ACCA

China and sustainability: risks and opportunities

SUMMARY OF THE ACCA AND CSR ASIA BREAKFAST BRIEFING, 14 MARCH 2012

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Founded in 1904, ACCA has consistently held unique core values: opportunity, diversity, innovation, integrity and accountability. We believe that accountants bring value to economies in all stages of development. We aim to develop capacity in the profession and encourage the adoption of consistent global standards. Our values are aligned to the needs of employers in all sectors and we ensure that, through our qualifications, we prepare accountants for business. We work to open up the profession to people of all backgrounds and remove artificial barriers to entry, ensuring that our qualifications and their delivery meet the diverse needs of trainee professionals and their employers.

We support our 154,000 members and 432,000 students in 170 countries, helping them to develop successful careers in accounting and business, with the skills needed by employers. We work through a network of over 80 offices and centres and more than 8,400 Approved Employers worldwide, who provide high standards of employee learning and development.

This report summarises a briefing held on 14 March 2012 by ACCA and CSR Asia, the leading provider of information, training, research and consultancy services on sustainable business practices in Asia.

The session reviewed the social and environmental challenges that accompany the business opportunities arising from China's rapid development into the world's largest exporter and second largest importer.

FOR FURTHER INFORMATION

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THE PANEL

Gordon Hewitt (panel chair)
Gordon is sustainability adviser at ACCA. Gordon is a qualified accountant who has worked at Pricewaterhouse Coopers in London. He also has experience working at the UN Principles for Responsible Investment and UN World Food Programme. He holds an MSc in Environmental Technology from Imperial College London.

Ruth Dobson
Ruth is an independent consultant, and former PwC partner, in Shanghai and Beijing. When with PwC, Ruth lived and worked in China for nine years while heading the firms' sustainability and climate change team. She was a key contributor to the groundbreaking *China Greentech Report.*

Mark Bannister
Mark is ethical and environmental manager at New Look. Mark has developed a sustainable sourcing strategic action plan based on integrating sustainability into discussions with New Look suppliers. Previously, Mark developed a pioneering sustainable supply chain project with a leading UK retailer, which focused on helping Chinese garment factories understand and implement sustainability initiatives.

Tristan Edmondson
Tristan is a senior project manager at CSR Asia. Based in London, Tristan specialises in supply chain sustainability, having worked in Beijing running a small consultancy producing market intelligence on China's clean technology industry.

PRESENTATIONS FROM THE EXPERT PANEL

With the backdrop of the debt crisis in Europe and a probable recession in America, China is increasingly being viewed as the world's leading economic powerhouse. The country has shown consistent growth, with GDP increasing by an average of 9.3% a year over the past 10 years, and has a manufacturing sector that rivals any other. Many products are made for export, but as China is also the world's most populous country a vast internal market exists. With such levels of growth, many companies based outside China are outsourcing large elements of their business to the country.

While there is much opportunity, operating in China also opens up foreign companies to a number of significant risks. Modern municipalities such as Shanghai and Beijing have boomed in recent years, but large areas of the country remain very poor. This inconsistent investment environment creates a large number of legal, financial, political, social and environmental risks. Companies looking to invest in China need to be fully aware of a multitude of issues if they are to maximise their potential in the country.

SIGNIFICANT ECONOMIC GROWTH

Former PwC partner, Ruth Dobson, described living through China's incredible transformation over the past decade as an 'exhilarating experience': expensive shopping malls and office buildings have now replaced small, low-rise, dilapidated houses; thousands of kilometres of roads have been built, some still waiting for traffic while others are already clogged up; and multiple new airports have been constructed. This means, however, that China has been a building site for a decade, a country where well-known places have disappeared, and in which a host of sustainability issues are now emerging.

When trying to describe China's business philosophy, Ruth quoted Jeffrey Immelt, GE CEO, who allegedly said: 'What I love about China is that it's transparent…you don't have to guess. You just say, "What's the next five-year plan?"' And although it is just as much a myth that the Chinese government controls everything as it is that China is now an entirely free market, it is true that the government undertakes long-term, centralised five-year planning, a luxury that Western, democratically elected, governments generally do not have. Therefore, to succeed in China, businesses have to understand the central government mindset – including its approach to sustainability.

RESOURCING AND SOCIAL ISSUES

China's historical focus on economic growth was clearly reflected in previous five-year plans and the results are clear. China now has the second-largest economy in the world, overtaking Japan in 2010, and is the world's largest exporter, overtaking Germany in 2010. Conversely, it is also the world's second-largest importer, importing only slightly less than it exports. Although these imports include some luxury and consumer goods, they are primarily commodities such as iron, steel, oil and mineral fuels, as China is desperately short of the resources required to support its population's energy and other needs.

In addition, although economic growth has lifted millions out of poverty, huge social issues have also emerged, and are likely to grow, such as continued inequality; rural to urban migration, which is creating instability in family and community life; the growth in numbers of second-class citizens living informally on city perimeters; and concerns about air pollution, now a significant social and economic issue. Despite strong media controls, the internet has increased the risk of social unrest with, for example, the Chinese version of Twitter (Weiboa) becoming increasingly popular as a source of information.

China's economic growth has, therefore, been extremely successful but has also resulted in massive environmental and social issues that the Chinese government cannot ignore; sustainability in China is therefore not an option but a necessity, and recent government actions indicate that (to some extent) this is understood at the highest levels.

For example, it is now accepted that China cannot maintain such strong growth, or enable its citizens to attain a lifestyle comparable to that available in developed countries, with the limited resources it has available. China currently imports over 50% of its oil supplies, and has a per capita water supply currently only 25% of the world average (and decreasing). In addition, indoor and outdoor air pollution causes up to 1.3 million deaths per year.

TWELFTH FIVE-YEAR PLAN

Clear steps are being taken to address these issues, and even though current actions may not be far-reaching enough, and are raising acute implementation issues (especially at local government and municipality level), these steps are in the right direction and will be sustained, as demonstrated by the twelfth five-year plan, which has a clear sustainability agenda:

- priorities now include addressing social inequalities, improving environmental pollution, and dealing with resource scarcity
- economic growth is downplayed, although it remains a priority
- of the industry areas being prioritised, three are directly related to the sustainability agenda (alternative energy, clean energy vehicles, and energy conservation and environmental protection), and an additional four are highly relevant (next generation IT, including smart grids; high-tech equipment manufacturing, including LED lighting; new materials; and biotechnology).

The plan also indicates that measures such as taxation will be used to encourage industrial restructuring focused on energy and environmental conservation, including:

- consumption taxes – to suppress the overuse of limited resources
- resource taxes – to support resource conservation and environmental protection
- environmental taxes – to promote energy conservation and environmental protection, to be levied on pollutant emissions.

There is also a strong expectation that an independent tax on greenhouse gas emissions will target big consumers of coal, crude oil and natural gas. In 2011, the National Bureau of Statistics announced plans for a system to measure carbon emissions at major industrial companies, a crucial stage in the creation of pilot carbon markets and a carbon tax.

Furthermore, the China Banking and Regulatory Commission (CBRC) recently introduced 'green credit guidelines', which set out a clear framework to encourage banks to review their portfolios from a 'green' or sustainability perspective.

In terms of social policy, the social security system now encourages consumption rather than saving but also improves the social safety net for individuals, currently severely limited in China. In addition, direct encouragement to invest in inland provinces is already addressing some of the inequality and migration issues.

INVOLVEMENT IN THE CLIMATE CHANGE DEBATE

China is therefore serious about sustainability, even though it has received a significant amount of international criticism for its limited participation in the climate change debate. Ruth agreed that China's position could have been more helpful, but argued that this did not necessarily indicate a lack of commitment, but was instead evidence of China's reluctance to take a global lead on the issue, reflecting China's desire to be treated fairly vis à vis the US and other developed countries, and its greater interest in domestic rather than international issues.

China has, in fact, made bold commitments to carbon emission reductions (a 45% reduction in intensity as a proportion of GDP) yet, as this still leaves room for absolute growth in both emissions and the economy, some might argue that such commitments are not useful. From Ruth's perspective, however, these commitments indicate China's desire to balance economic growth, which translates into better lives for the population, with the need for carbon reductions.

There is also evidence of China's recognition that sustainable approaches are cost effective and make economic sense, certainly in the long term – something that many Western businesses still do not fully grasp. For example, China already has more installed wind-energy capacity, makes more solar panels, and has more high-speed train track than any other country. It is also making considerable investment into better ways of using conventional energy, though clean coal, carbon capture and storage and other, newer, technologies in the related to conventional energy generation, while also experimenting with eco-cities, carbon markets and electric vehicle schemes.

China is therefore a world leader in green technology, but despite this there is still an enormous amount to be done. Pollution remains a huge problem, whether air, water or waste (and the country is still rapidly expanding its network of coal-fired power stations), and social issues have not been adequately addressed.

For organisations working in China, sustainability issues can represent real opportunities, but these must be addressed carefully in what is often an unfamiliar environment, and any business trying to operate in an ethical and environmentally responsible way will find it very tough indeed. For example, regulatory compliance can make an organisation uncompetitive because regulations are not always equally enforced, and addressing a poor compliance culture can take a huge amount of management time and training investment. As enforcement and regulation increases so will business costs, which, along with increasing wage rates in China (good for the Chinese people) could reduce the competitiveness of companies operating in China, forcing them to move elsewhere.

Nonetheless, for those organisations that consider China carefully, look at macro-trends, put sustainability at the core of their business, and are willing to take a long-term view, China remains a source of huge opportunity.

ENSURING SUPPLY CHAIN SUSTAINABILITY

For those organisations already operating in China, however, sustainability issues are beginning to have an impact – often quite significant – on business strategies and practices employed, and the experience of New Look, the UK's second largest womenswear retailer, provides a good example of how the landscape is changing.

Mark explained that the company has a long-standing relationship with its Chinese suppliers as, to date, they have been well placed to meet the demands of a 'fast fashion' business model based on low-cost, high-speed manufacture.

New Look supplies a very large customer base: the privately owned retailer currently owns over 600 stores in the UK, and 1,000 stores globally. The company has a large factory base in China supplying 49% of New Look's products; the country offers low-cost labour – particularly important in the garment industry, which is difficult to automate and therefore very labour intensive – and a concentrated network of flexible factories offering high levels of skills in garment manufacture and an in-depth understanding of the processes involved.

In China, however, a number of sustainability issues are emerging, both environmental and political, which are beginning to affect New Look's business model. As sustainable manufacture is an important part of the New Look philosophy, these issues could also affect brand reputation and brand value, with important business consequences.

For example, the significant rise in labour costs experienced in the last six years – a staggering rise of 91% – has certainly affected New Look's margins, but this increase in the minimum wage (although not a negative trend per se) has also led to a labour shortage in the eastern regions where New Look's factories are based. As wage differentials decrease, the workforce has become less mobile and as a result more manufacturing has moved to the provinces, a shift supported by the Chinese government, which is keen to see economic success distributed more widely. From New Look's perspective, however, provincial manufacture is less well regulated and far more open to unsustainable practices, and to human rights abuses such as the use of child labour. Although macro-government policy may be laudable, implementation at the micro-level is inconsistent and often results in unacceptable standards of operation.

The rising costs of raw materials – especially cotton – are affecting garment manufacture worldwide, as is the rising cost of oil, but in China energy instability poses an additional threat. This is a growing problem in China, where east coast factories often shut down for up to two days a week, affecting both production volume and speed, in turn risking New Look's competitive advantage.

THREATS TO BRAND REPUTATION

Sustainability issues such as these have the potential to affect the New Look business model, in which margins are highly exposed to increases in wage rates, raw materials and speed of supply. In addition, if China is perceived to be an increasingly unregulated and unsustainable manufacturing base, then this has an adverse effect on brand reputation. Recently there has been increased media scrutiny of major organisations, such as Apple, and the practices employed at the Chinese factories manufacturing their products, and 'fast fashion' is now attracting similar attention.

Mark reported that focus group research shows that the issue of sustainability is important to New Look's customers, but that they want sustainable products to be supplied at the same price. It is therefore important that its buying team understands the full costs of all the sustainability issues at play in China, and where and how externalities and internalities potentially interact to compromise New Look's low margin. Working with CSR Asia, New Look is therefore mapping out these interrelationships in order to reveal where margins are most vulnerable.

CSR Asia's work with New Look has centred on two projects, the first one on developing and rolling out an environmental scorecard for social auditors to fill in when they visit supplier factories, and the second an energy efficiency guide for Chinese factories to understand how to start an energy savings programme.

Last year Tristan Edmondson, senior project manager at CSR Asia, visited some of New Look's Chinese factories to test the prototype of the energy efficiency guide. One factory owner told him that cotton costs went up by 40% in 2010, and that his supplier had said that the main reason was the coal price. Another factory owner told Tristan that electricity blackouts meant he had installed a diesel-powered electricity generator; this produced electricity at nearly twice the cost of grid electricity but he was forced to use it at least one day a week.

These problems show that New Look's suppliers need help with understanding energy efficiency, how it can benefit their business and how relatively straightforward it is to make quick and cheap savings on power bills.

Tristan explained how New Look is leading a multi-brand initiative with CSR Asia to pull together existing information on energy efficiency for the textile industry into one easy-to-use website.

While energy efficiency offers easily identified risks and opportunities for the apparel industry's supply chain, in order to make further improvements in the environmental impact of supplier factories, New Look needs to understand the current environmental capabilities and performance of each of its suppliers. Tristan explained how New Look's environmental scorecard will measure energy and water use, effluent discharge and material use, and also assess any environmental management systems in place.

This is being done to identify sustainability risks, enable environmental reporting, understand the problems factories experience, and help increase efficiency and productivity by enabling future environmental projects to be selected and planned better.

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