COMMENTARY

A TOTAL CAPITAL APPROACH FOR DEVELOPING A SUSTAINABILITY AGENDA

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Route2

Marakon
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Sustainability in Context

The gap between what markets value and what society values is closing. Financial markets and investors are increasingly focused on the fact that risks and opportunities linked to sustainability are tangible and can have a significant impact on business performance. For many business leaders sustainability, or a more balanced perspective on stakeholder value, is a management mantra that is overtaking the singular focus on maximisation of shareholder value. Delivering on the new mantra can present challenging trade-offs, in particular for resource allocation. However, if used effectively, quantitative methodologies like Total Capital Accounting can help leaders make trade-offs in a more objective manner as they seek to pursue becoming a more valued and valuable company.

Elaboration on The Challenge

Resource allocation and prioritisation of efforts linked to sustainability activity can be complex when the external negative impacts of business activities are systemic and diffuse and the direct financial benefits (costs) of addressing (or not), the adverse consequences of business activities are not known. This is often the case when businesses impact their broader environment through complex supply chains across multiple geographies, and through interconnected sets of stakeholders, often across short- and long-term time frames.

It can be difficult for leaders to prioritise what issues are most important within the context of their business, and to understand how much to invest and where. Lack of clarity on the *what* can complicate *how* those issues are progressed institutionally via different organisational mechanisms. The outcome is often a set of sustainability initiatives that are not integrated into core business activities and have relatively low impact on both shareholder and societal value.

Understanding the "What"

One solution is to be rigorous and systematic about assessing and quantifying the impact business activities have on a broader set of stakeholders inside and outside the company. By quantifying the full economic costs and benefits of business activities on a broad group of stakeholders, we can make like-for-like comparisons to inform choices about what issues to focus on and how much to invest to address them. A Total Capital Accounting framework is an effective and robust tool to do this.

How it Works

Step 1: Map Business Activities

Create a comprehensive map of business activities across the full value chain.

Step 2: Measure Impact

All business activities, directly and indirectly, depend on the functional flows delivered by six types of capital stock: natural, human, intellectual, social, manufactured and financial. For an activity to be sustainable the six capital stocks must be maintained and, preferably, enhanced. Over the long term the inflows (investment and appreciation) must outweigh and outpace the outflows (functional and depreciation). To track the inflows and outflows across the six types of capital stocks, we use a broad set of measurable impact indicators (see Exhibit 1).

Exhibit 1: Examples of Measurable Impact Indicators

Flow/Capital Stock	Natural	Human	Intellectual	Social	Manufactured
Business Activity Example:	Agricultural Commodities	Employment	Production Process	Total Factory Productivity	Mechanical Work
Investment:	Fallow Land	Employee Wellbeing Programmes	Training & Development	Local Procurement	Energy Efficiency Interventions
Depreciation: Internal	Water Pollution	Workplace Injuries	Knowledge Obsolescence	Non-Compliance	Workplace Accidents
Depreciation: External	Commodity Price Decline	Illness Via Pandemic	New Technologies	Competitor Behaviour	Stranded Assets
Appreciation: Internal	Farming Practices (e.g. Rotational)	Working Environment	Innovation	Corporate Governance	Reconfigured Assets
Appreciation: External	Clement Weather	Employee Engagement	Repurposed Processes	Positive Brand Awareness	Repurposed Assets

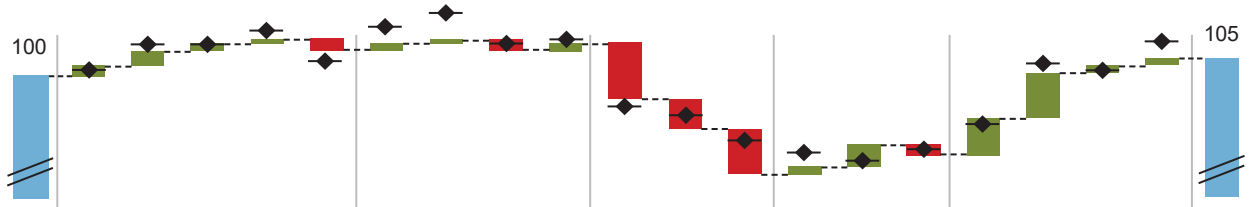
Source: Route2

Step 3: Translate Impact into Economic Costs and Benefit

A position statement translates theory and data into tangible output, providing an organisation with a current, comprehensive, comparative and interactive understanding of the wider impacts resulting from their activities. Each impact indicator has a specific and consistent economic valuation method grounded in a robust and clear set of assumptions. Where market prices and financial costs for the associated stocks and flows exist, they are used, both directly and indirectly. Where market prices are completely absent, stated preference techniques (i.e. contingent valuation) are used.

Exhibit 2: Position Statement – Total Impact of Business Activities v. Peers

Economic Value of Impact (Indexed to Client 2018 value, 2018 = 100) — Estimated Peer Average Performance



	2018 Total Capital	Employee Engagement	Apprenticeships	Employee Volunteering	Health Benefits	Leadership Diversity	Research & Development	Production of Protected IP	Knowledge Decay	Training & Development	CO2 Emissions	Plastic Waste	Food Waste	Customer Satisfaction	Community Investment	Later Payments to Suppliers	Investment in Fixed Assets	Food Produced	Renewable Energy Generated	Recycling Rates	2019 Total Capital
Client	100	3	4	2	1	(3)	2	1	(3)	2	(15)	(8)	(12)	2	6	(3)	10	12	2	2	105
Peer Avg.	115	1	5	1	3	(5)	6	9	(1)	2	(17)	(5)	(4)	5	1	(2)	8	14	0	5	141
		Human					**Intellectual**				**Environmental**			**Social**			**Manufactured**				

Source: Route2

Step 4: Quantify Value at Stake

Next, a business needs to understand which of these positive and negative externalities can be internalised by the business, i.e. by becoming either real financial costs or real revenue opportunities. For example, the introduction of a carbon tax (a transitional event) would shift a proportion of the external costs of greenhouse gas emissions into a new financial cost. Using scenario analysis to estimate the proportion of external costs and benefits likely to be internalised over 2-, 5-, and 10-year time frames, we can create an augmentation of the traditional financial statements. These augmented statements quantify the potential financial impact of internalisation and reveal a new picture of financial performance, highlighting strengths and fragilities of the current strategy or business model.

Example in Practice

Yorkshire Water is a UK-based utility that provides essential water and wastewater services to the people and businesses of the Yorkshire region. They use a Total Capital Accounting approach to improve their understanding of the impact (positive and negative) they have on customers, employees and the environment throughout the value chain. This provides a broader view of the risks to their services and the value they create, while also highlighting opportunities to enhance impact and value, and the inherent trade-offs when making decisions. By quantifying the economic value of actions to reduce or enhance their impact, the trade-offs become much more tangible. Yorkshire Water is using this insight to shape future strategy and ensure their services are resilient, while maximising their potential contribution to society, the economy and the environment.

Exhibit 3: Total Capital Financial Statements and Risk and Opportunity Statement

TCA Profit & Loss Statement

- Revenues
- **External Benefits**
- Costs
- **External Costs**
- Gross Societal Profit
- Net Societal Profit

TCA Balance Sheet Statement

- Total Capital Assets
  - **Current**
  - **Non-Current**
- Total Capital Liabilities
  - **Current**
  - **Non-Current**
- Net Assets
  - **Stakeholder Equity**

TCA Risk & Opportunity Statement

- Total Capital Risk
  - **Magnitude**
  - **Probability**
  - **Impact**
- Total Capital Opportunity
  - **Magnitude**
  - **Probability**
  - **Impact**

Source: Route2

Step 5: Define an Integrated Strategy and Sustainability Agenda

Using the quantified value at stake, we can define an integrated strategy and sustainability agenda focused on the biggest needle movers. With a clear understanding of the stakeholder impact and the implications on financial performance, we are better able to make decisions about resource trade-offs within and across the set of initiatives. Adjusting the strategic resource allocation approach in this way will result in a different and better set of priorities for the business.

For example, Yorkshire Water owns 28,000 hectares of land, much of which is open to the public. They've been using a total capital approach to make better decisions when assessing future options for their various sites. A recent assessment for a particular site looked at fives scenarios for investment:

1. Inclusive environment: encouraging all groups to interact with the environment
2. Active recreation: planting trees and encouraging sports such as mountain biking
3. Active biodiversity: protecting and restoring nature

4. Sustainable farming: working with farmers to better balance the needs of the environment
5. Sustainable forestry: focusing on tree and hedgerow planting across the majority of the site

By quantifying impact across the six capital stocks, Yorkshire Water determined that while active recreation has the highest direct financial cost, it has the greatest potential benefit due to the many positive social and human capital impacts.

When looking at their impact on human capital, Yorkshire Water determined that sickness absence and injuries cost over £6 million per year. This created a significant incentive to address occupational health and safety issues and a clear measure to weigh the cost of enhanced health and safety programs.

Implications for Company Leaders

Sustainability success is about both the *what* and the *how*. Total Capital Accounting is an effective tool to better understand the *what*. Other, more qualitative approaches to understanding stakeholder impact may also be used, but lack the grounding in economic impact that Total Capital Accounting provides. No matter what approach is chosen, real progress on stakeholder impact requires an equally rigorous consideration of how to elevate the sustainability discussion and embed sustainability considerations in the core business through key levers such as:

- Strong and visible leadership at the executive level
- The translation of sustainability goals into tangible, near-term operational targets that can be tracked
- Integration of Total Capital Accounting or other sustainability measures into the strategic planning and capital allocation process to better assess trade-offs
- A deliberate effort regarding cultural changes at all levels of the business
- Clear and elevated governance by the Board

In summary, by better understanding the relationship between stakeholder and shareholder value in the context of a company's operations, leaders can shape more robust, and appropriately resourced sustainability agendas. Once these agendas are progressed via an appropriate approach for institutional change, the company is then well on the path of simultaneous growth of both shareholder and stakeholder value.

Exhibit 4: Framework for Organising Strategy and Sustainability Efforts

What	How					
	Governance/ Organisation	Goals & Targets	Awareness & Engagement	Internal Policy	Resource Allocation & Investment Criteria	Reporting/ Disclosures
GHG Reduction						
Health & Safety						
Customer Satisfaction						
Customer Innovation						
Responsible Procurement						
Etc.						

Roadmap informed by systematically managing interplay between the "what" and the "how"

Source: Marakon analysis

Written by:
Charlie Johnson
Associate Principal, London
cjohnson@marakon.com
+44 207 664 3643

Christine Delivanis
Director, London
cdelivanis@marakon.com
+44 207 664 3737

Daniel Dias
Founder and CEO of
Route2, London
+44 208 878 3941

ABOUT MARAKON

Marakon is a strategy and organizational advisory firm with the experience and track record of helping CEOs and their leadership teams deliver sustainable profitable growth. We get hired when our client's ambitions are high, the path to get there is not clear (or taking too long) and lasting capabilities are as important as immediate impact.

ABOUT ROUTE2

Route2 is a specialist sustainability consultancy that specializes in Total Capital Accounting. Through over 10 years of helping clients better understand their impact on across all forms of capital, we've created a proprietary framework that enables us to quantify and evaluate the wider impacts of business activities.

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