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G U I D E P O S T

MEASURING FIRM PERFORMANCE IN A WAY THAT IS CONSISTENT WITH STRATEGIC MANAGEMENT THEORY

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Much empirical work in strategic management adopts measures of firm performance originally developed in accounting and finance. Not surprisingly, these measures are based on theories of how firms create value developed in these two disciplines. Strategic management has developed a different theory of how firms create value that focuses on assembling resources from multiple stakeholders, some of whom may be outside the boundaries of a firm. Progress in empirical research in strategic management will require the development of a measure of firm performance that adopts this stakeholder perspective.

The field of strategic management needs to develop an empirically tractable measure of firm performance that acknowledges the role that individuals and organizations outside the boundaries of firms—stakeholders—have on their ability of firms to generate economic profits.

Strategic management scholars are interested in how firms create an appropriate economic value (Brandenburger & Stuart, 1996). These processes often involve access to resources that are outside the traditional boundaries of firms (Adner, Oxley, & Silverman, 2013; Amit & Schoemaker, 1993; Barney, 2020; Dyer & Singh, 1998; Helfat & Peteraf, 2003). And yet, currently popular measures of firm performance in strategic management struggle incorporating the impact of such partners.

Consider accounting measures of performance, including ROI (Return on Investment) and ROA (Return on Assets). The numerator in these measures of performance focuses only on profits generated by a firm and not on profits generated by a firm and its partners. And the denominators in these measures—investment and assets, respectively—refer only to investments and assets a particular firm controls, despite the fact that access to resources outside a firm may be instrumental in generating profits.

These problems are not addressed in modified accounting measures of performance, including economic value added (EVA) and Tobin's q. For example, whereas the numerator of Tobin's q (a firm's market value) incorporates the effects of a firm's partners on its value, the denominator (replacement value of a firm's assets) focuses on those assets that a firm owns.

Finance also has measures of firm performance, including event studies, "buy and hold" measures, and, more generally, present value techniques. These measures examine firm performance from the perspective of a key stakeholder—shareholders. This emphasis on shareholders is justified by the assumption that a firm's shareholders are its only residual claimants and that all its other stakeholders have fixed claims.

However, the strategic management theory (Barney, 2020; Castanias & Helfat, 1991) suggests that treating all stakeholders, except shareholders, as fixed claimants means that—in most competitive settings—a firm will not be able to generate an economic profit, unless it is lucky (Barney, 1986). This is because non-shareholder stakeholders will generally be unwilling to make profit-generating resources available to a firm using fixed claim contracts because such contracts eliminate the possibility of sharing in the economic upside created by these resources. Put simply, the strategic management theory suggests that if a firm's only residual claimants are shareholders, then firms will not be able to gain access to the resources needed to generate an economic profit.

None of these observations about accounting and finance measures of performance should be understood as criticisms. Indeed, it would be surprising if measures of performance developed in other disciplines would be appropriate for strategic management research. What is required is not additional

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criticisms of accounting and finance, but rather a way of measuring firm performance consistent with the strategic management theory.

What would such a measure look like? First, it would have to abandon the firm as the only unit of value creation and appropriation and, instead, also focus on how bundles of resources assembled from extra-firm sources can generate profits. This suggests that this measure would have to incorporate a stakeholder perspective, but one that focuses mostly on stakeholders whose resources are important for profit generation. McGahan (2020) discussed that identifying who these stakeholders is not a trivial problem and will require additional theoretical development.

Second, this measure would have to calculate profits and losses at three levels: (1) at the level of the firm that assembles resources to generate profits (type one performance), (2) at the level of each of the individuals and organizations who make profit-generating resources available to a firm (type two performance), and (3) at the level of the set of all those who are involved in generating profits (type three performance). This acknowledges the possibility, for example, that a strategy might generate an economic profit overall (type three performance), that stakeholders providing critical resources to a firm might appropriate most of these profits (type two performance), but that the firm that assembled these resources to generate a profit appropriates relatively little of them (type one performance)—a possibility anticipated by Coff (1999). In this example, even though the focal firm does not appropriate much of the economic profit it helped create, it would be inappropriate to say that its strategies did not create economic profit.

Third, although this measure would have to recognize the importance of legally incorporated firms, it would also have to recognize that many parties may be instrumental in generating economic profits, besides firms. For example, some employees, customers, and other suppliers may be part of the bundle of resources that generate economic profits, but not be legally defined firms.

Finally, as suggested by Kaplan (2020), even as we develop this new measure of performance, it must be recognized that simply maximizing the expected level of this new definition of performance may not always be a sufficient guide to managerial decision-making. Sometimes, firms may have to make decisions, not because they positively affect the performance—however defined—but because they are the right things to do.

Developing this new measure of firm performance is likely to be challenging, but probably not more challenging than what accounting and finance scholars faced when they initially developed their measures of performance. Indeed, when it became clear that accounting measures of performance did not capture the broader social and environmental impacts of firms, new accounting measures of firm performance emerged—the Global Reporting Initiative (GRI) in 1997 and Sustainable Accounting Standards Board (SASB) in 2011. These reporting standards have substantially expanded traditional accounting measures of performance. Perhaps, similar efforts could be used to develop measures of firm performance that more fully capture the impact of a firm's stakeholders on its ability to generate profits.

However, as both McGahan (2020) and Kaplan (2020) have observed, developing this new measure of firm performance is likely to require both theoretical and empirical work. Additional theoretical work will be required to identify stakeholders who are instrumental in enabling a firm to generate economic profits. Empirical work will need to focus on how the profits generated by a bundle of resources are actually distributed across those that provided access to these resources.

In the end, for the field of strategic management to continue to evolve and grow, it must develop a measure of firm performance that is consistent with its theory of profit generation—a theory that recognizes that firms generate profits by accessing resources from a variety of stakeholders, including shareholders.

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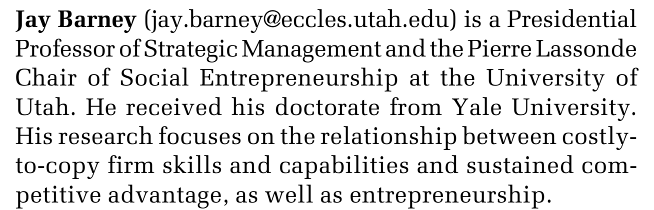

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