It is time we prepared accounts for the needs of a moral investor

Most investors are good people. We do not seek out investments that have damaging consequences. We would not want our investments to support child labour, slavery and environmental degradation any more than we personally would employ a child as a domestic worker or routinely dump household rubbish in the local park. Faced with a choice between two investments, one of which we knew to do these things and one which we knew did not, most of us would prefer to earn our return through moral means. We are at heart ‘moral investors’ who want to live in a moral world.

Rarely, however, are investors asked to consider anything but financial risk and return when they make their investment decisions. Investors are assumed to be rational, wealth-maximising individuals. It is rational to be moral at home, in places of worship and through philanthropy. But, as investors, we have implicitly put our trust in politicians and law makers to identify the moral limits of corporate action and to make illegal (and enforce) those actions that fall outside society’s moral bounds.

We assume that a combination of the law and a business’s financial accounts ensures that by and large none of these things happen.

But that’s where we make a mistake.

It is becoming increasingly apparent that this is not the case, whether it’s the effects on business in general on climate change or examples of poor labour conditions in retail supply chains, conflict minerals in our mobile phones or sugar and fats in our food, we cannot rely on legal systems to deal with or even always recognise legitimate claims and we cannot rely on financial accounts to have included costs that may be being incurred by people as a result of a business’s operations.

The general response has been for calls for more legislation and more company reporting. What has escaped our notice is the potential role of accountancy in providing a solution that can give us much more comfort as the moral investors we are.
The purpose of accounting

For many of us accounting is the process of counting up how much money a business has left after deducting its expenses from its income. What’s left is available for the investors.

In fact, accounting is the process of deciding what should be included in this income and expenditure and, once included, valuing it. The easy bit is the money a business has in the bank. But very quickly accounting is asked to make assumptions about the future; for example, what level of debts are unlikely to be paid. No one can know for sure. But accountancy allows us to make a reasonable estimate.

Reasonable perhaps. But for whom?

Bad debts are relatively easy. As soon as you get into asset valuations, the closure costs of mines and the level of contingent liabilities you quickly enter into a world of uncertainty. And so ‘stated profits’, the amount that can be distributed, can be heavily influenced by these estimates. Accountancy seeks to minimise the risk that money will be paid to investors out of capital but the decision on what should be included or excluded has to be informed by something. And this has come to be the needs of a ‘wealth maximising investor’.

The invention of the wealth maximising investor

The idea of a wealth maximising investor currently underpins financial accounting.

But how did we end up basing our accounts on the assumption of an idealised wealth maximising investor?

A brief history with the royal charters and limited liability companies will help. Initially, any company seeking limited liability required an Act of Parliament, which tended to be given only where there was a clear purpose and that purpose was considered a public good. Limited liability was awarded for specific purposes to undertake beneficial activities, often with monopolistic access to a region and product/service – building railroads, utilities. The
accounts that governments mandated for railroads and utilities were primarily for the government to ensure that rates and prices on consumers were fair. The limited liability company, which most are today, and corporate reporting, began with an explicit public purpose\(^1\). The motivation of the investor was for financial return but framed by a public good.

Accounting historians, such as David Hawkins and John Edwards, have noted that, in the early years of securities investing, companies provided very little information. Perhaps only three or four lines. Investors – those who did not have the power to ask for tailored accounts – were thought of more like gamblers, working on hunches and odds, rather than as analytical information users.

Accounting standards emerged to improve comparability across companies and coherence within accounting practice and to establish a way for regulators and courts to know if financial reports were ‘true’.

US scholar Joni Young has analysed the process that followed, how the Financial Accounting Standards Board (FASB) iteratively stylised and abstracted needs of users into something that was consistent and homogenous across all users. Influenced by classical economic theory, from the process emerged the image of the investor as a wealth-maximising, non-moral being.

Although the international framework was modelled on the FASB framework, initially it differed – describing the purpose of accounting as accountability and stewardship\(^2\). Over time, however, it too has adopted the FASB’s focus on information for investors. Gradually, additional information has been included in the accounts; for example, directors’ remuneration and estimates of closure costs of mines. So it can be seen that introducing a new, hypothetical, stylised investor whom the accounts were to serve, changed the structure, the content and the values of those accounts.

\(^1\) Morgan E and Thomas W (1969), The Stock Exchange p 130

Recognising that wealth maximisation is an assumption that reflects some, but not all, investors’ objectives opens up the possibility of choice; of choosing to define the investor differently – as a moral investor.

The fundamental assumptions about the nature of investors that underpin all accounting are precisely that – assumptions – and they have massive, far-reaching consequences for how money flows through our society.

Acknowledging that we have a choice in the assumptions highlights the importance of public debate.

**True and fair?**

Accounting is the process we rely on to assess which investments will achieve our investment goals. Investment choices are informed by the expectation of future demand and current profitability and profitability will be informed by how the accounts are prepared.

Section 393 of the UK Companies Act states that accounts should give a ‘true and fair view’.

But the decision on what should be included for the accounts to be true and fair has to be informed by something. And this has come to be the needs of a ‘wealth maximising investor’.

‘Truth’ has come to mean ‘in accordance with accounting standards’. Most people agree that a ‘truer’ picture of a business’s financial position includes estimates of bad debt, product returns, depreciation etc, even though none of those items are absolutely certain. A large part of what standard setting does is draw lines around these estimations and projections. The standards provide guidance as to how assets are to be valued, how future obligations and possible risks are to be represented in monetary terms in the account, if at all. The standard leads to a version of truth. And it is constantly in flux.

A real-life example of this is the effect of different accounting standards on business profitability. For example, in 1996 Glaxo Wellcome’s shareholder equity changed 566% when restated from UK accounting rules to US
accounting rules. In 2001, British Airways shareholders’ equity declined by 27% when similarly restated\(^3\).

What is interesting is that despite this constant flux in the truth, we don’t seem to mind. Accounting and audit give us enough confidence to invest.

National regulations, sanctions, penalties and incentives can also have an effect on the accounts. These create a monetary implication for certain behaviours that are considered to have social or environmental implications. For example, where regulations require that a company harvesting a forest must pay for it to be replanted, the cost of replanting the forest will appear on the financial statements. Where no regulations exist, no cost appears, even if the forest ought to be replanted. Two companies with similar financials, reporting under similar standards, may report different truths, due to place-specific regulations.

Representations of a company’s financial affairs are greatly influenced by accountants through setting standards and exercising judgement, and by regulators through imposition of costs and incentives. If the representations are taken as a truth, then it holds that accountants and policy makers can influence this truth.

All this complexity sometimes loses sight that the decision on what to include and how to value what is included and the standards that have developed to make this reasonable are based on the needs of a wealth maximising investor.

**Sustainability reporting**

Sustainability reporting has developed from the recognition that there are other stakeholders with different information needs. Many companies voluntarily prepare sustainability reports, sometimes self-fashioned, sometimes in accordance with a sustainability reporting standard such as the Global Reporting Initiative (GRI). This trend has advantages in that it is has increased the type and quality of sustainability disclosures.

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However, these supplementary reports do not adequately meet the needs of the moral investor.

At present, the standards and auditing of these reports are not as stringent as in financial accounting, making it difficult to know whether a business is addressing wider effects of its operations or making distributions and calling into question the confidence investors should place in these disclosures. Further, while standards around what to disclose have emerged, there is still little consensus on how to value and estimate social and environmental outcomes, and how to assess ‘materiality’ (which outcomes or transactions to include in the accounts) for investors.

A second trend is the broadening of risk disclosures within existing financial standards. Expansion of material risks results in more disclosures where the company may be doing harm. Disclosure of labour relations, environmental degradation and health hazards has increased, with greater emphasis on risk disclosures. These, too, fail to meet the information needs of the moral investor, for two reasons. Firstly, risk is defined as risk to the profitability of the business. Activities that may result in substantial social or environmental harm, but have little financial implication, fall outside the disclosure; likewise those risks expected to have minor social or environmental consequences but material financial consequences would be disclosed. Risk disclosure informs the wealth maximising investor, who is attuned to social and environmental effects only insofar as they affect expected financial return. They do not adequately inform the moral investor. Secondly, and importantly, risk disclosures do not give a business the opportunity to report the value of the positive things it is doing. Businesses generate a huge amount of ‘good’, through employment, wealth creation for a community, the provision of products and services that increase our quality of life. None of these upsides can be captured through the risk lens.

A third trend is Integrated Reporting. The International Integrated Reporting Council (http://www.theiirc.org) defines an integrated report is “a concise communication about how an organisation’s strategy, governance, performance and prospects lead to the creation of value over the short,
medium and long term”. This provides a guidance structure for the narrative portion of the annual report in a manner that, as the name suggests, integrates social, environmental and economic impacts. An Integrated Reporting Framework was released in December 2013. This focuses on aligning social and financial reporting. It is an improvement over the above two approaches because social, environmental and financial disclosures will appear in a single report. Further, there will be disclosure and auditing guidelines for all aspects of the report, increasing confidence in the disclosures. It is a strong step in the right direction. True accounting for the moral investor, however, will take the idea of integrated reporting even further.

Whilst there will always be a need for accounts to be supported by non financial information (of the type set out by supplemental or integrated reporting) our argument is for a different type of integration. Changing the presumed intentions of the investor will change what is material to the accounts. ‘True and fair’ will come to include more issues, and accountants will then need to value these issues so that they can be synthesised and included.

All these approaches reflect an increasing recognition that social returns are important. However, they sit alongside existing accounting practice. If the underlying assumptions about the investor that uses accounting are changed, then accounting is likely to evolve into a profession with expertise not only for summarising, estimating and presenting volumes of financial data, but also synthesising these numbers with social and environmental issues in a manner that will allow the moral investor to balance adeptly financial return with social purpose.

**Accounting for the moral investor**

Accounting requires disclosure of items that are material to the investor. In accounting, information is considered material if its omission or misstatement would likely influence the economic decisions of a user.

When creating and applying standards, accountants (whether as standard setters, auditors or in accounting departments) must make assumptions about the information upon which investors wish to base their decisions. To do this,
they consider the item’s nature, size and/or surrounding circumstances – on the assumption that the all investors are wealth maximisers.

If we were to specify the investor to be a moral investor, these materiality decisions would be based on different assumptions.

The work of the GRI (the Global Reporting Initiative), TEEB (The Economics of Ecosystems and Biodiversity), and the SROI Network shows that it is possible to identify and value the effects of a business’s activities on its stakeholders. Likewise, ‘Impact Investing’ – a growing segment of the securities industry which caters to investors who seek a social as well as a financial return – shows that there is a demand from investors and that it is possible to consider social returns alongside financial returns. 4

In these initiatives the level of accuracy required is not as high as that required for the existing financial elements of the integrated statements.

These approaches make the decision on whether to include issues in the accounts on the needs of all stakeholders who are materially affected. This is a problem for financial accounting which is designed for the needs for one stakeholder, the investor. However redefining the morality of the investor to be someone who is interested in the material effects on all stakeholders resolves this problem.

The moral investor only wants a reasonable level of assurance that there are issues and that the business had a role in creating them.

A good example of what this might look like at the moment is Puma’s environmental profit and loss account. The environmental cost of Puma’s activities are estimated to be $146 million. Puma’s environmental costs are not material to a wealth maximising investor. It is not a cost that it is likely Puma

4 There is a growth of interest in impact investing. Impact investors differ from moral investors, in that they are real investors are seeking to generate positive social impact through their investments, whereas the moral investor is a theoretical investor, underpinning accounting, who simply wishes to consider social and environmental issues in investment decisions.
will have to pay. It is, though, material to a moral investor who is interested in comparing the relative environmental cost per unit of expected financial return.

Change the motivation of the investor and it would be possible for this amount to be recognised on the balance sheet as a provision. There is no immediate cash payment but distributable reserves and profitability are reduced. The business has an incentive to reduce the provision and the investor has confidence the business is in a position to do so. Businesses with lower provisions become on balance more profitable and attract more capital and their cost of capital reduces.

One possible concern about this treatment is that the timescale for the liability, and the process by which this estimate may become an actual cash payment is uncertain. However, the objective is to ensure that the business does not distribute profits which may be needed or used at some point in the future to address the impact that the business has had on other groups of people. The link to cash remains and is less certain than in some other items on the balance sheet.

A second concern is that the level of accuracy of the estimate may also be less certain than with other valuations. For the redefined investor this is not a problem. This investor simply wants some assurance that these factors have been accounted for. In the event of a future payment there may well be a difference between the provision and the actual cash payment but this is no different to other future and uncertain items on a balance sheet.

Incorporating social and environmental information into the accounts, under the assumption that the investor cares is a more effective approach than relying on regulation to internalise externalities.
Conclusion

Accountants have presumed, over time, that they must cater for a certain kind of investor in their accounting decisions. For the vast majority of today’s investors, however, there is some level of social or environmental harm at which they would choose to forgo some amount of financial return.

We are arguing for a redefinition of that hypothetical investor in whose interests the judgements about accounting estimation, valuations and disclosures are made. And we believe investors will change their investment decisions more quickly if these issues are included in financial statements, in the bottom line. The easiest way to achieve this is for public policy to redefine the motivations of the investor in company law – and then ask the accountancy profession to prepare accounts on that basis.

Accountants themselves are ‘caretakers’ of accounting and rightfully need to be conservative. But it is time for a public discussion – and decision – about the motivation of investors on whose behalf the caretakers’ judgements are made.