Financial measures 1781 essay

To : The Board of Directors, GENERAL ELECTRIC COMPANY

Subject : NEW FINANCIAL AND STATISTICAL MEASURES TO MONITOR

THE SUCCESS OF GENERAL ELECTRIC COMPANY

After Mr. Weltch announced my new assignment, I pondered how I could go about guaranteeing the best possible result: a creditable and well organized work that is going to help you, the Board of Directors, plan for the future of the company in a better way. Before starting my analysis, I must specify that my target is not to abolish the traditionally used financial and statistical measures but to develop new ones to be used as guidance for the corporationA? s future development.

Our Chairman recently wrote that A? the hottest trend in business in 1995 — and the one that hit closest to home — is the rush toward breaking up multi-business companies and spinning off their components, under the theory that their size and diversity inhibited their competitiveness … breaking up is the right answer for some big companies … for us it is the wrong answer. A? 1

For us the new trend is the entrance into the service industry.

The question must then be: is this the right answer?

GE is expecting to increase its revenue by the year 2000 to $120 billion compared with $58 billion in 1990. In other words, if the forecast proves to be correct, it will obtain an average annual rate of growth of 7. 5%. This high rate is mainly attributed to the expansion of the services sector of the company, which is estimated to increase by an average annual rate of 13% compared with a corresponding one of 2. 1% for manufacturing. Today nearly 60% of GEA? s profits comes from services — up from 16. 4% in 1980. 2

This is our new direction and therefore my target is to find these measures that are going to help us understand how the business is going to perform in that particular field. I also consider that our attempt to expand internationally is extremely important and in a way is something new for us. International operating profit was $3. 0 billion for 1995 compared with $2. 3 billion in 1993. 3 This extremely rapid expansion hides a lot of dangers, and at the same time shows another new A? trendA? of our corporation. In my analysis I will include the international sector. I will also narrow in on employees, stockholders, goodwill and on potential investors.

1) MIEC (Manufacturing Industry Expenses Comparison)

As we know, the basic organization of the company A’s continuing operations consists of 12 key businesses, which contain management units of different sizes. 4

From these only three are specified in the service field, including: (a) Capital Service, (b) NBC, and (c) Information Service. On the other hand, the manufacturing industry is divided into nine different segments, some of which will be mentioned later. Although it is not our main concern, the manufacturing segment of GE can be used as the yardstick for the success of the service industry. This is so because this sector of General Electric has been extremely successful and very well established during the past few years. Almost $40, 000 million in revenue and almost $9, 110 million in profit came this year from manufacturing operations. 5 We know that what we have achieved in manufacturing is success. So the question that arises is why should we stop investing in A? successA? and enter a completely different field. The first measure which we are going to analyze in this part of the discussion attempts to answer that question. MIEC, the manufacturing industry expenses comparison, compares the amount of money spent for the service industry to the expenses made for the manufacturing industry. Thus it is equal to :

Expenses made for the service industry

MIEC = ———————– Expenses made for the manufacturing industry

Therefore, according to the financial statements of the previous years we would have6:

MIEC 1992 = 15842/29991= 0. 52

MIEC 1993 = 18560/30657= 0. 60

MIEC 1994 = 19787/30890= 0. 64

MIEC 1995 = 26156/33152= 0. 78

By establishing the MIEC, we can see the relationship between the amount of money spent on service and the amount of money spent on manufacturing. MIEC is a simple number that is does not seem to have a very important use on its one. However, if this ratio is combined with other facts we can come to several conclusions about what the companyA? s future decisions should be.

For example, if we combine MIEC with the return on assets, 7 we can see that the return on assets is higher for the service industry than it is for the manufacturing industry, and thus are able to infer that a good decision would be to increase the ratio by spending more money on the service industry. On the other hand, if the return on assets is lower for the service industry than it is for the manufacturing segment, then we should decrease this ratio by investing more in the latter. What we want to create by using this measure is some sort of equilibrium between the two main parts of our corporation. Mr. Welch has recently said that he would have wished for the percentage of profit coming from the service industry to have attained a staggering 80% instead of 60%, todayA? s figure. 8 In order to achieve this, we should invest more in the service industry, thereby increasing the MIEC ratio.

The question for the future would be: by how much should we increase this ratio? From what we have said up to this point, we should adjust the MIEC ratio up to the point where: return on assets from the service industry = return on assets from the manufacturing industry. Of course, this equilibrium cannot really occur, but it can only be approached; however, it can help us make future decisions in the best possible way. To give an example, let us suppose that :

Return on assets from the service industry = 15%, and

Return on assets from manufacturing industry = 12%.

From the above we can conclude that more investments should be made to strengthen the service industry. However after a certain point the A? good ideasA? would be eliminated. The firm would have to invest in less profitable areas and the return on assets from the service industry would fall, then begin approaching the return on assets of the manufacturing industry, which is already satiated. At this point we should stop increasing MIEC, and we should keep it stable, ceteris paribus.

To expand the share of the services GE had to transform its assets form buildings, machinery and equipment into well trained intelligent employees, software experts, service networks, etc. This transition will cost a lot to the company, and the MIEC shows us just how much it will cost in comparison to the well-established manufacturing industry. It also helps us estimate if this ratio has the value that it should really have for our corporation to be efficient.

2) EC = The Employees Comparison

The EC (Employees comparison) has to do with the profit that each employee brings to the corporation. This ratio is equal to :

Net Income

EC = ——————————————————–

Number of Employees in the Firm

For this year EC= $6. 6 billion / 222, 000 =$30, 000. 9

In a way, EC shows how much profit is generated by each employee. That measure can be used in a lot of different ways. First it can be used to judge if the average salary in the company is settled in the right way. If for example we find out that during the year 199x the average salary was $60, 000, and our other expenses were equal to $250, 000 (if divided per employee) then the return on our investment would be less than 9%, which is not good enough due to our goal — double digit earnings. If we find out that our other expenses are reasonable, then we can suppose that either salaries should be decreased or the firm might have to reduce the total number of employees.

During the 1980s, General Electric had to pare payrolls for most of its departments because the salaries where considered to be too high for the income generated. 10 But as the corporation is getting bigger and stronger, there might be people working in the newly purchased companies that the corporation controls whose salaries are higher than the actual service that they offer to the company. In order to avoid that, we should find the EC for each of the companies individually and compare them.

We could also compare the EC between the two industries, the service and the manufacturing industries. Since the manufacturing industry is older, many changes have been taken place in difficult times for the company. 11. Thus, we can suppose that the number of employees was adjusted during the years in such a way that the corporation could function efficiently. Therefore, a good target for the newly bought service firms would be managing to reach the EC of the manufacturing firms that belong to General Electric.

The same can happen with firms in the USA and international firms, the majority of which have been acquired during recent years. For example in 1995 we would expect that the 72, 000 employees working abroad12 would bring in approximately: 72000 x 30000 = $2, 160 billion (as mentioned above $30, 000 was the value EC for 1995).

On the other hand we can see if the measures to increase the profits of an organization are too harsh for the employees, or are not rewarding the employees well enough. For example, if an outsider can describe a salary of $80, 000 as high, no one can say if this salary is high enough unless he/she takes the EC into account. So by using the EC we can estimate the correct amount of bonus that an employee can receive for performing well, or even the bonus for the entire firm that performed well. We should not forget that salaries considered to be too harsh will lead valuable employees to quit in order to find better paying jobs.

To summarize, we can say that the salary level should be well balanced so that it does not disappoint employees by paying them less then they believe that they should to be paid, nor should it reach levels that would cause losses or sizable reductions in investment, as this might bring future losses as a result. The EC measure can help us create this balance more accurately.

3) In the third part of our analysis, I am going to discuss dividends. As we all know, it is very important to keep our stockholders satisfied. Until today, there have been measures that have been gauging what stockholders receive only in a mathematical way. For example, we could say that in 1995 the dividend declared was $1. 69. But what does this really mean? Let us take another example. Some would say that if for example we offer the 50% or more of the corporationA? s profit to the stockholders, they will be satisfied. Can we be certain that this is true? How can we judge?

With the new measure that I am going to introduce, we are going to be able at any time to estimate the utility that each of our stockholders receives by the dollar amount of the dividend that we pay to him/her. In order to create such a measure, we have to take many factors under consideration. First, we must clarify that when we talk about stockholders, we are not referring to people who are just investing in the stock market for the purpose of gaining money from the short term ups and downs of GEA? s common stock market price. We are referring to the people that in some part of their lives wanted to invest their accumulated wealth and decided to buy shares of GE. In order to see if the investors are satisfied in choosing our stock, we must take into consideration what their situations would be if they had chosen another form of investment or another corporation in which to invest their money. 13

I will suppose that the closest investment, for a household, to buying shares of GE is buying bonds. Bonds certainly do not have a great potential for very large profits. In addition the risk when buying a bond is very low. Therefore the new measure should combine these two characteristics of buying a bond and compare them with the profits from buying shares of stock that have the same value as one bond. I will name the new measure: Stockholders Comparable Utility = profit from buying shares of the company / profit from buying a bond. 14

As you see in the above ratio, risk is not taken into consideration. This may not be correct for another corporation, but it is the correct choice for GE. If we wanted to take risk into consideration, we could create an index where: risk from buying a bond = 1, risk of buying shares of stock of the same value = X. We would have to examine the financial position of the company and we would assign a value to the risk of buying the shares. Then we would multiply that value with the SCU ratio. However, in the case of GE the risk of buying shares of the company is as low as the risk of buying a bond (from the company or from the government). Hence, for GE the SCU ratio depends only on the profits (or losses which will be calculated as negative numbers in the SCU ratio) derived from the two possible investments. To close we have to say that since: RISKbond = RISK shares of GE = 1 any SCU > 1, any dividend that would give higher return than a return that a bond should satisfy our long term stockholders. However, if for any reason during the next few years we find that the above equation is not correct, we should make the appropriate changes.

4) Besides the long term investors there are a lot of people that closely watch GEA? s performance, such as creditors and short term investors. All of these read our annual reports but at the same time try to find any sort of information about the actions that we take. We know how important it is to show to the indirect users of the financial information that we are doing well and that we should never cause any suspicions of fraudulent financial reporting. That can be partially achieved if we use creditable and conservative financial procedures, but that is usually not enough. We can take for example a newly formed corporation that creates its first financial reports by using the commonly accepted accounting methods. At the same time lets suppose that this company reports huge earnings for the first year which are real. What is the reaction of the market going to be? Certainly not as substantial as if General Motors, or Unilever reported a huge increase in profits. There will be mistrust. In my opinion what could make the investors

and the creditors trust a corporation A? blindly A? is the companyA? s prestige. Of course these two huge corporations may have achieved much respect but they should definitely make anything possible to keep up with that good name that they have created. One can say the effort to do that is only related to an attempt, for example, not to create pollution or not to be guilty of any kind of racist attitude in the company. Of course, it is true that if we were guilty of any of these actions we would probably be humiliated in the eyes of the consumers. Many of them would not prefer us any longer and we would therefore be a weaker company. Thus we would loose a lot of our potential creditors or investors. However, we can see that the above have only an indirect connection to what the investors would feel about our firm and it is related to what the financial statements show about GE. If we report lower earnings, banks will not give us as many loans as the are giving us now.

With the new ratio that I am going to introduce I am making an attempt to help eliminating any kind of mistrust to the company due to reasons which are not related to the financial statements and have a direct connection to the investors. That mean that there are several actions that we should consider making that are not actually going to increase our earnings by satisfying our customers but are going to increase our A? prestigeA? — our goodwill. I will focus on one of them, the ability to participate in bids, and to be the preferred company. Therefore the new ratio equals: Goodwill Creating Ability (GCA) = number contracts signed / number offers made. The number of offers made refers to the number of bids at which the company participated. If we manage to be the preferred company in a lot of bids then it will be commonly known that we have the power not only to show good past and present financial data but also to continue in doing so through the next years. The question that arises is how this measure is going to affect our movements for the following years.

In my opinion the idea of this measure and its effect on the creditability of the company will first of all affect the way we think before entering a bid. We often try to make a deal for which there are great doubts if it is going to offer any earnings in the future and at the same time our chances to be preferred are quite limited. If we do not take the above ratio under consideration the only risk related to our entrance to the bid would be the chance not to make enough earnings to cover our expenses after actually being the preferred company. However the GCA shows that the actual risk is much higher and therefore we should possibly reconsider entering into several risky bids (that can be lost easily).

There are some times, however, when our estimations were not correct and although we entered the bid, yet other rival firms appear to have strong chances of actually being the A? preferred ones. A? For example lets suppose that local CHANNEL X enters an auction to buy a studio in the Providence area. NBC, on the other hand, the huge broadcasting company which we recently acquired wishes to buy the same studio so it enters the bid. After a few days, secret information are offered to GE which reveal that CHANNEL X is going to offer the price of $10, 000, 000 to buy the studio. We also know that the maximum revenues that this studio can create for the next 20 years are $9, 000, 000. That is a good indicator that it is not a smart move for us to make a higher offer. Someone would think that the best thing to do would be to make a lower offer and hope that the information given to the company is incorrect. This choice does not seem to be irrational, because of the commonly accepted cost benefit analysis. But in this case, is this the right answer? Lets suppose that we do give a lower offer. The following day we see that CHANNEL X, offered $10, 000, 000 to buy the studio. The result would be losing from a channel that hardly anyone knows and that is much weaker than NBC. How is this going to sound to all these that on a daily base watch the actions that we take? Channel X reported operating profit of $2, 000, 000 for the financial period ending December 1995. For the same period NBC reported operating profit equal to 738 million dollars. 15 What could someone think then about the creditability of our financial statement? I am not suggesting that nobody is going to realize what has actually happened but can we be sure that nobody who is very important to us will think differently? How can a multi-million dollars firm loose by an unknown company? Our prestige would not be so high any longer. That is why, in several cases, we should reconsider offering a price that might give us profits if we win, but it does not guarantee that we will actually do so. In some cases we might have to lose money in order to make our company prestigious. To prove why this is correct take under consideration all the expenses that we make and that are made only because we want to create a better name and consequently to receive the benefits of that. A good example is advertising.

In my opinion as long as we realize that a firm is not only buildings and equipment but also a name we can realize why the GCA ratio is very important as a new way of thinking. We should make sure that this ratio only increases.

5) I have already referred to a measure that is affiliated with stockholders, the Stockholders Comparable Utility. I justified the creation of this measure by saying that it is very important to monitor on a constant basis the utility of our stockholders which derives from the dividend that we give to them. The question that can arise out of this statement and could be partially answered by the creation of the last measure is, A? how much power do the stockholders actually have over the corporation — or put another way, how important is it to keep them happy? A? It can be said that the larger our need to find cash in order to expand the larger the importance of investors for us. However, such a measure would refer to future investors and not to the ones that already have claims over the assets of the business. In order to see the actual power that the latter have over the corporation we have to consider the Claims of the Stockholders Ratio which is equal to: Number of Shares Outstanding / Number of Shares Issued. For example for 1993 the CSR was equal to: 1, 707, 302 / 1, 853, 128 = 92. 1%, for 1994: 1, 705, 967 / 1, 857, 013 = 91 % and for 1995: 1, 666, 512 / 1, 857, 013 = 89. 7%. 16 From the above facts it is obvious that the stockholdersA? equity is decreasing over the years and, consequently, so is the control that they have over the corporation. The question that arises is what is going to be affected because of that and how is it going to be affected. The answer is given in the following hypothesis.

As we know the corporation issues shares of stock if the cash available for investments is not enough for the planned expansion of the company. If GE manages to have better cash flow results, then it will not have the need to issue a many shares of stock as before. At the same time GE will be able to buy some portion of its outstanding common stock (as mentioned in footnote 16, GE does not have any preferred stock) and, therefore, reduces the stockholdersA? equity over the assets of the company. If this procedure continues successfully during the next few years, then it will be obvious that GE does not A? needA? its stockholders or the potential investors that much. On the other hand, we know that when a company wants to attract more investment has to offer a high dividend to its stockholders. Thus, if the corporation does not need to attract as much investment, and can rely more on its own power to invest, then the amount of money given to the stockholders should be decreased.

To close we can say that if the CSR is a simple measure based on the simple supply – demand convention.

I hope that the five measures that I have created will be useful to you, Members of the Board of Directors, in planning for the future of GE. I have confidence that the firm is going to continue putting forth its best efforts towards growth and expansion, which will bring outstanding results. I believe that the measures that I have suggested will help in that direction, and will be crucial in attaining our future goals. Thank you.