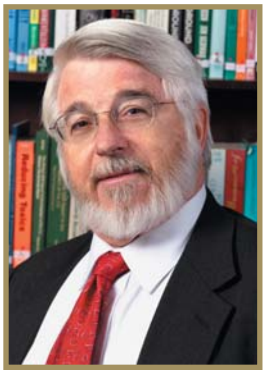
From the President



The Greening of the Balance Sheets

by Fred L. Smith, Jr.

In June, the United Nations' Global Compact Leaders Summit brought together U.N. environmental bureaucrats, international NGOs, labor leaders, and representatives of the financial world—banks, brokerage firms, social investment funds—to promote a concept known as Corporate Social Responsibility (CSR). Summit attendees endorsed adopting "voluntary" principles "to embed environmental, social and governance best practices at the heart of the world's markets."

CSR is premised on the idea that politics should determine societal goals. Private firms should then be incentivized—through regulatory quotas and taxes—to achieve them efficiently.

One CSR goal is to transform the corporate balance sheet to include not only profits, but also concerns like labor rights, human health, civil liberties, environmental quality, sexual equality, and social justice. One activist group, the California-based Rose Foundation, petitioned the Securities and Exchange Commission (SEC) to require reporting of environmental liabilities by U.S.-listed firms. At first glance, this seems prudent. Liabilities—from Superfund to asbestos—have bankrupted otherwise healthy firms. In today's litigious world, such disclosures are desirable on fiscal conservative grounds. Or are they?

Accounting, after all, is the heroic attempt to translate the dynamism of the modern firm into a set of numbers—much like characterizing an individual as a set of test scores. Never easy, accounting has nonetheless encouraged capital to flow toward firms with sound balance sheets and away from firms with weak or suspicious accounts. And this result is clearly desirable. Narrow economic accounting, of course, doesn't reflect all societal values, but was it ever supposed to?

There are an infinite number of possible futures and thus an infinite number of possible liabilities. Trial lawyers and activists attack chemicals in our water, calories in our food, automobiles on our highways, and emissions from energy production in our air. Human rights and labor activists would assign multinationals financial liabilities because they operate in nations where civil liberties or workers' rights aren't well protected. And there are always Acts of God—earthquakes, floods, and hurricanes—which prove costly.

But only some of these possible risks will ever be borne out. Accountants find it difficult enough to report upon intangible liabilities. At what point does the noise from such additional guesstimates undermine accounting's informational value? In seeking to disclose information about less likely risks, don't we obscure information about more likely risks? Should unlikley but possible windfalls be listed, too?

CSR activists already use shareholder resolutions to push corporations to adopt their agendas. Mandating the inclusion of politically charged information on balance sheets will strengthen those within the firm responsible for ancillary issues like NGO outreach, government relations, or environmental investment. Those favoring new investments to expand output to increase shareholder value—supposedly the firm's core mission—may well lose influence. Trial lawyers may use those internal conflicts over corporate policy to strengthen their case against the corporation.

This threat should be taken seriously. As the late political scientist Aaron Wildavsky noted in his criticism of earlier such efforts: Accounting may be only a social construct (as some post-modernists claim), but it has been a very valuable one. It has made markets and corporate management more efficient—producing a wealthier society.

Yet these concerns have little standing among CSR advocates. The modern corporation, they argue, has great power—power that should be harnessed to ensure social justice, sustainable development, and global stability. That's a tall order, one for which they intend to use accounting rules as a tool.

In today's world, to paraphrase Jimmy Durante, everybody wants to get into the corporate accounting act. If all restraints on what the balance sheet should list are abandoned, then everyone will expect their preferred values to gain primacy.

Should economic accounting be abandoned as no longer providing adequate guidance for a just world? Should the SEC mandate inclusion of any value championed by a politically powerful group? Or should regulators allow accountants to devise a variety of rules for different firms and different purposes? The answer, to us, is obvious.

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