Sustainability—
The Accounting Perspective

By Michael Kraten

Consider an American multinational corporation in the energy industry that secures a major contract to construct a massive hydroelectric power plant at a waterfall in an African nation. At first, the financial investment community joins several major charitable organizations in applauding the project. In addition to securing profits for investors, the project promises to help the nation’s citizens by generating a stable supply of electricity and employment. In addition, an adjoining eco-tourism development promises to raise awareness about the importance of the natural environment.

But troubling news about the project begins to emerge. The technology is risky, creating a sense of uncertainty about costs and profits. There is an undocumented cash payment by the company to the regulator who approved the project—funds that might help maintain a repressive government. Furthermore, the project threatens to obliterate the sole habitat of an endangered species known as the blue frog.

An accounting methodology is needed to assess the relative benefits and costs of the project’s financial, social, and environmental considerations. As the American company struggles to define and implement such a methodology, a major Asian corporation unexpectedly proposes an alternative project, with the Asian company in place of the American one.

This daunting scenario is not unique to global companies expanding into Africa. For-profit energy companies seeking to expand in rural areas of New York and Pennsylvania are confronting similar challenges. New York Governor Andrew M. Cuomo, for example, continues to delay the issuance of regulations for “fracking” energy operators along the state’s southern tier. (For more information, see Freeman Klopp, “New York Decision on Fracking Operations Delayed,” Bloomberg Sustainability, Jan. 29, 2014.) Organizations that are striving to serve local communities and restore the environment in urban “brown field” zones are encountering these obstacles as well. For example, Brooklyn’s Gowanus Canal—called “one of the filthiest waterways in the nation” by the New York Daily News—is home to both environmental protection groups and private for-profit corporations. (For more information, see http://gowanuscanalconservancy.org and Natalie Musumeci, “Sneak Peek Inside Gowanus Whole Foods, the Company’s First Brooklyn Store,” New York Daily News, Dec. 15, 2013.)

The discipline of sustainability incorporates all of the analytical and assurance practices that organizations must apply in order to manage such scenarios. An accounting perspective—one that encompasses financial analysis, valuation activity, risk management, and internal control design—is indispensable in holding the discipline of sustainability together.

A Familiar Model

CPAs who have performed accounting or audit services for the “due diligence” phase of a proposed merger and acquisition or for the continuing operations of a joint venture are undoubtedly familiar with the need to evaluate the crucial trade-offs that confront all of the affected parties.

How many parties are involved? For starters, there are always two (or more) sets of owners and managers with diverse interests. Although many of these interests are complementary in nature, many others inevitably conflict. There are also unions, regulators, and major customers, all with their own arrays of complementary and conflicting interests. For example, after years of negotiations and regulatory challenges...

OPPORTUNITIES IN SUSTAINABILITY

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In addition, both are collaborating with the Rhode Island Society of CPAs to develop and implement a metric and pilot business-development program, “Re-define, Re-invent, Re-vitalize Rhode Island.” (For more information, see the Rhode Island Small Business Journal, http://www.risbj.com/mode-island-small-state-big-challenges-big-ger-opportunities-and-an-even-bigger-vision.)

According to Poland, the scorecard metrics are needed to summarize the massive volume of data that is presented in the annual reports.

“Think about the roles that are played by rating agencies and independent investment researchers in the mainstream capital markets,” she noted. “They help investors make sense of publicly available data, building metaphorical bridges that ‘connect’ sources and recipients of capital.”

Poland perceives similar opportunities for investment professionals in the sustainable field: “There’s a reason why global corporations engage accounting firms to examine their sustainability reports. They understand that savvy investors, business partners, and other constituents utilize this information to analyze the benefits and risks of transacting with—and investing in—the corporations.” Investing involves risk including loss of principal. No strategy or investment analysis tool assures success or protects against loss. The return from a socially-responsive based investment strategy may be lower than if investment decisions were based solely on investment considerations. The experiences described here are for informational purposes and may not be representative of any future experience of our clients. Individual results will vary. Past performance is no guarantee of future results. Paul Herman and HIP Investor are not affiliated with Provo Financial Services, Inc., Provo Wealth Management Group nor LPL Financial.
challenges, US Airways and American Airlines finally closed their $17.7 billion merger transaction in December 2013; the subsequent merger of operations is expected to require up to two additional years. (For more information, see Ely Portillo, “US Airways, American Merge Monday: What You Need To Know,” Charlotte Observer, Dec. 8, 2013.)

The critical success factor in any joint venture, merger, or acquisition arrangement is an ability to measure all of the actual and potential benefits and sacrifices that confront each stakeholder and to develop a business model that produces a “net positive trade-off” for each party. Then, once operations commence, assurance activities are required to monitor the adherence of the parties to the responsibilities of the relationship; monitoring activities are required to assess the continued production of the net positive trade-offs.

Consequently, CPAs who possess experience with such engagements are already familiar with the accounting perspective of sustainability. To grasp this discipline, they simply need to expand their scope of vision beyond the direct transactional parties of owners and managers, as well as unions and regulators and customers; they need to think of human societies and the natural environment as relevant transactional stakeholders as well. Related to this notion is the concept of a “triple bottom line” that quantifies corporate, social, and environmental impacts, as well as traditional accounting profits. Proposed in 1994 by John Elkington, it represented an extension of the “balanced scorecard,” a management accounting technique introduced by Robert Kaplan and David Norton in a 1992 Harvard Business Review article, “The Balanced Scorecard Measures that Drive Performance.” (For more information, see “Idea: Triple Bottom Line,” Economist, Nov. 17, 2009, http://www.economist.com/node/14301663, and Robert S. Kaplan, “Conceptual Foundations of the Balanced Scorecard,” working paper, Harvard Business School, 2010.)

This concept will not be unfamiliar to anyone who has participated in a project that aroused local community opposition or that drew the attention of local zoning boards or government environmental protection units. In fact, the directors of many such local projects are increasingly relying on accountants to design, measure, and provide assurance about the standards and guidelines that help balance the interests of all stakeholders.

**First FASB, Now SASB**

The Sustainability Accounting Standards Board (SASB) is now developing standards for 10 industry sectors in the United States. Although SASB’s sets of standards do not carry the weight of FASB standards, its financial statement disclosure requirements are explicitly designed to be integrated directly into the Form 10-K reports of publicly traded organizations. (For an example, see http://www.sasb.org/sectors/health-care.)

The global investment community has designed its own set of standards. The Global Impact Investing Network (GIIN) has produced the Impact Reporting and Investment Standards (IRIS), encompassing a generic version for all industry sectors and customized versions for six specific sectors (http://iris.thegiin.org). The Global Reporting Initiative (GRI) has produced its own Sustainability Reporting Guidelines, with multinational organizations from BP to the United Parcel Service (UPS) producing annual reports with detailed financial, operational, and management discussion and analysis–style information. (The fourth generation of the GRI standards, G4, is available from https://www.globalreporting.org/reporting/g4/Pages/default.aspx.)

For example, BP is currently utilizing the third generation of the guidelines (G3.1). Ernst & Young performed a limited attestation engagement on BP’s 2012 report and issued an assurance statement to summarize its findings. The sustainability section of BP’s website describes its sustainability activities and presents the Ernst & Young statement in its entirety (http://www.bp.com/en/global/corporate/sustainability/about-our-reporting/reporting-standards/global-reporting-initiative.html).

UPS’s corporate sustainability report provides another informative example in the genre of sustainability reporting activities. The 2012 report notes that Deloitte & Touche LLP conducted an examination and a supplemental review of its contents in accordance with the AICPA’s AT section 101, “Attest Engagements.” (For the UPS report, see https://www.global

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**THE BENEFIT OF CASE STUDIES**

John Formica is an assurance partner and the industrial products business development leader in the metro New York practice of PricewaterhouseCoopers. He has worked closely with the accountancy faculty at Providence College to design the general framework and the operational details of the blue frog academic case.

Formica explained, “As a partner in a public accounting firm, making decisions to provide services to clients with high-risk profiles can be challenging. The blue frog case captures the essential trade-offs between reward and risk that must be weighed before our firm decides to sign an engagement agreement with a new client.”

Formica has visited Providence College on many occasions to engage in case role playing exercises with business students.

“It’s gratifying to work with the students as they walk through the structure of the case analysis to develop defensible recommendations,” he said. “These students represent the future of our profession, and exposing them to sustainability risks in a controlled environment is a great way to create awareness of this important issue.”
reporting.org/Pages/FR-UPS-2013.aspx or http://www.responsibility.ups.com/Sustainability). The GRI’s required performance indicators are highlighted in the report. A detailed description of materiality guidelines (including a materiality matrix that features assessments of “Importance to Stakeholders” and “Influence on Business Success”) is included as well. An independent accountant’s examination report and a complementary independent accountant’s review report, each issued by Deloitte & Touche LLP, are presented therein; both reports specifically refer to AT section 101.

Advisory and Consulting Engagements

Standardized annual reporting and attestation activities, of course, do not address the challenges that are confronted by organizations engaging in the type of scenario described in the introduction to this article. Such organizations tend to employ accountants as advisors and consultants in short-term, transaction-focused engagements.

So what about these advisory and consulting engagements? How are public accounting firms assessing the opportunities, as well as the risks, associated with such professional activities? Which critical skills and expertise must partners, managers, and staff possess in order to pursue these opportunities in a financially and operationally responsible manner?

The scenario described in the introduction to this article is based on a staff training case that was originally developed by the assurance practice of PricewaterhouseCoopers. It was later expanded into a case study by the accountancy program at Providence College, and it is now being assessed and employed by academic and professional accounting organizations around the world. (The case, along with a spreadsheet valuation model, a lesson plan, teaching notes, a list of reference materials, and an assessment rubric, is posted online in its entirety at http://bluefrogcpa.wordpress.com. Accounting students at Xi’an Jiaotong University in China are utilizing a customized version of the case, and the case will be presented at the 2014 meeting of the public interest section of the American Accounting Association. It was previously presented during a series of three online continuing education sessions, cosponsored by the Business Learning Institute.)

The case trains accountants in public accounting firms and the private sector to employ a “four-by-four” matrix approach to assess the benefits and risks of the hydroelectric project from the corporation’s perspective, as well as the benefits and risks of providing assurance or advisory services from the public accounting firm’s perspective. The four phases of this assessment process involve—

n developing a financial statement valuation model;

n analyzing the sustainability risks, then revising the valuation model;

n assessing the business risks and controls, then further revising the valuation model; and

n considering all ethical and moral implications, then finalizing the valuation model.

Furthermore, each of these four steps requires the same set of four advisory activities, thereby forming the four-by-four matrix of professional service work. These steps involve—

n completing a review of the relevant standards and other regulatory literature,

n producing advisory recommendations that are supported by the regulatory literature,

n assessing the strength of the recommendations by referring to client precedents and case histories, and

n developing “what if” scenario recommendations to address the possibility of failure.

This four-by-four matrix approach to advisory service engagements embeds all sustainability considerations directly within the analyses of valuation and risk, while maintaining an appropriate focus on professional ethics and moral behavior.

Developing Sustainability Expertise

Whether CPAs are currently working for an organization that is addressing sustainability issues or interested in pursuing new opportunities that focus on such concerns, they will need to develop knowledge in this emerging field. But what are the key steps?

Build upon an existing client practice. Recognize that any sustainability analysis

FINANCIAL MODELING

Maher Habbal is a financial modeling specialist in the global energy industry. He focuses on the development of cash flow and profit projections for major oil and gas investment projects at multinational state-owned energy firms and publicly traded multinational corporations.

“The internal rate of return and net present value estimates of long-term energy development projects cannot be based on static sets of assumptions,” he noted.

“Before investing in such projects, organizations must prepare sensitivity analyses of key variable assumptions and ‘what if’ assessments of alternative scenarios. Advanced Monte Carlo style simulations may be required too.” (This article’s author previously addressed Monte Carlo simulation modeling techniques in a pair of CPA Journal articles about the investment management industry: “Using ‘Monte Carlo’ Simulations to Enhance Planning Recommendations: Rolling the Dice,” September 2007, and “Revisiting ‘Monte Carlo’ Simulation Modeling: Client Service in an Era of Extreme Investment Volatility,” September 2009.)

“How can any company perform such analyses without considering the potential impact of sustainability risks? If a pipeline rupture or an oil tanker spill spreads toxic waste and decimates the environment, the financial costs—not to mention the reputational losses—can destroy a company,” Habbal said.

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represents an assessment of the trade-offs between the financial, social, and environmental benefits and costs that affect organizations, communities, and the natural world. CPA firms that already serve clients or operate projects that face such trade-offs already possess expertise in sustainability issues.

**Develop a general familiarity with existing industry standards.** Most accountants engaged in the fields of financial reporting and auditing possess, at the very minimum, a general awareness of the standards of the AICPA, FASB, the IASB, the IRS, and the PCAOB. Likewise, it would also be helpful to develop a general awareness of the standards of the GIIN, the GRI, and SASB.

**Incorporate sustainability considerations into existing practice management models.** Although the four-by-four matrix developed for the blue frog case study is only one example of an advisory or consulting service model, its elements are typically found (in some form) in any transaction-focused evaluation engagement.

In fact, looking back at the second of eight elements of the matrix and substituting a different strategic consideration for “sustainability risk,” one would find that the matrix remains useful. For example, if the success of a business initiative depends on the continued availability of a favorable tax regulation, then “regulatory risk” or “political risk” could simply be substituted for “sustainability risk.” Under such circumstances, the primary strategic concern would focus on the future sustainability of the after-tax profit stream, as opposed to the future sustainability of the health of the organization.

**An Integrated Approach**

The common theme that underlies all of these key steps is the integration of sustainability considerations into CPAs’ existing business activities. By treating such practices as extensions of their standard operating procedures, accountants can successfully integrate the philosophy of the triple bottom line into their organization. The sidebars provide some examples of professionals who have capitalized on opportunities in the sustainability field and used the principles discussed above in their work.

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