Integrated Thinking and Acting

Integrated management control in the context of modern performance management systems

An opinion paper by
the University of St. Gallen
and PwC Switzerland

pwc

University of St.Gallen

We are pleased to be able to share with you the main findings of the survey based on a questionnaire that was designed and distributed by PwC in association with the professors of the Accounting department at the Institute for Public Finance, Fiscal Law and Law and Economics of the University of St. Gallen. The goal of the St. Gallen researchers (led by Prof. Dr. Thomas Berndt and Tobias Müller) and the PwC team (under the direction of Peter Eberli and Stephan Hirschi) was to gain valuable insights into the organisation of performance management systems and the external stakeholder management of the participants, and to draw conclusions from the information that was gathered. We also evaluated the familiarity with and application of relevant standards regarding non-financial reporting, and explored the impact of the derived information on the quality of decision-making and economic success.

As senior managers (from CEOs to heads of risk management) from a variety of different fields and a wide range of companies took part in the survey, we consider the survey for companies in Switzerland to be meaningful. Firms from the financial sector had the largest voice, with over 40% of the participants coming from this field.

In an effort to prevent you, esteemed board members and senior managers, from being overwhelmed with an excessive amount of itemised information, we have prepared an opinion paper mainly based on the results of the survey. This publication is designed to provide you with a comprehensive overview of our findings, which are divided into the following sections:

1. Private standard setters and regulation

2. Performance management systems

3. Relationship between financial and non-financial performance

4. Importance of modern performance management systems

5. Usefulness of standards and frameworks

6. Success through integrated thinking and acting

In each section, we have focussed on key factors for success. Direct recommendations for actions can be derived from these factors. The appendix provides an overview of relevant private standard setters in the area of non-financial reporting.

We would like to thank all the companies, and especially their senior managers and board members, who participated in the survey. Without your cooperation, we would not have been able to gain such valuable insights for the future. We are delighted to share these forward-looking findings with you.

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Management summary

Financial performance is of vital importance to the senior management of a company. Non-financial performance, however, often lurks in the shadows and is relegated to specialised departments such as the accounting department, or treated as a separate part of sustainability.

The results of our survey show that such an approach is counterproductive. Senior managers interested in long-term value creation and success must take into consideration the concerns of their company's various stakeholders, and identify financial as well as non-financial value drivers. Long-term value creation and success not only depend on the identification of key value drivers, but also, in particular, on the establishment of a performance management system that allows for controlling these drivers. The results of our survey show that there is an expectation gap in this context.

The message is clear: the more intensively senior management is involved in the modification of a performance management system, the greater its acceptance and usefulness for decision-making. Higher decision quality, in turn, is positively linked to performance. Senior management members should therefore ask themselves how they can take into account (and manage) all the key aspects, of both a financial and non-financial nature.

Integrated thinking and acting create added value, counteract a silo mentality and render a separate sustainability department unnecessary: medium and long-term value creation is enabled by integrated thinking and acting. A strategic commitment is required from management so that key aspects are linked to strategy and not outsourced to operational units.

1. Private standard setters and regulation

Numerous private standard setters and basic regulatory conditions exist for non-financial reporting. Although the appendix provides an overview of some of these, at this juncture we would like to take a closer look at the importance of regulation in particular. In Europe and Switzerland, two current developments are of particular relevance to regulation:

Directive 2014/95/EU

CSR directive on the disclosure of non-financial information, is to be adopted in the EU at the start of the 2017 fiscal year.

This directive requires companies to disclose information regarding the development, performance, position and impact of their activity with respect to environmental, social and employee-related matters. The company's business model, key actions, due diligence processes, main risks and relevant non-financial information (KPIs) must also be described.

The SIX Exchange Regulation directive on Information relating to Corporate Governance (DCG)

The Issuer's Committee of the SIX Swiss Exchange Regulatory Board added an amendment on sustainability reporting to Article 9 of the DCG which took effect on 1 July 2017.

Companies whose primary or main equity securities are listed on the SIX Swiss Exchange are given the opportunity to "opt in" to publish information from their own sustainability reports on the SIX Swiss Exchange website. To do so, the sustainability report must comply with an internationally recognised standard, thereby ensuring the quality of the sustainability reports that are published.

Furthermore, SIX Exchange Regulation plans to publish a list on its website with various rules that have already been approved by the market. This only applies to companies with sustainability reporting, which remains voluntary.

2. Performance management systems (PMSs)

In the context of the survey, the application and use of the following key PMSs were analysed, among others:

Balanced scorecard (BSC)

The balanced scorecard is a holistic model that supports strategy development and implementation while expanding an overarching financial outlook across three perspective levels: process, customer, and development and learning. The various dimensions are interlinked by KPIs, made quantifiable and aligned to achieve an overall goal.

Core element: Strategy implementation

Stakeholder orientation: customer as the sole external stakeholder (in the standard version)

Activity-based costing

As a full-cost accounting instrument, activity-based costing allows for a separation of costs into variable and fixed. With activity-based costing, indirect service costs (e.g. marketing) are measured, and once charged, carried over as overhead rates. Individual activities that make up processes serve as the basis for activity-based costing.

Core element: allocation of overhead costs

Stakeholder orientation: no consideration of stakeholders

Target costing

Target costing is used to determine the prices of products. With target costing, a target profit is subtracted from a target price (derived from market research). The result is the amount to be targeted per item (target costs). If estimated actual costs exceed target costs, the gap has to be closed. The cost reduction is applied according to the value to the customer of different components of the product

Core element: pricing

Stakeholder orientation: consideration of value to the customer (for achieving target costs)

Total Impact Measurement and Management

Total Impact Measurement and Management (TIMM) is a tool for measuring and managing the overall effects of a company's business activity. TIMM not only identifies the economic effects of the company's business activity, but also illustrates the latter's impact on public finances, the environment and society as a whole.

Core element: holistic approach

Stakeholder orientation: consideration of various stakeholder interests

Integrated dashboard (cockpit)

An integrated dashboard consolidates a company's existing data and presents it in a clear-cut fashion to facilitate the decision-making process of the management team. The dashboard makes it possible to review important KPIs at a glance and identify deviations.

Core element: umbrella term for a variety of different PMS approaches

Stakeholder orientation: dependent on the choice of KPIs

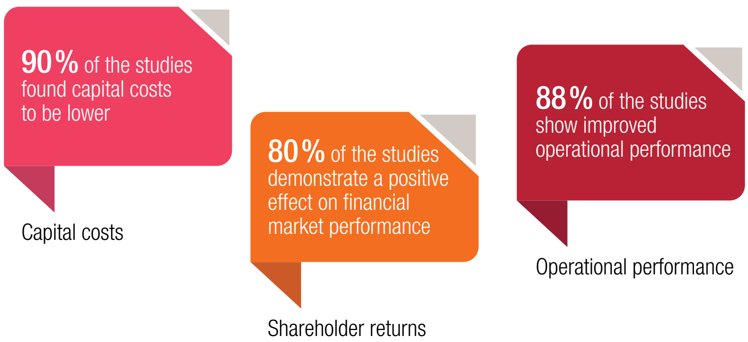
3. Relationship between financial and non-financial performance

3.1 Non-financial information counts

Considering that the number of studies illustrating the relationship between corporate financial performance (CFP) and ESG[1] criteria has risen by more than 400% since the year 2000, and that there are now over 2,000 empirical studies published on the subject[2], we consider meta-studys to be especially useful. These meta-studies analyse at an aggregated level the results of individual studies dealing with the relationship between financial and non-financial performance. The results are clear: 90% of the studies demonstrate a non-negative correlation between non-financial and financial performance.[3]

An in-depth meta-study conducted by Oxford University in association with Arabesque, in which more than 200 different sources were analysed (including not only scientific studies but also books, newspaper articles and industry reports), comes to the following conclusions:

A focus on sustainability standards and ESG practices



Why sustainability is worthwhile[4]

3.2 The increasing importance of non-financial information

The business case for non-financial information seems to be valid, even in the absence of long-term studies. The fact that non-financial information has yet to reach the maturity level of financial information should not be seen as an obstacle. On the one hand, we can assume that the maturity level of non-financial information will increase over time and become comparable to the maturity level of financial information. On the other hand, discretionary room for manoeuvre also exists for financial information in the form of model assumptions, accruals and estimations. It therefore seems logical to integrate non-financial variables into a PMS – not for reasons of "greenwashing" but because it pays off economically.

3.3 The role of regulation

When it comes to reporting, regulation plays an important role. Large listed Swiss companies, for example, perform worse in terms of integrated reporting than listed companies from South Africa, where law has required integrated reporting since 1994.[5] This is not a surprise when one takes into account South Africa's standards and specifications regarding the use of integrated reporting. At the same time, companies with high reporting quality in both countries rank closer to each other than companies with poor reporting quality. Regulation seems to play a minor role for successful companies, as these companies are forerunners and hence not concerned with minimum regulatory requirements.

1 Environmental, social and governance.
2 cf. Friede, Busch & Bassen, ESG and financial performance: aggregated evidence from more than 2000 empirical studies, 2015.
3 Ibid.
4 University of Oxford & Arabesque Partners, FROM THE STOCKHOLDER TO THE STAKEHOLDER, 2015.
5 Vgl. Berndt, Müller & Wachira, ALIGNMENT AND UNIQUENESS OF INTEGRATED REPORTING: A CROSS COUNTRY ANALYSIS, 2016.

Initial findings by the Harvard Business School on the effects of the EU directive are also interesting. These results present a somewhat different picture: while the capital market reaction remains positive for companies with above-average sustainability reporting and non-financial performance, a negative capital market reaction emerges for "underperformers" in the area of sustainability reporting and non-financial performance.[6] New findings by the Accounting department at the Institute for Public Finance and Fiscal Law of the University of St. Gallen suggest that positive capital market reactions are delayed. While regulation in the area of non-financial reporting at EU level initially causes negative capital market reactions, positive effects can be seen in the national implementation process of the EU directive. At first, it is above all the costs for implementing an upcoming regulation which are assessed negatively. The advantages of increased capital market transparency and subsequent improved quality of decision-making for investors matter later, during the national implementation phase, in the form of positive capital market reactions.

3.4 Relevance for Switzerland

Since the EU directive does not have to be implemented in Switzerland, its effects do not apply to the country directly. The increasing importance of non-financial reporting is however a global phenomenon that is not only observable in the EU, but also in emerging markets such as Brazil and India. In the medium and long term, Switzerland will not be able to escape from this trend. The Harvard study shows that companies that are not prepared risk sanctions from the capital market. Firms that commit to sustainability and non-financial performance regardless of regulatory requirements are likely to be rewarded by the capital market.

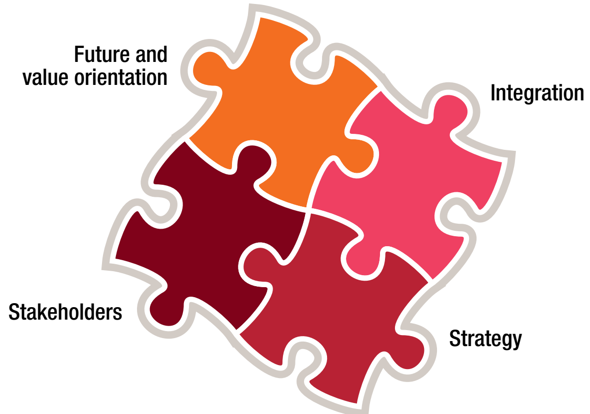
In our opinion, the positive effects a company can experience as a result of integrated thinking and acting are a greater motivation than any potential sanction by the capital market or possible negative effects.[7]

6 Grewal, J. Riedl & Serafeim, Market Reaction to Mandatory Nonfinancial Disclosure. Harvard Business School Working Paper, September 2015.

7 cf. Müller & Berndt, Weniger wäre mehr ("Less is more"), THE EUROPEAN VALUE INVESTOR, 2015.

4. Importance of modern performance management systems

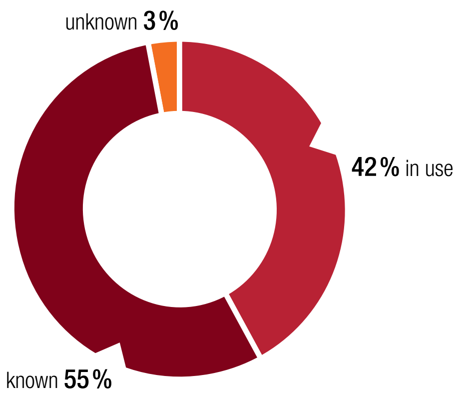
A PMS is defined as all the tools used by an organisation to measure its operational performance and management.



Characteristics of a modern PMS

4.1 Comprehensive value orientation

While traditional KPI systems mainly focus on monetary figures, the focus of modern PMSs and dashboard solutions is on value orientation – in the widest sense of the term. This means that along with financial information, non-financial information in particular is also included. Furthermore, modern PMSs take into account various stakeholder concerns, are attached to the company's strategy in a single integrated approach and enable value creation in the medium and long term. Traditional KPI systems, on the contrary, are more backward-looking.



Use of a balanced scorecard

4.2 Balanced scorecard established, but debatable

According to our survey, the BSC is the most widely used of all modern PMSs, followed by activity-based costing and target costing. The latter, however, only deal with certain aspects of performance and are therefore less comprehensive.

The top 3 PMSs currently in use

In general, the widespread use of the BSC can be seen as a positive development. The results of our survey also show, however, that opinions regarding the BSC diverge: the BSC is the best-known modern PMS and used by almost half of all those surveyed. Yet those who do not currently use a BSC do not plan on doing so in the future either. No other PMS demonstrates such a decisive split.

In the standard version of the BSC by Kaplan and Norton, the BSC not only takes into account the financial perspective, but also the customer, potential (learning and growth) and (internal) process perspective, thereby allowing strategic goals to be fully reached in a variety of different areas, on the basis of KPIs.

Since the BSC is the most widely used modern PMS, we have deduced that some companies consciously forego the use of multidimensional PMSs.

Along with the standard BSC, there are a number of other versions in use that are tailored according to current trends and a company's specific needs. An integrated balanced scorecard presents a whole new approach, one that takes into account a variety of capital types (not just financial but also manufactured, intellectual, human, social & relationship and natural) and the way these capitals are connected. The connectivity is relevant for implementing strategies.[8]

8 cf. Freidank & Hinze, Integrated Balanced Scorecard zur Umsetzung einer integrierten Unternehmenssteuerung und -berichterstattung ("Integrated balanced scorecard for the implementation of integrated corporate management and reporting"), 2016.

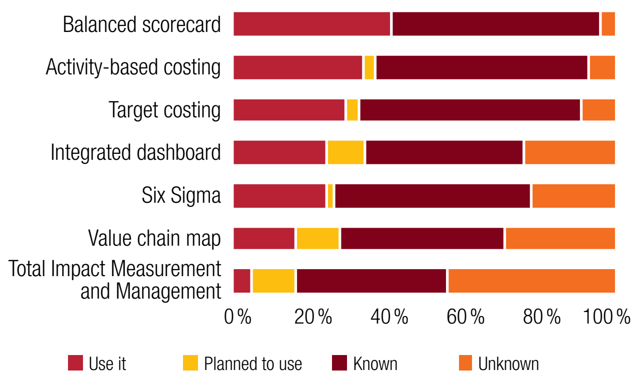
4.3 The customer as the only external stakeholder

In the standard version, the customer is the only external stakeholder (along with the capital investors) that the BSC considers directly. For this reason, the BSC should be supplemented by other tools which take greater account of non-financial aspects, and therefore meet the demands of various stakeholders. Our study shows that there is room for improvement for Swiss companies in this area.

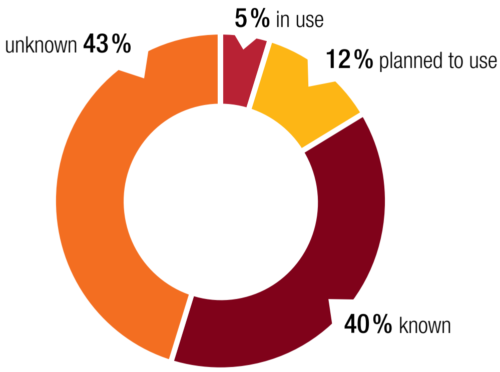
4.4 TIMM as an opportunity

Swiss companies rarely use Total Impact Measurement and Management (TIMM) and value chain maps. TIMM helps companies in making better decisions by allowing them to take a holistic approach to value creation. TIMM not only identifies the economic effects of a company's business activity, but also illustrates the latter's impact on public finances, the environment and society as a whole.

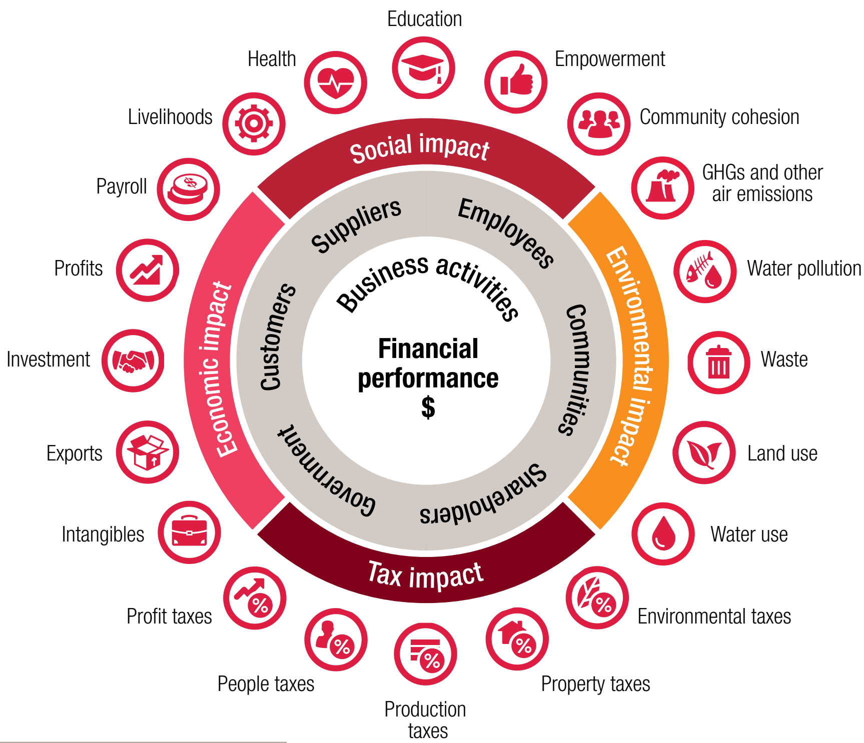
Value chain maps can be used internally to better understand the economic effects of a company's activities on various stakeholders in the value chain, as well as externally by allowing companies to present these relationships in a more transparent manner, and as a result, justify their "licence to operate".



Use of performance management systems



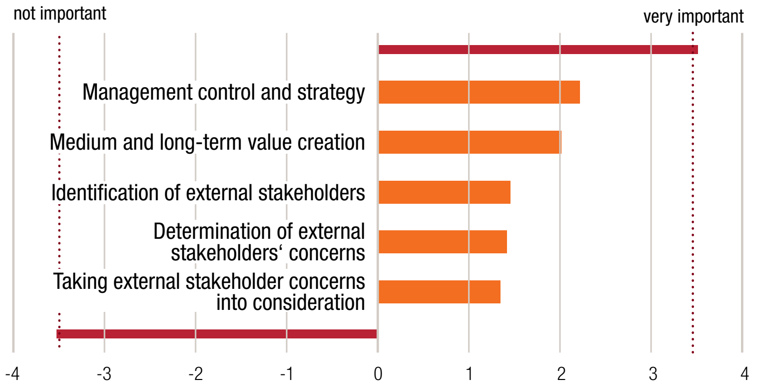
Total Impact Measurement and Management



What is TIMM and how widespread is it?

4.5 Expectation gap identified

Companies that are eager to create value in the medium and long term must consider how to reconcile the concerns of various stakeholders. Simple cost models and one-dimensional PMSs neither allow for the interests of important stakeholders to be taken into consideration nor for management of these interests. In small firms, especially family-run businesses, stakeholder orientation may be anchored in the local culture and therefore not require a corporate-based management system solution. This can for example be seen in a "customer is king" mentality. For medium-sized companies and larger corporations with complex structures and multiple stakeholder groups, however, the use of modern PMSs is vital.



Expectations of a PMS

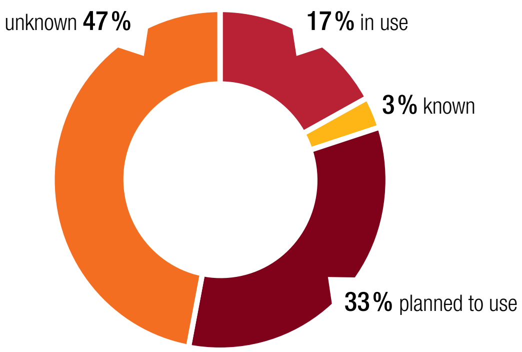
Our survey shows an expectation gap: on the one hand, more than 90% of the participants consider it as important that the PMS is used for medium and long-term value creation. 86% of the participants even see the consideration of various stakeholders as an essential characteristic of a PMS. On the other hand, our survey also shows that half of all participants do not use any known multidimensional PMS. We interpret this as a gap between the expectations of the PMS and its actual characteristics.

4.6 Importance of the materiality matrix

As far as the use of the materiality matrix is concerned, the results of our survey come as a surprise: even though the matrix can be seen as both, a basic prerequisite for the implementation of relevant non-financial reporting standards and for professional stakeholder management, nearly half of all participants are not familiar with it. A company's professional stakeholder management means more than just knowing one's stakeholders (identification) or categorising them according to certain criteria (typology). It demands the identification of concerns of relevant stakeholders and its consideration in the decision-making process. These concerns can be visualised in a materiality matrix.

There is no standard model for designing a materiality matrix. In practice, many companies follow the guidelines according to GRI and represent the significance of economic, environmental and social impacts on the X-axis, and the influence on stakeholder assessments and decisions on the Y-axis.

Materiality is mainly operationalised by sector-specific guidelines in practice. These refer to sustainability guidelines for specific sectors including sector-specific performance indicators. Process reliability in the operational processes of a bank is, for example, a fundamentally different topic than security within the production processes of a chemical company. A one-size-fits-all approach is inappropriate. Sector-specific guidelines therefore make good sense.



Materiality matrix

4.7 Process knowledge is crucial

It is important to understand that sector-specific guidelines are rather recommendations than a set of checklist criteria. A materiality matrix displays the prioritisation of important aspects and is the result of a materiality determination process. To us, the fact that a materiality matrix is unknown to half of the survey participants means that processes for determining materiality are often not in place or underdeveloped. We consider such processes, however, to be essential for gaining a better understanding of the views of important stakeholders and a proper application of guidelines, such as those of GRI. We also believe that this is a subject for a company's managing board and board of directors.

4.8 "Engaging for Impact"

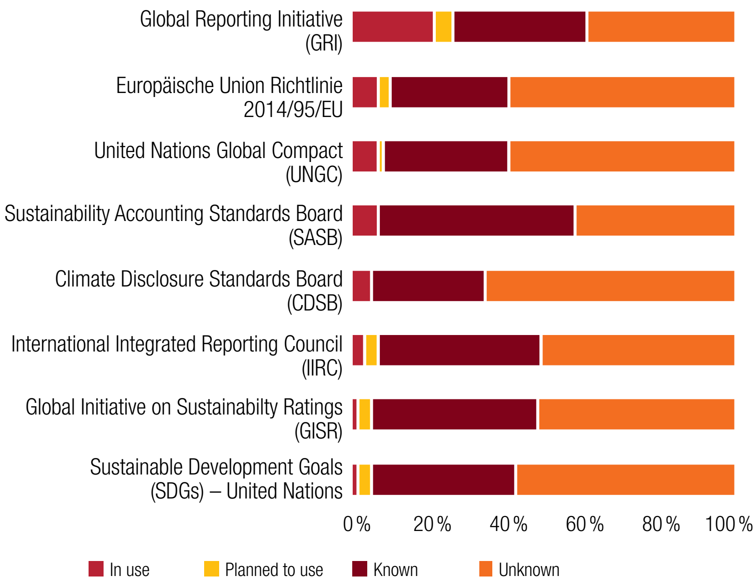
A current study by the Harvard Business Review shows that "Engaging for Impact" is one of the four main characteristics of a successful CEO, along with "Deciding with Speed and Conviction", "Adapting Proactively" and "Delivering Reliably".[9] "Engaging for Impact" involves mastering the balancing act between meeting financial goals on the one hand, and professional stakeholder management on the other. CEOs with a sound understanding of the priorities of important stakeholders, who succeed in including these stakeholders in the value creation process, are 75% more successful in their jobs than those CEOs who do not.

9 cf. Botelho, Powell, Kincaid & Wang, WHAT SETS SUCCESSFUL CEOS APART, Harvard Business Review, May June 2017.

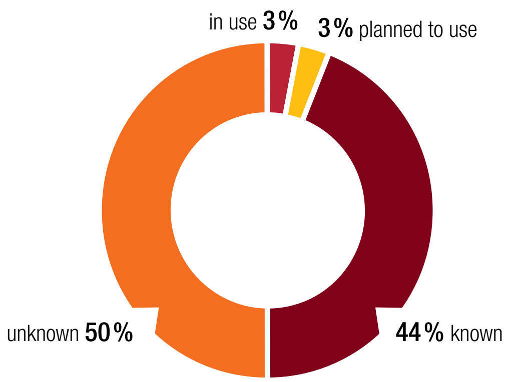
5. Usefulness of standards and frameworks

5.1 GRI as favourite

The results of our survey illustrate that the GRI guidelines on sustainability reporting are the favourite amongst those non-financial reporting standards and frameworks that are currently in use, at least in Switzerland. SASB is more widespread in the USA, the EU directive does not apply to Switzerland, and United Nations Global Compact (UNGC) is based on general principles.



Relevant standards and frameworks



International Integrated Reporting Council (IIRC)

5.2 Integrated reporting framework underestimated

We find it astonishing that many survey participants are unfamiliar with the framework of the International Integrated Reporting Council (IIRC). The IIRC framework seeks to use guiding principles and content elements to create the basis for integrated reporting. The IIRC approach is principle-based.

5.3 Strategic commitment

The framework requires a strategic commitment by management and cannot be implemented by checklists. Yet this is exactly how companies can take full advantage of it. With an integrated approach, the focus is not on reporting, but on management control. Integrated reporting is the communicated result of an integrated management approach that takes the interests of all important stakeholders into consideration while demonstrating the connection between various types of capitals and organisational units.

The principles defined in the IIRC framework are not only the basis for integrated reports, but can also be seen as preconditions for an integrated management control. A company's management team plays an important role for a successful switch to an integrated approach. The materiality determination process should therefore not be outsourced to operational units, but be seen as a strategic task on the management agenda. The company's business model and strategic orientation determine which capitals are particularly important for a company and the performance indicators that should hence be derived. Management control based on the selected performance indicators operationalised by a PMS will subsequently have an impact on the future strategic orientation. The more intensively senior management is involved in the modification of a PMS (such as during the selection of relevant capitals), the greater its acceptance and usefulness for decision-making.

5.4 Focus on financial capital

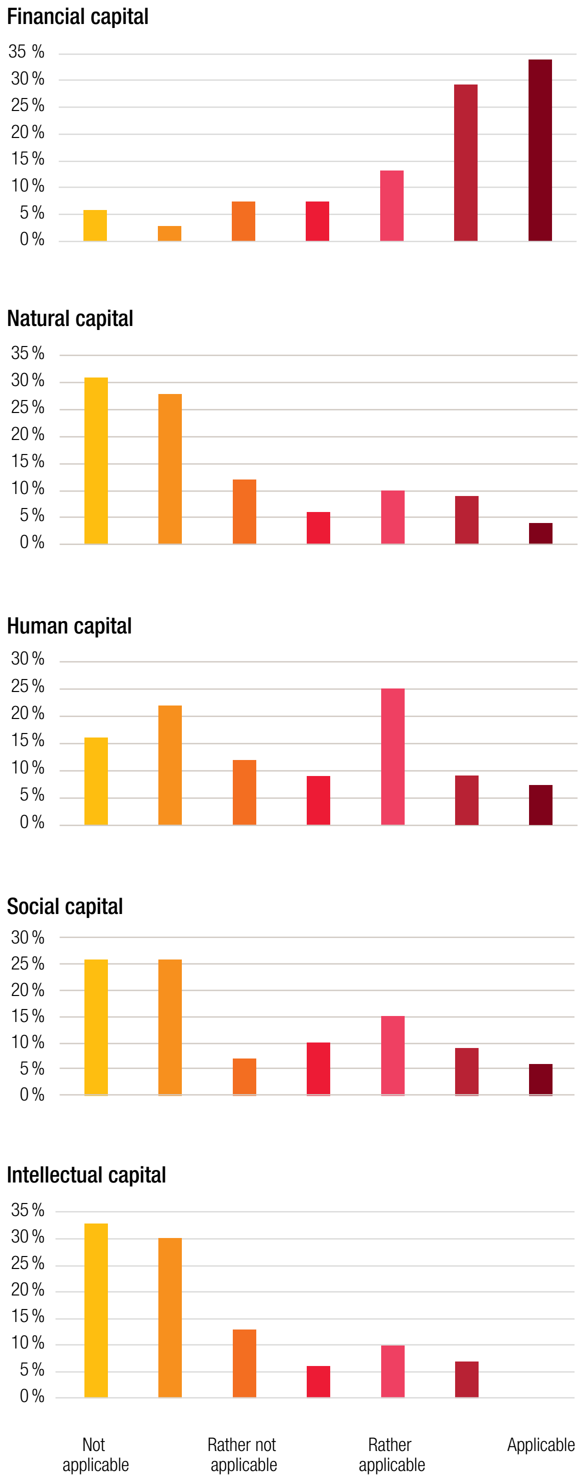
The notion of capital is far-reaching. In addition to financial capital, it also includes manufactured, intellectual, human, social, relationship and natural capital. The results of our survey show that companies focus primarily on financial capital, with less than 60% of companies also using intellectual or natural capital in their KPI management. Perhaps it does not always make sense for a company to take into account all capital types, and it is true that value chains vary, especially between different sectors.

The IIRC framework, however, is not about supplying companies with a fixed set of tools, but instead inspires them to think on a strategic level about the connection between reporting and control, and consequently about the design of a PMS and the inclusion of various types of capitals. In this context, materiality plays a crucial role. The focus is on those aspects which have a significant influence on the decisions of capital investors, and those which are enablers for sustainable value creation. Given the fact that the market capitalisation of companies is increasingly driven by intangible assets, such as a company's reputation, it may ultimately not be in a company's best interest to focus primarily on tangible values such as financial capital. Here too, we see an expectation gap: the survey participants strive for medium and long-term value creation and widely embrace the consideration of non-financial information, yet management is still mainly based upon financial capital.

5.5 End of silo structures

The results of our survey also show that in general, standards and frameworks on non-financial reporting are less well-known than PMSs. This is not surprising if we consider that in practice, these frameworks – contrary to PMSs – are rather aimed at specific departments such as the accounting or a sustainability department and less geared towards a strategic controlling or finance department.

This finding, however, is based on the assumption that the different departments of a company are isolated from each other and that there is little interaction between them. Hence, in many cases, interdepartmental aspects are ignored. We believe that for successful companies, such a model is obsolete. As integrated thinking, acting and reporting increase within companies, so will the future cooperation between the companies' various departments. In this respect, frameworks for non-financial reporting take on greater meaning for the financial department.



KPI management includes various types of capital

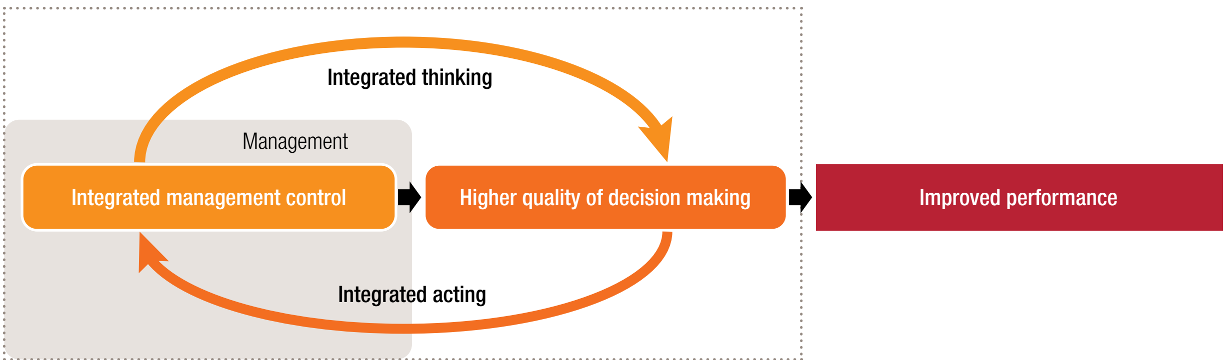
6. Success through integrated thinking and acting

The silo mentality encouraged in many firms by outdated governance systems has negative consequences. A Harvard study illustrates this point, using the example of risk management: many companies divide risks into several different categories, such as IT, reputation, supply chain and HR risks. While avoidable risks can easily be addressed in silos, this is not true for strategic risks that are taken deliberately and for external risks such as natural disasters or political factors. In the latter cases, organisational silos result in a scattering of available information and responsibilities, and prevent, in particular, the interaction of various risks from being considered. For companies, integrated risk assessment is essential.[10]

By abandoning the silo mentality, companies give themselves the opportunity to think and act in a more integrated fashion. The concept of integrated thinking also includes the consideration of the relationships between a company's various operational and functional units, as well as of its relevant capitals. As is the case with risks, the main concern when it comes to capital is the relationship between the various capital types. Such relationships can only be represented via the use of modern, multidimensional PMSs. PMSs should include both, financial as well as non-financial KPIs, and be linked to the company's corporate strategy. The ensuing management control should be based upon relevant KPIs, which are neither chosen at random nor considered from a mere marketing point of view. In the first step, it is crucial that such performance management systems are in place. However, being in place does not automatically imply that the systems will be used intensively. In the second step, integrated acting must be added to the thinking. This means that fundamental KPIs will also form the basis for operational and strategic decisions. The consideration of key financial and non-financial target figures in the management's remuneration scheme can play an important role in this respect.

A PMS is not an end in itself, but rather designed to help management make better decisions. A company's quality of decision making is closely and positively tied to its performance. High quality of decision making is attained when all important factors, whether financial or non-financial in nature, are taken into consideration. This requires professional stakeholder management, and an integrated management control where departments work together in a cross-functional manner.

Modern performance management systems



Why integrated thinking pays off

10 Vgl. Kaplan & Mikes, MANAGING RISKS: A NEW FRAMEWORK, Harvard Business Review, June 2012.

Appendix: private standard setters and regulation

Global Reporting Initiative (GRI): has been publishing recognised guidelines (GRI guidelines) on sustainability reporting since the year 2000. In the current version of the guidelines, the emphasis is placed on materiality. The main purpose of the guidelines is to provide value-relevant information.

Sustainability Accounting Standards Board (SASB): founded in 2011 as a result of Harvard University's Initiative for Responsible Investment, and financed and monitored by a foundation (SASB Foundation) since 2017 for reasons of autonomy, emphasises the point of view of the investor. The focus is on sector-specific standards and useful information for investors.

International Integrated Reporting Council (IIRC): in 2013, developed a highly regarded, generic framework for integrated reporting and integrated thinking in companies.

Global Initiative for Sustainability Ratings (GISR): accredits companies as part of a voluntary process with regard to sustainability assessment, and issues rankings or indices on the basis of the company's compliance with the twelve principles of GISR accreditation.

United Nations Global Compact (UNGC): runs a platform for a global movement of sustainable firms and stakeholders whose strategy and operations are in line with the ten Global Compact principles on human rights, labour, environment and anti-corruption. The long-term objective of the movement, which has been joined by some 9,500 companies in more than 162 countries, is the fulfilment of the UN sustainable development goals, with a focus on teamwork and innovation.

Sustainable Development Goals (SDGs): an agenda and action plan featuring 17 sustainable development goals covering a variety of universal themes, such as the supply of clean drinking water.

Climate Disclosure Standards Board (CDSB): an international consortium of business and environmental NGOs committed to advancing and aligning the corporate reporting model to equate natural capital with financial capital.

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