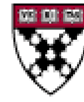

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New Agenda for Corporate Accountability Reporting

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Author: Martha Lagace

*Professor **Karthik Ramanna** explains three ways to make corporate accountability reports potentially more useful to constituencies that include shareholders, communities, bondholders, and customers.*

How do you measure corporate accountability? And can you do it credibly?

Since the financial crisis of 2008-2009, for-profit corporations are facing greater demand to disclose more than revenues and expenses on annual financial reports. In response, some are pointing to their positive contributions like local community-building initiatives. Others disclose activities rather more guardedly: effects on environmental pollution, for example. As of April last year, there were over 32,000 such reports of "global corporate responsibility" archived on CorporateRegister.com.

Yet it is still not clear what exactly corporate accountability reporting is, or how to evaluate its usefulness to different constituencies such as customers, bondholders, shareholders, employees, and communities. It's not clear how it affects managers' decision-making or impacts shareholder value, or whether and how it affects social value in society at large.

That could soon start to change.

Karthik Ramanna, an associate professor at Harvard Business School who studies the political economy of corporate accountability and financial reporting, proposes that best practices in financial accounting can be leveraged to test and improve the quality of corporate accountability reporting.

Ramanna thinks accounting theory has a lot to contribute, in three particular ways: (1) by giving stakeholders the ability to verify what the corporation tells them about its corporate accountability activities; (2) by helping companies separate their accountability reporting into what in financial accounting is called "stocks" and "flows"; and (3) by helping companies develop technologies to clearly compare actions and outcomes in corporate accountability—what financial reporting lingo calls "matching" technologies.

"There is a lot of room for improvement in current corporate accountability reporting practices"

Corporate accountability means "the obligation of a corporation entrusted with a duty to others to explain its performance of that duty," Ramanna says. So far, he gives existing corporate accountability reports a "satisfactory" score for handling the first task. But otherwise, "there is a lot of room for improvement in current corporate accountability reporting practices, and technologies in financial reporting can be helpful in driving change."

There is enormous potential for innovation in this area, he continues. "If we were to put an accounting lens on corporate accountability reporting, there is potential for innovation both for practice and for academic research to advance practice."

In January 2013, an invitation-only conference at HBS that Ramanna is organizing with McArthur University Professor Rebecca M. Henderson will dive into these themes and other ideas to develop and clarify reporting standards. For the conference, Henderson and Ramanna teamed up with the *Journal of Accounting & Economics* to leverage the journal's editorial resources to develop this important subject. In addition, Ramanna's paper, "A Framework for Research on Corporate Accountability Reporting," forthcoming in the journal *Accounting Horizons*, helps to sketch out the challenges and goals of the developing field. Questions being asked include:

- Does corporate accountability reporting have measurable economic consequences for society?
- What is the effect on the firm?
- How does the reporting vary according to the relative power of stakeholders such as labor unions, bondholders, shareholders, and environmental and community activists?
- When and how does such reporting affect how managers make decisions in ways that increase or decrease shareholder value?
- What are the main welfare effects of corporate accountability reporting?

Using the lessons of financial reporting to develop and evaluate corporate accountability reporting is simply common sense, says Ramanna. After all, for the past 30 years accounting scholars have put a lot of effort into building a rigorous set of frameworks and hypotheses to explain and predict financial reporting practice. They've worked to increase the information value and the accountability of financial reporting practice in the broader capital market system, he explains.

"We can use some of the insights of these 30 years of research to study this much broader, much more difficult subject, which is accounting for externalities."

But there's also good cause to be wary about it, Ramanna continues. "We are dealing with something that is outside the price system, which makes accountants very uncomfortable. And outside the price system there is no common basis of measurement for things like units of carbon emission, units of water usage, and measures of quality of life."

"The challenges are incredibly complex but also very rewarding to work on," he adds.

Three gold standards

Ramanna's paper outlines how best-practice standards of financial accounting could be tested and potentially used in corporate accountability reports. In a nutshell, these are:

1. Stakeholders—whether they are shareholders, bondholders, or a local community, for example—must be able to verify information contained in corporate accountability statements or reports. But the corporation always has more information than the constituency. Ramanna says that technologies should be in place so this disconnect cannot be exploited by the corporation or the manager. In financial reporting, auditing and reporting conservatism are two such technologies.

2. Corporate accountability reports should also have the equivalent of a balance sheet to highlight the difference between stocks and flows. Stakeholders need performance metrics

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(like "flows") to get a sense of what the corporation has been doing toward its goal. But stakeholders also need to see the equivalent of "stock" to see how well the corporation stewards the resources that have been given to its control.

3. A sound system of accountability has to compare benefits with costs *over time*. This is especially true when corporate activities concern factors where the output of actions is not felt until well into the future. "Costs need to be recognized over time," says Ramanna. "This does bring in enormous challenges around measurement, but the theory is very clear, that there should be what we call in accounting 'matching' technologies."

Beyond window dressing

Of course, following economist Milton Friedman's argument that "the social responsibility of business is to increase its profits," outlined in a *New York Times Magazine* article in 1970, many advocates of current practice question whether it's even proper to venture outside the price system. This is the widespread perception that scholars and practitioners of corporate accountability must tackle if reporting is to achieve legitimacy in the system of market capitalism, says Ramanna.

"One of the things we hope the conference does is bring to bear some of our research methods to address this central question of whether the business of business is just making monetary profits."

If you start to see technologies like matching and balance sheets in corporate accountability reports, he continues, then it is less likely to be 'window dressing' in the sense that Milton Friedman described it.

"We have to define what it is we want corporations to do"

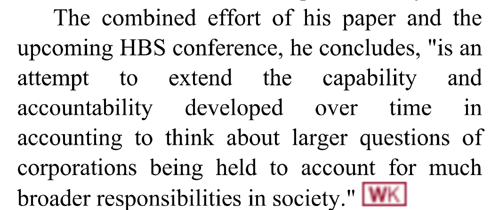
"For these technologies to sustain themselves in reporting, they have to underline real actions. Matching is the ultimate accountability metric. If there is no benefit created, then the matching will belie that. As we start seeing such advanced reporting technologies, then we expect there is real activity underlying it."

In addition, the stakes for society are high, Ramanna says. After all, corporations are human creations that society endows with certain humanlike properties such as the ability to survive beyond founders and to contribute to the political process.

"We give them these sorts of humanlike features because we expect them to create some value for society," he says. "And how do we hold them accountable for that? That is the fundamental question here. We have to define what it is we want corporations to do. Maybe all we want is to create a monetary profit. But many communities have come to recognize that we need more than that, including here in the United States."

Ramanna adds that "people do want corporations to create and enrich human life in many broad ways. So far we only hold them accountable in the context of price activity."

The combined effort of his paper and the upcoming HBS conference, he concludes, "is an attempt to extend the capability and accountability developed over time in accounting to think about larger questions of corporations being held to account for much broader responsibilities in society." WK



About the author

Martha Lagace is a freelance writer for *Harvard Business School Working Knowledge*. She is also a PhD student in social anthropology at Boston University.

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