February 2017

‘Green’ Bookkeeping shows real business costs

In 2010, Puma pioneered a new form of corporate reporting.

The German sportswear company produced an environmental profit and loss account, which estimated the company and its supply chain to have caused €145m of environmental damage that year, relative to €202m of net profit.

In other words, if Puma expensed the costs to the environment of its activities and those of its suppliers, earnings would fall by more than two-thirds.

Conventional bookkeeping allows companies to ignore such damage. The activities of Puma’s supply chain involve a number of environmental and social costs, such as the chemical pollution of waterways via the dumping of untreated wastewater.

But because these costs are imposed on outside parties, and therefore fall outside the scope of suppliers’ P&Ls, there is no obligation to quantify or expense them. Instead, they go unrecorded and are borne by the rest of us.

This is what economists call market failure. Companies are not forced to pay their full costs, leading to socially inefficient outcomes – and the results are all too apparent. In China, the global centre for textile production, the government acknowledges that nearly half of the rivers are so contaminated with hazardous chemicals as to be unsuitable for human contact; Greenpeace, the environmental group, estimates the proportion is much higher.

Evidence suggests that Puma and its supply chain are not unusual. The activities of the largest 3,000 public companies globally are estimated to cause environmental damage equal to 50 per cent of combined earnings.

The same fundamental issue is triggering a parallel debate at a macroeconomic level. Chinese gross domestic product includes the output of the factories polluting its rivers, the necessary clean-up projects and the medical expenses of the villagers poisoned by lead, mercury and arsenic. It ignores the associated loss of life, livelihoods and ecological vitality.

The patent absurdity of using this as a guide to public policy has led to the formation of a number of alternative, broader conceptions of progress. Such ideas are slowly seeping into public discourse and policy formation around the world.

Chinese agencies, for instance, attempted to calculate a “green GDP”. Despite the results ultimately being blocked by the government, the idea survives. Pilot emissions trading schemes are in place, 74 cities have been forced to publish real time air quality data and companies in polluting industries made to procure “compulsory insurance” to ensure they can provide compensation to victims of the damage they inflict.

In China and elsewhere, political and regulatory threats to “business as usual” are rising. Privatisation of profits and socialisation of costs is increasingly unacceptable to the public and the principle of the polluter pays has gained widespread policy acceptance, in theory if not yet in practice.

The consequence is that the ability of the private sector to externalise costs is waning. Companies in numerous jurisdictions are already forced to pay for the most obvious aspects of their environmental damage through carbon taxes and cap and trade schemes, as well as emissions charges. To combat the threat they pose to public health, tobacco and alcohol producers and retailers are being regulated more onerously. In future, such state intervention is likely to broaden in scope and deepen in nature, be it to expand emissions schemes to more sectors and pollutants, or to target excessive fat, salt and sugar content through taxes or caps.

These threats present clear business risks to a very wide range of companies and industries. Executives and investors need to consider these as core business and investment issues. Corporates ought to act pre-emptively to mitigate these risks by managing and reducing external costs wherever possible, and long-term investors ought to encourage and demand they do so. Not doing so means running the risk of losing long-term social licenses to operate.

Quantifying external costs is a powerful step in this direction. Puma's 2010 environmental P&L is the first step of three that will attempt to incorporate the environmental, social and economic impacts of the company and its supply chain. The final version should represent a pioneering set of full cost accounts that allow managers to identify risks, audit the supply chain and take remedial action.

Putting a monetary value on external costs is particularly useful, since this allows companies to incorporate thinking about how to alleviate them directly into existing financial and operational systems.

Momentum is gathering behind such initiatives. Next year, a dozen companies are reported to be joining Puma in publishing EP&Ls and creating an industry coalition to push for broader adoption.

More widespread calculation and disclosure of environmental and social impacts – even at the margin and far short of Puma's ambitious effort – should be welcomed and encouraged by long-term investors attempting to identify franchises that are well positioned for coming challenges.

Jack Nelson

First published in the Financial Times on
Monday 24 June 2013

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