

## Assessing Long Term Viability of Firms: Future Capability Model[FCM]

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**Abstract:** The need to evaluate the long-term sustainability of a firm is frequently felt by researchers and professionals in a variety of fields. Bankers, Equity Researchers, Portfolio Managers and Credit Rating Agencies can benefit a lot from the knowledge of long-term sustainability of a firm.

The first step towards assessing the long-term sustainability of a firm is to profile its capabilities and vulnerabilities with respect to itself and its environment; with respect to its critical factors. But how does one profile these ? Or assess the long-term sustainability of a firm?

Altman [1968] attempted to forecast the future financial health of the company using past financial data. This model had two major drawbacks: [a] It relied totally on financial parameters and [b] It did not consider the changes in the external environment. The literature on project appraisal [UNIDO Guidelines, OECD Manual etc] depicts another attempt to forecast the sustainability of the firm. It does consider the externalities of the firm to an extent, but the strategic factors of the firm do not get reflected in the analysis. The strategic thinkers [Porter (1985), Prahalad & Hamel (1989) etc.] have identified various aspects that have impact on the long-term sustainability of the firm. Their focus is more on the future capabilities of the firm; less emphasis on its past capabilities. The earlier models are inward looking and static; the latter models are outward looking and dynamic. There is a definite need to combine these two sets to create a unified approach.

This is the genesis of the Future Capability Model [FCM]. FCM attempts to have the intellectual rigor to capture the attention of the theoretician; it also aims to possess the simplicity to excite the practitioner.

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**Preamble:** The need to evaluate the long-term sustainability of a firm is frequently felt by researchers and professionals in a variety of fields. Bankers and lenders could do a lot better with this knowledge while making

credit decisions that have long-term impact. Equity researchers require this knowledge to forecast the future prices of the scripts. Portfolio managers require it in identifying the scripts to be included in their portfolios. Credit rating agencies can benefit from the knowledge of long-term sustainability of a firm.

The first step towards assessing the long-term sustainability of a firm is to profile its vulnerabilities with respect to itself and its environment; with respect to its critical factors. Enterprise-wide Risk Management [ERM] is all about such a risk-mapping and initiating preventive measures. But how does one profile the vulnerabilities of a firm? Or assess the long-term sustainability of a firm?

The Altman model [Altman, 1968] analyzes the financial statements of immediate past years to forecast the future financial health of the company. The model presumes that the business environment of the firm – the externalities – remain unaltered in the foreseeable future. This is a wild concession to make in a fast-changing, turbulent world. Another drawback of the model is that it focuses on the financial parameters only; it does not factor in many other key aspects of business – like management capability, leadership, strategy, innovation etc. What is implicit in the model is that the impact of strategic factors will get reflected on the financials of the firm. This is true for the past; the changes in the strategic parameters of the firm in the future have no way to get factored into the model.

The elaborate literature on the subject of project appraisal culminating in the seminal treatise called UNIDO Guidelines [Amartya Sen, et al 1970] too has its limitations. It does consider the externalities of the firm to an extent – to the extent of assessing the market prospects. Beyond this, the strategic factors of the firm do not get reflected in the analysis.

The strategic thinkers like Michael Porter [Porter, 1985] CK Prahalad and Gary Hamel [Prahalad & Hamel 1989] have identified various aspects that have impact on the long-term sustainability of the firm. They tend to focus at the future and hence, perhaps, the approach is more dynamic. But they generally ignore the past capabilities of the firm. The earlier models are inward looking and can be termed static. There is a definite need to combine these two sets of approaches to create a unified approach.

This is the genesis of the Future Capability Model [FCM]. FCM attempts to have the intellectual rigor to capture the attention of the theoretician; it also aims to possess the simplicity to excite the practitioner.

### **Towards a Comprehensive Frame-work**

Any comprehensive frame-work should fulfill the following pre-requisites.

- a. It must have the ability to understand the past performance and from that project future performances and capabilities. The past performances can be in the form of physical performance, financial performance, productivity in various aspects etc. These must be the basis or the starting point in the effort to predict the future performances.
- b. It must be able to combine the intrinsic factors driving the firm with the external factors effectively to predict the future performances and capabilities. The intrinsic factors are those relating to the operational aspects of the firm. Factors relating to product-market, relating to the financial markets, relating to the industry, relating to the economy etc will have to be combined with the intrinsic factors and capabilities of the firm.
- c. It must be able to assimilate the emerging trends in the industry and economy. Major paradigm shifts are taking place in the global economic arena. For instance there is a pre-eminence of service sector firms in place of manufacturing firms over the last century. Similarly emphasis on market-orientation and customer focus has been increasing. Organisations have been becoming more knowledge oriented. These and such other trends must be able to be incorporated into the frame-work.

### **The Firm as a Living Entity**

The concept of organization is a creation of man in his endeavor to survive and grow through a myriad of situations, over the ages. It reflects the genius of man in organizing human activities – be it social, political, economic or others. In the evolution of the concept of organization it is reasonable to presume that man has been influenced by what he saw in nature and the innumerable systems in nature. Today, in understanding the intricacies of the organization, in analyzing the organization as a self-sustaining entity we could draw a lot of lessons from some of the self-sustaining systems found in nature.

Fitzgerald [5] in looking at the organization as a living entity describes it as an entity that breathes, that lives, that grows, that thinks, that decays, that becomes unhealthy, that heals and that, very often, dies too. He describes the organization as having a personhood. Given this background can we draw analogies from the theories that describe the human behavior? Can Maslow's[6] theory on the hierarchy of needs be extrapolated to the organization?

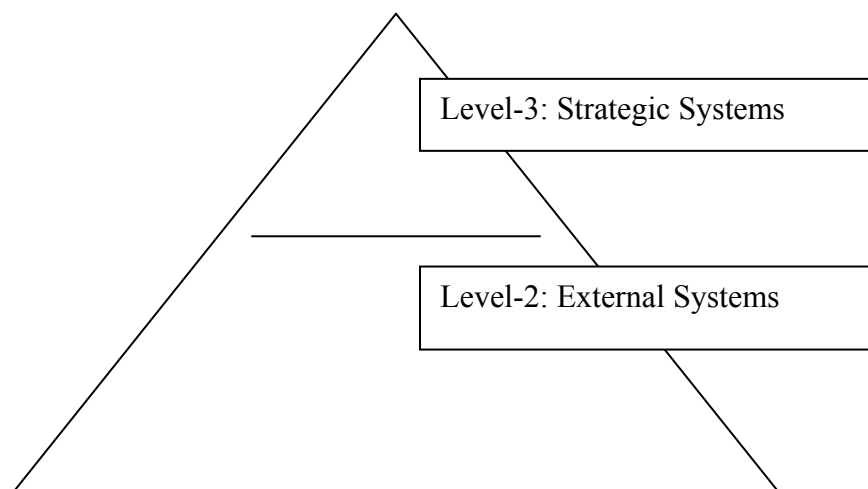
Swami Chinmayananda[7], in his discourses on Bhagawad Gita, describes human existence at three levels – Physical Level [Body], Mental Level[Mind] and Intellectual Level[Intellect]. Sankara[8] looks at human existence at five levels: Annamaya Kosha [Physical Layer], Pranamaya Kosha[ Life Layer], Manomaya Kosha[ Mental Layer], Vijnanamaya Kosha[Intellectual Layer] and Ananadamaya Kosha[Bliss Layer].

Wolfgang Mewes[9], a German management consultant, has looked at the firm as consisting of five levels of hierarchical systems: Physical/Material Systems, Technological Systems, Informational Systems, Financial Systems and Strategic Systems.

In all these perceptions, whether it is Maslow or Sankara or Chinmayananda, or Mewes, there is a perceptible gradation from physical or tangible systems to intangible systems. Definitely an organization is also characterized by physical systems and intangible systems. With these in background and considering the pre-requisites for a comprehensive model listed in the earlier section, a framework to understand and analyse the firm has been developed; this is the Future Capability Model [FCM ]

### **The Future Capability Model [FCM]**

The framework looks at firms in three structured levels.



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Level-1: Physical Systems
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**Fig.5: Future Capability Model – an Outline.**

The primary or the bottom-most level [Level-1] analyses all physical and technological aspects relevant to the firm's functioning. It concerns with the factors and parameters that are relevant for the immediate existence of the firm. To that extent it can reflect on the success or failure of the firm in the very short-term horizon.

The next higher level [Level-2] evaluates the external factors relevant to the firm's functioning. Broadly this level covers product-market aspects, aspects relating to the finances of the firm and the financial markets, aspects relating industry and economy in which the firm is functioning. These factors enable a better understanding of the firm in its context and its environment; this enables an understanding of the prospects of the firm in the medium-term horizon. It could give you a SWOT analysis of the firm; it may not be sufficient to describe the capabilities of the firm to survive and grow in the long-term.

The next level of analysis [Level-3] looks at the firm in terms of its strategic dimensions. This analysis looks at the brain of the firm; its capabilities in creating and managing its own destiny; its ability to adapt to the emerging scenario; its ability to write its own script. The focus is on the strategic capabilities of the firm, its capabilities in knowledge management, its capabilities in managing creativity, innovation and leadership.

Critical parameters of evaluation under each of these levels is discussed in subsequent sections.

**Physical Systems**

The major parameters to be evaluated under this level are:

- Materials and Utilities: Sources, availability, supply situation, quality and reliability of supplies, Long-term arrangements, cost comparison, Supply-chain management initiatives etc.
- Technology: Sources, alternatives and comparison, Technological forecasting, R& D Initiatives
- Machinery and facilities: Sources, alternatives and comparisons, costs, spare-parts, maintenance services, capacities, economies of scale, international comparisons etc.
- Manpower: Quality, quantity, availability, prices[wages], attitude, skill/ knowledge, long term arrangements, HR processes, Policies etc.
- Physical performance: Output, capacity-utilisation, productivity, international comparisons etc

### **External Aspects**

The major parameters to be evaluated in this level are:

- Market-segment: customer perceptions, customer characteristics, stage of the product-life-cycle, market-share, market growth, market-share-growth etc.
- Analysis of competition, structure of the market, competitive advantage, marketing processes of the firm, marketing strategy etc.
- Perception of opportunities and threats
- Financial analysis, capital structure, cost of capital, financial management processes, policies, control systems etc.
- Stock-market performance, price, P/E ratio, market capitalization, dividend policy, share-holding pattern etc.
- Analysis of the industry and economy, emerging trends and impact areas etc.

### **Strategic Aspects**

The critical parameters of evaluation under this level are:

- Strategic perspectives of the firm [vision, mission, Long-term goals, Long-term planning process etc]
- Management philosophy and culture: quality of the Board, process of inducting talents into the Board, succession planning, strategic leadership, nurturing leadership etc.
- Focus, portfolio redefinition process etc.
- Corporate image, ethical behaviour, quality of governance, corporate social responsibility, brand image/value etc.

- Value creation capabilities
- Nurturing knowledge, innovation, creativity, leadership etc.

### **Conclusion**

A broad outline of a frame-work to assess long-term viability of a firm has been presented in this short paper. In order to make this frame-work attractive to the practitioner it will be necessary to list the critical parameters in more details and specifics and on this basis specify the contours of risk mapping of the firm.

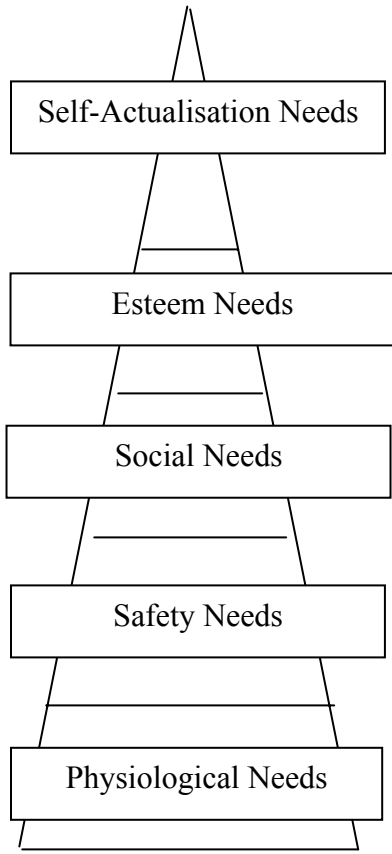
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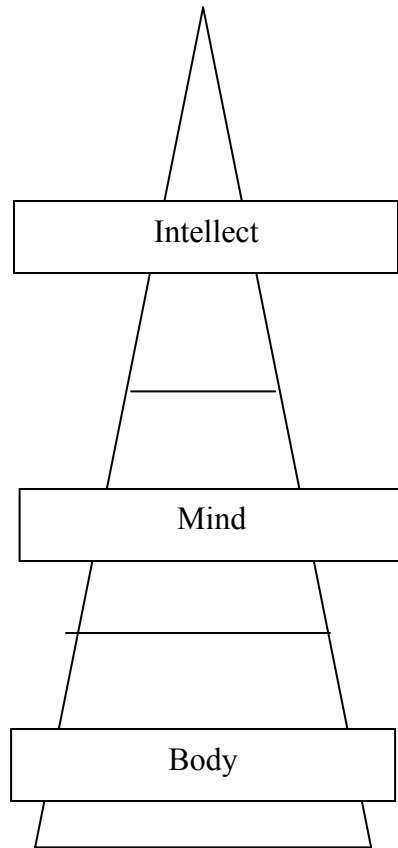
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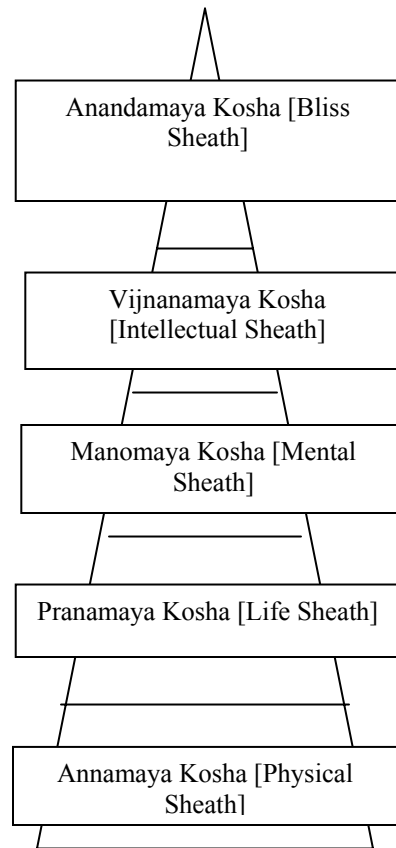




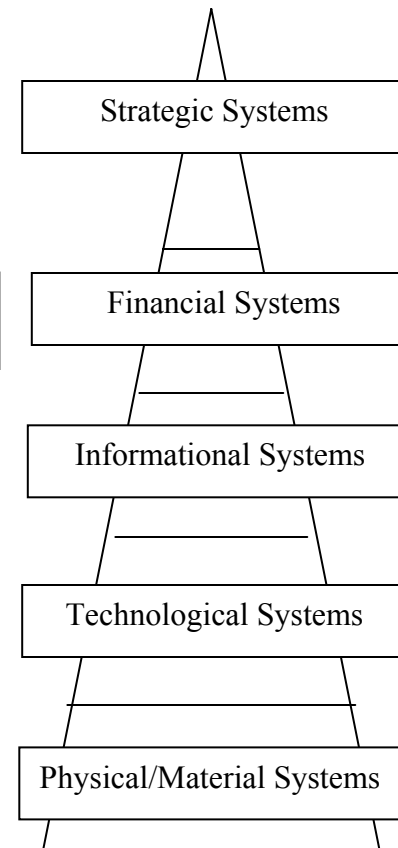
**Fig.1: Maslow's Hierarchy of Needs**



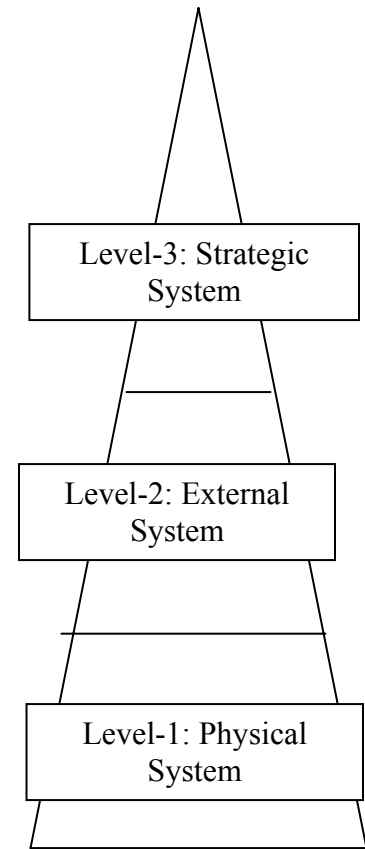
**Fig.2: Chinmayananda on Human Existence based on Bhagavad Gita**



**Fig.3: Sankara on Human Existence**



**Fig.4: Wofgang Mewes Concept of a Firm**



**Fig.5: Future Capability Model – an Outline.**

