THE CASE OF MONETARY VALUATION

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REASONING TO INTEGRATE MONETARY IMPACTS IN ACCOUNTING SYSTEMS

Executive Summary

Monetary valuation of business impacts is the language business understands, it enables comparability, it incorporates the local context and the complexity of how impacts arise and is relatively easily integrated into traditional accounting systems and decision making. We call on policy makers, standard setters, and other actors to integrate the concept of monetary impact valuation in the relevant processes and frameworks.

I. Background

The asset foundation of the economy has changed from industrial to intangible but rules governing the economy have not adjusted, especially accounting frameworks at both, national and corporate levels, failing to provide a comprehensive picture of our existential challenges including climate change and social inequalities.

Business activities create, preserve, and destroy environmental, social, and economic values for different stakeholders. The tremendous capital, expertise, and global reach of businesses make them crucial actors in establishing sustainable and inclusive economies. Companies need to integrate sustainability objectives into their strategy and KPI systems. Financial market actors need to re-allocate capital to drive the transition and they require consistent and comparable information on sustainability performance to be provided in corporate reports. Governments need to use impact data from the private sector to understand progress vs national targets, in areas such as innovation and achievement of the SDGs.

The risks and opportunities associated with the world's rapidly degrading natural capital and societal challenges are today insufficiently captured in corporate decision-making and financial market capital allocation. To effectively capture the related risks and opportunities, corporations and financial market actors must take into account both the impacts generated by the business on nature, society and the economy (inside-out perspective), and its dependency on the availability of air, water, land, biodiversity, the rule of law, human capital etc. (outside-in perspective). These aspects are strongly inter-related, and so a comprehensive and integrated management approach is required.

Today, the impacts of businesses on other stakeholders beyond shareholders are hardly captured at all and evaluated in a fragmented way due to fragmented and disparate standards. The definition, measurement, and valuation of business impacts need to be adjusted due to the:

- increasing recognition of business risks and opportunities related to the impacts on the state of the environment, the well-being of employees, communities, consumers, and their contribution to the development of an inclusive economy

- and the accelerating transition from industrialized economies to digitalized economies characterized by intangible assets such as human capital, brand, intellectual property, and qualitative growth

The transformation of the economy requires a change in understanding of value drivers and growth: from profit maximization for shareholders to value optimization for all stakeholders. A more comprehensive strategy is needed to understand the impact and dependencies of business: in addition to answering the question of whether a business is financially successful or not, the overall positive and negative impacts of business models and their progress needs to be measured, valued, and managed. Intangible values like natural, social, and human capital must be more visibly reflected in the process of determining enterprise value, and the external effects on society must be assessed to understand the true value (contribution) of a company and its future business resilience.

Several approaches are currently used by a growing number of organizations to arrive at the monetary value of business impacts and dependencies using market price equivalent and cost-based methods. Compared to qualitative or quantitative metrics, the monetary valuation of impacts on society and their influence on enterprise value seem to be the most promising way to develop sustainability accounting systems that are meaningful, scalable, and business-oriented. For the monetary valuation of impacts several methods are used such as total cost concepts or preference models.

II. Reasons for monetary valuation

1. Business language and integration in today's accounting system

Monetary units are widely used in our economy; they are the language that business decision makers and financial market actors understand and to which they are accustomed. Corporate decisions and accounting systems are primarily based on monetary values as are the heuristics to evaluate business risks and opportunities. Business impacts have traditionally been measured in metrics specific to environmental science, public health and policy, human capital, and other academic disciplines, which are challenging for non-experts to understand and integrate into decision-making. For these reasons, monetary environmental and social values best illuminate the understanding of impacts and their integration in general discourse as well as management accounting.

These advantages also apply for sustainable finance. Monetary valuation provides a tangible, quantitative unit and reduces complexity for financial market actors to better assess and evaluate the sustainability performance, risks and opportunities of a company compared to physical metrics and qualitative and narratives only.

Monetary valuation of non-market priced impacts allows a single unit to consolidate various categories of business impacts and dependencies among business activities and the capitals on which they depend. With the objective of optimizing the greatest total value and minimizing negative impact, using a monetary unit for impacts allows their direct integration of these measures without the necessity of translating them into business processes such as investment opportunities, risk exposures, resource allocation, etc.

2. Materiality, trade-offs and integration in corporate strategy, decision-making and monitoring

Business decision-making involving financial, natural, social, and human capitals leads to trade-offs. Today, these trade-offs are mostly invisible, as they are difficult to evaluate transparently due to the use of different units. Furthermore, given the complexity of these units, decision-making may often be based on intuition rather than the true cost and benefits of impacts. A common unit for financial and non-financial impacts on human well-being such as USD, €, or GPB enables the comparison of different categories and indicators and, therefore, better understanding and management of trade-offs. Monetary valuation of impacts and dependencies allow a new way to assess the relevance and materiality of sustainability topics and integrates local conditions and context in the global strategies of corporations (e.g., social cost of water in arid and non-arid areas). It supports decision-making and allocation of resources by providing guidance on highest risk exposures in trade-offs and thresholds. This is important to both internal corporate decision-makers as well as to investors who bear much of the risk arising from improperly managed material sustainability issues.

When based on a robust approach, monetary valuation facilitates the comparability of economic, social, and environmental aspects of business impacts and dependencies, and the total costs and benefits created by business models. This is helpful not only with respect to risk mitigation but also in identifying potential business opportunities as well. The tangible unit can be translated into KPIs, comparable to profits and other financial targets of companies. This allows broad consistency in corporate strategy development and target setting, which can easily be tracked over time and compared with peers using standardized assessment methodologies and reporting frameworks. It turns information into actionable management decision-making and steering.

III. Caveats to keep in mind

Whilst monetary valuation offers many important advantages and opportunities for mobilizing and supporting companies in the transition towards a sustainable and inclusive economy, there remain important caveats to keep in mind.

- Monetary sustainability accounts are no alternative for assessing and measuring physical impacts. Physical metrics already provide meaningful information for various stakeholders. Monetary valuation is a necessary step to better integrate impacts and dependencies in management accounting and corporate reporting. However, it relies on quantified, physical data in the areas of natural, social, and human capital.
- Monetary sustainability accounts should not be used to cover up negative impacts. Positive impacts should not be netted against negatives and should be disclosed separately when they are presented. Easily understood guidelines, including thresholds and contextualization of impacts, are needed for ethically and comparably reporting and management of impacts.
- Monetary valuation of business impacts relies on a set of assumptions that need to be further consolidated from a scientific point of view. As theoretical and applied research expands, the validity and robustness of frameworks for monetary valuation need to be regularly assessed in the light of new scientific evidence.

IV. The path forward

Monetary valuation is a necessary step to better integrate impacts and dependencies in management accounting and corporate reporting. More testing and piloting is required to understand where monetary valuation benefits business decision-making and reporting most, and how it facilitates a positive impact by business on society. More work needs to be done to overcome the caveats and tailor monetary valuation approaches for application across businesses, large and small:

- change the math and develop an institutional framework: Standardized and robust methodologies for assessments, tools for calculations, and IT systems for data collection and storage need to be developed and tailored for large, medium, and small companies to measure impacts and dependencies along the value chain in an auditable way. A standard-setting institution needs to be identified or established to independently develop and provide consistent, credible, science-based, and trusted impact pathways and monetary valuation factors to the community based on multi-stakeholder engagement. An auditing body or accreditation frameworks for auditing stakeholders need to be set up to ensure solid results and foster the acceptance of the approach. Stakeholders affected by impacts and reported on should participate in the development and auditing process to legitimize indicators, valuation, and their interpretation.
- change the conversation and build personal skills: Next steps need to include better understanding of the interdependencies between value to society and value to business, as well as between different capitals. Companies need to build on and improve competencies in collecting data, running calculations, and understanding potential trade-offs to develop their strategies, target setting and performance towards value optimization for all.
- change the rules and adjust incentive systems: The broad uptake of new steering and performance measurement models needs to be supported by key stakeholders in the business community. The case for monetary valuation requires the support of standard-setters and policy-makers in order to i) incentivize stewardship of the corporate value chain; ii) integrate monetization in regulatory frameworks, as well as financial markets; iii) request monetized performance indicators consistently across various capitals.

We are convinced that the monetary valuation of impacts is the best way of integrating sustainability into management accounting and companies' external disclosures. We call on policy-makers to support efforts to achieve generally-accepted valuation standards.

GIST

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