

# Corporate Governance: Company Assessment

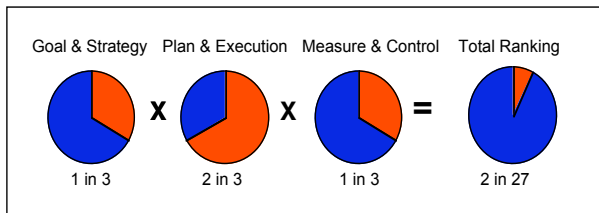
By Paul A Zaman MBA, MSC



## Paul A. Zaman explores Sun Tze's Art of warfare & Porter 5 forces analysis for assessing a company.

Let us explore how you can complete a indicative assessment on any company, large or small, private or listed. This takes just a few minutes for a quick assessment or a couple of hours reading two or three annual reports. In a well-run company, all of the key information will be clearly disclosed in the annual report.

Simply we do a qualitative assessment of the following three factors that contribute to creating long-term shareholder value: goal and strategy formulation; planning & strategy execution; and measurement & control. This relates to Peter F Drucker the guru of modern management if we describe the three core aspects of business success, as innovating, walking the talk and making profitable sales. This is illustrated in the chart.



We also can do a quantitative analysis of the capital structure using three measures, Cash created, Return on Assets and Return on Equity. In a well-run company, these are disclosed in the annual report so you do not need to calculate anything. Or for a small business reviewing your bank balance does this.

Based upon the combination of the above parameters you have a simple guide as to whether you are looking at a well-run company.

The purpose of any company is primarily about providing a service or product that customers are willing to pay for. The secondary objective is making sure that the product can make a worthwhile profit. Investors have a choice as to which companies to invest in. Investors seek the answer to two key questions: what is the product the company provides and why is a customer willing to pay for it rather than buy a competing product. Therefore, the what and the why relate to the company's well-formed business goals and strategy.

### Assessing a company's goals and strategy

Goals are the point of destination or the desired state to achieve. This also means that there must be a realistic

assessment of the point of departure or the undesired state currently experienced. Goals for formulating strategy and checking progress towards their achievement must be measurable and so also specified on a time line.

Strategy is simply what you do to close the gap between the undesired state and the desired state. Within the strategy there are very likely to be an action plan with milestones and tactics to move between milestones.

The word strategy is derived from the Greek word stratēgos, which referred to a 'military commander' during the age of Athenian Democracy. The Art of war by Sun Tze is a Chinese military treatise written during the 6th century BC concerning military strategies and tactics. The Art of war has often been applied successfully in recent years to business strategy. Therefore this is a useful definition to use the word in this context of using your capabilities and the environment to beat the external forces.

Michael Porter also created the five forces framework in 1979 to determine the attractiveness of a market to help in formulating business strategy. These five forces are; the bargaining power of customers; the bargaining power of suppliers, the threat of new entrants; the threat of substitute products, the intensity of competitive rivalry.

Therefore the application of Sun Tze and Michael Porter tools should give for most companies a well-formulated strategy.



Louise Carroll in his book, Alice in Wonderland, nicely expresses goals – Alice stopped at the crossroads and asked the Cheshire cat, which direction do I go? The Cheshire Cat replied, any if you do not know where you are going!

Questions to assess a company's goals and strategy  
Does the company have well formed goals, quantified in measurable terms and in time?

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Has the company specified its core capabilities that the company product and business model is based upon? Does the company have a well-formed strategy, which clearly shows how the company will achieve the point of arrival, the goals bearing in mind the point of departure and leverage the core capabilities?

Assess the company on a scale of one to three. Three points for being good on all three question areas, two for average and one point for poor. Write this score down as a fraction.

Assessing a company's ability to successfully execute the strategy

Some companies have great intellectual prowess and create well thought out strategy and yet fail miserably. Strategy by itself is not enough to win in the game of life. You must have the execution plan plus the human resource capability, assets and core capabilities to deliver. Strategy execution also means leadership which simply is about rallying people to the purpose. The purpose must be clearly communicated and understood by all. Lastly there are many facets and areas so people must know exactly what their role is that is what they are meant to do and the first action to take. Remember, a 5000-mile journey starts with the first step.

Questions for assessing the execution capability:

Has the company a clear company wide execution plan, broken down into periods and milestones, specifically with clear actions for the first 3 months?

Has the company broken down the corporate execution plan, so that each person knows what aligned action to make?

Has the company all the human capital and other resources in place or alliance partners that can offer these capabilities?

Assess the company on a scale of one to three. Three points for being good on all three question areas, two for average and one point for poor. Write this score down as a fraction.

Assessing measurement and control. If a company has good measurement and control systems then the company will either grow slowly or die slowly. Dying slowly is good last option as it gives the investor time to exit the investment. It also gives time for a Change of Board Directors and a change in goals and strategy. Companies with tight financial control systems can survive and grow.

We saw in the dot.com bubble what happens when there are ill-conceived goals, strategies and execution plans and poor financial control. The investment money is burnt and the companies fold. The few dot.com companies that survived quickly got effective financial control in place and in that window of opportunity they re-invented themselves with new business models, goals and strategies. Consider are Google, Yahoo and Amazon.com the same businesses when they were first created in the late 1990's?

Questions for assessing effective management control: Has the company got a tight financial control system in place as seen by a measurement, control and reporting of financial and operational statistics?

Do the CEO and CFO discuss and disclose the rational dashboard indicators by which they actually manage the business on a month-to-month basis?

Do the CEO and CFO know and talk about how they are travelling against the execution plan and specifically highlight unexpected events and the management's remedial actions to get back on track and achieve the previously stated milestones?

Assess the company on a scale of one to three. Three points for being good on all three question areas, two for average and one point for poor. Write this score down as a fraction.

Now the crunch. Multiple the numbers together as fractions. The maximum score in each area is three out of three (1.0) and the minimum score in each area is one out of three (0.33). Then by multiplier the scores from each of the three assessment areas together. The maximum score is 1.0 (1.0x1.0x1.0) and lowest score is 0.036 (0.33x0.33x0.33). There are a few exceptional companies that score a hat trick and the maximum score of 1.0. A great score is 0.4 and above. The majority of companies will be much lower than this. Remember it is your judgement so to create a normalised assessment level do this simple assessment on a few companies you know.

Now let's do a quantitative cross check on your qualitative assessment by looking at the actual financial results of the company. Yes profit and earnings does matter. We can look at three easy to identify and read indicators found in the annual report of a well-run company. In the Annual report there is a section called cash flow statement. There is the final line that shows the net cash position at the end of the year for the business. Is it growing or declining each year? Likewise if you are assessing a small business, is your bank

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account balance increasing or decreasing? The weakness in this measure is that often a company has to spend (invest) today for income (cash flow) tomorrow. So we can look at two more ratios.

Now look at the return on assets (ROA) and return on equity (ROE). These are usually summarised in the annual report so you do not have to do any maths. If you do, think about changing your ranking of the company in the measurement and control assessment area. These indicators are the declared profit divided by the total net assets for return on assets (ROA) or total shareholder equity for return on equity (ROE), both are expressed as percentages by multiplying by 100.

The assets are bought with shareholder investment funds plus bank debts. Therefore assets are usually a larger number than shareholder equity. The shareholder equity is the shareholder investment funds adjusted up for accumulated profits or down for accumulated losses. Look at the trend of the ROA and ROE year by year for several years. Is the return increasing, staying flat or declining?

If the company goals and strategy are well formed and well executed, then both the ROE and ROA will be strongly increasing. If not, then the declining trend means management is investing money in areas that do not make money.

The ROA and ROE range varies between business sectors so it is often good to look at peer companies in the same business sector. As a simple guide if the ROA and ROE is in most years above a 9 to 12% range then the company is creating shareholder value. If the ROA and ROE is below a 9% to 6% range then it is destroying long-term shareholder value. The ROE in a well-managed company with a great business model can be in the 30 to 50% percentage range.

For a small business, estimate the amount of money you and your partners invested in terms of real folding notes and forgone salary. We will call this the shareholder equity. Then look at your bank balance at a specific date each year and then work out the difference in the bank balance between each year. Then add back to each year the salary you and your partner took in that year. We will call this sum the total business earnings for the year. Divide the total business earnings by the shareholder equity, and this will be the estimate for your return on equity for a small business. In this case focus upon the trend, is it increasing, flat or decreasing.

Finally ask yourself how well did your qualitative assessment match to your quantitative assessment?

This is a useful simple screen to focus time and effort on investigating more deeply companies and perhaps time to get some expert investment advice, huh!

*Qualvin Advisory was founded in 2003. We provide advisory services to the Board, CEO and CFO of listed and unlisted companies in S.E.Asia. Qualvin facilitates the Board in areas such as formulating corporate goals & strategy and governance & CSR. Qualvin also formulates and executes the financial investor relations strategy to: increase shareholder value and institutional following; firm the share price and raise new capital. Contact Paul Zaman at email [pzaman@qualvin.com](mailto:pzaman@qualvin.com).*