these arenas will lead to the failure of the firm. The totality of value drivers determines the capital value of the firm. Consideration of all value drivers is the Holy Grail of enterprise valuation.

Certain value drivers in particular make reference to external concerns. Incorporation of these value drivers into the firm's internal calculations imports public goods into the dynamics of firm self-interest.

For example, social capital accounts look to the levels of education and trust in a society, and to that society's quality of contract enforcement and rule of law. These are factors external to a firm, but determinative of its commercial success. As one of my friends once said: "We will do business in Singapore but not in Sierra Leone." The government of Singapore under Lee Kwan Yew's leadership has been working diligently to improve Singapore's social capital for 40 years. As a result, Singaporeans enjoy one of the highest standards of living in the world.

The better way, therefore, to envision a firm is to see the business as a (hopefully) never-ending circular flow of capital mobilized for production of goods and services sold to customers for a profit which is then used as a return on the various forms of capital used in production

Reputational capital measures a firm's market power in an important way. How strong is the pull of its good will? How loyal are its customers? What pricing premium does its brand support? Concern for reputation is indeed a concern for the values of customers, but simultaneously shows a concern for the firm's profitability.

A firm's human capital accounts look to the intangibles of employee loyalty and productivity, creativity and expertise. With low human capital accounts, a firm is not well positioned to survive market upheavals. Taking into account the preferences and needs of employees and treating them with respect and not as a cost only will improve a firm's capacity for long-run success. The self-interest of its owners converges with the virtue of doing right by its employees.

The quality of a firm's output also embraces external variables. If the product or service is defective or leads to serious consequences (tobacco to death from lung cancer, or dumping pollutants to legal restrictions on manufacturing, for example), those further consequences can increase a firm's costs or cost it market share.

The Holy Grail of business valuation demands a full accounting of the positive and negative vectors associated with all value drivers.

A new Theory of the Firm

Once we look at a firm as the sum of its value drivers, we have in effect a new theory of the firm.
We will no longer consider a firm only in micro-economic terms, as an intersection of cost of production with the meeting point of supply and demand curves in a market responding only to the utility curves of self-centered, rational-choice theory. That model of a firm is too close to a one-time sale to be of much help in assessing the firm's capacity for sustainable profitability.

A firm must be more than a transaction; in a transaction, you can take the money and run giving little or no concern to the future consequences of the negative externalities arising from one's conduct. A firm - if it is to have capital value - must stay in business over repeated cycles of production and sales. A firm is a series of transactions, happening one after another over time. Only the cumulative returns of many sales give capital value to a firm.

The better way, therefore, to envision a firm is to see the business as a (hopefully) never-ending circular flow of capital mobilized for production of goods and services sold to customers for a profit which is then used as a return on the various forms of capital used in production. The business must make enough profits to ensure that it can pay enough for its forms of capital to ensure the continual supply of capital and other inputs.

The successful enterprise is a revolving process, not a one-way journey seeking only the payout of ownership interests. Any robust theory of the firm must reflect this dynamic of continuous profitability.

Accounting and measurement of firm profitability

A theory of the firm divorced from the measurement of results would provide little help in managing an enterprise. Unfortunately, traditional accounting conventions and categories do not embrace the full range of value drivers implicit in a robust theory of the firm.

New ways of recording and reporting relevant data are needed to make a conceptual Holy Grail of business valuation really useful to managers and investors.

What needs to be recorded is data bearing upon the positive or negative tendencies of the various value drivers supporting a firm's sustainable profitability, and the capital value derived from the size and quality of that income stream. Intangibles as well as traditional tangible financial metrics need to be included; some external variables need to be estimated objectively as well.

If one thinks of the sustainable profitability of a firm as a function of its "quality," then lessons can be drawn from the quality movement of the 1980's and the work of W. Edwards Deming for the design of more comprehensive metrics for measuring the Holy Grail of business valuation.

The quality movement looked to external subjective conditions such as levels of customer satisfaction and to statistics on production results to design management standards and benchmarks to improve the quality of output. In the United States, the Malcolm Baldrige Award developed a philosophy of inquiry to create a scoring system of management results not dependent on traditional accounting concepts and conventions. The Baldrige Award process asks first if a company has taken an "approach" to quality. Second, the company is graded on the extent to which it has "deployed" management goals to implement that approach. Third, the company is scored on the results it has achieved in meeting the goals set forth in its "deployment" strategy.

This overall approach to the assessment of a company's position vis-à-vis a key value driver like quality of product can be extended to other value drivers as well. A pro-forma comprehensive assessment of a firm's situation vis-à-vis all its key value drivers has been developed by the Caux Round Table. We consider this a self-assessment and improvement process to provide owners and managers with the data necessary to shape strategic decisions impacting value drivers in a positive manner. Further information about this process is available on our website: www.cauxroundtable.org

Integrating virtue and self-interest at the level of the firm is possible. Through management decision-making, capitalism can internalize concern for the public welfare without sacrificing the efficient rationality of seeking profitability. Such a form of capitalism can be a more moral one, less deserving of criticism on social justice grounds.