

# THE ROLE OF THE SUSTAINABILITY REPORT IN CAPITALISTIC FIRM

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*The aim and the central topic of this research is the understanding of the importance of Sustainable growth strategy approach as a driver to achieving top-line growth and bottom-line results.*

*The main contributions of this line of research are to demonstrate the idea that the sustainability report is an instrument for social interaction and social cost/benefit analysis and to show that such an instrument can describe, comment on and sum up the firm's own behaviour aimed at sustainable growth.*

*The work integrates the CSR management literature with a large body of research in accounting and finance.*

*This study draws from theoretical research about the nature of the corporation, its role in society and contributions by recent research on corporate social, environmental, ethical responsibility and accountability.*

*Our research demonstrates that the economic existence of the capitalistic firm as a producer of economic and financial values must be appreciated, in terms of the sustainability of the development path of the firm, and evaluated by a wide range of social performance measures of outcome or benefit.*

*It also shows how the Sustainability report emphasizes the link between firm and territory, and affirms the concept of the firm as an entity that, by pursuing its own prevailing interests, contributes to improving the quality of life of the members of the society in which it operates.*

*This paper contributes primarily to the academic debate by reviewing past attempts to theorise CSR and stakeholder dialogue, identifying gaps and weaknesses, and proposing the Sustainable Growth implementation processes for the creation of value. It also highlights the relationship between CSR activity and corporate image and performance.*

*The research shed light on aspects of CSR activity for which little is known and much less is being understood; namely, the channels and the mechanisms through which the CSR impact is perceived and realized for creation of value.*

*Carlotta Meo Colombo (3) considers the capitalistic firm as Business Value-Creating Organizations and Patrizia Gazzola (1-2;4-6) considers the Sustainable Growth implementation processes for the creation of value.*

*Keywords: Sustainable Growth, Creation of Value, Sustainability Report, Performance, Stakeholders.*

*JEL codes: M14, M41*

## **1. Introduction**

Strictly speaking, firms are traditionally considered as systems for the creation of economic and financial value for their shareholders, and their performance – profit and the value of capital – is measured by a coherent system of monetary values.

Nevertheless, if we do not limit our view to simply the shareholders but consider instead a vast group of stakeholders, we must then also broaden our notion of the production of sustainable value in order to include both the social value and the environmental value.

In effect, the firm sets a system of objectives for itself which is centered on its sustainable growth, but, at the same time, develops a strategy for achieving a multi-dimensional growth that encompasses the economic, social and environmental dimensions.

This implies intense social managerial actions based on transparency, growth of reputation, dialogue with the stakeholders, continuous research and development in all sectors and processes; these actions require effective communication instruments, primarily in the economic crisis (Iamandi, Constantin and Jodes 2010: 963-969)

In this sense the sustainability report, as far as it certifies the ethical profile of the firm and legitimizes the latter's social and environmental role, emphasizes the link between firm and territory, and affirms the concept of the firm as an entity that, by pursuing its own prevailing interests, contributes to improving the quality of life of the members of the society in which it operates and that can, in all respects, represent a means for the creation of sustainable value.

## **2. The overall fitness of the capitalistic firm as a system that produces “value”**

Despite the differing perspectives from which the firm can be viewed, we believe it is appropriate to accept the basic thesis that considers the capitalistic firm, or *Business Value-Creating Organizations* (BVCO), as an autopoietic production, business and profit-oriented organization (Mella 2007: 413- 421, 2009), whose fitness resides in its capability – or efficiency (Beer 1981) – to produce adequate levels of economic and financial values through a network of specialized organs and processes (Alter and Hage 1993).

We propose the following basic Hypothesis:

- a. a condition for the creation and survival of a *capitalistic firm* is that the entrepreneur succeed in developing a portfolio of businesses with sufficient return to acquire and maintain invested the capital necessary to activate and continually renew the productive and economic processes and the investment cycles;
- b. the overall fitness of the firm, which guarantees its autopoiesis, is revealed by *financial measures of performance* that denote the efficiency and effectiveness in the production of shareholder value in terms of return and capital gains;
- c. the overall fitness includes the *productive* and *economic* fitness, indicated by a system of performance measures that denote the economic and productive efficiency revealed in the production of *economic values*;
- d. the autopoiesis of the firm, when viewed as an economic social actor, depends on its capacity to earn the appreciation of the stakeholders who are not components of the organization but who gain external advantages, individual or social, from its existence (Toffler 1985).

As a social unit, the firm must produce social shared “value” (Harrison and St. John 1998) in the broader sense that its economic existence as a producer of economic and financial values must be appreciated, in terms of the *sustainability* of the development path of the firm, and evaluated by a wide range of social performance measures of *outcome* or *benefit*: the efficiency of materials; technical innovation; energy efficiency; community relations; eco design; product recyclability; and employee relations.

The attainment of perceived levels of social performance produces reputation, brand and confidence, so that the environment itself sets the conditions for the firm's legitimation and consent, which favours autopoiesis and thus a lasting existence for the enterprise as a social unit as well as an organizational type (Gazzola and Pellicelli 2009).

This implies, on the one hand, the organizational ability to recognize the set of relevant stakeholders as well as to identify their expectations and, on the other, the capability to

communicate the global “value” produced in terms of social benefits and prevented damage to the physical environment.

### 3. Performance measures for Capitalistic Firms as systems that produce “values”

There are quite a number of financial performance indicators; however, we feel that only a limited number are sufficient to express the fitness of the capitalistic firm as a system for producing values, according to the basic thesis at the end of the preceding section (Mella 2005: 25-52).

The most concise performance indicator is the return on equity, *roe*, defined as the ratio between the net income *R* and the equity *E* during a period *T*:  $roe = \frac{R}{E}$ .

This indicator is particularly significant in that it expresses, in extremely concise form, the capacity of the firm to satisfactorily remunerate those who have invested equity in it, guaranteeing a return that is sufficient to maintain the capital’s integrity, both in monetary terms (preserving its purchasing power), financial terms (financial return, interest, dividend and capital gains at least equal to that obtainable from investments with similar risk conditions), and real terms (capacity to renew investments at the end of their cycle) (Ruefli, Collins and Lacugna 1999: 167-194).

If *roe* is a relevant measure of performance for shareholders, the most important performance indicator for the *financial transformation* is the return on investment, *roi*, which is the ratio between the operating result, *OR*, and the invested capital, *IC*, over a period of time *T*:  $roi = \frac{OR}{IC}$ .

It is important to observe that *roe* depends directly on *roi* by means of the well-known general law of returns (Modigliani and Miller 1958: 261–297):

$$roe = [roi + (spread\ der)], \text{ where } spread = roi - rod, \text{ and } der = \frac{D}{E}$$

This previous Modigliani-Miller relation clarifies how the firm’s general *financial* performance, indicated by *roe*, is a function both of *economic efficiency*, expressed by *roi*, and the capacity of the firm to acquire a financial structure, expressed by *der*, that permits it to take advantage of the *financial leverage* effect in the presence of a differential in returns indicated by the *spread*.

From *roe* and *roi*, we can derive other concise indicators of financial fitness that refer to the firm’s ability to meet the expectations of investors: the *economic value added* (EVA), the *dividend on equity* (*doe*) and the *economic value of the firm* (EVF).

EVA can be defined through the following equation:

$$EVA = IC (roi - coi),$$

in which *cost of invested capital* (*coi*) – or also *capital cost rate* (*ccr*) or *weighted average capital cost* (*wacc*) – represents the *cost of investment* and is determined by the following expression:

$$coi = \frac{rod\ D + roe^* E}{IC} = rod \frac{D}{IC} + roe^* \frac{E}{IC} = wacc$$

Thus, while *roi* is the *return on investment*, *wacc* represents the part of this return that is needed to pay the interest on the Debt, at an average cost equal to *rod*, as well as to guarantee the shareholders a proper return equal to their opportunity cost, *roe\**.

The spread (*roi – coi*) thus takes on the meaning of *overall financial performance* (which is independent of the scale of the investment), whose absolute value is instead represented by the EVA, taking into account the amount of *IC* (Stern and Hutchinson, 2004).

In general shareholders, being holders of pure investment equity, compare their satisfaction not so much on the basis of the indications from *roe* as on

$$doe = \frac{R}{E}d = \frac{DIV}{E},$$

where  $d$  is the average dividend rate that would guarantee a self-financing adequate for the firm's growth.

The EVF is defined as the level of capital capable of producing a net result equal to that effectively achieved by the firm as a financial transformer,  $R$ , under the assumption that this capital was invested with a satisfactory return equal to  $roe^\circ$ , which is considered acceptable to shareholders.

Since by definition  $EVF * roe^\circ = R$ , and  $R = roe E$ , with  $roe$  equal to the effective financial return, through substitution we obtain:

$$EVF = \frac{roe}{roe^\circ} E.$$

From the preceding performance indicators it follows that the fitness of the firm is linked to its capacity to produce:

a  $roe$  which is not below the minimum or fair  $roe^*$  necessary to satisfy shareholders, thereby creating value;

a  $roi > roi^* = coi$ . If this *second condition* is met, then  $EVF > E$ , thereby achieving the financial integrity of the equity capital invested by the shareholders.

This shows the relevance of human capital and intangible assets in capitalist production and the need for:

- *creativity*, by which products and processes are continually innovated (Christensen 1997; Deephouse 1999), thereby favoring applied scientific research and technological innovation (Von Hippel 1995);
- *intelligence* in understanding internal and external processes, in order to rationalize the technical processes of production;
- *organizational learning* and the formation of learning organizations to the competitive challenges through new work rules (Schmitz Jr 2001)
- *management control* (from the Decision Support System to Just-In-Time ) (Wilcox and al.);
- *a good reputation* for the firm in its environment (Carter and Manaster 1990: 1045-1067).

According to the concept of sustainability – originally introduced in the 1987 Brundtland report, *Our Common Future*, which was commissioned for the United Nations – whose central principle is “*development which meets the needs of the present without compromising the ability of future generations to meet their own needs*” (WCED 1987), we propose the following Hypothesis: the capitalist firm, as a social unit, must produce social shared “value” (Harrison and St. John 1998), understood in the broader sense that its economic existence as a producer of economic and financial values must be appreciated, in terms of the *sustainability* of the development path of the firm, and evaluated by a wide range of social performance measures of *outcome* or *benefit*: the efficiency of materials, technical innovation, energy efficiency, community relations, eco design, product recyclability, and employee relations.

#### 4. From the corporate balance to the sustainability report

The system of values achieved by the corporation as a system of economic transformation is reflected in the corporate balance which translates the values produced into performance indicators in order to assess whether or not the economic-financial objectives of the business and profit organization have been achieved.

Due to the fact that the system of economic and financial values in the balance derive only from monetary exchanges and reflect only the conditions of productive, economic and financial efficiency, the balance that contains such values has three limits with regard to the information it conveys.

In the first place, it is not able to express the conditions for long-term success that derive from the non-monetary ties to the social environment.

Secondly, the traditional corporate balance cannot account for the ethical values and other intangibles which are fundamental to the success of the enterprise in creating economic values.

Thirdly, the statement of produced values does not provide sufficient indications of the ability of the firm to expand in a way compatible with the environmental resources and the social values.

In order to evaluate the overall impact of the firm's activity on the collectivity (Hill and Jones 1992) it is necessary to come up with a document that supplements the traditional corporate balance, which is called the sustainability report, since its objective is to indicate the value created by investments in the social field and, more generally, the results of the firm's social and environmental policy.

Thus, the sustainability report represents the means by which the firm describes, comments on and reports its role and behaviour with regard to sustainable growth, and through which the firm's social actions toward its stakeholders is made visible and transparent.

The sustainability report, providing information on corporate policy with regard to the Corporate Social Responsibility (CSR) (Blowfield and Murray 2008), promoting an image that gains the consensus of the collectivity and enhances the reputation of the firm, and ensuring greater trust by the stakeholders (Zadek 2001), thus shifts attention from the creation of *economic and financial values* by the productive organization to the creation of *social and environmental values* by the organization as a social agent.

It is for this reason that the sustainability report is the fundamental instrument to ensure the public's appreciation for the social activities of the firm (Griffin 2008), enhancing its reputation in order to create the value of the firm as an actor in the social context as well as to engender trust, which in turn represents the basis for improving the firm's economic and financial transactions and, as a result, making the production of values more efficient. (Kerr, Richard and Chip 2009).

In order to enhance its reputation (Figge and Schaltegger 2000) and trust, which are the fundamental elements for the production of value by the firm, it is thus important for the firm to be able to demonstrate, by means of the sustainability report, the extent and limits of its own CSR.

From this perspective a comprehensive relational process and a continuing dialogue with the social agents become essential elements for creating a relationship of trust with the stakeholders and a context of shared values.

The sharing and pursuit of objectives by means of the trust that is generated through the development of long-lasting relations leads to the spread of a culture (Kotter and Heskett 1992) of shared responsibility. This culture is the condition for the organization's success as well as a source of long-term competitive advantage, which are useful and effective elements for the creation of value in the organization (Mankelov 2006).

## **5. Sustainable growth and the “Triple Bottom Line”**

The firm, as a social agent, must base its growth on ethical behaviour (Dyrud 2007: 36-44) which involves safeguarding as much as possible the environmental conditions that will be “passed on” to the future generations. Thus the firm must compete on the social and environmental (Freedman and Jaggi 2009) front as well as the economic-financial one.



In fact, in developing its strategies the firm must take into account the concept of *sustainable growth*, which defines the ability of the present generation to achieve a type of growth that, while satisfying the needs of the present, does not compromise the ability of future generations to satisfy to their own needs.

Sustainable growth represents a necessary condition to obtain medium- to long-term success (Clarkson 1995), managing its businesses so as to improve its economic results (Heal 2008) but at the same time, safeguarding the natural environment and promoting social justice.

The corporate balance - as clearly shown in the "*Sustainability Reporting Guidelines*" in the "*Global Reporting Initiative*" ([www.globalreportinginitiative.org](http://www.globalreportinginitiative.org)) - cannot by its own nature identify and point out the many ways in which firms influence the environmental and social ecosystems they operate in, beginning with the use of human, natural and capital resources and the creation of value.

The European Commission has asked all the large firms listed in the Triple Bottom Line Reporting (Elkington and Fennell 1998) to communicate their economic, social and environmental performance to the shareholders, supplementing the economic aspect of their management with the social and environmental ones, to the benefit of the relationship with its stakeholders and the markets.

*Economic prosperity, environmental quality and social justice* are the pillars on which the creation of corporate value is based, according to the "triple bottom line" (Warren 1999).

## **6. Conclusion: The communication of the social and environmental commitment to create value**

The creation of social value for the firm is necessary to maintain an effective process for the creation of economic and financial values (Siregar and Bachtiar 2010: 241 – 252).

The sustainability report represents the instrument for monitoring, financial accounts preparation and communication regarding the responsible management approach to achieve a sustainable growth that respects the shared values of the context in which the firm operates.

In order to measure social (Kaplan and Norton 1992) performance (Clarkson 1995) it is necessary to insert indicators (EEA 2001) into the sustainability report that allow the stakeholders to measure the firm's capacity to create well-being for the collectivity (Zakhem, Parker and Stoll 2007) and to demonstrate the firm's social utility by indicating, from both an internal and external point of view, its capacity to achieve social and environmental objectives.

A firm that focusses not only on the quality of the product but also on the safety of its employees, the social impact of its activities and the use of ethically-correct procedures is creating value (Zadek, Pruzan and Evans 1997) by gaining the trust of its workers, the market and its collectivity of reference.

In conclusion, the sustainability report can be viewed as a means for giving value to the firm, since it permits the firm to monitor and prepare the financial accounts for the process of responsible management between the firm and its interlocutors in order to increase its economic advantage and at the same time its social legitimization.

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