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A cancer patient's frozen T-Cells arrive at a Novartis facility to be reengineered.

Why it's important to measure and report long-term value

The Embankment Project for Inclusive Capitalism is working to improve the way that businesses measure and report on the value they create.

How much of a company's value is reflected in its financial reports? This fundamental question has been the focus of increasing debate in recent years, as global businesses and their stakeholders have begun to emphasize the importance of long-term value creation for capital markets, and for society as a whole.

This discussion revolves around a well-known trend: the declining proportion of a business's value that is captured on its balance sheet as tangible assets. In 1975, more than 80% of corporate value was typically reflected on the balance sheet. Research suggests that today, across all global markets, this figure is only 50%; for some companies, such as major technology businesses on the S&P 500, it falls below 20%.

This shift reflects the hugely increased importance – as economies become more service-based – of intangible assets such as intellectual property, human capital, organizational culture, corporate governance and public trust. These are all difficult to measure using conventional reporting frameworks but are vital components of business value.

George Serafeim, a Professor of Business Administration at Harvard Business School whose research focuses on measuring, driving and communicating corporate performance and social impact, has written: "Large corporations in society have a purpose, and that purpose extends beyond simply making profits. Rather, corporations are assuming broader responsibilities that increasingly affect their valuation in the stock market and their value to society. Because corporations are the world's most powerful engines for growth and prosperity, this behavior is a positive development with global impact. By understanding corporations' environmental and social activities and integrating this understanding in investment decisions, investors can advance and benefit from companies' creation of long-term value."

A solar power plant in Russia

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> Professor of Business Administration, Harvard Business School

So what needs to change in order to give investors this insight? “The problem is that standard accounting practices show the costs associated with these intangible assets, such as the cost of training employees or investing in innovation,” says Hywel Ball, Head of Audit at EY in the UK, “but they still don’t reflect the vast majority of their value.”

This creates increasing problems for companies and investors alike, because the more of a business’s value lies in areas it does not report on, the more investors will develop their own approaches and data sources to assess that value.

One company that has recognized this issue is Swiss pharmaceuticals group Novartis, which has been measuring nonfinancial value since around 2015. Patrice Matchaba, Group Head of Global Health and Corporate Responsibility at Novartis, says this has been partly driven by demand; 15%–20% of the company’s current shareholders ask for nonfinancial disclosures, and he believes that proportion is certain to grow.

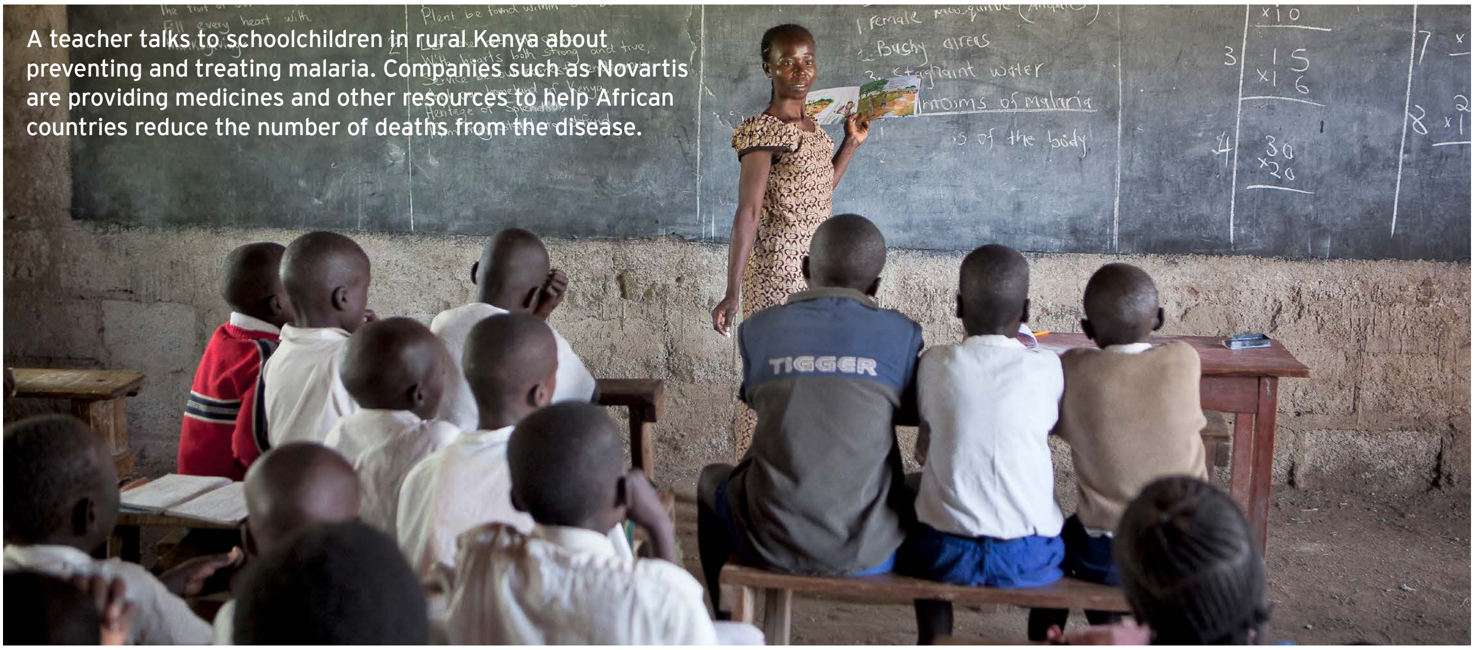
“Shareholders are demanding this – particularly the newer generation,” he says. “This is the number one priority for the younger group of investors who are coming in. They want to see beyond margin and top-line growth to what the true impact is on society, and if everybody is doing that, they can compare like with like.”

But change isn’t purely being driven from outside the company. “We believe it is important to measure nonfinancial value,” Matchaba explains. “With macroeconomic changes, pricing pressures, the fact that the pharmaceutical industry has the lowest rank in the US in terms of public perception – something has to give. If we don’t start preparing to articulate why we need to exist, and the benefits we bring beyond transformational medicines, then we are not doing our job.”

Areas for debate

For corporate boards and asset managers considering whether to extend the range of metrics they report on, the question is whether there is potential conflict between their so-called fiduciary duties as stewards of assets owned by others, and the desire to create positive outcomes for a broad group of stakeholders, not all of whom have a direct financial interest in the company. Serafeim argues strongly that – contrary to what many believe – laws in the US and elsewhere do not oblige corporate boards to concentrate on maximizing shareholder value over other goals.

“The duty of the board of directors is to the company itself, which means you can be a purpose-driven corporation, provided what you are doing is in the long-term interests of the company,” he says. Clearly, providing rigorous, transparent metrics to support the case that long-term value is being



A teacher talks to schoolchildren in rural Kenya about preventing and treating malaria. Companies such as Novartis are providing medicines and other resources to help African countries reduce the number of deaths from the disease.

created provides important support to those who take this position.

Similar questions arise for asset managers: should they not simply concentrate on maximizing the financial value of their holdings? "That's a huge area of debate," says Ball. "What you're getting into there is shareholder primacy versus stakeholder primacy. It's one of the biggest political debates we've got on the agenda."

The debate over how companies can meaningfully communicate long-term value creation is at the heart of the work of the Embankment Project for Inclusive Capitalism (EPIC), a collaborative effort that has brought together a collection of participants with both market strength and diversity across the entire investment chain, representing US$30t of assets under management and almost two million employees around the world.

Although its origins go back much further, EPIC took a big step forward – and gained its name – in February 2017. That was when the then Unilever CEO Paul Polman hosted a meeting of 10 multinational CEOs at the company's headquarters on the Victoria Embankment in central London at which they discussed how businesses could improve the way they

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The business benefits for Novartis

Patrice Matchaba believes that more rigorous nonfinancial metrics will bring a number of benefits for Novartis. One is in communicating the company's social impact more clearly to its employees.

"In a pharmaceutical company, the individuals should be heavily driven by purpose, and that purpose is to save lives or make suffering less. If we can tell the story that in your country, besides these medicines, here is what we are doing in terms of contribution to GDP, to third-party employment, families, education and so on, we can motivate our employees even more."

This also helps with recruitment, he adds: "As we try to attract younger talent, we are realizing that these things really do matter to them."

And measuring long-term value also helps when it comes to making the case for investment in medicines to finance ministries around the world. Matchaba gives an example of how this can work in practice.

"Classically, in a low- to medium-income country, you are going to have to make some sort of investment in strengthening the health system and generating data before you introduce innovation," he says. "If you start with the innovation alone, it's too expensive and you won't achieve your desired impact. But if the authorities see that you have created an ecosystem over the last three or four years that can absorb the innovation efficiently, and you can measure it, that is a different discussion."

measure and report on the value they create for a wider group of stakeholders.

Meanwhile, Ball, the architect of the EY Long Term Value Framework, had been looking for ways to kick-start a proof-of-concept project that would help develop the framework into a useable set of metrics that companies, asset managers and asset owners could adopt to measure value. Having teamed up with Lady Lynn Forester de Rothschild, founder of the non-profit Coalition for Inclusive Capitalism, Ball was invited to pitch the idea to the meeting at Unilever's head office; four hours later, EPIC was born.

The organizers assembled a group of 31 participants from the top tier of global business: companies including Unilever, Novartis and PepsiCo, and asset managers and owners including BlackRock, Fidelity, Vanguard, Norway's vast Government Pension Fund Global, CalPERS, MetLife and Allianz. Together, they embarked on an 18-month program of work – "by the market, for the market" in Ball's words – to flesh out new ways of measuring business value.

Armed with the Long Term Value Framework that EY had developed through 2015–16, the EPIC members agreed to spend 18 months developing a number of metrics. The project was organized into seven working groups, each of which included companies, asset managers and asset owners, along with an eighth group to ensure a consistent methodology across the workstreams, and a ninth to examine complementary initiatives that EPIC could engage with.

Meaningful metrics

In November 2018, the project participants unveiled the results of their work in a report that was launched in Washington, DC. This set out a detailed series of metrics to help companies measure and report on the nonfinancial value they create for multiple stakeholders, as well as recommendations for how the subject should be addressed in narrative reporting, across the seven areas covered by the working groups. Under each heading, the report describes what good practice should look like.

The result is a framework that represents a meaningful first step toward allowing investors and others to make like-for-like comparisons between companies' nonfinancial performance in the same way that they compare financial performance using internationally accepted accounting frameworks.

The 63 specific metrics agreed on range from disclosures on workforce and leadership diversity, staff turnover and absenteeism rates, to a standardized survey that companies can use to assess organizational culture. Innovation metrics track R&D investment and success rates as well as a "vitality index" that shows the percentage of revenues from recently launched products, services or processes, and "societal value generated," which sets out how much of the business's innovation activity is addressing sustainability challenges such as the United Nations Sustainable Development Goals. In areas of deep social concern such as climate change, the report recommends standardized measures of the business's energy intensity and its exposure to risks arising from future changes in the pricing of carbon emissions.

However, challenges exist for companies and their investors in changing the range of metrics they report on, beyond the task of agreeing the methodology and metrics. Matchaba says the major challenge for Novartis continues to be the lack of a common language and strong standardization.

"The key thing is to get system movement," he explains. "You want a bottom-up, standardized approach from companies that is useful for internal decision-making and is picked up by investors and governments. But if it's only coming from one party, and it's not comparable, it doesn't work."

Although one of the main intentions of EPIC was to catalyze change in the way businesses measure and report on value, other important issues also formed part of the discussions. A key concern among major companies and fund managers was to find ways to rebuild society's trust in business, which has declined sharply in recent years; according to the Edelman Trust Barometer, 60% of respondents globally agree that "CEOs are driven more by greed than a desire to make a positive difference in the world." The project participants suspected that more rigorous measurement and transparent disclosure of a business's impact on its broad stakeholder group might begin to repair trust in companies.

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> Head of Audit, EY in the UK

Lady de Rothschild argues that "the activities that society expects from business are changing and this will affect value creation for long-term investors. EPIC addresses this reality and represents a breakthrough in how businesses can measure and report the true value they create for all stakeholders."

Similarly, participants realized that the exercise might help to address what Ball calls "the disconnect in the value chain." He points out that businesses

Unilever's London headquarters on the Victoria Embankment

measure performance in areas that are vital to their success – such as employee engagement metrics in service businesses, for example – but do not typically disclose the results to the market. Some investors generate information of this sort independently, for example by scraping data from employment-related websites, but there is no generally accepted framework for disclosures such as these. However, if more investors made clear that they valued this type of information, companies would be more likely to report on it, and to do so in a standardized way that can be assured and allows investors to make meaningful comparisons.

"You need fund managers to say, 'If we knew this, we would find it valuable in making long-term investment decisions,'" says Ball. "Companies aren't going to disclose it unless they know the demand is there. That's what this project was trying to achieve – a value exchange, if you like, between investors and companies."

Catalyzing market change

The EPIC participants aren't the only ones who are rethinking the business world's societal contract. In August 2019, the Business Roundtable (an association of the CEOs of nearly 200 of the most prominent companies in the US) announced that it had a new purpose. After explicitly putting shareholders first for 20 years, it released a 300-word statement in which those shareholders were only mentioned once, among references to creating "value for customers," "investing in employees," fostering "diversity and inclusion," "dealing fairly and ethically with suppliers," "supporting the communities in which we work," and "protect[ing] the environment."

Similarly, the Value Balancing Alliance, founded in Europe in 2019, strives to develop a standardized model that empowers decision-makers to create and protect long-term value. Developing a standardized cross-sector methodology is a first step toward transforming the metrics by which society values the contribution of corporations to society.

Against a backdrop of such changes of emphasis at the highest levels of business, EPIC represents a timely contribution to the debate. It might ultimately require regulation from governments to mandate the kind of reporting that EPIC proposes, though.

"The question is, at what point do you regulate?" Ball says. "What we're trying to do through this is to catalyze market change. If it gets increasingly adopted by the market because it's something the market needs, and then at some point becomes systemically important, that's the right time to regulate."

That is still some way off. The priority for EPIC now is to open the project to wider discussion and contributions and agree the best way to ensure further development and uptake of the framework.

A good example is the way it has contributed to the thinking of the World Economic Forum (WEF), whose International Business Council (IBC) launched an initiative in August 2019 to help companies demonstrate their long-term value. A consultation

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paper was released during the WEF's Annual Meeting in January 2020 that proposes a common, core set of 22 metrics and recommended disclosures, as well as 34 expanded metrics representing a more advanced way of measuring and communicating sustainable value creation. Some of these were taken directly from work completed in EPIC. These will be further refined and vetted by IBC members, investors and other key stakeholders.

In the meantime, EPIC is keen for investors and companies to use the results of phase one. This can be done, for example, when shaping and implementing investment mandates, refining strategic plans and communicating value creation to stakeholders. ■

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