CORPORATE ACCOUNTABILITY IN THE CONTEXT OF SUSTAINABILITY – A Conceptual Framework

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Abstract

The purpose of this paper is to integrate the context of sustainability in a framework for greater corporate accountability. The current framework for corporate accountability is failing the environment, society and business. This paper aims to show that current accountability frameworks force companies to focus on a narrow source for value creation based on imperfect economic theories, inadequate response to societal issues and misleading measurement systems. The current conceptual accountability frameworks are dramatically inadequate in the context of escalating sustainability issues and needs of both society and business. The business responses, through Corporate Social Responsibility (CSR) initiatives, are only a poor attempt to address the fundamental sustainable development challenges. The main contribution of this paper toward theory development is in demonstrating that meaningful corporate accountability framework in the context of sustainability can connect social progress to the economic value of the firm’s strategy. The recent proposal for Creating Shared Value (CSV) moves this debate in the right direction; it lacks, however, a specific framework to measure shared value creation. By re-defining corporate value in the context of sustainability through the conceptual framework of a balance sheet, this article proposes to show that a new accountability framework provides strong ethical incentives for corporate accountability. This paper proposes a direct valuation and formal accounting of externalities on the corporate balance sheet, with an offsetting appraisal of the social licence to operate for the corporation, thus creating a meaningful and integrated basis for accountability.

Keywords

Corporate Accountability, Externalities, Sustainability, Corporate Social Responsibility (CSR), Creating Shared Value (CSV), Balance Sheet
1. Introduction

The objective of this article is to review the literature and provide support for a framework for corporate accountability in the context of sustainable use of all resources within a market economy. Current accountability frameworks do not hold companies accountable for environmental, social and human externalities of their activities. As a result many companies are unaware of new sources of value and, consequently, are sub-optimising both the economic value of the firm and value to society. This article intends to establish a theoretical basis in literature for a new corporate accountability framework.

The three main areas of research that are relevant to the above thesis are sustainability, corporate accountability and corporate valuation. This review is narrowed down to the literature that is directly relevant to the topic of corporate accountability and valuation of externalities. Economic theory and social accounting literature provides information on the conceptualisation and valuation of externalities. Corporate Social Responsibility (CSR) literature is reviewed to provide a broad definition of corporate accountability.

The remaining section of this paper is a review of the literature on definitions and conceptualisation of accountability and externalities both in the economic and CSR literature. This is followed by a discussion of the literature to re-define corporate accountability in the context of sustainability challenge and show why a minimum standard for corporate accountability must include valuation and formal accounting of externalities. Concluding comments, limitations and future research are noted in the final section.

2. Corporate Accountability – a lack of definition

While the concept of accountability is widely used in business and sustainability reporting there is a need for clear definition. A key challenge discussing the literature on corporate accountability is the apparent lack of agreement on the definition of accountability (Cooper and Owen, 2007). Gray et al., (1996) provide the most direct definition of accountability as “the duty to provide an account (by no means necessarily a financial account) or reckoning of those actions for which one is held responsible”. Cooper and Owen, (2007) add to this
definition a normative standpoint, by including a requirement for “purposeful communicative action” and “empowerment, in terms of facilitating action” by stakeholders. In recent years, there seems to be an increasing convergence of corporate governance and sustainability reporting which is enhancing accountability (Kolk, 2008). In a framework for human rights Ruggie (2008) calls for ‘positive duty of due diligence’ on companies in their discharging of their responsibility. It is essential that a more clear definition of corporate accountability is established, one that is grounded in the sustainability context and facilitate collaborative action.

3. Externalities and Accountability - early economics and how we got started on the wrong foot

This section discusses the literature on the importance of externalities to both corporate value and social progress. Externality is an important ontological economic concept that is pervasive in everyday individual relationships however; it has managed to elude proper accountability. Early economic theory focused on explaining the role of governments, markets and human behaviour. These explanations were positivist, focused on rational choice, individual liberty and the innovation potential of the individual. At the firm level, theories focus on efficient resource allocation and, through the mechanism of market price, lead to optimum results at all levels; individuals maximise utility, firms maximise profits, markets achieve clearing prices and society achieves maximum welfare. This is the mathematical result of perfect competition and the theory of general equilibrium. To achieve such an appealing model, the early economist assumed away scarcity and the limitations of nature’s resources. This simplifying assumption in hindsight is the beginning of our problems. This model meant that there is no limit to growth; markets priced all important resources; firms optimised profits and, at the same time, maximised social welfare while the individual had a limitless choice to pursue personal well being.

Lagueux (2010) provides an interesting account of externalities over the history of economic literature, characterising externalities as a “residual” concept relative to the market. Externalities, which this article aims at highlighting, hold the key to corporate legitimacy and sustainability, were reduced to a semicolon (;) (Scitovsky, 1954 as cited in Lagueux, 2010) and referred to as factors to the “right of the semicolon” in the economic production function (Mishan, 1965 as cited in Lagueux, 2010). A very different emphasis is placed on externalities by Buchanan with his work starting in the early 1950’s. To Buchanan
externalities were the main subject of economic studies and not just a market failure of no consequence that can be ignored. During the neo-classical period, the focus shifts from perfect competition to Laissez-faire (Freidman, 1970). Externalities were not seen as signals of market failure but as part of the normal market operations. Coase’s (1960) seminal contribution to explain “why the firm and not the market” in terms of transaction costs was later conceptualised to show that, at zero transaction costs, markets would find the optimal allocation of resources and that there were no externalities that a fully developed market could not internalise (Marciano, 2011).

The conceptualisation of externalities by Heal (2005) is a most useful one; indeed, in one of his remarkable papers, he presents a very clear exposition of the importance of the “resource-allocation role for CSR.” The contribution of this paper is that externalities are conceptualised and applied in a different way to most other studies. Heal’s focus on externalities as social cost has allowed him to see externalities and market failures as a source of value. This new conceptualisation of externalities does not need to explain away the impact of externalities but brings it to the centre of business strategy and value creation. Heal (2005) also calls for CSR initiatives to deal with distributive justice issues related to exploitation of workers mostly noted in the extended global supply chains of multinational corporations. It is about time that the business world puts to practice the management mantra of “people are our greatest asset.” Strategically, the value of people is well recognised in concepts such as key core competencies (Prahalad and Hamel, 1990); this concept is true for a very large number of companies and becoming increasingly important. To date, this ‘asset’ has not been recognised and recorded on any corporate balance sheet within the standard accounting framework. This fact cannot be explained by lack of agreed accounting standards, it also represents a serious failure of strategic management to not recognise a true source of value creation. With this failure to recognise strategic value of employees, social exploitation continues both of the disfranchised workers and the talent pool that has the most potential to create future value.

Externalities are the main source of most of the intense conflict between business and society (Heal, 2005). The implicit driver for corporations to act responsibly, as summarised by Heal is that there is an implicit contract: “society accepts the legal status quo provided that the corporation does not exploit it to society’s disadvantage” (Heal, 2005). In recent times, this contract seems to have been disregarded in most countries as a result of the increased economic power of the corporations and the hollowing of the state’s authority and power over
economic activities. The result is that corporations have been able to extend the boundaries of this social contract, together with the corresponding increase in social costs, with no corresponding increase in private cost to the firm, thus resulting in higher levels of private profit at the expense of society.

There is wide agreement with Heal’s views that CSR initiatives could have an important role to play, “as substituting for missing markets, if we see external effects as arising from missing markets or as taking what Friedman sees as the government’s place in addressing external effects and distributional issues” (Heal, 2005). However, other scholars have argued that the firm does not have the legitimacy (Freidman, 1970; Vilanova et al., 2009; Jensen, 2010) to undertake some of these roles. Another view in the literature is that the bounded rationality of the financial markets is predetermined to exclude any considerations of externalities. This is the ‘dominant logic’ argument put forward by Amaeshi (2010) on the financial market. Amaeshi challenges the view that corporate social governance and financial management share the ‘same underpinning logic’, which is commonly assumed in the literature.

4. Emerging limitations of CSR – failure of corporate accountability

This section of the literature review maps the vast and growing literature on CSR, with a particular focus on corporate accountability, its conceptual framework, attributes important to its successful implementation, and recent proposals in the literature to refine corporate accountability frameworks. Corporate social responsibility can be seen as a business response to businesses’ failure to account for externalities (Heal, 2005). This view is further explored in the context of the key theoretical basis for CSR.

Shareholder theory provides a standard account of the nature, purpose and responsibilities of business. In this respect, business is seen as accountable to the shareholders for maximising profits and returns to shareholders at the exclusion of all others. It defines the primary duty of a corporate executive as maximising shareholder wealth. This is the basis of legitimacy and accountability to the shareholder. Corporate responsibility of the business and its executives, in this view, is limited to obeying the law, not engaging in fraud or deception and pursuing open and free competition (Friedman, 1970; Jensen, 2002, 2010; Cosans, 2009). These views can be seen as a normative statement of corporate behaviour. In this view, externalities cannot exist, as “good citizens”, being also “good business professionals”, are “sensitive to
the duties, desires, and understanding of the others’ perspective” (Cosans, 2009). This definition of the good citizen, or that of the perfect market or the perfect government, has never been a reality and is not likely to be a reality on which we can build a society. As such shareholder theory has only a limited appeal as a useful basis for CSR, particularly in respect to broader corporate accountability.

Stakeholder theory provides an alternative view on corporate governance and business ethics. Stakeholder theory informs us that managers should take account of the interests of all the stakeholders in a firm when making decisions. Stakeholders include all individuals or groups who can substantially affect, or be affected by, the welfare of the firm. This definition of stakeholders includes not only the financial claimholders, but also employees, customers, communities, and governments. CSR and business ethics literature is richly covered with many different notions of this idea (Freeman, 1984; Clarkson, 1995; Donaldson and Preston, 1995; Mitchell, 1997; Freeman et al., 2004; Bradley, et al., 2008).

Following the initial debate in the literature between shareholder and stakeholder theory, there has been a number of attempts to refine and elaborate both these major theories. Carroll (1979) triggered this debate by defining CSR as a hierarchal framework, with economic responsibility at the base of the pyramid and, for the first time, the explicit requirement of ethical behaviour standing above the economic and legal ones. Following Castello and Lazano (2011), the domain of CSR research can be categorised into a number of themes that have advanced this debate, including social performance (Carroll, 1979); social contract (Freeman, 1984; Donaldson and Preston 1995); accountability (Elkington, 1999; Valor, 2005), corporate governance (Freeman et al., 2004), business ethics (Solomon, 1993), corporate citizenship (Waddock, 2001; Zadek, 2006), and bottom of the pyramid concept (Prahalad and Hammond, 2002).

According to the literature, there are four important motivational factors for CSR initiatives, namely, business case (Freeman, 1984; Money and Schepers, 2007, Eccles et al., 2011), strategic (Vilanova et al., 2009), legitimacy (Mathews, 2000), and business ethics (Donaldson and Preston, 1995; Carroll, 1999). Eccles et al., (2011) presents a strong case of CSR. In this longitudinal study which has an innovative research design to counteract common issues of causality provides “evidence that companies in the High Sustainability group are able to significantly outperform their counterparts in the Low Sustainability group” (Eccles et al., 2011, p. 30). From the literature review, it is clear that a lot of effort has been expended into
creating a clear ex ante business case for CSR initiatives based on the benefits for such actions; however, businesses have not widely accepted these justifications while, where businesses have implemented CSR programs, the stakeholders and civil society seem not to be satisfied. It seems that attempts to address sustainability challenge through the short-cut of CSR initiatives have failed both the society and business. The problem remains in finding a common goal for companies to expend private resources for public benefits.

5. Accountability for Externalities – a measure of shared value creation

A recent paper by Orts and Strudler (2010) is very critical of stakeholder theory and calls for research in business ethics to move “beyond stakeholders”. This adds to the chorus of critical voices from scholars demanding a more considered effort to meet our sustainability challenges (Zadek, 1998; Mathews 2000, 2008; Gray, 2006, 2007; Hahn and Figge, 2011). In addition, a number of multi-stakeholder professional organisations and practitioners have been engaged in refining the CSR reporting frameworks (GRI, IIRC, TEEB, and Tomorrow’s Company).

Meyer and Kirby (2010) specifically call for corporate accountability for externalities. This is an important departure from the traditional view of externalities seen as a problem to be minimised to an opportunity to learn from and create value. Meyer and Kirby (2010), note that companies have long prospered by ignoring externalities and now they must learn to embrace them. The authors argue that, as a result of changes in the scale of operations and the resulting impact of corporate activities on social and environmental amenities, the rapidly advancing innovation in technology to measure this impact and the elevated “sensibility” of environmental and social issues mean that corporate accountability of externalities is “unavoidable” (Meyer and Kirby, 2010). The contribution of this paper is the call for direct action by business to “take ownership” of externalities that are part of the core business and can be directly measured. This is similar to the conceptualisation, within the creating shared value framework, of opportunities within the supply chain (Porter and Kramer 2011). A second area of opportunity for the company to contribute to society while addressing the external cost, exists wherever there is an indirect spill-over impact that the company has “particular problem solving competences” (Meyer and Kirby, 2010). This is also similar to the opportunities identified by the CSV framework for new products and markets (Porter and
Kramer 2011). In the interest of positive engagement, the company is also encouraged to manage the most “distant ripple effects”, where the company does not have any “special competence to ameliorate” the negative effect of externalities by directing the company’s “efforts through trusted channels” (Meyer and Kirby, 2010). Again, this is supported by the CSV framework with a call to create “clusters” of expertise (Porter and Kramer, 2011).

The calls from Meyer and Kirby (2010) and Porter and Kramer (2011) are similar to earlier calls from Margolis and Walsh (2003) for creative ways to allow allocation of control and resources which enables the firm to engage in providing solution to ‘social ill’ and realising the benefits while managing the risks of such social engagement. The potential responses from the company include “make, buy, and hybrid arrangements” (Margolis and Walsh, 2003, p. 288). These options for corporate engagement correspond closely to opportunities in supply chain (make), conceiving new products and markets (buy), and creation of clusters of expertise (hybrid) noted by Porter and Kramer (2011).

6. A Conceptual Framework for Corporate Accountability

Corporate accountability matters. It plays an important role in the provision of basic needs of our society, the quality of our living planet, the level of trust in businesses and the creation of a sense of shared meaning and common purpose. The context of corporate accountability has changed dramatically in the last 20 years while the social construct of the corporation has not change since the creation of the Limited Liability Company (LLC). The human kind is consuming planetary resources faster than the ecosystems’ ability to regenerate, poverty is becoming more widespread, trusted financial institutions have failed us, our governments have less fiscal and social capital to fix problems and traditional macro-economic solutions of consumption-led growth seem less plausible. In this situation companies have an important role in providing potential solutions for sustainability and at the same time discovering new sources of value creation. In this sense the corporate accountability is to both the society in solving environmental and social problems and also to the shareholders for securing new sources of value creation.

As noted above there is a very large number of corporate accountability frameworks in the extant literature and an even greater diversity in the applications of these frameworks in practice. Companies undertake a number of activities under the broad banner of CSR.
could be a one-off donation to a local charity, a corporate philanthropy program, or an integrated CSR program extended over a period of time. Through these programs the company can achieve high levels of social engagement however this does not guarantee corporate accountability. Corporate accountability defined as the positive duty of due diligence to provide an account to society in the collaborative management of environmental, social, human and financial capitals is only possible by internalisation of externalities.

A conceptual framework is presented in Figure 1 below to show the nexus of corporate accountability and need for internalisation of externalities in the context of sustainability challenge. In this framework corporate accountability is defined as four interconnected concepts. First, corporate accountability is conceptualised as positive duty of due diligence to provide an account of those actions for which one is held responsible. The principle of due diligence places an obligation on the company and particularly its board of directors to discover, measure, value and report the impact of the company’s operations and strategy. In this sense this conceptualisation of corporate accountability is consistent with Gray et al., (1996) concept of providing an account and Ruggie’s (2008) call for a positive duty of due diligence on companies.

The second concept in the definition of corporate accountability as presented below in Figure 1 is that this accountability is to all stakeholders and not just to the shareholders. The debate in current literature between shareholder and stakeholder theories continues however in this paper corporate accountability is conceptualised as accountable to all stakeholders. This conceptualisation is based on the recognition of needs and demands of the context in which the companies find themselves. As noted above the context of corporate accountability has changed dramatically in the last 20 years. The sustainability challenges are now severely limiting the value creation potential of the many company’s business models. In a resource-constraint world companies are limited in their ability to gain and maintain competitive advantage and at the same time rapidly losing their social licence to operate. In this situation companies have an important role in providing potential solutions for sustainability and at the same time providing the companies with a potential to discover new sources of value creation.
The third concept in the definition of corporate accountability is to ensure that the matrix for accountability is designed to share information that allows for collaboration between the company and its stakeholders in a meaningful way where the outcomes and progress to shared goals are measurable. Today such a matrix and process does not exist. The neoclassical economic models, accounting standards and corporate strategic planning process do not facilitate collaboration and measurable shared outcomes.

The last concept that is required to make corporate accountability a reality is the appropriate incentives which would enable all stakeholders to strive for the achievement of all the shared goals. Again today such incentives systems do not exist. Today the forces of bounded rationality of market economics and overwhelming focus on short-term financial gains are major obstacle to the implementation of ethical incentive systems. The future incentive systems will need to be broadly defined with strong ethical considerations for all human beings and the planet to account for sustainability and distributive justice issues. These four interrelated concepts provides a stronger definition of corporate accountability as a positive duty of due diligence to provide an account to all stakeholders to facilitate collaboration and measurable outcomes where there is consequences for achievement of shared goals.
The second part of the framework outlined in Figure 1 provides context for the institutionalisation of this stronger definition of corporate accountability. Companies are social constructs governed by rules and regulations operating within societal expectations and constrained by planetary resources. However, today companies continue to operate beyond rules and regulations, ignoring the limits of a resource-constraint world and rapidly losing trust with majority of civil society. This is not a sustainable business model. A new business model which is grounded in the management of environmental, social, human and financial capital in ways that does not compromise the wellbeing of future generations is required. This is a minimum requirement for sustainability of the planet and the corporation. In such a context of sustainability corporate accountability requires a different conceptualisation of externalities.

The final element of this conceptual framework for corporate accountability is the re-definition of externalities as social cost requiring systematic measuring, valuation and reporting to provide a platform for collaboration based on transparency of the current and future shared value of the company’s business model.

In the framework outlined in Figure 1 externalities are required to be measured, valued and reported at the company level and through the formal accounting of externalities environmental, social and human balance sheet statements are created. The creation of a social licence to operate as a contra entry to the cost of externalities on the corporation’s balance sheet instantaneously recognises the systemic failure to account for externalities and grants a new asset to offset this failure (Mohammed, 2012). In this way, this proposal allows for a way forward for collaborative governance (Zadek, 2006). This contra entry to the value of the externality represents the cost to society from the negative impact of this externality (or the positive impact, where there is public good or spill-over benefits) which the society provides to the firm in the form of a social licence to operate. The formal accounting of externalities onto the corporate balance sheet needs to be transparent and clearly demonstrate the imperative for strategic action on the part of the organisation, as well as the level of obligation to the society inherent in the current business model (Mohammed, 2012). These can have the format of individual balance sheet schedules to capture the environmental, social and human capital of the corporation (Mathews, 2008).

Creating contra entry on the corporate balance sheet, equal to the value of the externality in the form of the social licence to operate, could represent a valid approach to the mutual
acceptance of both the *a priori* rights of the firm and societal demands for greater engagement from the business world in sustainable development. In doing so, it also locks in the common interest of both the firm and society to find sustainable development paths (Mohammed, 2012).

This accounting process re-defines corporate value and provides a minimum standard for a meaningful and integrated corporate accountability. The accounting of externalities in this way can be seen as independent of the historical cost concepts prevalent in accounting, free from the economic definitional issues, un-hinged from legal responsibility excuses, spared from CSR legitimacy imperatives and above the political debate on the role of governments. This conceptualisation of externalities holds the key to securing legitimacy for the corporations and at the same time contributing to the sustainability challenge.

The views of Buchanan, Heal and Meyer and Kirby on externalities seem to provide support to including externalities into the corporate accountability framework. Buchanan provides strong theoretical support to include externalities in a framework for corporate accountability. Heal calls for externalities to be at the centre of business strategy and value creation. As a generalised conclusion, firms can create shareholder value and resolve market failures by focusing not on “private cost” and trying to explain this but recognising “social cost” as a source of value. From these case studies, it is also clear that strategically picking specific CSR initiatives and implementing them in a holistic way, taking into account all stakeholders can be the critical difference between the extraordinary success and the demise of the firm, there is no short-cut solution for corporate accountability. Meyer and Kirby (2010) conclude that corporate accountability of externalities is “unavoidable” calling for corporate action to learn and thus create value directly in the extended supply chain, through new products and positive engagement in CSR initiatives.

The literature on CSR is less conclusive. While there has been an expansive effort in creating a clear *ex ante* business case for CSR initiatives, businesses however have not widely accepted these justifications and where businesses have implemented CSR programs stakeholders and society seem not to be satisfied. Scholars in social accounting have in recent times been calling for a re-definition of role of business to include externalities. In this view proper account is given to the impact of business on the environment and society, and advocates new forms of corporate governance.
The recent proposal for creating shared value provides a strategic framework for partnership between business and society (Porter and Kramer, 2011). This article illustrates a number of case studies where inspired business leaders were already using and deploying elements of this framework to create shared value. The example of Nestlé is particularly interesting, in the sense that the company clearly selected three strategic areas which have the greatest potential to create both long-term value for the company and enormous benefits for the broader communities within which the company operates. Here, we find the solution to a number of issues raised in the shareholder-stakeholder debate pertaining to the identification and management of stakeholders, balancing of priorities, and managing for the long-term. In this specific example of CSV, the solution for Nestlé is an internal strategic priority, not an externally imposed program. This approach overcomes a number of design issues of specificity and legitimacy noted in a recent review of international accountability standards (Rasche, 2009).

However, current financial and non-financial reporting systems neither recognise nor report this value creation. A new accountability framework which includes corporate externalities and a contra entry which represents the firm’s social licence to operate could provide a basis to measure the creation of shared value (Mohammed, 2012). This form of social accounting could free companies from the narrow focus for value creation to finding solutions in broader environmental and social problems.

The extensive literature on externalities encountered in economic theory and the vast literature on CSR provides support for the proposed conceptual framework for corporate accountability. Corporate accountability defined as the duty to provide an account to society as a result of the social licence to operate and the positive duty of due diligence to discover and report their obligation to society.

**Conclusion and further research**

Today there is increasing recognition by both business and civil society that businesses need to engage in a more meaningful way with the environmental and social issues. This engagement can be enhance through the integration of sustainability context into a framework for greater corporate accountability. The corporate accountability framework proposed in this paper is based on a stronger definition of accountability requiring proactive actions by the companies to discover, share and design action programs to collaborate with all stakeholders.
In the context of the sustainability challenge facing most companies, this level of accountability is only possible by internalising the externalities of their business models. The proposed corporate accountability framework calls for proper account of externalities in the value creation model of the firm. This conceptualisation of externalities holds the key to corporate legitimacy and sustainability. The main contribution of this paper toward theory development is in demonstrating that meaningful corporate accountability framework in the context of sustainability can connect social progress to the economic value of the firm’s strategy.

Lack of proper definition of corporate accountability in the context of sustainability has limited both conceptual academic research and empirical analysis. Internalisation of externalities into the corporate accountability framework is one way to broaden the academic research agenda and could lead to greater engagement of business in sustainability challenge. Further research is required to demonstrate the application of this framework in the corporate sector, clarifying the new concepts and typologies and identifying weaknesses and gaps for future research.

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