A REGULAR 'SOCIAL AUDIT' WILL STEER BUSINESS TO ENTREPRENEURSHIP FOR SOCIETAL VALUE

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Society expects companies to operate in light of the legitimate interests of citizens, consumers, the environment and communities. However, those interests often lose out to the company's pursuit of profit. This could change with the implementation of a corporate social audit, in which (large) companies are cyclically assessed on the basis of selected criteria of societal value.

In brief:

- An audit creates a form of accountability of companies in relation to society, and thereby renews their license to operate.
- Those who, according to the audit, perform above average, will receive a financial premium, those who perform poorly will receive a fine.
- Such a system generates a competition, by which companies are rewarded if they operate on the basis of societal value.

In the Netherlands, Booking.com caused a major public scandal when it applied for government support as a result of the Corona crisis, in spring 2020. The year before, the company had paid a massive dividend (worth 5 billion euros) and had bought back its own shares (worth 8 billion euros), benefiting from favorable Dutch tax rules in doing so. Booking.com became a symbol of the shadow side of capitalism: celebrating shareholders in good times, holding out a begging hand to the government in bad times.

Now it turns out that Booking.com was not at all alone. According to a recently published Oxfam report, during the Corona crisis, profitable multinationals worldwide have prioritized distributions to shareholders over helping their employees or building up buffers. Even loss-making companies did so, while at the same time, they were firing staff and requesting government support (Oxfam International, 2020).

Entrepreneurship is vital to the development of new products and services. Well-functioning markets allow for the interests of consumers to be quickly and adequately met. But the decisions of (large) companies have profound effects on employees, customers, suppliers, citizens and the environment. How do we ensure that companies will focus actively on their interests as well? The point here is not merely about scandals and excesses. How do we encourage companies to contribute sufficiently to solve today's major societal problems of climate change, inequality, exploitation and racism? For many of these topics, the contribution of corporations is crucial.

In this article, I provide a practical proposal which does not rely on blind faith in markets, but also doesn't fall back on traditional state regulation. Once every few years, companies should be subjected to a social audit in which their societal contribution is being assessed. By attaching financial consequences to the assessment and by setting up a competition, companies

will be stimulated to take their societal role seriously.

From shareholders to stakeholders

With regards to the societal role of companies, there are two opposing visions. The first paradigm is that of shareholder capitalism. In short, its formula is the following: 'market + regulation'. In line with Milton Friedman's famous mantra that 'the social responsibility of business is to increase its profits' (Friedman, 1970), companies themselves do not have to consider the interests of anyone other than shareholders; except, of course, to the extent that this would harm the interests of those same shareholders. Where other stakeholders cannot sufficiently protect their own interests contractually, the government must step in. For shareholder capitalism, regulation is thus the means by which those societal interests that are neglected the market are taken care of. This is the paradigm which, in recent decades, has become dominant in Anglo-Saxon countries and – to a lesser extent – also in Europe (Bezemer et al., 2017).

The second paradigm is that of stakeholder capitalism, and the related idea of Corporate Social Responsibility (CSR). Within this paradigm, the idea is that companies are guided by the interests of all stakeholders: employees, customers, suppliers, the environment, and the local and national communities in which the companies are embedded (Freeman et al., 2010).

In the summer of 2019, after decades of having published Friedman-like statements about 'corporate purpose', the Business Roundtable, a club of America's largest companies, converted to stakeholder capitalism. In 2016, the Committee van Manen introduced a similar idea in the Netherlands in the revised Dutch Corporate Governance Code: "The board," so it stated, "will focus on the long-term value creation of the company and its affiliated enterprise, and to this end it weighs the relevant interests of the stakeholders."

CSR in Practice

But words alone are not enough. Despite the Business Roundtable's statement, American companies have not changed their behavior (Cools, 2020). Putting CSR into practice remains an uphill struggle. After all, shareholders have an interest in companies not paying too much attention to the interests of other stakeholders, whenever this detracts from the profitability of the company. In his recent book, Jeroen Smit describes how Paul Polman, as the CEO of Unilever, tried to make the production of his company radically more sustainable (Smit, 2019). Some ideas were to provide the farmers who produce the tea of Lipton Ice with a 'living wage', to eliminate child labor and to buy only sustainable palm oil. But many of these measures will lead to a higher cost-price. For this reason, shareholders and stock market analysis were less enthusiastic. Local managers, too, prefer to steer their product lines on traditional financial indicators such as turnover, margin and profit. And consumers do not always prefer the more sustainable products over the less sustainable ones.

CSR tries to initiate change from within the market itself. In doing so, it appeals to the motivation of companies themselves. Where this works, it is a powerful driver for change. But because CSR will often lead to higher cost-prices and hence creates a competitive disadvantage, it requires a considerable willingness to sacrifice on the part of the companies. The associate threshold is often too high, and so in practice, the results of CSR often remain very limited (Ruggie, 2018; Vogel, 2005).

Disadvantages of regulation

What about regulation, then? An obvious advantage is that regulation, if properly implemented, is obligatory. Regulation ensures an equal playing field on which companies cannot gain a competitive advantage by cutting back on ecological or social aspects.

But regulation comes with disadvantages as well, if only because making adequate laws and regulations takes time. For this reason, rules are often lagging

behind existing developments, especially in rapidly developing industries.

From a more principled perspective, prescribing external rules turns out not always to be feasible. By definition, many decisions are up to companies themselves: what they invest in, what kind of policy they implement in relation to their personnel, what kind of policy they implement with regard to political advertising (Facebook) or censorship in China (Google), et cetera. Regulating all this would be extremely expensive and complex. And yet, those decisions have important societal effects.

Finally, regulation is often heavily influenced by the sectors that need to be regulated. On the playing field of lobbyists, the business community is much better represented than the stakeholders are. Plus, regulation can be provoked by large companies because they can meet the administrative burden where their smaller competitors cannot.

So is there a way of connecting the advantages of CSR and regulation, while avoiding the disadvantages? Can an equal playing field be enforced, as with regulation, and in such a way that companies themselves are motivated to take stakeholder interests more seriously, as with CSR? And if so, how? As an answer to this question, I would like to propose the idea of a Corporate Social Audit (CSA).

The Corporate Social Audit

The basic idea of the CSA is simple. A committee appointed by the government would assess all companies that are subject to the CSA. For example, if we want to focus on larger companies, only companies with more than 250 employees would be subject to the CSA. The assessment is cyclical, for instance once every five of six years. At the start of the cycle, a CSA-body draws up a set of criteria. These criteria express what, at that time, society considers the desired societal value creation of companies. At the end of the cycle, CSA-committees assess the participating companies on the basis of these criteria.

The outcome of this assessment generates a public ranking of all the participating companies. This ranking can then be divided into, for instance, five categories: the best scoring companies receive an A-tier status, the least scoring companies an E-tier status, and those in between a B-, C- or D-tier status.

Finally, the government imposes financial consequences for every company. A different financial rate applies to each category. Placement in a higher category yields money, placement in a lower category costs money. This way, CSA-performances directly impact the bottom line of every company and motivate them to take their own societal performance seriously.

The assessment within such a CSA is not a form of regulation that may or may not be complied with. It is a place- and time-bound evaluation, which comes in gradations (insofar as companies are awarded more or less points). For the same reason, the assessment cannot be seen as some sort of legal verdict against which a company can appeal in court. Rather, it is an act of 'co-management' in the field of corporate governance relations, comparable to the decisions of a Shareholders' Assembly, Work Council or Supervisory Board. Just like the voter in the voting booth or like the referee on the football field, the CSA is always right in its assessment.

Various options are possible with regard to the specific structure of the CSA. Box 1 outlines a number of important design choices and their implications.

Box 1: four design choices for the Corporate Social Audit:

1. *Criteria: how are companies to be assessed?*

At the start of each cycle, a CSA-body defines an indefinite number of criteria and a maximum number of points to be obtained per criterion (e.g. ten criteria, with a maximum of ten points per criterion). The main choice here is: should the body make a very detailed list of criteria, or only a brief list of some basic criteria of responsible entrepreneurship? The first allows for more certainty about expectations, which the companies involved will appreciate. The latter provides the companies with more room to give substance to their strategy themselves and to make adjustments along the way if the circumstances ask for it. It also gives the assessing committee more freedom to hold companies accountable for their behavior in unexpected situations. If companies ask for government support only shortly after distributing among their shareholders a handsome reward, that will not reflect well on them in the eyes of the committee.

2. *Ranking: how should companies be ranked?*

An important choice is one between a competitive and a non-competitive ranking. In case of the former, only a limited number of places is available per tier. Only the top 20% ends up in tier A, only the next top 20% ends up in tier B, and so on. Such a set-up guarantees (just like the market mechanism does) a race to the top. For an A-tier status, companies will have to score better on the criteria than others have. At the start of each new cycle, companies know what kind of investments have led to an A-tier status in the previous cycle. So, equaling or exceeding that benchmark will be necessary in order to have a new chance to win an A-tier status in the new cycle. This way, at least if the financial incentive is effective, companies will stimulate each other to try to achieve ever-higher results over the course of a number of cycles.

An alternative is a non-competitive set-up. Then all companies could, in principle, receive an A-tier status, if they would all excel. Such a system can set in motion a virtuous circle as well, but only if at the start of each new cycle, the CSA-committee indicates new, higher score as the required threshold for achieving tier A, B, C, etc. status. This might be susceptible to forms of undue influence: if all companies present themselves sympathetically, a CSA-committee may be tempted to score everyone high. By contrast, within the competitive set-up outlined above, committees are forced to distinguish the good from the better.

3. *Consequences: how should the financial incentive be designed?*

One possible financial incentive consists in a progressive discount on the corporate tax – the higher the higher the tier a company has reached. This resembles the principle behind the motor vehicle tax, by which more sustainable cars pay less tax. However, because companies themselves can influence and manipulate the presentation of the profits on which the tax is levied, it might be better to set up a separate CSA-Fund. At the start of each cycle, all the participating companies pay a fee to the Fund. Subsequently, each company receives a payment, which is higher as the company reaches a higher tier. For some companies, the net sum (fee plus benefit) will be positive (bonus), for others the net sum will be negative (malus). The payment is relative to the turnover of the company, so that the incentive is equally meaningful for each company. After all, the aim is not to fill the treasury, but to provide the desired incentives to companies.

4. *Composition: who does the assessment?*

The composition of the CSA-body establishing the criteria as well as the composition of the CSA-assessment committees can be focused either on political consensus or on expertise. Expert committees are expected to make independent judgments and consist, for instance, of scientists, accountants and experienced officials from regulatory authorities such as, in the Netherlands, the ACM (Authority for Consumers and Markets).

In a more politicized variant, the CSA-committees consist of representatives of NGOs, trade unions, the government and the business community (polder variant); of members of the parliament (parliamentary variant); or of citizens appointed by a drawing of lots (civic variant). Mixed forms are also conceivable. Imagine, for instance, a committee with both experts and politically legitimated committee members.

Playing field in motion

There are multiple recent developments which aim to make CSR more obligatory. A CSA would align with them, but would give them a unique twist.

Purpose in statutes

First, there is a increasing attention for the possibility of making companies define a purpose in their statutes, which may or may not become mandatory for all companies (Levillain and Segrestin, 2019; Mayer, 2018). In the context of the Netherlands, 25 professors of Corporate Law recently called for this. They also urged that a duty of care should be established in the Civil Code: the board must come to see it as its task to make sure that the company 'participates in social interactions as a responsible company' (Winter et al., 2020). This would be an open norm, to which the board itself must give further substance.

If, then, companies come to serve a new purpose, that is; the purpose of societal value creation in addition to mere economic value creation, there must be a way in which they can be held accountable. The idea is that the monitoring of these new duties would be placed in the hands of existing bodies: the Supervisory Board and the Shareholders' Assembly.

Yet the question remains whether shareholders are the right constituency for this – whether they are willing to cut in the flesh of their financial interest in high returns (Hart and Zingales, 2017). Of course, the interests of stakeholders could also become anchored at the company level, for example by setting up a Social Council (Loonen and Mulder, 2020), which may or may not replace the Supervisory Board.

The CSA proposes a different route. By holding companies accountable for societal value creation at a national level (or at the European level, see below), accountability is detached from those people directly involved in the company itself. With that, a unique possibility opens up: to compare companies among each other, to put them in a competitive relationship with respect to societal value creation, and by doing so to stimulate them financially.

Non-financial reporting

A second development consist of a revolution in reporting and accounting. For several years now, the European Union has forced large companies to report on non-financial information in their annual report. More and more frameworks for doing so have become available. Organizations such as the Global Reporting Initiative (GRI), the International Integrated Reporting Committee (IIRC) and the Sustainability Accounting Standards Board (SASB) have led the process. In addition, there are companies such as Sustainalytics, which collect information about Environmental, Social and Governance (ESG) performances of companies.

These frameworks come with an entirely new vision on the company, as an organization in which different forms of capital (financial, material, human, intellectual, societal and natural) serve as input to generate different types of output – financial and non-financial.

A risk, however, is that these frameworks will continue to serve a narrow function, as information for investors about long-term risks with regard to the investment in their financial capital. They are not required to take into serious consideration the multiplication of other forms of capital, and so to take into consideration the trade-offs between financial and other forms of capital (Gleeson-White, 2020, p. 147).

Within this context, a CSA would have two beneficial effects. First, it would ensure uniformity, by establishing an unambiguous public standard for societal (non-financial) value creation. The multitude of existing initiatives could be channeled if one standard is used on a national or (better, still) European level.

With that, the aforementioned trade-offs would be put squarely on the table. These trade-offs require choices which cannot be made in a neutral or objective manner. At the same time, societal interests are immense. For that reason, there is a need for democratic legitimization of such choices (Davis, 2020). Through a CSA, a publicly legitimated opinion is formed about how much societal value a company has really created, in comparison to other companies.

Possible objections

One can imagine a range of objections, when thinking about how to implement a CSA. Here, I will limit myself to four of these.

First, there is a concern that companies will be able to manipulate their scores and to make themselves appear better than they really are, as it is also the case with the 'greenwashing' of existing CSR-initiatives. An important way to limit this risk is that the information on the basis of which CSA-committees decide is made public. In this way, third parties, such as NGOs, scientists, journalists, and the companies themselves, will be able to submit information based on their own research. Accountants can process this information. The CSA can serve as the catalyst for a public debate about the expectations we have of the companies that are being scrutinized.

Second, does a CSA not inhibit the dynamics of innovation on the market? Indeed, innovations that are developed at the expense of the legitimate interests of stakeholders will suffer, as they are accompanied by a new price tag. After all, the CSA internalizes the external costs of those innovations. This way, the CSA helps the market focus on innovations that do not have such external costs.

To what extent the CSA steers innovation in the desired direction, depends on its 'financial firepower'. A CSA-incentive that is too weak will not bring about a substantial change in the behavior of companies towards more societal value creation. A CSA-incentive that is too strong might curtail financial value creation too much. How the importance of financial value creation must be weighed against the interests of other stakeholders is a political question. The financial rates adopted by the CSA in a specific country provides that country's answer to the political question.

Third, will a CSA not lead to a competitive disadvantage for Dutch companies? After all, they will be subjected to a CSA whereas their German, American of Chinese colleagues will not. This objection cannot be fully overcome in the absence of a 'world government', but a CSA at EU-level should come a sufficiently long way. After all, the EU already implements a great deal of regulation which might, potentially, increase costs for companies. This might put European companies at a disadvantage worldwide. But access to the European market is an attractive price, for which non-European companies are often willing to subject themselves to European regulation. The same could be the case for the CSA. It remains an open question whether a Dutch CSA, as a precursor to the establishment of a European counterpart, is also a good idea.

Fourth: what about the assessment of foreign subsidiaries of multinationals which have their headquarters in the Netherlands? In an ideal world, these subsidiaries would be subject to the CSA of other countries. This way, different countries could place their own emphasis among the societal expectations they have of companies on

their own territory. But as long as these other countries have not yet implemented a CSA, I think it would be legitimate to have the performance of subsidiaries of Dutch multinationals assessed by Dutch CSA-committees. Lurking in the background is a risk of nationalism; perhaps people abroad would arrive at a (very) different assessment. The addition of foreign input to the relevant committees could mitigate this risk.

It is clear that there are challenges in all these areas. However, alternative paths to effectively steering the behavior of companies towards greater societal value are no less challenging.

Conclusion

Although right now, the CSA is still a plan on the drawing board, it does align with recent developments in thinking about the accountability of companies. There are all kinds of variants conceivable on the idea of a Corporate Social Audit. The feasibility and desirability or each variant could be debated by citizens. Economists could make calculations, psychologists could estimate the behavioral effects and lawyers could design legal texts. The audit could be experimented with. For instance, one could first launch one cycle as a trial audit, without any financial sanctions.

Companies have a lot of economic power, which is increasingly invoking concern among citizens. A way must be found to ensure that their actions do not detract, but instead contribute to societal goals. A new spirit of democratic experimentalism is necessary, and in that spirit, the idea of a CSA might very well prove valuable.

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