

Review

# Profit creation, intra and inter-generational equity: Need for new company law

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The issue of profits in company management is as old as the joint stock company but remains ever topical and somewhat controversial. Accountants have one measure for profit and economists another measure, whilst some others want to do away with the idea of profits entirely to ensure social responsibility by companies. The theory of sustainability calls into question the existing theory of profits, apparently based on subsidization and negative externalities, as a result of its failure to factor into company accounts their true environmental costs. Not only does the principle of sustainability appear to validate stakeholders' rights in corporate profits but it also calls into question the current theories of profit creation and distributional equity based on shareholder theory, as well as existing company laws. This paper examines the relevant issues and argues that new legal rules on corporate accounting and profits reflecting generational equity, rather than reliance on voluntary compliance, are imperative for good corporate governance and sustainable development.

**Key words:** Corporate profits law, CSR/corporate sustainability, sustainability accounting, generational equity, IFRS environmental standards, intra/inter-generational shareholders equity.

## INTRODUCTION

The issue of profit creation in company management is as old as the joint stock company but remains ever topical, as profit is the usual measure of value creation meant to satisfy the interest of shareholders to a return on their equity and of the effectiveness of company management. At the onset the term was not even defined in statute in England (Chan et al., 2010). Yet the concept of profit as a measure of value creation is somewhat controversial, as some would argue that task achievement is the true test of value creation (Fletcher, 2006), or that customer satisfaction or multi-stakeholder satisfaction (Gill, 2006) and wealth maximization of society (Wilson,

2003) is a truer test. Others point to maximization of shareholders' value (Friedman, 1970); others still, shareholders' optimization (Bainbridge, 2002). On the other hand, the entity maximization theory (Keay, 2008) has also been suggested, whereby the aim of directors should be to ensure the overall long run wealth of the company (People's Department Stores v Wise) in the interest of all who invest in it as an objective. Accountants have one measure for profit and economists another measure, whilst some others want to do away with the whole idea of the trading company and profits entirely in order to achieve sustainability (Mitchell, 1995; Fox, 1996).

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The major controversy has been on what amounts to and how to assure financial sustainability, although iterations of company law appear to be more concerned with solvency and the protection of creditors (Chan et al., 2010).

The distribution of value is not merely an issue in strategy; there is controversy as to whether shareholders are indeed entitled to profit, on the basis that it comprises rents, not wholly or even at all derivable from their investment (Greenwood, 2006). Therefore, it is argued that other stakeholders have a preeminent or equal claim to corporate profits (Greenwood, 2006). Keay (2008) prefers to treat profits as a business expense required to retain shareholders and not as a portion 'owned' by them as a dividend of ownership. As between the various classes of shareholders' inter se and intra se, the matter of equity in the exercise of power and distribution of benefits in the company is a cardinal rule of company's law (exemplified by section 125/127 of the English Companies Act, 1985, section 630/633 English Companies Act, 2006). The agency issue (Jensen, 1976; Fama and Jensen, 1983; Frug, 1984) of fiduciary duties of company executives relates essentially to the felt desire to allow the appropriation of value only in a manner that satisfies the tests of loyalty and avoids conflict of interest - the so-called fiduciary duty of directors. Yet, executive compensation has been on a stratospheric course of increase over time, such that the allure of bonuses and stock dividends is often proffered to be one of the principal causes of the global financial crisis. One suggested remedy is the strengthening of the shareholders' constituency (Heath, 2011; Squire, 2010; Ho, 2010; Stout, 2008; Fairfax, 2008 ;Velasco, 2007).

A different track of theory based on stakeholders' perspective argues that a company is a network of interests (Donaldson, 1995; Boatright, 2002) and that other parties have a valuable but differentiated stake in the company and its wealth and thus entitled to partake in its distribution. Or that companies are created by society essentially to fulfill social roles, satisfy the interests of other stakeholders and not just the maximization of shareholders' wealth (Freeman, 1994; Branco, 2007). The concept of sustainable development has led to the interesting notion of inter-generational equity (Puaschunder, 2012; Collins, 2007; Weiss, 2007). This has been added to the erstwhile concerns about intra-generational equity (Woods, 2011; Dobson, 1998), which stakeholders' theory reflects on. Sustainable development theory has given us the concept of multi dimensional sustainability: not just economic or financial sustainability, but also eco-system sustainability and social sustainability (human rights). The theory calls into question the existing theory of profit creation which is based on subsidization, as a result of failure to factor in the true

costs of earth resources, as well as creation of future value for forthcoming generations. Not only does this argument seem to give validation to stakeholders' rights in corporate profits or value creation but it also calls into question the extant theory of profit creation and distributional equity based on shareholders' theory, as well as the existing company's law. Some even argue that profit should be distributed to future generations (Jacobs, 1997; Phillips, 2000).

This paper seeks to review existing literature and answer the question: what alternative legal policy governing the measurement and distribution of corporate profits is desirable in light of the established but still evolving theory of multi-dimensional sustainability? It starts by examining the contesting traditional theories of profit and then examines the concept of sustainability. A discussion of sustainability accounting and management methodologies takes up the theme of sustainability, followed by a statement of the legal rules on corporate profits in several jurisdictions. The paper next examines issues of intra and inter-generational shareholders' equity, as well as shareholders' and intergenerational (stakeholder) equity. It concludes that the existing legal rules are outdated and fail to reflect, incentivize and drive the movement towards corporate sustainability and sustainable development. The principle of good corporate governance requires that companies must align with sustainability goals on an integrated and holistic basis mandated by law in view of the clear and present danger of irreparable injury to civilization by a 'business as usual' approach.

### **Value creation, accounting profit, economic profit and shareholder profit maximization**

Accounting profit (Mauboussin, 2002; Merchant and Tatiana, 2009) represents a surplus of revenue over costs in gross terms but is usually an imprecise index of true prosperity or profitability of the firm (Fuller, 2011). It does not factor in all necessary production costs or the time value of money and is difficult to measure. Indeed companies' directors have to spend quality time trying to determine if the company made a profit.

Accounting profits can also be manipulated, depending on the accounting method used to record transactions (Fuller, 2011). It may well allow management to claim good performance and to earn a performance bonus. All too often this is nothing but a gimmick that cannot be sustained in the medium term or may simply result from deleterious actions that would damage the company and profit performance down the road, for example, because of under-investment in innovation, employee capacity building, etc. Management actions that maximize profit in

the short term, even when they are not gimmicks cannot, therefore, presumptively lead to a conclusion that the company has created value for the shareholders and society (Wallman, 1991).

Economic profit (Mauboussin, 2002; Merchant and Tatiana, 2009; Mankiw, 2012) is the net profit that emerges after factoring in the cost of capital into profit after tax (PAT). It occurs when the firm is able to create returns that are greater than the best alternative uses or opportunity cost of input resources. It incorporates the time value of money and inherently requires a longer term horizon in its computation. It allows equity providers to be sure that the business is creating rather than destroying value. It enables managers to discern the most profitable parts of the firm and equity providers to make the most efficient investment decisions. In other words it is a better and truer measure of value creation as it eliminates waste and inefficiency.

Generally, company statutes and accounting standards do not require the reporting of economic profit as a measure of value creation, however, at least explicitly. Yet, Kleiman (2012) argues; '... the right of shareholders to receive an economic return on their investment is as legitimate as a creditor's right to receive interest.' Some companies' laws by incorporating extant accounting standards require payment of dividends based on solvency measures since dividends can only be paid if there is a surplus of assets over liabilities. Ordinarily, that should assure payment of dividend from economic profit, however, according to Chan et al. (2010), some of the International Financial Reporting Standards (IFRS) apparently allow appreciation in the fair value of a company's assets to be treated as 'realized profits' which is distributable. Fair value accounting is itself not foolproof measure against self interested valuation and accounting measures. Besides, the theory of economic profit implicitly suggests that it is ephemeral and difficult to assure on a sustainable basis in a situation of truly competitive markets (Greenwood, 2006).

Therefore, at the accounting level, shareholders' profit maximization based on mere accounting profits and short term horizon may be a myth and more often than not a scam on shareholders, at least long term investors. However, economic profits only appear to encourage financial sustainability at best and do not necessarily engender other aspects of sustainability.

The expectation of society is that a company should create economic gain or value over its life span. The capital it utilises includes natural/environmental resources and social capital invested by society in capitalist production. Producing financial profits is therefore just one side of the equation. Moreover, in order to determine true economic gain, financial profit must be assessed from the point of view of return on investment of these

capitals. It is relevant to inquire in particular whether it has covered their cost and created a surplus. It is more correct to inquire whether it has made the best use of the capitals so as to provide optimal 'three-dimensional' profit. This point is further explored in the section after the next.

### **Generational equity and sustainability concept**

The idea of generational equity derives essentially from the principle of sustainable development. This is generally defined as development that engenders optimal development of current generations without constraining the ability of future generations for optimal development (Brundtland Commission, 1987). It connotes the provision of an equal platform or opportunity for development by all members of the current generation, therefore sounding in social justice and good governance. It requires ecosystem sustainability, meaning that the utilisation of the ecosystem as a productive resource should not degrade its regenerative capacity to maintain equilibrium at all times, so as to sustain present and future living. It also requires productive use of the ecosystem as a basis for providing optimal living standards for current generations as well as innovations that will ensure that the quality of life of future generations is not worse than that of the current. That requires sustainable economic activity that produces growth. However, it should also do so in a manner to enhance human rights and cultural, spiritual and personal freedom. The three dimensions are to be reflected by corporate organisations (Yilmaz and Flouris, 2010; Sneirson, 2011) by balancing financial or economic goals with net neutral or positive impacts on the environment and society.

The more radical implication of the principle derives from two lines of theory. The first line, situated in environmental science, argues that profits and sustainability are antithetical concepts, as the lure for profits drives the use of ecosystems services in an unsustainable manner, whereas there is compelling need for the current generation to moderate its impacts on the environment so as to remedy its overuse or to avoid exceeding the carrying capacity of the earth (Meadows, 1972; Hawken, 1993; Gore, 2011). The second line of theory suggests that when environmental costs are adequately factored into company balance sheets the notion of profit will disappear unless companies radically reengineer their processes, operating models and society the ideology of the market or political capitalism and its penchant for rewarding rent seeking activities that incentivise waste and unsustainable exploitation of earth resources (C.f., Fox, 1996). Contrarian theory argues that management of environmental and social issues leads to better and increased profits

and that sustainability and profits can indeed benefit and conciliate one another to all round beneficial impacts on Environmental and Social Governance (ESG) goals (Elkington, 1994; Mitchell, 1995; Murphy, 2002; Porter, 2011).

### **Profit making, value creation and the sustainability principle**

Elkington's Triple Bottom Line (TBL) concept (Elkington, 1994; Savitz, 2006), although primarily a concept and framework for measurement of impacts of companies on society generally and originally meant to encourage CSR, also connotes an accounting, auditing and reporting paradigm. The most common use of the concept is in the practice of environmental reporting, a largely voluntary based practice meant to incentivize companies to drive environmental and social goals through the reputational pressure that public reporting generates. Increasingly legislation and company's law mandate environmental reporting (Parker, 2005) in annual accounts in financial terms without requiring their incorporation into the balance sheet or profit and loss accounts. The European Commission Recommendation 2001/453/EC of 30 May 2001 on the recognition, measurement and disclosure of environmental issues in the annual accounts and annual reports of companies promoted the strategy of sustainability reporting. The European Accounts Modernization Directive, 2003<sup>1</sup> elaborates on the Recommendation of 2001. It provides, inter alia, that annual accounts:

'... where appropriate [sustainability reporting] should lead to an analysis of environmental and social aspects necessary for an understanding of the company's development, performance or position...' Section 417 of the Companies Act of United Kingdom offers an illustration of the implementation of the Directive. The section requires companies to include in their annual accounts a business review including information about environmental matters (including the impact of the company's business on the environment), employees, social and community issues and any policies of the company in relation to those matters and the effectiveness of those policies. The review must, to the extent necessary for an understanding of the development, performance or position of the company's business, include analysis using financial key performance indicators, and where appropriate, analysis using other key performance indicators, including information relating to environmental and employee matters.

Accounting innovation is also making triple bottom line accounting measure specific. This is one route that implicitly focuses on shareholder optimization. It is anchored on reasoning that this is the best position for reputational and competitive advantage that benefits shareholders and produces a win-win position for other stakeholders.

Another approach adopts shareholders' profit maximization as the basis for profit creation and distributional equity. Hence, Millon (2010) examined a 'third way' using the concept of Enlightened Shareholder Value (E.S.V.) wherein conditioned choice of a long-term view to profit-making and pressure to comply with social values would be applied by the force of market or social pressure by N.G.O's, community activists, the media, employees, institutional investors and consumers, etc. This appears to be the classical CSR model. It could be regarded as a manifestation of shareholders' optimization strategy (Bainbridge, 2002). However, he also examined the limitations of that approach. The public can only react if they have information about questionable behavior and companies may embark on merely symbolic gestures or outright stonewalling. A third approach is to eschew shareholders' profit maximization or optimization as a basis and to focus on value creation exclusively. Fletcher (2006) characterizes the 'third way' model as the 'purpose driven company' which she defines as one that defines a purpose first and then uses profit as a measure of success.

The sustainability paradigm is not inherently hostile to the idea of creation of value, and by implication also profits. It implicitly assumes use by the present generation of the resources of the earth, being based on conservation, rather than a preservation ethic. Indeed, it inherently requires a cost-benefit approach in order to apportion inter-generational equity and must incentivise activities that generate economic profit, return optimum value to economic agents so as to create surplus or wealth and reserves of value that can be enjoyed by future generations. At least it should not incentivise activities that destroy generational value. Activities that do so must be continued, whilst activities that destroy generational value must be discontinued (Sowell, 2000).

The sustainability principle fundamentally, therefore, requires value creation and sustainable profit (financial sustainability). 'Sustainable value creation has two dimensions—how much economic profit a company earns and how long it can earn excess returns '(Mauboussin, 2002). Since futurity or long term consideration is required to more accurately estimate value creation, sustainable value creation will require the same longer term horizon and considerations for firm profit strategy to avoid paying executive compensation and dividend out of unearned profits. In Anglo-American company law, *Dodge v Ford Motors* (Dodge v Ford Motors) epitomizes

<sup>1</sup> Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003.

the profit maximization, short term norm. To make a gratuitous pay-off to employees about to be laid off, or when the company was exiting trading or for some unrelated act of corporate philanthropy could not count as an investment, could not increase the net present value of the company (Grant, 2009) and was an unauthorized donation of corporate assets, or shareholders' capital essentially. That was a prescriptively narrow view, as it ignored the possible positive contribution to economic profit or shareholder value of reputational benefits that could accrue to companies from CSR activities.

However, this emphasis on economic profit leaves out the need for beneficial environmental and social impact as it is focused narrowly on shareholder interests. Sustainable value or what Haque (2009) terms 'thick value' must redound in meaningful, sustainable value to customers, businesses and society. This is contrasted with 'thin value'. Porter and Kramer (Porter, 2011) talk about the *'right kind of profits – profits that create societal benefits rather than diminish them.'* This appears to be the same thing as 'thick profit'.

There has been a copious scholarly debate about environmental accounting. The basis and methodologies of accounting for the environmental impacts of companies are available (Debnath, 2012), albeit imperfect and not unanimous. The theory of negative impact as cost is clear. But there is another theory that companies can also create value by their interaction with the environment (C.f., Porter, 2011). The problem has been how to ensure disclosure of these variables in the financial accounts at all, or in sufficient detail. There is no doubt that a historical negative environmental occurrence, as defined by extant legislation, incurs liability and must be captured as cost, expensed or provisioned if it is a 'probable' present obligation. Several cost management methodologies now exist for capturing environmental impacts, such as wastage accounting, material flow cost accounting and environmental performance indicators (Debnath, 2012). Other independent methodologies, such as life cycle assessments, life cycle costing, full cost accounting, materials flow accounting also exist, some of which apply the 'polluter pays principle' (Debnath, 2012). There is of course a separate framework for carbon accounting.

The difficulty lies in agreeing financial accounting methodology for capturing possible future liability from current environmental impact, or for environmental risks; in which case materiality is an accounting requirement, requiring reflection of the risk in the estimation of the future value of the company (Thistlewaite, 2011). The time dimension is one element – is the liability anticipated in the short term? If so, it ought to be captured as a provision or contingent liability. Or is it really a risk of 'possible obligation' from current activities likely in the long term (such as the next generation) and, therefore,

might be regarded as too long term to be deemed as material and worthy of disclosure or relevant for current investment decision? In that case, it appears that the current IAS guidance is that it should be provisioned if the probability of loss is 'other than remote' (Thistlewaite, 2011). Ordinarily, an accountant ought to err on the side of disclosure but the current guideline gives him discretion in the matter. The possibility then is that pressure to avoid disclosure and to maintain a healthy balance sheet will allow firms to understate their environmental impacts. As indicated earlier, even the 'fair value' concept allowing discretion as to what value to assign gives room for manipulation.

The accounting methods discussed so far are internal to and stop at the company gate. They do not necessarily relate or integrate the company's interaction with the environment from the point of view of the national environmental commonwealth, normally perceived as discrete and finite stock. National environmental regulatory standards may promulgate limits of impacts on the environment and, therefore, hopefully apportion not more than the acceptable aggregate in total to an industry or activity, therefore, proving a basis for monitoring each company and the industry within the boundary of the carrying limit of the environment (Rondinelli, 2000). However, that strategy of environmental management is fraught with several difficulties (Rondinelli, 2000). Is the benchmark data used in allocating 'pollution or use permits' accurate? Is the regulatory authority capable of adequately monitoring the industry, etc? What methods of regulation are optimal? Therefore, it is important to situate the company within the national environmental asset and liability account, after all companies income is a component of the national income account. A few examples of ideas and methodologies will suffice.

Full Cost Accounting is one of the methodologies that reflect environmental and social costs (Rondinelli, 2000). For example, Atkinson (2000) argues for environmental full cost accounting that appropriately values the impact and cost of a company's operations on the environment on the basis of national environmental accounts in correlation with the income it generates. If that cost exceeds the income then the company is prima facie unsustainable. The lesser the impact of the firm on the environment the more 'sustainable' it is. He also echoes the point that value creation must be holistic; 'socially dimensioned and useful' rather than solely company specific and cannot be measured on a financial dimension alone.

Sustainability management is aptly described as living off the income generated by the social and environmental capitals (flows) rather than degrading the capital itself (stock) (Bent, 2003). The role of a sustainability Balance Sheet will therefore be to capture the capitals, whilst the

Profit and Loss Account will reflect the in and out movement of the flows over time. Sustainability accounting methodologies are being developed and refined (C.f., Bent, 2003). These seek to factor sustainability related costs and benefits into the Profit and Loss Account and to extend the notion of assets in the Balance Sheet to cover human capital and aspects of social capital (such as reputation). Value added statements are a useful means of reporting sustainability performance over time and show returns to stakeholders (Bent, 2003).

Figge and Hahn (2004) propose that rather than use a linear measure such as benefit versus costs or ratio between value creation and resource utilization an efficiency measure based on opportunity costs is more helpful. This would require that companies create value above a particular benchmark based on the resources allocated to the company; thereby 'it measures whether a company creates extra value while ensuring that every environmental and social impact is in total constant.' This proposition should better ensure that 'apples are not compared with oranges' and is notionally superior. Operationalising and implementing it would probably be a greater developmental and a logistical challenge respectively. However, it underscores the necessity of truly measuring value creation as 'thick value'.

The notion of generational accounting (Diamond, 1997) is itself open to criticism on several fronts (Williamson, 2011). A few will suffice for illustrative purposes. The issue of the base line of the market is itself an ideological construct that is political and subject to political evolution and manipulation, the life cycle model is itself just that, a model, not a necessary reflection of reality (Buiter, 1997) and in event based on a parameter that is not static (Havema, 1994). Another criticism is that the framework over-emphasizes the costs incurred by the current generation and underestimates the savings or value bequeathed to the succeeding generations (Williamson, 2011).

Voluntary environmental management systems are a non-accounting option that has seen increasing innovations. International Guidelines like ISO 14001, 26001 have been available since 1996 and 2010 respectively. They enable companies to move beyond compliance and to internalize eco-efficiency and corporate social responsibility in their operations (Rondinelli, 2000).

However, the idea of assessing and regulating the impacts of current generations on the environment is unassailable and cannot be discarded, but should be improved. The important consideration is that social equity requires a basic measure of justice in allocating environmental assets or patrimony, or in participating in economic activity among all citizens, including corporate persons. Concomitantly, society has a duty to avoid wastage; therefore, in determining whether a citizen has

created or destroyed value it is important to be able to assess the value of the assets assigned to him as a productive asset. Measures to track that metric in the operations of companies are, therefore, required from a reporting and regulatory perspective. These can only be legislated and not voluntary measures in view of the weight of the legacy allocated and the serious impact that its use has, not only on current, but also succeeding generations. Company law is a relevant locus for such legislated metric in view of the nexus it bears to the issue of governance and accountability internally and externally to the company. The Porter hypothesis (Porter and Linde, 1995) also suggests that corporate innovation is the key to corporate sustainability and environmental regulation can be used to spur innovation by companies, and in many instances to pay for the cost of regulation (Ambec, 2011).

### **Corporate profits law**

For reason of the need for practicality, brevity and the phenomenon of convergence to IFRS standards (Chan et al., 2010) only a brief survey of few regionally dimensioned global jurisdictions, with English law as benchmark, will now be undertaken.

The rule of maintenance of capital enshrined in section 121 of the English Companies Clauses Consolidation Act, 1845 implied that dividend could only be paid out of profits. However, no definition of profit was prescribed. Section 14 of the Joint Stock Companies Act, 1856 introduced the solvency rule by prescribing civil liability for the payment of dividend when the company was insolvent. Section 39 of the Companies Act, 1980 defined profit as: 'accumulated realized profit...less accumulated realized losses'. Public companies were required to maintain the solvency rule under section 40. The Companies Act, 1981 linked realized profits to the principles of approved accounting standards, which in the case of UK is IFRS. As indicated earlier, some IFRS standards allow appreciation in the fair value of a company's assets to be distributed as realized profit (C.f., Chan et al., 2010).

As the solvency rules and the link to generally accepted accounting standards were required by European Community Directives (the Second and Fourth Directives respectively), implicitly the same principles apply generally speaking within the EU. There is of course convergence to IFRS by many other countries, with United States expected to do so by 2014. The Delaware General Corporation Act implicitly recognizes the solvency rule (Articles 160, 170), as does section 510(b) of the New York Business Corporations Law. Section 501 of the California Corporations Code (as amended by Act No. 571 of 2012) is of similar effect.

The Australian Corporations Amendment (Corporations Reporting Reform) Act, 2010 stipulates a three part test before the payment of dividends. First, that there is a net surplus of assets sufficient to pay dividends immediately before its declaration (not based on the last audited accounts), secondly, that the payment of dividends is fair as between all classes of existing shareholders and thirdly that the company's ability to pay its creditors is not compromised. The law is apparently an improvement by referring to the balance sheet, where shareholders' equity and returns to capital employed are represented, yet issues of classification and determination of 'fair value' may still not allow for unanimity and accuracy on measurement of value (Chan et al., 2010). However, the law neither explicitly, nor implicitly requires companies to consider other stakeholders, apart from creditors, of course. The South African Companies Act, 2008 appears to go even further by requiring a fair valuation of a company's asset as a basis for determining profit distribution. Section 46 of the South African Companies Act, 2008 imposes a solvency and liquidity rule on the basis of a fair valuation of a company's asset and the ability to pay its debts as they fall due within twelve months according to section 4.

New Zealand follows the solvency rule under section 52 of the Companies Act, 1993. Section 380 of the Nigerian Companies and Allied Matters Act, 1990 mirrors section 39 of the UK law and imposes the solvency rule as well. Sections 365 and 169 of the Malaysian Companies Act, 1965 impose similar conditions. Section 205 of the Indian Companies Act, 1956 has provisions that require depreciation for assets in accordance with specified rules before the payment of dividends. An amendment Act of 1974 requires the transfer of a specified percentage to the reserves before the payment of dividend. The Companies Bill of 2009 would require the approval of directors, shareholders and current creditors before the payment of dividend, but appears to abrogate the previous two innovations described. Article 167 of the Chinese Companies Act, 2005 also essentially imposes the solvency rule. It goes further by requiring ten percent of profit to be allocated to the statutory surplus fund up to a maximum of fifty per cent of the registered capital. Past year losses must be provided for before any profit can be allocated to the discretionary surplus fund before any remaining after-tax profit can be distributed to members. Article 189 of the Brazilian Companies Act similarly requires the solvency rule. Article 193 mandates the transfer of five per cent of net profit to Legal Reserve up to a maximum of twenty per cent of registered capital. Article 187(2) provides that '...any increase in the value of assets registered as a Revaluation Reserve may only be computed as a profit after its realization.'

The brief survey of corporate profits laws suggests that

they do not distinguish between income and capital profits generally; but only emphasize 'realized profits.' The South African Law requires assets to be fairly valued before distributing profits and may possibly allow for distribution of unrealized profit. The inference is that they only really require accounting profits. The solvency rule and the treatment of capital reserves may, however, serve to lock in some of the economic profit, although the chief objective is the security of creditors (Greenwood, 2006). Secondly, there is no direct reference to environmental or sustainability accounting in many laws, except as recognized by IFRS, or for purposes of environmental reporting based on moral-suasion. As discussed earlier, the IFRS's environmental standards are still evolving and not at all comprehensive. Thirdly, the emphasis is on building and distributing shareholder value.

New developments, particularly in the U.K. (Williamson and Lynch-Fannon, 2008) and Europe require environmental reporting, but not for the purpose of incorporation in the P & L and Balance Sheet, as previously indicated. The principle of voluntary assumption of responsibility for sustainability management is, therefore, promoted by implication. At best, pressure to comply is left to the desire for reputational capital, compliance with public and regulatory laws or as strategy for gaining competitive advantage. The security of creditors continues to be protected with stringent measures and with so much gusto in corporate profits law. Apparently, it is accorded greater preference than the security of current and succeeding generations. That appears to be an outdated anomaly that should be now redressed on a holistic internal corporate governance and collaborative global basis. This is imperative for sustainability management at all levels, private and public and moves beyond mere fashionable posturing around the concept of CSR or 'green washing'.

### Inter-generational shareholders equity

The case of *Fulham Football Club Ltd. v Cabra Estates* (Fulham Football Club Ltd. v Cabra Estates, 1992) underscored the principle that the company is to be managed to satisfy the interests of current and potential members. It would only be logical to expect directors to have regard to the company as a continuing institution in the performance of their duties (Parkinson, 1993) This would be perfectly consistent with a view that companies could defer short term profit under the business judgment rule (*Howard Smith Ltd. v Ampol Petroleum Ltd.*, 1974; *Shlensky v Wrigley*, 1968) so as to protect the rights of creditors 'both present and potential'. Why could they not do so in order to attend to corporate philanthropy or CSR activities that would incidentally benefit the business in

the long run? Is this good ground for deferring short term profits in favour of potential shareholders (Hu, 1990; Orts, 1993; Keay, 2008)?

It would be legally impossible to restrict declaration of dividend and distribution of dividend on the explicit basis that some potential shareholders in the short or long term should be apportioned part of the value created in the current term. (*Greenhalgh v Arderne Cinema, 1951; Peters v American Delicacy Co. Ltd. & Heath*). Directors would, therefore, find it hard to trump the interest of current shareholders to optimum returns on their investment on the basis of an explicit proposition of wanting to preserve profit for future generations. However, shareholders cannot insist on dividends unless declared by directors and as *Howard v. Seawell 1972*, analogically demonstrates directors may invoke the 'interests of the company' doctrine to benefit other constituencies if need be. They may indirectly benefit future shareholders by concentrating on a policy of preserving capital, even if they do not manifest an express indication as to their reasons for a decision not to prefer current shareholders. Section 172 of the Companies Act of United Kingdom, 2006 impliedly empowers directors to defer short term profit or to restrict dividend to current shareholders on the ground that it is in the best interests of the company so to do (Alcock, 2006). There are mixed views on the potential ecological value of the section; some regard its focus on the long term as positive, others believe that public policy and regulatory law is the better vehicle, whilst others feel the accent on maximization of profit is incompatible with sustainability (Collison, 2011). There is no evidence that the section has led to any change of behavior or had meaningful impact on company directors (Collison, 2011).

However, ultimately it is usually in the interest of shareholders to build up shareholder equity by growing value sustainably through a long term profit creation and distribution strategy. That appears to be one sure way of ensuring intra-generational equity in companies. As for ensuring inter-generational equity, the essential element then is not the indefinite existence of the company but of its viability over a long term by means of sustainable value creation and the facilitation of even longer term benefits to succeeding generations of stakeholders, if not directly by the company then indirectly by its contribution to a more sustainable domestic and global economy during its term of existence.

#### **Inter-generational equity – dominant and minority shareholders and other stakeholders**

Shareholders will have to forego excessive concentration on short term profit if companies must concentrate on sustainable value creation, as this would not only require

a longer term horizon but also reinvestment in the company for innovation and compliance with sustainability legal standards and ethical values. In the United Kingdom and the United States, particularly, where the phenomenon of managerial capitalism and atomization of shareholding is more pronounced, there is some evidence, of an emphasis on short-term returns (Palmer, 2011; Eldomiaty, 2006; La Porta et al., 2000, 1999; Cannon, 1992). Alternatively, in Japan, where stakeholders - employees, banks and society are in league, with mostly family or bank owned firms to promote the global dominance of Japan Inc., reinvestment in the company is at least 10% higher (Toonsi, 2011; Cannon, 1992). To a lesser extent in Europe, where family owned firms and institutional investors dominate and the stakeholder model is emphasized, a longer term focus is also discernible (Toonsi, 2011; Lane, 2003).

If the managers of companies are discouraged by the attitude or behavior of shareholders or capital markets from taking the long term view (Millon, 2002) required for optimum reinvestment in innovation and corporate sustainability then the conditions for promoting sustainable value creation would be lacking. It follows that shareholders must be recruited as vanguards of the corporate sustainability constituency. This may require shareholder education, but legal and regulatory standards also play an educative function. In other words, law and regulatory rules for promoting corporate sustainability are necessary, especially to allow for true value creation by requiring economic profit creation.

Secondly, they must be empowered to enable them exert the required standards of internal oversight and accountability on management. This requires more shareholders' control rather than less, particularly in the Anglo-American model where speculative and predatory takeover and investment practices and separation of ownership and control led to 'outlaw' management risk taking and compensation practices that almost brought down the global economy in 2008.

#### **CONCLUSION AND LIMITATIONS**

There is now need to extend statutory company law by imposing clear, detailed and comprehensive legal standards and rules for corporate profits and sustainability accounting, beyond a voluntary and 'values only' framework advocated by most proponents of CS or CSR. Sustainability accounting should be made mandatory in corporate law, on the basis of environmental full cost accounting. Corporate law should also innovatively prescribe necessary measures for sustainability management or corporate sustainability and a longer term focus on distribution of value meant to promote economic profit

making. If explicit creditor and investor protection rules and institutions are regarded as imperative for promoting economic growth, surely promoting sustainable development cannot be left to acts of voluntarism and ad hoc acts of charity, nor can the values of corporate sustainability be reserved for internalization through market competition and moral-suasion of proponents of CSR and activist civil society alone. Therefore, the duty of directors should now include an explicit rule to 'promote sustainable value creation on the basis of inter-generational equity'.

Explicit rules and sanctions of law and regulation are the quickest and most effective means of motivating and institutionalizing the internalization of the values of corporate sustainability in corporate governance in company managements and officers. Law, codes and regulation exist to protect investors and creditors, to promote financial and capital markets and to make directors accountable to shareholders and society, particularly in the realms of economic growth. Surely, the principles of sustainability now need to be explicitly assimilated into and suffice law, codes and regulation governing companies (Lynch-Fannon, 2007).

One limitation of the study is the apparent non-availability of case law interpreting the IFRS environmental standards and other sustainability accounting methodologies. Another is the limited scope of corporate laws reviewed.

## Conflict of interest

The author has not declared any conflict of interest.

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