Chapter 9: Extending corporate accountability: the incorporation of social and environmental factors within external reporting

Solutions

9.2 We can refer to the definition of accountability provided by Gray, Owen and Adams (1996, p.38), this being:

*The duty to provide an account (by no means necessarily a financial account) or reckoning of those actions for which one is held responsible.*

According to Gray, Owen and Adams, accountability involves two responsibilities or duties, these being:

(a) the responsibility to undertake certain actions (or to refrain from taking actions); and

(b) the responsibility to provide an account of those actions.

In relating *accountability* to *accounting* we need to consider what we actually mean by ‘accounting’. There is no definitive definition of accounting but perhaps we can describe accounting as the process of providing information to various stakeholders to allow those stakeholders to assess various aspects of the entity’s performance and position for the purposes of making various decisions about the entity (inclusive of whether they will support the entity through providing labour, investment capital, consuming the entity’s products, and so on). Traditionally, accounting has been considered to be a process of providing information about financial performance and position to parties that have a direct financial interest in the organisation—but this is an extremely restricted perspective of accounting. (As an example of this myopic perspective, for a number of years in the early to mid-1990s the author of your textbook was often asked ‘what has the environment got to do with accounting?’. Thankfully, many more people can now understand the relationship). In a sense, accounting provides the mechanism through which accountability can be performed or exercised. Since different managers will have different perspectives about what is expected of them from their various stakeholders, different entities will
develop different accounting systems (for example, some organisations develop systems that can generate social and environmental performance reports, while others do not).

In considering the relationship between accountability and organisational responsibilities, we can say that the two are directly linked. An organisation has a responsibility to provide an account (that is, it has an accountability) of its activities to enable others to determine whether the entity has been acting in the manner in which it is expected to act. Gray, Owen and Adams (1996) developed an ‘accountability model’ to explain the relationship. They consider that accounting and the act of reporting is responsibility driven, rather than demand driven. The view is that people have a right to be informed about certain facets of an organisation’s operations. By considering rights, it is argued that the model avoids the problem of considering users’ needs and how such needs are established. The role of corporate reporting under this perspective is to inform society about the extent to which actions for which an organisation is considered responsible have been fulfilled.

9.4 This can actually be quite a controversial issue. The term ‘sustainable development’ is used in many different ways by different organisations. For example, some managers discuss how they seek to be sustainable at the same time that they pursue increasing profits. Many people would argue that pushes for increased profits do not sit well with visions of maintaining a sound environment – also raising issues such as how much profit is enough.

From a theoretical perspective a sustainable organisation is one that leaves the environment no worse than it was at the beginning of the period and considers the interests of the communities in which it operates such that it does not advantage some people at the expense of others. Sustainability also necessitates consideration of future generations such that the current activities of the organisation should not adversely impact people of the future.

The most widely used definition of sustainable development is the definition provided in the Brundtland Report this being, development that meets the needs
of the present world without compromising the ability of future generations to meet their own needs.

The notion of sustainable development, and the view that we must consider future generations, necessarily requires us to give some consideration to reducing our current (unsustainable) consumption patterns. Wealth creation should not be the *all-consuming motivation* of modern business if sustainability is a ‘real’ goal. Sustainable development necessarily requires reduced reliance on performance indicators, such as *profitability*. This requires thinking other than in self-interest. As we have seen throughout the text, central to many economic theories is the assumption that individual action is driven by consideration of one’s self, rather than consideration of others. If we are to believe that self-interest drives all actions (as the positive accounting theorists assume) then we would be resigned to a view that sustainable development is nothing other than a fanciful dream.

9.9 Externalities can be defined as impacts that an entity has on parties (not necessarily restricted to humans) external to the organisation, parties which typically have no direct relationship with the organisation. Financial accounting practices can tend to ignore externalities because of the way the elements of financial accounting are defined and because accounting adopts an *entity assumption*.

In relation to the entity assumption adopted within financial accounting, this assumption requires the organisation to be treated as an entity distinct from its owners, other organisations and other stakeholders. The implication is, if a transaction or event does not directly impact on an entity, the transaction or event is to be ignored for accounting purposes. This means that the externalities caused by reporting entities will typically be ignored, thereby meaning that performance measures are incomplete from a broader societal perspective.

In relation to the definition of the elements of accounting, definitions of assets and expenses as provided in various conceptual framework projects throughout the world (and as developed by the IASB) rely upon a notion of *control*. For
example, in the *IASB Conceptual Framework* assets are considered to be resources ‘controlled’ by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. If something is not controlled, such as the waterways, the air, the local national parks, then it is not considered to be an asset. As such, any reduction in the quality of the ‘public’ resource will not be considered an expense of an entity (unless there are some associated cash flows, for example, environmental fines). Also, local communities are not ‘assets’ of an entity from a financial accounting perspective and hence any health problems caused to them by the entity’s operations will typically be ignored (unless, again, some legal action has been instigated). Such externalities caused by the reporting entity will be ignored.

As indicated in Deegan (1996), and using a rather extreme example, under traditional financial accounting if an entity was to destroy the quality of water in its local environment, thereby killing all local sea creatures and coastal vegetation then to the extent that no fines or other related cash flows were incurred, reported profits would not be directly impacted. No externalities would be recognised and the reported assets/profits of the organisation would not be affected.

9.28 (a) Positive accounting theory predicts that all individual action is ‘economically rational’—that is, the decision to undertake certain activities, such as report, is based on self-interest tied to the goal of wealth maximisation. Hence, managers will elect to provide social responsibility disclosures to the extent that it increases the value of the organisation. Managers would be motivated to do this as a result of various mechanisms that align the interests of the manager with increasing firm value, such as profit-sharing bonus schemes, holding shares in the firm, the market for managers, and the market for corporate takeovers (these mechanisms are discussed in chapter 7). Research which has adopted the PAT paradigm has suggested that social responsibility disclosures are made to reduce the *political visibility* that the firm is subject to and hence, to reduce the wealth transfers that are associated with political scrutiny.
(b) Legitimacy theory predicts that firms will undertake various actions to ensure that they appear to be operating in a manner consistent with the norms and expectations of the community in which they conduct their operations. That is, that they appear to comply with the terms of the ‘social contract’ (the theoretical notion of a social contract is discussed in chapter 8). Hence, various social responsibility disclosures will be made in an effort to legitimise the ongoing existence of the organisation. If it is considered that the community does not expect the firm to make social and environmental disclosures (that is, it is not part of the social contract), then no disclosures will be made. As the chapter indicates, where the legitimacy of an organisation has been brought into question (perhaps as the result of a major environmental accident or event), corporate management often use media such as the annual report in an effort to restore legitimacy.

(c) As chapter 8 explains, there are two branches of stakeholder theory—the managerial branch and the ethical (or normative, or moral) branch. Under the managerial branch, disclosures are used as one strategy to control the actions of powerful stakeholders. Powerful stakeholders are often considered as those parties who have resources which are important to the ongoing survival of the organisation. Under this perspective, it is the needs of the powerful stakeholders that are attended to over and above the needs of other parties affected by the entity’s operations. If the powerful stakeholders expect social responsibility disclosures then the firm is predicted to make them. By contrast, under the ethical, or normative, branch of stakeholder theory there is a view that disclosures are responsibility driven and that all stakeholders that are impacted by the operations of the entity have a right to information about its operations (the notion of right-to-know). Hence, under this perspective, social responsibility disclosures are made in response to an ethical responsibility, rather than in response to any desire to maximise wealth or to appease particular, powerful parties.
As chapter 8 indicates, institutional theory provides a number of reasons why corporations might make corporate social responsibility disclosures. There is a view that organisational form and practices might tend towards some form of homogeneity—that is, the structure of the organisation and the practices adopted by different organisations tend to become similar to conform with what is considered to be ‘normal’. Organisations that deviate from being of a form that has become ‘normal’ or expected will potentially have problems in gaining or retaining legitimacy. There are two main dimensions to institutional theory. The first of these is termed isomorphism while the second is termed decoupling. Both of these can be of central relevance to explaining voluntary corporate reporting practices.

The term ‘isomorphism’ is used extensively within institutional theory and DiMaggio and Powell (1983, p.149) have defined it as ‘a constraining process that forces one unit in a population to resemble other units that face the same set of environmental conditions’. That is, organisations that adopt structures or processes (such as reporting processes), that are at variance with other organisations, might find that the differences attract criticism. DiMaggio and Powell (1983) set out three different isomorphic processes. These three isomorphic processes are referred to as coercive isomorphism, mimetic isomorphism and normative isomorphism.

Pursuant to coercive isomorphism, organisations will only change their institutional practices because of pressure from those stakeholders upon whom the organisation is dependant. This form of isomorphism is related to the managerial branch of stakeholder theory whereby a company will use ‘voluntary’ corporate reporting disclosures to address the economic, social, environmental and ethical values and concerns of those stakeholders who have the most power over the company. The company is therefore coerced (in this case usually informally) by its influential (or powerful) stakeholders into adopting particular voluntary reporting practices. Since these powerful stakeholders might have similar expectations of other organisations as well, there will tend to be
conformity in the practices being adopted by different organisations—institutional practices will tend towards some form of uniformity.

*Mimetic isomorphism* involves organisations seeking to emulate (perhaps copy) or improve upon the institutional practices of other organisations, often for reasons of competitive advantage and in terms of legitimacy. When an organisation encounters uncertainty then it might elect to model itself on other organisations. There are links between the pressures for mimetic isomorphism and pressures underlying coercive isomorphism. Unerman and Bennett (2004) maintain that without coercive pressure from stakeholders there would be unlikely to be pressure to mimic or surpass the social reporting practices (institutional practices) of other companies.

*Normative isomorphism* relates to the pressures arising from group norms to adopt particular institutional practices. In the case of corporate reporting, the professional expectation that accountants will comply with accounting standards acts as a form of normative isomorphism for the organisations for whom accountants work to produce accounting reports (an institutional practice) which are shaped by accounting standards. In terms of voluntary reporting practices, normative isomorphic pressures could arise through less formal group influences from a range of both formal and informal groups to which managers belong—such as the culture and working practices developed within their workplace. These could produce collective managerial views in favour of or against certain types of reporting practices (such as collective managerial views on the desirability or necessity of providing a range of stakeholders with social and environmental information through the medium of corporate reports).

Turning to the other dimension of institutional theory, *decoupling* implies that while managers might perceive a need for their organisation to be seen to be adopting certain institutional practices (and might even institute formal processes aimed at implementing these practices) actual organisational practices can be very different to these formally sanctioned and publicly pronounced processes and practices. Thus, the
actual practices can be decoupled from the institutionalised (apparent) practices. In terms of voluntary corporate reporting practices, this decoupling can be linked to some of the insights from legitimacy theory whereby social and environmental disclosures can be used to construct an organisational image very different from actual organisational social and environmental performance. Thus, the organisational image constructed through corporate reports might be one of social and environmental responsibility when the actual managerial imperative is maximisation of profitability or shareholder value.