Practice Note

No 'Values' in Valuation – is CSR Dead?

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All CMAs are expected not to blindly pursue profits in increasing their company's monetary value, but instead consider the company's ethical values and social responsibilities. The study of *Environmental and Social Management Accounting (ESMA)* – also commonly known as *Corporate Social Responsibility (CSR)* – is compulsory for all management accountants. Indeed, an entirely new form of corporate reporting, called *Integrated Reporting*, in being slowly introduced to large corporates.

The case for the need for CSR has two motivations. The first is that it is good for society – i.e. the wider community of stakeholders, the Earth itself, and the future generations to sustain its needs. The second motivation is that potential shareholders will reward companies that are run on an environmentally and socially responsible manner by demanding their shares and thus increasing their share prices. Proponents of this argument point to the existence of trillion dollar 'Ethical Investment Funds".

Thus, the argument goes that *"Good moral and ethical 'Values" leads to higher corporate "Valuations".*

However, recent high-profile cases of iconic companies that are blatantly indulging in morally and ethically corrupt practices - ranging from money laundering, poisoning the environment, violating privacy, overcharging customers for non-existent services etc. – are forcing a reconsideration of this nexus between good corporate 'values' and high corporate 'valuations'. The reason is that in every case, after a slight downward adjustment of share price once the bad news breaks, the share prices have caught-up, and in some cases gone significantly higher than what it was before.

It almost looks like *"Corrupt moral and ethical 'Values" leads to higher corporate "Valuations".* In fact, bigger the scandal, higher the valuation!

Let me give a few high-profile examples:

Volkswagen

VW installed software in diesel engines on nearly 600,000 VW, Porsche and Audi vehicles in the US that activated pollution controls during Government tests and switched them off in real-world driving. The software allowed the cars to spew harmful nitrogen oxide at up to 40 times above the legal limit. There are some estimations that the health of up to 200,000 people around the would have been negatively impacted by these actions alone.

US regulators confronted VW about the software after university researchers discovered differences in testing and real-world emissions. Volkswagen at first denied the use of the so-called defeat device

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but finally admitted it in September of 2015. Even after that admission, prosecutors said, company employees were busy deleting computer files and other evidence.

In April 2017, six high-level Volkswagen employees from Germany were charged in the VW emissions-cheating scandal, while the automaker itself agreed to plead guilty to criminal charges and pay $US4.3 billion ($5.7 billion). The German company pleaded guilty to conspiracy, obstruction of justice and importing vehicles by using false statements. Under the agreement, VW must cooperate in the continuing investigation, which could lead to the arrest of more employees.

Volkswagen previously reached a $US15 billion civil settlement with environmental authorities and car owners in the US under which it agreed to repair or buy back up to a half-million of the affected vehicles. VW also faces an investor lawsuit and criminal probe in Germany. In all, some 11 million vehicles worldwide were equipped with the software(ABC News, 2017)[2].

In announcing the charges and the plea bargain, US Justice Department prosecutors detailed a large and elaborate scheme inside VW to commit fraud and then cover it up, with at least 40 employees allegedly involved in destroying evidence.

"Volkswagen obfuscated, they denied and they ultimately lied," said US Attorney-General Loretta Lynch.

Such negative publicity, massive criminal charges, huge civil settlements and potential investor lawsuits and criminal probes should surely have affected its share price in the long-run?

Not so. After a massive 20% fall when the diesel-emissions scandal broke in October 2015, just two-years later in November 2017, Volkswagen AG's share price was back above where it was. Since its nadir in October 2015, the company has clawed back more than 35 billion euros (US$40 billion) in market value (Bloomberg, 2017)[3]. In fact, in April 2018, Volkswagen AG's share price rose despite a drop in earnings (McGee 2018)![4]

HSBS

In 2012, the US Department of Justice (DoJ) revealed that HSBC had laundered $881m through its entities for Mexican and Colombian drug cartels, and that the bank violated US sanctions by working not only with Iran, but Libya, Sudan, Burman and Cuba. The US law enforcement officials illustrated, amongst other findings, how two of Latin America's bloodiest drug cartels designed specially shaped cash boxes to fit the precise dimensions of the teller windows at HSBC!

Due to these findings, HSBC, Britain's biggest lender, had to pay a $1.9bn (£1.4bn) fine in 2012 to the US DoJ. Alongside the payout, HSBC agreed to a five-year *Deferred Prosecution Agreement* (DPA) with the US DoJ under which it promised to clean up its act.

At that time the DoJ's commented that, "*The record of dysfunction that prevailed at HSBC for many years was simply astonishing".*

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2 ABC News (2017) "Volkswagen pleads guilty in emissions scandal, agrees to $5.7 billion settlement, *ABC News,* Updated 12 Jan 2017 http://www.abc.net.au/news/2016-10-26/us-judge-approves-record-deal-in-volkswagen-diesel-scandal/7965280

3 Bloomberg (2017), Scandal? What VW Scandal? *Bloomberg*, Nov 2017. https://www.bloomberg.com/gadfly/articles/2017-11-02/vw-s-40-billion-recovery-is-nothing-to-celebrate

4 Patrick McGee (2018) "VW shares rise despite drop in earnings", *Financial Times*, April 26, 2018. https://www.ft.com/content/e334fcc0-492e-11e8-8ee8-cae73aab7ccb

The Mexico and Colombian drug saga is one of a number of misconduct scandals that have hit HSBC in recent years. Others include evidence it helped wealthy clients evade tax through its Swiss private bank and allegations of rigging foreign exchange and precious metals markets (Withers, 2017)[5].

A number of other outstanding misconduct issues remain unresolved. HSBC is expecting a $1bn-plus fine in the coming months for its role in mis-selling toxic mortgage products in the US ahead of the global financial crisis. It is also separately being investigated by UK regulators for its alleged links to money laundering by South Africa's billionaire Gupta family, whose links to former-president Jacob Zuma are at the heart of a political storm in that country.

Despite incurring the hefty fine and subsequent monitoring costs, HSBC's fate could have been worse – it could have faced a full criminal prosecution. However, it emerged in July 2017, that both former UK chancellor George Osborne and British regulators weighed in on HSBC's behalf (behind the scenes) to try to dissuade US regulators from pursuing criminal action. They had argued that criminal proceedings against a "systemically important" bank such as HSBC would risk "global financial disaster".

With such political pressure being exerted on behalf of HSBC, in December 2017, the US DoJ agreed to allow the Deferred Prosecution Agreement (DPA) to expire.

Interestingly, it has been over five years since the HSBC money laundering scandal broke. Further, although the US DoJ decision to allow the Deferred Prosecution Agreement (DPA) to expire was a welcome relief to HSBC, the verdict is still out on their response to money laundering in South Africa and other issues.

So where is its share price now?

HSBC's share price has surged more than 70 per cent in the past two years, and in February 2018 it was trading above where it was when the scandal broke[6].

Too Big to Fail; and also, Too Big To Jail!

Facebook

A decade of apparent indifference for data privacy at Facebook has culminated in revelations that organizations harvested user data for targeted advertising, particularly political advertising, to apparent success. While the most well-known offender is Cambridge Analytica—the political consulting and strategic communication firm behind the pro-Brexit Leave EU campaign, as well as Donald Trump's 2016 presidential campaign—other companies have likely used similar tactics to collect personal data of Facebook users (Sanders and Patterson, 2018)[7].

The Facebook data privacy scandal centres around the collection of personally identifiable information of "up to 87 million people" by Cambridge Analytica, and others. These companies were able to gain access to personal data of Facebook users due to the confluence of a variety of factors, broadly including inadequate safeguards against companies engaging in data harvesting, little to no

5 Iain Withers (2017), "HSBC spared further US money laundering sanctions as it battles to clean up its act", *Telegraph,* Nov 12, 2018, https://www.telegraph.co.uk/business/2017/12/11/hsbc-spared-us-money-laundering-sanctions-battles-clean-act/

6 Martin Arnold (2018), "HSBC hopes to leave era of scandals behind", *Financial Times*, London, February 18, 2018, https://www.ft.com/content/303a4296-12a2-11e8-940e-08320fc2a277

7 James Sanders and Dan Patterson (2018) "Facebook data privacy scandal: A cheat sheet", *Tech Republic*, June 14, 2018. https://www.techrepublic.com/article/facebook-data-privacy-scandal-a-cheat-sheet/

oversight of developers by Facebook, developer abuse of the Facebook API, and users agreeing to overly broad terms and conditions.

The chronology of this scandal starts in 2005, when researchers at MIT created a script that downloaded publicly posted information of over 70,000 users from four schools. In 2007, activities that users engaged in - on other websites - was automatically added to Facebook user profiles as part of Beacon, one of Facebook's first attempts to monetize user profiles. As an example, Beacon indicated on the Facebook News Feed the titles of videos that users rented from Blockbuster Video, which was a violation of the Video Privacy Protection Act. A class action suit was filed, for which Facebook paid $9.5 million to a fund for privacy and security as part of a settlement agreement.

In 2011, following an FTC investigation, the company entered into a consent decree, promising to address concerns about how user data was tracked and shared. That investigation was prompted by an incident in December 2009 in which information thought private by users was being shared publicly, according to contemporaneous reporting by The New York Times.

In 2013, Facebook disclosed details of a bug that exposed the personal details of six million accounts over approximately a year. When users downloaded their own Facebook history, that user would obtain in the same action not just their own address book, but also the email addresses and phone numbers of their friends that other people had stored in their address books. The data that Facebook exposed had not been given to Facebook by users to begin with—it had been vacuumed from the contact lists of other Facebook users who happen to know that person. This phenomenon has since been described as "*shadow profiles*."

On March 17, 2018, an exposé was published by *The Guardian* and *The New York Times*, initially reporting that 50 million Facebook profiles were harvested by Cambridge Analytica; the figure was later revised to "up to 87 million" profiles.

On April 18, 2018, Facebook updated its privacy policy.

On June 3, 2018, a report in *The New York Times* indicated that Facebook had maintained data-sharing partnerships with mobile device manufacturers, specifically naming Apple, Amazon, BlackBerry, Microsoft, and Samsung. Under the terms of this personal information sharing, device manufacturers were able to gather information about users in order to deliver "the Facebook experience," the Times quotes a Facebook official as saying. Additionally, the report indicates that this access allowed device manufacturers to obtain data about a user's Facebook friends, even if those friends had configured their privacy settings to deny information sharing with third parties.

On June 5, 2018, *The Washington Post* and *The New York Times* reported that the Chinese device manufacturers *Huawei, Lenovo, Oppo, and TCL* were granted access to user data under this program. Huawei, along with ZTE, are facing scrutiny from the US government on unsubstantiated accusations that products from these companies pose a national security risk.

Australia has also launched a Facebook investigation expected to take at least 8 months.

But on May 10, 2018, just two months after the March 17 exposé, Facebook issued solid earnings reports - and had a high-profile but uneventful Congressional appearance by CEO Mark Zuckerberg - its shares had fully recouped their losses from the data privacy scandal. Although the prospects of a billion-dollar federal fine and reduced profitability from tighter regulation remain, Wall Street remains optimistic about the social network's earnings potential (Mirhaydari, 2018))[8].

8 Anthony Mirhaydari (2018) "Facebook stock recovers all $134B lost after Cambridge Analytica" *CBS Moneywatch* May 10, 2018.

Clearly, investors value 'Profit' above 'Social Responsibility'!

The Australian Banking Industry

The *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (in Australia), headed by former High Court judge Kenneth Hayne, has uncovered an impressive rap sheet of misconduct – including bribery, fraud and outright lying - by Australia's banking behemoths. The work of the Royal Commission is still ongoing, but scandal after scandal involving all players in the industry have shocked the general public (Irvine, 2018).[9]

And the scandals keep coming. The Commonwealth Bank confessed to charging fees to dead people. AMP, a large insurance, superannuation (pension) and financial advice company has admitted it misled the corporate regulator ASIC on its overcharging with a "fees for no service" to clients of its financial advice business. Westpac (Bank) admitted it paid bonuses to a financial adviser it knew was churning clients into high-fee investments.

The breadth and seriousness of the crimes revealed in these businesses has led to calls for radical reforms forcing banks to sell these financial advisory and wealth management businesses. Less radical reform options include greater accountability and transparency, and better standards and licensing of advisers.

The role of the corporate watchdog, the *Australian Securities and Investments Commission (ASIC),* has also come into question; it has been labelled "asleep at the wheel" by some.

The royal commission is bringing to light failures in Australia's banking system as never before. The public want answers to two questions: First, how did things get so bad in Australia's once trusted banking industry? And second, how can it be fixed?

The Banking Royal Commission has been a delight for anyone who wishes to see justice done in the financial sector. Across the plush-carpeted corporate offices of major financial institutions, heads are rolling. The CEO of AMP is the highest profile example. The boss of the huge asset management and insurance firm was forced to resign when it was revealed that AMP had lied to the corporate regulator and charged customers for doing nothing at all. Executive departures are a sign of change and renewal. They plant seeds of hope for the future that companies will be run in a morally and ethical manner.

When the Royal Commission was announced in December last year, the share prices of Australia's four major banks fell initially, with Commonwealth Bank of Australia leading the way down to close below $79 a share on 4 December, 2017. But a day later, the banks' share prices had actually recovered (Freeman, 2018).[10]

The share prices of most of these major financial institutions have been falling during the Royal (Macquarie Bank being one notable exception), appearing to indicate that unethical behaviour will be punished by investors. These share price falls across the financial sector are a sign that banks will have less leeway in future to do what they want with the rules and take more responsibility for its actions. This is undeniably good (Murphy, 2018).[11]

9 Jessica Irvine (2018) "Breach of trust: how Australian banks went bad', *Sydney Morning Herald*, 20 April 2018, https://www.smh.com.au/business/banking-and-finance/breach-of-trust-how-australian-banks-went-bad-20180420-p4zarc.html

10 Glenn Freeman (2018) How Australia's big 4 will fare this year, Morning Star, 18 Jun 2018.

11 Jason Murphy (2018), "How we will all pay for the bad behaviour of the banks" News.com, April 21, 2018 https://www.news.com.au/finance/money/investing/how-we-will-all-pay-for-the-bad-behaviour-of-the-banks/news-story/42688f283fe8b3621d99ef4cafe7f986

However, the Banking Royal Commission final report is due only in *February 2019. Once the full extent of the fines imposed are known at the time, most analysts predict that "all will be forgiven" and the share prices will bounce back to previous levels. The reason for such a bullish-prediction is that the Finance* industry is a huge part of the Australian economy. It makes up around 35 per cent of the top 200 Australian stocks. It is likely that anyone who has invested in an industry superannuation (pension) fund, would have their money invested partly in finance companies. Therefore, when Australian finance company share prices fall, their super savings also shrink.

Most investors will not want to punish bad behaviour by the banks, as that would mean giving up a more comfortable retirement with a good pension.

It appears that not only is the need for social responsibility dead in the corporate world, but also its demise has resulted in an increase in corporate profitability and shareholder value.