**MANAGEMENT ACCOUNTING CONCEPTS AND TECHNIQUES**

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**CHAPTER 24: Corporate Social Responsibility**

***“But you were always a good man of business, Jacob,”* faltered Scrooge….**

***“Business!”* cried the Ghost, wringing its hands again. *“Mankind was my business. The common welfare was my business; charity, mercy, forbearance, and benevolence, were, all, my business. The dealings of my trade were but a drop of water in the comprehensive ocean of my business!”***

**- Charles Dickens, *A Christmas Carol***

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**Introduction:**

Most of us balance multiple objectives. Probably, you are attempting to balance your efforts across two or more classes this term, in order to earn good grades in all of them. You are probably also balancing your accomplishments in school with other obligations and goals related to work, hobbies, your involvement with charities, and your relationships with friends and family. There is no “summary measure” or “overall grade” of your success in balancing these multiple objectives and goals, all of which compete for your time and effort.

Similarly, most government programs and organizations balance multiple objectives. City governments allocate scarce resources across diverse activities such as public safety, street maintenance, and public libraries. How does the citizenry choose between two more police officers or a new children’s wing for the library? How does one develop a single measure to evaluate the city’s overall success in meeting its goals?

Public schools have a goal not to leave any student behind. Schools also have goals to provide challenging opportunities for the very brightest students, and to provide extracurricular activities for all students. Schools must allocate limited resources across these sometimes-competing objectives.

The National Forest Service attempts to balance the economic needs of local communities and timber-dependent industries with the goal of conservation and with the goal of providing outdoor-enthusiasts recreational opportunities on public lands. These goals are so disparate that almost nobody thinks the Forest Service does a good job. The National Park Service has a comparatively easier time: it only balances the two competing objectives of conservation and recreational opportunities. Even so, the Park Service faces controversial decisions such as closing roads to private vehicles in some of the most popular and congested parks, and balancing different types of recreational activities.

**The Objectives of Business Organizations:**

Given that all individuals, and most not-for-profit and governmental organizations must balance competing objectives, it is interesting to observe that both in practice and in theory, businesses have often focused on a single objective. That objective is to maximize economic returns to owners.

For example, a popular microeconomics textbook tells students:

***… When we model the behavior of firms, we will want to describe the objective as profit maximization and the constraints as technological constraints and market constraints.***

***- Hal Varian,* Microeconomic Analysis *(1984)***

And a widely-used textbook in corporate finance states:

***Success is usually judged by value: Shareholders are made better off by any decision which increases the value of their stake in the firm.”***

***- Brealey and Myers,* Principles of Corporate Finance *(1988)***

Examples from practice can be drawn from corporate mission statements available on company websites. For example, the athletic footwear company Nike has established the following mission:

***Nike’s corporate responsibility (CR) mission is simple and straightforward. It is clear acknowledgement that CR work should not be separate from the business – but should instead be fully integrated into it. Our CR mission:***

***- We must help the company achieve profitable and sustainable growth.***

***- We must protect and enhance the brand and company.***

***- Nike (2005)***

Although generously-worded, and sprinkled with friendly words like “corporate responsibility” and “sustainable growth,” there is really nothing in this mission statement that implies the company has any other objective than to maximize long-run profits to shareholders.

The mission statement for pharmaceutical company Pfizer states:

***We will become the world's most valued company to patients, customers, colleagues, investors, business partners, and the communities where we work and live.***

***- Pfizer (2005)***

Does Pfizer have a business philosophy that would ever place the interests of the community above the interests of investors? If the CEO is meeting with local community leaders, he or she can point to this mission statement and imply so, but if the CEO is meeting with stock analysts and investment bankers, there is no need to interpret this mission statement that way.

If you work forty or more hours a week for an organization that does not have, as one of its ultimate goals, the objective of providing its employees with a challenging, rewarding, safe, and fair work environment, but only attempts to satisfy these objectives as an intermediate step in its efforts to maximize shareholder wealth (while complying with labor laws and maintaining acceptably-low levels of employee turnover), then your own ability to achieve your personal goals will be all that more difficult. Perhaps this fact helps explain the popularity of small, entrepreneurial forms of business; a proprietor or partner in a small company can strive to achieve non-economic goals as well as economic goals within the framework of his or her business.

Similarly, if companies do not have, as a goal, the objective of minimizing pollution, but only minimize pollution to the extent necessary to comply with environmental laws and maintain a favorable public image, then a society committed to achieving and preserving a clean environment will find attaining that objective more difficult. For example, it is possible that the costs incurred by society from major oil spills—the cleanup costs and the costs of long-term damage to the environment—are greater, in total, than the costs of additional steps to prevent oil spills in the first place. Even if double-hull oil tankers are not cost-effective from the oil company’s perspective, they may be cost-effective from a societal point of view.

Given that we as a society, and all of us as individuals, have non-economic objectives as well as economic objectives, and given the enormous volume of activity that occurs within for-profit businesses—the human capital, energy, creativity, and material resources invested in business—one might ask whether businesses should focus only on the goal of maximizing shareholder wealth. Are we as a society better off operating in an economy in which the sole objective of corporate America is to maximize the economic resources of owners, and owners then use those resources to achieve their economic and non-economic goals; or would we be better off in an economy in which companies, as well as governments, not-for-profit organizations, and individuals, contribute directly and deliberately to the non-economic objectives of our society? To choose the second scenario is to ask companies to assume multiple objectives, and to ask management to balance resources across those objectives in a manner, and to an extent, that goes beyond the traditional role that owners have assigned to corporate managers.

The question of whether companies have a single objective to maximize economic returns to shareholders, or multiple economic and non-economic objectives, significantly affects the standards of corporate social responsibility by which managers should be judged. At a minimum, if managers are ultimately responsible only for maximizing shareholder wealth, society nevertheless requires managers to comply with laws and regulations, and to meet standards of business ethics related to honesty, integrity, and fair-play. On the other hand, if companies have, as ultimate goals, social and environmental goals, then standards of corporate social responsibility might include the conduct of managers towards achieving these goals.

**Sustainability:**

There is increasing concern by government leaders, policymakers and the public over the accelerated rate at which natural resources are being depleted, and the associated environmental degradation. As a result, many businesses and business leaders have recognized “sustainability” as a worthwhile goal: companies should strive to conduct business in a sustainable manner. However, there is no widely-accepted definition of sustainability. In 1987, the World Commission on Environment and Development (commonly called the Brundtland Commission) defined sustainability as follows:

***Sustainable development “meets the needs of the present without compromising the ability of future generations to meet their own needs.”***

This definition has been adopted by many organizations, but does not provide guidance on how to make these intergenerational trade-offs. A slightly different view was recently expressed by former Soviet leader Mikhail Gorbachev:

***We desperately need to … adopt a new paradigm for development, based on the costs and benefits to all people, and bound by the limits of nature herself rather than the limits of technology and consumerism.***

Can we expect the profit motive to induce companies to adopt sustainable business practices? Does economic theory, and do observed business practices, suggest that the goal of maximizing long-run profits is consistent with the goal of sustainability? If timber companies harvest all of the forests under their control, without replanting, their subsequent profits from timber sales presumably will be zero, so the companies would appear to have economic incentives to harvest forests responsibly, and to replant. Companies, unlike individuals, have indefinite lives, so they might be more motivated than individuals to make long-term investments in the environment, if those investments also offer long-term economic returns.

Unfortunately, neither observed business practices nor theory provide strong support for this line of reasoning. Many industries in both renewable and nonrenewable resources, such as oil and timber, are depleting these resources at alarming rates.

Finance theory postulates that companies should maximize the present value of future free cash flows. With appropriate assumptions, free cash flows over the life of the company equal the sum of earnings over the life of the company, so that accounting theory postulates that companies should maximize current and future profits. Does this theory predict that companies will use resources in a sustainable manner?

Consider an oil company with oil reserves that can last 100 years at a given level of production. Assume a discount rate of 8% (see Chapter 19 for an explanation of discount rates). Assume, for simplicity, that the company anticipates zero inflation and a constant sales price for oil. How important are the resources available to the company during the last 50 years of this 100-year period, to the value (and the stock price) of the company today? The answer is: not very important. Consider an even more extreme question. How important are the resources available to the company during the last 80 years of this 100-year period? The answer is that because of the 8% discount rate, approximately 80% of the value of the company today derives from oil sales over the first twenty years. Only 20% of the value of the company derives from the last 80 years. Can we expect wise stewardship of the resources controlled by this company, when the company’s actions to ensure the availability of these resources more than twenty years into the future have such a minimal impact on the company’s stock price today?

**Corporate Social Responsibility and Negative Externalities:**

Another reason that market mechanisms are unable to consistently induce companies to engage in sustainable business practices arises from what economists call negative externalities. When the actions of a company impose costs on third parties, the economic terminology is that a **negative externality** exists. For example, if a company discharges pollution into a river, then there is a negative externality that constitutes a cost to people who live downstream. If the company can pollute the river without violating environmental laws or incurring negative publicity that ultimately affects sales, then this negative externality can be difficult to remedy.

Despite numerous laws and regulations designed to limit the costs imposed by negative externalities, they are pervasive. Examples today include cruise ships that dump sewage into coastal waters, and the economically-motivated introduction of invasive foreign plants and animals that then displace or destroy native species, harming the people and industries that appreciated or depended on them.

One type of externality is called the tragedy of the commons. The term literally refers to overgrazing of common lands that can occur in an agricultural community, because each family realizes that if they limit the opportunity for their animals to graze on the commons—which would be the socially-responsible behavior—they would make themselves worse off in the short-run without improving their situation in the long-run, because acting alone, one family does not materially affect the health of the pasture. Similarly, companies in many industries today take advantage of public goods that are subject to the tragedy of the commons. The most poignant examples relate to resources that cannot be owned by one company or country, such as the oceans and atmosphere. For example, ocean fish populations for some species no longer support commercial fishing: depletion of these fish populations constitute both an environmental tragedy and an economic tragedy for small fishing communities.

Limited attempts have been made to use the efficiency of the marketplace to limit the costs imposed by negative externalities. For example, governments have experimented with pollution credits for certain types of emissions. Because companies can buy and sell these credits, they have incentives to reduce emissions without being subject to blanket emission-caps that might not make sense for a particular company and community. Such attempts do not represent a move away from the single-objective, profit-maximizing framework of our economy, but rather constitute efforts to use regulation to induce for-profit companies to internalize part of the cost of negative externalities.

**Social Responsibility as a Means to an End:**

Some argue that when companies fail to operate in a sustainable manner, when they impose negative externalities on society, and when they otherwise fail to act in socially-responsible ways, the resulting negative publicity will eventually translate into decreased sales and profits. Hence, the profit motive is all that is needed to align corporate objectives with society’s non-economic goals. Historically, there are a few instances in which this chain of events has perhaps occurred. Arguably, the divestiture by some pension funds and other investors in the stock of companies that conducted business in South Africa helped end apartheid. Most people agree that the grape boycott led by Cesar Chavez led to long-term improvements in the lives of Hispanic and Mexican migrant workers.

However, such examples are rare and usually involve particularly emotional issues and charismatic leaders. According to Harvard BusinessSchool management professor Lynn Sharp Paine:

***It strains credulity to suggest that Nike would have benefited financially from requiring its suppliers to meet higher standards at the inception of its then-novel overseas manufacturing program in the 1960s. Insistence on adult workers (no children), safe working conditions, and reasonable hours and pay would have cost Nike real dollars and cents. Prior to the 1990’s, when workers and consumers in industrialized countries awakened to the conditions of workers overseas, it would have been difficult to cite even minimal reputational benefits from such a stance.***

Neither an overview of business history, nor current events, seems to support the idea that the free-market mechanism is a general remedy for all of the ills that the conduct of business, in its pursuit of profits, imposes on society, even if we could agree on what those ills are. Most of us would like to see locally-owned, “Main Street” businesses thrive, yet we shop at the mall and at Wal-Mart for price and selection. When we travel, we eat at McDonalds’ instead of the local diner, because we know what to expect from the fast-food chain restaurants in terms of quality and cleanliness. Many of us would prefer to buy eggs laid by free-range chickens, if we gave the matter any thought, but we won’t pay an extra fifty cents a dozen. Most of us oppose child-labor, and no doubt, we all oppose child slave labor, but many of us won’t pay an extra dollar for a candy bar made with fair-trade chocolate, which is the only way today to ensure that the chocolate was not harvested by children under forced-labor conditions.

On the other hand, there are alternative views, and in any case, the future might not resemble the past. For example, Oekom, a German company that grades companies based on environmental and social performance, conducted a joint study with the investment banking firm of Morgan Stanley. The study found a positive correlation between financial performance and sustainable business practices. According to Markus Knisel, director of Morgan Stanley Private Wealth Management, “The positive correlation between sustainability and financial performance will provide an enormous boost to the sustainable investment sector.” Hence, it is possible that market mechanisms do encourage sustainable business practices, and will be more effective in doing so in the future.

**Social Responsibility as an End in Itself:**

Some argue that a more effective and efficient framework for our economy and society would be for corporate management to internalize the non-economic objectives that the owners themselves share. Finding the common denominator of values and non-economic objectives across hundreds or even tens-of-thousands of owners is difficult. However, it is not impossible, as demonstrated by the success over the past two decades of such diverse products as mutual funds, credit cards, and long-distance telephone companies that target financial support for particular social or environmental goals.

Such a philosophy of business involves the expectation by shareholders that corporate managers will consider environmental and social factors in their decisions, as well as economic factors, and will consider these factors above and beyond what is required by law or would result in negative publicity that ultimately hurts profits. In fact, shareholders might accept lower economic returns in exchange for corporate behavior that aligns with their personal values. How much lower? Probably not much; but if it is any amount at all, then management must abandon the appealing simplicity of a single-minded focus on economic profits, and address multiple objectives in a meaningful way.

**Non-Economic Goals and Management Accounting:**

Regardless of whether one believes that companies should adopt non-economic goals as well as profit maximization as ultimate goals, or whether one believes that the profit motive is sufficient to encourage companies to act in socially and environmentally responsible ways, there is an important role for management accounting. Specifically, shareholders, potential shareholders, and customers must have access to the information that enables them to make investment and purchase decisions consistent with their values.

Traditional accounting and financial reporting systems were not designed to collect and report information about social and environmental performance, in part because many of these measures are non-monetary, and accounting systems traditionally relied on the monetary-unit as the common denominator in which to measure economic activities and transactions. Two relatively recent innovations in management accounting and corporate reporting that provide a framework for companies to formally incorporate nonfinancial objectives into management decision-making and corporate reporting are the **balanced scorecard** and the **triple-bottom-line**.

**The Balanced Scorecard:**

The balanced scorecard is a performance measurement tool and a performance management system created in the early 1990s by Robert Kaplan and David Norton. The balanced scorecard emphasizes traditional financial measures, but also adds nonfinancial measures. An important motivation for adding these nonfinancial measures is the observation that many financial measures are backward-looking, while many important forward-looking measures of performance are nonfinancial. In part, the balanced scorecard seems to have been a response to what was perceived as an inordinate preoccupation by analysts and shareholders on quarterly earnings announcements, which reflect very short-term past performance, and are not necessarily a strong predictor of long-term future performance.

The four original components of the balanced scorecard were

1. The learning and growth perspective

2. The internal business process perspective

3. The customer perspective

4. The financial perspective

Sometimes, sustainability is added as an additional perspective. Each of these perspectives has performance measures associated with it, and these performance measures are tailored for the specific circumstances of the company implementing the scorecard. An important advantage of the balanced scorecard is that it explicitly acknowledges the fact that companies have multiple stakeholders: investors, creditors, customers, and employees.

The popularity of the balanced scorecard is illustrated by the results of a recent survey of 100 large U.S. companies. The survey found that 60% of these companies use some variation of the balanced scorecard. Among companies using the balanced scorecard, 80% of the companies are either using the scorecard or planning to use it for incentive compensation purposes.

The use of the balanced scorecard does not imply that the company is compromising its focus on economic profits, or that the company has identified multiple objectives as ultimate goals. In fact, the survey referenced above found that among companies using the balanced scorecard, on average, financial measures are given 55% of the total weight in the scorecard, and the remaining 45% is shared by all of the other elements of the scorecard combined. Hence, financial measures still predominate. Many companies adopt the balanced scorecard because management believes that superior performance along the nonfinancial components of the scorecard will improve long-run financial performance.

**The Triple-Bottom-Line:**

The balanced scorecard is a management tool. By contrast, the triple-bottom-line is an external reporting tool designed for shareholders and other financial statement users. The triple-bottom-line reports periodic (quarterly or annual) information about the company’s performance along environmental and social dimensions, as well as the usual information about the company’s economic performance. Reporting under the triple-bottom-line is divided into three components:

1. **Economic performance** reports traditional measures of financial performance, and possibly additional statistics related to economic performance such as product market share or information about new product development.

2. **Social performance** reports measures of performance related to employee welfare, such as employee injury rates, training programs, and hiring and retention statistics. This category also reports other social performance measures such as charitable contributions, and the company’s activities in shaping local, national and international public policy.

3. **Environmental performance** reports the impact of the company’s products, services and processes on the environment. This component of the triple-bottom-line might report on the release of pollutants into the air and public waters, the utilization of renewable and nonrenewable natural resources, and the company’s stewardship of natural resources on company-owned or company-controlled lands.

There are no “Generally Accepted Accounting Principles” for reporting under the triple-bottom-line. However, the Global Reporting Initiative (GRI), sponsored by the United Nations Environment Program, has emerged as a prominent source of guidance for triple-bottom-line reporting. According to GRI, over 500 organizations worldwide follow its reporting guidelines. An alternative framework that is widely used for reporting on environmental performance is ISO 14000, established by the Organization de Standards International. This organization is a management practice standard-setting body founded in Amsterdam in 1947. ISO establishes standards for a variety of products and production processes, and compliance with ISO is a contractual requirement by some corporate customers.

The triple-bottom-line is gaining momentum in some other nations more quickly than in the United States.

**Conclusion:**

Reporting on sustainability is no more synonymous with engaging in activities that promote sustainability than reporting on economic profitability is synonymous with being profitable. However, in the current U.S. regulatory environment, companies are required to report on economic performance in accordance with Generally Accepted Accounting Principles, whether they have good news to tell or bad. By contrast, reporting to shareholders and to the public on environmental and social performance is generally voluntary in the U.S. and in most other nations. Hence, we would expect that company managers that choose to report this information believe it will be viewed favorably by financial statement users. Companies that engage in activities that promote environmental and social performance goals are the companies most likely to report these activities using the triple-bottom-line or some similar reporting framework. Companies that do not engage in these activities, or engage in them minimally, probably will not report under the triple-bottom-line.

Consequently, investors and consumers that wish to make investment and purchase decisions based, in part, on companies’ environmental and social performance are hampered by the lack of universal reporting (not all public companies report this information) and by the lack of uniform reporting (among companies that report this information, they do not report the information using the same criteria in the same way). Another component in the reporting framework that is present for financial data, but generally absent for environmental and social reporting, is third-party attestation. Financial statements are audited by public accountants, and financial statement users can place more reliance on the accuracy of that information because of the independent auditor’s third-party verification role. No such audit requirement exists for information that U.S.companies report voluntarily about environmental and social performance.

Hence, whether one believes that the profit-motive and reputational effects are sufficient to induce companies to engage in responsible environmental and social behavior, or one believes that companies should include environmental and social goals as ultimate objectives along with traditional economic objectives, it would seem that the following elements are essential—but currently absent—for either mechanism to work effectively: First, the regulatory reporting regime should require that environmental and social performance information be reported to investors and consumers using commonly-accepted criteria. Second, the information should be audited, to enhance the credibility of this information with financial statement users.

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