Rethinking Performance – A Framework

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Judith Stroehle

The purpose of companies has been the subject of much recent discussion and debate. On August 19th, 2019, the influential and traditionally shareholder-oriented Business Roundtable (BRT) – whose members are the chief executives of most major U.S. based global corporations – released a "Statement of the Purpose of a Corporation[1]" which promises an end to the decade-long shareholder-primacy of modern capitalism and instead launches a "fundamental commitment to all [the companies'] stakeholders".

While this statement was recognized as an important signal from the leaders of major global corporations, it also inspired significant criticism due to its lack of detail and scepticism about how this new vision of corporate purpose could be put into practice. To establish that the BRT statement is more than just "empty rhetoric", the signatories of this statement must now address how performance is defined in their organizations and over what timeframe they are committing to create long-term value (Winston, 2019).

How can this be done? First, to prepare a holistic and long-term oriented definition of corporate performance, each company needs to define its own purpose beyond the generic "shareholder-focus" outlined by the BRT. In so doing, a company needs to define its core business focus and highlight what problems it seeks to solve (Mayer, 2019). Once a company has defined its purpose, it must put this purpose into practice by ensuring that it is at the heart of how long-term value and performance are defined across the organization.

To do this, companies need to create consistent and purpose-aligned measurement systems which ensure that business targets are set in accordance with the corporation's purpose and that progress is measured against these targets. The targets will be both financial and non-financial to capture the variety of risks, dependencies and opportunities that are related to a company's long-term value.

The measurement of non-financial targets remains a challenge, as there are no universal standards for metrics which companies or investors can refer to. These measures are however key for implementation, internal alignment, and external evaluation of a firm's purpose. At the functional level, stringent non-financial targets are important to create incentive structures for good management decisions which further purpose implementation. The capacity to make these good decisions relies heavily on consistent and reliable non-financial measurement.

[1] The Business Roundtable (2019), Statement online under https://opportunity.businessroundtable.org/wp-content/uploads/2019/12/BRT-Statement-on-the-Purpose-of-a-Corporation-with-Signatures.pdf

At the board level, non-financial key performance indicators are key to define which issues are considered as material to a company's purpose. Boards which communicate clear non-financial priorities create alignment within their organizations around how purpose is to be put into practice. At the investor level, reliable and consistent non-financial information enables the allocation of capital to those companies which act responsibly and create sustainable profit without creating harm.

To date, companies' non-financial performance is often evaluated using a mix of corporate reporting and for-profit environmental, social and governance (ESG) data. Data quality and reliability are a serious concern as ESG ratings and rankings are often created in a black box, often with a high degree of inconsistency and lack of correlation between different data providers.

At all three levels – the functional, board and investor level – rethinking performance, as a broader concept of long-term value creation in accordance with a company's purpose, requires consistent and reliable non-financial measurement systems. Currently, many of the non-financial data sources used are supply driven. The for-profit ESG data providers expect companies to create certain non-financial data for their rankings, and investors use these data in their investment decisions for lack of alternatives.

In contrast, if rethinking performance is purpose-driven – as we suggest above it should be – then the creation of non-financial metrics and measurement systems should also be purpose-driven. Concretely, the creation of non-financial information must be focussed on solving the material questions and problems of actors at the functional, board- and investor-level. In other words, the definition and creation of non-financial measurement systems should be driven by the needs of the users of the data, rather than by the providers of this information.

With a focus on questions rather than answers, non-financial measurement systems can provide clear answers to the problems of management, boards and investors. On the reporting side, which is particularly relevant for investors and boards, there is a strong demand for these measurement systems to be standardized. The assumption is that disclosure standards provide a transparent and comparable data environment for all stakeholders, while creating a level playing field for those companies reporting on these standards (Stroehle, et al 2019). The call for standardization is not inconsistent with focussing measurement on the user side.

In addition to universal measures, there will still be a need for the disclosure of sector- and company-specific information. The current ecosystem of non-financial reporting already offers a variety of standards which range from conceptual reporting frameworks to concrete measurement indicators and valuation methodologies. To promote agreement between the largest and most important organizations behind these frameworks, the non-profit Impact Management Project (IMP) has created a structured network to facilitate "a unique shot at agreeing on standards of practice that might ultimately become generally accepted globally"[2].

For management decision making and internal alignment behind a corporate purpose, rethinking internal corporate performance evaluation is also important. Social and environmental management accounting can concretely focus on the questions which managers face regarding their daily business. The evaluation of performance on an individual, functional, project and business unit level can all be linked to non-financial goals in alignment with the corporate purpose. Additionally, traditional financial performance measures – such as profit – should be adjusted to reflect a corporation's performance net of the cost needed to correct negative impacts. A truly sustainable profit therefore accounts for negative externalities in the area of human, social and natural capital.

This idea is reflected in the British Academy's Principles for Purposeful Business (2019). Through the incorporation of capital maintenance processes and the provision of their cost on corporate income statements, companies set strong incentives for their business executives to act and manage the firm according to its purpose (Barker and Mayer 2017). The Economics of Mutuality framework aligns with this thinking around cost-based adjustments of the income statement and offers a measurement and management technique for its practical implementation.

An alternative for the adjustment of financial accounts according to negative and positive corporate externalities is the impact measurement and valuation methodology. Here, impacts are directly attributed a financial value which is not linked to the cost to the company, but rather to the cost and value to society. Organizations currently working on the standardized measurement of impact valuation are the corporate-led Value Balancing Alliance and the academic-led Harvard Business School Impact-Weighted Accounts Initiative.

In rethinking performance, we focus on three levels: the functional management level, the corporate board level and the investors. At all three levels, the reliable and consistent evaluation of a company's non-financial performance is key to aligning business practice with corporate purpose. To achieve this alignment, the definition of performance and measurement systems should be focussed on the questions of managers, boards and investors that arise in solving the problems they seek to address. Both, on the reporting and accounting side, the standardization of a universal set of these measures is desirable to create a level playing field. In addition, company-specific measures will be required to capture each company's idiosyncratic purpose, risks and dependencies.

[2] Impact Management Project, 2019. List of members and more information about the IMP structured network online under https://impactmanagementproject.com/structured-network/the-imp-launches-global-network-to-mainstream-impact-management/

Literature

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