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PEGASUS

A NEWSLETTER FOR THE CAUX ROUND TABLE FOR MORAL CAPITALISM NETWORK LOOKING AT BUSINESS ABOVE THE CLUTTER AND CONFETTI

Pegasus

Introduction

What is something worth? Who would buy it? Who would go to the trouble of making it? Value which can be priced in transactions is the heart of market capitalism. What has no value to others can't be sold. Real value, in a social sense, requires a meeting of different minds on the same terms or if different, at least mutually acceptable terms.

One would, therefore, like to conclude that capitalism, as an economic system, does rest on a social or moral foundation of reciprocity. But that condition, we know, is not always true. People can be fooled as to the "value" of a good or service; they can fool themselves, too. Power can be exerted to coerce people away from their better judgment into a forced, unethical acquiescence as to the price they must pay for a good or service. Terms can be "take it or leave it" or "my way or the highway." Power can come in various forms: violence, psychological, market monopoly, social or political. Dominance takes many forms. Some subtle. Others crude and raw, red in tooth and claw.

It would seem that we are entering an era of re-thinking the price of companies in global capitalism. We hear lots of talk about replacing short-termism with long-term value creation.

What is a company worth? What should determine the worth of a company – its quarterly profits only? The merits of its goods or services brought to market? Its social standing or cultural profile? The price of its stock in trading markets? Its net book cash value?

This year, we are convening round tables around the world to bring forth ideas and concerns about the valuation we place on companies. This issue of Pegasus brings you the proceedings of our first two round tables held in Sydney and Amsterdam.

We have also included a concept paper on the need of global capitalism to rebalance how it prices financial capital in relationship to social, human and natural capitals. The idea for this proposal to improve the outcomes of capitalism was suggested by our Dutch colleague Herman Wijffels, former Chairman of Rabobank. Herman outlined to me his insight into today's transition of capitalism from one era into a new one when I visited him recently in Utrecht.

I often hear American business executives and professors of business ask: "What is the value proposition here?" The question seems practical and important. It puts attention on why an act, idea or thing might be worth our time and investment. Pricing worth sorts out our priorities and guides our behaviors. That is why I am disposed to spend time on thinking about value as the heart of a moral capitalism.

Stephen B. Young
Global Executive Director
Caux Round Table for Moral Capitalism

Round Table on Valuation

Sydney, Australia

May 14, 2019

Westpac Bank hosted a round table on valuation at its headquarters in Sydney, Australia, on May 14, 2019. Carolyn McCann, Group Executive, Customer & Corporate Relations and Siobhan Toohill, Group Head of Sustainability, convened the discussion. Noel Purcell, Chairman Emeritus of the Caux Round Table for Moral Capitalism (CRT) and former executive for Westpac in its stakeholder governance, marketing and corporate communications functions, attended. Jack Flanagan, Emeritus Professor of Accounting at Australian Graduate School of Management, University of New South Wales, Sydney, participated as a guest of the CRT.

Given the recent report by the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, the round table discussion returned again and again to the problem of giving financial institutions an asset "value" in the public mind as a force for good. Having financial institutions recognized for having such a "social" asset value would imply that such firms deserve a "license from society" to carry out their business activities and to prosper for the good of all.

Participants drew the inference that an institution such as Westpac needs to support its contribution to Australia as an "asset" for its future flourishing, more than as a transactional force taking in cash profits from the society and giving out "impacts," good and bad, for the country and its economic, cultural, political and natural environments.

There was agreement that our current ways of measuring economic results narrowly but also separately from non-financial impacts (GRI, triple bottom line, sustainability reports, SDG scorecards and dashboards, social, human and natural capital protocols, integrated reporting formats, etc.) do not provide an over-all net "value" of a firm as an institution drawing upon and contributing to its human and natural ecologies.

After the round table, Prof. Flanagan sent me a reference to a reporting format suggested in the 1970s of "value added statements" as an expanded version of P&L statements which attempt to report on the resources used by a company to produce a range of outcomes.

He sent me the following recent 2017 value added statement of Volkswagen:

> *The value added statement indicates the added value generated by a company in the past fiscal year as its contribution to the gross domestic product of its home country and how it is appropriated. Due to the improved operating profit before special items and lower negative special items, the value added generated by the Volkswagen Group in the reporting period was up 16.8% year-on-year. Added value per employee increased to €107.7 thousand (+13.9%) in 2017. Employees in the passive phase of their partial retirement as well as vocational trainees are not included in the calculation.*

VALUE ADDED GENERATED BY THE VOLKSWAGEN GROUP

Source of funds in € million	**2017**	2016
Sales revenue	230,682	217,267
Other income	18,912	17,907
Cost of materials	−151,449	−140,307
Depreciation and amortization	−22,165	−20,924
Other upfront expenditures	−17,615	−23,990
Value added	**58,364**	**49,953**

Appropriation of funds in € million	**2017**	**%**	2016	%
to Volkswagen AG shareholders (dividend, 2017 dividend proposal)	1,967	3.4	1,015	2.0
to employees (wages, salaries, benefits)	38,950	66.7	37,017	74.1
to the state (taxes, duties)	3,433	5.9	3,486	7.0
to creditors (interest expense)	4,344	7.4	4,070	8.1
to the Company (reserves)	9,671	16.6	4,365	8.7
Value added	**58,364**	**100.0**	**49,953**	**100.0**

The round table noted the following concerns:

1) Complexities of operational risks – risk assessments have their limitations.
2) What risks are material and so deserve board consideration?
3) Role of the board in stewardship of firm asset values?
4) Good risk management deserves reflection in the present valuation of a firm and conversely, poor risk management should de-value current prospects for a firm.
5) As a research approach for a material area of operations, a reasonably likely scenario should be projected and its impacts on future cash flows estimated.
6) Trust is a capital asset of every firm which is not currently set forth for management action, either quantitatively or qualitatively.
7) The mega trend today for business is the transformation of its ecosystem from a relationship world of stakeholder/firm engagements to a transactional one using more and more impersonal exchanges of data via computers. Firms are thus becoming more and more remote from stakeholders and can more easily take them for granted until social media demands remediation of shortcomings. As large firms in particular turn inward in their decision-making dynamics, they become victim to the inertia of self-absorption.

Round Table on Valuation

Amsterdam, The Netherlands

June 25, 2019

ABN AMRO, the Impact Institute and the Caux Round Table for Moral Capitalism (CRT) jointly convened a round table discussion of valuation and impact assessments for companies.

A general conclusion from the presentations and discussion was the standard for a new capitalism of "from us all, for us all, by us all." The renewed capitalism should stimulate long term value creation for all stakeholders. To integrate long-term value creation in decision-making, companies need to measure, report and steer on impact and embed stakeholder influence. In doing so, the Sustainable Development Goals (SDGs) provide a clear language and objective.

Steve Young, Global Executive Director of the CRT, opened the discussion with a presentation on the work of the CRT in formulating a new theory of the firm which includes intangible capitals such as social capital, human capital, reputation capital and intellectual capital. The use of such capital accounts permits recording long-term the availability of resources necessary for sustained firm success. By creating more comprehensive balance sheet accounting, owners and investors can focus on long-term impacts of firm behavior more than is possible when only profit and loss statements are used to steer enterprise decision-making.

Adrian de Groot Ruiz of the Impact Institute then described the institute's recommendation that firms use impact statements in addition to financial statements. By directing focus to the "impacts" of firm behavior, such statements will enhance steering the company towards long- term value creation for itself, including its shareholders and for society at large. The impact statement internalizes the quantity and quality of the firm's outputs, overcoming past overcoming past difficulties in bringing future externalities into firm decision-making, thus overcoming a long-standing failure of micro-economics.

Adrian asked: what variables should be used to "steer" a company forward? Profit or a multiple of outcomes?

The proposed impact statements provide context: contributions (and risks) to value for investors, net value creation for each stakeholder constituency, a do-no-harm ethic for firm decision-making and contributions to the SDGs.

It should be noted that the impact statements validate the relevance of the CRT Principles for Business, specifically the first two principles.

Third, Tjeerd Krumpelman of ABN AMRO described his bank's work in drawing up an impact statement for 2018. The effort enhanced integrated thinking and reporting. It improved bank decision-making, made explicit growth in capitals contributing to a better society and gains or losses to sustainability. The impacts recorded could be easily associated with one or more of the SDGs.

Professor Dirk Schoenmaker then argued for the central importance of governance. Governance mechanics steer the integration of thinking and multi-factor analysis of the economic, society and biosphere.

A point was then made that "steering" a company is the challenge.

Yet, steering towards what beach? Many search for a financial "landing" for their company boat which is outperformance of the market in the generation of cash flow.

Pension funds do have long-term horizons for their investment objectives which are limited in concern for the wealth effects on those to be supported financially in their older years.

Former Dutch Prime Minister Jan Peter Balkenende advised that the standards needed to assist private companies in contributing to implementation of the SDGs should be: global in applicability; measurability (measurements are necessary for governance, just as a compass facilitates steering a boat to the desired destination); a change in mindset as to the purpose and modalities of capitalism – a commitment to a good life for all; and a common language for assessment which the SDGs now provide.

Nicolette Loonen noted that governance for long-term value creation required integrated reporting, both internally within the firm and externally for society. Therefore, new metrics for firm management are needed. The recording of non-financial data needs to be assigned. Such data will illuminate the risk-exposure climate affecting a firm. The external valuecreation is what benefits most stakeholders. The non-financial metrics illuminate the "pre-financial" substructure, the use of which permits a firm to achieve profitability. The materiality of such non-financial data needs to be assessed with care and skill. To obtain more insightful metrics, a firm should institutionalize, as part of its governance, regular consultations with stakeholders.

She recommended the creation of a social council to advise boards of directors; linking incentives to long-term value creation; integrated reporting as foundational; a special committee of the board to guide transition from short-term metrics to long-term impact assessment; and composing boards with those who have insight into these new dimensions of firm governance.

It was agreed that reporting increases awareness and prevents blind spots from destabilizing firm success. Impact statements can be a lever for innovation. They can create a tipping point for improvements in firm culture and governance.

It was noted, as a caution, that too much reporting leads to excessive bureaucratic formalities getting in the way of timely decision-making and individual assumption of personal leadership in acting wisely for the firm and its stakeholders.

Adrian presented a new initiative of the Impact Economy Foundation which is to create a global community of "impact professionals" to serve as stewards of a new discipline of long-term value creation. Such a professional commitment would give an added skillset and sense of purpose to managers, owners, lawyers, accountants, scientists, NGO activists and public officials.
The CRT welcomes such an innovation in setting vision and mission for those whose daily work determines our global future.

Herman Mulder closed by summarizing the table discussions and inviting all participants to stay involved in the movement we were jointly creating.

In addition to the plenary discussions, the were many other discussions that took place. From these, the following themes and observations were reported back by the facilitators:

Transparency

Transparency was identified as a driver for change. Harmonization of methods was considered key in the short-term. In the long-term, integrating impact information in financial reporting standards, such as IFRS/GAAP and regulation, such as the EU directive, was considered key. A potential risk of impact reporting was seen in greenwashing and bias. Hence, the ability to measure impacts to a sufficient degree of objectivity was also mentioned as a key success factor.

Urgency

A question was whether businesses would feel sufficient urgency to really start steering on impact. Some feared there was not sufficient discomfort to put businesses in motion absent a new crisis. Others were more optimistic about progress made by businesses and believed the changes in societal expectations of businesses (e.g. the tax avoidance discussion) should provide sufficient rationale for businesses.

Capital Markets

A key issue was how valuing and steering on impact could be scaled up in the face of extremely competitive capital markets focusing on short-term returns. One important avenue people considered was enabling investors to be more rational and consider long-term shareholder value which is much more aligned with societal interests than short-term profit. Still, even long-term shareholder and stakeholder value can diverge in the face of externalities. Potential avenues to close the gap were pro-social investors, multi-stakeholder governance, multi-stakeholder ownership and government incentives to internalize externalities.

Ownership

Various dimensions of ownership were identified: financial, moral and control. In order to steer on impact, it may be that the current ownership model would have to change in one or more dimensions. It was noted that family businesses already have a very different dynamic than publicly listed companies.

Governance

Nicolette's proposals received wide endorsement. There were many discussions on the specifics of the proposal. Also, the risk of overregulation was identified. Still, many considered it a risk worth taking. Various participants expressed willingness to further work on these ideas.

Movement

A trend worldwide was seen of similar initiatives focused on a different form of capitalism. On the one hand, potential fragmentation was seen as a risk. On the other hand, it also provides the opportunity to create a movement with a critical mass. Several participants agreed that more companies should just start doing it. The idea to form coalitions of the willing emerged.

People

The human element was deemed crucial. Leadership should get and feel the mandate to prioritize impact and sustainability. It was noted that rarely, competences to run a sustainable business was a part of the profile when searching and hiring new CEOs. In addition, for measuring and valuing impact to influence steering and not just become a technicality, integrity and intrinsic motivation was seen as a sine qua non.

Rebalancing Capitalism

Stephen B. Young
Global Executive Director
Caux Round Table for Moral Capitalism

Statement of the problem:

Contemporary capitalism, due to its excessive creation of financial means – money and credit – has upset a healthy balance among its various means and ends. Imbalances always degrade systemic sustainability. Moderation and self-correction are the hallmarks of sustainable equilibrium, the service in due proportion of all parts of the system. Health and wellbeing, flourishing, depend on balance and prevention of excess. This was the insight of Aristotle, of Old Testament guidance to "Have mercy, do justice and walk humbly with thy God," of the middle path of the Buddha, of the Chinese concept of the Tao and of the Qur'an's guidance not to "transgress the balance (Mizan)."

Our present dynamics of capitalism underserve the biosphere which sustains our civilization, the natural capital upon which human happiness depends and our social capital by facilitating divisive politics and a narcissistic hedonism. The problem before us is not capitalism but maldistribution of power among its component capitals. We do not properly value financial, social, human, intellectual, moral and natural capitals.

Financial capital is overvalued, while the other capitals necessary for wellbeing are undervalued.

At the dawn of the industrial age in Holland, Scotland, England and their colonies in North America, financial capital was scarce and the other capitals (coal and iron ore deposits, farmland, forests, fish, clean air and labor power) were readily available. The price of financial capital was high but low for natural, social and human capitals. This new capitalist system, as so insightfully described by Adam Smith in his book The Origins and Causes of the Wealth of Nations, privileged financial capitalism by giving it legal ownership rights of first access to wealth created. The older common law of property and contract was not revised to impose on owners responsibility for the cost of the consequences of enterprise – externalities, be they low living standards for workers or degradation of the environment.

As the impact of capitalism grew in the nineteenth century, the common law and statutes evolved a more comprehensive program of tort liability in negligence and strict liability to force enterprises to be prudent in what they produced and how they did so. In the late nineteenth and early twentieth centuries, as the social welfare state bureaucracies emerged and evolved, the state became a supervising partner of the capitalists.

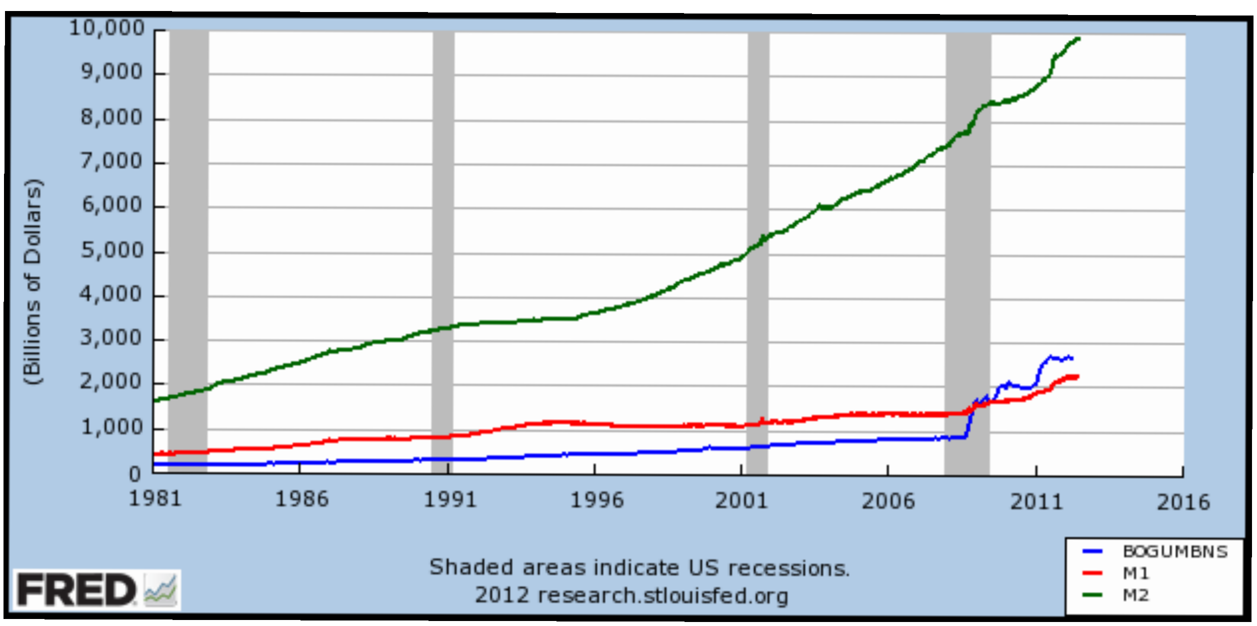
But the inner discipline of capitalism continued to privilege financial capital until today.

In the 1970's, a false anthropology under the name of the "agency problem" dictated the use of financial incentives as the guide for personal ambition and decision-making in capitalist enterprises. This led to systemic focus on short-term monetization of enterprise and systemic neglect of long-term asset accumulation. Such a capitalism directed income and wealth to the top 10% which had access to financial asserts. Returns paid to labor and vital social assets such as education, health, rule of law and to nature were stingy by comparison.

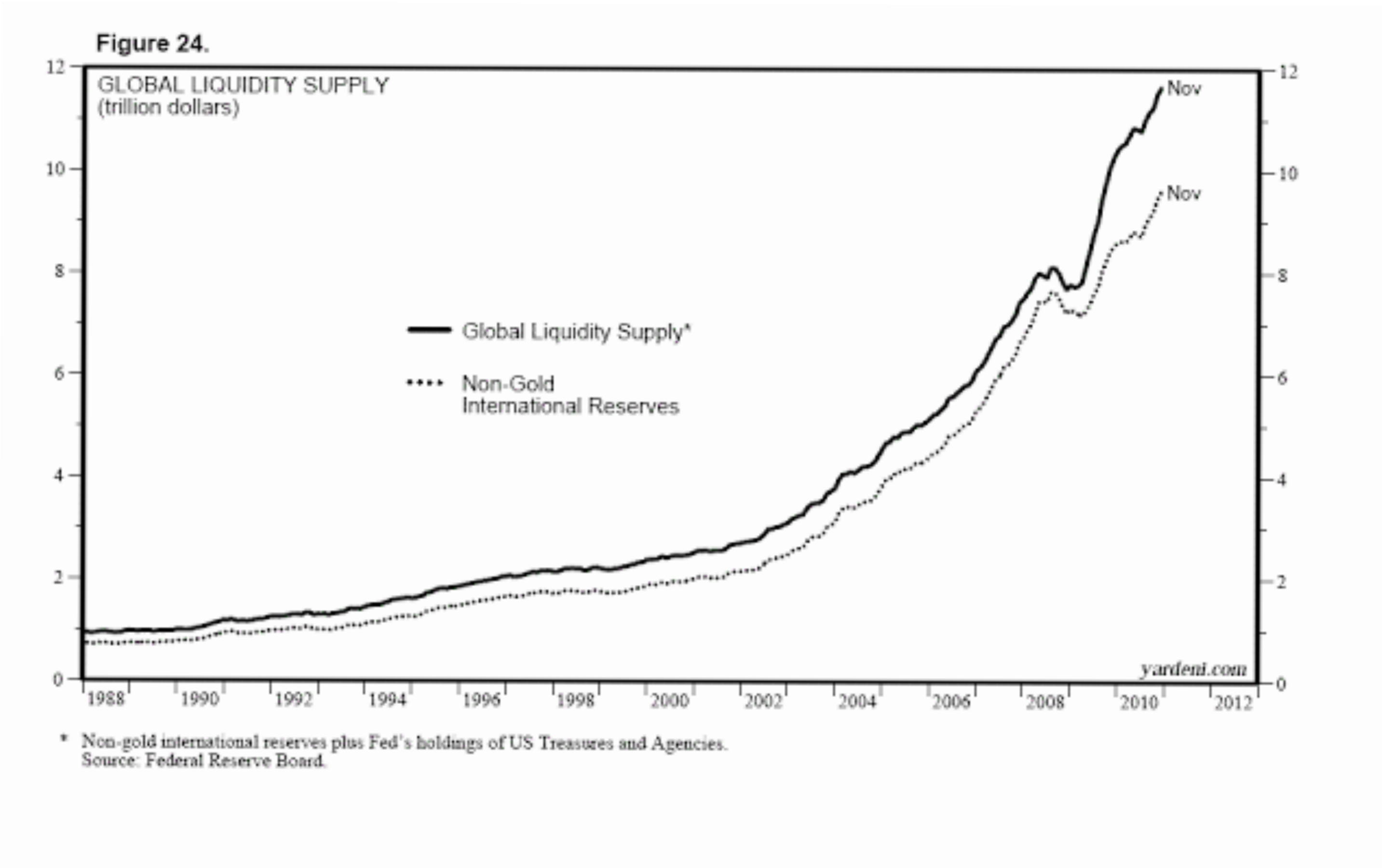
In the 1980's, sophisticated mechanisms of finance for the creation of money, credit and contract rights to share in future wealth creation created vast amounts of liquidity, driving down the price of financial capital. Today, there is no dearth of financial capital, so much so that billions of dollars are available to companies such as Uber and Tesla which do not earn profits.

On the other hand, no investment has been made to make up for depletions and disruptions in the supply of natural capitals.

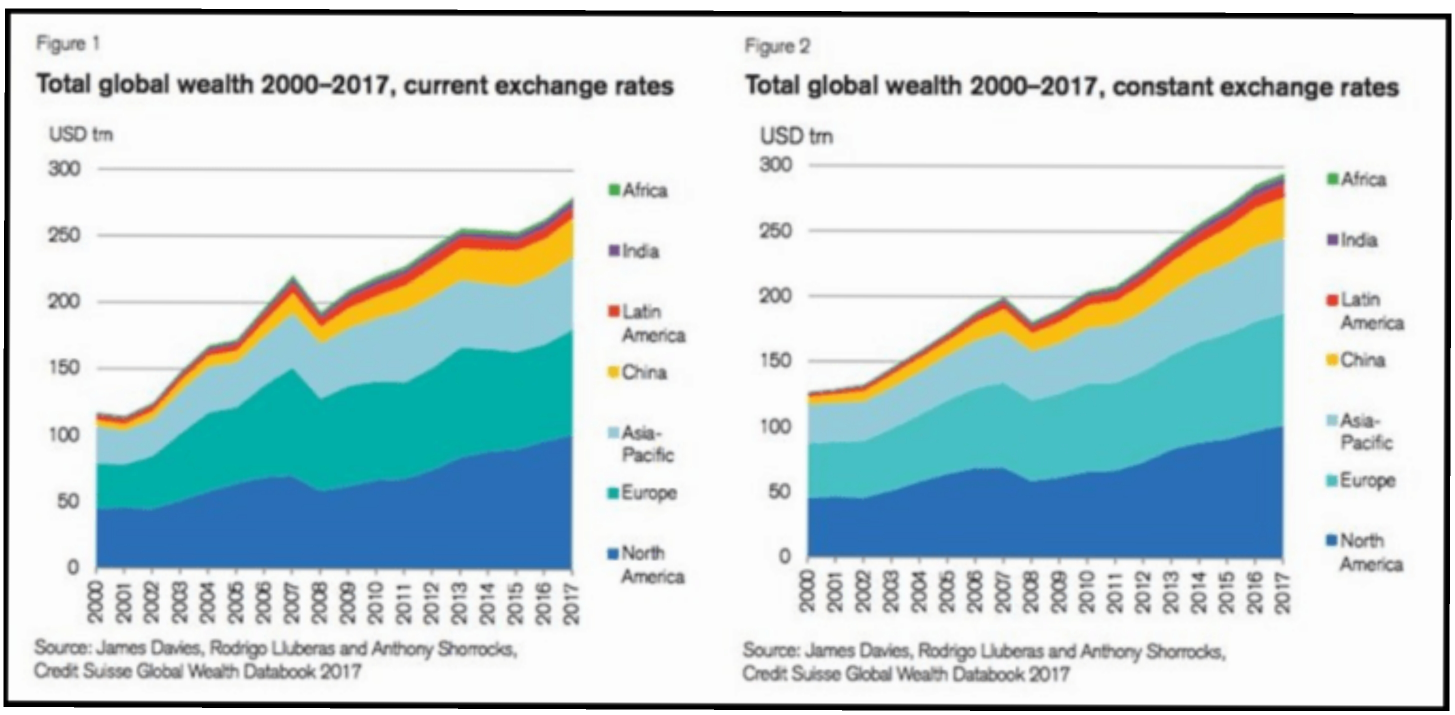
The global supply of money has increased dramatically:



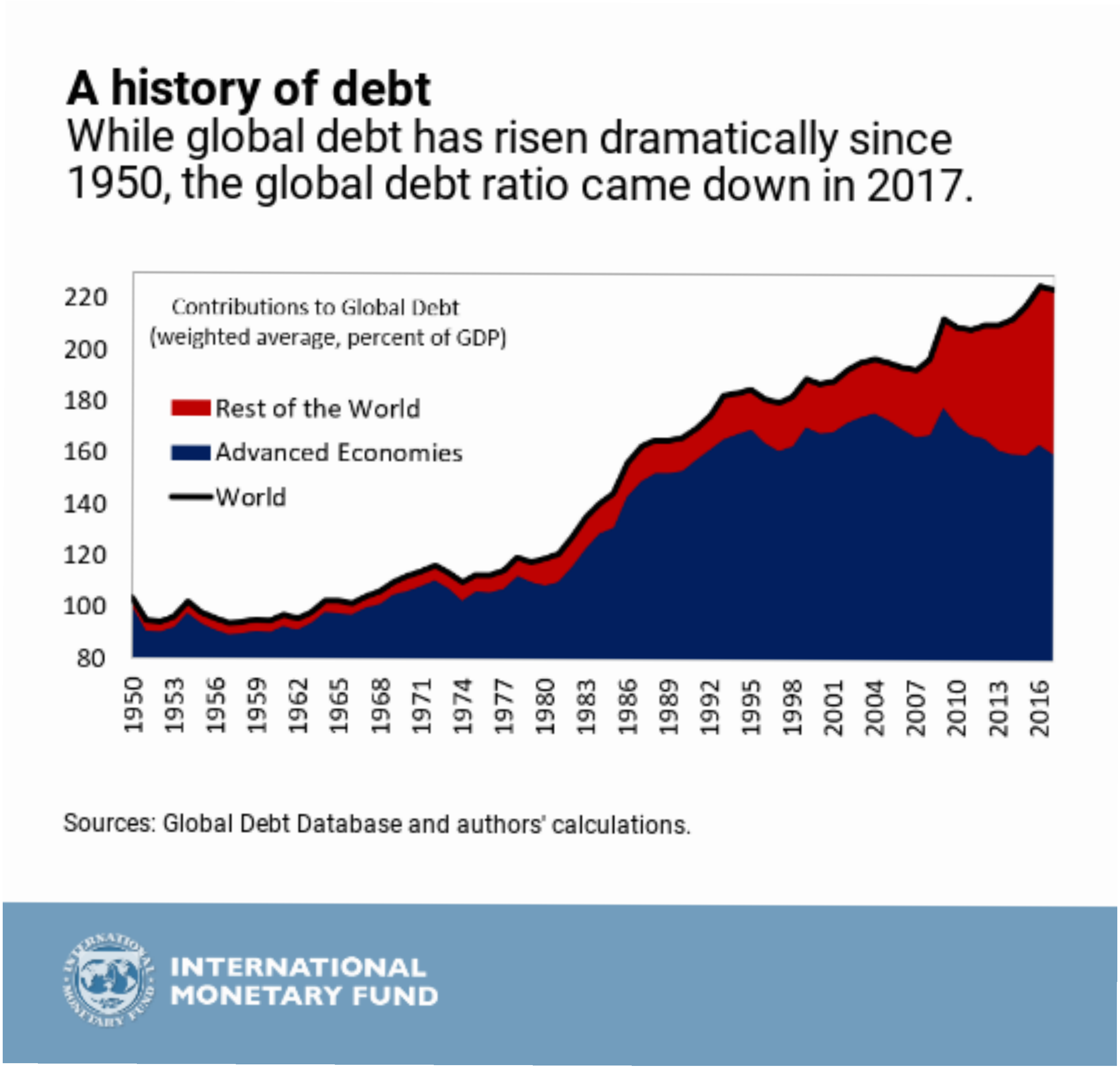
Recent growth in world liquidity is:



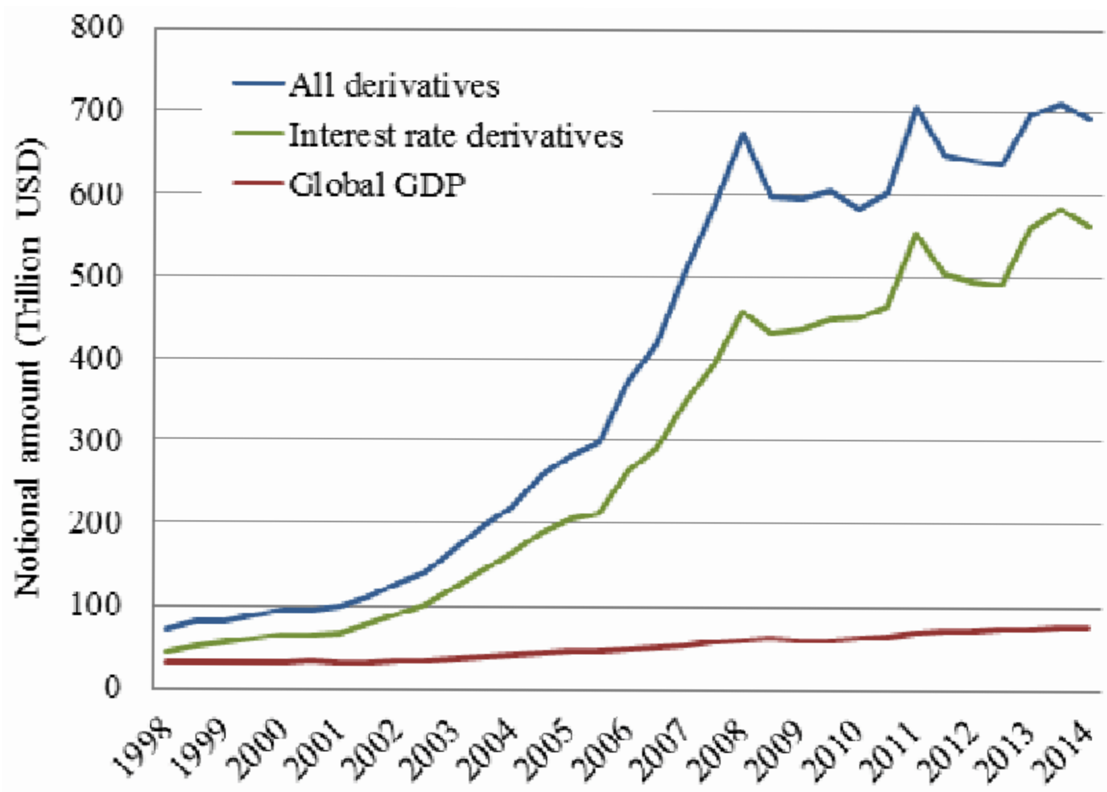
Total global wealth as of 2017:



Global debt has also grown apace:

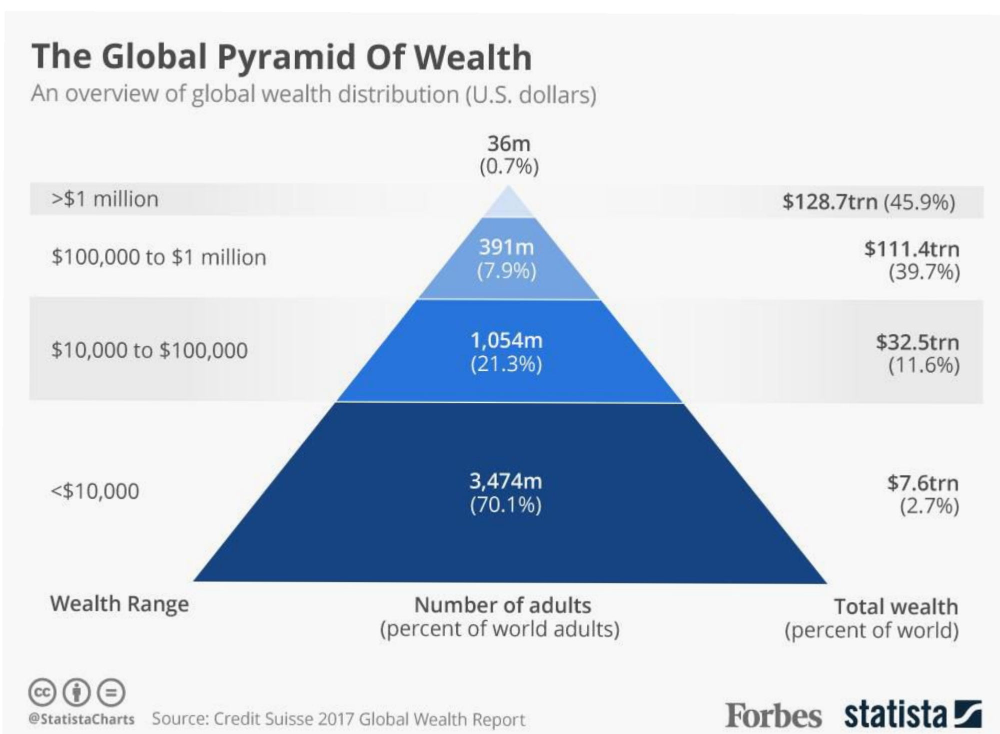


Notional value of all derivatives has grown:



Notional value of OTC derivatives as of June 2018 was $595 trillion. Gross market value was $10 trillion.

Share of global wealth by the top 1% in 2017 was:



Today, we need to urgently restore the health of capitalism by decreasing the returns to finance and increasing the returns to natural, social and human capitals.

Only by energizing and expanding the power of social, human and natural capitals can our civilization achieve the 17 Sustainable Development Goals agreed to by the governments of the world.

The active use of robust social, human and natural capitals will minimize the risks of an imbalanced climate, mean-spirited populism, corruption and abuses of human rights.

1) We need new metrics for the measurement of impacts – good and bad – of enterprise.
2) We need an alternative way to value enterprises to off-set the influence of the nominal prices set by financial markets and used for speculation and excessive diversion of liquidity to the few and far between.
3) Such metrics will permit better "steering" of investment and enterprise towards optimal outcomes. Better metrics will lead directly to better governance of firms. They will permit owners, boards of directors and managers to focus more on stewardship responsibility.
4) The express purpose of the firm, the theory of the firm, must transition from seeking short-term cash profit to a more comprehensive and balanced achievement of accumulation of capitals as assets supporting sustainable human fulfillment.
5) Leadership of capitalism must be entrusted to a cadre of newly recruited and trained impact professionals.

Outro

To borrow Winston Churchill's famous declaration about democracy, most of us would probably concede that capitalism is the worst economic system in the world -- with the exception of every other economic system.

If the fall of the Soviet Union and its array of puppet states, the increasing turn of countries like China to a kind of nationalized socialism that privileges the mechanism of capitalist production and wealth formation but under the strict guidance of the state, as well as the epic rides of boom-and-bust that have rocked the Western world on a regular basis prove anything, it is that capitalism works best when there is a balance between production and finance, a system of reasonable and enforceable regulations and, above all, the embrace of the Sustainable Development Goals or social development goals by corporations, especially large ones, in the finance, production and services sectors of the economy.

We are not quite there yet, but there are certainly signs of progress – and a growing awareness on the part of the corporate world that their benefits must accrue to a wide variety of stakeholder communities, while at the same time minimizing the externalization of costs, especially in critical areas like environmental impact and wealth distribution.

Since its development in the late 17th and early 18th centuries, capitalism has been the greatest engine of prosperity ever known. Even Karl Marx recognized the phenomenal wealth creation of capitalism before calling for its replacement with a workers' paradise of state-run enterprises somehow governed by the proletariat. And as the reports contained in this issue demonstrate, in this, the 25th anniversary of the creation of the Caux Round Table for Moral Capitalism's Principles of Business, a comprehensive roadmap to moral capitalism, the game is afoot in countries around the world. Powerful actors are now at work to ensure that capitalism does not simply survive, but that it thrives in ways that will ultimately save capitalism – and with it, quite possibly, the world in which we live.

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