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Business Sustainability and Key Performance Indicators

Zabihollah Rezaee[1], Heshmat (John) Rezaee[2]
(1. Fogelman College of Business and Economics, University of Memphis, Memphis, TN 38152-3120, USA;
2. Florida Power and Light Company, 700 Universe Blvd, Juno Beach, FL 33408, USA)

Abstract: Business sustainability has gained considerable attention in the aftermath of the 2007-2009 global financial crises. Business sustainability focuses on activities that generate long-term economic performance (ESP) of firm value maximization as well as voluntary activities that result in the achievement of environmental, social, and government (ESG) sustainability performance that concerns all stakeholders. More than 5000 companies worldwide are now reporting on some dimensions of their sustainability performance by disclosing both financial and non-financial key performance indicators (KPIs). This paper examines ESP and ESG dimensions of sustainability performance and presents KPIs for these sustainability dimensions.

Key words: sustainability performance; key performance indicators; sustainability reporting and assurance; corporate social responsibility

JEL codes: G32, M40

1. Introduction

The 2007-2009 global financial crisis and the resulting economic meltdown and regulatory responses underscore breakdowns in corporate governance, business sustainability, and ethical practices of corporations. Businesses worldwide now recognize the importance and need for business sustainability in managing their companies and creating sustainable performance. Companies that are governed effectively, accountable socially and environmentally, and are conducted ethically are expected to produce sustainable performance, create shareholder value, and gain investor confidence and public trust. In this context, sustainability focuses on business activities that generate long-term economic performance (ESP) of firm value maximization as well as voluntary activities that result in the achievement of environmental, social, and government (ESG) sustainability performance that concerns all stakeholders. Sustainability reporting is the process of disclosing information relevant to both financial and non-financial key performance indicators (KPIs) for both ESP and ESG dimensions of sustainability performance. This paper examines ESP and ESG dimensions of sustainability performance and presents KPIs for these sustainability dimensions.

2. Sustainability Performance Dimensions

In today's business environment, global businesses are under close scrutiny and profound pressure from

Zabihollah Rezaee, Ph.D., Professor of Accounting, The University of Memphis; research areas/interests: corporate governance, business sustainability, professional ethics, financial reporting and auditing. E-mail: zrezaee@memphis.edu.
Heshmat (John) Rezaee, Lean Six Sigma, MBB, Florida Power and Light Company. E-mail: hrezaee@yahoo.com.

lawmakers, regulators, the investment community, and their diverse base of stakeholders to focus on sustainability. Brockett and Rezaee (2012a, 2012b) discuss multiple bottom lines (MBL) dimensions of business sustainability as economic, governance, social, ethical, and environmental performance (EGSEE). Many companies have made a conscious effort to “go green”, given the threats of global warming and climate change. Companies must pursue actions that are optimal for a broad class of stakeholders rather than simply one class of shareholders. Investors who adhere to this more long-range view may find environmental and social responsibility important in determining their return on investment (ROI). Thus, corporations have started to issue sustainability reports that provide relevant information on all dimensions of EGSEE performance.

Sustainability reports are expected to be value-relevant to both external and internal users of such reports. Investors and other stakeholders, including suppliers, customers, government, and society, can have more transparent information about EGSEE sustainability performance, which enables them to make more informed decisions. Sustainability reporting can also improve internal management practices by enabling companies to establish better relationships with investors, customers, suppliers, employees, regulators, and society. Sustainability reporting can also create more incentives for management to refocus its goals, strategic decisions, and actions from a short-term to a long-term prospect. Recently, it has been reported that more than 5,000 public companies worldwide are issuing sustainability reports on various EGSEE dimensions of sustainability performance (Global Reporting Initiative, 2013).

This paper classifies EGSEE sustainability performance dimensions into two general categories, namely ESP and ESG. Theoretically, management engagement in ESG activities, performance, and disclosure can be viewed as value-increasing or value-decreasing for investors. On one hand, companies that effectively manage their business sustainability improve ESG performance, enhance their reputation, fulfill their social responsibility, and promote a corporate culture of integrity and competency. On the other hand, companies can only survive and generate sustainable performance when they continue to be profitable and are able to create shareholder value. Nonetheless, ESP and ESG sustainability performance disclosures supplement each other and are not mutually exclusive. Significant debate has taken place about whether ESG programs are feasible and cost-efficient, where the cost of these programs is immediate and tangible and the related benefits may not materialize in the short-term and are often non-measurable in the case of corporate social responsibility (CSR). Primary goals for many corporations have refocused from profit maximization to increasing shareholder wealth and now, in light of recent sustainability initiatives, to create shareholder value while protecting interests of other (e.g., employees, customers, government, society, and environment). More transparent sustainability disclosures on EGSEE performance create opportunities to identify and correct operational inefficiencies and reputational and financial risks that would improve economic performance. Organizations worldwide recognize the importance of business sustainability and thus are focusing more on achieving sustainable performance in all areas of EGSEE.

The relative importance of ESP and ESG sustainability performance with respect to each other and their contribution to the overall firm’s long-term value maximization is affected by whether ESP and ESG are viewed as complementary or conflicting factors. Sustainability performance dimensions (ESP and ESG) can be seen as complementary because firms must be prominent financially in the long run to be able to perform well in terms of other sustainability activities (e.g., social and environmental activities). Firms that are economically profitable and viable are in better positions and have more resources to create jobs and wealth and better fulfill their social and environmental responsibilities. In addition, firms that are committed to corporate social responsibility (CSR) and environmental obligations and are governed effectively can also be sustainable in generating long-term financial performance. However, it is also possible that these dimensions are viewed as conflicting and a tradeoff exists between investing in environmental initiatives, CSR and corporate governance, or business activities that maximize economic profits. This paper focuses on two overall dimensions of sustainability performance of ESP and ESG while an ethical dimension is integrated into other dimensions, as explained in detail in the following sections.

3. Economic Sustainability Performance (ESP)

All dimensions of sustainability performance are important to stakeholders. However, the ESP is regarded as the main objective function for business organizations primarily because companies have to do well financially in order to do measurable good for society. Although the conventional measures of cash flows, earnings, and ROI are essential in evaluating ESP, they do not reflect sustainable performance and future growth. The 2013 KPMG report identifies the key measures of ESP as operational efficiency, customer satisfaction, talent management, and innovation that should be derived from internal factors of strategy, risk profile, strengths and weaknesses, and corporate culture, as well as external factors of reputation, technology, completion, globalization, and utilization of natural resources (KPMG, 2013). The primary goal of business organizations has been and will continue to be to earn profit in a socially responsible way to ensure the creation of shareholder value and the achievement of their desired rate of ROI.

Funk (2003) argues that companies that are engaged in business sustainability activities are better able to generate long-term value for all stakeholders. A recent report by the Conference Board presents many cases in which ESG sustainability actions and performance have a positive impact on ESP and thus, on financial performance (Bertoneche & van der Lugt, 2013). The report also highlights the importance of establishing the link between ESG and ESP by using KPIs that demonstrate the association between ESP and ESG while educating both sustainability experts and financial officers about the integrated aspects of ESP and ESG (Bertoneche & van der Lugt, 2013). A new business model is suggested that links ESG sustainability performance to ESP sustainability financial performance through connectors (lead indicators) (Bertoneche & van der Lugt, 2013). Anecdotal evidence suggests that ESG sustainability performance affects financial ESP performance. For example, ESG sustainability activities of attracting and retaining customers through high-quality customer services, safe and interesting products, and attractive brands increase sales (Bertoneche & van der Lugt, 2013).

Brockett and Rezaee (2012b) suggest that the following KPIs relevant to ESP are:

- Financial Statements (Balance sheet, Income statement, Statement of cash flow, Owners' equity).
- Note Disclosures.
- Accounting Policies.
- Segment Information.
- Changes in Business Structure (business combination, discontinued operation).
- Material and Unusual Items.
- Post Balance Sheet Events.
- Stock Prices.
- Risk Management.
- Codes of Conduct and Ethics.
- Executive Compensation.

- Stock-Based Compensation.
- Dividend Policy.
- Budget and Performance Evaluation.
- Earnings Releases.
- Non-GAAP Financial Measures.
- Operational Information.
- Quantitative Analysis.
- Forward-looking Data.

4. Environmental, Social, and Governance (ESG) Sustainability Performance

There has been growing international interest in CSR, including environmental, social, and governance (ESG) issues. Sustainability programs related to ESG are designed to minimize the conflicts between corporations and society caused by differences between private and social costs and benefits. They are also designed to align corporate goals with those of society. Examples of conflicts between corporations and society are related to environmental issues (pollution, acid rain, global warming), wages paid by multinational corporations in poor countries, and child labor in developing countries. Corporate governance measures, including rules, regulations, and best practices of CSR programs, can raise companies' awareness of the social costs and benefits of their business activities. The ESG issues can affect the company's performance, its supply chain management, and investment portfolios and thus, should be considered when assessing operating and investment decisions. To address this important global issue, in 2005, United Nations Secretary-General Kofi Annan invited a group of representatives from 20 investment organizations in 12 countries to establish a set of global best practice principles for responsible investment (PRI, 2006). The PRI are voluntary and aspirational rather than prescriptive, providing a framework for incorporating ESG issues into investment decision making and ownership practices. Compliance with the PRI is expected to lead not only to a more sustainable financial return, but also to a close alignment of the interests of investors with those of global society at large.

Effective corporate governance promotes accountability, improves the reliability and quality of financial information, strengthens the integrity and efficiency of the capital market, and thus, improves investor confidence. Corporate governance is a process affected by legal, regulatory, contractual and market-based mechanisms, and best practices to create shareholder value while protecting the interests of other stakeholders. The ethical conduct of many corporations during the current financial crisis has been questioned. Adherence to professional ethics by corporate gatekeepers (the board of directors, management, and auditors) can significantly improve corporate performance and promote the reliability of financial reports. Teaching professional ethics to business students can also better prepare them to respond properly to ethical challenges in the real world.

KPIs for ESG determine the nature and extent of commitments made to society by business organizations. Social activities and related KPIs can be measured through social contribution, strategic partners, community outreach and involvements, and time spent volunteering. Brockett and Rezaee (2012b) provide the following examples of ESG KPIS:

Environmental KPIs:

(1) Continuous replacement of scarce resources that are nonrenewable.

(2) Disclosure of ecosystem changes.

(3) Disclosure of gigajoules of total energy consumed.
(4) Disclosure of metric tons of total CO_2 emitted.
(5) Disclosure of risk exposure and opportunities of climate changes.
(6) Disclosure of toxic chemical use and disposal.
(7) Efficient utilization of unconventional renewable and nonrenewable natural resources.
(8) Efficient use of recycled materials.
(9) Environmental profitability analysis and assessment.
(10) Maximum effective utilization of scarce natural resources.
(11) Measurement of resource depletion.
(12) Minimizing the use of environmentally harmful materials and products.
(13) Preventing negative impacts on ecosystems.
(14) Production and use of environmentally safe products.
(15) Promoting environmental performance.

Social KPIs:

(1) Percent of employees who consider that their business acts responsibly.
(2) Number of full-time employees (FTE) dedicated to social investment projects.
(3) Funds raised per FTE for non-profit and humanitarian organizations.
(4) Philanthropy as a percent of (pretax) profit.
(5) Percentage of operating income dedicated to social contribution.
(6) Percent of suppliers that affirmed business code of conduct.
(7) Social contributions spent per employee.
(8) Percent of eligible employees who signed the Code of Conduct and Ethics Policy.
(9) Number of initiatives to promote greater environmental responsibility.
(10) Total investment in the community.
(11) Donations and other social expenses.
(12) Description of social and ethical activities and projects.
(13) Diversity and equal opportunities.
(14) Fair wages, contracts, and benefits for employees.
(15) Training and internal continuing education.
(16) Employee diversity and compositions by age, specialization, minority, and ethnicity
(17) Number of employees, turnover, and hiring/firing procedures.
(18) Whistle blowing policies, programs, and procedures.
(19) Employee productivity.
(20) Employee satisfaction, competence, and commitment.
(21) Customer satisfaction, retention, loyalty.
(22) Fair competition.
(23) Truthful advertising.

Governance KPIs:

(1) Number of board committees.
(2) Percentage of board independence.
(3) Full independence of board committees.

(4) Board diversity in terms of ethnicity, sex, expertise, minority.
(5) Staggered board.
(6) Separation of the position of the chair of the board and chief executive officer (CEO).
(7) Board accountability and liability.
(8) Number of board meetings.
(9) Number of members in the board.
(10) Percentage of insider directors on the board.
(11) Number of members in the audit committee.
(12) Number of audit committee meetings.
(13) Number of audit committee financial experts.
(14) Value of stock options awarded to the directors.

5. Conclusion

Corporate reporting has been the focus of corporate and performance reporting for several decades. In recent years, stakeholders have become more interested in certain non-financial information that goes beyond the traditional financial reports. Thus, many stakeholders are looking into broad corporate reporting which reflects both financial and non-financial key performance indicators (KPIs). This paper recognizes the current reality in financial reporting and suggests corporate reporting that conveys both ESP and ESG sustainability performance.

Business sustainability requires organizations to take initiatives to advance some social good beyond their own interests and be in compliance with applicable regulations. The true measure of success for corporations should be determined not only by reported earnings, but also by their governance, social responsibility, ethical behavior, and environmental initiatives. ESG sustainability has received considerable attention from policymakers, regulators, and the business and investment community during the past decade and is expected to remain the main theme of the 21st century. Some of the key challenging issues for ESG are: competition issues (the use of advertising and the arrival of new types of ESG risk with new technology); environmental issues (climate change and regulatory changes for hazardous substances and waste); human rights (labor rights); product responsibility (access, safety, risk, disclosure labeling, and packaging); bribery and corruption (financial reporting fraud, financial scandals, money laundering); respect for privacy; ensuring transparency and accountability; institutionalization of ESG; stakeholder engagement; battle for talent; community investment; supply chain and product safety; social enterprises; and poverty alleviation.

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