Are we accounting for value?

Inequality is increasing. Not only are the rich getting richer but more and more people are living on 1 or 2 dollars a day.

There is increasing evidence that widening inequality is expensive. Inequality costs, though of course the costs are not equally shared. And for many of us it seems pretty obvious that societies that say work hard and you can succeed are being pretty clear about what this means to those that don't succeed. Books like the Spirit Level (inequality can make you ill) and Fooled by Randomness (some of us get rich by chance), explain the problems that many feel.

Inequality isn't just a statistic; it is something that affects all our lives, and our well-being, as well as the basic needs of the poorest. It brings risks of conflict within, and between, countries. It increases the costs of accessing the raw materials on which we all rely. It increases the costs of insuring ourselves, if we can afford it, against these risks. We pay more for our houses in communities where there is less crime and more on our security in communities where there is more crime. We know all this, and it is no surprise that those of us who have benefited most from our economic system are unlikely to agree with the diagnosis. No surprise that some of those who have benefited have more resources available to make the case that climate change is a myth or that inequality is a good thing, a motivator to success.

Our main solution to inequality has been to transfer resources from rich to poor. However it is our economic systems that generate inequality and, as so well put by Stiglitz in *The Price of Inequality*, the erosion of the checks and balances societies put in place to ensure equality of opportunity, to stop monopoly power controlling resource allocation. There are various parts of the way our society organises the trading relationships between people; a combination of laws, politics and cultural norms – a combination that results in our financial system. All rules and policies will have effects on the distribution of resources between people. There is also one aspect of our financial rules and policies for the system that we don't tend to talk about – financial accounting.

Financial accounting informs decisions on what should be included in a set of accounts and how these things should be valued, and is based on a set of principles – not scientific laws. For many things, this is pretty straightforward – what money came in and what money went out. But then there are adjustments for money still owed, by and to the organisation; this is where the fun starts. Accounts are a record of transactions – actions across people – but when is a transaction a transaction? When should a transaction be recognised by the accounting entity and how should it be valued?

These principles and the standardised way in which they are applied effect the relative profitability of different sectors. Current debate on accounting for operating or financial leases for example, will affect business profitability, but not equally. How these topics are resolved by the accounting profession will change profits and may have a bigger effect on some businesses than others. Some will see profits increase and some will see profits decrease. Some have less to distribute to their shareholders and some will have more. Some will attract more investment and some less.

Thinking about transactions as being effects on people, as a result of business activity, would widen the number of things a business would have to account for. A great deal of the focus of sustainability reporting is on these issues. If organisations have to recognise these effects they would need to be included in a company's accounts. Whether they need to under current accounting practice hinges around three things. Is the information material to the organisation? Can it be valued? Can the effect be attributed to the business?

Whether it is material depends on whether the primary user of a set of accounts (and the primary user is the current or potential investor) would make a different decision with the information than without it. This is because financial accounts provide investors with information on the current reserves that can be distributed to owners and, if they wish to use it in this way, as an indication of future performance. At a time when we are all rethinking capitalism, let us surely assume that this investor is a moral investor. They may not be. But this should be our starting point for the discussion about what should be included. If the moral investor is our starting point then this investor won't want to benefit if this means that other groups have to pay, for example, if communities access to water is removed, if employees health and safety standards are not the same as the investor would expect for themselves, if the level of pay is not a living wage. I suspect many of us would have hoped that this is what accounting already did, that it ensured that people did not benefit at a cost to others.

And then these transactions which have an impact need to be valued, not only actual and probable cash flows, but recognition of value created and destroyed for others. Price is only a proxy for value. The price we pay for a cup of coffee is a proxy for the value we get from it. The price a business has to recognise for these effects will also be a proxy yet would have an effect on the level of reserves. We tend to rely on market prices for our proxies for value as, even though the markets may be imperfect, the willingness of a buyer and seller, even only two of them, to exchange resources, can be used as a value. Actually, financial accounting has long had to rely on other approaches to valuation, for example, the value of shares owned by a business in another business. So there is debate taking place but meanwhile values are estimated, included and signed off by the auditors.

We are becoming more advanced in our ability to generate good valuations of social outcomes. For example, work on well-being valuation allows us to estimate the value of changes experienced in a number of factors that are generally accepted to contribute to life satisfaction. Of course we can debate these, and they can get better, but this shouldn't get in the way of getting organisations to value their effect on social outcomes, now that we have our moral investor. After all they value all sorts of other uncertain future events.

And so perhaps to the hardest challenge - In our global society attributing individual actions to changes experienced by communities, let alone global change, is not easy. Dealing with this will need a different approach. The problem is, when costs faced by a group of people (or, for example, the costs faced by us all as a result of climate change) are the cumulative effect of the actions of many businesses and many consumers of goods and services. In these situations it is not easy to attribute the share of the cost to individual businesses. For climate change we have found a proxy – carbon intensity – and we have developed markets to price carbon. Whether the price is a full recognition of the cost is debatable but it shows what can be done.

Where we don't yet have proxies, and where it is more difficult to attribute the share of the cost to different businesses, we need another solution. Simply saying we can't, and therefore allowing the costs to build up, seems like a massive denial of the problem. In order to operate, businesses have a contract with society. This is recognised more in some sectors, for example, mining, than others, but it is true of all businesses. People come together to provide goods and services to other people. The deal is that the benefits should exceed the costs. Limited liability is a contract – you can have limited liability because that offers benefits to society as a whole but in return for a series of obligations. We can change the deal. For those transactions where the cost is recognised but the attribution isn't we could operate a more general requirement for businesses to provide for an estimate of the cost in their accounts. Not a tax. Not a payment from the business to others, just a provision. But a provision that would reduce the distributable reserves. This won't be perfect and they would affect relative profitability of different businesses. Even if the principle is accepted there will be lots of argument.

But accounting practice already considers this, to some extent, in accounting for contingent liabilities which has to account for both the probability of the event that will lead to a liability occurring and whether the businesses will be liable for the event. Again we could expand the range within which the judgement of whether something should or should not be recognised. More information will be available for our moral investor.

The changes we would need are

- Recognise the moral investor as the primary user of accounts.
- Be willing to use new approaches to valuation as reasonable estimates of the values that the moral investor can understand.
- Provide information with a higher level of uncertainty

The recognition of a moral investor would have an effect on distributable reserves as additional issues require provisions. The willingness to provide new information may not affect reserves, for example as in Puma's environmental profit and loss account. But both, combined with new approaches to valuation, may also have an effect. There is no reason why the current financial statements, the profit and loss and balance sheet, could not be presented differently, for example showing three classes of transaction separately; cash transactions, estimates of non-cash items like debtors and creditors, and estimates of social and environmental outcomes. This would also provide a means of integrating financial and sustainability information in one account.

These changes focus on organisations being more accountable for costs. But organisations have positive effects on people as well and one would expect these to be concentrated in charities. It would be equally possible to recognise and value **these** benefits and perhaps show them as a type of reserve. It would be hoped that those contributing to charities would be examples of the moral investor, the investor who would not like the costs of their investments to offset the value of their donations. Perhaps a group of people who would support a proposal that accounting should start from a presumption of a moral investor.

Government policy shapes market forces and has effects on the distribution of resources between people. These policies are open to debate. Accounting is not quite the same. Whilst corporate law requires companies to produce accounts, the rules and the assurance that the rules are applied properly, have been outsourced. Yet these rules also have distributive effects.

This is not intended to provide detailed technical proposals but to argue that it is time to have a debate about how these principles could be applied to have a positive effect and to reduce the extent to which inequality emerges from economic activity.