TOMORROW'S CHALLENGES

FROM TRIPLE TOWARDS ONE BOTTOM-LINE

HOW TO INTEGRATE FINANCIAL AND SUSTAINABILITY REPORTING

By IMD Professor Paul Strebel

IMD
Chemin de Bellerive 23
PO Box 915,
CH-1001 Lausanne
Switzerland

Tel: +41 21 618 01 11
Fax: +41 21 618 07 07
info@imd.org
www.imd.org

At the 2016 Annual General Meetings of Exxon and Chevron, institutional investors forced a vote on whether the companies should release detailed climate impact reports, adopt greenhouse gas emission reduction targets, and increase transparency of climate change lobbying efforts. Although there were not enough votes to carry the motions, there were enough (around 40%) to signal that the issues are unlikely to go away. Meanwhile in Europe, Shell, BP, Statoil, Rio Tinto, and Glencore have decided to accept shareholder proposals for climate risk reporting.

The pressure for more responsible corporate behavior is not limited to ecological sustainability, but also includes societal impact, illustrated by the following examples. In 2013, more than a 150,000 people in the U.K. signed a petition calling on Amazon to pay its fair share of taxes and in 2016, the European Commission fined Apple €13 billion for illegal tax avoidance in Ireland. In 2014, more than 50,000 signed a petition calling on Amazon to pay its workers more and in 2016, bad publicity on labor conditions at SportsDirect forced a change of CEO and worker practices.

In the banking industry the pressure is on rent-seeking behavior (seeking profits through market distortions). The credit card oligopoly is under attack from regulators, in addition to peer-to-peer lenders and alternative payments systems. The too-big-to-fail subsidy is being eroded by tighter regulation of proprietary trading and increased capital requirements, the Federal reserve is raising interest rates removing the benefits from quantitative easing, governments are talking increasingly about closing tax loopholes, and illegal value extraction is under assault from more muscular legal enforcement regimes.

Corporate irresponsibility is becoming a systemic risk

Pressure is building on companies in all industries to reveal how much their business depends on free-riding and rent-seeking, and begin moving their business model into a more sustainable direction. The 2016 MIT Sloan Management Review Sustainability Report on sustainability practice reports that “Investors are beginning to see a strong link between corporate sustainability performance and financial performance. That’s creating a bigger demand for better data and better business models.”

Beyond its increasing impact on market values, corporate irresponsibility is feeding systemic socio-political risk. In general, the value extracted by companies through free-riding and rent-seeking is not being reinvested. Instead it is used to finance stock buybacks and dividends distributed to shareholders, directors and top management. The buybacks and dividends at a representative global bank between 2010 and 2014 averaged about 50% of reported profits of which we estimate more than half was financed by value extracted*. The passing on to shareholders of value extracted from stakeholders and society-at-large distorts the distribution of income in favor of capital at the expense of labor. This contributes to increasing inequality and harms growth.

The interplay between corporate irresponsibility, political lobbying and market power is not lost on people in the street. The scandals generated by the exposure of value extraction are stoking populist passion on both sides of the Atlantic. They are making a mockery of sustainability and responsibility reports and undermining the social trust in business. In the banking case, the value extracted was more than ten times the value shared with society through the philanthropic projects described in the responsibility report*.

Estimate competitive profits net of value extraction

Taking a cue from the natural resource industries, investors could insist in all industries with significant signs of irresponsible behavior that companies report on the impact of value extraction. However, it is time to get rid of triple bottom-line reporting in the form of separate economic, eco-sustainability and social responsibility reports. Instead the annual financial report could be required to describe rent-seeking and free-riding activities. And then assess to what extent these activities are at risk of attack from regulators and civil society, what the financial impact might be, what the net “competitive profits” would be if these activities were stopped, and what the plans are to shift the business model in the direction of sustainable value creation.

Getting the support and data for such integrated reporting is not trivial. But as the MIT Sloan survey found, better and better data is becoming available. In the banking case study, we were able to get estimates on the rent-seeking and free-riding associated with the too-big-to-fail syndrome, the benefits from quantitative easing, the credit card oligopoly, tax-optimization, and engaging in legally borderline activities*.

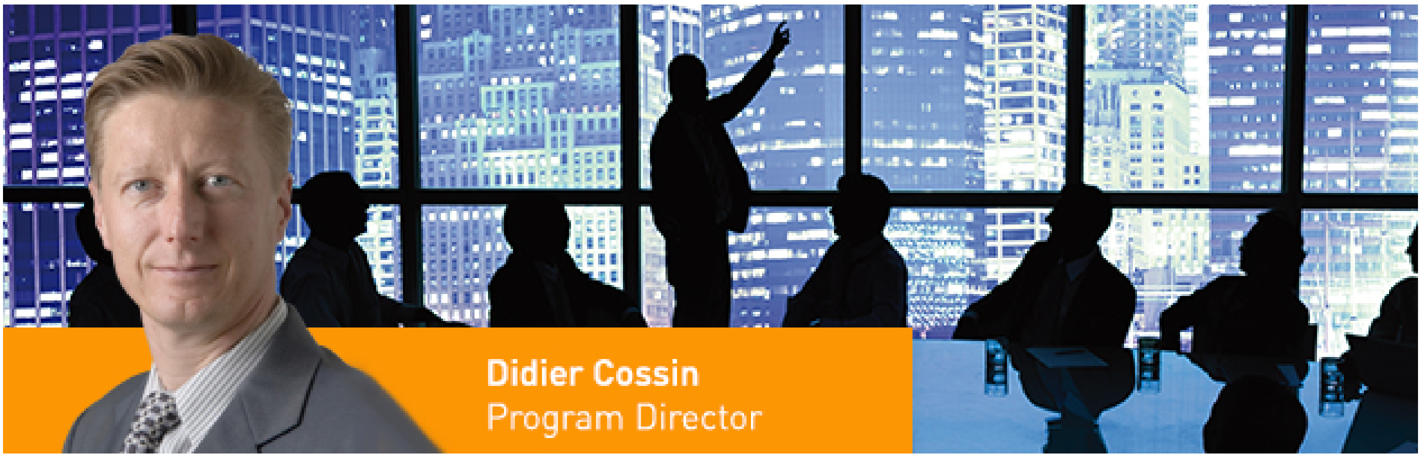
However, we cannot expect executive and supervisory boards of irresponsible companies to pull the rug from under their own feet and reveal the value extracted in their profits and compensation. Rather it is longer term investors, exposed as they are to the increasing risks associated with corporate irresponsibility, who could take their cue from the institutional investors at Exxon and Chevron and insist that companies make their rent-seeking and free-riding activity transparent and provide related information in the financial report. They could insist on an estimate of competitive profits and long term sustainability. If companies maximize the real value created in the form of competitive profits, they will be fulfilling their social responsibility. In brief, it is time to drop the triple bottom-line and go back to Milton Friedman's maxim that the true responsibility of business is the maximization of profits, where the one relevant bottom line is competitive profits net of value extraction.

Reference

*P. Strebel, M. Cording and J. Shan, "Competitive profits and the annual report: measuring the sustainable business," Journal of Business Strategy (37), no.2 (2016): 42-49.

Paul Strebel is Professor Emeritus of Governance & Strategy, IMD Global Board Center, Board Director & Advisor. He teaches on the following programs: High Performance Boards (HPB), Leading the Family Business (LFB), and Leading the Family Office (LFO).

Related Programs



HIGH PERFORMANCE BOARDS - http://www.imd.org/hpb

How board directors make a real difference
Program Director Didier Cossin

- Identify what makes best practice boards
- Evaluate and mitigate risk, and maximize opportunities, through strategic board involvement
- Learn how to drive positive board culture, manage a board in crisis and ensure successful succession plans
- Develop an action plan to address your board challenges

ORCHESTRATING WINNING PERFORMANCE - http://www.imd.org/owp

Create your own learning journey
Program Directors Michael Wade and Dominique Turpin

- Get exposed to the latest management thinking and to practical and innovative solutions for your business
- Anticipate global business trends
- Boost your performance, broaden your perspectives and expand your global network
- Design the program that suits you and your team
- Become a complete executive through activities that develop your mental, physical, and emotional health