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Corporate Social Responsibility and Accounting: 2 CSR Case Studies and a Literature Review

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Corporate Social Responsibility and Accounting: 2 CSR Case Studies and a
Literature Review

By

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Introduction

Companies make promises from the day they are registered. Their brand, their marketing promises, and their promises for change when faults are discovered all pile up to a list of guarantees made to the public. While the financial statements of companies are verified by third-party auditors for fraud, the non-financial information released by companies is not required to be verified. While companies also promise various results, many don't follow up on these results which can lead to public scandals or loss of public faith in corporations. Corporate social responsibility reporting (hereafter referred to as CSR) is a corporation's assessment of the company's effects on issues related to social and environmental responsibility. Monitoring and reporting the CSR efforts of companies is more important in the modern day than ever because in recent years, the public faith in corporations has seen a steady decline. With this public decline in confidence, it is becoming increasingly important for companies to prove their credibility. While credibility is not an easy thing to prove, there are ways for companies to hold themselves accountable to the public. One of the most effective ways for companies to prove their credibility can come from standardized reporting that can be compared among companies and third party verification of the information in CSR reports.

Background

Modern companies gather, analyze, and report a great amount of data through the use of accounting. Companies gather information for corporate social reporting and corporate social performance measurement increasingly over the years.¹ Companies are also increasingly

¹ Governance & Accountability Institute, Inc.

directing their strategies around their corporate social performance, but they still fall short of full transparency with their reporting. While many companies hire accounting companies to look into their corporate social responsibility and have the data for it, the data is rarely published and verified publicly. To combat this, firms have been employing accounting firms to not only to audit companies financial statements, but to audit their efforts in global responsibility, environmental impacts, social impacts, etc.

Based on studies done on the impacts of corporate social performance on company profitability, it is beneficial for companies to report their social performance to investors and the public.²

From the financial statements in a company's mandatory financial reporting to the management's discussion, and analysis--management's public explanation of the company's performance--companies try to increase their levels of transparency to shareholders and the public without compromising their competitiveness. This recent increase in transparency is a result of the ever decreasing level of trust between corporations and the public. According to the Edelman trust barometer, over 50% of people don't trust institutions, and the levels of distrust have been rising steadily from the beginning of the study.³ From the accounting scandals in the 1990s to the social scandals throughout the 2000s, the public trusts corporations less than ever, making it difficult for companies to succeed in a field where trust is a major component.

Social responsibility generally becomes a focus for companies following scandals. In the event of a scandal, companies tend to increase their transparency and make promises to change their social impacts in some way, but the results are not always long lasting. In this paper, we will

² Waddock, Sandra A., and Samuel B. Graves.

³ 2017 Edelman Trust Barometer

look at two case studies on companies that have experienced corporate social responsibility scandals, their promises as a result of these scandals, and how these promises were developed. From here, recommendations will be made for how companies can monitor their corporate social responsibility through resources they are likely to already have before neglect turns into scandal.

Nike Case Study

Nike is a company in the shoe and apparel industry. Its business strategy focuses primarily around low-cost innovative sports gear sold at optimal pricing. Nike's operations include 490 factories in 52 countries.⁴ Nike operates through outsourcing its shoe and apparel manufacturing. It has a trusting relationship with its shoe manufacturers, even though its shoe factories are independent contract manufacturers. Nike has a relationship with many of its shoe manufacturers due to consistent partnerships and able to quickly negotiate the testing and turnaround of different shoe innovations. While Nike's shoe manufacturers remain stable and constant through the years, its apparel manufacturers are constantly changing based on costs, style demand, etc. Because of the fluctuating nature of the apparel industry, Nike's relationship with its apparel manufacturers is not as trusting and consistent as its relationship with its shoe manufacturers. This leads to difficulty regulating the operations within the third-party manufacturers. Because of this, Nike was hit with a series of corporate social responsibility scandals throughout the 1990s that shaped its company's image for a time. Currently, there is no regulation for company accountability to their third party subcontractors, but there is an expectation that companies operate through ethical procedures even within third party contracting. In this case study review,

⁴ Nike 10-k SEC

we will look at three separate corporate social responsibility scandals in Nike's history, how Nike responded to the scandals, and how its responses were followed up.

One of the early Nike social responsibility scandals involved low wages in Indonesia. In the early 1990s, various NGOs and labor activists began reporting on the low wages being paid to the workers in a factory owned by one of Nike's Korean contractors. Because of Nike's increased presence in Indonesia, its relationship with those contractors was increasingly scrutinized. Many of the workers at the factories were not even being paid the minimum wage of \$1 a day because of "hardship" exemptions that the government granted to factories who claimed inability to pay minimum wage. The minimum wage of \$1 a day was estimated by the government to cover around 70% of the needs for an individual as it was. Initially, Nike ignored the reports, claiming they were not responsible for the management of its independent third-party contractors. As the scandal became increasingly harmful to its image though, Nike instructed its contractors to stop applying for the minimum wage exception. As more time passed and it became clear that simply instructing its contractors to stop applying for minimum wage was not enough to be considered socially responsible, Nike increased its corporate social responsibility efforts. Nike promised to raise its contractors wages above minimum wage to \$26.00-\$37.50/month and to monitor its third party contractor wages.⁵ Overall, in the case of Indonesia, Nike had a rough start but over time incorporated its corporate social responsibility to its company strategy.

Nike's next large CSR scandal took place in Pakistan. One of the highest quality producers of soccer balls is located in Sailkot, Pakistan. Around 70% of the world's high quality soccer balls

⁵Locke, Richard M

are made in Sailkot.⁶ “Homework” is a practice that was popular in the area in the 1990s and led to many well-known human rights issues. In 1996, Life magazine published a photograph and an article of a 12 year old boy hand-stitching a soccer ball. The photo and article caused a wave of criticism against Nike for employing child labor. According to the vice president of compliance at Nike at the time, Dusty Kidd, Nike was already working with the supplier to eliminate the use of homework and to become more accountable for its employees. After the wave of criticism hit, Nike signed the Atlanta Agreement, implementing a program to eliminate child labor from the soccer ball through International Labor Organization (ILO) monitoring, social protections, and training of other-income generating activities. Also in accordance with this agreement, any plant caught employing a child is required to remove the child, but continue paying its wages up to when they reach working age. According to ILO reports, many of these companies continue employing children and production has moved to the less regulated surrounding areas of Pakistan in order to go around this regulation.

The third global scandal for Nike involved health and safety problems in Vietnam. In 1997, an Ernst & Young report paid for by Nike was leaked to an NGO and subsequently made public. This report showed that Nike’s Tae Kwang Vina factory had Toulene concentrations from 6-177 times the acceptable standards in certain sections of the plant. Toulene is a chemical that causes various skin and eye irritations along with liver and kidney damage and central nervous system depression. The scandal was made worse when it was brought to attention that the UN Ambassador, Andrew Young had visited the plant recently before the report yet had not mentioned any health problems. To combat the negative publicity Nike was receiving for all of

⁶Locke, Richard M

its CSR scandals, it formulated a code of conduct to be followed by all of its supplier factories.

Companies working with Nike were obligated to sign its code of conduct as well as an agreement to abide by the laws of OSHA. Nike also created new departments to combat its ever growing global problems. Its compliance department was moved into its apparel branch to combat the problems where most of them appear. It also created an incentive system for managers to improve environmental and labor conditions through implementing a Manufacturing Index.⁷ A manufacturing index provides measures for evaluating the environmental and social performance of companies and acts as Nike's measurement of corporate social responsibility for their third party subcontractors.

In order to publicly be held accountable for the promises made regarding its global corporate social responsibility, Nike designated internal employees as well as hired third parties such as PWC to audit its supplier's factories. Nike employs 85 people specifically designated for labor and environmental compliance and conducts inspections by managers weekly or monthly depending on the company size and use frequency. In the early 2000s, the world watched as Nike embraced corporate social responsibility and went from the face of social corruption to an accountable company that continued and even grew in success. Since these scandals, Nike has been successfully monitoring its third-party suppliers and has eliminated petroleum based chemicals in footwear productions. While there are still imperfections in Nike's social responsibility, it made its CSR position clear to the public through exponentially increasing its social monitoring and reporting since the 1990's.

⁷Locke, Richard M

Nike Timeline

Indonesian trade union newspaper publishes report on South Korean shoe company producing for Nike			"Code of Conduct and Memorandum of Understanding" created by Nike for contractors.			Life Magazine published photograph of child stitching soccer ball			Nike sets up 30% pay increase for shoe workers. (The first time Nike forced contractors to pay above the statutory minimum.)				
1988	1	1	1	1992	1	1994	1	1996	1997	1998	1	2	2001
	9	9	9		9		9				9	0	
	8	9	9		9		9				9	0	
	9	0	1		3		5				9	0	
The Oregonian newspaper prints an article on Nike's operations in Indonesia			Nike hires Ernst and Young, and accounting firm to do "social audits" at contracted factories in Indonesia			Ernst & Young report on Vietnamese health issues published			Nike implements second pay increase (25%) for shoe workers in Indonesia. Wage increases to 250,000 rupiah (\$23) per month.			Nike releases first corporate sustainability report	

Volkswagen Case Study

Similarly to Nike, Volkswagen (Hereafter known as VW) encountered a corporate social responsibility scandal that brought its public image down. In September of 2015, the California Air Resources Board began testing cars on the road. These tests led to the stunning discovery that VW diesel cars emitted more than 40 times the regulation threshold for nitrogen oxide.⁸ An investigation was launched by the EPA and it was discovered that VW had equipped its cars with deceptive software to cheat through the inaccurate lowering of emissions during emissions tests. Because of this, VW experienced immense economic downturn with a net loss of \$1.4 billion. Car sales, stock value, and company value all plummeted and VW was suspended from the Dow Jones Index.

So how could a company with such a strong standing go through such a terrible scandal?

According to the case done by Jung and Park, it was “austere leadership styles, insular corporate governance, and drawbacks from family feuds and nepotism,” that led to such a hostile corporate environment.⁹ The CEO at the time, Ferdinand Piech, was notorious for having a toxic leadership style that reflected an “at any cost” mindset throughout the corporate leadership. The board for the company was ruled with a majority by the Porsche and Piech families who made all decisions amongst themselves without consideration of other board members. Volkswagen had set its bets on diesel when many companies were investing in technology. Finding it difficult to keep up with the Obama administration’s environmental regulation, Martin Winterkorn, the interim CEO changed the company focus to simply meeting the environmental standards at any cost.

⁸ VW Case Study

⁹ Jung and Park

Volkswagen faced many economic and political consequences through recalls and lawsuits. In response to the scandal, VW changed its entire managerial system promising maximum transparency.¹⁰ Before the scandal, the company published public CSR reports focusing on their efforts in sustainability, diversity, and environmental health. While this information was published, it was not verified by outside sources. If the Volkswagen CSR was verified by third parties, there is a chance that the auditors may have caught the defeat devices prior to the scandal occurrence. If auditors tested the vehicles using different methods than Volkswagen, as the California Air Resources Board did, they would have seen the extremely high output of nitrogen oxide from the vehicles.

Since the scandal, it does not appear that VW is keeping up with the promises immediately following it. In a recent article from Forbes, shareholders are demanding more transparency, but VW is deflecting.¹¹ Volkswagen reacted to the demand for an increase in transparency by making promises and fixing the problem at hand, but how does that affect the public trust in the company? Measuring public trust through stock pricing, its stock reached its 5 year peak on April 10th, 2015 at a price of \$253.20 prior to the scandal and bottomed out on October 2nd 2015 at 92.36 after the scandal was discovered publicly. The stock is currently around \$163 which means that it is slowly climbing back from the scandal, but there is still clear hesitancy in the market to bring Volkswagen's pricing back to post-scandal pricing. While Volkswagen implemented corporate social reporting even before its scandal, there was no third-party check to verify the information. Because of this, even the implementation of its CSR was ineffective in preventing this scandal.

¹⁰ VW Case Study

¹¹ Forbes Magazine

Volkswagen Timeline

<p>Volkswagen sets strategy to focus around diesel engines to increase low market share in the United States..</p> <p>Engineers realize a new diesel motor cannot meet stricter American emission standards.</p>	2006	7	<p>Volkswagen pushes clean diesel marketing campaign</p>	2008	<p>2 2 2 2 0 0 0 0 0 1 1 1 9 0 1 2</p>	2013	4	<p>CEO winterKorn resigns - company blames rogue engineers for defeat device</p>	2015	<p>2016</p>	<p>2017</p>
<p>Executives decide to install illegal software</p>					<p>West Virginia team gets grant to test cars on the road and publish their findings</p>			<p>CARB tests cars on the road. It is discovered that Volkswagen cars are emitting 40 times the regulation threshold for nitrogen oxide.</p>			<p>Volkswagen pays additional \$4.3 billion fine for violation of the clean air act.</p>

Summary of Case Studies

	Nike	Volkswagen
Time Frame Studied	1889-2001	2006-2017
Scandal Perpetrator	Nike overseas third party subcontractors	Volkswagen management and engineers
Initial Response	Ignore - Third party CSR is not the responsibility of the company	Ignore - Blame the problem on rogue engineers
Long Term Response	Hiring department for CSR	Management change
	Publishing public CSR Reports	Increase in CSR reporting
	Having third party verification of CSR reports	Recall cars and pay off car owners

Literary Review

Why does fraud occur? In a study done about media coverage as an influence on accounting scandals and CSR, it was discovered that fraud may occur due to managerial negligence, a lack of segregation of duties, and insufficient monitoring through third party verification.¹² In the cases of Nike and Volkswagen, there were clear problems with management, negligence, and insufficient monitoring. While both companies hire accounting firms to audit their financial statements, Nike also utilized their accounting professionals to monitor and report their social performance. This extra step in CSR implementation gives Nike the advantage of transparency and knowing where it stands in corporate social responsibility which allows Nike to foresee any negligence in its CSR and fix it before scandal occurs.

Following scandals, many companies will switch out their management, as seen in the case of Volkswagen, but will not follow up on their other CSR promises, usually consisting of increased monitoring and actual change in the company managerial style. While this may be difficult to follow up on, it is very important. If the management of a company is changed but the managerial style and actions remain the same, is the company really less likely to fall to the same scandals that caused the initial change? With growth in the number of scandals, the public trust in corporations only declines with time. As public trust in corporations declines, it becomes more important to have third party verification of the corporation's reports. Third party verification (usually in the form of an audit) helps ensure the accuracy of data and controls. Controls are the internal systems in place to ensure accurate reporting. The decreasing level of trust in corporate promises not only affects the companies neglecting their social performance, but all companies.

¹² Bhutta et al.

Social misconducts not only arouse negative investor reactions to the company committing the misconduct, but to rival companies as well.¹³ This means that the effect of a scandal in any industry has a ripple effect from the company caught in the scandal, to all other companies in the industry.

With the rise of globalization and increase in complexity in technology, it has become increasingly difficult to hold companies accountable for any damages they cause. The topic of corporate social responsibility is widely debated not because professionals disagree on whether corporations should be held responsible for their actions, but because there is disagreement on how responsible companies are for the less direct impacts of their actions. There is no standardization on corporate social responsibility as of 2018 in the United States, although there is CSR standardization in the International Accounting Standards Board (the accounting standards predominantly used by European and Asian countries). The board that sets the accounting principles used in the United States has been trying to merge US with international accounting standards for years. Including CSR standardization in corporate annual reports that are audited may bring the U.S. standards one step closer to consolidation with international standards. Additionally, having data in corporate annual reports that is audited by independent third parties would help keep companies accountable for their impacts on societies and the environment.

From older papers such as “The corporate social performance–financial performance link,” to newer CSR papers such as “How does corporate social responsibility contribute to firm financial performance?”¹⁴ The mediating role of competitive advantage, reputation, and customer

¹³ Zhou et. al.

¹⁴ Saeidi, Sayedeh Parastoo, et al.

satisfaction” research consistently links corporate social responsibility to beneficial financial performance to three corporate characteristics. The three main characteristics of strategic CSR are issues, organization, and communication. Companies implementing CSR must consider the issues as well as the scope of the issues they may be faced with. Some examples of issues are child labor and environmental issues. These issues vary widely in impact and in measurement methodology, but there are ways to measure each of them. In our case studies, Nike was faced with child labor and other social issues while Volkswagen was faced with environmental issues. Companies must also decide how their CSR fits within their organization. How much will the company focus its strategy around being globally responsible? Nike greatly incorporated CSR through focusing whole groups of employees around CSR and through hiring its accounting firms to audit CSR impacts. Volkswagen chose not to focus on CSR at all and to ride out the scandal. Standardization of CSR reporting would make it mandatory for companies to include CSR in their company strategy at least to a certain extent.

Lastly, organizations must decide how much CSR will impact their branding strategy. Both Nike and Volkswagen’s strategies are focused around social responsibility for their branding. Both companies market being socially responsible. These three characteristics of CSR have been linked to both Nike and Volkswagen’s strategies, but these companies don’t necessarily act on CSR the same way. While Nike actively monitors and published its CSR impact, Volkswagen remains a shot in the dark. Nike incorporates third party verification in the form of audits to their CSR reports whereas Volkswagen publishes their own, unchecked results.

When choosing an internal or external branding strategy, companies must answer the three questions on their CSR characteristics. They must decide how much of their resources they will

contribute to their CSR. These stances impact company reactions to CSR scandals they come across as well. Promises made as a result of scandals help companies decide what issues to focus on, how these promises will impact their organizations, and how their short-term branding strategy will be affected by their social responsibility stance. Companies increasing their focus on CSR must consider methods for monitoring their CSR impact.

One of the more commonly occurring monitoring methods of CSR in the modern day is hiring professional accounting firms to monitor CSR.¹⁵ Accounting and CSR have been linked through auditing practices as seen in the case of Nike. Accounting firms were hired by Nike to externally audit its overseas factories and provide an “unbiased” report of its compliance with Nike’s code of conduct. While not all factories were compliant, raising the monitoring increases Nike’s understanding of what was working and what was not. Raising the level of monitoring in CSR is the first step to increasing social responsibility in any case and helped Nike begin to increase its global responsibility. This, in turn, brought it to number 87 on the Reputation Institute’s list of companies with the best CSR reputations in the world in 2017. Volkswagen was number 100 on the list in 2017.¹⁶

While the companies have both gained back their reputations since their scandals, Volkswagen is more likely to fall into another scandal based on its lack of change in their corporate social accountability and culture. Nike is less likely to have another scandal because of its transparency. Hiring third party auditors to look over corporate social reports allows Nike the comfort of knowing that it is doing everything it can to be responsible as a company.

¹⁵ Duff, Angus, and Xin Guo

¹⁶ The Reputation Institute.

According to a paper written by Angus Duff and Guo Xin, it has become more common practice for large corporations to hire professional accounting firms to oversee their CSR.¹⁷ In fact, accounting firms are beginning to implement methods and strategies for monitoring CSR for companies as a part of their business model. Whether a company hires an accounting firm to monitor their CSR or decides to monitor internally, it is important that companies have methods of monitoring and reporting CSR.

Recommendations

I will not argue that management in companies should be more strictly standardized because that takes away the freedoms of companies to make their own corporate decisions. I do think that the impact that companies have on society and the environment, whether direct or indirect, should be considered within their decision making processes. The standardization of CSR reporting may take corporations a step closer to global responsibility through the creation of reports that are comparable to other companies within their industry and easily verified. My recommendations for the use of accounting within CSR are as follows:

- Include CSR in accounting reporting through inclusion of an audited section in the annual report. (Similar to overseas accounting standards IFRS)
- Create standardization for CSR reporting for comparable reporting
- Create a private sector for CSR rulemaking overruled by the U.S. Securities and Exchange Commission.

Based on the research, there are a few key factors are at fault in studied scandals, whether they are financial or social scandals. There are issues with management not having guidelines to serve

¹⁷ Duff, Angus, and Xin Guo

as a boundary in the case of CSR. Including an audited section for CSR in annual accounting reports would help public companies be socially responsible through the release of public-third party audited information. Auditing is the act of an independent third party verifying the accuracy of information. While this would be difficult to implement initially, over time, report styles could be developed for sectors with similar issues to help standardize the reporting. Larger accounting firms such as PWC and EY have already begun implementing methods for CSR auditing. Currently, accounting firms are used to audit financial information, but there is no verification of non-financial information. Including a section for CSR in companies annual reports would allow the information to be public and would make it simple for accounting firms to simply audit an additional section of the report.

The second recommendation is based on a lack of standardization in CSR reporting currently that makes it difficult to compare corporate responsibility among companies. If companies were given a general guideline on how to create their reports, it would be simple for auditors and the public to understand the contents of the reports across companies. The last recommendation also follows the standardization of accounting principles with a standardization “board” that oversees the guideline setting in CSR. There is currently no group or writing that acts as to standardize CSR. Within financial reporting, the financial accounting standards board (hereafter referred to as FASB) was created in order to set rules for accounting standards as they changed. Since FASB is a private board overseen by the government, it contains accounting specialists who are able to create rules that are befitting to financial situations and are still regulated. Creating a private board for CSR would allow specialists to set standards for corporate reporting on social issues. CSR has been developed over the years into a well-used and important part of the way

companies function, but some companies still refuse to allow their social responsibility to impact their decision making promises. Because of the lack of regard for social responsibility by some companies, especially following public scandals, it is difficult for the public to trust the promises of companies who have made publicly known mistakes in their social responsibility. As companies like Nike have shown, through systematic monitoring, transparent reporting, and external oversight, it is possible for companies to regain the public's trust and be successful.

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