Unsustainable business is not profitable

A sea change has occurred in the attitude towards sustainable investments. The biggest investment firm in the world now says that investing in sustainability is good for profits.

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The change has been swayed greatly by Laurence ("Larry") D. Fink, CEO of the world's largest investment firm, BlackRock. The firm now manages a total of $10 trillion in assets as of January 2022, and it holds significant shares in companies such as Apple, Microsoft, Google, Amazon, Tesla, and Facebook.

Every year, Mr Fink publishes an open letter to CEOs and the public. In 2018, his letter made waves when he made it clear that BlackRock wanted the companies it invested in to "serve a social purpose." In 2020, within weeks of stating that climate change would become a defining factor in BlackRock deciding who it invested in, "many blue-chip businesses announced plans to become carbon-neutral or carbon-negative," reported *The Times*.

In his latest letter, Mr Fink made it clear that the driving force behind his position is the same driving force that has always driven capitalism—profits. In bold letters, he wrote, "**In today's globally interconnected world, a company must create value for and be valued by its full range of stakeholders in order to deliver long-term value for its shareholders.**" He then uses the words *durable profitability* and *long-term* profitability.

That means that the efforts at raising awareness and stopping the destruction of our planet are working. But there is a deeper issue involved.

Are accounting principles preventing companies from adopting social causes?

Whereas the grassroots movement is spurring this metamorphosis in corporate *attitude*, the fundamental *system* is still broken. More specifically, the accounting principles used in the USA might actively be preventing large corporate clients from investing more in ESG—Environmental, Social, and Governance, which is the term used to describe a company's investments in social causes.

We won't make this too technical, but here is the gist of it for the uninitiated:

The world runs on two main types of accounting principles: The GAAP (Generally Accep[ted Accounting Principles) used in the USA and a handful of other countries. And the IFRS, the International Financial Reporting Standards, adopted in Europe, and in a total of approximately 90 countries.

The GAAP was established in 1936 and is a set of rigid rules that must be followed without question. The IFRS was established in 2001 and has seen several major iterations. IFRS uses a more flexible reporting standard that is open to each accountant's interpretation. For this reason, financial reports created using IFRS tend to have numerous explanatory notes for investors to understand how the figures are arrived at.

GAAP is an accounting standard that measures *cost* and only *cost*. **It has long been decried as a standard that penalises the acquisition of talent or investment in ESG.**

For example, in IFRS, a company can invest in diversity education and then *capitalise* that expense over a number of years. To capitalise an expense means that you spread the expense over several years. It is an accounting method to show that a certain purchase—say, a fleet of new vehicles for a delivery company—is an *investment in the future*.

Under IFRS, it is possible to spread the cost of *investing* in better corporate governance, or better diversity, over a few years. A company that spends €50,000 on ESG could log that expense as only €5,000 each yea for the next 10 years.

This makes the company look more profitable on its Income Statement.

Under the principles of long-term profitability, being able to capitalise an investment in ESG provides a completely different picture of a company's financial standing compared to when companies use the GAAP method. Public companies are required by law to do their accounting following GAAP in the United States. This is a systemic flaw that must be addressed.

Europe ramps up ESG reporting

Data from various global S&P indexes revealed that companies that met sustainability criteria provided better returns for investors. **This puts European companies in the interesting position of being able to promise investors better ROI than their US counterparts.**

One problem within Europe, however, has been that it has had too many standards and frameworks with which to report compliance to its ESG obligations.
These standards have included the:

- **Carbon Disclosure Project (CDP**
- **Climate Disclosure Standards Board (CDSB)**
- **Task-Force on Climate-related Financial Disclosures (TCFD)**

And many others.

Some of the standards are more consumer-centric, while others are aimed more at investors. This can create confusion for investors when looking through reports. To resolve this issue, the IFRS announced the creation of an International Sustainability Standards Board (ISSB) in November 2021, which will sit under the IFRS foundation, and exist in parallel to the International Accounting Standards Board. The ISSB will bring various sustainability reporting frameworks under one umbrella.
The board has since issued two drafts for suggested obligatory reporting by companies:

- **IFRS S1.** General Requirements for Disclosure of Sustainability-related Financial Information;
- **IFRS S2.** Climate-related Disclosures

These reports were created in direct response to calls from "investors, lenders and other creditors" for "more consistent, complete, comparable and verifiable sustainability-related financial information to help them assess an entity's enterprise value."
The reports hope to provide vital information to investors and creditors about activities and factors that relate to sustainability, especially those which might directly affect the company's profits such as risks to natural resources that the company relies on.

With obligatory sustainability reporting, European companies will once again be raised higher than their US GAAP counterparts in placing a focus on ESG activities. Investors, becoming familiar with the new, consistent reporting format, might start to insist on the same from US companies. Until then, EU companies will have an upper hand.

Integrating sustainability into your company: a strategic decision

European companies have, for now, an advantage in satisfying investors, and they should make the most of it. However, to be something concrete, credible and meaningful, **sustainability must be understood as a process of transformation that affects the entire company**, from production to communication, including the corporate structure.

There are many ways to do this: adopting a circular supply chain (where the goods are designed not only to last longer but also to be reused, recycled or resold), shifting to renewable energy sources, allowing an increasingly flexible way of remote working, obtaining the B Corp certification, or supporting long-term projects that bring environmental and social benefits.

Whatever your choice will be, **let purpose and a clear sense of values be your guide.** Our shared goal, as companies and people, remains the same: increased profits and a better world.