

How to Measure and Evaluate Financial Performance

Situation Anno 2010

It is not fair to kick somebody who is already down on the floor and gasping for breath, like today's banks, states and international experts. However, if we do not learn and react on what has happened, the next crisis will be around the corner and this time it will not help printing more money or - for states - borrow more and invest into infrastructure projects¹.

The Problem

The methods on how to evaluate a company's performance are very much focused on quantitative methods. "What gets measured gets done"², is the mantra taught today at most business schools all over the world. As a controller, my job was to calculate a Net Present Value (NPV)³ on future cash flows to find out which decision would give the highest return on capital. The risk was taken into account via the weighted average cost of capital, which means that the longer and riskier the investment, the higher was the capital cost calculated. So far so good you may say, but if we look into practice, factors like customer value, on time delivery and quality, company culture, framework for innovation and leadership are not taken into account, because these factors are "soft and can only be changed in the long run"⁴, therefore too complicated to account for in a NPV calculation. This ignorance of strategic qualitative factors can lead to wrong management decisions.

- Example from real life (1)

As a controller I was given the task to find out which one out of three "sourcing" units (factories) was to be closed in order to raise the supply

¹ Hiroshi Yoshikawa "Japan's lost Decade",
<http://www.juhtimine.ee/hiroshi-yoshikawa-japans-lost-decade>

² Barnevik ABB

³ Net Present Value as defined by Richard A. Brealey, London Business School and Stewart C. Myers, Massachusetts Institute of Technology

⁴ "Quintessenz des strategischen Managements", Nils Bickhoff, 2008 Springer-Verlag Berlin Heidelberg, p. 14.

efficiency by reducing the number of suppliers. The direct actual cost calculation gave a very clear message to close the factory in Finland and keep the ones in the U.K. and Italy. However, if you eliminated the impact of exchange rates (the Finnish Markka was at that time was very strong) and included qualitative factors like delivering the right product at the right time, time to reorganize production lines or increase/decrease production, the Finns were much better than the others! Since the managers at that time wanted to reach the end-of-year targets, no attention was given to my "total" calculation, however.

In Germany, 70 % of all professors in business administration⁵ say to believe in Shareholder Value⁶ and when studying to become a certified rating specialist, you are told to deliver solely data that are quantifiable, that is measurable. Although methods like Balanced Scorecard (BSC)⁷ and the philosophy of Shareholder Value do proclaim to consider long term value creation, the implementation on a corporate level is a different matter. MBO (Management by Objectives)⁸ and its further development BSC are usually regarded as a management tool using quantifiable indicators to get better control of strategic implementation on an operational level. In Germany, both methods are being seen as a top-down approach to improve efficiency, more stick than carrot, and are not being seen as supportive in improving qualitative factors like customer satisfaction, cooperation or employee motivation within the organisation⁹.

- Example from real life (2)

One of the world's leading companies in the sporting goods industry decided not to rebuild its sporting facility for the headquarters' 3.000 employees.

⁵ Handelsblatt 2008

⁶ Creating Shareholder Value: A Guide for Managers and Investors: The New Standard for Business Performance, Alfred Rappaport, Free Press, 1. Dezember 1997

⁷ Robert S. Kaplan and David P. Norton, 1992

⁸ Peter F. Drucker "On the Profession of Management",

<http://www.juhtimine.ee/peter-f-drucker-on-the-profession-of-management>

⁹ Untersuchung Mittelstand und BSC, IfM, 2007, Bonn

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Although highly profitable, it was decided to maintain the profit margin on a slightly weakening sports market and to increase the dividend at the cost of this investment into employee motivation.

It is not really worthwhile to criticise banks or management gurus about lending too much money and therefore building up a gigantic bubble economy based on easy credit and to build bonus or management systems that undermine this on a corporate level. However, the first question we have to ask ourselves is what kind of work and what kind of leadership do we want to promote? The second one is how can we measure or assess this and who should do this?

A society which wants to exist over time has to be righteous. This means there must be perspectives for its citizens to become part of a middle class through skilled and honest work. The outcome of this work must also be distributed in an efficient (low corruption) and economically reasonable way in order to avoid social unrest and tension between those who have less and those who have more. If this difference becomes high, the question will arise if this difference can be ethically supported. If not, there will be a conflict¹⁰ which may lead to a crisis. I think we have to ask ourselves this question today, in Estonia as well as in the rest of the world. When Peter F. Drucker (see above) introduced the concept of management after the Second World War in the U.S., the short term gain was evident. America had the highest industry output on earth and was the leading adopter of new technologies. In this phase, the only thing you had to do was to find a way to distribute these goods and services to the world markets. The managers were doing what they were paid for, administrate the existing resources as efficiently as possible and get those resources out on the (world) markets. However, last year (2009) General Electric sold its household goods division to investors and today GE is more an investment bank than an industrial conglomerate. If we take away the American exports of IT and financial services, there are hardly any American products left keeping world class quality standards! I think one of the reasons has

¹⁰ See the background to the French revolution

been the focus on short term financial goals and how quickly you can use existing resources to make a profit, on personal as well as corporate level. This focus on profit only, necessarily leads to a shorter investment horizon and therefore no financial allocation is made to keep or increase a strong competitive position in the future.

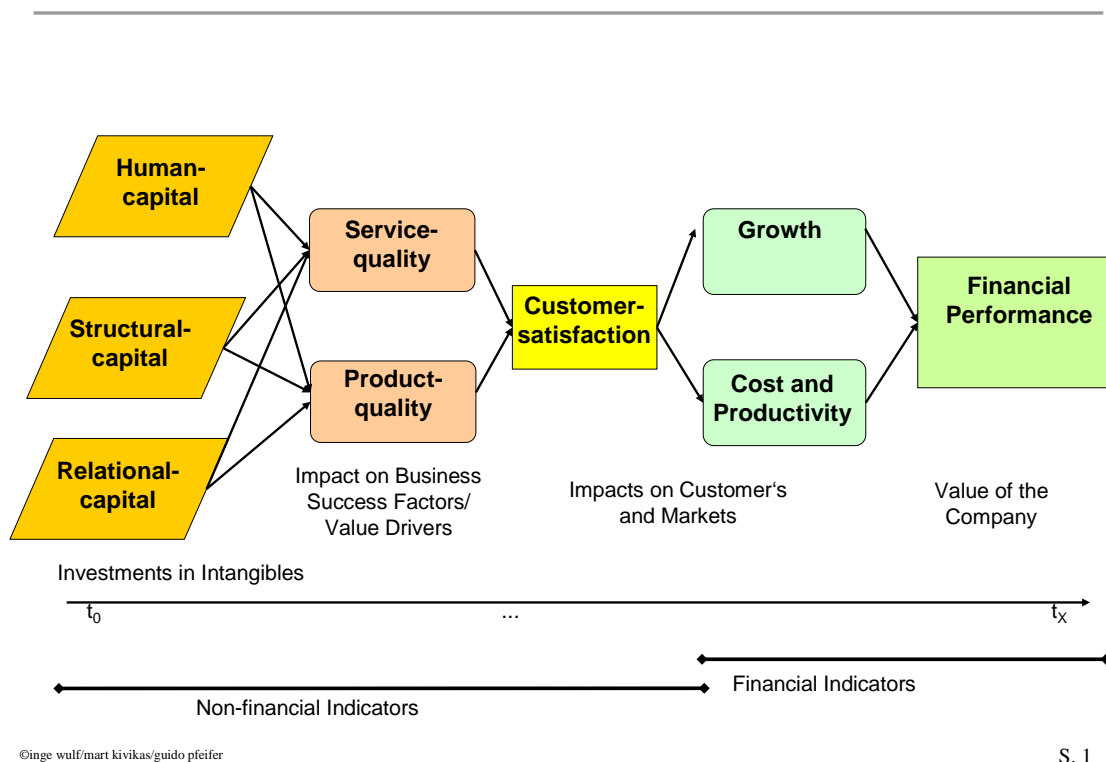
- Example from real life (3)

If you want to build a house in California, there are four parties involved:

1. The buyer of the house
2. The builder
3. The broker
4. The banker/lender

If the parties 2-4 only are evaluated after turnover and no future risk is considered, they all want to drive the prices upwards. Only the buyer may obstruct, but every family wants a house and if you can finance up to 110 % of the purchase price, it is difficult to resist buying. A wrong management bonus system leads to gigantic societal losses.

We need a balance between people building up resources and executives who can put those resources into customer value. The dangerous motto of today must be changed, away from "asset sweating" into "asset creation" (Pic. 1.).



Pic. 1: The Process of Sustainable Value Creation

- Digression I

A problem existed in accounting since its birth in Renaissance Italy in the 15th century. How can we measure or appraise investments that cannot be immediately traded or how can we quantify qualitative factors?

I think we will never be able to quantify, that is, to show how much profit we make out of an investment in a new sporting facility for the employees at the headquarters or to show the NPV of raising the IT competencies of the staff. However, a prudent and foresighted leadership knows the value of those investments and is also able to explain the financial value of these investments to different stakeholders. Leadership based on foresight and common sense, in other words, experience.

If we look at picture 1, the time horizon is important to understand. In order to build up customer relations, a functioning organisation and a

motivated work force, you need time. To cut costs or to use stick instead of carrot you can do immediately. If you consider the competitive environment for corporations in the globalized economy today, shareholders usually want to see results within a period of two maximum three years. The qualitative factors need more time to be managed before they become profitable, however, the profit will be more sustainable.

Methods to assess the Qualitative Factors in Performance Evaluation **– History**

In the introduction we learned the shortcomings of trying to quantify and measure everything. However, we cannot live without some kind of statement or measurement of an output, initiated from a deliberate action. This is important for two reasons: Firstly, to have a base for a reasonable discussion on, for instance, rewarding human action and secondly, to realize what a human action actually can effect. Therefore, the efforts from controllers and analysts to “balance” something over a specified time period is not wrong, the question is what success factors we apply on those being measured and are we measuring them correctly?

- Digression II

In the German language, the expression “Bilanz ziehen” (to balance) does not necessarily mean a balance sheet as in the Anglo-Saxon language. It means that change itself can actually be balanced as well. This is an important linguistic difference between German and English and therefore can show the cultural difference in the understanding of how an organisation creates value. In Germany there is still a moral compassion within many SME owners and leaders of companies of having a social and local responsibility as well, the stakeholder values. This so called

“Rheinkapitalismus”¹¹ is not new, and was one of the major success factors for the German “Wirtschaftswunder” after World War II. In Germany there is a saying that you will meet your business partner at least twice in a lifetime, therefore a more long term and ethical view on management behaviour is advocated in a lot of business communities especially in Southern Germany, Northern Switzerland and parts of Austria.

In appendix 1, the German initiative “Wissensbilanz – Made in Germany” and Intellectual Capital Statement are explained. This initiative from 2004 was the first of its kind to find a real echo from the target group, small- and mid-sized enterprises in Germany and was followed up by the European Commission in the project “Intellectual Capital Statement – Made in Europe”¹² in 2006.

Although there has been enough media attention and financial support, especially from the German Federal Government, METI (the Japanese Ministry of Economy, Trade and Industry) and the European Commission, it seems that those initiatives are to be lost in the whirlpools of the current financial and economic crisis. The reasons can be categorized from a historical, political and financial perspective.

To start with the historical perspective, it is clear that the importance of people (or human capital), company culture and technology level (structural capital) and markets/customers (relational capital) are not new when it comes to create value. Actually, before financial capital became the sole base for trade and income, those relations were the only ones necessary to

¹¹ <http://www.juhtimine.ee/max-weber-protestantlik-eetika-ja-kapitalismi-vaim>

¹² <http://www.incas-europe.eu/> based on -> RICARDIS (2006), “Reporting Intellectual Capital to Augment Research, Development and Innovation in SMEs”, European Commission, [online http://ec.europa.eu/invest-in-research/policy/capital_report_en.htm], Report to the Commission of the High Level Expert Group in RICARDIS: European Commission, June 2006: EUR 22095 EN.

understand and to cultivate. However, when all entrepreneurial efforts only focus on short term financial value (and therefore shareholder value) and when this is even set as the final moral goal¹³, there is a risk that those qualitative factors will be put aside, especially when losses are “socialized” and profits go to management and shareholders. So, the reason to have a more balanced view on performance is not a revolution, it is rather a wish to go back to old virtues that built Europe before the Industrial Revolution lead to a financial one with all its highs and lows.

- Example from real life (4)

In Rothenburg ob der Tauber, Germany, in the early Middle Ages, the king appointed the mayor who, together with the local nobles, was responsible to save when times were good in order to be able to feed the townspeople and give them work in difficult times. Before the Industrial Revolution and urbanization, this was seen as the legitimacy for kings and nobles not having to pay taxes and therefore being able to accumulate capital. Failure to do so made them to have to pay with their heads, as seen in the French Revolution.

So history shows that the development we have had in the last centuries is more an exception and definitely not a dialectic necessity as some leading experts today proclaim. Many scientific researches show the same result in Sweden and in Germany – employees prefer job security and future perspectives instead of short term financial rewards.

Behind this historical reason we can also see a political one. In a study¹⁴ made in 2009, 80 % of the Germans did not trust their managers. Only two categories were worse, brokers and politicians. There is a saying that we

¹³ Ayn Rand, „Atlas Shrugged“, first published 1957 in the United States is the philosophical framework for “objectivism”, with strong influence on the Chicago School of Economics and the former Chairman of the Federal Reserve System (Fed.), Alan Greenspan. Also see <http://www.businessinsider.com/lloyd-blankfein-says-he-is-doing-gods-work-2009-11> were Lloyd Blankfein, CEO Goldman Sachs, is quoted saying he is doing “God’s work”.

¹⁴ Gallup study, Financial Times Deutschland 2009,

get the politicians we deserve, but this is wrong. No democracy has ever worked over time when there is no clear understanding of rights and responsibilities between the ruling classes and those ruled¹⁵. Because of the specialisation of our society after the Industrial Revolution, also a political class has occurred, where the leaders are chosen within a party at a relatively young age and they are promoted in a world of sophists and very rarely have any experience from working besides their political qualities. This class is very easy to control by lobbyists and other experts. Because of WW II, the generations thereafter were forced to work to survive and each nation had a national agenda to stay independent and to put the people into work. However, today, via heavy tax systems and high state deficits in the western industrialised countries, there is not much the politicians can influence. Because of the unclear responsibilities, populist (short term) politicians win votes from responsible (long term) politicians. Since the media hype covers almost every square inch of our world¹⁶, a clever populist politician can reach all homes within seconds and when there is no control and follow up on political decisions, there is very little chance to make reforms like cutting public spending in order to balance a budget¹⁷ or to raise any taxes.

Furthermore, strong and professionally managed lobbying always finds excuses to stop necessary rules which would benefit a silent majority.

This political problem would not be so important if not all companies and entrepreneurs in Europe would depend on decisions made today in order to survive tomorrow and in the long run. Balance Sheets and Income Statements must be made at least once a year in order to collect taxes for the state. An employer who does not pay the social taxes in due time will end up in prison.

¹⁵ See Perikles and his apologies to have built up a bureaucracy of civil servants in Athens, around 430 B.C.

¹⁶ See how CNN and CNBC treated the financial crisis and now recently the Greece problem

¹⁷ A very typical example is the German law to have a balanced budget, not today but as of 2015! See also the medical reform in the US, March 2010.

Even the financial sector is distorted through the EU and the political mechanism.

- Example from real life (5)

In Europe up to 50 % of the investment volume is funded by the EU. This can lead to a situation where an existing distributor with long term customer ties suddenly can be confronted with a newcomer in the market who has 50 % less warehouse expenses. This means, that a modern entrepreneur must be very well informed about all the various subsidies that affect his industry.

The rules of Basel II have also raised the costs for banks to give a loan. In Germany, a good personal relation between owner and his local bank¹⁸, used to be sufficient to get credit, even in bad times. This has become extremely difficult today and many loan approvals are now made by centralized computer systems and there is no longer a personal relation on a local level. Today's visible credit crunch is based on the fact that Basel II supports a joint collective reaction to a crisis and demands from banks to support given loans with a higher equity in riskier times, thus leading to a negative spiral for the economy. The existing opinion seems to be that money is just a commodity that "does not smell" and the control of it can easily be automated through computer models with a minimum of human interferences¹⁹. These assumptions do not work in reality, but the politicians who are elected to supervise the banking system have been poorly advised so far²⁰.

The third and last reason why we got the problems we have to confront today is how the financial markets work. Already Adam Smith proclaimed²¹ that the markets must be regulated by the state and that there must be a "face-to-face" relation between lender and borrower. This is

¹⁸ Das „Hausbank“ Prinzip

¹⁹ See Black Swan, Nassim Nicholas Taleb, 2007

²⁰ Today experts are already working on a Basel III.

²¹ Adam Smith, „the Wealth of Nations“, 1776

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obviously no longer the case on a macro economic level, however many savings & loan banks that have operated nationwide on a micro level are not hit by the tremendous losses the "too big to fail" banks have performed in 2008 and 2009.

However, most top brains from business schools still join international banks, preferably in New York or in London in order to make money²² and they use the Discounted Cash Flow Model (see note 3 above) to assess the value of a firm as their professors have taught them.

- Example from real life (6)

When I graduated in 1991, most of the important investment banks had offices in Stockholm with their own analysts. Today only a few of them employ local staff, instead they have concentrated their know how on European investments in London and on international deals in New York. When I was visiting one of the biggest quoted IT companies in Poland, I was told that their stock was in the focus of many investment funds, but so far no analyst had actually accepted an invitation to visit them at their site in Southern Poland. A lot of analysts only use official quantitative statistics on a macro and micro level to assess the base for their DCF value. Qualitative factors are not taken into account as a reason to buy or sell stocks.

When studying to become a certified rating analyst, you are not allowed to make any statement without mathematical proof. This immediately disqualifies all qualitative factors because of their character as not being transaction based values.

Markets are definitely more efficient and bigger today, but the ignorance of long term (qualitative) factors and unclear risk taking, is making those markets extremely vulnerable for unforeseen events, like 9/11. However,

²² The initial salary to top people is usually around 1. Mill \$ per year. This has not changed since Lehman Brothers collapsed.

the sub-prime crisis and the collapse of Lehman Brothers were of a different character, they were foreseeable²³.

With this attempt of a brief historical overview of why we have the problems we have today and that we caused these problems ourselves, a common base is found for discussion how to handle this. In the next chapter we will present a way to combine the traditional quantitative financial factors with the qualitative ones we get from the Intellectual Capital Statement²⁴ in order to give management a more complete base for decision making.

The Earnings Capability Index (ECI)™

Definition of the Earnings Capability Index (ECI)™

The future earnings capability of a firm can only be assessed under the premises that the material, financial and intangible resources (or the intellectual capital) are secured.

The financial data or hard facts from an organisation show the current financial status and are the base for any future economic activities.

However, they can only show the short term of the **earnings capability**.

The ability to make money in the mid or long term can only be secured by investing in intellectual capital. These investments are usually difficult to find in the accounting system, because they are usually booked as cost in the income statement although those investments could be the ones that give an organisation **competitive advantages** in the future. For instance, investment in a new product generation does not give an immediate competitive advantage, but could secure new customized products or services for the future which will guarantee competitive strength and thus the survival in five to ten years. Classical financial indicators are not adequate to manage those resources. In this case, the context over the interdependency analysis and how qualitative factors influence quantitative

²³ See also an interview with Alan Greenspan, Handelsblatt March 2010, which explains the role of the FED, the Federal Reserve System and for its history, <http://news.goldseek.com/GoldSeek/1095269452.php>

²⁴ German Wissensbilanz

factors like profit is more adequate as information for managers to make good strategic decisions. This is why it is extremely important to understand those rather abstract connections and their strategic consequences for the organisation. The clearer this picture is, the higher the likelihood that managers have the right information in their decision making and therefore have a better control of the outcome. Of the same importance is the ability to quickly find out if management has made a wrong decision and to be able to react in a correct and timely manner (early warning). With the mid and long term earnings forecasts, relevant risks and opportunities can be covered in order to secure the future competitive position of a firm.

With this background, the future earnings forecast shows:

- The earnings capability as a base for future business success and profitability (cash flow)
- To find and secure intangibles (and IC) potentials as a base for future earnings and profitability (cash flow) as well as
- An understanding of how qualitative and quantitative factors work together and what impact management decisions will have in the organisation when these factors are affected or changed, also over time²⁵.

How the Earnings Capability Index (ECI)TM connects Strategic and Operational Management

Strategic management deals with the planning, implementing and controlling of corporate strategies. It can be divided into definition of goals, business environment analysis, company analysis, selection of strategy and the implementation of this strategy. After defining the **strategic goals**, an **analysis of the business environment** follows. In this analysis, the so called **SWOT** (strengths, weaknesses, opportunities and threats) method is successfully proven and follows a specific pattern with questions to find out where the company stands compared to competitors and can also be adjusted to different scenarios with economical, technological and political

²⁵ See picture 1 above

variations. Relevant parameters are the existing resources within the company. With this method, the comparative advantages as well as disadvantages can be found, especially in the area of strategic intangible resources.

Changes in the market environment as we have seen in the current financial and economical turmoil are not yet part of the ECI. However, the overall score can in specific cases be adjusted to those circumstances and the interval in the tool can be changed or widened, a justified "override". The reason for having this override feature in the tool is for instance posing special limitations on sustainability issues.

The ECI™ integrates strategic management with the operational level (see pic. 1). The factors under competitiveness and ability to change are parts of the index and show the strengths and weaknesses in the strategic process of the firm, primarily based on indicators. The usually already existing financial indicators are used to evaluate the current earnings status of the firm. In combination, a holistic view of the organisation is possible, based on existing information and later aggregated over financial and non-financial indicators to get the whole picture to understand where the organisation stands in order to meet future financial (and strategic) goals.

The Structures of Earnings Capability Index (ECI)™

The ECI™, as aggregated management tool, is an important component to assess the future earnings possibility of a firm. This "fit for the future" test includes seven steps as shown in the following table (pic. 2):

Steps	Criteria	Sources
1. Current financial situation	Profitability/Cash	Annual Report, Bankratings, BSC
2. Competitiveness	Customer segments, branch, competitors, structural- and relational capital	Business environment analysis, Intellectual Capital Statement, BSC
3. Ability to change	Innovation capability, fixed vs. Variable costs, human capital	Intellectual Capital Statement, BSC
4. (Future) Earnings Capability (steps 1 to 3)	Earnings Capability Index™	Analyse of steps 1 to 3.
5. Management action points	Activity plan	ECI report, BSC
6. Implementation (in business operations)	i.e. CRM or HR development	i.e. job and process descriptions, customer survey
7. Follow-up, controlling	Verification of index	Actuals vs. Plan, KPI (adjusted)

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S. 3

Pic. 2: The seven steps of " fit for the future" (extract)

The starting point of the "fit for the future" test is to analyse the classical financial data in order to assess the current earnings situation (step 1). These data will be completed with facts and data on competitiveness (step 2) and ability to change (step 3). The result of the three steps ends with a preliminary ECI™, a forecast on the company's future earnings capability (see pic. 3 below). The outcome of step 1 to 4 will be summarized in an activity plan (step 5) with management action points to improve the overall ECI score and therefore the overall value of the firm. This activity plan is the base for the implementation (step 6) on the operational level as well as the follow up (step 7). After implementation and the agreed time of impact in the activity plan (usually between 6 – 24 months), the results of the action points will be analysed. If the results do not reach expectations, the activity plan (step 5) must be revised and adjusted. The objectives in the activity plan should be realistic and agreed upon with managers and employees to make them operational.

With the ECI™ tool, quantitative (hard) and qualitative (soft) success factors become compatible with the firm’s strategic goals and prepared for implementation. To verify those factors, classical financial data as well as indicators from the “Competitiveness” and “Ability to Change” analysis are used as well as qualitative methods like Balanced Scorecard or the IC Statement²⁶. Regarding the qualitative methods and reports, it is important to include the time horizon in order to avoid unrealistic expectations. The logic of how the total score is reached, is depicted in picture 3. The major difference to existing management tools is the shift from focusing primarily on financial and quantitative indicators and also to include the qualitative factors in the decision making process.

The Logic behind the Earnings Capability Index (ECI)™

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Pic. 3: The logic behind the Earnings Capability Index (ECI)™

²⁶ German Wissensbilanz

The predefined financial and non-financial indicators or data used in the ECI™ will be evaluated on a scale where the highest score is 100. Through an industry specific weighting, the data is transformed into an index score in order to aggregate to the next level. Each index score will be weighted then regarding its relevance for the three dimensions of time: short, mid, and long term. With this, the company can get an overview of its different abilities to earnings today and also in the future. To get the overall scoring, the results of the three dimensions of time are added into one value, the ECI™ score. In order to get the total score, the interdependency matrix is taken into account.

The systematic from the ECI™ can be used in almost every company and business sector. However, an adjustment of the weightings must be made regarding the type of industry, market maturity and socio-economic conditions. To handle this, a basic questionnaire has been developed but with different indicators to be used. The score to be used for comparison and the weighting for specific branches is still under development in some industry sectors.

Case Studies

After this introduction about how the ECI™ is built up, two company cases will show what advantage the ECI™ gives in strategic decision making, compared to classical financial data. Due to confidentiality, the individual values are set to zero. In the following two pictures, the upper side depicts the data used from the auditing association to assess the future value and current business risk of those two cases based on classical data adjusted with the ECI™ weightings. In the bottom part, extracts of the ECI™ is shown, deviating from the picture 4 above. The qualitative data in those cases are gathered from the companies respective IC-Statements²⁷.

Using classical data in case 1 would lead to an overall score of 242, which is derived from the sum of 91 (current earnings), 67 (competitiveness) and 84 (ability to change). As the following picture 5 shows, this result is different

²⁷ German Wissensbilanz

from the result of the ECI™, which in this case is 230, the sum of 87, 76 and 67.

Future Earnings Capability based on classical financial data	Current Earnings		Competitiveness		Ability to change	
	Cost / Income Ratio		Customer Value		Innovation and Growth Capability	
	Value	0,0 %	Value	0,0 %	Value	0,0 %
	Score	0	Score	0	Score	0
	Weight	1	Weight	1	Weight	2
	92		100		95	
	Accrued Earnings		Customer Potential		Payroll Flexibility	
	Value	0,0 %	Value	0,0 %	Value	0,0 %
	Score	0	Score	0	Score	0
Weight	2	Weight	2	Weight	1	
100		100		50		
Return on Equity		Market Penetration		Process Efficiency		
Value	0,0 %	Value	0,0 %	Value	0,0 %	
Score	0	Score	0	Score	0	
Weight	1	Weight	2	Weight	1	
98		0		100		
Short term EC forecast		Mid term EC forecast		Long term EC forecast		
91		67		84		
Earnings Capability Index	Earnings Sustainability		Quality and Systematic Relational Capital		Quality and Systematic Human Capital	
	Value	0,0 %	Value	0,0 %	Value	0,0 %
	Score	0	Score	0	Score	0
	Weight	1	Weight	2	Weight	2
	71		72		67	
	Quality and Systematic Structural Capital		Interdependency Analysis HC, SC and RC			
	Value	0,0 %	Value	0,0 %	Value	0,0 %
	Score	0	Score	0	Score	0
	Weight	1	Weight	2	Weight	2
	30					
Weighted Sum		Weighted Sum		Weighted Sum		
92		64		67		
Weight short term	80 %	Weight short term	40 %	Weight short term	5 %	
Weight mid term	15 %	Weight mid term	40 %	Weight mid term	50 %	
Weight long term	5 %	Weight long term	20 %	Weight long term	45 %	
Short term EC forecast		Mid term EC forecast		Long term EC forecast		
87		76		67		
<p>Earnings Capability forecast based on classical financial data and indicators = 242 (= 91 + 67 + 84) Earnings Capability Index (quantitative and qualitative indicators) = 230 (= 87 + 76 + 67) → Difference: -12 Punkte = -5%</p>						

Pic. 4: ECI™ - Case 1

The integrated evaluation and analysis from quantitative and qualitative factors with the ECI™ does not lead to any revolutionary differences compared to existing (classical) evaluation approaches. However, looking at the three dimensions of time - short, mid and long term - the differences become significant. Firstly, the classical financial approach shows a bigger variation between the three pillars of current earnings, competitiveness and ability to change. Secondly, there is a significant difference in the long term pillar, ability to change, where the classical analysis comes to 84 compared to 67 with the ECI™.

Case 2 shows only a slight difference in the classical analysis over time, 81, 82 and 78, total score 241. However, as picture 6 shows, with the ECI™, including the qualitative factors, the score is significantly lower in all three categories. The total ECI™ score comes to 207 (73+70+64).

Future Earnings Capability based on classical financial data	Current Earnings		Competitiveness		Ability to change	
	Cost / Income Ratio		Customer Value		Innovation and Growth Capability	
	Value	0,0 %	Value	0,0 %	Value	0,0 %
	Score	0	Score	0	Score	0
	Weight	1	Weight	1	Weight	2
	54		100		51	
	Accrued Earnings		Customer Potential		Payroll Flexibility	
	Value	0,0 %	Value	0,0 %	Value	0,0 %
	Score	0	Score	0	Score	0
Weight	2	Weight	2	Weight	1	
79		100		81		
Return on Equity		Market Penetration		Process Efficiency		
Value	0,0 %	Value	0,0 %	Value	0,0 %	
Score	0	Score	0	Score	0	
Weight	1	Weight	2	Weight	1	
97		58		100		
Short term EC forecast		Mid term EC forecast		Long term EC forecast		
81		82		78		
Earnings Capability Index	Earnings Sustainability		Quality and Systematic Relational Capital		Quality and Systematic Human Capital	
	Value	0,0 %	Value	0,0 %	Value	0,0 %
	Score	0	Score	0	Score	0
	Weight	1	Weight	2	Weight	2
	68		50		48	
	Quality and Systematic Structural Capital		Interdependency Analysis HC, SC and RC			
	Value	0,0 %	Value	0,0 %	Value	0,0 %
	Score	0	Score	0	Score	0
	Weight	1	Weight	2	Weight	2
	51		35			
Weighted Sum		Weighted Sum		Weighted Sum		
75		71		56		
Weight short term	80 %	Weight short term	40 %	Weight short term	5 %	
Weight mid term	15 %	Weight mid term	40 %	Weight mid term	50 %	
Weight long term	5 %	Weight long term	20 %	Weight long term	45 %	
Short term EC forecast		Mid term EC forecast		Long term EC forecast		
73		70		64		
<p>Earnings Capability forecast based on classical financial data and indicators = 241 (= 81 + 82 + 78) Earnings Capability Index (quantitative and qualitative indicators) = 207 (= 73 + 70 + 64) → Difference: -34 Punkte = -14%</p>						

Pic. 5: ECI™ - Case 2

This case shows that using classical indicators, no real management action is needed to secure the future of the firm. They have an estimated good market position today and tomorrow. With the ECI™, however, the result shows that immediate action is needed to remain competitive. In this case, especially the pillars competitiveness and ability to change must be improved.

Results and use of the Earnings Capability Index (ECI)™

To secure the survival of a firm in a competitive environment, qualitative factors like employee motivation, brand reputation and customer value are essential. The management tool ECI™ which combines the quantitative and qualitative factors in order to support management with the correct information for decision making and an understanding of the consequences

of their decisions. The tool can be seen as an early warning system in case the company is losing track in their strategic direction.

Outlook

When handling today's recession due to the financial crisis and growth of "easy credit" in the world economy 2006-2008, a lot is at stake. If decision makers do not analyse the real causes for this recession, our economy will turn into a depression with political consequences we cannot foresee yet²⁸. To avoid a collapse, political insight and consequent work is necessary. To give the responsibility to those decision makers who caused the problems is wrong. The market mechanism has failed, which makes most existing economic theories useless and we need to go back to the roots of how value is created and distributed to different stakeholders.

The impact of ECI™ on a company level could also be adapted to a national agenda – from a micro perspective to a macro one. It is a question of how we create value in a sustainable way and how we decide to distribute the value created within our society. It is a question of how we evaluate work and how we take control of the results of our work. On a company level, it is important that the company leaders have the goal to create a higher company value, not primarily shareholder value²⁹. If the shareholders do not have the goal to create a sustainable company value, but only to have a short term return of capital between 25 – 30 %, there will be a gap between expectations of employees and shareholders which will eventually lead to conflicts.

This article shows, that there is a structure that supports all stakeholders to claim a part of the value creation starting at a company level. This bottom

²⁸ The recent general elections in Hungary and the referendum in Iceland on the savings guarantee towards customers in the U.K and the Netherlands show that the Hungarians and Icelandic actually withdraw their confidence to their political leaders to be able to solve present problems. Also the crisis management lead by EU and the IMF in Latvia and Greece, will not give those countries any real chance to recover.

²⁹ See Fredmund Malik, St. Gallen, Switzerland in Handelsblatt, March 2010.

01/06/2010

up approach is necessary, because without entrepreneurs and employees, there is no real value created to be shared and no taxes can be collected to finance the work of our state. However, transparency over the market and its players and a political will are prerequisites to reach those goals. There will be no easy way out, but since the existing problems were man made, we also have the power to make things differently and resolve these problems.