Shareholder Value, Sustainability, Organizational Ethics, and Internal Audit

Dr. Daniel K. Saint
November 10, 2009
Session Overview

- Introduction to Sustainability
- Corporate Purpose
- Manaus Case Study
- Carroll’s Four Responsibilities Exercise
- Ethical Models for Decision Making
- Conclusion
Sustainability and Internal Auditing
By Hans Nieuwlands
CIA, CCSA, CGAP, RA

Internal Auditor
February 2005

Corporate Social Responsibility
Recognizing the value of good will and high ethical standards, organizations worldwide are evaluating their contributions to the welfare of society.
“I ask what the person thinks about sustainability? If they do not know what I am talking about, the interview doesn’t go any further.”

Darcy Winslow
General Manager
Women’s Sports
Nike
Sustainability and Corporate Social Responsibility (CSR)

- "Sustainable development is meeting the needs of the present without compromising the ability of future generations to meet their own needs" (The World Commission on Environment and Development, 1987).
- Triple Bottom Line—new accounting model measuring
  - Environmental stewardship,
  - Social responsibility, and
  - Economic prosperity.
- Elements of Sustainability
  - People—Labor Practices, Human Rights, Society, Product Safety
  - Planet—Materials, Energy, Water, Biodiversity, Emissions, Products
  - Profit
Modern Artifacts

- Wall Street Journal Advertisements
  - Approximately $3 million spent on “green” ads last month
As McKinsey research indicates, executives around the world increasingly recognize that the creation of long-term shareholder value depends on a corporation’s ability to understand and respond to increasingly intense demands from society.¹ No surprise, then, that the topic of socially responsible investing has been gaining ground as investors seek to incorporate concepts like sustainability and responsible corporate behavior into their assessments of a company’s long-term value.

Investing in **sustainability**
Walk the Talk.

You've heard about it.
You know it's important.
But how do you do it?

BRANDING FROM THE CORE™

105 baybridge • gulf breeze, florida 32561 • 850.934.7823
Four Characteristics of Companies in Trouble

- Pressure to maintain numbers goals and performance
- Fear and silence
- Youth and inexperience of the management team
- A culture of social responsibility
  
Corporate Purpose: Shareholder Value and Stakeholder Theory

Our assumptions of corporate purpose determine what socially responsible behavior is
Corporate Purpose

- Our views on corporate purpose set the foundation of modern financial theory and reflect the fundamental assumptions of modern economic theory.

- Finance and accounting as language—theory of social constructionism.
Corporate Purpose

- *The purpose of the firm is to maximize shareholder value* (shareholder value theory)
- This is one of the most important and topical issues of the day because of the influence of business on society and increasing demands of society on business.
Shareholder Value Theory

- The language and relationship of shareholder value is systematically embedded in business schools
- Primary theory of MBA finance texts

“Stock price maximization is the most important goal of the firm.” (Brigham et al., 1999)
Corporate social responsibility, stakeholder theory and firm performance are interrelated issues. (Harrison & Freeman, 1999)

*Stakeholder theory* has “emerged as the dominant paradigm of corporate social responsibility.” (McWilliams & Siegel, 2001)

Intended antithesis of shareholder value maximization as purpose of the firm
# Theory—Purpose of Firm

<table>
<thead>
<tr>
<th>Stakeholder Theory</th>
<th>Shareholder Theory</th>
</tr>
</thead>
<tbody>
<tr>
<td>To commercially serve broader societal interests “...no priority of one set of interests and benefits over another.”</td>
<td>To maximize shareholder wealth “...the interest of shareholders remains second to none.”</td>
</tr>
<tr>
<td>(Donaldson &amp; Preston, 1995)</td>
<td>(Levitt, 2000)</td>
</tr>
</tbody>
</table>
**Theory—Dimensions**

<table>
<thead>
<tr>
<th>Stakeholder Model</th>
<th>Shareholder Model</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Definition of CSR</td>
<td></td>
</tr>
<tr>
<td>• Corporate Behavior</td>
<td></td>
</tr>
<tr>
<td>• Marketplace Role</td>
<td></td>
</tr>
<tr>
<td>• Government Role</td>
<td></td>
</tr>
<tr>
<td>• Management Role</td>
<td></td>
</tr>
<tr>
<td>• Investment Capital</td>
<td></td>
</tr>
</tbody>
</table>

*Experience. Results. Value.*
Manaus

Case Study

Based on a real story from a local company

The details have been significantly modified for learning purposes
Natural Vegetation

- Tropical rain forest
- Tropical semideciduous forest
- Paraná pine forest
- Transitional palm forest
- Thorny scrub (caatinga)
- Savanna* (cerrado)
- Grassland
- Mangrove and/or dune vegetation (coastal)

* Savanna grass, low trees, shrubs; ranging from grassland with scattered trees and shrubs to scrub woodland.
You have been asked your professional perspective on a potential business venture. An international investment company is considering an investment into Brazil.

Proposal:
- Build an automotive manufacturing plant in Manaus
- Local joint venture
- Production to serve only the Brazilian market

Due to local government incentives, alternative seen as most beneficial way to enter Brazil—lowest investment, highest margin alternative.
Manaus Case – Assumptions (hypothetical)

- No import taxes compared with high tariffs for other market entry alternatives.
- No air, ground or water pollution constraints for at least first ten years. No enforceable safety standards or consequences for workforce and consumers injuries.
- Enforced policy of discrimination— women are allowed to do only the jobs not appropriate for men such as the tedious work of installing the wire in the wiring harnesses by hand. There work areas must be segregated from the men’s areas.
With no constraints on pollution, the engineering experts calculate a significantly higher ROI if the new plant ignores environmental considerations.

- Should the company take advantage of the local regulations? What are some points to consider?
Manaus Case Study - Dialogue

- While the government directs a policy of discrimination towards a certain class, HR experts calculate no financial impact to do so.
  - Should this have an effect on decision making? Should this be a deal breaker?

<table>
<thead>
<tr>
<th>Should Consider Environment and/or HR?</th>
<th>Should Consider Environment and/or HR?</th>
</tr>
</thead>
<tbody>
<tr>
<td>YES</td>
<td>NO</td>
</tr>
</tbody>
</table>
Case Review

- In this brief case, we have considered the impact on several stakeholders of the venture: consumers, the local community, employees, and the environment.
- We concluded that business is not concerned merely with profit, but it also takes seriously its responsibilities for avoiding pollution, avoiding discrimination, providing fair employment and ensuring employee and consumer safety.
- We concluded that a business does have a social responsibility.
Case Review

- In this brief case, we have considered the impact on several stakeholders of the venture: consumers, the local community, employees, and the environment.
- We concluded that business is concerned merely with profit; it has no responsibility for avoiding pollution, avoiding discrimination, providing fair employment and ensuring employee and consumer safety.
- **We concluded that a business does not have a social responsibility.**
### Carroll’s Four Responsibilities

- **Business has four major responsibilities:**
  - Discretionary,
  - Ethical,
  - Economical, and
  - Legal

- **Of those four, business:**
  - Must do one,
  - Has to do one,
  - Should do one, and
  - Can do one

**Note for following Slides:**
- Not necessarily presented in order
- No wrong answers
Carroll’s Four R’s—Matching Exercise

<table>
<thead>
<tr>
<th>Legal</th>
<th>Must Do</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ethical</td>
<td>Have to Do</td>
</tr>
<tr>
<td>Economic</td>
<td>Should Do</td>
</tr>
<tr>
<td>Discretionary</td>
<td>Might Do</td>
</tr>
</tbody>
</table>


<table>
<thead>
<tr>
<th>Carroll’s Four R’s—Matching Exercise</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Legal</strong></td>
</tr>
<tr>
<td><strong>Ethical</strong></td>
</tr>
<tr>
<td><strong>Economic</strong></td>
</tr>
<tr>
<td><strong>Discretionary</strong></td>
</tr>
<tr>
<td><strong>Must Do</strong></td>
</tr>
<tr>
<td><strong>Have to Do</strong></td>
</tr>
<tr>
<td><strong>Should Do</strong></td>
</tr>
<tr>
<td><strong>Might Do</strong></td>
</tr>
</tbody>
</table>

---

**Experience. Results. Value.**

---

**JEFFERSON WELLS**

A Merger Company
Carroll’s Four R’s—Matching Exercise
## Carroll’s Four R’s—Matching Exercise

<table>
<thead>
<tr>
<th>Discussion</th>
<th>Legal</th>
<th>Ethical</th>
<th>Economic</th>
<th>Discretionary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Must Do</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Have to Do</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Should Do</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Might Do</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Experience. Results. Value.**

**JEFFERSON WELLS**

A Merger Company
Carroll’s Four R’s—Matching Exercise

Legal
Ethical
Economic
Discretionary

Must Do
Have to Do
Should Do
Might Do
Carroll’s Four Responsibilities

<table>
<thead>
<tr>
<th>Responsibilities of Business</th>
<th>Social Responsibilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic (Must Do)</td>
<td></td>
</tr>
<tr>
<td>Legal (Have to Do)</td>
<td></td>
</tr>
<tr>
<td>Ethical (Should Do)</td>
<td></td>
</tr>
<tr>
<td>Discretionary (Might Do)</td>
<td></td>
</tr>
</tbody>
</table>


As presented in MBA course text *Strategic Management and Business Policy* (Wheelen & Hunger 2002)
Carroll’s Four R’s—Discussion

- Background—academic response in opposition to Friedman justifying stakeholder theory
Shareholder Value and Economic Theory

- Business has no social responsibilities.
- Business has no responsibility for providing employment, eliminating discrimination, avoiding pollution, ensuring consumer safety or any other popular misconceptions regarding corporate social responsibility.
- Business is concerned merely with making a profit.

Milton Friedman
When I hear...about the social responsibilities of business... that business is not concerned "merely" with profit but also with promoting desirable "social" ends; that business has a "social conscience" and takes seriously its responsibilities for providing employment, eliminating discrimination, avoiding pollution and whatever else may be the catchwords of...reformers...they are...unwitting puppets of the intellectual forces that undermine the basis of a free society.... (Friedman, 1970)
Return to Manaus Case Review

- We concluded earlier that:

  **Should Consider Environment and HR?**
  
  YES
  
  NO
Carroll’s Four R’s—Discussion

- What does this model imply?

**Responsibilities of Business**

<table>
<thead>
<tr>
<th>Economic (Must Do)</th>
<th>Legal (Have to Do)</th>
<th>Ethical (Should Do)</th>
<th>Discretionary (Might Do)</th>
</tr>
</thead>
</table>

- What are the consequences of optional ethical behavior?

Scott Sullivan, Worldcom
Andrew Fastow, Enron
Mark Swartz, Tyco

Awards Sponsor: Arthur Andersen
Business Week’s CEO of the Year for 2001…

Dennis Kozlowski

Tyco CEO of $6,000 shower curtain infamy later indicted for securities fraud and “looting $600 million from shareholders”

Convicted
Royal Dutch Shell Chairman
Sir Philip Watts

Knighted in the 2003 in recognition of his services to business and to the World Business Council for Sustainable Development…

2004 announced $70 billion overstatement of assets…

“…executives felt compelled to increase oil reserves…managed reserves to satisfy investors.”

Early last week, three days before he was ousted, Sir Philip was meeting with investors, assuring them he was not leaving, and sharing the theme of the annual meeting in May at which he was planning to speak about the problem of AIDS in Africa.

(NY Times, 2004)
A few months later, in a “damning report,” the SEC ordered Fannie Mae to revise its earnings downward by $9 billion in an accounting scandal that led to the ousting of several top managers including the CEO.
## Up to date...

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 2008</td>
<td>$7 billion in losses as a result of &quot;rogue trades&quot; at French bank Société Générale.</td>
</tr>
<tr>
<td>March 2008</td>
<td>Swiss investment bank Credit Suisse announced $2.65 billion of write downs after discovering &quot;intentional mismarkings.&quot;</td>
</tr>
<tr>
<td>2008</td>
<td>Lehman Brothers, Merrill Lynch, Bear Stearns, AIG, Fannie Mae and Freddie Mac</td>
</tr>
<tr>
<td>2009</td>
<td>European banks reveal their exposure to ex-Nasdaq chairman Bernard Madoff's alleged $50 billion Ponzi scheme</td>
</tr>
</tbody>
</table>
Closer to Home

- How many SEC investigations can you think of here in Michigan?
Open Discussion of Ethical Models for Decision Making
### Cavanaugh Model

- Gather the relevant facts
- Determine the ethical issues
- Relate to the most appropriate norms
  - Utility
  - Caring
  - Rights
  - Justice
- Apply the norms and make the judgment
An Ethical Decision-Making Model

- Clarify
- Decide
- Implement
- Monitor and Modify

### Personal Example

- True story involving teaching and Carroll’s model:

#### Responsibilities of Business

<table>
<thead>
<tr>
<th>Economic (Must Do)</th>
<th>Legal (Have to Do)</th>
<th>Ethical (Should Do)</th>
<th>Discretionary (Might Do)</th>
</tr>
</thead>
</table>

**Social Responsibilities**
Conclusion

- Open Discussion
- Thoughts
- Questions
Jefferson Wells is a professional services firm specializing in finance and accounting, internal audit, tax and technology risk management. It is a subsidiary of Manpower. The firm has offices in North America, Europe and Asia.

For more information, contact:

Daniel K. Saint, PhD  
Managing Director  
Jefferson Wells  
Great Lakes Region  

1000 Town Center, Suite 1000  
Southfield, MI 48075  
office: 248-350-3006  
alternate email: saint@LTU.edu