

A NEW WAY TO MEASURE THE VALUE A COMPANY CREATES

Financial profit captures the value to the shareholder, while the Integrated Profit and Loss (IP&L) captures the value to society

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ABSTRACT

Critical to every company is knowing the value it creates. Profit and loss statements have historically been used to measure whether a company has been successful. While this has served us well to date, it only provides one perspective of value, and that is the monetary return to the shareholder. Today we want to know more. We also want to know if society gains value from the company's existence, or is adversely affected. We want to know what our contribution is towards liveability. And we are all seeking to place 'customers at the centre'. But how can we measure all of these?

One methodology that does include a broader perspective to measuring value is Integrated Profit and Loss (IP&L). This includes reporting impacts on natural capital, social capital, and human capital, together with financial capital results. Yarra Valley Water prepared an IP&L account for its 2014/15 financial year. In a year where traditional financial accounting methods recorded a profit of \$50m, the IP&L account was \$446m, made up of \$374m in financial value addition, \$53m of natural capital impacts, \$13m in human capital, and \$6m in social capital. Interestingly, the profit to the shareholder using traditional accounting is only 11% of the total value to society recorded using the IP&L methodology.

That leaves 89% of value to society that is not recorded in traditional accounting methods. Having access to such information improves strategic decision making to improve the social value a company creates.

INTRODUCTION

Critical to every company is knowing the value it creates. After all, isn't that why a company exists? Historically, we have relied on traditional accounting profit and loss statements to measure success. And while this has served us well to date, it only provides one perspective of value, and that is a monetary return to the shareholder. It doesn't provide a measure of the quality of the service that we provide.

It also doesn't answer whether the company is environmentally sustainable. For example, whether it will have enough of the environmental resources it requires to continue business into the future. Or whether its profits come at an environmental cost to others. It doesn't answer whether the community gains value from its existence, or is adversely affected. It doesn't answer how much the company relies on the intellectual value that individuals bring, nor whether employees are better off working for this company, or another. It doesn't help a business select which projects to select to increase business value. And finally, it doesn't provide the total picture of all of the monetary benefits the company brings to others because of its existence.

Gleeson-White (2014) estimates that, when all of these other values are considered, current accounting methods would only capture between 20 and 30 per cent of a company's value. They go on to explain that this change has only occurred relatively recently. In comparison, back in 1975, a company's reported balance sheet was considered to capture over 80% of its value.

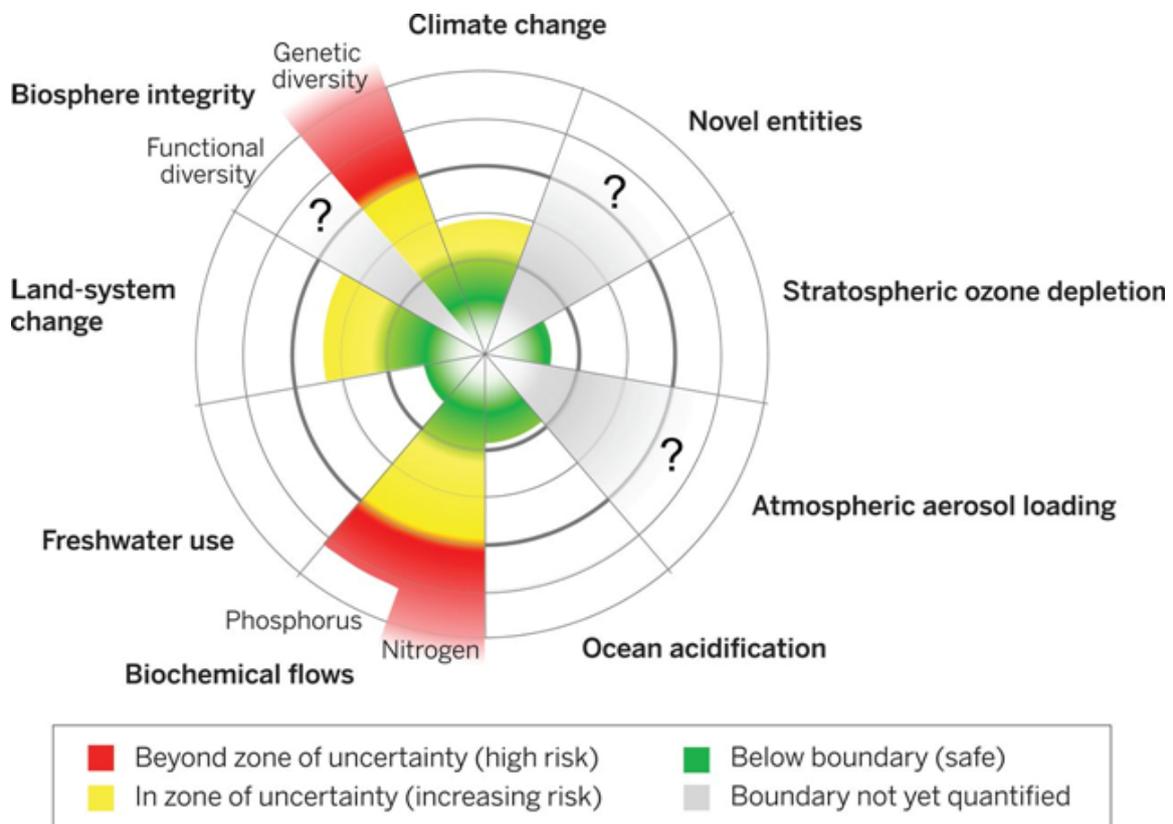


Figure 1. Planetary boundaries identify where we are no longer sustainable

We consider three factors that shape this change; we now face environmental constraints, some companies are now larger than individual countries, and present management theory highlights the benefit of thinking from the customer’s perspective.

We now have many independent studies taken from the following perspectives all highlighting that our contemporary lifestyle is no longer environmentally sustainable: the ecological footprint; Chambers et al (2001), ecosystem assessment; Millennium Ecosystem Assessment Board (2005), greenhouse gas emissions; IPCC (2007), and planetary boundaries; Steffen W et al (2015).

The concept of planetary boundaries is designed to define a ‘safe operating space for humanity’; Steffen W et al (2015). They highlight that, of the nine planetary boundaries that we rely on, four have now passed a

safe operating space for humanity (Figure 1), hence are unsustainable. If we are to achieve environmental sustainability, change is required.

Company size has now also reached such a point where the financial capability of companies is becoming larger than many countries. Of the 100 largest economic entities in the world today, 51 are now global corporations; with only 49 being countries. This raises the question of whether companies will be expected to take on a broader social role?

And finally, present management theory as described by Sinek (Accessed 13 Feb 2017), postulates that companies that can reframe their existence with the ‘why’ as their core purpose, and frame this from a broader customer value proposition, will be the ones that will be more successful.

Integrated profit and loss

The poster examples of contemporary companies that are now 'up for a bigger picture' include Apple and Proctor and Gamble. Apple states its purpose thus: 'create the experience Apple customers truly want'. Proctor and Gamble expresses its purpose as 'we will provide branded products and services of superior quality and value that improve the lives of the world's consumers, now and for generations to come'.

This is also mirrored in the direction taken by today's water companies, where liveability and sustainability take precedence in licences ahead of profit to shareholders. An example of how this manifests itself is seen in Yarra Valley Water's purpose statement, which is to '...contribute to the health and wellbeing of current and future organisations.' Adopting a broader company purpose accordingly requires a broader methodology for measuring value.

METHOD

One methodology that does include a broader methodology to measuring value is the Integrated Profit and Loss (IP&L). This includes measuring impacts on natural capital, social capital, human capital, together with financial capital. Definitions for each of these follows:

- ▶ Natural capital - Impacts on the limited stock of natural assets (both renewable and non-renewable, including air, water, land, habitats) from which goods and services flow to benefit society and the economy
- ▶ Social capital - Third-party costs or benefits of the social impacts of an enterprise, resulting from its business model, CSR programs, and policies
- ▶ Human capital - A measure of the increase in an individual's future earning potential. The increase is due to the training being provided by the employer and as well as the company brand value imparted to the individual

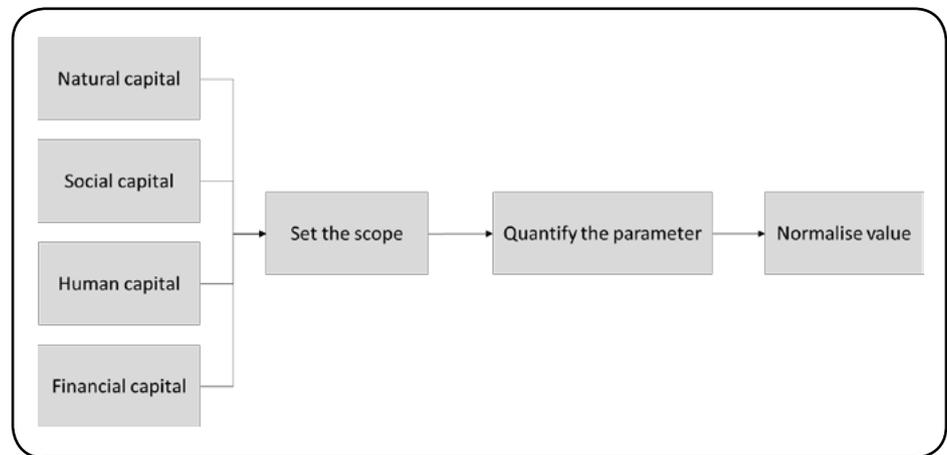


Figure 2. Simplified methodology

- ▶ Financial capital - Elements of financial value added by the company (such as salaries, rents, and taxes paid) *beyond* shareholder profits.

We have used Trucost and GIST Advisory to compile an IP&L report for Yarra Valley Water for 2014/15. A simplified schematic of the methodology is shown in Figure 2. A separate evaluation is undertaken for each capital.

Firstly, the scope of what is to be included has to be decided. In our analysis, we included our maintenance contractor, because to all of our customers it is seen as Yarra Valley Water. We purchase our water and have most of our sewage treated by another company, so chose to compartmentalise this differently to all the activities within our immediate zone of control. And then, for our social capital assessment, we started by only evaluating two projects, our Hardship Program, and our 'Choose Tap' Program. We picked these because we considered them to have the greatest potential, and this assessment being the first time we have evaluated any social aspects, wanted to see the materiality of such programs.

Each capital then requires parameters to be selected that capture the potential impacts. For example, natural capital at Yarra Valley Water is experienced through land clearing, pollutants discharged into waterways, water extraction, and greenhouse gas emission.

Integrated profit and loss

Each is quantified, and requires a separate analysis to determine the environmental impact, in many cases drawing upon previous modelling done elsewhere and translated to this site. And for each of these, an economic value is then determined, also using the best available methodology.

RESULTS

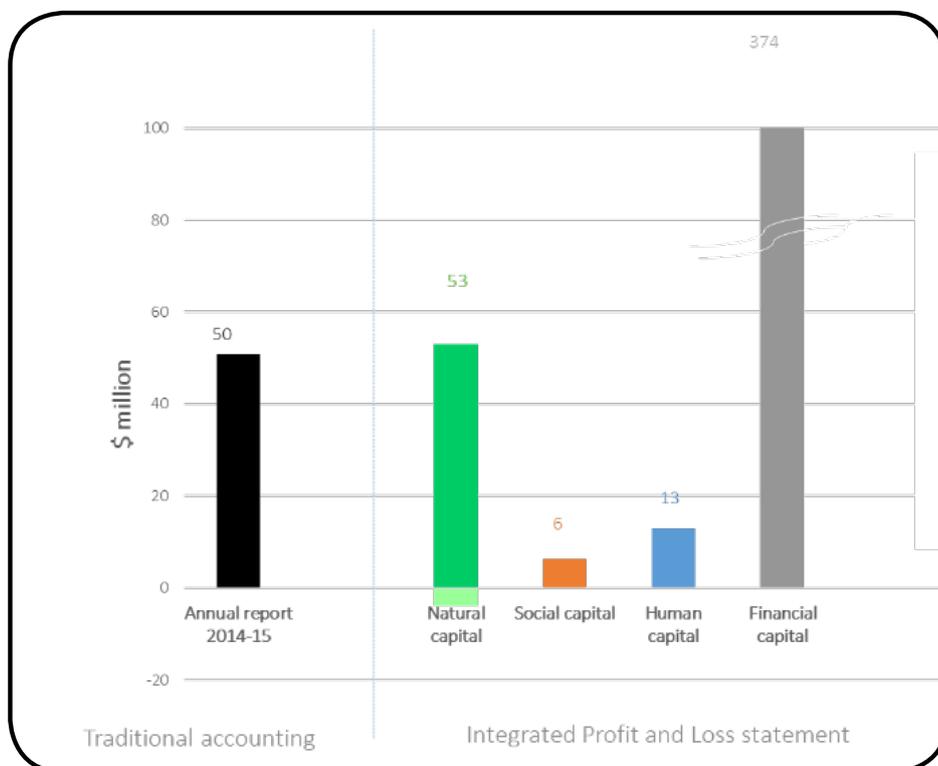
The end result is an IP&L account; Trucost and GIST Advisory (2016). Figure 3 summarises Yarra Valley Water's IP&L account for 2014/15. In a year where traditional financial accounting methods recorded a profit of \$50m, the IP&L account was \$446m, made up of \$374 in financial capital, \$53 in natural capital, \$13m in human capital, and \$6m in social capital. Interestingly, the profit reported using traditional accounting is 11% of the value recorded using the IP&L. Another way of comparing the financial profit with the IP&L is to note that the financial profit captures the value to the shareholder, while the IP&L captures the value to society.

A key outcome from the analysis was the inter-relationship of the supply chain on the delivery of Yarra

Valley Water's services. Most of the water that Yarra Valley Water sells is harvested by another company, and equally the bulk of sewage discharged is also treated by another company. It is, accordingly, not surprising that most of the environmental impact is attributed to those parts of the process.

When considering all of the negative environmental impacts associated for the delivery of water and sanitation services to its customers, Yarra Valley Water found that approximately 95% of the environmental impact was associated in the supply chain outside of its direct control. Such awareness highlights the interconnection between companies, and the need to work together if the delivery of water and sanitation is to be done in a sustainable way.

Analysing the results in greater detail shows that the majority of environmental benefits within its zone of control for Yarra Valley Water come from the removal of water pollutants from the sewage treatment plants, while the largest negative environmental impact comes from greenhouse gas emissions.



Within social capital, the benefits of the Hardship Program were calculated to be \$4.8m, and had a Social Return on Investment (SROI) of 82%. That means for every \$1 invested, an additional \$0.82 was realised by society. The Choose Tap Program had a positive benefit of \$1.9m and an even higher SROI of 365%.

The human capital creation, or benefits employees gained, was \$13m. This was the value that all employees got from working for Yarra Valley Water, predominantly from our training programs.

As regards financial capital, additional value of \$374m came from interest, taxes, and salaries paid by Yarra Valley Water in addition to the recorded \$50m of profit.

Figure 3. Yarra Valley Water's IP&L summary for 2014/15

DISCUSSION

At the end of any research it is important to take a step back and think about how this new information could be used, particularly against the key questions that initiated the research, which was: “how can we measure the value we create?”. We want to ensure that we are adding value at both a project scale and at a business scale.

An important use of our IP&L learning is that projects that were selected in the past based on intuition now have a more robust selection process, together with a measure of materiality of their relative importance. Publishing an IP&L report puts us at the forefront of businesses around the world interested in the concept of true value creation at a business scale.

For example, we were surprised to see the relative value from our Choose Tap Program and Hardship Program. This has given us a different insight into our contribution to liveability, and opened up a new dialogue of exploration of what else we could do in this domain to further increase value.

The IP&L statement has also highlighted that our largest negative value is due to greenhouse gas emissions, which is shown to be 54% of our negative value. Realising this provides us with a strategic imperative to look for a way to reduce that figure. Placing all the capitals together also helps to ensure that one capital isn't increased at the cost of another. For example, GHG does need to be reduced, and a way has to be found that can achieve this without reducing financial capital creation, because only then will the total value increase. Yarra Valley Water's waste to energy plant at Aurora is an example that delivers on this strategic imperative.

Talking about value in this way changes the focus from projects to actual outcomes. As soon as the focus is on outcomes, we then move from talking about what we are doing, to why we are doing them. Ultimately, it is to deliver value to customers. Completing an IP&L accordingly, provides a material way to measure how well a company is delivering on its 'why'; as described by Sinek (Accessed 13 Feb 2017)

We have published our IP&L report in our annual report. Doing this provides a transparent insight to our customers, stakeholders, and shareholders of our intent, and our true performance. For who knows where our next value addition may well come from? Presenting it to the public is a generational advancement to involving others in our decision making process, providing the

possibility to also explore other ways to add value.

We have also gained some major insights to help others who want to embark on a similar journey.

Firstly, the shaping of an Integrated Profit and Loss report is highly dependent on the question that one wants to answer, and care has to be taken not to extrapolate across boundaries not considered in setting up the study. For example, our study has not included the health benefits from providing water and sanitation services. It could be argued that it therefore does not identify all the value that Yarra Valley Water provides. That is true. However, the primary purpose of our study was to contribute to future decision making, and from that perspective, collecting data on such health benefits was seen to be very complex without providing material differences between the potential options we would be considering in the future.

We also learnt that 95% of the environmental impact from us providing water and sanitation services to our customers occurred outside the immediate control of our business. We do not imply that either we or our customers have no responsibility in this, however, there are many different discussions embedded within this issue. They move into the context of zones of control, influence, and care, and each will have different responses.

We have also learnt that many people feel uncomfortable seeing all the externalities aggregated into dollars. They rightly highlight that not everything can have a monetary value put against it.

This may well be philosophical, but it also presents us with a challenge of a major divide that must be crossed before the evaluation of externalities will be accepted by the majority. From our perspective, the question of value is fundamental, and we consider that the greater access we have to more and more data, the better our final decision will be.



Integrated profit and loss

Maybe it is akin to a pilot flying a plane, who has a large panel of gauges to access to make a decision. We too, as managers, want to have as many gauges as possible. But ultimately, we also want to know if we are heading in the right direction, rather than being skewed by any one instrument. We consider that an IP&L can provide us that direction.

This work has also provided the Melbourne water industry another opportunity to come together to explore a common way to measure value generated. From the state's perspective, such value should be common to us all.

Two separate processes are in place to advance this challenge.

Colleagues from the water industry are exploring how to share such work amongst one another, while the Victorian Department of Environment, Land and Water

Planning has a group in place to advance how the state accounts for natural capital.

And finally, this work has opened up possibilities not considered before. We now want to further explore the material contribution to these multiple capitals from all the other potential projects we could do. For example: should we be improving social equity by finding new ways to help customers pay their bills; or advancing public health by improving public access to drinking water; or improving affordability by educating the public to use water more efficiently; or improving public amenity by beautifying public assets; or improving our workforce by offering scholarships. We are accordingly now in the process of undertaking further research to increase our understanding of what projects deliver the greatest value. Through these projects we want to identify the key variables that contribute to health and wellbeing, so we can ideally incorporate them into our project selection to find the greatest value enhancement.

CONCLUSION

An Integrated Profit and Loss report provides Yarra Valley Water with a new way to measure the value it creates. Interestingly, it may be the deeper discussion that such an analysis opens, rather than the actual

results that may be of greatest value. After all, for utilities who are seeking to place 'customers at the centre', we each need a different way to assess the value we provide, not only to our shareholders but also to the community and society. An Integrated Profit and Loss report does just that.

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