CORPORATE SURVIVAL
In a New Business Environment
-
A Declaration of Interdependence

By

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and

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Preamble

During recent years we have made a number of presentations with various headings, all focusing on a better understanding and reporting of companies and business than what traditional tools for analysis and reporting can provide.

On many occasions people have said: "It's a pity that we didn't record your presentation". We therefore decided to write down what we usually say during a full day lecture.

During the breaks participants often line up to comment on what has been discussed so far. They can often be sorted in two groups.

One group says in essence: "You are destroying my job!" To them our reply has always been: "No, we point at a business opportunity for you to grasp! The sooner the better."

The other group says essentially: "This was the most liberating speech I have ever heard!"

This paper is all about the dangers of using financial data and other traditional management tools as bases for important decisions and the usefulness of attacking the problems from other angles and using other tools, leading to other conclusions and better action plans.

Such well tested tools are presented along with some examples and experiences.

Part I. Where We Are Now

Background and History

Hans V.A. Johnsson

Hans Johnsson´s background is a lifetime in corporate management, in banks, industrial corporations and other organizations, and then a ten-year period of consulting. Most of the time has been devoted to the concept of communications, in a wide sense, with a focus on target-oriented planning and execution of corporate communications programs and projects, and with specific attention to measuring the results of the programs and projects. His first two books dealt with these aspects of corporate life, the first one (in Swedish) called ”Market Communications – a Paradise for Amateurs", and the second called ”Professional Communications – for a change"

In the 1990´s the Swedish Public Relations Association hired HJ to help design and manage a long-term multi-company project called ”Return on Communications". The objective was to develop concepts and methods to make the return on investments in corporate communications visible and measurable. The tangible result of this project, sponsored by a number of major Swedish-based international corporations, was published in 1993, in the form of a report, with experiences, guidelines and case stories, called ”Return on Communications". (The report is available for download from the web site of the Swedish PR Association, www.sverigesinformationsforening.se)

From this background in a lifetime´s work towards identifying and measuring non-accounting contributions to company growth and development, the next step seemed very natural. Through a mutual friend and colleague, Per Erik Kihlstedt and Hans Johnsson got introduced to each other and joined forces. Per Erik was then at a very interesting point in the development of RealBiz®, as an experience-based and computer-supported method to identify and measure non-accounting influences on company development and growth.

In addition to marketing material for RealBiz®, the first substantial proof of our cooperation was ”The Baseline Revolution”, a self-published book, presenting a new, dramatically different company reporting model. A few years later (November 2005), an extended version of this material was published by John Wiley & Sons under the title ”Performance-Based Reporting. New Management Tools for Unpredictable Times.”
http://eu.wiley.com/WileyCDA/WileyTitle/productCd-0471735434.html

It has been followed up by presentations to business and academic groups in Europe, the Middle East, Africa and the US. The fact that its publication largely coincided with Enron, Parmalat, and other examples of the intrinsic weaknesses, in terms of poor reliability and diminishing relevance, of accounting-based systems, as a platform for decision-making, has contributed to the interest in this book.

The rest is history . . . .

Per Erik Kihlstedt

This paper is built on conclusions from thoughts and experiences PEK has had the opportunity to gather during many hundreds of analyses of different businesses of all kinds, all sizes, and in many countries.

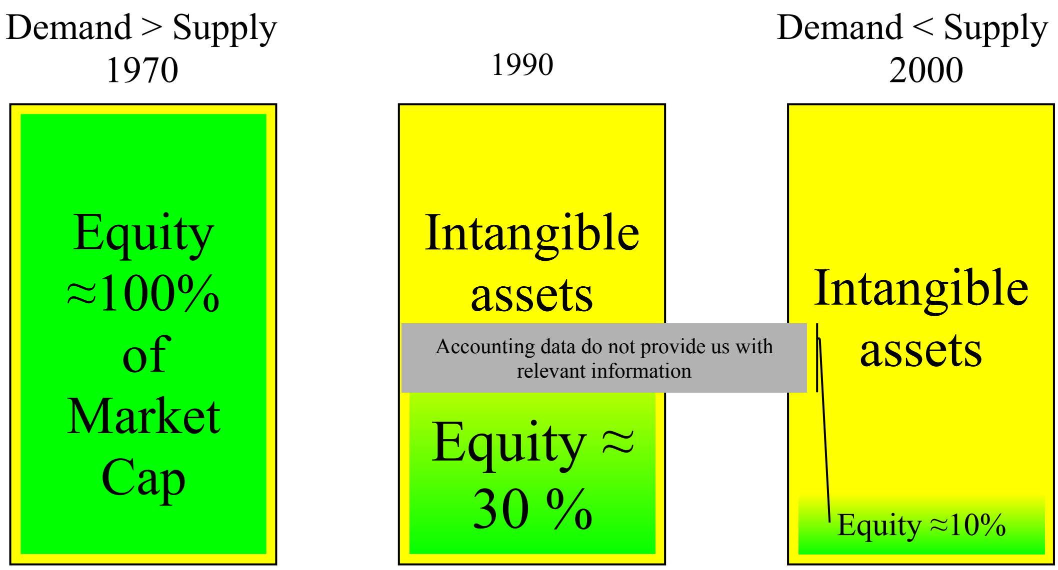
During the last decade of the last century PEK met with Hans V A Johnsson, Sarasota, Florida, USA, who contributed immensely to the concept and brought the idea to design a reporting model based on experience rather than on accounting theory. The result: “Baseline Reporting” is presented in the second half of this paper.

In short, the history so far of this concept is:

- In 1980 PEK started to acquire small companies as CEO of a Venture Capital Company, part of the Uddeholm group listed on the Stockholm Stock Exchange. He soon learned that traditional tools for analysis and valuation of companies didn’t bring very useful information. Something always happened in the different subsidiaries that prohibited them from reaching the goals agreed upon in the budget work.
- PEK then started his search for tools to foresee such events. Being an engineer he gradually realized the harsh consequences of the Chaos Theory, that the future is genuinely unpredictable. All efforts to foresee future events are in vain. A mission impossible! PEK had to go back and attack the problem from another angle.
- In 1984 he had a vague idea of how to go about it and started his own company. He soon got assignments to assess businesses from CEOs of larger groups who wanted to know what to do with certain subsidiaries and from banks who wanted to know if certain customers were credit worthy or not. In some cases the companies had already gone bankrupt and the question was if the bank should sell them as going concerns or sell the assets piece by piece. This work was demanding, since it was totally manual and to a great extent intuitive. But in 1988 after about 200 analyses PEK realized that he was able to describe the intuitive processes explicitly.
- He started to try to make a computer program to support the process and make it consistent and repeatable. Despite help from professional programmers, four serious attempts failed in a mess due to “everything’s dependency on everything else”. Not until he had ironed out the problems themselves was it possible to describe them in the form of computer code.

- In the early nineties PEK had developed a prototype that created some interest. Cap Gemini invited him into a European project called “Common KADS”, part of the ESPRIT program. His prototype was used as an object to analyze in order to improve the capabilities to design so called knowledge bases (often called artificial intelligence).
- After that project was finished Mr. Karl Kramming offered to transfer the prototype into a PC-based program, a task that showed to be much larger than expected. It was, however, completed in 1996.
- That program was used in more than 1000 analyses with great success. In fact, to the best of our knowledge, it never produced faulty results.
- In 1999 the largest telecommunications company in Sweden, Telia, offered to transfer the PC-based program into an Internet-based service, a job that was completed in 2002.
- In parallel with this development the conceptual work progressed and in 1999 Hans V. A. Johnsson and PEK started to design what was later named “Baseline Reporting”, an “80% accounting-free reporting model for companies”.

Something is Going On!



Up to about 1970 there was a close correlation between a company's equity and its market cap, i. e. the price of the shares multiplied by the number of shares. (A silly measurement, if used to show a company's "value", since all existing shareholders want a higher price and all potential buyers want a lower price). The Equity to Market Cap ratio was often equal to 1 or thereabout. This experience resulted in the erroneous conclusion that the equity represented the "value" of the company, a statement that has shown to be totally wrong.

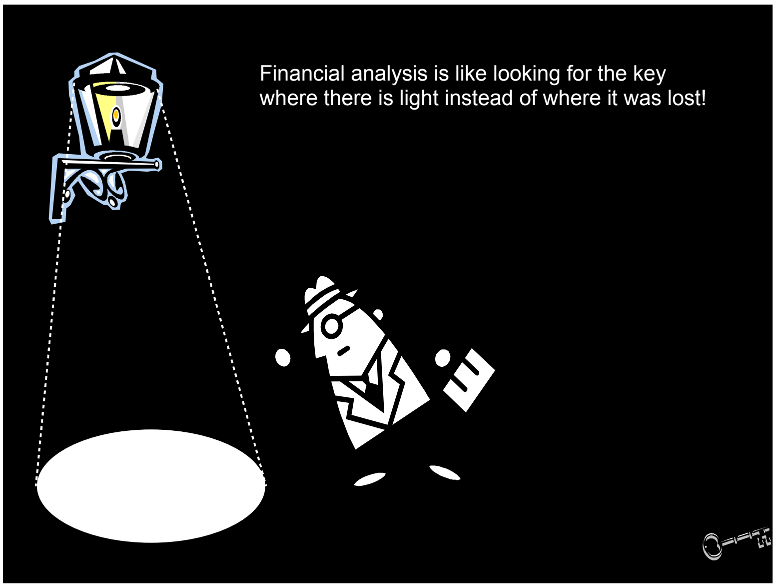
In the nineties, this ratio was about 1/3 and in 2005 it was 1/8 as an average of companies listed on NYSE according to Business Week December 2005. European stock exchanges lag behind, but show the same development trend.

Equity is, however, not even related to the value of the company, as will be explained further down in this paper. The reason for the 1:1 relation before the seventies was that at that time the demand for products and services in general was bigger than the supply. It was the time of industrialism when the companies developed, produced, and delivered standard products to average customers. If you ordered a Volkswagen Beetle in the fifties you didn't know the color of it until it was delivered. It was mass-production. In such times an investor had the choice of either acquiring a company or setting up a similar and still get roughly the same yield.

The times of industrialism ended in the late twentieth century and we gradually entered into the Fourth Economy, to be described below, where the supply of goods and services exceeds the demand. The answer to this situation is "mass-customization", the design and production of individual products according to individual customer's specifications. If you order a car today, you can specify it on Internet and have it shipped to you exactly as you ordered it. In these times the survival, growth, and profitability of the company depends on factors to which the present accounting system is blind, such as customer relationships, staff competencies and skills.

The conclusion is that accounting and thus the financial reporting system becomes less and less relevant to assess a company's ability to develop, despite the fact that this is what the reporting system is used for.

If the financial system is unsuitable, we need to develop new systems.



The fourth economy was mentioned above as today's situation. This expression puts today's reality in a historic perspective and a proper context:

- The First Economy – the world of hunters and gatherers
- The Second Economy – earth-based, with agriculture as a primary business
- The Third Economy – industrial, manufacturing- and capital-based
- And now The Fourth Economy, characterized by three dominating features:
    - Fast, unpredictable change, with unexpected influences from all corners, science, technology (much of it accessible at low cost), politics, socioeconomic and cultural trends.
    - Wealth creation and productivity derived from "*minds in interaction*" (research, innovation, diversity, communication etc.), not from "assets" (of whatever kind).
    - Interdependence, virtual relationships, "the network economy", globalization, "the flat company" – not only the much touted "flat world", replacing traditional hierarchies and vertical relations.

The consequences for companies of these three characteristics include:

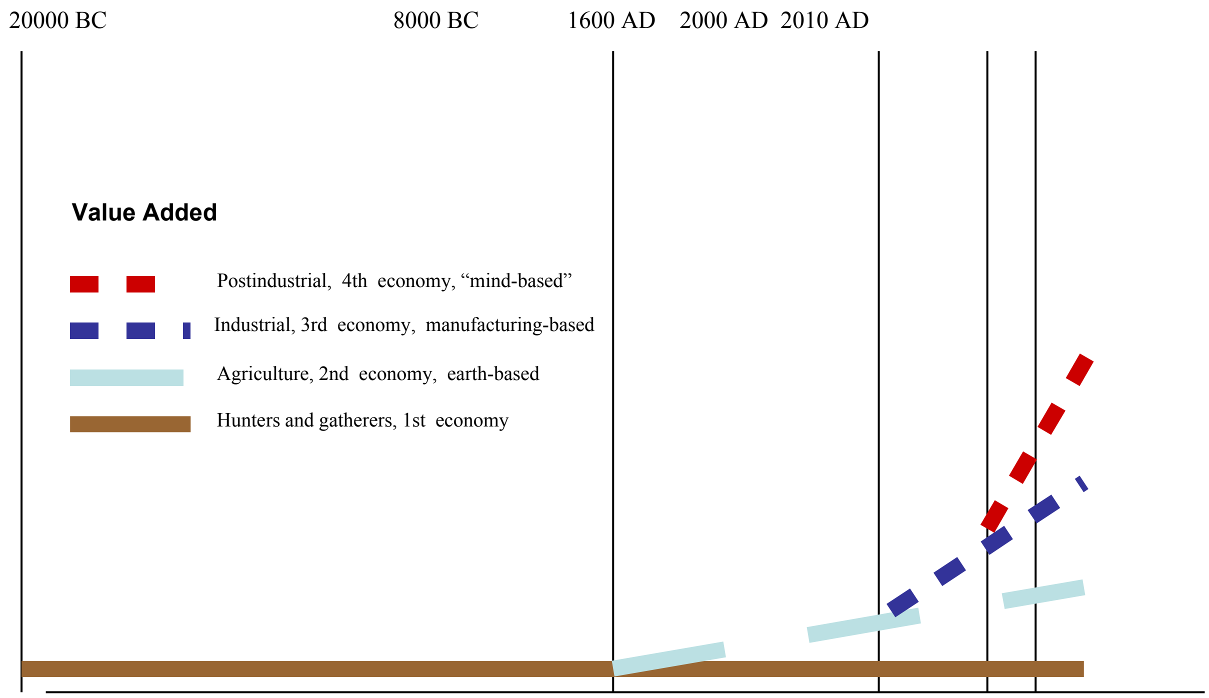
- The end of "business as usual" and the prioritizing of flexibility
- The end of relevance of traditional balance sheets, and an emphasis on education and relationships
- The end of traditional formal company structures, and a highlight on networks

Fast, real-time communications via telecom, the Internet and other media, and advanced information processing and storage techniques are among the basic conditions that make our time unique – but not the only ones.

Never before, in the history of mankind, has virtually all human knowledge generated and saved through the ages been available anywhere, in real time! Call it "The Google Factor", if you like!

Each new economy built on the previous one and added new features

Diagram of the value added in the four economies



The first economy is still around, as a dominant model in some areas, as a supplementary model in other areas, and as a hobby environment. Its role in terms of providing "Value Added" is limited, however.

The second, earth-based economy (agriculture, mining etc.) is still important. Its main contribution was and is a more stable supply of food, clothing, and natural resources. It remains a valid segment of the present economy.

The third economy, the industrial economy, is also an important part of business today. Its main contribution: increased *productivity in physical processes* such as manufacturing and transportation.

The main contribution of the present economy, the fourth economy, is *previously unimaginable gains in the productivity of mind-based processes*, and, since it is not based on limited physical resources, an unlimited (!) potential for wealth creation. Maybe, ultimately, time and ability to consume what is produced will be the limiting factor. The fourth economy has helped add tremendous amounts of job opportunities and major contributions in terms of value added to the economies of old and new countries, including more than 300 millions of new jobs in countries such as China and India.

Each shift to a dominating new economy has meant much more than just a change in business. It has also been accompanied by broad and deep changes in culture and lifestyles. That is what we are witnessing also at this time.

For business management, the three main characteristics of the fourth economy lead to far-reaching changes in attitudes and perspectives:

In a world	***of fast, unpredictable change***	***where wealth is created by minds in interaction***	***where relationships are a condition for survival***
managers can not:	**rely on trend extrapolations, prognoses or forecasts**	**measure success or failure by material assets alone**	**limit their views and measurements to what happens within company walls**
instead they must:	**prioritize flexibility and diagnoses**	**define and measure non-financial value drivers**	**define and measure the impact of relationships**

The conditions of the fourth economy create a need for a new approach to company reporting that focuses on today´s relevant information for users such as investors, creditors or those who are interested in any type of relations with the company.

Financial Reports – Useful Data or a Cemetery for Numbers?

"The Value Mess" and "The Value Trap" – unsatisfactory definitions of maybe the most important concept in business

Many would say that the primary purpose of a company, or the whole business world, is to create and increase "value". Since the word and concept of "value" is such a central issue in the business community, we all have a responsibility to use it with caution. Today, the word "value" is used in economic discussions, presentations and rule systems in a wide variety of definitions – or without definitions. The first requirement to get some order into company reporting is to know and agree on what we talk about, when we use the term "value".

Any dictionary lists a range of different definitions of value, of which some apply to business:

Value$^{\text{any amount}}$, like "Which value did you put on line 12?"

Value$^{\text{historic price}}$, like a purchase price on a balance sheet (Value$^{\text{b.s.}}$), perhaps modified through depreciation and other adjustments,

Value$^{\text{potential (future) price}}$, like the expected or anticipated or guessed price when you sell a house, a definition used by those who want to promote "Fair Value" reporting,

and Value$^{\text{usefulness}}$, indicating the benefit or pleasure the owner or user derives from something.

Each of these meanings is entirely unrelated to the others.

VALUE$^{\text{amount}}$ is just another word for number. VALUE $^{\text{historic price}}$ can be interesting as a record of what one once paid. It is made substantially less interesting by the accepted manipulation of write-offs etc. VALUE $^{\text{potential future price}}$ is a "guesstimate", nothing else. In a time of fast, unpredictable change it is less reliable than ever. It is the fourth meaning, VALUE $^{\text{usefulness}}$, which is the really important kind, the kind that drives the economy, and makes somebody willing to pay for an item or a service.

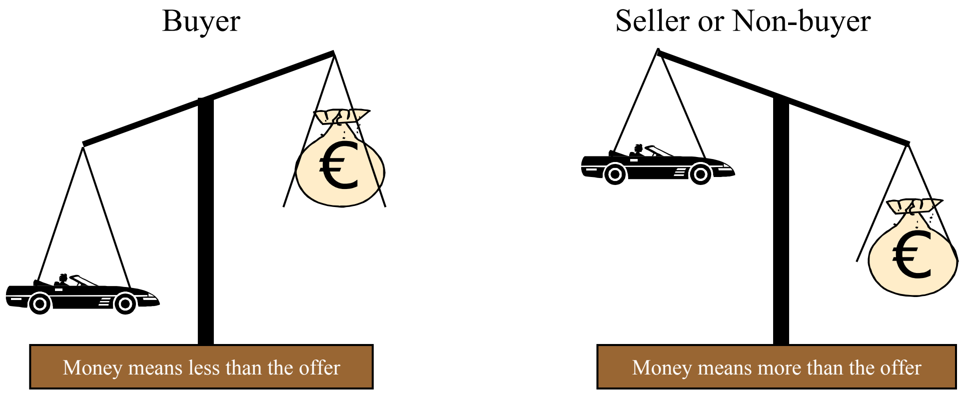
The customer pays for three components of VALUE ^{usefulness}:

- The benefit of the **thing** or service itself.
- The benefit of the **place** where it is delivered.
- The benefit of the **time** when it is delivered.

A new model for business reporting and analysis must recognize and sort out the semantic mess of "value". Today the use of the word and concept is severely compromised, a fact that makes financial reporting less useful.

Price is not Value

A frequent definition of the value of an item is the price someone is prepared to pay for it. This is, however, not correct. Nobody buys an item if he or she does not value it higher than the price. Or, even more precisely, if the buyer does not value the benefits of the item more than the good feeling of keeping the money.



This example shows that seller and buyer by definition put different ”values” on the item. This valuation depends on the perception they have of the ”value” of the item, relative to their perception of the money in question. The obvious conclusion is that value, in the sense of usefulness, is NOT a quality in the item itself. It is a feeling within the person who wishes to sell or buy an item. The misunderstanding that an item has a value in itself is what we call the Value Trap.

The stock market is an excellent example of this. On a certain day, as an example, the buyers and sellers on the NY Stock Exchange felt that a Dow index of 12,400 represented a balance of seller and buyer interests (NOT the ”Value” of the stock market!) On the following day, under the impression of oil supply scares, ongoing concerns about the war in Iraq, a few new lawsuits against CEOs and other emotional shake-ups, the sellers and buyers downgraded their feelings by 350 units. The ”intrinsic value” of the shares had nothing, or very little, to do with the downfall! No major negative earnings reports had been published. A conclusion is that the only realistic representation of ”P/E numbers” is Price/Emotions, not Price/Earnings.

The facts about the four entirely different meanings of Value need to be restated:

VALUE^{amount}: must be expressed in numbers, not necessarily in a currency number, but in a number.

VALUE $^{historic\ price}$: Expresses the price once paid for an item. In traditional accounting, this is the source of the numbers on the Balance sheet. At one time, when much of the value-creation in a company was based on equipment and material, which had been purchased at a specific price, even the distorted numbers on a balance sheet could have made some kind on interesting reading, even if it never reflected the ”value” of a company. However, in today's economy any link between the Balance sheet and company value is tenuous, if it exists at all.

VALUE $^{\text{potential future price}}$: is a guess or a dream. It may be expressed in numbers, but it is still a dream. Whether it will ever be realized is a matter of chance, e. g. if the right buyer will show up at the right time. Real estate processes, mergers and acquisitions, selling your used car, investment planning, the daily movements on the stock exchanges, currency exchanges or commodity markets are all examples of the dream world of potential future prices. The term should certainly never be mixed up with VALUE $^{\text{usefulness}}$.

VALUE $^{\text{usefulness}}$: The real driver of business development. However, VALUE $^{\text{usefulness}}$ is not an objective concept. It depends entirely on the perceptions and situations of the parties involved in it considering a transaction. It is ultimately a feeling – and we should all be aware that feelings can not be expressed in numbers.

Valuation of companies

This also means that all methods aiming to set a monetary ”value” on a company or other assets are wrong, by definition. If in doubt, just consider all the crazy ”valuations” made of companies in M&A processes, during "the IT bubble", and in too many other cases to mention. At this writing, Daimler has decided to spin off the Chrysler division for the meager sum of US$7.4 Billion (of which Daimler gets just over US$1 Billion). The sum sounds impressive, but it is, indeed, meager – compared to the amount Daimler paid for it nine years ago: more than US$37 Billion! Too bad for the investors! It also raises the justified question what "the real value" of Chrysler is. Our point, of course, is that there is no such thing as a "real value" that can be expressed in numbers.

One of the frequently used methods to put a price tag on a company is also one of the worst examples of stupid methods used to assess a "real" or "correct" value: the Discounted Cash Flow (DCF) method. It is just amazing to see how a prestigious award such as the prize in Economics in Memory of Alfred Nobel can be given to those who design and launch such methods, in reality not much more reliable than palm reading or horoscopes.

What ***is*** then the value of a company? Well, it is created in the mind of a beholder and is based on his or her perception, at this moment, and in the existing situation, of the company's ability to survive, grow, and be profitable. This is the only way to read some sense into the wild roller coaster of company valuations (such as Chrysler´s!). To create value in the eyes of the potential interested parties, a company must measure and communicate these abilities in a transparent and reliable way. How this can be done, including the inherent limitations and risks even in these methods, will be dealt with later in this paper. Please be prepared as a reader: Discounted Cash Flow will NOT be considered!

Balance Sheets and Earnings Statements

Depreciations

Write-offs in a Balance sheet are nothing but a taxation technique. They do not reflect in any sensible way a reduction in the VALUE $^{\text{usefulness}}$ of the assets. The numbers originally listed on the Balance sheet are VALUE $^{\text{historic price}}$, an entirely different concept, which has nothing to do with the usefulness of an item.

Audits

This is also why an auditor can never certify that the assets on a balance sheet have been listed at their ”correct” or even ”reasonable” ”value”. He can only check and certify that the assets have been listed correctly and that they have been priced according to the rules. The VALUE ^{usefulness} depends on how management feels about the assets – and that feeling can not even be expressed in monetary terms.

Fair value

IFRS, International Financial Reporting Standards requires as of 2005 that some assets should be listed at ”fair value”, i. e. market price or, in case there is no market price, the net present value of the cash flow the assets are supposed to generate. This rule is entirely illogical. This means that one can build an item on the balance sheet based on expected future cash flow. This ruling by the IFRS is nothing short of an intellectual disaster. “Fair value” is a chimera.

For a review of the pros and cons of the “Fair Value” idea, see an important article in CFO Magazine, Sept. 1, 2006: “Will Fair Value Fly?”.

The CFO article lists a line of weaknesses in today´s accounting-based reporting systems, both reliability and relevance issues. The weaknesses are well known, but they deserve to be repeated over and over again, until the truth sinks in. The article lists equally clearly a range of shortcomings in the ”fair-value” system. The gist of the article is that both systems have so many weak points that neither one of them meets the needs of adequate business reporting for our time. CFO editor Ronald Fink deserves praise, when he squares off the criticism fairly equally between the two systems.

The two systems put executives in the awkward situation of Ulysses in Homeros´ classical epos, choosing between a Scylla of accounting-based reporting and a Charybdis of ”fair-value” reporting. Either way, the result is likely to be the same kind of shipwrecks we have seen too much of lately: failed M&A´s, governance disasters, poor banking records, risk management processes tainted by extrapolation and ”discounted cash flow”, strategic decisions based on financials rather than business facts, erratic analyst predictions, and stakeholder reporting leaning on financial data, not business realities.

We need
- full coverage, not fractional
- a broader basis of information
- an appropriate time perspective:

Accounting only covers cash and material assets, which are less and less significant as indicators of company development. We need a broader, if possible “all-inclusive” reporting model.
The ”past transactions” base links accounting-based reporting inextricably to – the past. But we know from mutual funds ads and daily experience that past performance is not an indication of future results.
The time perspective in ”fair-value” is less clearly defined, but in most cases it seems to lean on guesses about the future. We need a system that leaves the past behind and is cautious about the future. A good system would define and measure *present conditions* for company success or failure.

”Fair-value” makes two dangerous assumptions:
1) that we all talk about the same thing when we use the term ”value”. Our discussion above shows that that is not the case.

2) ”Fair-value” advocates seem to assume that an asset has a measurable, intrinsic value, like a physical quality, rather than accepting the fact that Value, if it is to make any real sense at all, is a concept that is created in the minds of interested parties.

The CFO article quotes critics that state that ”GAAP[1] remains seriously flawed,” even after Sarbox[2]. ”Managed earnings” remain one of the major (though not the only) unreliability stigma. ”Fair-value” promises to end ”managed earnings”. Instead, it lays the groundwork for subjective assessments or ”managed value”. We need reporting systems that avoid the Scylla of managed earnings without hitting the Charybdis of managed value. We need a system that offers a course of objective, measurable conditions for company success or failure. That can be done – if one is prepared to move outside the box.

J. Michael Cook of Deloitte is quoted in the article: ”Net income is a virtually useless number”. Thomas Linsmeyer of FASB defends ”fair-value” by attacking accounting: ”I believe that revenues, expenses, gains, and losses are accounting constructs.” On the other hand, James Barge, SVP of Time Warner, joins those who contend that ”fair-value” methods that include the ”present value” of potential, but unrealized, contingent payments could be unreliable and misleading. Barge: ”I disagree with (this application of fair value) on principle.” Where does this debate leave those who want to attain a higher level of transparency?

Great minds have tried for some time to initiate a search for something out-of-the-box.
- More than 10 years ago, Citibank chairman Walter Wriston said: ”Flying with faulty instruments is dangerous”.
- KPMG chairman Steven Butler, in BW, May 13, 2002, sighed almost desperately: ”In our post-industrial economy, our accounting system doesn’t do a good job of describing any modern company.”
- Management guru Peter Drucker agreed in ”Managing in the Next Society”, 2002: (We must) ”change basic record-keeping to accommodate present economic reality, something accounting was never intended to do.”
- Peter Wallison, American Enterprise Institute, and Robert Litan, Brookings, collected critical views of traditional accounting thinking a couple of years ago under the title ”The GAAP Gap.”
- Deloitte chairman J. Michael Cook, in the CFO article, pronounced ”financial statements almost completely irrelevant”, and added: ”It´s time to play offense”.

To sum up: The CFO article shows that there is no winner in the struggle between accounting-based reporting and ”fair-value” reporting. When Homeros wrote the Scylla and Charybdis part of The Odyssey, his solution was to plug the ears of his hero, Ulysses, to the siren songs from both sides. Maybe it is time for the global business community to do the same: phase out the old fundamentalist beliefs in accounting and the old-new enthusiasm for ”fair value”, and chart out a straight course for business reporting that avoids both, a course that can help create reliability, relevance, and transparency, and gain credibility in the process.

Profit

The income statement only remotely reflects the earnings of the company. We all remember the story of the CEO who asks the CFO what the profits were for last year, and gets the

[1] Generally Accepted Accounting Principles
[2] Sarbanes – Oxley Act. See below.

sincere answer :"Well, what do you want them to be?" The best to be said of the income statement is that it may serve as a platform for taxation.

The components of the Balance Sheet

The Balance sheet does not reflect the VALUE $^{\text{usefulness}}$ of the company assets, nor does it reflect VALUE $^{\text{historic price.}}$ It is only a distorted (because of write-offs) presentation of the original cost of some (not all) of its assets and some (not all) of its liabilities. The mix-up of different value concepts becomes complete if, as IFRS prescribes, VALUE $^{\text{potential future price}}$, is allowed to enter the list as well.

"Total assets" only serves as a check item to make sure that the double Italian accounting adds up properly. It does not have any other information to offer.

"Equity" also serves as a check item to ensure that the double Italian bookkeeping has been added up properly. It has no other information to offer. Yet, the meaningless Equity concept is used by people with straight faces (and probably in pin-stripe suits) in corporate legislation, in banking etc., and it is allowed to influence real decisions.

"Goodwill" is also a check item without information value. It is not an asset to be written off. IFRS, in this case, makes a change for the better, when it decides that Goodwill should no longer be written off .

All this goes to show that the financial perspective of a company is fairly useless. Its backward looking and inability to register the vast majority of the value drivers of a company disqualifies it as a viable tool for decision making.

Financial reporting is a system that systematically produces incomplete, at best, or outright erroneous results in relation to its purpose. It is a deceptive system.

Prognoses – Useful Data or Nonsense?

The Future is Genuinely Unpredictable

There is a law of nature that says that the future is genuinely unpredictable. This goes for everything in every situation. There are no ifs and buts. Mankind has learnt the lessons of this law through thousands of years. The law is proven to the last decimal in the Chaos Theory. Our world is simply made in this way, thank God!

In fact at every moment in time the development can go in any direction! The number of possibilities are infinite.

In a new book (2007) about the futility of predictions, "The Black Swan", the author, Nassim Nicholas Taleb, defines the Black Swan as the impact of the highly improbable: "History is going to be dominated by an improbable event, I just don´t know what that event will be." The same is true about companies – your company!

Contemplate for a moment the consequences of this condition!

All prognoses, including budgets, trend extrapolation, future price development and scenarios are nothing but guesses. They should be treated accordingly. The cost to acquire them should be limited to their value as bases for important decisions, i. e. zero.

Experts cannot be better than amateurs, the only difference is that experts charge those who are silly enough to pay for their services.

For examples, just check your financial media for the daily dosis of mistaken financial analyst predictions. "Company X did not meet /or surpassed/ analysts´ expectations". Either way, of course, indicates a miss in predictions, and either way, it could have led innocent investors and others to make decisions that turned out to be wrong!

Here is a sample of other prognoses made by "experts":

- "The horse is here to stay, but the automobile is only a novelty - a fad." A president of the Michigan Savings Bank advising Horace Rackham, Henry Ford's lawyer, not to invest in the Ford Motor Company in 1903. Rackham disregarded the "expert´s" advice and bought $5.000 worth of stock and sold it several years later - for $12.5 million.
- "Computers in the future may perhaps only weigh 1.5 tons." Popular Mechanics, forecasting the development of computer technology, in 1949.
- "There is no reason for any individual to have a computer in their home." Kenneth Olsen, president and founder of Digital Equipment Corp., in 1977.
- "Who the hell wants to hear actors talk?" Harry M. Warner, Warner Brothers, in 1927.
- "We don't like their sound. Groups of guitars are on their way out." Decca Records, rejecting the Beatles in 1962.
- "Stocks have reached what looks like a permanently high plateau." Irving Fisher, professor of economics, Yale University, Oct. 1929, just before the big crash.

But there have been some bright guys around before. Let us keep this in our minds:

- Edmund Burke (1729-97) in a letter to the National Assembly, 1791: **"You can never tell the future by the past."**

Autonomous Systems vs. Interactive Networks

Somebody may want to argue that if the future is genuinely unpredictable, we would not be able to tell if and when the sun will rise tomorrow or any other day in the future. Yet we can!

Autonomous systems, i. e. those that are not influenced by outside factors in the time frames of mankind do not change their behaviors and allow us to prognosticate them. When wider time frames are applied, these systems like any other system are no longer autonomous and thus not predictable.

Companies work in networks where they interact with other companies, individuals, authorities and other environment factors. The wider these networks grow the more complex the whole system becomes, which means exponential increases in influences beyond the individual company's control. Globalization brings complexity and added unpredictability, along with enhanced opportunities.

A company´s future business conditions can never be prognosticated.

Risk Assessment – Useful Information or Counterproductive Activity

Do We Talk *Risk* or *Uncertainty*?

The concept of *risk* applies to situations where all possible outcomes of a decision or an action are known. A good example of such a situation is throwing a dice.

Companies, however, do not work in an environment of risk, but under *uncertainty,* where all possible outcomes of a decision or an action are **not** known. In fact, the number of potential outcomes, at any given time, is infinite.

Probability assessments

Identifying and assessing future events that may complicate or prevent a company from achieving its goals in a legal and ethic way are thus a never ending story. It is also an impossible task. Nevertheless it is the normal definition of the job of a risk manager.

If, at the same time, he or she is supposed to estimate or calculate each event's probability to occur, the situation becomes even "more impossible". What is the meaning of calculating or estimating the probability of an event when there is an infinite number of non-considered events that may happen?

As a lecturer Per Erik always carries eight Lego pieces in his briefcase. When the above discussion comes up there is often someone who tries to advocate that he or she can calculate the probability of an event. PEK then shows the eight pieces and asks the person to tell the probability that he can foresee how PEK is going to put the pieces together. The normal answer is that the probability that they are right is 1/64, or something in that vicinity. Sorry, PEK says, the right answer is somewhere around 1/108,000,000. And we claim that every decision to be made by a manager is far more complex than putting eight Lego pieces together. The Lego example is a risk situation, not a situation of uncertainty.

The danger of dealing with risk, as impact x probability, is clearly shown in the LTCM example:

Long Term Capital Management was founded by two Nobel Prize Laureates. It collapsed in 1998. The LCTM risk model told them that the loss they incurred one day at the end of August 1998 had a probability of occurring once every 80 trillion years.

It happened again the following week.

It is not the risk that hurts but the impact. All disasters have two things in common: Their high impact and their low probability.

Vulnerability

We have seen that we cannot identify events that may occur in the future and that it is useless, or counterproductive, to bother about probabilities. What can a company do to prevent disasters?

Instead of trying to identify future events, it is much better to focus on which companies, individuals, authorities, and other environment forces have the potential power to influence the company in question. Instead of what can happen, ask the question: *"Who or what has the ability to control or affect the company's ability to achieve its goals?"*.

This approach reduces the infinite number of events to a limited number of potential environment forces. This is a fact-focused way, not a guess-based, to identify where the company has its vulnerabilities, regardless of whether, how, and when the environment attacks the company.

”Boots in the Bed” – Correlation as Tools for Deception

If you wake up in your bed with your boots on, you are likely to have a headache. Boots in the bed are strong indicators of headache. But are boots-in-bed a reason for headache?

If you just decide to take a nap in the afternoon with your boots still on, you are quite likely not to have a headache.

Cause and effect, and the correlation between two or more factors, are tricky issues that call for more than superficial linkage.

Practically every day, books, reports, charts, measurements etc. are published featuring successful companies. The idea is to show common denominators for successful companies and then market miraculous advice: ”Do this, and your company will be successful!”

The problem is that you make a mistake of the same kind as the headache as a consequence of sleeping with your boots on. Many of the common denominators between successful companies may have a link, a correlation, to their level of success – but that does not prove that they are the causes of success. That cause-effect relationship has to be proven in a separate process.

In the financial world, a ”strong balance sheet” is sometimes quoted as an indication of a good company. There may well be a correlation – but not necessarily a cause-effect relationship, something which bank lenders have sometimes realized too late, with a similar kind of headache as the person waking up with his boots on.

In the Middle of a Paradigm Shift

A paradigm shift is a change in norms in the society. Such a shift is normally generated by external factors that make people realize that their way of thinking doesn’t fit the problem. History shows that paradigm shifts are rarely initiated by experts in the area of consideration. Almost without exceptions, major changes are created by outsiders breaking into the area of expertise from a totally new perspective.

During the last 15 years we have had three major disasters in the financial world, apart from the ongoing inability to bring the majority of mergers and acquisitions to successes.

The Bank Crisis

In the beginning of the 90-ies there was a crisis in banks in most developed countries in the world. It was caused by bad debts mainly in the real estate sector of the economy. Behind this were a number of factors:

- Belief that value is an intrinsic property of, in this case, a piece of real estate.
- Belief that this value can be calculated using the DCF method.

The banks obviously did not discover, until it was too late, their vulnerability to a possible break in the willingness of tenants or investors to pay expected rents or prices of the properties.

The remedy? Well, Basel II is an international convention suggesting certain rules for banks in their credit allowing process, the New Basel Capital Accord.

The New Basel Capital Accord, however:

- Uses the concept "Value" throughout the text as a property of an asset. - **It is not.**
- Has not accepted that the future is genuinely unpredictable, but states that credit institutions should use history and trend extrapolation to assess the future performance of individual borrowers. – **This is impossible**. It IS, however, possible to assess present conditions for future performance, but it requires using business data, not financial data, as we shall see later in this paper.
- Suggests that five or in some cases seven years of historical data on borrower must be available to use the system of Internal Rating in case the development of the borrower is unstable. – **This is useless! "You can never tell the future by the past!"**
- Requires the use of the probability of a given event with low frequency and in an ever changing environment when assessing operational risks. – **Disregards the difference between risk and uncertainty.**
- Is based on the "most important risk events", - **despite the fact that they are innumerable and – what is worse – unforeseeable**.

The IT bubble

The IT bubble in the beginning of the 2000s is a good example to show that words create and destroy value. Companies with very little operation were "talked" up to sky high prices. It was also based on the concept of "Value" as a property of the companies, until finally investors' fear became bigger than their greediness.

The prices were pumped up by using the most weird valuation models. The sellers "forgot" that value cannot be expressed in monetary terms.

The Reporting Scandals

Shortly after the IT bubble we were hit by the wave of major reporting scandals. In short, the performers of that show found that it was quite possible to **use financial reporting to describe a business as they wanted it to be, not as it was.**

The remedy this time was the Sarbanes – Oxley Act prescribing in a detailed manner how to try to achieve that the financial report really describes the business as it is.

This has forced companies to spend large sums of money to make sure that a limited and largely insignificant part of business reporting, the financials, are correct, while the significant parts, the conditions for survival, growth, and profitability, are not considered.

Fair Value

The IASB (International Accounting Standards Board) issues IFRSs (International Financial Reporting Standards). It has tried to solve part of the difference between equity and Market Cap, described at the beginning of this paper, by prescribing that certain assets, liabilities, and equity instruments shall be noted at "fair value" on the balance sheet. It has then given different and sometimes contradictory definitions of the concept "fair value".

The idea is to substitute balance sheet values, i. e. prices of the day of acquisitions, with prices of the day the balance sheet was made, or at some time in the future, when a transaction is expected to take place. This is however not feasible for assets that are not frequently traded. In such cases the balance sheet value is supposed to be the net present value of the future cash flows the asset in case is supposed to generate, a number that is impossible to assess.

> In real life, ”Value”, which ”fair-value” advocates often appear to equate with price, changes from one situation to another, often within very wide (and unpredictable) limits, not only for rarely traded items, or untraded items, but for regular everyday traded items. A two-liter bottle of Coke can go for 89 cents one day and $1.59 another day. What is the intrinsic or ”fair” value of a bottle of Coke? What value would you attach to a glass of water, if you stand at your kitchen sink? What value would the same glass have, if you are in the Mojave desert for the third day without water? Value, it deserves to be stated again and again, is NOT a quality embedded in thing itself. It is an assessment made in the minds of those concerned, at a given time, in a given situation.

The IASB mixes all kinds of “value” without consistent definitions. The harsh criticism has finally forced the IASB to launch a project to “clarify the definition of fair value” and to “establish a single source of guidance for all fair value measurements required by IFRS”.

Framework for Financial Reporting

The IASB has also produced an “Improved Conceptual Framework for Financial Reporting” where it states in the initial paragraph (S2):

“*The objective of general purpose external financial reporting is to provide information that is useful to present and potential investors and creditors and others in making investment, credit, and similar resource allocation decisions.”*

Financial data, however, contribute only marginally to support decisions on resource allocation. Other data, such as market conditions, the legal and business environment, company management, competitor action, innovation level, etc., play much greater roles. The stated objective is, at best, exaggerated, at worst, totally misleading, for several reasons, such as:

1. Most value drivers in companies, especially in today’s companies, are not included in accounting statements or other financial reports. Consequently, financial statements provide limited amounts of useful information for business-oriented decision-making.
2. Balance sheets report only some (not all) company assets, and some (not all) liabilities. Even the limited data they include are based on historic costs, then processed (= manipulated) to meet certain presentation objectives. Consequently, their role in supporting decision-making is not very strong.
3. Neither income statements nor other instruments of financial reporting can fulfil the lofty objective of the paragraph S2, since they, too, are subjected to management estimates and other influences.

Fundamentalism - a non-intellectual attachment and loyalty to established dogmas and creeds

Just as in religion, there are fundamentalists in the sphere of economics. Both categories are dangerous, in that they leave rational thinking behind and accept continued adherence to old thought patterns, even when the reality has changed.

There are economic fundamentalists who still believe that:

- Value can be expressed in monetary terms

- The value of a thing can be calculated
- Balance sheets and earnings statements can be used as bases for important decisions
- Budgets and other forecasts can be used as bases for important decisions
- Traditional Risk Assessment can be used for Risk Management

Most people today accept that the creation stories in the Bible, and those expressed in other old religious legends, are myths, not expressions of scientific facts. Darwin, and his followers, have added proof to scientific concepts.

Economists and business executives have to learn from this parallel. If companies continue to trust accounting-based models to manage the company's real performance, they are not only wasting their resources. They are leading their companies into dangerous territory, using outdated and misleading models. This is nothing but bad Corporate Governance fostered by auditors and the financial regulatory complex as well as traditions-based universities and schools of economics all over the world!

Steve Forbes, the owner of Forbes Magazine, who is not necessarily known as a radical, issued a warning (in Forbes Magazine, Dec. 26, 2005) that leaving economics to “experts” “is akin to leaving astronomy to pre-Copernican astronomers”. We could not agree more!

Three Different Reporting Models

Item	Transactions-Based (GAAP)	"Fair-Value" Based (IFRS)	Conditions-Based
Time perspective	The past is seen as a guide to the future	Present and future "Value" can be estimated	The future is genuinely unpredictable. Forecasting is not a viable tool.
Basis of info	Past transactions	Estimates about the present and the future	The company's business situation
The concept "Value"	Assumes accounting reflects an "intrinsic value"	Assumes accounting reflects "intrinsic value" and can be measured	Intrinsic value does not exist. "Value" is set between two parties
Overriding strategic goal	Survival, growth and earnings		
Success is measured by	Increase of equity	Increase of "Value"	Increase of Freedom to Act
Takes into account	Financial and hard assets. A big share of the company's market cap is left unconsidered	Financial and hard assets. A big share of the company's market cap is left unconsidered	All-inclusive. Covers all factors that control and limit company survival, growth and profitability
Stakeholder reporting	Apparent precision over relevance	Neither precision nor relevance	Relevance and reliability in focus
Support for:			
Corporate governance	No	No	Yes
Investment decisions	No	No	Yes
Bank lending	No	No	Yes
Stakeholder reporting	No	No	Yes
Mergers/Acquisitions	No	No	Yes
Strategic decisions	No	No	Yes

Attempts to Regain Confidence

How can anyone expect legislators and the financial community to enjoy confidence, when the general public will realize that much of our legislation and regulatory system is based on meaningless data? How will they react, when they realize that much of the information they are served about companies they have invested in is useless or based on intellectual misconceptions?

An addiction can be defined as use of a substance that may in itself be a good thing for purposes or in quantities that incur risks. Most of us are aware that addiction to tobacco, alcohol or drugs has substantial health risks. By the same token, misguided or exaggerated use of accounting has substantial risks for the health of the global economy.

Financial reporting has one, and only one, legitimate role: to register past business transactions. All efforts to use financial data for any other purposes are misguided. They lead to accounting addiction and to an increasingly unstable global economic system.

Attempts to regain confidence must start with some basic agreements:

- Accept that financial reporting will never be able to contribute more than marginally to the basis for resource allocation decisions! We must leave the financial "box" if we want to regain confidence!
- Solve the Value Mess! Agree on sensible definitions of various kinds of "Value".
- Accept that Value is a perception, created in the minds of involved and interested parties, not an objective quality in "the thing as such".
- Respect the law of nature that the future is genuinely unpredictable!

We must liberate ourselves from the tyranny of financial information!

Part II. Where Do We Go From Here?

The big changes we need to make are…

1. Step away from the partial reporting system that financial reporting represents, and build a more all-inclusive business-based reporting system that takes into account, literally, more of today's relevant drivers of company performance and success
2. Step away from the rear-view perspective of accounting-based data and build a reporting system based on present, as much as possible real-time, data that shed light on ***present conditions*** for company success or failure.

This calls for an entirely new approach in business reporting, as far from di Pacioli´s 500+ years system as Einstein from Newton, as Darwin from old creation myths, and as today's astronomy from that of Copernicus.

Can it be done in practice? We will outline a system that works according to these principles, a system that has shown its worth in practice, over a period of 25 years, in 2.000 very different businesses, and in more than 20 very different countries.

What we propose, in principle, is to replace the "past transactions" perspective of accounting data, with a "present conditions" perspective, that defines, assesses, and measures, important aspects in and around the company that have significant impact on the company and its business.

We are not surprised that our drastic approach, while attractive to many who begin to realize the dangers of addiction to an irrelevant, unreliable system, is also a red flag to the defenders of the old school.

Yet, even in the massive wall of resistance, from the practitioners, perhaps surprisingly, rather than from academics, there are now voices that call for a new approach. Perhaps the strongest so far comes from a very authoritative group, the CEOs of the six biggest global accounting and auditing networks. One of the six items on their must do-list in the executive summary of their important paper called "CEO Vision" (November 2005) states that we need:

"A new business reporting model is developed to deliver relevant and reliable information in a timely way." (We could not have made a stronger claim.)

A new business reporting model …

A **new** model – not a brush-up of the five hundred years old transactions-based model we still live with.
A **business reporting model** – not a **financial** reporting model.
…is developed …
Something that calls for a new, creative approach, not a rehash of old ideas.
…to deliver relevant and reliable information …
Not the financial information which we know, from many scandals, not to be **reliable**, and which, in today's economy, turns less and less **relevant**, since an increasing share of the factors that influence and drive a company's development, are outside the financial sphere.
…in a timely way.

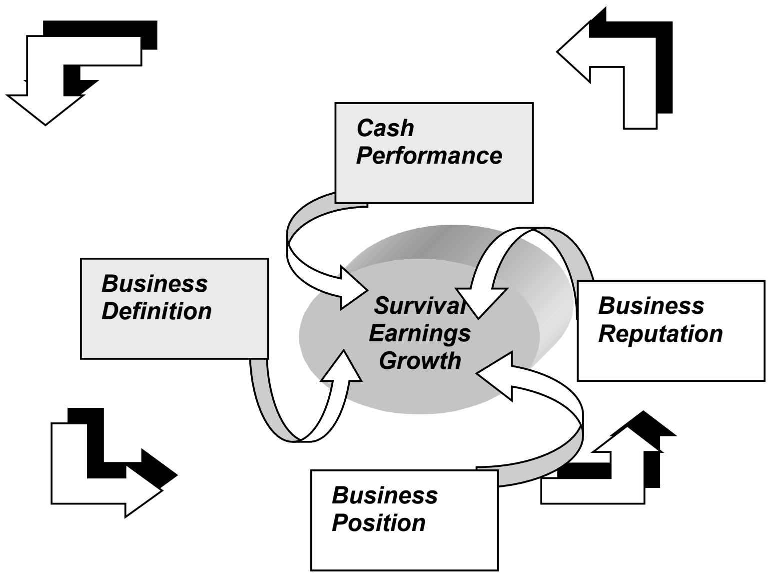
The reporting we use today, based on past transactions, is by nature focused on the **past,** which is not satisfactory to guide management and other decision-makers in a world of fast, unpredictable change.

We look forward with great excitement to the future moves from the six CEOs. Meanwhile, we are pleased to present a working system that meets the requirements put forward by the CEOs. It is called Baseline Reporting, and builds on four ”Baselines” or four groups of business fundamentals.

Baseline Reporting – a complete business assessment and reporting system.

Baseline Reporting is a system that focuses on the conditions the business needs to meet in order to be successful, rather than measuring past financial performance. In short, it does the following:

- It identifies the ways the company is supposed to earn its profits via the Business Mapping procedure described above.
- It identifies and measures all the important factors that limits the company's freedom to act.
- It measures the company's reputation among important stakeholders.
- It measures how strategically focused management is in their decisions concerning resource allocations.



Baseline Reporting is at the same time a tool for business planning, allowing management to leave systems based on prognoses of different kinds and focus on actions to be taken as and when the cash situation allows.

Baseline Reporting is also a system for Enterprise Risk Management on the strategic level.

And last but not least Baseline Reporting is a system for relevant and transparent information to all stakeholders including staff and potential partners of all kinds in order to gain confidence and at the end "license to operate".

Base 1: Business Definition or Business Mapping

Most companies have several business areas. It is necessary to look at the separate business areas in order to get an opinion on the conditions for survival, growth, and profitability.

A typical example of this was an international company producing, marketing, and selling the same products to the same type of customers all over the world, and satisfying the same need. The way of doing business was however so different in different parts of the world that it has four different business areas: Europe, Asia, South America, and North America.

The complexity increases as the number of target groups and needs increases. An extreme example of this was a small trading company in Scandinavia having almost the same number of business areas (35) as employees (42). Trying to run in all directions at the same time resulted in not moving at all.

A typical Business Mapping of a company involves the management team and takes normally four to six hours.

(The Business Mapping process is described in more detail in the Appendix)

Base 2: Business Position: RealBiz®

Once the different business areas are defined the process to measure their respective freedom to act can start. This also involves the management team who has to arrive at an answer that all can agree to on all questions presented by the Internet based RealBiz® System.

Almost all these questions are factual and leave normally little room for different opinions. Such differences rather represent ignorance. The process under Base 2 is therefore highly educative and gives the management team a common view on where the company stands.

The RealBiz® System selects by itself what questions are relevant to pose, as it gradually learns the special circumstances of a particular company. It phrases the questions using bodycopy and input earlier in the process. It also phrases the alternative answers, so the users should only agree to what alternative they should go for.

Once the answer is entered it is validated by the RealBiz® System so that it is not contradictory to any other information previously entered. Then it makes certain calculations and points at the next question to be posed. The process goes on until the system declares that it has all the information it needs.

At any point in the process a RealBiz® Check List can be produced to document what answers were asked, what answers and comments were entered.

As soon as the last question is answered the RealBiz® System automatically makes a diagnosis and produces a report with all the graphs presented in the Appendix and explanations to how the system has arrived to its conclusions.

It not only shows the situation of the individual business areas but also a consolidated picture of the company as a whole. If this situation is worse than the individual business areas it is a sign of a risk accumulating strategy, if it is better the strategy is risk spreading.

This Internet supported process normally takes a full day to accomplish. The physical entering of data takes only minutes so the vast majority of the time is used by management to arrive at unified answers to all questions.

The RealBiz® Strategic Seminar

When the Baseline Reporting system is used for business planning a second phase of Base 2, the RealBiz® Strategic Seminar takes place. Its purpose is to arrive at feasible actions to improve the freedom to act, the conditions for survival, growth, and profitability.

The strategic seminar lifts all the individual aspects pin pointed by the system as important to the freedom to act of the company. Three questions are then posed to the management team for each aspect:

- How can we eliminate the threat?
- How can we reduce company's vulnerability to this threat?
- How can we reduce the probability that the threat realizes?

The answers to these questions are noted and the proposed actions are then prioritized. The actions are also given an identification in the book keeping system to be used in Base 4, see below.

(The computer-supported RealBiz® process is described in more detail in the Appendix)

Base 3: The SMART Dashboard

SMART stands for "Stakeholder Management and Reputation Test".

Base 2 is all about impacts from single factors or stakeholders. But what happens if many members of a group of stakeholders arrive at the same conclusion? This could also have an important, positive or negative impact on the company's development.

We have identified five important groups of stakeholders that almost always have a possible important impact on the company. This list can be completed with other stakeholder groups that the company has an important relation with.

The five prioritized groups of stakeholders are:

- Customers
- Employees
- Investors
- The Public
- The Management

There are certain standard questions posed to the members of these stakeholder groups allowing for different interpretations of the results. It can be a benchmarking process in case the company has the corresponding information from competitors, or measurement of progress when compared to previous results, or finally a measurement compared to target indicators in a company development project.

When performing Base 3 the company normally uses external companies specialized in measuring company relations or uses Internet based measurement instruments.

The SMART Seminar

As in Base 2 there is a similar seminar performed where the management identifies actions to be taken to improve the situations where the company gets less favorable scorings and to secure their good scorings. Also these actions are prioritized and given an identity in the book keeping system.

Base 4: Cash Use – The Ultimate Tool to Measure Management Performance

This part of the Baseline Reporting system is a control instrument to be used by management and the board to verify the quality of their work. It measures how well the cash that is available to them for company development is spent, i. e. spent to support the defined strategic priorities. An information indeed longed for by outside investors and others.

Three KPIs (Key Performance Indicators) are identified as measurement on management and board performance.

- **Direction** – Shows which business areas get most funding.
- **Focus** – Shows to what extent the cash available is used for actions prioritized in Base 2 and 3.
- **Charge** – Shows how much of the cash available is saved for later (major) actions.

Many Purposes – One Process

It is obvious to any reader that the use of Baseline Reporting system consolidates the business reporting, business development, risk management processes, and management training in strategic issues into one single process. There is no need for data transfer from one system to another. It is therefore highly rational to adopt such system as a management tool.

When companies adopt Baseline Reporting the demand for financial reports ought to diminish. They could therefore be allowed to run a simplified financial reporting system without advanced cost matching and periodization and other non-transaction value changes. This would reduce the costs for the traditional reporting a lot. The errors induced ought to be insignificant in relation to present standards given the blindness of the financial reports to the important factors controlling the company's development.

Mergers and Acquisitions

There are other processes in management that need to be improved. One such is the Mergers and Acquisition procedure. We have witnessed many disastrous examples even among big and well managed companies that have used all possible, but traditional, tools to evaluate the deal before it was carried through. The bad results are also countless when companies have acquired seemingly similar companies in their own industries. The low rate of success, <25%, shows clearly that present tools are insufficient.

We therefore want to show how the tools in Baseline Reporting can be used when selecting target company and assessing its price.

Is it the Right Partner?

To verify that the target company is the right one to acquire one utilizes a three step process:

1. Use the existing Base 2 analysis of the acquiring company to establish the strategic issues that need to be solved, and to monitor the present Biz-index.
2. Analyze the target company as is and identify its strategic problems and measure its Biz-index.
3. Make a pro forma analysis with the two companies together. Did the merger solve both companies' strategic issues? If yes the Biz-index of the pro forma analysis should be higher or at least as high as both of the individual companies.

If this is not the case then it is not a good deal, one has given up some of its freedom to act in order to improve the situation of the other. This is to nourish future problems.

Is it the Right Price?

The reason for a lower Biz-index of the pro forma analysis than the acquiring company's could also be too high a price of the target company thus weakening the financial strength of the acquirer. In such situations the RealBiz® tool can be used to find out what price level is acceptable by using "what if" analyses.

Enterprise Opportunity Management

Many may think the Baseline Reporting is focusing on potential threats and problems and not on opportunities. This is a misunderstanding.

An opportunity is a business area with high freedom to act and a guesstimated high market growth for the nearest future. If the conclusion is that the freedom to act is above +2 and the anticipated market growth is high there is a good investment opportunity.

Credit Allowance

We have previously criticized the Basel II Accord using irrelevant data in the credit allowance process. In fact the banks rely far too much on financial data when giving credits to companies and therefore increase their own vulnerability in rapidly changing markets. Banks need to include assessment of the companies ability to pay back the loans based on relevant data, that are not financial, as has been proven above, but rather a measurement of the borrowing company's ability to survive, grow, and be profitable, i. e. its Freedom to Act.

A Call for Civil Courage to Challenge Management by Tradition

We are very well aware of that this text is highly controversial. Only a person outside of the normal financial market but with enough experience and a personal freedom to act can be able to tell some sometimes harsh truths that highly respected persons have disregarded or misunderstood or simply never thought about.

We have presented the whole or important parts of the above text for thousands of persons of all categories in the business world. So far no single person has proven that our ideas are wrong. Many stop arguing when they realize the reality. Sadly enough they feel that they have to continue with business as usual, a typical ostrich policy and lack of civil courage.

It is however encouraging that there is research work for a doctors degree in economics going on at the Swedish School of Economics in Helsinki, Finland, by Mr. Hannu Ritvanen contributing to academic verification of the ideas.

The COIMBRA Initiative

Hans V. A. Johnsson has also initiated the COIMBRA (the Coalition for IMproved Business Reporting and Analysis). It has as goal to act as a sparring partner to different organizations that look for an improved business reporting and to suggest reporting models based on intellectually sound principles and that result in relevant information from a user's point of view.

Anyone who wants to join is welcome to register with coimbragroup@aol.com.

The Special Responsibility of Schools and Universities

It is obvious that a major change of the present situation has to start at schools and universities. Apart from the School of Economics in Gothenburg, that arranged a panel discussion on the subject, most universities seem unaware of most of the lack of usefulness of financial reporting and to the best of our knowledge have not been able to produce any serious new ideas on how an all-inclusive business reporting model should look. We hope we are wrong on that statement.

Please regard this as a contribution in the spirit of Coimbra.

Appendix:

Business Mapping

In order to be able to judge the conditions for a company to earn money one must know how it is supposed to do so. This requires a definition of its business idea. This is done in a multiple question process arriving at a distinct definition of the general market conditions. Sometimes to the surprise of the management, most companies have several business ideas.

These business ideas, business areas or market segments are defined by the following factors:

1. Target groups.
2. Products and services.
3. The need the target groups satisfies when buying the products/services.
4. Geographical focus of the business.
5. Who at the customers make the final decision to buy?
6. In what situation is the decision maker when he or she decides about purchase?
7. Are the customers end users or not?
    a. In case of “not”, who is the end user?
8. **Generic Competition** - Can the target group refrain from satisfying their need under at least one year?
    a. If “yes”, what are the best arguments the company uses to make the target group to prioritize this need before other needs?
9. **Substitute Competition** - Can the target group satisfy the need using another method that the company uses?
    a. If “yes”, what method?
    b. What criteria does the target group to select among the available methods?
    c. Who is the most severe competitor using another method?
10. **Direct Competition** - Can the target group buy from another supplier than the company?
    a. If “yes”, what criteria does the target group use to select among the suppliers?
    b. Who is the most severe direct competitor?
11. What competencies and resources does the company need to be successful in the different sorts of competition?

Using this method one arrives at clear understanding of what different market conditions a company meets in its different activities.

RealBiz®: an Outlook, a Tool, an Internet Service, and a Way to Reach Consensus in the Management Team

As described in the chapter “Background and History” RealBiz® is an Internet based service to identify and assess all factors that influence the company’s ability to survive, grow, and be profitable.

A Different Definition of the Concept "Company"

The liberation from the belief in the benefits of financial reporting allows us to define a company in a way that is more in line with the characteristics of the fourth economy. Instead of looking at a company as a self-contained legally defined box, we consider a company a node in a wide-spread network.

A node that all interested parties and some other factors connect to, to make the exchange possible. This means that stakeholders like staff, management, and board are considered external parties. They are individuals able to influence the company's development as well as customers, competitors and all other factors.

All Living Entities Live From Their Environment

We have stressed some basic truths impossible to shut one's eyes to in the text above. They have formed a floor plan for the development of new management tools for unpredictable times together with a few more truths. One such is that all living entities live from their environment. This is also valid for companies.

Still another one is that the environment is always bigger than any company.

This approach opens a possibility to assess a company by looking how well it is adapted to the environment, that has the power and ability to control the company's development. The thinking is parallel with Darwin's theses for species in the nature.

Relationships

Since a company lives from its environment it must have an exchange with it. This exchange is realized via relationships between the company and the different environment factors. Based on more than 20 years of experience we have found that we need to define 31 groups of such factors.

They are:

Perspective	**Stakeholder/Environment factor**	**Definition**
Market	Customers	Pay with their own money and have a free choice of supplier.
Market	Direct competitors	Sell similar products/services as we do.
Market	Substitute competitors	Satisfy the customers need with another method than we do.
Market	Generic competition	The competition for the customers discretionary buying power. This is when the customer can refrain from satisfying the need we try to meet.
Market	Suppliers	Sell goods or services to us.
Market	Agents	Sell our goods or services and gets remunerated by commissions.
Resources	Board	Controls the company from a strategic point of view and delegates the operations to the management.

Resources	Managing director	Runs the operations of the company.
Resources	Staff	Key personnel who contribute with something that is important to the company and who are hard to replace.
Resources	Holders of patents and rights	Hold the right to something that is important to the company.
Resources	Uninsured assets	Assets not covered by an insurance. Normally accounts receivable and financial instruments.
Resources	Creditors	Lend money to the company.
Resources	Owners	Have invested in the company's equity.
Rules and regulations	Conflicts of interest	Settled by the public sector.
Rules and regulations	Rules controlling the demand	Apply when the public sector prescribes the need for our products or services.
Rules and regulations	Rules controlling the competition	Apply when the public sector licenses the competitors in a market. Ex: banks.
Rules and regulations	Rules controlling the supply	Apply when the public sector regulate the access to raw material or components.
Rules and regulations	External environment	Rules controlling what emissions and other influences on the nature are allowed.
Rules and regulations	Work environment	Rules controlling the staff's security and well being at work.
Rules and regulations	Interest rates	The rates that apply to incremental borrowing of the company.
Rules and regulations	Currencies	The effect in case of a depreciation of the currency that the company uses for its reporting in the country it is registered.
Rules and regulations	Support	Any form of direct support from the public sector to the company. Ex: Credit guarantees, special loans.
Rules and regulations	Infra structure	Limitations of the company's development due to insufficient infra structure, such as roads, energy supply et c.
Rules and regulations	Legal structure	Limitations of the company's development due to an unclear legal situation.
Rules and regulations	Political restrictions	Apply when the business is dependent on the political color of the regime.
Other environment factors	Mass media	The potential influence of mass media on the company's development in case they would start "digging into" it.
Other	Pressure groups	Different actors, such as unions, Green Peace

environment factors		and other groups influencing the opinion.
Other environment factors	External culture	Cultural factors that may influence the company's development.
Other environment factors	Corporate culture	The impact on the company's development by the corporate culture.
Other environment factors	Season and weather	The impact on the company's development by season and weather.
Other environment factors	Disasters	The impact on the company's development in case of fire, theft, or break down.

The potential influence on the company by these factors can be identified by analyzing who "pulls the string", i. e. who has the power to influence the other.

It is interesting to note that there are only four types of relations between two parties. They come in two pairs: Dominance – Sub-ordinance (Underdog) and Alliance – Competition.

- Dominance means: The company has the power to apply its conditions for the exchange with the other party.
- Underdog means: The other party has the power to apply its conditions for the exchange with the company.
- Alliance means: The two parties gain from cooperation.
- Competition means: One party gains at the others' expense.

It is not enough to know the type of relation, we also need to know its strength, i. e. the potential impact in case the relation is broken or one party utilizes his force against the other. We have defined three classes of strength.

- Class 1: The potential impact is not very important.
- Class 2: The potential impact is serious but not fatal.
- Class 3: The potential impact is fatal.

We have now defined four types of relationships and three strengths. That makes 12 combinations.

Unfavorable relations

Designation	**Meaning**
C2	Strong competition.
U2	The other party has the strength to hurt our business seriously but not fatally and we can not do anything about it.
C3	Competition on life and death.

U3	The other party has the strength to stop our business and we can not do anything about it. There is a latent bankruptcy risk.

Potentially unfavorable relations

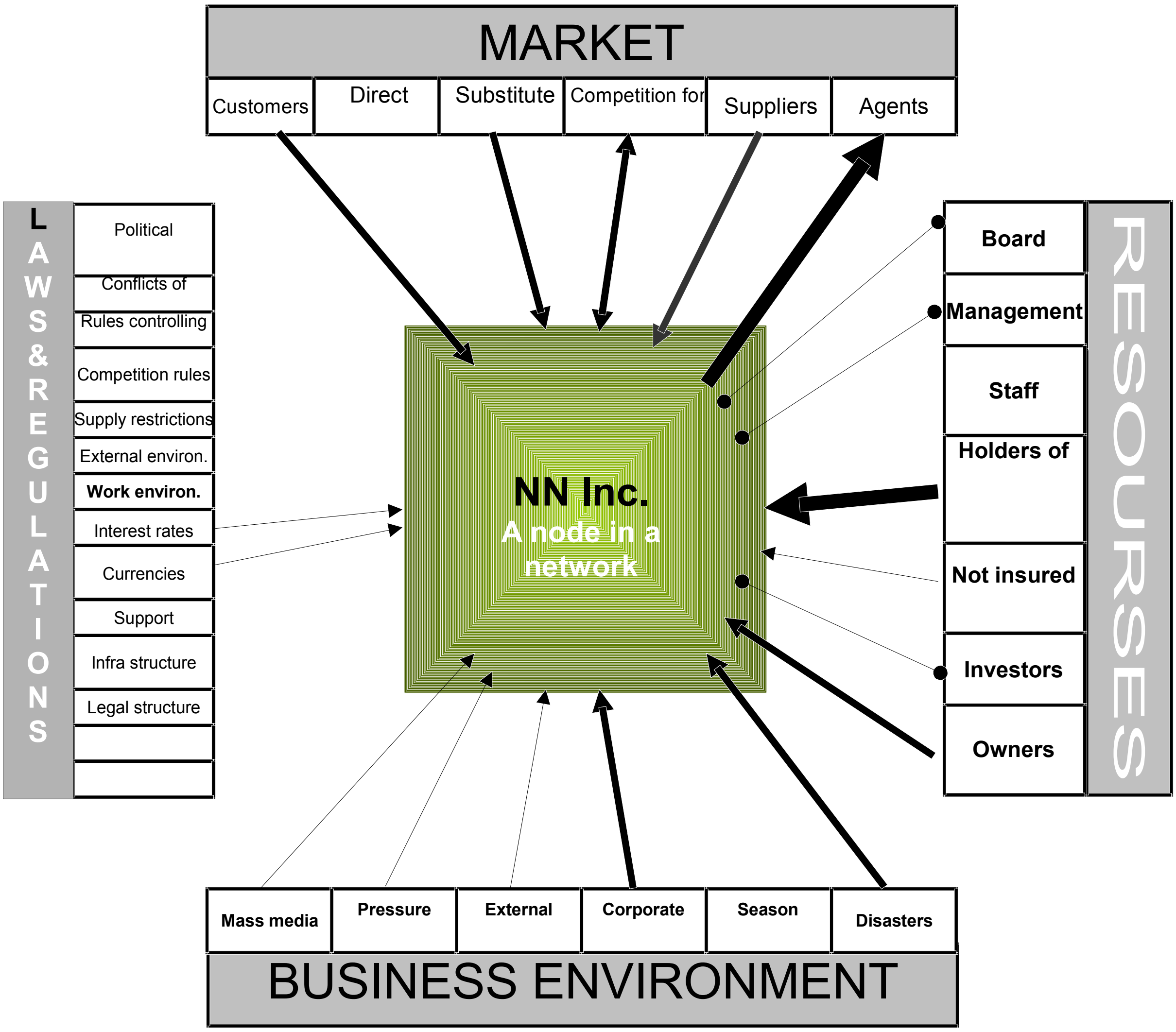
Designation	Meaning
A2	The parties depend strongly on each other. In case the other party vanishes for some reason the company remains strongly depending on somebody who does not exist any more.
D2	The company has the strength to hurt the other party’s business seriously but not fatally and the other party cannot do anything about it. It can however be expected to do whatever it can to get out of the company’s grip.
A3	The parties depend fatally on each other. In case the other party vanishes for some reason the other party will die.
D3	The company has the strength to stop the other party’s business and the other party cannot do anything about it. It can however be expected to go to the extremes to get out of the company’s grip.

Favorable relations

Designation	Meaning
U1	Unimportant dependency on the other party.
C1	Weak competition with the other party.
A1	Weak alliance with the other party.
D1	Weak dominance over the other party.

The Business Position Diagram

The exhibit below is a Business Position diagram showing the potential forces acting on NN Inc. The diagram should be read as follows:



NN Inc. is heavily but not fatally dependent on at least one customer. It has no direct competitors, i. e. competitors who do the same thing as NN Inc. It has however substitute competitors who satisfies the need of the customers using another method. That method is significantly better that the one NN Inc. uses. NN Inc is exposed to generic competition and the need that it satisfies is not very high on the priority list of the customers. It is also heavily dependent on at least one supplier. It dominates an agent totally. It has a normal weak alliance with the board and the managing director. None of the staff is a key person. All individuals can be replaced without any serious difficulties to the company.

The fatal vulnerability of NN Inc. is its fatal dependency on a holder of a patent who can, regardless of reason, withdraw the license. That would be the end of the company.

The biggest uninsured asset, in this case the biggest exposure regarding accounts receivable, is not serious to NN Inc. The company has a normal weak alliance with its creditors, but is heavily dependent on its owners, who have different purposes with their ownership.

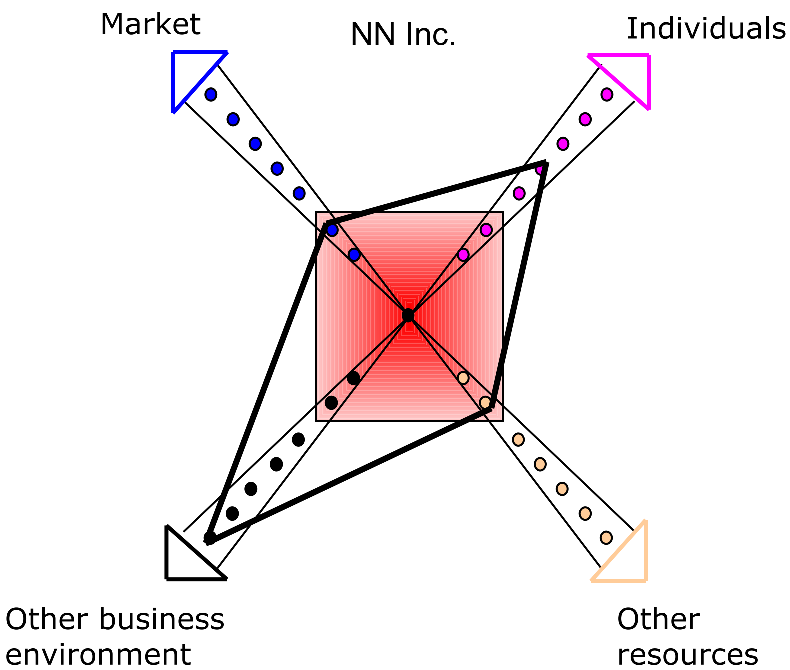
A disaster, like fire, would be serious to the company despite insurance. There is no influence from season or weather on the business. But the corporate culture needs improvement, not to be a hinder for the development. External culture, Pressure groups, and Mass media may have only limited influence on the business.

The business is almost totally independent of influences from the public sector setting up rules and regulations, but there is unimportant influences from exchange rates and interest rates.

The RealBiz® System explains how it has arrived to these conclusions in an automatically written RealBiz® report.

The Realbiz® Kite

The RealBiz® Business Position Graph contains a lot of information, especially when one reads all the aspects used by the system when drawing its conclusions. For reasons of comparison there is another graph called the Kite that looks like this:



The rhombus describing the sustainability of the business idea often looks like a kite. It should have as large and even wings as possible to fly also in weak winds. The kite should not be forced by outside factors into the red area. Then there is a weak point where the vulnerability could be fatal. In this case some factors in the market place and a fatal dependency on a resource used by the company describe fatal weaknesses.

Freedom To Act – The Ultimate Measurement of Power

The dependencies on environmental factors influences the management's ability to arrive at the goals for the company. We therefore introduce the most important factor controlling its ability to survive, grow and be profitable, its Freedom to Act.

A high Freedom to Act means that the conditions for the company to arrive at its goals in an effective and ethical way are good. A low Freedom to Act means that there are many obstacles on the way that may hinder the company to achieve its goals.

Freedom to Act is fundamental for a company's:

- **Survival** – Since no single factor can threaten its business.
- **Growth** – Since Freedom to Act means many alternative developments and power to grab opportunities
- **Profitability** – Thanks to the "Power of Good Bye", i. e. having a stronger negotiation position than a counterpart with lower Freedom to Act and using it to enforce the wanted terms.

Freedom to Act is a significant measure of a company's conditions for development.

It is possible to run a company with a low Freedom to Act and be successful thanks to luck that none of the serious threats has materialized yet. Sooner or later those factors will however hit the business and destroy all or most of what had been achieved. It is just a question of when.

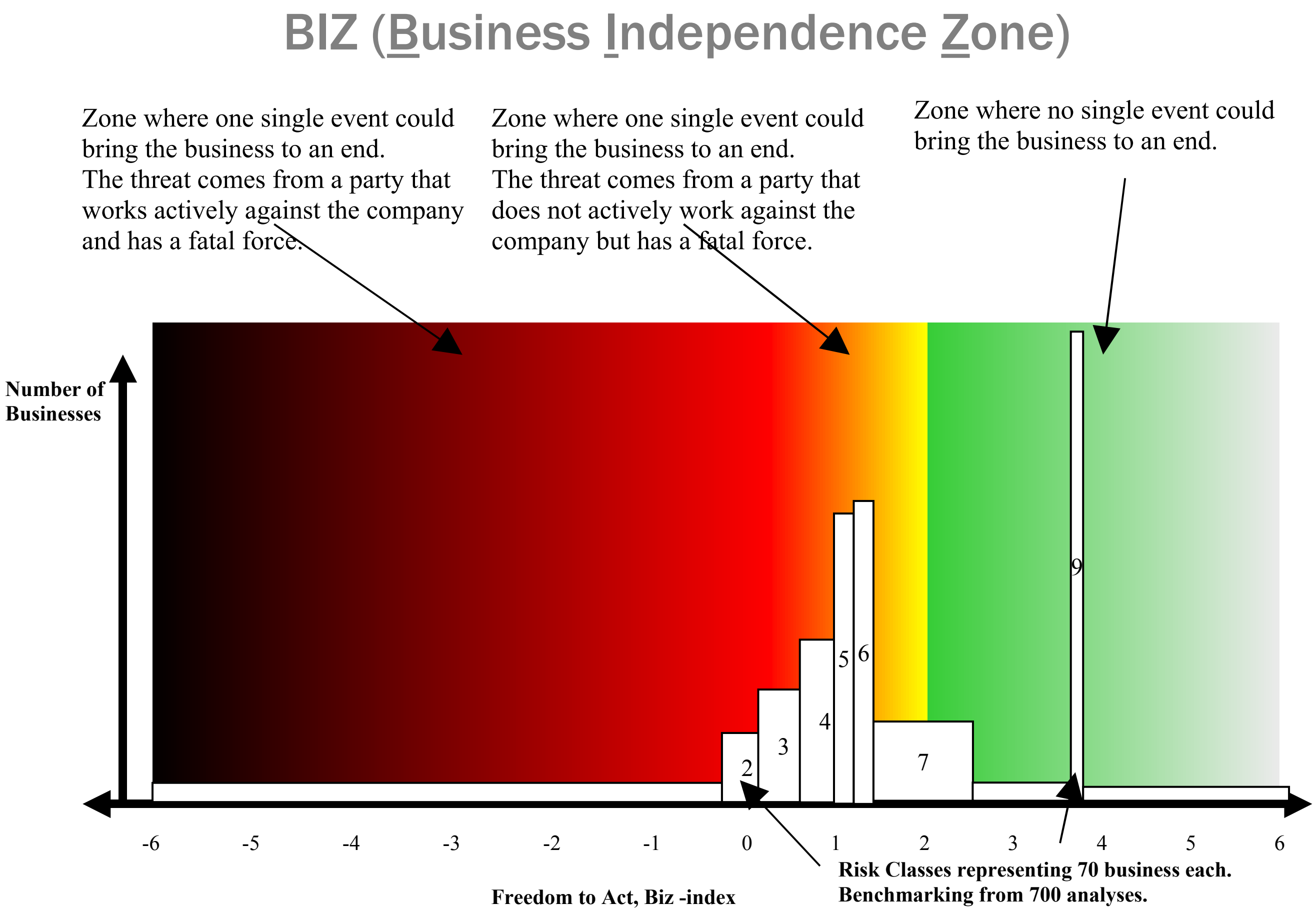
A well communicated Freedom to Act means value to a beholder, since it contains the three most important factors a he or she assesses!

Freedom to Act is the most important factor to consider by the board when making important decisions. The rule is to maintain or increase the Freedom to Act of the company.

Biz-index

Many of our customers have demanded an even simpler way to describe the Freedom to act of the company, to be able to make simple comparisons over time or between for example different investment alternatives.

Then the RealBiz® Biz-index was developed to satisfy this need. The RealBiz® Biz – index is a number varying from –6 to +6.



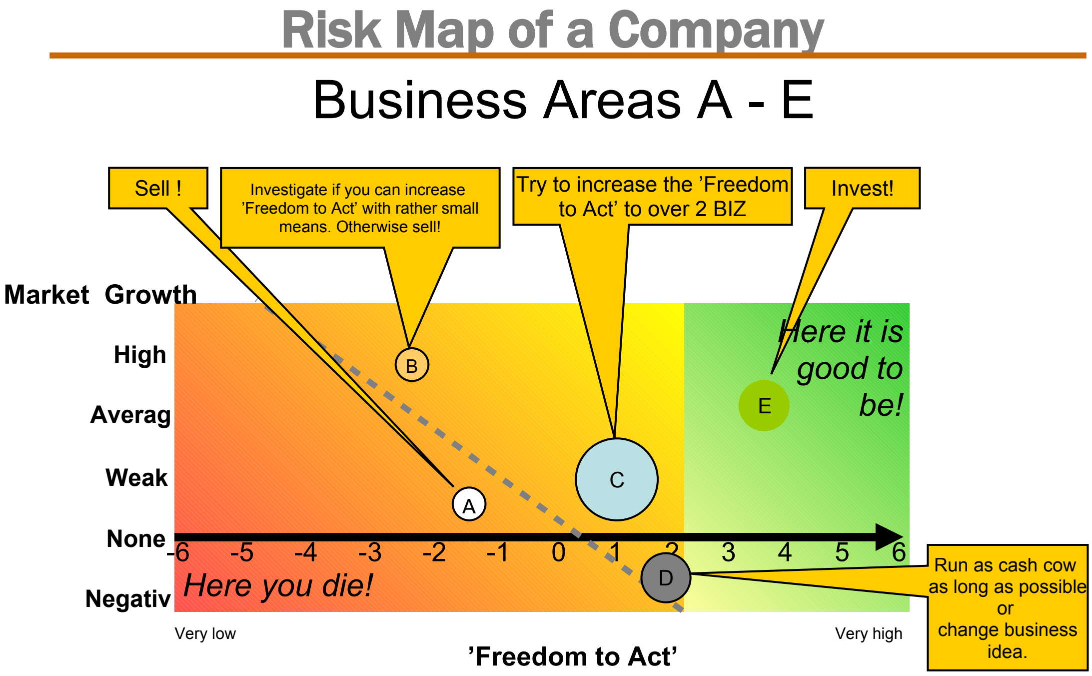
–6 represents the worst possible situation of a company. No freedom to act at all. No business has so far never reached such a bad rating. They always die on their way "down the drain". At the other extreme, +6, we have so far registered three business areas of about 2000 analyzed with the very best rating, but never an entire company.

As can be seen in the risk classes there is a sort of "natural distribution" around Biz-index 1. Around 3,8 there is however a cluster of well run businesses, but with at least one potentially serious but not fatal problem that remains unsolved.

NB this is based on the analyses we have run using the RealBiz® Tool and is not necessarily representative to all businesses in the world. The RealBiz® Biz-index is however a very useful tool to compare the over all results of different analyses.

The Top Management's view

A major concern for the top management of a company or a group is what business areas should they invest in and what should rather be pruned off. The RealBiz® System contributes with good bases for such decisions. Below is a typical example of a company with several business ideas (or business areas).



This is a graph with the Biz-index on the horizontal axis and anticipated market growth on the vertical. The dotted line is tentative and suggests the limit for what should be accepted in the short run. Of course this limit is very subjective.

A small business area enjoys a safe harbor in a large company since the company can afford to assist with its resources if and when needed. As it grows it will demand bigger and bigger resources and the more important it becomes to the company the more it has to live on its own merits. To assess if a growth area is worth an investment one can make a "what if" analysis of it and enter other fundamentals that influence its agility.

Money To Green

The costs to bring a business area to position where the Biz-index exceeds two is called "Money to Green". In some cases a business area with an unfavorable position can be moved into the desired green area by simple actions. Then the "Money to Green" is low in relation to its resources.

In other cases even a small change from a bad position would cost a lot of effort and money. Such areas should enjoy limited support from the company.

"Money to Green" is an interesting way to prioritize different actions to be taken by the company in its different business areas. The importance of the business area, the change in Freedom to Act, and the cash needed for the actions are factors that decide their relative priority.

ERM – Enterprise Risk Management

The purpose of ERM is to maintain and increase the company's value by avoiding disasters and balance risk.

As stated above value is a perception at the beholder. The perception of the company's ability to survive, grow, and be profitable. These factors decide if an interested party wants to make business with, or work for the company.

Therefore the purpose of ERM is to make it more plausible that the company will survive, grow, and be profitable. This is a question about both the risk management itself and the transparent and reliable reporting about it.

It means to position the company so that it is not hit by changes in the environment but can surf on the waves of change by having a high degree of Freedom to Act, i. e. its ability to resist or avoid the potentially destructive forces of the environment.

Baseline Reporting

As mentioned above Mr. Hans V. A. Johnsson several years ago suggested that we should complete the RealBiz® concept with some more information in order to design a Business Reporting model. He shared Per Erik's view on the uselessness of the financial reporting as basis for important decisions. He had also chaired a major work among Swedish listed companies to improve their reporting apart from the financials.

Thus Base 3 and 4 as described earlier.