FOUR SHIFTS IN FINANCIAL PRACTICES TO BOOST THE CIRCULAR ECONOMY

The progress towards a circular economy is slow

The circular economy appears to be reaching a tipping point as a fast-growing number of organizations are starting to embed circular economy targets, initiatives, and strategies. Among consumer companies, the global retailer IKEA aims to be a circular business by 2030, and Unilever aims to use 100% reusable, recyclable, or compostable plastic packaging by 2025. And among cities, Amsterdam is embedding the circular economy into its policies and roadmaps.

At a national level, Scotland's national Zero Waste Scotland accelerator program fosters circular economy growth in small and medium-sized enterprises. Regional and national regulatory pressures are also coming into effect, such as the EU Circular Economy Action Plan, and more recently the UK's Critical Minerals Strategy.

However, despite these positive signals, the world is not becoming more circular. According to the 2023 Circularity Gap Report, materials cycled back into the economy after their useful life account for only 7.2% of the total in 2023, down from 8.6% in 2020. From a macro perspective, there is a long way to go regarding providing the right infrastructure, access to finance, supply chain transparency, and regulations.

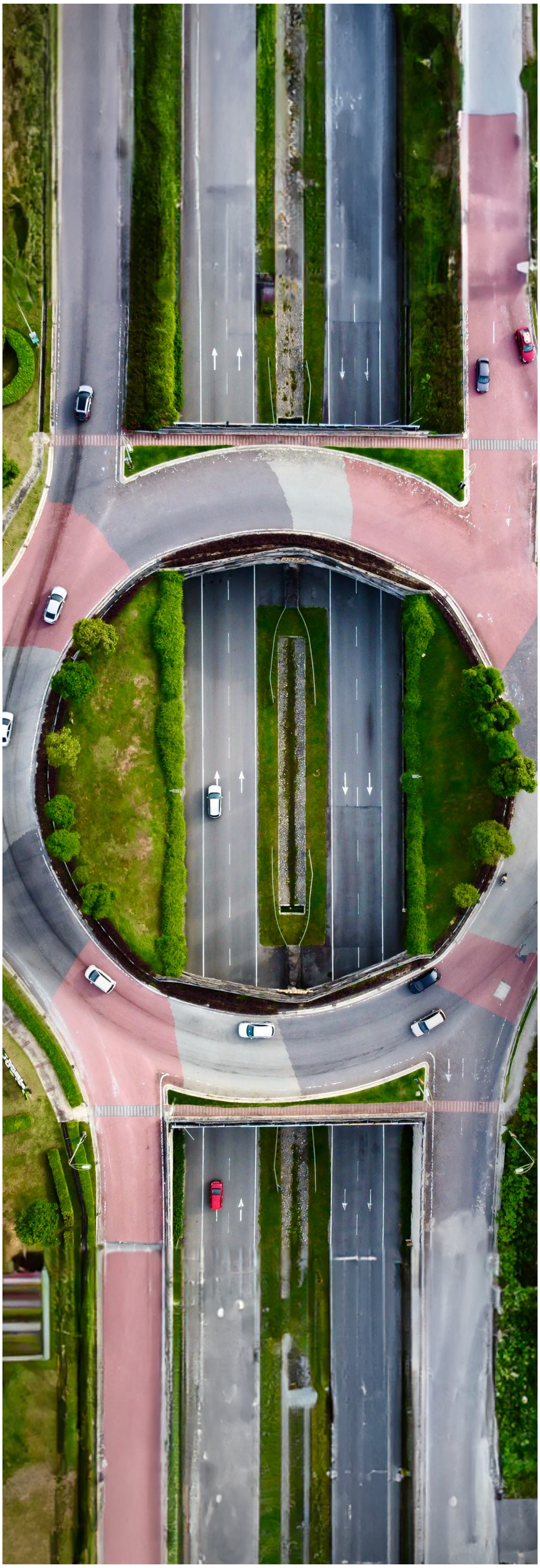
From a company perspective, despite the rise of circular economy business models, progress is slow: current management practices are not in sync with circularity, starting from financial and accounting tools and approaches. We know that systemic change does not come easily, especially when what is required is a fundamental rethink of the way that organizations do business.

The role of finance and accounting

At the heart of understanding why organizations are still struggling to launch and scale circularity is the concept of value. The current and dominant way of thinking about value is linear. All the seemingly laudable and useful practices, criteria, and metrics adopted so far have been consistent with this linear paradigm.

But the circular economy transforms the value concept. Value is created through what would have been labelled in a linear economy as waste - through circular value chains, networks, and strategies such as leasing and re-defining products as services.

Trying to gain internal buy-in and navigate gate keeping processes for circular investment is difficult when organizations are dominated by linear practices and thinking. This is especially true when significant budgets and financing is needed to support the scale-up.



If the circular economy is to move from enthusiasm to achievement, we need to shift from a theoretical debate about the strategic benefits to concrete business innovations powered by new financial models and metrics that enable people to write successful business cases - to understand and price risks, and to financially account for the transition to a nonlinear model. Updated financial tools will need to account for the complexity of a value-chain-wide transformational shift, redefining the value of resources and including multiple future scenarios. Our research and consulting experiences with pioneering companies demonstrate that a change is not only necessary, but possible.

Empowering Finance: Taking the lead with Four Key Shifts

The circular economy challenge is so complex that we are now at a point where it requires finance and accounting teams to assume a leading role. This is because these teams contribute to overall decision-making in organizations, including OpEx and CapEx budgets, assessing risks and viability associated with new business models, and typically holding large amounts of data to manage reporting and transparency. As part of this role, they will need to become innovation agents and show the rest of the organization the way to make change possible.

To make this shift more actionable, we recommend focusing on four main financially-oriented components, see Figure 1. The first two (#1and #2) would be part of any major innovative effort, but circularity makes them even more critical and urgent. The other two (#3 and #4) are strongly linked with new sustainability and circularity imperatives.

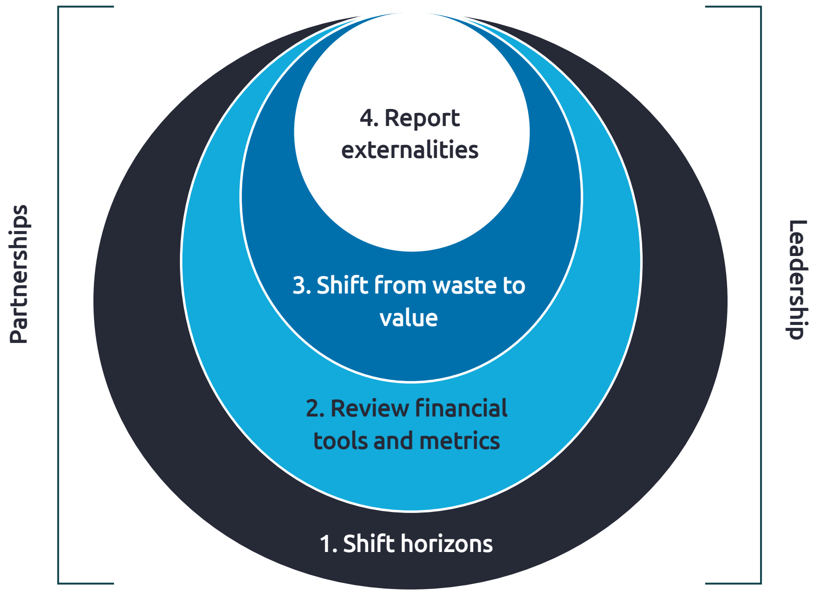


Figure 1: Four Key Shifts and two critical enablers in financial practices to boost the adoption of a circular economy

1 Shift horizons

Maximizing the use of resources and the wider benefits from a circular economy will not be visible within a financial quarter, at least not in the earlier stages. Organizations must avoid the trap of short-termism and redesign their metrics and the structure of their profit & loss (P&L) to incentivize longer-term investment.

The reality is that a short-term focus kills value-creating opportunities. While this concept is generally accepted, the corporate reality remains stubbornly locked on the short term. At Unilever, then CEO Paul Polman made a frontrunning move to simply stop quarterly reporting in 2009, making it clear where the company's focus should lie. This was a bold move for the organization and its investors, but it paved the way for the ten-year horizon of the Unilever Sustainable Living Plan and helped create a culture of long-term thinking and being purpose-driven. The results speak for themselves. After Polman's tenure, total shareholder returns equaled 292% in comparison to the 131% FTSE index.

This way of thinking can be applicable in the automotive industry. Car sharing and subscription services are key routes to promote circularity and extend vehicle use. With many OEMs shifting towards **future mobility services**, this highlights a potential new revenue opportunity too; focus on utilization and not units. So, with this logic, why has no great traction developed over the past 5–10 years?

These services often focus on new car fleets, resulting in elevated costs and unattainable prices, often neglecting sustainability and long-term value in their business models. Recently, ONTO, a UK EV subscription service, went into administration, crippled by falling residual values. This highlights one of many challenges for OEMs expanding into circular offerings and facing the risk/reward dilemma. Without a reprioritization of longer-term returns and sustainability business case, the challenges of meeting new sales volumes, using the same metrics persist.

Shifting the horizon is a precondition. Without this shift, talking about sustainability and circularity is useless, if not dangerous, as it creates cynicism.

2 Review financial tools and metrics

An abundance of research shows how traditional financial tools tend to favor linear thinking, leading to inaccuracies due to incorrect assumptions and a misguided understanding of which questions to ask.

The well-documented shortcomings of Net Present Value (NPV) and its anti-innovation bias become critical issues when circularity is taken into account. For instance, linear assumptions do not consider the uncertainty of climate-related supply chain disruptions or the overall impact on society. Indeed, they usually assume the business will continue to be viable even if the company (or the sector) does not invest in circularity and, more generally, in sustainability. This leads to inaccurate scenario planning with inadequate versions of the future.

Scenario planning and investment decisions require a deeper understanding of climate-related risks, including the price volatility of resources, supply chain and operational resilience, consumer pressure, as well as the business and social impacts of new laws and regulations.

Additionally, in a linear economy, innovation risk around a product or service is not well understood because the explanatory data is either not available or often not used in the right way. Selling a T-shirt, for example, is less complex than assessing risk and determining the Total Cost of Ownership (TCO) for clothes-sharing platforms—a common challenge observed across sectors when transitioning from ownership to service-based models.

The innovation process itself requires a revamp, with revised metrics that not only reflect the ambition of change but also the uncertainty of the future. Pilots and MVPs should be designed to learn, engage the value chain, and collect data. Trial and error must be viewed as a positive approach and a fail-fast mentality needs to prevail.

3 Shift from waste to value

In the linear economy, residual value refers to **the estimated value of a fixed asset at the end of its lease term or useful life.** Typically, producers and manufacturers generate waste that is often not redistributed or reused. This by-product, often

referred to as an undervalued resource, contradicts the principles of a circular economy when its worth is measured solely by residual value accounting. Instead of recognizing it as a valuable resource, it is unfortunately labelled as waste. According to the Coalition Circular Accounting (CCA), this financial metric **disincentives innovative approaches to maintain their value**. Instead, the CCA suggests looking at waste through the lens of 'residual resources' to change mindsets and understand the hidden value of the resources.

A four-year study by The Renewal Workshop evaluated different fashion brands' perception of waste and its lack of financial value. Across 50 product assessments, 83% of products that were classified as waste could have been renewed and resold. This highlights the potential of accounting and financial mechanisms to unlock new principles. Once organizations shift their mindset from 'it is waste' to 'it has value,' products and resources can be managed in a way that maximizes their use and reduces their negative impact on the environment.

Mature second-hand markets are a good indicator to understand the value of the resources and the price that consumers are willing to pay. Think of organizations such as the UK retailer Tesco. It launched an online marketplace that enables suppliers to sell or donate surplus stock to other manufacturers, or to commonly known platforms such as eBay, Facebook Marketplace, Vinted, and Depop. However, marketplaces still do not account for the future value of resources.

A longer-term approach to residual value would treat them as contingent assets. This is where the assets are valued on potential economic benefit, dependent on future events – for example, laws and regulation on critical materials and waste. This approach is becoming prevalent in the built environment, where tradeable future contracts are developed based on the value of building materials at the point of deconstruction. Residual value is not the only metric that can be used to valorize waste, but it can be a good starting point for businesses to understand value.

4 Report externalities

Integrating social and climate factors into accounting reporting can help organizations manage their impact and keep track of performance, identify hotspots for change, and create internal incentives to improve. As many approaches and initiatives have already been developed, the current priority is shifting towards a convergence of standards and the implementation of concrete, real-world applications. Organizations can begin to understand the wider implications and externalities they contribute to and create strategic plans to reduce impact.

A key challenge to reporting on circularity is the lack of standardized metrics or indicators. There are several frameworks – such as WBCSD Transition Indicators, IISO on Circular Economy, EU taxonomy for sustainable activities, Global Reporting Initiative's Waste Standard, the Ellen MacArthur Foundation's Circulytics, and Cradle to Cradle Certified – but each has its own purpose and methodology.

True Cost Accounting could be a promising new approach: it considers the holistic costs associated with the full life of a product or service. For example, the true cost of a wooden table would include not only the direct costs like raw materials and labour but also the future cost associated with the tree not sequestering carbon for its lifetime. While some experiments of true cost accounting are found in the food and agriculture sector, there is still a general lack of data and of an established framework and consensus on principles.

A more mature approach is the Integrated Profit & Loss (IP&L) method developed by the Impact Institute, which supports organizations in understanding their impact beyond financial profit and loss and takes into account value generated for all stakeholders (clients, organization, society, investors). Negative impacts are estimated by referring to the costs of restoration or compensation. Gaining momentum, in 2019, ABN Amro became the first bank to publish an impact statement based on this framework.

Empowering Finance: The importance of Partnerships and Leadership as enablers

Partnerships and collaboration are crucial to achieving a true circular economy, given the interdependence of supply chains across a variety of organizations. David Monciardini, a Senior Lecturer at the University of Exeter in the UK, says "The conventional approach to accounting practices remains limited to the boundaries of legally constituted entities, and this is a major challenge for Sustainability Circular Economy accounting".

Systemic transitions towards sustainable and circular ecosystems require networked collaboration across multiple stakeholders, including private firms, consumer-citizens, public-sector organizations, and social enterprises. However, this interdependence of actions, resulting from lateral information flows and networked collaborations, is problematic in terms of traditional financial planning, budgeting, and performance evaluation practices. What is needed is an understanding of effective inter-organizational cooperation, including cost management across organizations, supply chains, and supplier selection practices.

Given the immaturity of the circular economy transition at a systemic level, courageous leaders need to take the lead and involve other leaders both within and outside their organizations. Think of the likes of Yvon Chouinard from Patagonia, Ray Anderson at Interface, and Paul Polman at Unilever.

A call to action

Companies that really want to 'walk the talk' on sustainability and circularity should significantly review their systems, practices, and metrics. Finance and accounting teams are the lubricant oil that can unlock the mechanics to enable the business case for circular business models, through the right metrics and financial mechanisms.

Organizations must not be afraid to experiment and learn in their circular innovation initiatives.

Without the know-how to develop a circular business case, companies must start with making innovative incremental changes, pilots, and MVPs, to collate data and learn from successes and failures. On the back of those learnings, they will be able to innovate under new principles and develop business case models that are uniquely aligned to their product or service.

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