SUSTAINABILITY

How to Measure a Company's Real Impact

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In recent years, most major international airlines have reported healthy profitability. But our calculations show this to be a mirage. In the case of Lufthansa and American Airlines, for example, accounting for their environmental costs of $2.3 and $4.8 billion respectively would make both companies unprofitable.

What explains this discrepancy? To date, there has been no way for companies to account for their benefits and costs to society and the environment. We have been working to change that.

Accounting for impact took a major step forward in July with our publication of the cost of the environmental impact of 1,800 companies by the Impact-Weighted Accounts Initiative (IWAI) at Harvard Business School. Next year, the IWAI will publish the cost of product and employment impacts too, providing a complete picture of the impact companies create.

The era of impact transparency has begun, and it is moving the goal posts for businesses and investors. Technology and Big Data have combined with longstanding efforts by many individuals and organizations to make the measurement and valuation of corporate impact a reality. With the arrival of impact transparency, impact *and* profit set the new rules of the game.

Analyzing the IWAI's extensive dataset for 2018 through an impact lens brings a new perspective on the true profitability of companies. It becomes apparent that many companies are creating environmental costs that exceed their total profit (EBITDA). Of the 1,694 companies which had positive EBITDA in 2018, 252 firms (15%) would see their profit more than wiped out by the environmental damage they caused, while 543 firms (32%) would see their EBITDA reduced by 25% or more.

For certain industries, including airlines, paper and forest products, electric utilities, construction materials, containers and packaging, almost all firms would see more than a quarter of their EBITDA eliminated, according to our group's calculations.

Within other industries, huge variation is revealed in the environmental damage companies create. In food products, for example, environmental costs range from 5% of EBITDA (Nestle, $1.6 billion) to 62% (Associated British Foods, $1.8 billion). In the challenged oil and gas industry, where 75% of companies would see more than a 25% reduction in EBITDA, a few best performers have overtaken their competitors. And in semi-conductors, industrial conglomerates, food and staples retailing, and beverages, significant variation is similarly found between leaders and laggards.

It is not all negative though. Companies also create positive impacts through their products and employment, which do not show up in their bottom line. Take Intel's employment impact as an example. In 2018, it created approximately $3.6 billion of positive impact in the U.S. through the wages it paid and the jobs it provided in areas of high unemployment. Intel can increase this impact by improving its level of diversity and offering more equal opportunity for racial minorities and women to advance within the company.

Impact transparency will have far-reaching consequences. First, instead of taxing all of us to remedy negative impacts such as pollution, pay below the minimum wage, and products that cause obesity and ill health, governments will be able to tax companies directly for the harm they create. They will also be able to provide direct incentives — in the form of reduced taxes, subsidies or preferential procurement — for companies to deliver positive impact through their products, operations and employment practices.

Second, investors will price the environmental and social impacts of companies into their investment analysis. More than $30 trillion flowing today in ESG and impact investments, equivalent to more than a third of the world's professionally-managed assets, are already doing their best — despite the absence of all the relevant data — to integrate climate change, employee diversity and customer health into their investment decisions.

Firms with greater negative impact generate less investor interest, which reduces their stock market valuation and raises their cost of capital. Impact transparency will, therefore, motivate management to improve corporate impact, in order to increase stock market value and, sometimes, their own compensation too.

The IWAI's 13,000 observations of environmental impact reveal a significant correlation between negative environmental impacts and lower stock market valuations in many industries, including chemicals, apparel and construction materials. Such a correlation does not yet appear in other industries such as utilities, hospitality, or industrial conglomerates. But it can be expected to appear once impact transparency enables investors to reliably account for impacts in their valuation analysis.

Third, transparency will allow customers — be they individuals or companies — and employees to align their purchasing and career choices with their values. "Impact-washing" is currently widespread because relevant impact data is sparse. For instance, all automobile manufacturers claim that their products benefit society more than the products of their competitors. But when we measure all manufacturers' product impact, according to safety, affordability, customer satisfaction, fuel efficiency, and emissions, we find that only a few companies, such as Tesla, Renault, Hyundai and Nissan, can justifiably make these claims.

Transparency and accountability go hand in hand. To date, the absence of effective impact measurement has obscured the accountability of companies for the harm they cause. Rewriting accounting rules to include impact will alter investors' assessment of corporate performance, leading them away from negative-impact companies to positive-impact ones, and catalyzing a change in corporate behavior.

How far are we from adding impact to the profit paradigm that has driven capitalism since its origin? Last year we identified 56 leading organizations around the world that practice some impact-weighted accounting. This list is growing every week. Danone, the French food leader, has just published earnings per share that are weighted for its environmental impact. Detailed methodologies, data sets, and guides now exist for the preparation of impact-weighted accounts that reflect the operational, employment and product impact a company has on people and the environment. The Covid-19 crisis will exacerbate already flagrant inequality, intensify the need for a fair and sustainable recovery, and accelerate the shift to impact-driven economies.

The introduction of impact-weighted accounts is sped by a global network of innovators, companies, investors, NGOs and other stakeholders. These actors have come together through the GSG (Global Steering Group for Impact Investment) and the IMP (Impact Management Project) which have initiated the IWAI with Harvard Business School. Numerous other organizations in the field are contributing directly and indirectly to hasten the shift to the new paradigm.

The sooner governments mandate the publication of IWAs — and align companies and investors with the great effort needed to tackle climate change, inequality, and Covid-19 — the better off our society will be.

In the meantime, we each have a valuable role to play. If you lead a company, then measure and communicate your impact-weighted performance. If you are an investor, demand impact transparency from the companies in which you invest and use impact-weighted numbers to assess opportunities and risk. If you are a regulator or government official, mandate the publication of impact-weighted accounts, and use taxes and other incentives to motivate companies and investors to create positive impact. And since we are all consumers, let's buy the products and services of companies that deliver positive impact to improve our planet and society.

Impact transparency will reshape capitalism. By shifting the pursuit of profit away from negligently creating problems to purposefully creating valuable solutions for the world, it will redefine success, so that its measure is not just money, but the positive impact we make during our lives.

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