

# thebigpicture

guideposts for the private investor

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## **Publishing and Subscription Information**

*thebigpicture* guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial and business evaluation and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

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## ARE THREE BOTTOM LINES BETTER THAN ONE?

**A triple bottom line is an oxymoron. Adoption of the idea for corporate reporting might signal a company being pulled in too many different directions.**

Among listed companies there are more resources than ever being committed to compliance with traditional accounting standards. Ironically, at the same time, these accounting standards are increasingly seen as inadequate benchmarks by which to judge public companies. There is a global movement to have companies include their social, environmental and economic impacts in public reports.

By extending their reporting responsibilities in this way, proponents argue, companies are compelled to recognize their wider obligations to a fuller range of stakeholders. Some would go further and suggest that the performance of companies is improved by having to identify and address explicitly the matters considered important by this larger audience.

Many have also attempted to show that companies reporting across the so-called triple bottom line tend to display a superior financial performance and, for public companies, are likely to show a relatively strong share price appreciation.

Of course, cause and effect are hard to distinguish. Companies with already superior financial performance have the resources to deploy to measure their triple bottom line and might, therefore, be more likely to do so. Certainly, poorly performing companies, measured by conventional criteria, have many more immediate pressures. In being reluctant to deploy the resources for a more extensive reporting regime, they reinforce the correlation.

The triple bottom line is, of course, a misnomer. It is a gimmick used to capture the virtues of actually having a bottom line where none can exist. For accounting purposes, there is a bottom line. Usually, it measures net profit after tax. Accounting standards might differ across the world but this is a prevalent measure of business performance. There are no similar summary measures of environmental, social or economic impact let alone a measure which incorporates all these factors in an overall assessment of performance.

That being the case, why should companies consider moving in this direction?

One reason is that there are pressures from governments and nongovernmental organizations around the world aimed at forcing companies to report in this way. The impetus to do so increased as the examples of corporate wrongdoing seemed to multiply in the late 1990s. It is a silly notion that because of what happened at Enron companies should report on their environmental impact. Nonetheless, the opportunity has been taken by company antagonists to force the pace for change using Enron and other examples of often unrelated corporate misbehaviour to do so.

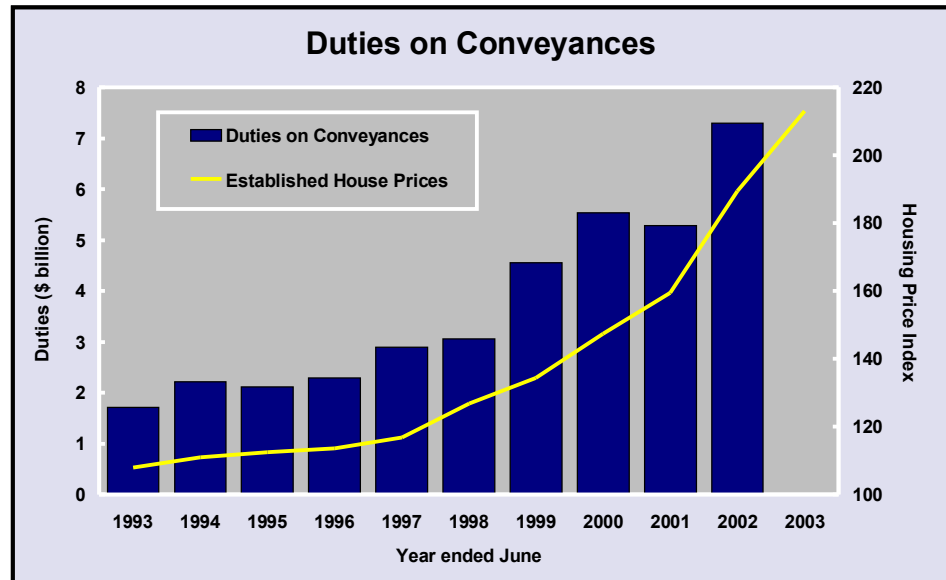
Because of the nature of their activities, some companies have a greater impact on their physical environment than others. Companies exploiting natural resources are most obviously in this category as are those generating relatively sizeable quantities of physical waste. Choosing to report against some agreed standards helps to ameliorate some of the social and political pressures exerted on their activities.

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*"...to measure [environmental, social and economic indicators] would be a wasteful diversion of resources if there were no way in which they could be conveyed meaningfully to stakeholders..."*

## THE WEEKLY CHART SPOT

*“By stealth, governments have managed to introduce a tax on accumulated wealth. Luckily for the governments, with rising house prices, the opposition to this has not been great but there is a risk of backlash if property values begin to falter.”*



Source: Australian Bureau of Statistics

The discussion about negative gearing is opening up debate about government policy toward the housing industry. Taxes on conveyances are one element of government policy which are important because they are effectively taxes on mobility and wealth which affect the demand for new housing and, therefore, levels of construction activity.

In Australia, state governments typically charge in the range of 3.5-5% of the purchase price of a house to allow a transaction to occur. Exemptions vary from state to state but are usually confined to first home buyers and low-income earners.

As the table shows, for someone paying \$500,000 for a house in Victoria, tax of \$25,660 would be payable. This is at the top end of the range. The lowest taxes on conveyances are paid in Queensland.

An individual seeking to move to a new location for lifestyle or employment related reasons would, in moving, incur a charge even if the value of the newly acquired property was the same as the one being sold. By stealth, governments have managed to introduce a tax on accumulated wealth. Luckily for the governments, with rising house prices, the opposition to this has not been great but there is a risk of backlash if property values begin to falter.

For some faced with the rising impost, staying put and renovating has made more sense where they might have had some discretion over the decision to move.

Even so, since they are *ad valorem* taxes, the rapid rise in property values has delivered governments a largely unanticipated windfall. In the year ended June 2002, the latest full year for which data are available for all the governments, \$7.3 billion was collected compared with the \$1.7 billion collected in 1992/93 implying an eight year average rate of growth in collections of 17.5% a year.

The increase in the last four years to June 2002 averaged over 24% a year. The only sign of weakness was in 2000/01 when revenues dropped back as property buyers sought to avoid the impact of the GST from 1 July 2000.

The rate of revenue collection has outstripped the rate of increase in housing prices. Over the same period, the average price of established homes in the eight Australian capital cities increased at an average annual rate of 6.5%.

	Tax paid (\$)	Effective average rate (%)
NSW	17,990	3.6
Vic	25,660	5.1
Qld	15,975	3.2
WA	19,055	3.8
SA	18,830	3.8
Tas	17,550	3.5
ACT	18,015	3.6

## ARE THREE BOTTOM LINES BETTER THAN ONE? CONT'D

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Other companies have opted for reporting their social and environmental activities to alleviate some of the effects of their products on consumers and to counter some of the associated social costs. Marketers of cigarettes, alcohol and recreational gambling having been accused of causing social and economic harm. Broader reporting commitments help to divert the barbs of their critics.

For these, reporting to multiple stakeholders is incidental to commercial activities and not on a par with the deference shown to financial stakeholders.

Are there any reasons why investors should want companies to report on social, environmental and economic impacts?

The proponents of triple bottom line reporting start incorrectly by assuming that the original bottom line is of value to investors.

Public companies report in accordance with accounting standards which do not include any references to appropriate rates of return. Whether a profit of \$100 million is acceptable or not depends on the funds employed to deliver it and on their cost and yet there is no compulsion for companies to report on this to shareholders. Nor is there any requirement for a company to identify remedial action if the performance is inadequate. And, yet, achieving an adequate rate of return or putting in place the changes to achieve it are at the heart of a sustainable business.

More companies are becoming conscious of the need to move down this path but the approach is by no means widespread among even publicly listed companies.

## MAKING MONEY AND DOING GOOD CONT'D

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Where should the boundary be drawn? What about a technology company supplying systems which can be used in weapons guidance equipment but not made specifically for that purpose? For some, a biotechnology company which undertakes research using human embryos would be unacceptable. But others would see it as life saving.

Then there are other matters such as a company's acceptance of trade unionism. The Australian waterside workers dispute

Consequently, the interests of investors would be served better by companies improving their financial reporting before attempting to divert resources to other stakeholders – and perhaps also reporting inadequately to them or in a way which fails to meet their needs.

A reporting framework should include at least three important steps.

- The Board should commit to setting objectives consistent with the company improving its economic returns with a clear definition of what directors mean by that concept.
- These objectives should be reported on in the annual report and at the next AGM with an explanation of how remuneration is to be tied to these outcomes.
- A report should be made at the subsequent AGM (and in the annual report) on:
  - ~ the prior year's performance and its remuneration consequences, and
  - ~ the new set of objectives for the coming year.

Consistent application of such a framework would be the clearest evidence of an investor friendly company. Of course, once a company has adopted this framework for its financial reporting, it could relatively simply extend it to include environmental, social and economic indicators.

To attempt to measure these other factors would be a wasteful diversion of resources if there were no way in which they could be conveyed meaningfully to stakeholders generally or to investors who want to make a judgement about a company's overall impact.

in 1998 raised many issues of how far a company should go to achieve profitability at the expense of its workforce.

Having decided how influential moral judgements should be in investment decision making, individuals then have to decide how to implement these objectives. An individual investor might find it very difficult to find a fund manager whose moral drivers are identical with his own and with whom he can entrust his capital knowing that his objectives will be pursued.

*“The triple bottom line is, of course, a misnomer. It is a gimmick used to capture the virtues of actually having a bottom line where none can exist.”*

## MAKING MONEY AND DOING GOOD

**Ethical investing is a close cousin to the triple bottom line and sustainability reporting. Investors can place funds with managers who restrict their investments to companies selected using ethical or moral guidelines.**

The choice can be based on negative or positive screens. Negative screens are designed to exclude companies which produce socially harmful products or provide services which are inherently deleterious (although not illegal). On these criteria, tobacco manufacturers and marketers, producers of alcoholic beverages, gaming companies and arms and munitions manufacturers fail to qualify as investments. Depending on how strict the regime might be, companies exploiting non-renewable resources might fail the test of acceptability.

However, the judgements can be subjective. Mining companies, despite some having been heavily criticized for their attitudes to environmental management are often included in ethical funds. Where they have adopted environmental reporting procedures, many ethical funds accept this as qualifying as ethical behaviour.

Aside from those companies explicitly excluded, fund managers using negative screens are free to invest wherever they are attracted on normal investment criteria

Positive screens are arguably more effective in supporting the ethical standards which are being applied. Criteria are adopted which define the sort of companies which are deemed to be desirable. This might include, for example, companies focused on new technologies which will reduce the use of non-renewable power or companies actively engaged in improving third world living standards.

Which of these two methodologies a fund manager might adopt will greatly influence the nature of his investments. Use of negative screens would most likely involve only a limited number of exclusions from the main market indexes and enable

the fund manager to perform in line with the market more consistently than a fund manager who adopts positive screening.

Positive screening might lead more frequently to the choice of smaller market capitalisation companies including those at relatively early stages in their development when their fortunes are more likely to depend on technological breakthroughs and commercialization of new ideas making them more likely to need additional capital. This opens an investor to greater volatility in returns.

### Sustainability Reporting: The Players

The triple bottom line, sustainability reporting and corporate social reporting are all monikers for frameworks within which companies can report their activities to a wider range of stakeholders than simply providers of capital.

The Global Reporting Initiative (GRI) is a United Nations sponsored programme to develop multi-stakeholder reporting guidelines. Started in 1997 by the Coalition for Environmentally Responsible Economies, the GRI became independent in 2002 and is an official collaborating centre of the United Nations Environment Programme working in cooperation with the UN's Global Compact.

Recently, the Australian government, through Environment Australia, published a set of detailed guidelines for company environmental reporting and has foreshadowed publication of similar documents reviewing social and economic criteria consistent with the GRI.

The World Business Council for Sustainable Development, formed by 160 international companies as a corporate advocacy group in support of sustainable development, has been playing an active role in developing reporting guidelines. However, it has also been keen to limit the extent to which the GRI becomes an overly prescriptive and onerous burden on companies because of the great amount of detail which would have to be reported if a company's reporting accorded with the GRI standards.

How far should an investor take his or her moral stance? In other words, how much performance is an investor prepared to forego to be assured that his funds are supporting only activities which accord with his moral or ethical precepts? That itself is a value-laden question.

It might appear reasonable to take a stand against tobacco manufacturers for a product which is widely recognized as having consistently deleterious effects on people. But what about the major banks which supply services to such companies? Should they be eschewed too?

*(Continued on page 3)*

*“An individual investor might find it very difficult to find a fund manager whose moral drivers are identical with his own and with whom he can entrust his capital knowing that his objectives will be pursued.”*