Response to the FRC Discussion Paper on The Future of Corporate Reporting

Professor Alex Edmans, London Business School,

www.alexedmans.com, aedmans@london.edu

5 November, 2020

I commend the FRC on suggesting a major step forward in the future of the corporate reporting. I agree with the vast majority of proposals presented in the discussion paper. Therefore, I will focus this response on only one question, where I have somewhat different views.

Q8: Do you agree with the introduction of a Public Interest Report and the suggested content as set out in Section 6?

It is indeed critical for a company to report the items discussed in Section 6, e.g. internal outcomes, external outcomes, and societal impact. However, I believe that this should be part of the Business Report, rather than a Public Interest Report. This is for the following reasons:

1. From Ancillary to Core

How a company serves society is inextricably linked to its core business; hiving it off into a Public Interest Report makes it seem an ancillary activity. Indeed, this is the fundamental difference between Purpose and Corporate Social Responsibility (CSR). Purpose is why an enterprise exists – its reason for being, who it serves, and the role that it plays in the world – it is fundamental to why it is in business in the first place. CSR can be undertaken even by non-purposeful businesses; even a tobacco company can donate to charity. Allowing a company's public interest activities to be separated out from the core business allows it to claim "public interest" by engaging in ancillary activities rather than fundamentally transforming its core business and ensuring that it is one that serves society.

The importance of linking a company's societal impact to its core business is particularly critical to ensure that it is not vulnerable to market conditions. Viewing public interest as a separate activity renders it susceptible to being cut in a pandemic, or whenever times are tight. Instead, ensuring that its core business is one that serves society can be practiced at all times.

2. From Greenwashing to Comparative Advantage

Milton Friedman's famous article, "The Social Responsibility of Business is to Increase Its Profits" is much maligned, but actually provides valuable guidance on how companies can best serve society. He recognised that *individuals* indeed have social responsibilities beyond profits – employees and shareholders may care about social causes rather than just their wages and dividends. He argued that the social responsibility of *business* is to increase profits because doing so gives individuals maximum flexibility to support their preferred social causes. For example, instead of donating £1 to charity, the company could pay out that £1 as higher wages to workers or higher dividends to investors. They could then use that £1 to support whatever charitable cause they want to support – it is not the CEO's prerogative to choose her own pet social cause. Nor does the CEO have expertise in choosing which charitable cause is most worthy – if you are a drinks company, your expertise is in making drinks.

As a result, companies should *only* engage in societal activities if it has a *comparative* advantage in doing so – if £1 invested in that activity generates more than £1 of benefit.[1] Companies typically have a comparative advantage in activities related to their core business. Thus, instead of donating money to Black Lives Matter in the light of George Floyd's tragic death (which workers and investors could have donated themselves, used to support another charity such as Cancer Research UK, or used to fund their children's education), they should have invested their money in recruiting under-represented minorities at all levels, stamping out discrimination in their promotion and evaluation processes, and ensuring that their culture encourages a diversity of thinking – actions that only they can control, which means they have a comparative advantage in doing so.

Allowing public interest activities to be reported separately gives companies license to engage in "greenwashing" activities that are not linked to the core business, and so do not generate a large social return for a given investment.

3. From "Do No Harm" to "Actively Do Good"

Many of the activities in Section 6 are about "do no harm" – minimising a company's negative impact on society and the environment. While this is indeed important, an even greater way in

[1] Edmans, Alex (2020): "What Stakeholder Capitalism Can Learn From Milton Friedman." ProMarket

which a company serves society is through a relentless commitment to excellence and innovation in its core business. For example, in 2012, Vodafone because the first telecoms company worldwide to release a tax transparency report showing how much tax it was paying to governments around the world. Tax transparency is certainly important and in the public interest. However, Vodafone created even more value by launching M-Pesa in Kenya in 2007 – which lifted 200,000 Kenyan households out of poverty in the first seven years. The value of excellence holds even for companies that may not seem to be operating in transformative industries such as tech, telecoms, and healthcare. By being excellent at its core business, a train company can connect citizens to jobs, allow families to live closer to communities rather than the office and enable new enterprises to start. Ensuring that its trains run on time creates even more value than engaging in community profits. An excellent toy company can create substantial value by making toys that entertain and at the same time educate children.

All of these are examples of creating value through the core business, rather doing no harm through public interest activities. A company's contribution to society should not be separated out from its core business or core competencies.

4. From Non-Financial to Financial

I was surprised that the "Public Interest Report" came under the section of "non-financial reporting". Non-financial factors are central even to the core business. Any company should care about factors such as employee turnover, workplace injuries, employee training, impact of product on society etc. as they are central to its commercial success. To hive these off into a separate "Public Interest Report" suggests factors are non-core. Indeed, rigorous research shows that factors that we often think of as "non-financial" are ultimately "financial" in the long-term – they improve long-term shareholder returns.[2] Thus, any business leader should take non-financial factors seriously; this is not simply a question of public interest.

[2] Edmans, Alex (2020): "Grow the Pie: How Great Companies Deliver Both Purpose and Profit". Cambridge University Press